

UNIT I AGENCY LAW:

AGENCY LAW

1. Fiduciary relationship where one person (agent) acts for another (principal)
2. Agency exists where: (1) one person (the principal) consents that another (the agent) shall act on P's behalf and subject to P's control and (2) A consents so to act
3. RULE: agent for an undisclosed/partially disclosed P is presumed to be a party to a K unless K explicitly specifies otherwise
4. It is the principal who creates the authority
5. P is only liable for A's act w/in the scope of his authority
6. If A exceeds actual/implied authority & 3rd party relied, go after agent
7. Principal's liability in contract: Restatement § 144: a principal "is **subject to liability upon contracts made by an agent acting within his authority** if made in proper form and with the understanding that the principal is a party"

Mill Street Church of Christ v. Hogan: Church hired painter, painter hired brother to help w/ job and brother broke arm

- i. Person has authority to do certain acts that will bind P based on past practices, the way business is operated, economical nature of job (2 person job)
- ii. He had implied authority b/c it was necessary to implement A's express authority
- iii. There was apparent authority b/c he was allowed to hire brother in the past
- iv. Rationale? Court says: Implied authority "includes such powers carry out the duties" as are rea
- v. Different kind of implied authority: Did agent believe based on present or past conduct that he had authority? Job needed two men and the church had let him hire Sam in the past No clear instructions to the contrary expressed to agent, even if in principal's "mind"
- vi. "Apparent authority is the power to affect the legal relations of another person by transactions with third persons, professedly as an agent for the other, arising from and in accordance with the other's manifestations to such third persons."- Restatement § 8
- vii. Manifestation of consent: "authority to do an act can be created by written or spoken words or other conduct of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principal's account-Restatement § 26
- viii. **Rule of Law.** Implied authority is actual authority that is proven circumstantially to indicate that the principal intended to delegate powers to the agent that are necessary for carrying out the agent's duties, and one major circumstantial factor is prior work performed by agent for principal

370 Leasing Corp. v. Ampex Corp.: π contracted w/ ▲'s salesman to lease computer parts to ▲; ▲ later took back the deal b/c π couldn't meet ▲'s credit requirements; π sued for breach of K

- i. A salesperson binds his employer to sale if he agrees to that sale in a manner that would lead the buyer to believe that sale has been consummated
 - ii. Agent has apparent authority to bind P when P acts in manner as would lead a RPP to suppose that A has authority he purports to exercise; this sale was incidental to his capacity as salesperson
 - iii. Factors that gave rise to apparent authority: employed as salesperson, reasonable for 3rd parties to assume salesman has authority to make sales
2. Fiduciary Duties of A to P
 - a. Not absolute & can be changed through K's
 - b. Duty of care-mostly w/ Corps & partnerships
 - c. Duty of candor/disclosure-mostly w/ Corps & partnerships
 - d. Duty of good faith & fair dealing/duty of performance
 - e. *Duty of loyalty-most important
 - i. A can't steal opportunities from P
 - ii. A can't act to the detriment of P
 - iii. How to violate duty of loyalty:
 1. A receives payment from 3rd party in connection w/ some transaction between P and 3rd party (kickback v/ tip)

2. A makes secret profit from agency relationship by secretly transacting w/ 3rd party
3. A uses his position to make personal profit for someone who has no relationship w/ P,
General Automotive, Reading

iv. Damages for breach of K less than for breach of fiduciary duty

3. Agency cost-cost that P assumes b/c A is looking out of his interest, which may be opposed to P's
 - a. Information asymmetry
4. Creditors & debtors do not owe one another fiduciary duties
5. **Rule of Law.** An agent has the apparent authority to act in a manner that is reasonable for a person in the agent's position, and a third party can rely on those actions when a principal indicates through its actions that an agent had the appropriate authority.
6. **Facts:** Plaintiff was a leasing company that approached Defendant company's representative, Thomas Kays, to purchase computer hardware. Plaintiff was going to act as a middle-man between Defendant and a second purchaser of the hardware that Plaintiff found. Defendants submitted an unsigned purchasing agreement to Plaintiff, and Plaintiff signed the agreement. Kays followed the exchange with a letter indicating that part of Plaintiff's order would be shipped directly to the second purchaser.
7. **Issue.** The issue is whether Kays entered Defendant into a contract with Plaintiff under an apparent authority to act in that capacity.
8. **Held.** The United States Court of Appeals for the Fifth Circuit held that Kays had apparent authority to act on behalf of Defendant in contractual matters with Plaintiff, and that Kays did enter into an agreement when he promised shipment of the hardware. It was reasonable for Plaintiff to rely on Kays, a salesman, to conduct a sales transaction with Plaintiff. Defendant agreed to continue negotiations through Kays, and any evidence to demonstrate that Kays did not have that authority was never relayed to Plaintiff.

Watteau v. Fenwick: Restatement calls it "inherent agency power": "Inherent agency power is a term used in the restatement of this subject to indicate the power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent." Restatement § 8A.

Restatement § 161: "A general agent for a disclosed or partially disclosed principal subjects his principal to liability for acts done on his account which usually accompany or are incidental to transactions which the agent is authorized to conduct if, although they are forbidden by the principal, the other party reasonably believes that the agent is authorized to do them and has no notice that he is not so authorized."

Rule of Law. An undisclosed principal can be held liable for the actions of an agent who is acting with an authority that is reasonable for a person in the agent's position regardless of whether the agent has the actual authority to do so.

Facts. Defendant owned a hotel-pub that employed Humble to manage the establishment. Humble was the exclusive face of the business; Humble's name was on the bar and the license of the pub. Defendant explicitly instructed Humble not to make any purchases outside of bottled ales and mineral waters, but Humble still entered into an agreement with Plaintiff for the purchase of cigars. Plaintiff discovered that Defendant was the actual owner and brought an action to collect from Defendant.

Issue. The issue is whether Defendant is liable for damages resulting from an agreement between Plaintiff and Humble, who is knowingly acting outside his actual authority as an agent for Defendant.

Held. Defendant is liable for damages. Humble was acting with an authority that was inherently reasonable for an agent in that position. The situation is analogous to a partnership wherein one partner is silent but is still liable for actions of the partnership as a whole.

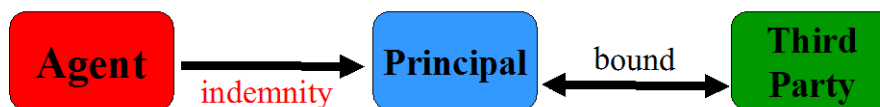
Discussion. The decision could not be based on apparent authority because the principal is disclosed under that doctrine.

The principal is held liable for actions by an agent that are expressly forbidden, but the case limits a principal to actions of an agent that are reasonable under the circumstances.

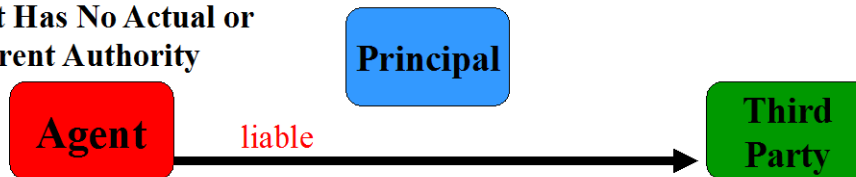
Agent Liability on the Contract



Agent Has Apparent Authority But Not Actual Authority



Agent Has No Actual or Apparent Authority



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In undisclosed principal cases, what is the scope of the agent's authority?: Watteau: "the principal is liable for all the acts . . . which are within the authority usually confided to an agent of that character"

Restatement § 195 - "agent enters into transactions usual in such business and on the principal's account"

Restatement § 161 - "A general agent for a disclosed or partially disclosed principal subjects his principal to liability for acts done on his account which usually accompany or are incidental to transactions which the agent is authorized to conduct if, although they are forbidden by the principal, the other party reasonably believes that the agent is authorized to do them and has no notice that he is not so authorized."

LIABILITY OF PRINCIPAL TO THIRD PARTIES IN TORT:

Humble oil & refining Co. v. Martin: Rule of Law. Determining whether a master-servant relationship exists, rather than an independent contractor relationship, is a question of fact that will be answered in the affirmative when the master exerts a considerable amount of control over the responsibilities of the servant.

"A master is subject to liability for the torts of his servants committed while acting in the scope of their employment." Restatement (Second) § 219 (1)

Facts. Love left her car at a service station to get the brakes repaired. The station was operated by W.T. Schneider through a "Commission Agency Agreement" with Humble. Love did not correctly secure the car before handing control to the

station, and the station did not check the car immediately to secure it. Love's car rolled downhill, out of the station lot and into Plaintiff's property, striking Plaintiff and his two children. Humble maintained that they were not liable because Schneider was an independent contractor.

Issue. The issue is whether Schneider is an independent contractor or whether a master-servant relationship exists between Humble and Schneider.

Held. A master-servant relationship exists between Humble and Schneider. Humble maintained considerable control over Schneider by dictating several important aspects of Schneider's business. Humble had significant financial control and supervision, rendering Schneider's station a retail marketing enterprise for Humble's products.



t have the right to tell the agent how to achieve that result, the agent is an independent contractor

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- **Exceptions Where P Liable Even if Outside Scope of Employment:** a) Principal retains control over the aspect of the work in which the tort occurs
 - b) Principal engages an incompetent contractor
 - c) Nondelegable duty
 - d) Activity contracted for is a "nuisance per se"
- Hoover

Restatement § 220(2)

- (a) the extent of control which, by the agreement, the master may exercise over the details of the work;
- (b) whether or not the one employed is engaged in a distinct occupation or business;
- (c) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;
- (d) the skill required in the particular occupation;
- (e) whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;
- (f) the length of time for which the person is employed;
- (g) the method of payment, whether by the time or by the job;
- (h) whether or not the work is a part of the regular business of the employer;
- (i) whether or not the parties believe they are creating the relation of master and servant; and
- (j) whether the principal is or is not in business

Hoover V. Sun oil company: Rule of Law. A master-servant relationship does not exist when an independent contractor controls the day-to-day operations of the entity that is responsible for damages suffered by a plaintiff.

Held. Sun Oil is not responsible for the negligence of Smilyk because he is an employee of Barone, who in turn is an independent contractor. The Superior Court of Delaware, New Castle, did not find any evidence to support a master-servant relationship and therefore allowed Sun Oil's summary judgment. Barone controlled all day-to-day operations of the station. Although Sun Oil worked closely with Barone in several day-to-day operations, Barone was not required to follow Sun Oil's advice. Barone was also able to sell competing products even if he elected not to do so.

Murphy v. Holiday Inns, Inc. Rule of Law. When establishing an agency relationship through a contract, the nature and extent of the control agreed upon will determine whether the agency exists.

Facts. Plaintiff slipped and fell on a puddle of water that was dripping from an air conditioning unit at the hotel. Plaintiff wanted to hold Defendant accountable for her injuries. A third party owned the hotel, but they agreed to a franchise agreement with Defendant that dictated the name and look of the building and fixtures. The agreement also required the third party to submit reports and pay Defendant a certain amount per room per day.

Issue. The issue is whether the franchise contract established a master-servant relationship.

Held. The contract did not establish a master-servant relationship. Many of the provisions of the contract were in place to protect Defendant's trademark. However, normal day-to-day operations, such as hiring, price structure and business expenditures were still controlled by the third party hotel owner.

Level necessary to create a principal-agent relationship?

- Minimal. A principal need not exercise physical control over the actions of its agent so long as the principal may direct the result or ultimate objectives of the agent relationship
- Hence, the requisite level of control may be found so long as the principal is able to specify the task the agent is to perform, even if the principal is unable to ensure that the agent carries out that task

FIDUCIARY OBLIGATION OF AGENTS: Reading v. Regem: Reading: if servant has unjustly enriched himself by virtue of his service w/o his master's sanction, the law says he ought not be allowed to keep the \$, but it shall be taken from him & given to his master b/c he got it solely by reason of his position while he occupied as servant to his master; the uniform & position as Crown's servant were the only reasons why he was able to get the \$; can't work for your own benefit

Rule of Law. An agent has a duty to act solely for the master, and any profit earned while violating this duty belongs to the master.

Held:The agent was required to pay over to the principal the secret profits made as a result of his misuse of the agency position. The sergeant "[took] advantage of his service and violat[e]d his duty of honesty and good faith to make a profit for himself." Where "the wearing of the King's uniform and his position as a soldier is the sole cause of his getting the money and he gets it dishonestly, that is an advantage which he is not allowed to keep."

Restatement (Second) Agency- § 387 – "Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency."

§ 404 – "An agent who, in violation of duty to his principal, uses for his own purposes ... assets of the principal's business is subject to liability to the principal for the value of the use. If the use predominates in producing a profit he is subject to liability, at the principal's election, for such profit...."

Town & Country House & Home Service Inc. v. Newberry: can't take customers away from your former employer; violation of fiduciary duties to engage in unfair competition; employee can owe a fiduciary duty to their employer for the employer's trade secrets after their service has been terminated; ▲ owe π profits they made from customers taken from π, but they do not have to cease their operations; ▲ had duty to protect π's trade secrets & are prohibited from profiting from secrets even after employment ended; customer listing was formulated through many much efforts on behalf of π, but their methods of cleaning house were nothing so secretive as to justify prohibiting ▲ from continuing their cleaning services

- i. Case implicitly applying a duty of loyalty
- ii. In a law firm setting, it is probable that most clients would like to keep their lawyers b/c of a closer relationship
- iii. **Rule of Law.** An employee can owe a fiduciary duty to their employer for the employer's trade secrets after their service has been terminated.
- iv. What is the default rule in Town & Country? : The law of trade secrets is incorporated as the default rule. Accordingly, ex-employees may not use a customer list that qualifies as a trade secret

UNIT II- PURPOSE OF THE VORPORATION AND THE LIMITED LIABILITY:

The Corporate Entity and Limited Liability (i.e. Piercing the Corporate Veil

- a. What do you need to pierce the corporate veil?
 1. Failure to observe corporate formalities (keep funds separate, have annual meetings)
 2. Corp is inadequately capitalized at the outset (show that it is insolvent)
 3. Requires injustice or a similar wrongdoing (protect creditors/other outsiders)
 - f. Some jurisdictions permit piercing solely on showing of total disregard for separate existence of corporation
 - g. Some jurisdictions adopt multi-factor test that appears related to general injustice req.
 - h. Recognition of injustice in corp were no recognized in Walkovsky, Sea-Land, In re Silicone
- b. Means that the SH's, officers, or directors will be personally liable for corporate obligations b/c the Corp is abusing the legislative privilege of conducting business in the corporate form
- c. In the case of a parent/subsidiary relationship, when parent and subsidiary fail to follow separate corporate formalities (both have the same board, do not hold separate directors meetings), when both are operating the

same business, subsidiary is undercapitalized, the public is misled about which entity is operating which business, corporate assets are intermingled, subsidiary is operated in an unfair manner

- d. When SH's treat the assets of the corp as their own, use corporate funds to pay their private debts, fail to keep separate corporate books, and fail to observe corporate formalities (holding meetings, issuing stock, conducting business by resolution), this usually means that the corporate entity is the mere **alter ego** of the SH. This operation results in some **basic injustice**
- e. Contract, Tort, and Bankruptcy cases involve piercing the veil; less likely in K case.
- f. DGCL102(b)(6): "[The certificate of incorporation may also contain a] provision imposing personal liability for the debts of the corporation on its stockholders to a specified extent and upon specified conditions; otherwise, the stockholders of a corporation shall not be personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or act"
- g. MBCA § 6.22(b): "Unless otherwise provided in the articles of incorporation, **a shareholder of a corporation is not personally liable for the acts or debts of the corporation** except that he may become personally liable by reason of his own acts or conduct"



shion”

h.

Walkovsky v. Carlton (MAJ): π was hit by taxi owned by \blacktriangle -corp; in complaint, π alleged that \blacktriangle was 1 of 10 cab companies of which \blacktriangle -individual was a SH & that each corp. had all but two cabs registered in his name; each cab corp. only carried the min auto liability insurance required by law; supposedly, they were operated as single entities-financing, repairs, employees; each corp. & its SH's were named as \blacktriangle b/c multiple corp. structure constituted an unlawful attempt to “defraud members of the general public.” \blacktriangle was fraudulently holding out the corps as separate entities when they actually work as one large corp.

- a. Π would have to show that \blacktriangle didn't respect the separate identities of the corps
 - a. Assignment of divers, use of bank accounts, ordering of supplies

- b. The fact that the corporations may have been one large corporation, however, does not prove that Defendant was controlling the corporations for his own behalf.
- b. Rule: using a corporation to further own interests pierces the corporate veil; whenever anyone uses control of the corp. to further own business, will be liable for corp.'s debts
- c. Upon the principal of respondeat superior, corp. is liable for negligent acts & commercial dealings of its employees/officers/directors
- d. Where a corp. is a fragment of a larger corporate combination which actually conducts the business, courts will not pierce the corporate veil to hold individual SH's liable absent some injustice or wrongdoing
- e. **Rule:** The corporate form may not be disregarded simply because the assets of the corporation, together with liability insurance, are insufficient to assure recovery – *not enough to pierce veil*
- f. Enterprise Liability: while the corporations may have separate names, they are really all just the same thing; allows P to reach the TOTAL enterprise but still keeps P away from the individuals
 - a. **Definition: when the P can reach the assets of other subsidiary corporations organized under the same corporate umbrella, but not any of the SH's**
 - b. Enterprise liability limits liability of the investor; gets to all the subsidiaries but not the common owner
 - c. How to argue enterprise liability-all subsidiaries are doing the same thing; they are held under one umbrella; court should hold all liable
 - d. The corp. is an entity is a form in and of itself
- g. Standard by which court decides whether or not to pierce the veil:
 - a. Where a shareholder uses control of the corporation to further his own, rather than the corporation's business, he/she will be held liable for the corp's acts and debts on a principal-agent theory.
- h. Enterprise Liability: this is NOT piercing the veil
 - a. P could recover if he could show that all 10 corporations could be considered one entity
 - f. Would have to show that the separate corps did not adhere to "separateness" and really acted as one entities
 - b. A separate theory P may be able to recover on w/o piercing the veil
- i. Under the principal-agent doctrine, the drivers/investors were the agents and the corporation was the principal; the agents would be responsible for the principal
 - a. Agency theory doesn't go through the company; it goes around the company; you are suing the owner as a principal under Respondeat Superior
- j. Dissent: *Thinks that we should have corporate social responsibility*; D intentionally undercapitalized for purpose of avoiding responsibility; taking advantage of the corp. form
- k. **Reverse pierce-goes through the corporation and to the owner**



Sea-Land Services v. Pepper Source: π was an ocean carrier who shipped peppers for \blacktriangle ; π couldn't collect its money b/c \blacktriangle 's corp. dissolved & \blacktriangle had no assets; π wanted to pierce the corporate veil and hold the sole SH of \blacktriangle -corp. (& other corps) personally liable & reverse pierce to get through to other entities partially or wholly owned by \blacktriangle

1. Reverse pierce: seize the assets for themselves & take w/ priority that is at least equivalent as a secured creditor; this lets them take the assets w/o going through all the formalities
 - a. If π can pierce the corporate veil to get through to \blacktriangle individually, then can get to the other assets of \blacktriangle (stock in other corps) via reverse piercing
 - b. Pecking Order for when a corporation goes bankrupt:
 - i. Lawyers for bankruptcy – “super-priority”
 - ii. Secured creditors
 - iii. Unsecured creditors
 - iv. Insider lenders – owner/director of the corporation who lends \$
 - v. Shareholders – usually by this time there's nothing left

2. Test for Veil Piercing:

- a. A corporate entity will be disregarded and the veil of limited liability pierced when two requirements are met: (1) there must be such unity of interest and ownership that the separate personalities of the corporation and the individual (or other corp) no longer exist and (2) circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice
 - b. **ELEMENTS:**
 - c. (1) Unity of interest & ownership between the corporation & an individual, and – “*alter ego*” test
- i Lack of corporate formalities, including failure to maintain adequate corporate records: a) Failure to hold

shareholder meetings

- b) Failure to hold board meetings
 - c) Failure to keep minutes of said meetings
 - d) Failure to keep separate books
 - e) Failure to issue stock
 - f) Failure to appoint a board
 - g) Failure to adopt charter or by-laws
-
- i. Commingling of funds & assets
 - ii. Undercapitalization
 - iii. Use by one corporation of assets of another as if those assets were its own
- d. (2) Where adherence to the fiction of a separate existence would sanction a fraud or promote justice
- i. Once the first element (alter-ego test) is established, *either* the sanctioning of a fraud (intentional wrongdoing) or the promotion of injustice will satisfy the second element (need to show that honoring the separate corporate existences would sanction a fraud or promote injustice)
 - ii. Promotion of injustice needs more than just unsatisfied judgment – you need some additional unjust enrichment, illegality, or fraud
 - 1. Some element of unfairness, something akin to fraud or deception or the existence of a compelling public interest must be present in order to disregard the corporate fiction
- e. Here, Alter Ego test met: corporate records & formalities have not been maintained, funds and assets have been commingled, D was undercapitalized, and corporate assets have been moved without regard to their source
- i. Single phone, physical presence, moves \$ around corps & himself
 - ii. Today, the single phone and one physical presence is not dispositive
- f. The second part of the test is more problematic: An unsatisfied judgment, by itself, is not enough to show that injustice would be promoted. This is because every veil-piercing action includes the prospect of an unsatisfied judgment – if this were all that was required then the veil would often be pierced.
- i. Have to show unjust enrichment or the deliberate use of corporate form to escape/defeat creditors
- g. Under this case, Carlton would've probably been decided the other way b/c having min. insurance is perhaps unjust



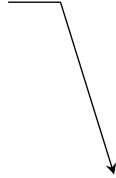
two
entities as separate
would sanction fraud
or promote injustice

In re Silicone Gel Breast Implants: π's claimed they had been injured by breast implants; MEC was subsidiary of ▲, and ▲ exerted significant amount of control over many MEC activities. VP of ▲ held position on BoD of MEC & couldn't be outvoted; MEC used ▲'s publicity depts, legal depts., research dept, sales staff, regulatory groups. MEC needed budget approval from ▲, and ▲ set salaries for MEC employees; ▲ listed their name on MEC products to offer a higher degree of credibility

- h. This is the multifactor totality of circumstances test to pierce veil
 - i. If test is met= direct liability
 - j. Subsidiary was alter ego
 - k. Direct liability (tort claim) claim differs from piercing the veil claim b/c in direct liability, the parent is liable; in piercing the veil, the subsidiary is liable
3. "Bristol contends that a finding of fraud or like misconduct is necessary to pierce the corporate veil. Despite Bristol's contentions to the contrary, Delaware courts ... do not necessarily require a showing of fraud if a subsidiary is found to be the mere instrumentality or alter ago of its sole stockholder."
 4. Should claims by contract creditors be disfavored.
 5. Why Contract creditors can (and should) bargain ex ante (Exception: Misrepresentation)

The Role and Purpose of Corporation:

Own the company
Participate in the
profits of the
enterprise
Limited
involvement in the
company's affairs



Appointed by
the board





- plans and actions.
- Other functions prescribed by law.

A.P. Smith v. Barlow: π corp had history of donating minor sums of \$ to various charities and institutions and in 1956 decided to give \$1,500 to Princeton. ▲ SH's questioned the proposed gift, asserting that corp.'s certificate of incorporation doesn't allow gift; issue was whether corp. could donate \$ w/o authorization from SH or through certificate of incorporation.

- Corp can give \$ to charities providing that total doesn't exceed statutory max & institution receiving the \$ doesn't own more than 10% of the stock; corporate gift-giving increases goodwill of corp. & public policy should encourage corps to give
- How can corp. argue this was not waste
- BJR is broadly applied; don't have to quantify when using the BJR

Dodge v. Ford Motor: Corp was dominant manufacturer of cars and were sold for \$900 at one point, but price reduced to \$440 and finally to \$360; Henry Ford admitted that price negatively impacted short-term profits, but defended his decision saying that his ambition is to spread the benefits of the industrialized society w/ as many people as possible; he also said that he paid out substantial dividends to SH ensuring that they made profit and should be happy w/o whatever return they got; instead of using \$ to pay dividends, he decided to put \$ into expanding corp.; **issue** is whether SH's can force ▲ to increase cost of product and limit the \$ invested into expansion in order to pay a larger dividend?

- This is an incomplete BJR; there are some decisions of Corp that court will not question; Ford didn't think court would 2nd guess his decision
- Court went further than any court will go today
- Rule: SH wealth maximization is still considered the primary purpose of a corp.; under BJR, the decision why doing something for someone is broad



al to pay amounts
to “such an abuse of discretion as would
constitute a fraud, or breach of ... good
faith”

d.

Question: Why was Ford’s decision re dividends improper? : Ford ran the company as an “eleemosynary” institution. “A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.”

Schlensky v. Wrigley: ▲ is director of the Chicago Cubs; though every other major league had installed lights, ▲ did not install them at Wrigley field b/c he was concerned that night baseball would be detrimental to surrounding neighborhood; π argued the team was losing money and competitors had higher attendance; π claimed that Cubs would draw more people w/ weekday night gains

- a. Caring about the community can be profitable in the long run
- b. Intangible factors outweigh the profit
- c. As long as there is a rational reason, the decision will be ok; court defers to Board
- d. Would come out differently if there was waste, but this won’t happen if the board is competently advised
- e. Business decisions shouldn’t be disturbed just b/c π can make a reasonable case that the policy chosen by the Co. may not be the wisest policy available
- f. **3 instances where the court will step in: fraud, illegality, conflict of interest**
- g. **Rule of law?** In the absence of a showing of fraud, illegality or self-dealing by the directors, their decision is final and not subject to review by the courts. **This is the Business Judgment Rule**. Since the courts won’t review such decisions, plaintiff has no standing

UNIT III BUSINESS JUDGMENT RULE AND FIDUCIARY DUTIES: The duties of officers, directors, and other Insiders: DUTY OF CARE:
DUTIES OF OFFICERS & DIRECTORS: Loyalty, Due Care, Good Faith, Candor (Full Disclosure)

Overview

I. Duty of Loyalty

- a. Corporate Opportunities, ex. Meinhard v. Salmon, Salmon took opportunity that belonged to p'ship
- b. Self-interested transactions, directors must be independent and not self-interested, Basic v. Levinson

II. Duty of Care

- a. Exercise care on behalf of a beneficiary, care may depend on context of relationship
 - i. Scope of duty of care depends on size of corp: the smaller the business, a lesser duty of care is required; it takes a higher duty of care for a larger Corp. (there's more work to do and more to review)
 - ii. Duty of care relates to gross negligence or egregious misconduct
 - iii. Directors not insurers of the corporations
 1. Directors must perform w/ reasonable care
 2. Good faith errors of judgment are insulated from liability
 - iv. Two situations implicating duty of care
 1. Duty to Monitor: must know what is going on in a larger corporation & must review
 2. Discrete Decisions: decision to have a president, sell the company, issue more stock, etc.; directors have to exercise some level of care in making these decisions – but these decisions are more protected than the duty to monitor
 - a. Generally protected by the BJR
 - ii. **RMBCA § 8.30(a)**: A director shall discharge his duties; in good faith with the care that an ordinarily prudent person in a like position would exercise under similar circumstances & in a manner he reasonable believes to be in the best interest of the corporation. (*more specific, but it all still goes back to agency laws to get a duty of care*)
 - iii. Duty to exercise care on behalf of beneficiary of the fiduciary relationship (usually described as “principal” when talking in agency terms)
 - iv. General Scope of Director's Duties: Francis v. United Jersey Bank

III. Duty of Disclosure:

- i. Reporting material facts: general duty to inform shareholders & not conceal material facts
- ii. Registration & reporting requirements under federal law: Securities Act, Exchange Act, Sarbanes-Oxley, etc.

IV. Business Judgment Rule: directors and officers will not be personally liable to corp. for mere mistakes in judgment, so long as their business judgment wasn't tainted by breach of the duty of loyalty or gross negligence

- a. Gross negligence standard: duty only to act reasonably; court's won't 2nd guess decisions if made in business judgment, even if they turned out horribly
- b. Doesn't provide any protection against claims for breach of loyalty
- c. Corps can't indemnify for breach of loyalty, the insurer won't pay claim either
 - i. Means that BoD really want the claims to settle so that they don't have to pay
 - ii. Rebuttable presumption: business decisions will be upheld if not done in bad faith or grossly negligent & act w/in their business judgment-directors are presumed to act on reasonably informed basis, in good faith and in honest belief that the action was taken in the company's best interest
 - iii. To rebut:
 1. No business purpose for definition
 2. Decision was made w/ conflict of interest or is otherwise self-interested
 3. Decision was sufficiently egregious such that it amounted to a no-win decision (utterly irrational, very rare but does happen, Disney)
 4. Decision results from obvious/prolonged failure to exercise proper supervision (uninformed)
- d. Types of due care:
 - i. Procedural: was process used in making the decision reasonable?
 - ii. Substantive: was actual decision substantively reasonable?

Loyalty

- a. Two situations where corporate the duty of loyalty arises: appropriating a opportunity & being an interested party in a transaction
 - I. If a reasonable person cannot say something is unfair, then the transaction is said to be entirely fair
 - II. If the deal is such that it isn't likely to get a better deal, then there are no damages!
- b. What is the relationship between BJR and the duty of loyalty?
 - I. BJR only protects discrete decisions against claims that they were made negligently, without care, and should have been different.
 - II. Duty of loyalty addresses situations in which the fiduciary stands on the opposite side of a transaction from the principal.
 - III. "Included within its scope is every situation in which a trustee chooses to deal with another in such close relation with the trustee that possible advantage to such other person might influence, consciously or unconsciously, the judgment of the trustee."
 - IV. *BJR does not protect claims of breach of duty of loyalty.*

Due Care

Kamin v. American Express Company: π brought derivative suit claiming AmEx engaged in waste of corporate assets by selling stock in DLJ at cost of \$29.9M that depreciated to \$4M; π claimed violation of director's fiduciary duty; it realized losses in February; if it had disclosed earnings loss in income statement to the world, price of stock would go down; they decided to give it out in dividends before they had to report; SH's complain b/c they had to pay tax on it; if Corp sold, could've recognized a tax loss and saved \$ for the company

Rule of law: A court will not interfere with the decision of a company's directors unless there is evidence of fraud, breach of trust, oppression, arbitrary action and dishonest practice.

Court observed: "The directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive situations, or tax advantages.

- e. This decision of what to do comes w/in BJR
- f. There is a duty of care in making individual/discrete business decisions
- g. BJR protects directors from liability for breach of duty of care in making discrete decisions unless decision is intentional, reckless, self-interested or grossly negligent (uninformed, bad faith or breach of duty of loyalty)
- h. Court adopts gross negligence standard of care-it is ok as long as it appears the directors are acting in good faith; no court inferences unless a clear case is made out of fraud, oppression, neglect of duties, or malfeasance
 - i. Neglect referred to by statute is neglect of duties, not misjudgment
- i. BJR presumes that directors act on informed basis, in good faith and in honest belief
- j. Here, it isn't enough to charge that directors made an imprudent decision or that some other course of action would have been more advantageous (these charges don't give rise to COA)

Smith v. Van Gorkom: BoD of Trans Union Corp. voted to approve merger agreement based solely on representations of Van Gorkom (director, CEO, owns large chunks of shares); he wanted to stage a leveraged buyout at \$55/share; Van Gorkom only consulted co's controller for help in calculating feasibility of such a takeover; decision to sell was made in a hurry and Van Gorkom didn't substantiate the \$55/share price; Board never asked how they could maximize SH value

Court Observed: "[The business judgment rule] 'is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'"

"[W]e think the concept of gross negligence is the proper standard for determining whether a business judgment reached by a board of directors was an informed one."

Who has burden of proof on this issue?
Party attacking the board's decision

What must that party prove?

Gross negligence by directors who failed to inform themselves of “all material information reasonably available to them”

- a. Example of procedural duty of care
- b. Though this exemplifies duty of care, should also look at immeasurable moral obligation duty of loyalty b/c Van Gorkom wanted to rush to sell it to any bidder so that he could get out of the company
- c. It's not a breach of duty of loyalty b/c Van Gorkom isn't being given any other benefit than what the other SH's get-\$55. There's a loyalty problem morally, not legally
- d. Rule: under the BJR, a business judgment is presumed to be an informed judgment, but the judgment will not be shielded under the rule if the decision was unadvised
- e. BJR shields directors/officers of a corp. from liability only if directors/officers acted on informed basis, availing themselves of all material info reasonably available
 - i. The director has a duty to the corp.'s SH to make an informed business decision regarding a proposed merger before it is subjected to shareholder approval
 - ii. **Subsequent SH ratification does not relieve the director from this duty, unless their approval is also based on an informed decision**
 - iii. A director/officer may not passively rely on information provided by other directors or officers, outside advisors, or authorized committees – the director may only rely on credible information provided by competent individuals, after taking reasonable measures to substantiate it
 - iv. **Del. Code § 141(a):** Presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company
 1. *This pretty much means that P loses if the directors really were informed*
 2. P can get around this by attacking the underlying assumptions of the BJR (judgment was not informed, there wasn't good faith, there wasn't a duty of loyalty)
 - v. **Del. Code § 141(e):** Permits directors to rely on the reports of officers, auditors, etc.
 1. A member of the BoD shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation & upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member **reasonably believes** are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.
- f. *Why wasn't it enough for them to rely on the reports of Van Gorkom?* They didn't even ascertain the basis for his knowledge of reporting the information
 - i. On Sep. 20th, they didn't inform themselves about the role of the forced sale, they were uninformed as to the intrinsic value of the company, and they were grossly negligent in approving the sale of the company in 2 hours, without prior notice & without any good reason for the crisis; the fact that there was a \$17 premium isn't indicative of fact that it was a good deal; not enough to force directors to sell; directors have independent duty to figure out what the value of the corp. is; agreed barred Trans Union from actively soliciting more favorable offers & from furnishing to interested parties any info about the co.
 - ii. On October 8th, they gave Pritzker a lock up deal where if the financing contingency were met or waived by Pritzker, Trans Union was required to sell to Pritzker one mil newly issued shares of Trans Union at \$38 per share.
 1. Pritzker wanted the options b/c he didn't want to be a stalking horse; worried that another company would buy it first; he wants to participate in the process; should've had a market test b/c if it really is worth more, should've seen if anyone else would've offered a higher price; he didn't allow diligence
 2. In theory, a **market test** is ok, but it has to be well done and not be a sham
 3. *Why wasn't this transaction ratified by the shareholders? Ratification only works if the ratifying body is fully informed, here they didn't have all the information*
- g. **Remedy = personal liability of the directors.**
- h. What could they have done differently? Could've waited longer, could've found out the real value of the stocks (go to an investment bank), show that it was a true crisis situation

- i. **Responses - Del. §102(b)(7):** Protection Against Van Gorkom Liability (in many jurisdictions); legislatures allowed corporations to put in their charters that the directors will be protected from court's decision
 - i. **102(b)(7)** – allows corps to indemnify their directors for breaches of duty of care (among others), but not as to breaches of duty of loyalty, for acts/omissions not in good faith or which involve intentional misconduct or a knowing violation of law, or for any transaction from which director derived improper personal benefit
 1. Many jurisdictions have adopted this approach
 - ii. Many jurisdictions permit a director to avoid liability by showing that transaction was “entirely fair” even though the director technically violated the duty of care. Not all companies opt-into 102(b)(7)

Plaintiffs can get around § 102(b)(7) by characterizing their claim as a breach of loyalty, Avoid only monetary damages by directors (not injunctive relief); does not protect against federal securities law.

Leveraged buyout: occurs when investor, typically financial sponsor, acquires a controlling interest in a co.'s equity and where a significant % of the purchase price is financed through (leverage/borrowing). The assets of the acquired co. are used as collateral for the borrowed capital, sometimes w/ assets of the acquiring co. Typically, LBO uses a combination of various debt instruments from bank and debt capital markets. Bonds or other paper issued for LBO considered not to be investment grade b/c of risks.

Rationale: leverages the financial return to the private equity sponsor.

→If someone thinks a co's equity is undervalued, they buy it out. They borrow \$ and it goes into the debt, which leverages up the corp. They take control and the value of the equity goes into the pocket of the acquirer.

- j. Summary of key points
 - i. Directors do have a duty to be informed; if you're going to create a mechanism to be informed, it better work
 - ii. Not able to rely on your expertise alone to satisfy your duty
 - iii. Will not be able to rely on a market premium
 - iv. Legislature responded by allowing corps to remove director's duty of care

Post Van-gorkham: BJR: Court will not review BoD decision, Preconditions:

- No fraud
- No illegality
- No self-dealing
- Informed decision making (gross negligence standard)
- No waste?

Rule of law: Under the business judgment rule, a business judgment is presumed to be an informed judgment, but the judgment will not be shielded under the rule if the decision was unadvised.

Court held: the directors of Trans Union breached their fiduciary duty to their stockholders by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend that Pritzker merger and by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer.

Francis v. United Jersey Bank: ▲, an old lady and widow, ignored her duties as director & allowed her sons to withdraw \$12M from client trust accounts; ▲ knew nothing about the basics of the reinsurance business & paid no attention to the affairs of the company

- b. This is an example of general monitoring of activities of the corp. and its employees
 - i. A director is liable for negligence in executing this duty of care
 - ii. General monitoring isn't covered by the BJR
 - iii. This is a departure from the general rule that a director is immune from liability & is not an insurer of the corp.'s success
 1. ▲ would owe a duty to the client here if the client is a SH, not if it is a corporation or creditor b/c SH's \$ is held in a corp. and creditors have a legal remedy whereas SH's don't

- iv. Director of a corp. stands in a fiduciary relationship to both the corp. & his SH's-inherent in this role is a duty to acquire a basic understanding of the corp.'s business & continuing duty to keep informed of its activities
 - 1. Entails overall monitoring of corp. affairs, and regular review of its financial statements, which may present a duty of further inquire
- v. D is liable for her negligence if satisfying her general duty of care was the proximate cause of the loss – she had a duty to monitor, and failed; she could have stopped her sons from looting or resigned, sold stock, appointed own director
- c. If you agree to be a director, you agree to exercise a certain level of care in serving that function: be familiar w/ corporate rudiments of business, w/ general financial status of corp., attend board meetings regularly, duty to inquire upon suspicion of wrongdoing
 - i. *What is the obligation of a director who discovers evidence that there may be wrongdoing?*
 - 1. They don't have to actually go out personally and find info, they can use representatives as long as there are qualified people in place to help monitor the system, must be reasonable based on the size of the corporation
 - 2. Having more than one director will help with this because as a body they are supposed to make decisions on behalf of the corporation (one director has no power at all, only the BoD can act as an agent of the corporation) - Each director devotes effort to make sure that the corporation is ran responsibly, and the power cannot be diverted
 - 3. Most jurisdictions also require you to have assured yourself that there is a reasonable information gathering system in place
 - 4. If the **red flags** turn out to be actual wrongdoing, then the director must stop it, report it, or resign
- d. Remedy: personal liability for directors' §102(b)(7) permits corporations to indemnify their directors for breaches of the duty of care (among other breaches), but not breaches of the duty of loyalty.
- e. You have to get into corp. waste before court will get into substantive due care
- f. What she could've done: resigned (gives other SH's a clue that something is wrong); reported to authorities; civil action against sons.
- g. Directors must "discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions" [N.J. **Rule of law**: A director can be personally liable, even to third parties, if they neglect to provide the ordinary care of staying current with corporate affairs as one would normally do in that position, and that neglect is the proximate cause of the damages.

DIRECTORS & MANAGERS: DUTY OF LOYALTY:

Bayer v. Beran: Directors of a Corp were charged w/ negligence & self interest in commencing a radio ad program; SH's brought a derivative suit alleging that Board was negligent in selecting the type of program and in reviewing the radio K, that directors were motivated by non-corporate purpose in causing radio program to be undertaken and in expending large sums of money; claimed that program was for benefit of director's wife; court applies rigorous scrutiny but directors satisfied it

- c. BJR protects directors from personal liability if they have not violated duty of loyalty
- d. Policies of business management are left solely to discretion of BoD & may not be questioned absent a showing of fraud, improper motive, self interest
- e. BJR only protects discrete decisions against claims that they were made negligently, without care, and should have been different.
- f. Where duty of loyalty is involved the BJR yields (loyalty is superior and examines whether a director is acting in self interest)
 - I. In cases where directors enter into personal transactions w/ their companies, it will be scrutinized, & upon the showing of any unfair advantage, will be voided
 - 1. The burden is on the interested director to demonstrate the transaction's good faith & inherent fairness to the corporation
 - II. *Duty of loyalty is triggered* when the transaction is one in which the director/officer or close personal or financial relation **stands on both sides of the transaction**.
 - III. No breach of care in this case b/c the advertising campaign was not structured around D's wife - her involvement was not central; expenditures not illegal b/c radio ad program wasn't taken up at any

formal meeting; although it is a general rule that directors acting separately and not collectively as a board can't bind the corp., in this case, that is not fatal b/c members associate on daily basis & directorate is composed largely of its exec. Directors

- IV. **Note:** When the court invokes the BJR, the directors of the corporation are almost always shielded from liability; however, the court will only invoke the rule following a preliminary determination that the duties of care & loyalty have not been violated
- V. **Rule of law:** A director has a fiduciary duty to support the corporation's interest over his or her own conflicting interests, and any competing interests renders the business judgment rule inapplicable.
- VI. The duty of loyalty trumps the business judgment rule. If the contract is fair, it is valid even though disinterested directors have not formally ratified it.

g. **Prof's Notes**

- I. If there is a conflict, burden shifts to ▲
- II. If there is no protection under BJR b/c breached duty of loyalty, must that what you have done is fair (proving **entire fairness** is difficult)
- III. Entire fairness review is not deferential to board; it requires board to prove that its actions were fair to the corp.
- IV. Today, the dominant approach is to find that where one director is conflicted, all of the board is

Benihana of Tokyo v. Benihana: BOT needed \$56M for renovations; sought advice on how to finance & considered variety of options; eventually settled on convertible preferred stock (considered by a small committee and not entire board); Abdo was on BOT exec committee and involved in co. that was to purchase the new stock; BOT's claim is that (1) Abdo's conflict of interest was not expressly disclosed to the board (is vice chair of other company and represented that company in negotiations); (2) Abdo breached fiduciary duty (self interest) by using insider knowledge to his advantage in negotiations; (3) transaction was aimed at diluting BOT SH voting power

- h. Rule: benefiting from a transaction that may appear self-interested doesn't always violate duty of loyalty; if board knows of director's position in the transaction and transaction serves a legitimate business purpose then no duty of loyalty problem
- i. Court found that Abdo's position was not explicitly disclosed BUT board did know of his involvement in other co. (Abdo presented on its behalf); no breach of loyalty (Abdo got a good deal but so did Behinana), purpose of the transaction served (deal was to secure financing and this was done)
- j. Court applied **DE §144** & BJR = no breach of loyalty

DE Sec 144: No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:

(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

Effect of ratification by directors:

“After approval by disinterested directors, courts review the interested transaction under the business judgment rule.”

k.

I. **DE §144(a) protects Schwartz**

1. **Says that if material facts are disclosed and majority of disinterested parties vote, then ok**
- II. Court didn't apply entire fairness standard where court looks at the fairness of the transaction instead of breach of loyalty; interested director must move entire fairness burden on Abdo (court said that there was no evidence that Abdo used confidential info)
- I. Other conflicts of interest
 - I. Family attorney-personal times to children, in a position to help them, he can protect the beneficiaries of trust (nothing he can do directly; can protect corp. & in thereby protect their interests)
 - II. Kevin Aoki-shareholder
 - III. Schwartz-pres, CEO, control, job security enhanced if there is a controlling SH; has an interest in reducing control and control his job (entrenchment)
 1. 2 theories of entrenchment
 - a. Eliminate the control block (dissipation motive)
 - b. Interested in putting the stock in friendly hands)
 2. Entrenchment alone will not be enough; need more, as in Gantler
- m. Transaction
 - I. Preferred convertible stock: BFC gets properties (seat on board (gives Abdo more control)), approval required for corp. transaction
 - II. Liquidity preference: 5% dividend; redemption option (can force co. to buy it back later), conversion option, SH voting rights
- n. §141-power to appoint directors if consistent w/ certificate of incorporation; probably a flexible provision; amending articles/certificate requires SH approval
- o. Having a flexible range of directors would be desirable if cor. Subsequently seeks to invest. Efficiency-it is cumbersome to modify the articles of incorporation
- p. Classified board-reelect directors every certain # of years; can be a danger in giving yourself a large range of control if it is an issue when incorporating
- q. Why Abdo wants redemption option? Benihana is an unstable business; want option to get investment back if co. misses dividends or becomes less profitable
- r. If Aoki votes against transaction, it is not a breach of duty b/c he's not interested; the K is between Aoki & BFC
- s. **Duty of loyalty comes up when interested director is engaging in transaction, not blocking it**
- t. Difference between voting no on a transaction and voting yes is that you have an interest in it

Court held: Yes. Delaware General Corporation Law § 144 provides a safe harbor for interested transactions if the material facts as to the director's relationship or interests as to the contract or transaction are disclosed or are known to the board of directors, and the board in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors. After approval by the disinterested directors, the court reviews the transaction according to the business judgment rule, which is a presumption that in making a business decision, the directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.

CORPORATE OPPORTUNITIES, *subset of duty of loyalty*

2. Corporate Opportunity: director/officer becomes aware of it by reason of his/her function
 - a. Through use of corporate information or property if the opportunity should reasonably be expected to be of interest to the corporation
 - b. Opportunity to engage in business activity of which a senior executive becomes aware and knows is closely related to corporate business or business in which corporation expects to engage
 - c. Different from director/officer being on opposing sides of a transaction
 - d. Seizing a corporate opportunity is speculative
 - e. If a director improperly takes corporate opportunity he/she will be liable for all profits - *If the opportunity fails, the corporation doesn't have to indemnify (windfall for the corporation!)*
 - f. Objective: To deter appropriations of new business prospects "belonging to" the corporation
 - g. Targets: Officers & Directors of corporation, Dominant Shareholders who take active role in managing firm

Broz v. Cellular Info Systems: ▲ utilized a business opportunity for his wholly owned corp. instead of CIS, π for which he served as a member of the BoD; ▲ was a role SH & Pres of RFB and member of board of CIS; CIS was in financial

trouble & in process of being acquired by PriCell; ▲ went after a MI-2 cell deal for RFB instead of offering it to CIS/PriCell; PriCell claims that ▲, as director of CIS, had duty to offer MI-2 to PriCell before exploiting it himself

- h. You only owe a fiduciary duty to the company—third parties generally can enforce a fiduciary duty; you don't owe a fiduciary duty to the opposing side in a merger deal
- i. *Corporate opportunity doctrine* comes into play when there's a conflict between fiduciary duties & self interest & director exploited the opportunity
- j. Threshold question: when is an opportunity offered to an individual who happens to be a director or officer of a corporation a "corporate opportunity"? There are four considerations:
 - a. Is the corporation **financially able** to take the opportunity?
 - b. Is the opportunity in the corporation's **line of business**?
 - c. Does the corporation have **an interest or expectancy in the opportunity**?
 - d. By embracing the opportunity, would the officer or director create a **conflict of interest** between his or her self-interest and that of the corporation?
 - e. **General Rule re: Director's exploiting corp opportunities:** if there is presented to a corp officer/director a business opportunity for which the corp is financially able to undertake, is from its nature, in the line of a corp's business and is of interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict w/ that of the corp, the law will not permit him to seize the opportunity.
 - f. *Compare to Meinhard:* partner seized opportunity to develop building before p'ship expired; if he had disclosed to Salmon, partner was free to compete; in this case, directors was to completely step aside as it becomes the corporation's opportunity. A director likely cannot disclose and then resign and compete – would likely still violate corporate opportunities sub-set of duty of loyalty.
- k. PriCell argues that since he never made a formal presentation, he should lose the opportunity; but presentation is not required; if there is a formal ratification, then person is protected (safe harbor); ▲ discussed his interest w/ a few other directors, CEO, and counsel and all indicated that they had no interest in pursuing it; Mackinac didn't offer prop to CIS; CIS was not financially able to exploit the opportunity, was never interested; it is not a DE law that presentation to the board is a necessary prerequisite to a finding that a corporate opportunity has not been usurped
- l. On the side of PriCell and CIS, in making a bad decision, the directors will be protected by the BJR; can't be liable if something unforeseen happens
- m. In this case, the tender offer was just a formality b/c ▲ was already set to buy it
- n. ▲ did not owe a fiduciary duty to PriCell b/c he is not a member of their board
- o. Material adverse condition clause-present in mergers; acquirer could get out of merger if target company does something wrong (sells ½ of its assets)
- p. PriCell didn't have an expectation that CIS would have a license
- q. CIS SH's could be harmed, risk that deal falls apart

HYPOTHESIS: there are 100 shares at \$2/share; the license costs \$720:

- i. PriCell should say to CIS that it will pay \$2/share if you don't have a license; \$3/share if you have a license
- ii. If CIS SH's would get some benefit from ▲ not taking corporate opportunity, then he may have a duty to PriCell through CIS
- iii. If \$2/stock, not cash, maybe breached duty to SH's; ▲ not a SH of PriCell → no duty

Rule of law: The corporate opportunity doctrine holds that an officer or director of a corporation can take a corporate opportunity if the opportunity is presented to them in their individual capacity, the opportunity is nonessential to the corporation, the corporation has no expectation for the opportunity, and they have not wrongfully utilized corporate resources to take advantage of the opportunity. CHECK FLOW CHART IN SLIDE 6 POWER POINT ON PG 29.

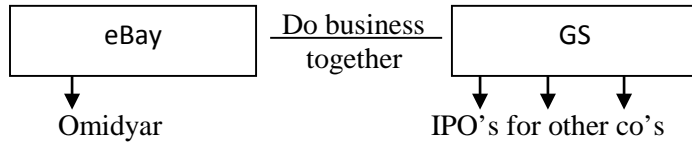
[Waiver of Corporate Opportunity Doctrine?](#)

DGCL § 102(b)(7): "In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: ... A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders"

[Waiver of Corporate Opportunity Doctrine?](#)

DGCL § 122(17): “Every corporation created under this chapter shall have power to: ... Renounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders.”

In re eBay, Inc.:



($\$20$ becomes $\$100$ in a few hours; in 1990's; these IPO's were offered at a cheap price in the first place b/c they create a lot of demand)

- eBay is buying a lot of shares; GS is given them certain people w/in eBay special favors, and not to the corporation directly, as a way of thanking them for their business;
- Omidyar is getting preferential treatment b/c of his official capacity as CEO of eBay; quasi-bribery; should've at least gone to the SH's
- Took business opportunities from eBay itself; have to give company a chance
- Court found that eBay usurped a corporate opportunity of eBay or breached its fiduciary duty; these lucrative offers were given to select insider directors and officers of that company; there is a conflict of interest between director's self interest and corp.'s interest

PROBLEMS

- k. S is a singer who is trying to break into opera circuit; few years ago, she took up w/ wealthy K and has married him. He would like to promote her career; he is CEO & majority SH in Chicago Inquirer. Shares are worth $\$100M$
- l. Suppose that Inquirer's BoD votes to make a $\$20M$ donation to start Opera Company. Chicago community is eager to have this new opera; company stands to receive much goodwill. If S doesn't sing w/ company, is there a problem?
 - i. *Probably no direct loyalty issues; but the amount of donation is substantial, and could constitute waste. Is the director using the corporation to satisfy his like of the opera?*
- m. Suppose that out of appreciation for K, music director of CCO offers to star S as the lead soprano in new production; is there a problem? Suppose that when offered, she responds, "We really don't need more money. I'd like to sing the lead, but I'll do it for free?"
 - i. *There is a conflict of interest; the Corp. is expending \$, wife is getting a personal benefit even though she's receiving no \$*
- n. Suppose that K owns 100% of the stock. Do answers to questions change?
 - i. *He doesn't owe a duty to anyone*
- o. Suppose that S is a genuine start, and CCO offers her the lead after holding an audition at which judges unanimously voted her for her talent?
 - i. *She has an equal interest; there is a conflict, but the transaction is fair.*

Duties of Dominant Shareholders

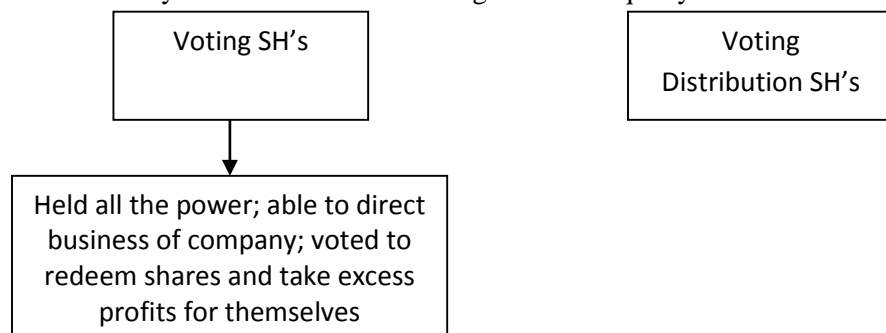
Sinclair Oil Corp. v. Levien: Sinven was a subsidiary of ▲. ▲ was a majority SH of Sinven & caused Sinven to pay dividends that were so large that amount exceeded the earnings of Sinven. ▲ neglected to meet terms of the K between them and Sinven, which required Sinven to sell all of its products to ▲ at specified prices; ▲ was late in payments & didn't fulfill min. purchasing obligations. ▲ contended that although it controlled Sinven (owned 97%) & owed it a fiduciary duty, its business transactions w/ Sinven should be governed by the BJR, and not by intrinsic fairness test; issue is whether ▲ was improperly engaging in self dealing when they issued excessive dividends and breached their K w/ Sinven

- k. SH's can take advantage of corporate opportunities, they do not have to give the opportunity to the corp. first

- l. Intrinsic fairness test should not be applied to business transactions where a fiduciary duty exists but is unaccompanied by self-dealing (where parent company receives some benefit to the detriment or exclusion of the minority SH's)
- m. Here, Sinven's SH benefited equally from payment of dividends (no self-interest) & π could not show Sinclair took business opportunities away from Sinven (b/c subsidiary had no right to develop oil fields outside Venezuela-all subs were country specific)-so no self dealing was demonstrated
- n. However, \blacktriangle did engage in self-dealing when it forced Sinven to contract with Sinclair Oil & then failed to abide by the terms of the contract, thereby invoking intrinsic fairness test
- o. Intrinsic Fairness - \blacktriangle must prove, subject to careful judicial scrutiny, that its transaction was objectively fair
- p. Where, as here, the situation involves a parent and subsidiary, with the parent controlling the transaction and fixing the terms, the test of intrinsic fairness is applied but ONLY when π can first show there is a fiduciary duty owed and that there was self-dealing.
- q. **Note:** In order to invoke the intrinsic fairness test & to shift the burden to \blacktriangle , π must, in addition to demonstrating existence of a fiduciary duty, show self-dealing on the part of the defendants
- r. When do majority shareholders owe duty of loyalty to the minority shareholders?
 - I. In Delaware, a SH can sell shares without violating fiduciary duties (*Nixon*)
 - II. In Mass., the courts think there should be a ~good faith/loyalty duty (*Smith, Sugarman*)
 1. *Duties triggered when it is a close corp., not when it is regular corporation*
- r. Prof's notes: transaction was intrinsically fair; SH elected BoD; you have a duty of loyalty issue when board engages in self-dealing; analyze via intrinsic fairness; ratification by majority of minority of SH will cure the problem
- s. Ratification of board will not suffice b/c they are not considered independent
- t. Dividends were paid completely equally, therefore no self dealing; if BoD directed payment of dividends, this is analyzed under BJR; apply same principle to the board, not intrinsic fairness
 - I. There could be an instance where an equally treated dividend would need the application of heightened scrutiny of fiduciary duty (intrinsic value)
- u. **Rule of law:** A standard of intrinsic fairness will be applied in any self-dealing transaction by a parent corporation whose majority ownership places a fiduciary duty upon the parent corporation, but the transaction only be self-dealing if the transaction is to the detriment of minority shareholders.
- v. Shareholders acting as shareholders owe one another no fiduciary duties
- w. Controlling shareholders owe fiduciary duties to the minority in certain situations
- x. **Intrinsic Fairness:** Intrinsic fairness used when parent has received a benefit to the exclusion of the minority shareholders of the subsidiary and at the expense of the minority shareholders of the subsidiary
- y. In BJR: BOP on plaintiff to rebut. In Intrinsic fairness: BOP on defendants to show that the transaction was fair to the subsidiary.
- z. Self dealing occurs when parent by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exhaustion of, and detriment to, the minority stockholders of the subsidiary.

Zahn v. Transamerica: AF was a tobacco co., whose principal asset was leaf tobacco; the value of tobacco was \$20M; \blacktriangle was a holding co and majority SH which entitled them to control AF operations; \blacktriangle converted all of the Class A stocks to class B stocks and called for redemption of outstanding Class A stocks @ \$80.80, which charter allowed; time of redemption was suspicious b/c after redemption, \blacktriangle liquidated AF; owners of Class A stock lost out on return; π brought suit for equitable relief to collect the value of the redeemed shares; \blacktriangle argues it followed corporate charter when voted for redemption

- a. Payment of dividends didn't go to SH's equally



- b. Court differentiated between a decision made by a SH and director
- c. P can win if the directors were acting on ▲'s behalf when they decided to redeem Class A shares; ▲ is entitled as a SH to vote his interests, but his capacity as director (if the directors are acting as an extension of the majority SH's) is limited b/c they owe a fiduciary duty to every SH
- d. Important factor: ▲'s control over Board, and the fact that the decision to redeem the share was a decision granted to directors & not shareholders
- e. **Aftermath:** a company can redeem its stock at a price less than the value of the company, but it has a duty to disclose to other SH's that they are planning to liquidate afterwards; this would give SH's the opportunity to convert stock into other stock
- f. **Fiduciary duty of good faith:** not going to let the dominant SH's take advantage of their positions
- g. **Rule of law:** Unlike a director, a shareholder, majority or otherwise, is entitled to vote in a manner that is most beneficial to their interests.

RATIFICATION:

Fleigler v. Lawrence: Duty of care claims :No Effect? If directors vote to ratify a transaction with an informed process then not even a duty of care claim to begin with?

Duty of loyalty claims against directors: Majority of disinterested director ratification leads back to the business judgment rule (BOP on plaintiffs) [144(a)(1)]

Facts. One of the Defendant directors, acting in his individual capacity, purchased a lease option for antimony (metal) rights. He offered the rights to Agau but the directors agreed that Agau's financial position would not allow the purchase. The director then transferred the rights to a company formed for the specific purpose of holding those rights. He then gave Agau a long-term option to purchase the holding company. A few months later, Agau's directors voted to exercise the option. A majority of shareholders voted the same way, but the directors also comprised a majority of shareholders. Plaintiff argued that Defendant directors usurped a corporate opportunity for their own individual benefit, and that the transaction was inherently unfair. Defendants responded that their vote was ratified by shareholders, thereby shifting the burden of proof to Plaintiff to prove that the transaction was fair, but they also offered proof that it was fair.

Rule of Law. Shareholder ratification of a transaction between the corporation and an interested party will not be legitimate if the majority of the shareholders are the interested parties.

Court Observed: Shareholder ratification can be used to switch the burden of proof back to a plaintiff to prove that a transaction was not legitimate. It therefore can reset the standard back to the business judgment rule.

In re Wheelabrator Technologies, Inc. Shareholders Litigation:

Facts: Defendant corporation was in the waste management field, specifically in the refuse-to-energy field. This field was shared in part by Waste Management. At one point, Waste management became the largest stockholder of Defendant, and they were eager to streamline both companies through a merger. Waste Management offered to pay a ten percent premium to acquire 55% of Defendant's shares. Defendant directors (which did not include directors appointed by Waste Management) voted to accept the offer. A majority of shareholders other than Waste Management voted in favor of the merger as well. Plaintiffs accused Defendant directors of breaching a fiduciary duty when they withheld pertinent information regarding a merger of Defendant target corporation Wheelabrator into Waste Management. Plaintiffs also accused Defendant directors of breach of loyalty and care in negotiating the merger by misrepresenting the time the directors took to deliberate about the merger. Defendants claim that the sh the decision, thereby extinguishing any duty of loyalty claims. Plaintiffs countered that at most the shareholder vote only turned the burden of proof on to Plaintiffs under an entire fairness standard.

Rule of Law. Shareholder ratification does not automatically extinguish a duty of loyalty claim, but it does make the business judgment rule the applicable standard that a plaintiff would have to overcome.

Duty of care claims: Extinguished by informed vote (but other avenues still available including waste)

Duty of loyalty claims against directors: Fully informed vote invokes the BJR with burden of proof on plaintiff to show waste

Duty of loyalty claims against controlling shareholder Fully informed vote shifts burden of proof to plaintiff to show unfairness

DGCL § 144

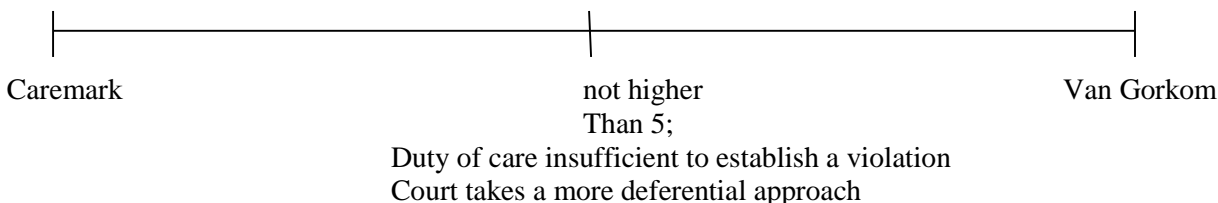
(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if ...

- (1) **The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders ...**

GOOD FAITH

In Re: Walt Disney: Disney appointed Ovitz as exec Pres and director; Eisner asked him to join and negotiated w/ him on compensation lead by compensation committee chair. Decided on \$24M, more than Eisner; they were compensating him for giving up his shares of CAA, at which he had guaranteed commissions; other members didn't know about this until negotiations were underway. Ovitz wanted his pay to increase if all was well and an exit package; there was a 5 year K; 1M options vesting each of year 3, 4, 5; 2 million more options if term was extended; termination agreement-if fired, gets all of 1M + \$7.5M/year for remainder of K + \$10M cash out of the \$2M. Report wasn't approved by whole board; board began to discuss; w/in year, he was terminated; he walked away w/ \$140M for a year's work. SH's brought derivative suit alleging that directors were grossly negligent in their approval of the package

- h. Directors not liable for gross negligence, which means a "reckless indifference to or a deliberate disregard to the whole body of SHs' or actions which are 'without the bounds of reason.'"
- i. Decision to hire was a business judgment. To counter, gross negligence or bad faith must be shown. They were all informed, there was good faith, w/ a subjective belief that he was right and in the co.'s best interests
- j. Court rejects argument that Ovitz himself breached a fiduciary duty by basically signing his own employment K b/c he was a de facto officer
- k. **Best practices:** it never hurts to have an independent valuation; they didn't b/c Eisner called the shots, being lazy; had they done a study, it may have revealed the actual value
- l. Court said that Board showed due care
- m. **Good faith:** if intentionally disregarded his duty, probably liable
- n. Deferential standard: difficult to prove intent, laziness inactionable; infer intent from conduct
- o. Gross negligence w/o more is not bad faith
- p. Deliberate indifference & inaction in the face of a duty to act
- q. If there is gross negligence, we have a question about deliberate indifference
- r. If Ovitz failed to follow Eisner's directives & was a habitual liar, maybe deliberate indifference



- s. Test

- i. If you fail to exercise a duty of care, which can be inferred, then you are potentially on the hook; proceed to the question of intent, deliberate indifference
- t. **In practice, directors can get away w/ anything as long as there is no self dealing**

In *Cede & Co. v. Technicolor, Inc.*, (Del. 1993), the Delaware Supreme Court described the business judgment rule as “a powerful presumption” against judicial interference with board decision making. It then stated:

“Thus, a shareholder plaintiff challenging a board decision has the burden at the outset to rebut the rule’s presumption. **To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care.** If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments. If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the “entire fairness” of the transaction to the shareholder plaintiff.”

DGCL § 141(e) provides: “A member of the board of directors, or a member of any committee designated by the board of directors, shall ... be fully protected in relying in good faith upon [specified documents and persons]

DGCL § 102(b)(7) provides that a corporation’s articles of incorporation may (but need not) contain: “A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: ... for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law....

DGCL § 145(a) and (b) only authorize indemnification of a director or officer who “acted in good faith.”

Court observed: Identified two types of fiduciary behavior as possible bases for finding that directors who committed them acted in bad faith:

- a) conduct motivated by subjective bad faith (i.e., an actual intent to do harm)
- b) “intentional dereliction of duty, a conscious disregard for one’s responsibilities
- c) Gross negligence =/bad faith

The Waste claim: This claim is rooted in the doctrine that a plaintiff who fails to rebut the business judgment rule presumptions is not entitled to any remedy unless the transaction constitutes waste. The court observed:

“To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was ‘so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.’ A claim of waste will arise only in the rare, ‘unconscionable case where directors irrationally squander or give away corporate assets.’”

Where the directors can not rationally connect the decision with the welfare of the corporation.

Stone v. Ritter: bank was laundering \$ and failed to issue reports; w/ bank’s help, two people were operating a Ponzi scheme; had bank employees been paying attention, would’ve uncovered the scheme; after it fell apart, bank was forced to pay \$50V in penalties; bank’s SH’s instituted derivative suit against directors for **wasting corporate \$**: argued that CP lacked adequate board and management oversight

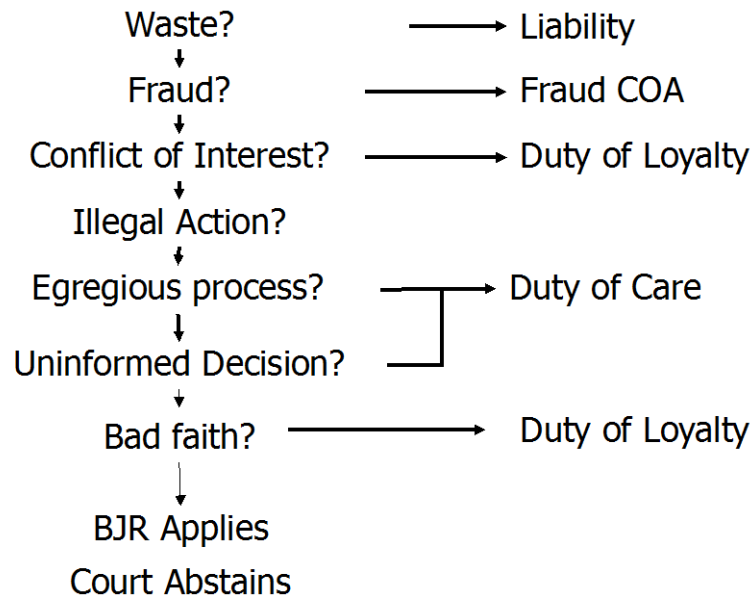
[In re Caremark Int’l Deriv. Litig.](#)

“[G]enerally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation ... only a sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish to lack of good faith that is a necessary condition to liability.”

- u. Standard for determining whether directors can be liable for failure to exercise oversight of employees who fail to comply w/ their duties was a lack of good faith as evidence by a sustained or systematic failure of a director to exercise reasonable oversight, as in Caremark. This is a high standard to meet.
- v. Two conditions necessary for liability under Caremark
 - i. The directors utterly failed to implement any reporting or information system or controls; or
 - ii. 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.
 - iii. In either case, imposition of liability requires a showing that the directors **knew that they were not discharging their fiduciary obligations**.
- w. There is no *duty of good faith* that forms a basis, independent of the duties of care and loyalty, for director liability; just because there was a bad outcome in this case, that was not evidence of bad faith on the part of the directors.
 - i. *Good faith is a subsidiary duty of the duty of loyalty*
 - ii. *Only duty of care and loyalty may result in liability, whereas a failure to act in good faith may do so, but indirectly.*
 - iii. *Fiduciary duty of loyalty is not limited to cases involving a financial/other cognizable fiduciary conflict of interest; also encompasses cases where the fiduciary fails to act in good faith*
- x. Basically, this case said that directors are not responsible for ensuring the legality of every act by the corporation's personnel, even if the illegal conduct would have been discovered if there hadn't been a failure of the corporate compliance program.
- y. “[A]lthough good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.”
- z. AFTERMATH: After Stone, on what grounds, if any, could a plaintiff bring a Caremark claim in cases in which the board of directors had implemented a reasonable compliance program and reporting system?
- aa. Forsythe v. ESC Fund Management Co. (U.S.), Inc.: .. with an effective compliance system in place, corporate directors are entitled to believe that, unless red flags surface, corporate officers and employees are

exercising their delegated corporate powers in the best interest of the corporation.

Roadmap



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UNIT IV: DERIVATIVE SUITS, INDEMNIFICATION AND INSURANCE: Shareholder Derivative Actions:

- II. Derivative means on behalf of other shareholders w/ similar interests; use this when there has been harm to a corporation generally; harm that is shared by all/most shareholders; action asserted by a SH in order to enforce a COA on behalf of the corporation
- Apply to SH's only indirectly in that it affects the value of their share of the corporation; is a suit in equity to compel the corporation to sue a 3rd party to enforce a right held by the corporation (equity allows SH to stand in corp's shoes). But like all corporate assets, litigation is under the control of the BoD.
 - A derivative suit is brought on behalf of corp against directors or 3rd party; COA belongs to Corp itself as an entity
 - Compare: direct actions-there is harm to each individual shareholder
 - Wrongful act separate and distinct from corporate injury
 - Denies/interferes w/ rightful incidents of share ownership
 - Generally direct actions arise from: interference w/ right to vote, interference w/ preemptive rights, dilution of voting rights, enjoin improper voting of shares, compel dividends, improper uses of

corporate machinery, oppression, compel dissolution, challenge improper expulsion of SH's, compel holding SH meetings

d. Representative-class action suit

III. See supplement on demand

IV. Proxy statement: statement containing specified info by SEC in order to provide SH's w/ adequate info upon which to make an informed decision regarding the solicitation of their proxies

V. The directors are the ones who decide whether to sue, but the problem is that directors are often friends with the people who do wrong, so the directors aren't likely to sue for breach of duty

a. If the crime is big enough, we want to give the shareholders a way to sue the wrongdoer when the directors won't do it themselves

VI. Generally Derivative Actions Arise from:

a. Misfeasance/misappropriation of corporate property

b. Enforcement of corporate contracts with 3rd parties

c. Actions against corporate directors for competing with corporation / appropriation of corporate opportunity.

d. Excessive salary suits (e.g., [Disney](#))

e. Third party torts against the corporation.

f. Correction of false entries in corporate records by directors

VII. Potential abuses:

a. Strike Suits = nuisance suits brought for settlement value

b. Meritorious suits = settled too easily

VIII. Other considerations

a. COA derivative or direct?

i. Test for direct v. derivative

1. Who suffered the most direct injury

2. To whom did the D's duty run? Corp or individual SH?

ii. Demand upon the board-SH demand board to pursue Corp's rights

1. If refusal is made in bad faith, directors are breaching their fiduciary duties & then can be sued personally b/c they are putting their interests ahead

2. Demand requirement may be excused if deemed futile

i. **Dismissal of derivative litigation by corporation**

1. Special litigation committees composed of disinterested, outside directors who were not involved in the wrongdoing

a. i.e. [Auerbach](#)

2. Refinement of SLC analysis into a two-step test:

a. (1) committee independent, acts in good faith, makes reasonable investigation; and

b. (2) court's independent inquiry

c. [Zapata](#)

ii. **Indemnification**

3. Directors are indemnified against most liabilities

4. Not indemnified against breaches of duty of loyalty

iii. **Attorney fees for successful settling plaintiff** - Derivative litigation is almost always lawyer driven. Any recovery goes to the corporate treasury in a derivative suit

iv. **Derivative Litigation: Standing**

5. Nominal plaintiff must have continuing interest throughout lawsuit – if you sell your stock, you lose your rights to sue

6. Justifications:

a. Efficiency versus monitoring costs.

i. NOTE that the shareholder doesn't really lose anything if their "right" to bring a derivative action is terminated; SH has not been injured. The wrong was done to the corp., not the shareholder. If the corporation terminates, there is no party who suffered a real, direct injury.

b. Derivative suits are one mechanism for monitoring agents' (directors') actions.

c. Efficiency requires being able to cut off at some point the ability of shareholders to sue derivatively.

i. Nominal plaintiff alienates shares (no continuing interest)

- ii. Corporation merges, dissolves, reorganizes – terminates shareholder’s interests and right to bring derivative action.
 - d. Exception to continuing interest requirement:
 - i. Merger, dissolution, or other reorganization gave rise to the derivative action.
 - ii. Shareholder deemed to have continuing interest.
 - b. Double derivative” actions: Shareholder of a parent corporation suing derivatively to enforce a right of a subsidiary corporation.
 - i. Securities for expenses:
 - 1. Many jurisdictions now require derivative P with small financial interest in the corporation to post security for expenses caused to the corporation by the derivative suit (not DE).

2. Process

- a. **Demand:** must request that board bring suit in alleged COA & must be sufficiently specific to apprise Board of the nature of the alleged COA to evaluate the merits; typically letter from SH to BoD required
 - i. Most states require P’s to demand that 1) director breach of duty to corp., 2) 3rd parties who have injured corp.
- b. Not filing a demand is a procedural bar to bringing suit
- c. Excused when demand would be futile b/c there’s not enough independence
 - i. 2 types of jurisdictions:
 - 1. “Demand futility” - demand is made, directors have a reasonable time to analyze demand and respond, but directors are interested parties
 - a. Analyzed under the BJR unless there is a breach of duty of loyalty.
 - 2. “Universal demand” – no matter what you have to make demand
 - ii. Is a rejection an absolute bar to suit?
 - 1. If BJR applies, rejection of demand is an absolute bar
 - 2. P can try to show decision to reject demand was self interested, bad faith, uninformed.
 - iii. How can a corporation protect itself from truly unworthy derivative actions? SLC’s
- b. Demand Requirement: Demand required unless plaintiff pleads particularized facts raising reasonable doubt that directors:
 - i. Would be disinterested and independent
 - ii. Would be entitled to protections of business judgment rule (plaintiff can show that decision to reject demand would constitute corporate waste).

IX. Duty of Care & BJR

- a. Directors owe their corporations fiduciary duties of loyalty, candor, and care
 - iv. Unless you can show that a director had a duty to disclose something & didn’t, stood on both sides of a transaction with the corporation, improperly seized a corporate opportunity for herself, and so on, all you’re left with is a claim that a director made a really bad decision
 - 1. We call such claims breaches of the duty of care
 - a. Example: hiring a president who turns out to be terrible; Making an extraordinary dividend distribution without thinking about the terrible tax consequences, thus costing the corporation tens of millions for no good reason.
 - v. Few individuals would be willing to serve as directors/partners/officers/managers if they could be exposed to liability for decisions that turn out to have been bad.
 - vi. Courts protect directors against liability for negligent (and probably grossly negligent, but not reckless or intentional) breaches of the duty of care through the business judgment rule.
 - vii. The business judgment rule is a presumption that courts will not 2nd guess director’s disinterested, informed good faith exercises of business judgment.
 - 1. If the business judgment rule applies, the plaintiff loses on a breach of duty of care claim.

Eisenberg v. Flying Tiger Line: π was a SH of ▲-corp & filed suit against ▲-corp to overturn a reorganization & merger that he alleged was intended to dilute his voting rights. ▲ organized a wholly owned subsidiary FTC → FTC organized FTL; 3 corporations merged into FTL & FTL took over operations; π is claiming that his vote was taken away, not that the corp’s vote was taken away; it was a direct action b/c he’s arguing his position, not the position of the corp.; the SH’s of the first corp. moved to the holding company away from where all the operations were; π was denied to vote on certain things; he argues that he can’t influence the company now (he doesn’t actually argue this b/c he brought a derivative suit, not a direct one)

- d. Case distinguishes harm to SH (direct action) from harm to corp. that diminishes value of the shares (derivative action)
 - i. Direct actions-generally request injunctive relief
 - ii. Derivative actions- generally seek damages for harm done to the corp.
 - iii. This was a nuisance suit b/c π didn't lose much in voting rights
 - iv. Eisenberg is trying to do form over substance; substantively, he hasn't suffered anything; other side can argue that he didn't suffer any injury; created a nuisance

Cohen v. Beneficial Industrial Loan: π alleged that managers & directors of \blacktriangle corp. have abused their positions to enrich themselves personally at expense of corp. π issued a demand, but it was refused. He owned very little of the company; state law required that people who own a small interest to pay reasonable expenses & atty's fees of the D's. Also required π to post a bond to ensure they would meet potential burden; π argued this was unconstitutional

- e. Court held statute should be followed; legislature enacted such a regulation remedy abuse of the derivative suit; here, b/c he is a rep for others, state has power to make him post security b/c he is responsible for protecting the interests of others
- f. Rule: SH derivative suits will still have to follow applicable state laws; states are within their rights to determine how they want to resolve competing interests
- g. Under Erie Railroad v. Tompkins (SCT 1938): 1) Federal law governs procedural issues 2) State law governs substantive issues
- h. Is the NJ security for expenses statute substantive or procedural?: Substantive because it creates a new liability, as well as a condition on standing
- i. Role of Special Committees
 - i. BoD may work through subcommittees
 - ii. Board may delegate authority to investigate & make determination regarding whether it is in the Corp's best interests to continue derivative litigation
 - iii. Special Litigation Committees (SLC)
 1. Is composed of independent, disinterested directors (i.e. outside of corp – not CEO) who make a informed (after reasonable investigation), good faith judgment to dismiss the derivative suit, that decision is reviewed under the business judgment rule
 2. Zapata twists this a little – created a 2 step process –
 - a. Review of independence & good faith of SLC (corporation burden)
 - b. Court applies its own business judgment whether to grant the motion

The Requirement of demand on the directors:

FRCP 23.1/Del. RCP 23.1:

In a derivative action brought by one or more shareholders ... to enforce a right of a corporation ... the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder ... at the time of the transaction of which the plaintiff complains or that the plaintiff's share ... thereafter devolved on the plaintiff by operation of law, and

(2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. **The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders ..., and the reasons for the plaintiff's failure to obtain the action or for not making the effort.**

The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders ... similarly situated in enforcing the right of the corporation The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders ... in such manner as the court directs.

What is "The Demand"? : Typically a letter from shareholder to the board of directors.

- Must request that the board bring suit on the alleged cause of action
- Must be sufficiently specific as to apprise the board of the nature of the alleged cause of action and to evaluate its merits
- “At a minimum, a demand must identify the alleged wrongdoers, describe the factual basis of the wrongful acts and the harm caused to the corporation, and request remedial relief.” *Allison v. Gen. Motors Corp.*, 604 F. Supp. 1106, 1117 (D. Del.), *aff’d mem.*, 782 F.2d 1026 (3d Cir 1985).

Demand futility

- A) Demand required
 - Unless excused
 - Excused when futile

B) What is standard for demand futility?

Del: *Grimes v. Donald*

NY: *Marx v. Akers*

Grimes v Donald: Facts. Plaintiff filed an action against the Board and Donald in order to invalidate Donald’s employment agreement. Donald and the Board agreed upon an agreement that would run until Donald’s 75th birthday. The agreement provided a salary, incentive plans and health insurance. The agreement vested to Donald the “the general management of the affairs of the Company.” The agreement further provided that if Donald was “constructively terminated without cause,” (which would be when there is “unreasonable interference, in the good-faith judgment of [Mr. Donald], by the Board or a substantial stockholder of the Company, in [Mr. Donald’s] carrying out his duties and responsibilities under the Agreement”), he would be eligible for a generous retirement package. Plaintiff understood this provision as the Board abdicating their management responsibilities to Donald. Plaintiff wrote the Board, demanding that they invalidate the agreement. The Board responded, explaining that a third part helped to develop the agreement, and that the Board was still capable of managing the company with this agreement in place. Plaintiff then brought suit, and added additional claims against the conduct of the Board.

Issue. The issue is whether Plaintiff’s pre-suit demand waives his right to contest the independence of the Board on all of his claims.

Rule of Law. A plaintiff, by making a demand, waives his right to contest the independence of the Board of Directors, and the effect of the demand will apply for all of a plaintiff’s stated claims.

Grimes v. Donald: Demand Futility

“One ground for alleging with particularity that demand would be futile is that a ‘reasonable doubt’ exists that the board is capable of making an independent decision to assert the claim if demand were made.”

“The basis for claiming excusal would normally be that: (1) a majority of the board has a material financial or familial interest; (2) a majority of the board is incapable of acting independently for some other reasons such as domination or control; or (3) the underlying transaction is not the product of a valid exercise of business judgment.”

Test derives from *Aronson v. Lewis* (Del. 1984)

Delaware Legal Standard for Demand Futility

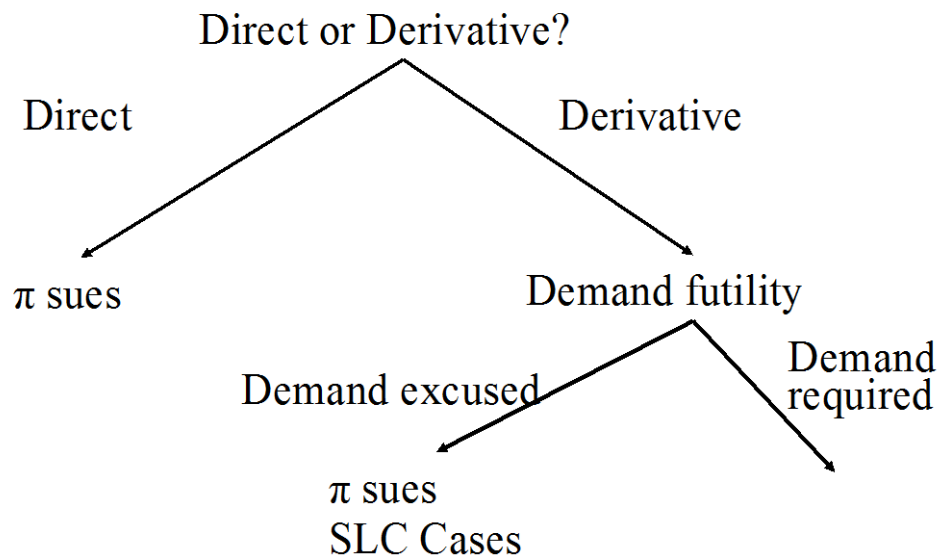
Plaintiff must allege particularized facts (pre- discovery using the “tools at hand”—including DGCL § 220) creating a reasonable doubt that the board is capable of making a good faith decision on suit:

1. Majority of board has material financial or familial interest
2. Majority of the board lacks independence (domination and control by wrongdoers)

3. Challenged transaction not product of valid exercise of business judgment

4. Disjunctive

Derivative Litigation Decision Tree

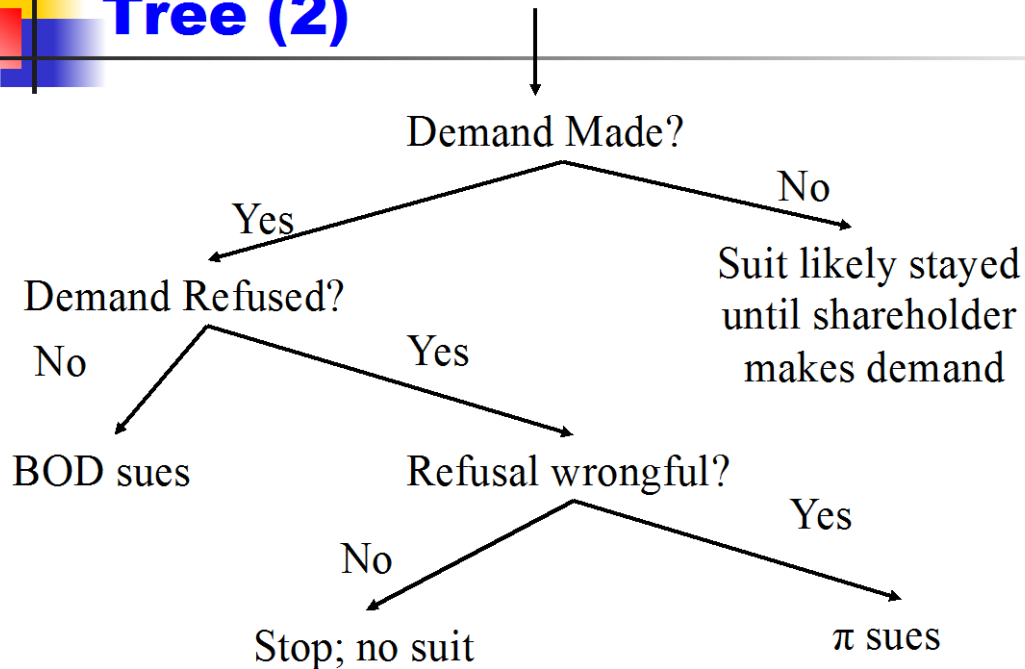


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If a demand is made and rejected, the board rejecting the demand is entitled to the presumption of the BJR unless the stockholder can allege facts with particularity creating a reasonable doubt that the board is entitled to the benefit of the presumption. If there is reason to doubt that the board acted independently or with due care in responding to the demand, the stockholder may have the basis ex post to claim wrongful refusal. The stockholder then has the right to bring the underlying action with the same standing which the stockholder would have had, ex ante, if demand had been excused as futile.

Derivative Litigation Decision Tree (2)





cision to refuse demand

Marx v. Akers: Plaintiff challenged Defendants' decision to increase three of the outside director's compensation to \$55,000 plus 100 shares of IBM stock. The increase was above the rate of the cost of living, and the company under Defendants has been struggling. Therefore, Plaintiff asserted that the compensation was excessive. Defendants argued that only three directors were affected by the compensation increase, and therefore a majority of the Board had no interest – and therefore demand was not excused. Defendants also argued that Plaintiff only asserted conclusory statements and did not assert with particularity any facts to establish that the compensation was excessive.

Issue.• The first issue is whether demand was excused because the directors had an interest in their own compensation.
• The second issue is whether Plaintiff asserted a factually-based claim against Defendants.

Held.• Demand was excused because the Defendant Directors have an interest in their own compensation.

• The Plaintiff did not adequately support his claim and therefore the suit should be dismissed. Other than asserting that the compensation was excessive, Plaintiff did not demonstrate with particularity what accounting decisions or any other facts that would establish the excessiveness of the raises.

Discussion.• The Court looked at universal demand, which would be to require demand in all instances, and the Delaware reasonableness approach, but they applied New York's statutory "particularity" requirements.

• The court does not provide much guidance as to a precise threshold to establish the excessiveness. Plaintiff established that the compensation was greater than the cost of living increase, and established that the company was not prospering under the current Board, but this was not enough.

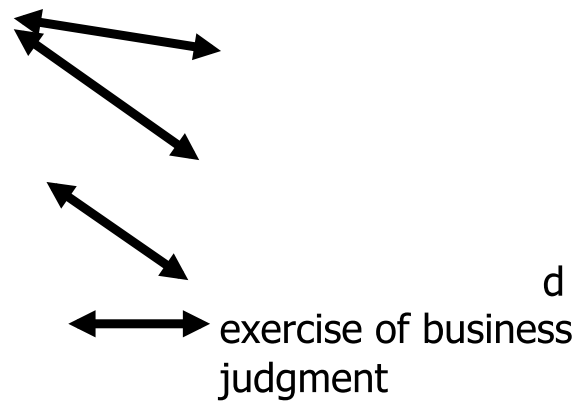
"[I]n New York, a demand would be futile if a complaint alleges with particularity that

(1) a majority of the directors are interested in the [challenged] transaction, or

(2) the directors failed to inform themselves to a degree reasonable necessary about the [challenged] transaction,

or

(3) the directors failed to exercise their business judgment in approving the [challenged] transaction.”



Longtime Delaware Standard : Aronson v. Lewis, 473 A.2d 805 (Del. 1984):

Chief wrongdoer owned 47% of the corporation’s stock and allegedly had personally selected each board member.

The supreme court held that this did not render the board per se incapable of exercising independent judgment.

Instead, **plaintiff must “demonstrate that through personal or other relationships the directors are beholden to the controlling person.”**



Versus

ation when it
is evident that directors
will wrongfully refuse to
bring such claims” – *Marx*

Role of special committees:

Auerbach v. Bennett: ▲ used special counsel to help investigate \$11M in bribes & kickbacks-4 directors personally involved; π sued in a derivative action on behalf of GTE against all the directors; alleging breach of corporate duties & seeking damages as reimbursement for the wrongful payments; BoD created SLC to investigate derivative action & determine what GTE’s position should be; committee comprised of 3 disinterested directors who had joined the board after the alleged transactions had occurred; committee concluded that ▲ had acted in accordance with general auditing standards & in good faith, that none of the Ds had violated their statutory duty of care or profited personally & that no proper interest of GTE or its shareholder would be served by continuing the claim against it – voted to dismiss suit

- j. Court may properly inquire as to the adequacy & appropriateness of a SLC’s investigative procedures & methodologies, but may not consider factors under the domain of business judgment
- k. The BJR recognizes that courts are ill-equipped to evaluate what are & essentially must be business decisions
- l. However, this rule shields the deliberations and conclusions of a SLC only if its members possess disinterested independence & do not stand in a dual relation that would prevent an unprejudiced exercise of judgment
- m. Court considered:
 - i. Disinterested independence: none of the committee were members of the board when the illegal payments took place
 - ii. Adequacy of Investigation: completeness of areas and subjects of inquiry; committee made a good faith inquiry
 - 1. Burden of proof is on P
 - iii. Committee’s decision not to pursue litigation came w/in sphere of BJR

iv. Courts are only able to evaluate procedural conduct of the committee

The court observed: “As all parties and both courts below recognize, the disposition of this case on the merits turns on the proper application of the business judgment doctrine, in particular to the decision of a specially appointed committee of disinterested directors acting on behalf of the board to terminate a shareholders' derivative

action. . . . In this instance our inquiry, to the limited extent to which it may be pursued, has a two-tiered aspect.”

What did court mean by “a two-tiered aspect”? a) First tier: Illegal payments

b) Second tier: Committee recommendation on terminating the litigation



cial scrutiny

Zapata v. Maldonado: π is a SH in \blacktriangle -Corp and sought to prevent the dismissal of his derivative action against \blacktriangle following the recommendation for dismissal by a Corp-appointed investigative committee; π didn't demand that the Board first bring action b/c all directors were named as \blacktriangle 's and allegedly participated in his wrongful acts; excused as futile; 4 of the named directors left the board, and 2 outside directors were appointed – the board created an independent investigation committee, comprised solely of the two new directors to investigate the allegations and see if the litigation should continue; the new committee decided that the action should be dismissed because it was not in D's best interest

- n. **There is a right to initiate a suit after a demand is refused; there is no absolute right to continue to control it**
- o. **2 contexts in which suit can be brought: (1) demand was made & refused; court will defer unless decision was wrongful; (2) no demand b/c it would be futile**
- p. Refinement of SLC analysis to **two-step test:**

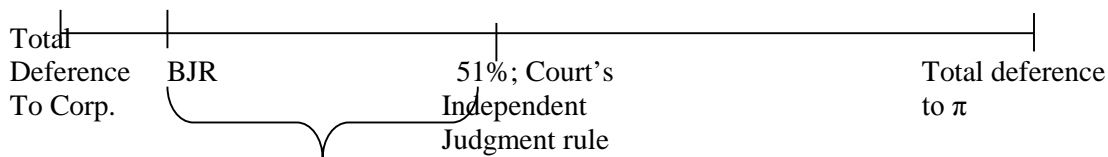
- q. Step One
 - i. Inquire into the independence and good faith of the committee
 - ii. Inquire into the bases supporting the committee's recommendations
 - iii. BURDEN IS ON THE CORPORATION
 - iv. Difference from Auerbach is that the court decides whether there was a reasonable basis for the decision
- r. Step Two
 - i. Court's independent inquiry – court may apply its own business judgment as to whether the case is to be dismissed
 - ii. Standard for court: (1) Does the corp have a compelling interest in having the suit dismissed; (2) matters of law and public policy.
 - iii. This step allows meritorious suits to go forward and accounts for structural bias problems
- s. When asserting a SLC's motion to dismiss derivative action, court must:
 - i. Determine whether the committee acted independently, in **good faith**, and made a reasonable investigation
 - ii. Apply the court's own independent business judgment
- t. A board has the power to choose not to pursue litigation when demand is made upon it, so long as the decision is not wrongful
 - i. Where demand has been excused, court have struggled between allowing the independent business judgment of a board committee to prevail & yielding to unbridled P stockholder control
 - ii. The test here allows for balancing these competing interest under appropriate court supervision – while courts should be mindful of judicial overreaching, the interests at stake necessitate the fresh view of a judicial outsider
- u. Prof's notes:
 - i. If SH sues entire board, and board replaces it w/ a new board, no need for a committee
 - ii. Board of director makes decision as to accept demand at the beginning
 - iii. Down the road, it can make a decision to terminate
 - 1. SH has right to initiate suit; board has power to cut it off
 - iv. When initiating suit, defer to BJR
 - v. When determining whether to terminate, there is a higher standard & a committee is necessary (majority of board is new or disinterested)
 - vi. If court applies its own business rule, can look at Corp's reasonableness; for Corp to show this would require a less than 51%

3. Test:

- a. Pretrial motion to dismiss filed by Corp.
 - i. Corp must meet the requirements of R. 56
- b. Court must question the independence and good faith of the committee
 - i. Corp has burden of proof
 - ii. Limited discover may be ordered
 - iii. If court determines it was not independent → deny motion
 - iv. If ok → go to step 2
- c. Consider how compelling the corporate interest is
 - i. Consider public policy

4. The standard:

- a. Reasonable is more than rational; court tries to reach middle ground between corp. & SH



Depends on circumstances; court will keep its eye out for injustice while sitting on the left end; resembles the doctrine of piercing the corporate veil in that there is a general rule, but court will keep its eye out for anyone abusing it



“Matters of law and public policy”

In Re Oracle: SH's of Oracle accused some of its directors of insider trading and began derivative suit; *in general, can't institute a derivative suit until you either ask directors to look into problem or can convince court that it would be futile to ask b/c majority of the directors are somehow involved*; Oracle formed special committee to look into SH's claims; it consisted of 2 of Oracle's outside directors that had no financial stake in the insider trading allegations; special committee found no wrongdoing; SH's sued again; SH's argued that directors on special committee were not disinterested b/c they were personal friends of accused directors; accused directors argued that friendship didn't matter, and that the only way the directors on the *special committee* could be found to not be disinterested was if there was "domination and control." Court said that they were not independent, *so their findings didn't preclude a derivative suit*; directors worked at a college that got lots of donations from directors

- b. Test: when evaluating whether a director is "disinterested" you have to look as broadly as possible. It isn't just a financial connection, or the ability for an interested director to 'punish them' (by firing them for example), you also have to look at non-economic social ties, or anything else that could affect that director's loyalties.
- c. **Note** that ruling is probably limited to situations where there is a director accused of wrongdoing. In situations where an independent committee is required to negotiate a merger or similar transaction that wouldn't cause require a decisionmaker to accuse a friend of wrongdoing, personal friendships are much less likely to be a basis for deciding that a director is compromised.; *avoidance of social awkwardness*
- d. Question of independence turns on whether a director is, for any substantive reasons, incapable of making a decision w/ only the best interest of the corp. in mind
- e. Had they come forth w/ the conflict, maybe would've come out differently



tween Oracle, the Trading Defendants, and any of the other defendants, on the one hand, and the SLC's advisors, on the other.



assumed to be non-independent.

al ties, to be





the
law and economics movement. Homo
sapiens is not merely *homo economicus*.
... [T]hink of motives like love, friendship,
and collegiality....”



eneral matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.”



ion in mind. That is, ... focus on
impartiality and objectivity.”





ether the substantive standard of independence in an SLC case differs from that in [other cases]

Indemnification and Insurance

- A. Situations that might give rise to liability
 - a. Claims by 3rd parties
 - b. Amount of damages is large in relation to individual wealth of officers
 - c. Corps may able to buy insurance to cover damages & expenses of defense
 - d. Officers & directors need to be concerned the corp. will be taken over by hostile persons
- B. In an indemnification/derivative suit, judgment is against director, and there's no indemnification b/c corp. would essentially be paying itself; if a director is liable, **he** must pay the corp. & indemnification would counteract the fact that he was liable
 - a. Best way for π to get paid is to plead everything (duty of care, loyalty, etc.)
 - b. Indemnification: obligation of a corp. to reimburse a director or pay in first instance for liabilities incurred by agent; pyt by a principal to the agent for liabilities incurred by its agent in connection with the agent's action on behalf of the principal; Waltuch, Citadel
 - c. **Note**: this limits only the monetary liability of directors-equitable remedies still available
- C. Limitations on Director's Liability
 - a. Statutory protection: legislation protects directors & officers, DE §102 & 145
 - i. Allows corp. to reduce (reckless conduct or intentional acts) or to eliminate director liability via charter & bylaws
 - ii. §102(b)(7) only applies to directors and says that certificate may contain a provision eliminating or limiting personal liability of director to corp. or its SH for monetary damages for breach of fiduciary duty, but the provision doesn't eliminate/limit liability for breach of loyalty, for acts or

- omissions not in good faith or which involve intentional misconduct or a knowing violation of law or for any transaction for which he derived an improper personal benefit
- iii. Officers also subject to duty of care, but are denied pardon by charter provision
- iv. If someone is a director and officer, §102(b)(7) only applies to actions taken solely in his capacity as director
- b. Articles of incorporation to include name of corp, address, nature of business, classes of stock, shares, book value, name and address of incorporators
- c. Articles of incorporation may include provisions of governance, majority or supermajority vote, provide for pre-emptive rights, limit on duration of corp, limit/elimination of personal liability of director for monetary damages for breach of fiduciary duty
- d. §102(b)(7) permits statutory exculpation provisions in articles
 - i. Excludes liability limitation for: breach of duty of loyalty, acts not in good faith, knowing violations of law, insider trading or securities manipulation
- e. Rights to indemnification: specified in every charter & statute
 - i. Two types of indemnification
 - 1. Permissive: corp. is allowed to indemnify officers & directors
 - 2. Mandatory: corp. must indemnify officers & directors

Waltuch v. Conticommodity Services: π sought indemnification of his legal expenses (\$2.2M) from his former employer after lawsuits against him were dismissed- π traded silver for firm; market collapsed & everyone sued him

- D. Indemnification rights can be broader than what is in statute as long as they are consistent w/ the corp.'s power to indemnify
- E. Corporate director/officer who has been successful on the merits or vindicated from the claims asserted against him is entitled to indemnification from corp. against reasonably incurred legal expenses
 - a. Here, π was successful on merits b/c suits were dismissed w/ prejudice w/o any liability on his part; since he agreed to forego his opportunity to show at trial that he acted in good faith, he is not entitled to indemnification under that provision
 - b. \blacktriangle argues that they didn't have to reimburse under §145(a) b/c he hasn't acted in good faith, but π argues that §145(a) isn't exclusive; he relies on §145(f)
 - i. Right v. power-need power before you get any rights; \blacktriangle says we don't have power to do this
- F. Statutes in case
 - bb. **§145(a)** – indemnification requires that the agent act in good faith
 - cc. **§145(f)** - The corporation can indemnify the person more if they choose to do so, but it must still be consistent with §145(a). This means you cannot get rid of or ignore the good faith requirement.
 - i. “Indemnification rights may be broader than those set out in the statute, but they cannot be inconsistent with the ‘scope’ of the corporation’s power to indemnify, as delineated in the statute’s substantive provisions.”
 - dd. P argues that **§145(c)** mandates indemnification where the D was “successful on the merits or otherwise”
 - i. Success on the merits – ask what was the result and not why. Success is different from complete exoneration/being found innocent.
 - ii. What does it mean to be successful?
 - iii. What’s missing in (c) is the power; it talks about rights of director/officer
 - iv. P argues that he was successful on the merits in the private lawsuits b/c they were dismissed w/ prejudice w/o any payment of assumption of liability by him
 - v. The court found that P’s settlement and dismissal of claims against him were sufficient to be success on the merits or otherwise, regardless of fact that D paid the settlement in the private case.
 - vi. Thus, D was liable for P’s legal fees in the private case.
 - vii. §145(g) expressly contemplates the lack of existence of power; if outside realm of good faith, corp. has conditional power to purchase insurance
 - 1. (a) allows corps. To circumvent good faith clause by purchasing liability insurance policy
 - ee. Plain text reading of statute; difference between “corp. shall have power to indemnify” and “director shall have right to be indemnified”
 - i. Look at the context (purpose of statute, other statutory provisions that support your interpretation, limitation on power, policy-would it be a good idea to allow indemnification under the circumstances, make sense of everything)
 - ff. If there’s a suit under duty of care→even if unsuccessful, can they still reimburse?
 - i. “C” provides for indemnification to a limited extent; co. can offer a greater expense;

ii. "F" says director not limited to "c," but still has to stay w/in the bounds of "a."

2. Article Nine of Conticommodity's articles of incorporation provided:

3. The Corporation shall indemnify and hold harmless each of its incumbent or former directors, officers, employees and agents ... against expenses actually and necessarily incurred by him in connection with the defense of any action, suit or proceeding threatened, pending or completed, in which he is made a party, by reason of his serving in or having held such position or capacity, except in relation to matters as to which he shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of duty.



ation."

- It only requires escape.



cement is merely
permissive under §145(e).

- §145(f) likely allows indemnification of certain expenses not contemplated by the statute.

4. **Distinction between indemnification, reimbursement & advancement of legal fees**

- i. Indemnification: payment of someone else's legal fees
- ii. Reimbursement: payment of legal fees after they've been paid by the claimant (pay claimant after the fact).
- iii. Advancement of Legal Fees: you need to get your money upfront!
 1. When the corp. enters into a contract with you to represent the client, the corp. agrees to advance the money to pay for it, but they have no say in the representation
 2. "Undertaking" is just a written promise to repay the legal fees if not successful on the merits or otherwise.
 3. Most statutes permit advances of legal fees upon giving an "undertaking"

Note on Insurance: many corporations carry director & operator insurance these days

UNIT V: SHAREHOLDING VOTING:

CORPORATE DEMOCRACY

- A. Agenda → annual meeting → SH proposals → proxy solicitations → vote
- B. SH proposals, Fed. §14(a)(8)-gives SH right to place proposals on the agenda; only applies to publicly traded firms
 - a. Rule supersedes state rules

- b. SH must meet procedural requirements (must own certain # of shares), give proposal to Board & SEC
- c. Once the procedural requirements are met, company must put the proposal on the agenda **UNLESS**
 - i. SEE HANDOUT
- d. BoD is authorized to make decisions for the company, including setting compensation
- e. If SH has a strong preference, maybe the board will include it in the proposal

Nomination Process

- A. Board nominates candidates, usually themselves
- B. For publicly traded companies (NASDAQ & NYSE), follow listing rules, which supersede state law
 - a. NASDAQ & NYSE require a nominating committee composed of independent directors
- C. Proxy solicitations-get a proxy card; could say that you authorize management to vote for them on your behalf
- D. Proxy Fights: insurgent groups (who believed their policies would yield higher profits & returns for investors) would seek to elect insurgent slate of directors to replace incumbent board
 - a. Each side tries to campaign for their position to get people to vote on their behalf
 - b. In a proxy contest, a group of SH's submit a proxy that is in competition w/ board
 - i. Usually deals w/ nominating board members
 - ii. SH is responsible for the expenses himself
 - iii. §14(a)(7), under SEC, company is obligated to give you a list of all SH's or it will send the proxy materials on your behalf if you paid for it
 - iv. Management will lobby all SH's. Dissidents can't do this b/c identity of SH's is private information
 - v. In practice, dissidents know about 70-75% of shareholders
- E. Insurgents rarely win. Why even launch it?
 - a. Controlling bloc doesn't necessarily mean a majority; not very many people submit their proxies
 - b. If aligned w/ board, more difficult for insurgents to wage a proxy war
 - c. **There is a safe harbor if there is SH ratification**
- F. Election of directors-1M proxies; brokers not allowed to vote

Problems of Control

- A. Proxy Fights
 - a. Proxy: authorization for an agent (the proxy) to vote the SH's share
 - i. SH must disclose to proxy how it will vote
 - ii. Proxy solicitation is usually governed by state law, but federal law governs rules of disclosure of what proxy solicitors must disclose when soliciting
 - b. Proxy Solicitation
 - i. Firm is hired to contact all SH's
 - ii. BoD of X Corp. solicits your proxy on the following matters that will be brought to vote at annual meeting
 - 1. . . .
 - iii. Rules may impose substantive requirements of fairness of voting
 - iv. Requires SH approval: mergers, some acquisition, sales, some corporate reorganization & fundamental changes to articles of incorporation
 - v. Solicitation is mailed to all the individual SH & for most part, people don't read it unless they are institutional investors & have a large stake in the company
- B. **Dynamics of Shareholder Voting:**
 - a. **Limited number of matters**
 - b. **State corporation statutes** (e.g., **Del §211**): SH MUST have an annual meeting
 - i. A lot of shareholders in big companies do not attend meetings and will give a proxy to an agent to cast their vote
 - ii. **Del §212** – authority for SH's to vote in person, by proxy or in writing
 - iii. **Collective Action Problem**: Tension between specializing functions versus monitoring agents actions
 - c. **Proxy process**
 - i. Board selects date of annual meeting (**§211(a) & §211(d)**) Can be as few as 10 days or as many as 60 days
 - ii. Board fixes record date (date which the shareholder list is finalized before the annual meeting)

1. If a shareholder shares after the record date & the date of the annual meeting, you still have the right to vote because you were a shareholder as of the record date
- iii. Board selects its preferred slate of director nominees and defines appropriate issues for shareholder action
- iv. Proxy solicitations are drafted and filed with the SEC
- v. SEC review solicitations
 1. Must fully disclose major issues
- vi. Identification of shareholders owning shares
- vii. Mailing of solicitations




s title

SEC PROXY RULES: 14a-3: Incumbent directors must provide **annual report** before soliciting proxies for annual meeting. Anyone who “solicits” a proxy must provide a written proxy statement **BEFORE** soliciting the proxy.

Levin v. MGM: π & ▲ were fighting for control of MGM, and each was campaigning for their directors to be elected at annual SH meeting; ▲’s used resources of co. and hired outside assistance to promote candidates, but π’s didn’t allege fraud or corruption; MGM limited proxy solicitation budget to \$125K; issue is whether directors of a co. can use co. resources to solicit proxies for upcoming vote for directors

- A. Incumbents can use corporate funds and resources in a proxy contest if the sums are not excessive and SH’s are fully informed; amounts must be reasonable; there must not be any fraud or corruption; no statute prohibiting solicitation



Levin v. Metro-Goldwyn-Mayer, Inc. (S.D.N.Y. 1967)

“It is quite plain that the differences between ‘the O’Brien group’ and ‘the Levin group’ are much more than mere personality conflicts.”

“The controlling question presented on this application is whether illegal or unfair means of communication ... are being employed by present management.”

“We do not find the amounts recited to be paid excessive, or the method of operation disclosed by MGM management to be unfair or illegal.”

19

B.

Rosenfeld v. Fairchild Engine & Airplane: Old board and new board of directors spent over \$250K each in soliciting proxies for a SH vote of new directors; old board was reimbursed for reasonable expenditures in defending their positions; π, a SH, brought a derivative suit to have the money that had been paid to both sides returned to the corp.

- A. Directors can be reimbursed for expenses in a proxy fight
- B. In contest over **policy**, corp. directors have right to make reasonable & proper expenditures from corp. treasury for purpose of persuading SH of correctness of their position & soliciting their support for policies that directors believe in good faith, are in best interests of corp.
- C. When directors act in good faith in contest over policy, they have right to incur reasonable & proper expenses for solicitation of proxies and in defense of their corporate policies, are not obligated to sit by
- D. SH can reimburse successful contestants for reasonable expenses
- E. Giving SH a choice between 2 sides is good, as long as they are working from a position of policy, the policy difference is a benefit to corp.
- F. What are reasonable expenses; disclosure statement to SH, phone solicitations, in person visits to major SH (inc. wining and dining and using private jet)
- G. As long as there is a good faith and no entrenchment, court will defer to directors (similar to BJR)
- H. Dissent: says there is a lot of waste and that burden should to be management to explain the expenditures
- I. Basic Rules
 - a. Corp. can't reimburse either party unless disputes concerns questions of policy
 - b. Firm may reimburse only reasonable & proper expenses
 - c. Firm may reimburse incumbents whether they win or lose
 - d. Firm may reimburse insurgents only if they win and only if SH's ratify the payment

- J. §145(g)-Corp. shall have power to purchase & maintain insurance on behalf of any director, officer, employee...against any liability asserted in any such capacity...
- K. Proxy creates an agency relationship because the proxy votes on behalf of the stockholder
 - i. If a stockholder does not like the proposal, he make seek proxies to start a proxy contest and oppose the proposal
 - ii. If a party soliciting proxies wins, then they can force the corporations to reimburse them for costs – you cannot get reimbursed if it is for the purpose of a power grab (must be policy involved)
 - 1. If the soliciting party loses, there is no money reimbursed to the losing party
- L. Process:
 - a. SH must own stock 60-90 days before annual meeting in order to vote & must own shares on the record date to vote. (BoD specifies the “record date”)
 - b. Shareholders can have proposals to be voted on at meetings; BoD sets agenda & lists nominees
 - c. Must file proxy solicitations with the SEC
 - d. Corporation must convey a proxy statement in manner understood by the average investor
 - e. If the old proxy statement has false/misleading info, a new proxy statement must be released
- M. **Private Action for Proxy Fraud – Distinction btwn common law fraud, securities fraud, and proxy fraud:**
 - a. **Common law fraud:** (1) misrepresentation or misleading omission; (2) of material fact; (3) scienter; (4) reasonable detrimental reliance; (5) causation; (6) damages.
 - b. **Rule 10b-5:** (1) misrepresentation or misleading omission; (2) of material fact; (3) scienter; (4) [FOTM = reliance & causation]; (5) damages [also technically shown with FOTM].
 - c. **Section 14(a):** (1) misrepresentation or misleading omission; (2) of material fact; (3) in a proxy solicitation; (4) damages.

SHAREHOLDER PROPOSAL: Shareholders inserting their own proposals in the Mgmt’s proxy.

Lovenheim v. Iroquois Brands Ltd.: Rule of Law. Under Rule 14a-8(c)(5), a shareholder proposed resolution for a proxy statement can only be turned down when the proposal both concerns less than 5% of total earnings or assets, and when it is not significantly related to the business.

Facts. Plaintiff wanted to insert a proposal to determine whether a supplier of pate de fois gras force-fed the geese in order to enlarge the livers. The pate represented less than .05 percent of Defendants sales, and the product operated at a loss. Therefore Defendants wanted to omit the proposal. Defendants believed that only a proposal related to economic purposes are required to be accepted per Rule 14a-8(c)(5), and that the 5% threshold was not exceeded. Plaintiff argued that material social issues that were relevant to the business would not fit under the Rule’s exception.

Issue: The issue is whether a company could refuse a shareholder proposal for a proxy statement if the proposal concerned less than 5% of the business sales, and the proposal was not economically based.

Held: The court held that precedent demonstrated that Rule 14a-8(c)(5) would only omit proposals that were less than the minimum 5% of sales and not significantly related to the business. In this case, the pate issue was significant to its pate business regardless that it did not comprise greater than 5% of sales. Prior cases also demonstrated that Congress wanted to ensure that non-economic factors could be considered as relevant to the business.

Discussion. The court holds that both sections of Rule 14a-8(c)(5) need to be met. The ruling is consistent with the idea that not all decisions made by a corporation will be made solely along economic lines.



n the company' s proxy statement

- Expense thus borne by the company



Personal grievance /
special interest

- Management functions
- Substantially implemented
- Others

Substantive grounds for exclusion: Effect of non-binding phrasing: Why? : Rule 14a-8(i)(1): “If the proposal is not a proper subject of action for shareholders under the laws of the jurisdiction of the company’s organization”

It must be an action which it is proper for shareholders to initiate (such as a bylaw amendment) Look to state law to decide that question E.g., DGCL 141(a) If shareholders not allowed to initiate, still ok if phrased as non-binding request

14a-8(i)(5):

If the proposal relates to operations which account for less than 5 percent of the company’s total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company’s business.

- Rule 14a-8(i)(2)—Violation of law
- Rule 14a-8(i)(4)—Personal grievance
- Rule 14a-8(i)(6)—Absence of power
- Rule 14a-8(i)(7)—Ordinary business matters
- Rule 14a-8(i)(8)—Proposals relating “to an election for membership on the company’s board of directors”

PROXY ACCESS:

AIG v. AFSCME: AFSCME submitted a SH proposal to AIG which would amend the AIG bylaws to require the Co. to publish the names of SH's nominated candidates for director positions; AIG wanted to exclude the proposal under R. 14a-8(i)(8); SEC said it could be excluded; the issue was whether under R. 14a-8(i)(8), a SH proposal relates to an election if it seeks to amend the corporate bylaws to establish a procedure

- A. Language in statute was ambiguous; court looked at interpretation by regulatory body (SEC)
 - a. Two interpretations
 - i. **Exclusion applies only to SH proposals used to oppose solicitations dealing w/ an identified board seat in an upcoming election**
 - ii. Exclusion applies to SH proposals that would institute procedure making such election contests more likely
- B. Justification for SEC argument that the exclusion applies to elections in general-don't need to many nominees; discouraging contests; makes it hard to get on the ballot to have proxy contests; if SEC comes in and makes it easy, state corporate law will be frustrated
- C. Practical policy concerns-labor unions may be concerned about union members, concerned about pension funds
- D. Incumbent directors may not be put on the board specifically b/c of their buyers; have fiduciary duty in nominating 1 director by other
- E. Trying to get a good return on their pensions
- F. **Rule:**A shareholder proposal does not relate to an election under the SEC's rules for exclusion from a proxy statement if it seeks to amend the corporate bylaws to establish a procedure by which certain shareholders are entitled to include.



(v) Otherwise could affect the outcome of the upcoming election of directors."

Proposals not permitted to be excluded: a) qualifications of directors or board structure (so long as the proposal will not remove current directors or disqualify current nominees);

b) voting procedures (such as majority or plurality voting standards or cumulative voting);

c) nominating procedures (other than those that would result in the inclusion of a shareholder nominee in the proxy materials)

CA v. ASCME: AFSCME was a CA SH; it submitted a SH proposal to amend CA's bylaws; proposal would require that CA reimburse the reasonable expenses incurred by a dissident nominating a rival slate of directors, provided that at least one nominee is victorious; directors of CA objected to proposal and asked SEC to exclude it from proxy statement; CA argued that SH proposal was improper b/c under §141(a), decision as to whether or not to reimburse election expense was at the discretion of the directors. SEA 14a-8 allows exclusion of SH proposals that would be illegal; AFSCME argued that §109 grants SH's the right to adopt bylaws. So their SH proposal was legal and 14a-8 did not apply

A. In general, the proposed bylaw related to director elections was a proper subject for SH proposal under 14a-8

B. But found that a SH proposal to amend the bylaws in the way AFSCME wanted would violate law b/c it **mandates** reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude or cause CA to violate DE law

C. Prof's notes

a. 2 issues

i. Is this a proper subject for a bylaw?

1. Yes. A SH proposal may not deal with substance, only w/ procedure, and this does so
2. Justification-141a-board controls management, not SH

ii. If it is, would it nevertheless be invalid?

1. Certificate can be amended-BoD has to suggest the proposal; has to be approved by the BoD & SH's
2. Who can amend bylaws-coextensive power
3. Bylaws are for process; have to accomplish something
4. In this case, proxy statement deals w/ reimbursement
5. CA says it is not a proper subject b/c it forces CA to spend \$
6. Proper under law, but can't do it

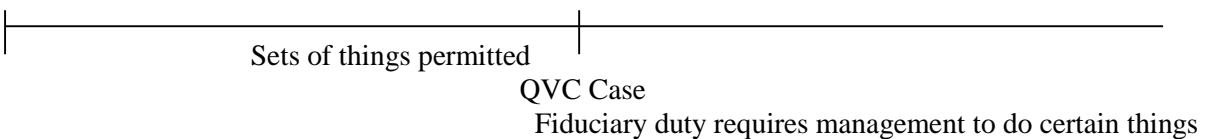
a. Court did not make it clear when it would be proper

b. Bylaw that puts a term limit on a director is valid b/c is procedural and doesn't infringe upon a director's fiduciary duties

c. Bylaw consistent with law?" "To the extent that a contract ... purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable."

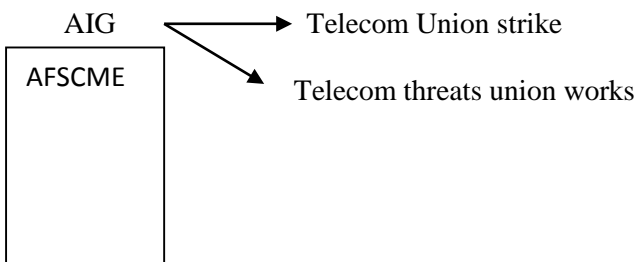
d. "[T]he Bylaw contains no ... provision that would reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all."

e. Scope of fiduciary duties



- If bylaw touches something BoD is permitted to do

- **Rule: SH can't infringe on what a BoD is permitted or required to do**



SHAREHOLDER INSPECTION RIGHTS: [Rule 14a-7](#)

If company makes a proxy solicitation and a shareholder makes a request the company must either:

a) Mail the requesting shareholder's soliciting materials to the shareholders (at the soliciting shareholder's expense) OR

b) Provide a shareholder list

Section 220(c): a) If shareholder only seeks access to the shareholder list, BoP on the corporation to show that shareholder doing so for an improper reason

b) If shareholder seeks access to other corporate records, BoP on shareholder to prove requisite proper purpose.

DGCL§220(b): Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose, and to make copies and extracts from: (1) the corporation's stock ledger, a list of its stockholders, and its other books and records...

Plus a limited right w/r/t subsidiary records

Crane Co. v. Anaconda Co.:

Rule of Law. A qualified shareholder is allowed, when in good faith, to inspect a corporation's stock register in order to notify shareholders of exchange and solicitation offers for stock.

Facts. Respondent announced a plan to purchase up to five million shares of Appellant by exchanging \$100 million in subordinated debentures. Appellant managers did not approve of the exchange. A consent order was issued as a result of litigation between the parties that limited Respondent to 5 million shares. Respondent requested a list of shareholders from Appellant before they owned any shares and again after they owned over 2 million shares. Both times Appellant refused. Respondent's second request was accompanied by an affidavit that it wanted to inspect its stock book only for the benefit of Appellant shareholders. Appellant offered to include the Respondent prospectus in a mailing to shareholders. Respondent, who now owned 11% of Respondent stock, petitioned to inspect Respondent stockholder information, claiming that their request conformed to Section 1315 of the Business Corporation Law because the inspection was for no other business than for the business of Appellant. Appellant argued that the inspection would have to be for the proper purpose from the perspective of the company and not the shareholder.

Issue. The issue is whether Respondent should be able to inspect a corporation's stock register in order to notify them directly of an exchange offer.

Held. The court held that it was in the shareholders' best interests to allow Respondent to inspect the stock register in order to identify shareholders who they can then notify of relevant offers for their stock. Section 1315 of the statute requires a written demand along with an affidavit that the inspection will be for a proper purpose, which Respondent did in this case (the proper purpose being the tender offer). Once Respondent met the statutory requirements, the burden is on Appellant to prove an improper purpose. The Appellant did not meet their burden.

Discussion. The proper purpose is determined from a shareholder's perspective rather than the corporation. The ability to identify other shareholders is rooted in common law where the identification of other shareholders was important in understanding the factors that affected a business.

UNIT VI: CLOSELY HELD CORPORATION: CLOSELY HELD CORPORATIONS

1. Basics/characteristics
 - a. Close Corp = (as the number of SH's approaches 0) LLC
 - i. As the number of shareholders becomes smaller and smaller, courts will allow corp more leeway to fit flexibility rules of company
 - ii. As the number of SH's grows, ease of corp to exist becomes less, need more protection of law; the less it looks like an LLC's b/c not part of K's
 - iii. As the number of shareholders grows, the chances of other shareholders' interests being compromised by agreements grow, even if there are 100 shareholders. Not publicly traded, so can't sell on open market
 - iv. This is why in public corporations, we haven't seen oppression claims; the answer in those situations is, sell your shares, BJR applies; here, the courts recognize oppression claims
 - v. "While the SH of a public-issue corp may readily sell his shares on the open market should management fail to use, in his opinion, sound business judgment, his counterpart of the close corp often has a large total of his entire capital invested in the business and has no ready market for his shares should he desire to sell." Gallor
 - b. Close corporations look like LLCs, LLP's & partnerships look like corporations
 - c. Vary from state to state
 - d. Usually few shareholders (30-50); may be related
 - e. Shareholders usually active participants
 - f. Firm is primary source of income for SH's; SH's usually employed by Corp
 - g. Illiquidity of shares-no free transferability of shares; difficult to sell them
 - i. Common for SH agreements to have provision that shares can't be offered to anyone w/o an offer of first refusal or consent by remaining SH's (relaxation of corporate formalities)
 - h. **Delaware §341-56** provides specific statutory standards for governance of close corporations
 - i. **Del. §§342-356** defines close corporations & how they are governed or structured
 - i. **§342:** Articles of incorporation must identify as closely held corporation; fewer than 30 shareholders; stock must be subject to some restriction on transfer
 - ii. **§351:** Management by shareholders
 - d. Compare - Characteristics of "public" corporations"
 - i. Thousands of unrelated shareholders
 - ii. Shareholders are passive, and do not participate in operations or control
 - iii. Shareholders rarely get primary income from the firm
 - iv. Shares are freely transferable
2. Benefits of CHC's: flexibility, limited liability, low risk of losing investment, large body of case law (knowledge as to how they are run and governed; predictability); SH's adopt the corporate form as means of cheap insurance thru limited liability & mechanism for gov, not for purpose of raising capital
3. Locked in & frozen out
 - a. Locked in as SH: close corps often restrict share transfers; even if no formal restrictions, no secondary market for shares
 - b. Risk of being frozen out of decision making & compensation:
 - i. Minority SH may have no control over co's activities
 - ii. May be denied compensation if denied employment
 - c. SH's primary concerns: oppression of minority SH's, no means of easy exit
 - d. To avoid oppression
 - i. Stock classes w/ varying degrees of control
 - ii. Supermajority voting requirements on certain issues
 1. This protects min SH if it requires 75% majority of BoD vote to sell/merge corp; minority gets to veto any major business decision covered by supermajority requirement
 - iii. Prohibition on director interference w/ SH votes: you want something that requires a high quorum or something that allows them to attend meetings some other way (email, phone)
4. Voting: to ensure minority gets one vote or more director slots if minority's share is large enough to be effective, Ringling
 - a. **Straight voting:** each share gets one vote for each director
 - i. X Corp has 100 shares, 3 directors (A owns 66%, B owns 33%)

1. A gets to vote 67 shares for each director and this controls the board by electing all of the directors
 2. B can vote all she wants, but mathematically, she can never elect even a single director
 3. Essentially, B is relegated to a passive investor
 4. What can B do? *B's position really sucks*
 - a. Sell back to A – get pennies on the dollar for the shares
 - b. Sell to the corporation itself – A is the one who votes on this
 - c. Dividends of the surplus – BoD (i.e., A) has to make the decision
 - d. Be an employee, officer, director; if Director, you can vote yourself a salary, but A can hire & fire B for any reason
- b. **Cumulative Voting:** each share carries number of votes equal to all the directors being elected; provides that each share votes equal to the # of directors being elected
- i. A gets 201 votes (67 x 3); B gets 99 votes
 - ii. A votes 100 points to Director M, 100 points for Director N, 1 point to Director O; B votes 99 points to Director O
 - iii. With a large enough minority, B is guaranteed at least one director; B doesn't get right to control, but B does get voice heard among the BoD
 - iv. Note: You don't use cumulative voting with 3 or more people
 1. Benefits: minority gets representation on the board
 2. Drawbacks:
 - a. Factionalization of the board
 - b. Majority can defeat by amending articles of incorporation to stagger election of directors so that fewer directors are being elected each year
 - c. If X Corp shareholders elected only 1 director each year to a 3 year term, A would always win
 - v. Some states require cumulative voting; some use it as default with option to opt out; Delaware requires corporations to opt in
- c. Class voting for director slots
- i. Class voting: divide shares into classes, each class has right to elect specified # of directors
 1. Benefits: minority shares always get representation on the board
 - a. Typically used for a board seat or for a disproportionate amount of votes
 2. Drawbacks: minority shares always get representation on the board
 - a. Holders of a class of shares may die (planning documents must address this contingency)
- d. **Voting Trusts:** legal title to shares transferred to trustee pursuant to Voting Trust Agreement
- i. agreement establishing a trust, whereby SH's transfer title to shares to trustee who is authorized to exercise their voting power
 - ii. Trustee votes those shares according to how it was worked out previously (per the agreement)
 - iii. Beneficial owners receive shares in voting trust that can be transferred, the trustee is the one who votes the stock as directed by the beneficiaries
 - iv. Voting trusts are disfavored – courts want to separate the vote from the stock
 1. Must comply explicitly with voting trust statute
 2. Court first looks to whether structure created by parties actually constitutes a voting trust
 - a. If yes, must comply explicitly with statute
 - b. Generally: voting trust must be publicly recorded as required by statutes to put other shareholders on notice of the existence of voting trusts
 - c. Some states require voting trusts to expire after a specified term (~ 10 years)
 - v. Written & Filed with the corporation's books & records
 - vi. Limited Term – *usually 10 years*
 - vii. Shares Held and voted by trustee
 - viii. Advantages: no possibility of shareholder deadlock, since everyone puts their shares in the trust and the trustee votes
 - ix. Disadvantages: loss of control; duration (limited to 10 years in most states); still possible for board to oppress minority.
- e. **Irrevocable Proxies:** permitted as long as the proxy holder has an interest in the corporation (proxy holder must own stock for an economic interest)

- i. **Proxies:** authorizations given by SH to another to vote the SH's shares as directed by the SH & are usually revocable at any time
 - 1. Courts hate irrevocable proxies
 - a. Separate the vote permanently from the stock
 - b. To survive, the irrevocable proxy must be coupled with an interest in the corporation
- f. **Vote Pooling Agreement:** voting shares alike (if there's a disagreement, arbitrator decides) ([Ringling, Clark](#))
 - i. Contract by some or all shareholders to vote together.
 - ii. Specifically enforceable.
- g. **Shareholder Agreements**
 - i. Enforceable if the purpose is just to elect the parties to board positions.
 - ii. Unenforceable if they attempt to "sterilize the board" (unless there is unanimous shareholder agreement)
 - iii. As we will see in connection with merger agreements, and as we have already seen in connection with the duty of loyalty and duty of care, a director has a duty to exercise her or his own independent business judgment on behalf of the corporation.
 - iv. An agreement between shareholders that attempts to interfere with that independence is unenforceable. The shareholders can't tell the board what to do.
- h. **Involuntary dissolution & forced sale agreements** ([Ramos](#))
 - i. **Forced Sale Agreements** – usually sold at book or market value ([Jordan](#))
 - j. **Trade Restrictions** – keep control of the close corp. in a well-defined control group, such as the family;
 - i. Four types of trade restrictions:
 - 1. Prohibition on transfer,
 - 2. Right of first refusal,
 - 3. Valuation provisions and formula,

Sale on death, bankruptcy, incompetence

Shareholder Voting Control: Stroh v. Blackhawk Holding Corp.
CONTROL IN CLOSELY HELD CORPORATIONS:

- 5. **Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling:** π & \blacktriangle entered into written agreement to act jointly in regard to all matters pertaining to ownership of their stock (they had a voting trust agreement that bound them to act jointly in all matters relating to their stock & ownership interest in Ringling Brothers (\blacktriangle)); there was a disagreement, they went to an arbitrator, as was provided in agreement, and \blacktriangle didn't vote like arbitrator recommended; court held that if no other SH's rights were violated & public policy wasn't violated as result of pooling agreement, SH should be allowed to benefit as they see fit from their voting rights, which often means banding together to strengthen their position. However in this case, court didn't invalidate the votes; kept those who were voted in; court treats SH voting rights as a form of property rights
 - a. Where there are a total of 3 SH, and two are involved in pooling votes to elect *directors*, this is **valid**.
 - b. *This was a vote pooling agreement; a control mechanism up front would've prevented all this*
 - i. *This was not a voting trust or irrevocable proxy b/c SH's vote their own stock*
 - c. Rule: SH's may contract to vote in any manner; may contract away voting rights while still retaining other rights regarding stock ownership; agreements between SH's purporting to be the exercise of their voting rights have also been upheld as a valid means of obtaining the advantages of concerted action

McQuade v. Stoneham: π was a director and wanted to be treasurer to get a salary; all members agreed to use their best efforts to keep each of the parties in their respective positions to protect his position as treasurer, he could've required board at time of formation to have a unanimous vote to require a vote to kick someone off; naturally, he wouldn't have voted himself out; provision could've also required that all SH's vote in favor of provision; to amend the certificate requires a vote of directors and SH's (2/3); issue was whether a SH agreement between them to use their best efforts to keep each of the parties in their respective positions was valid; court said that where there are multiple SH involved and they agreed to vote to keep their status, this was **invalid**. It was taking away the board's fiduciary duty to act in the best interests of the Corp. Invalid as a matter of public policy (SH's shouldn't be able to usurp the decision-making normally left to directors, and directors should be beholden to Corp and not the SH's).

- a. Case reminds us of the CA case, where neither the board nor the SH could pass a rule that binds the board's decision in the future; **can't contract away the board's fiduciary duty**
 - i. Rules that require v. permit the board to do something
 - (1) If there was a provision in Stoneham that required Stoneham to elect P v. a provision that prohibited Stoneham from being president
 - (2) To analyze, if you are taking an option away and there are plenty of other options, it would probably be valid
 - ii. How π could've avoid this: employment K, buyout agreement if there was a disagreement; personal agreement between π & \blacktriangle saying that if π was fired, \blacktriangle , in his personal capacity, would be required to pay the amount he was earning
 - iii. **Dissenting opinion:** takes a realistic view; says that if one guy has power to appoint all of the directors, of course he will do what they bid him to do; directors will act in accordance w/ what the majority of SH's say. So why not let minority SH's have substantive provisions or allow them to contract.
 - (1) The reason this argument didn't win is b/c it was easy to avoid the problem

Clark v. Dodge: π & \blacktriangle were sole SH's & directors in 2 pharmaceutical companies & they entered into SH agreement regarding π 's continuation as a manger & director; K was that \blacktriangle would vote for π to continue as director; in turn, π would disclose the formula to \blacktriangle 's son; K between them to vote for specified persons to serve as directors is legal, and not in contravention of public policy

- a. *Agreement has an employment aspect, and a "I will vote for you as director" aspect, which is always a valid agreement between shareholders and a director*
 - i. The **general rule** is the BoD have the unregulated responsibility of managing the daily operations of the corporation's business – courts have held that any departure from this standard is against public policy
 - 1. Shareholders don't get to tell the directors how to run the corporation or who to make executive officers.
 - ii. ALL of the shareholders unanimously consented to this agreement, so there's no one else the directors could owe a fiduciary duty to; If there were one other shareholder included who didn't enter into the agreement, then this agreement would not be enforceable
 - 1. Fiduciary Duty – Directors are agents, and directors owe fiduciary duties to corporation & through the corporation to the shareholders; duty to exercise independent, disinterested judgment
 - 2. If the Board is responding to what the shareholders want, they are exercising the judgment of the shareholders who do not owe fiduciary duties to anyone
- d. **Del 141 (a): All management is vested in the Board of Directors**
- e. The court attempts to analyze whether the parties here are improperly "sterilizing the board." Shareholders, acting as shareholders, generally do not have any authority to bind the discretion of the board in carrying out the board's business judgment on behalf of the corporation. (Didn't happen here.)
 - i. No problem of "sterilizing the board" b/c there was unanimous shareholder agreement, all shareholders were also directors, and there were no third parties to protest.
- f. In this case, the court orders specific performance. Clark gave up his secret formula and wants employment as per agreement. There is no way to remedy Clark's injury.
- g. Where there were 2 shareholders and both were involved in agreeing that one would get certain profits if he shared his knowledge and gets to continue as a general manager (officer status), court held this was **valid**
- h. **General rule: shareholders have the power to pool to elect directors, but as directors, they cannot pool their votes or contract to vote or to determine the way they will vote unless the agreement is unanimous and no party is harmed**

ABUSE OF CONTROL:

6. Abuse of Control

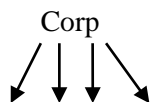
- a. Use of control devices at planning state will help prevent squabbles from destroying co.
- b. Generally, majority SH gets to control aspects of Co., unless there are protection mechanisms) and remaining SH's are stuck w/ their shares & are subject to the controlling SH deciding such things as dividends, and whether to employ/firm them

- c. Courts concerned about abuse of control b/c
 - i. Min SH's depend on ownership of the form as employment & salary (this is their principal benefit of stock ownership)
 - ii. Corporate structure defaults to total control for anyone owning more than 50% of voting shares
 - 1. Control group can bleed corporate assets
 - 2. Control group can force minority into risky business ventures or may use Corp for purposes not desired by min. shareholders
 - iii. Minority cannot easily exit
- 7. Fiduciary duties between SH's in close Corps
 - a. **MA:** SH in CHC's are like partners and owe each other fiduciary duties of loyalty, good faith, candor, Wilkes
 - i. MA doctrine (adopted in other jurisdictions)
 - ii. SH's may not act out of avarice in derogation of loyalty to other SH's (Meinhard)
 - 1. Interpreted as prohibiting majority/controlling SH's from acting in bad faith to frustrate minority's **reasonable expectations** of employment in the firm and to deny minority any return on their investment
 - 2. **ONLY APPLIES TO STATES THAT HAVE ADOPTED THE MASSACHUSETTS STANDARD AND ONLY APPLIES TO CLOSELY HELD CORPORATIONS!**
 - iii. **Delaware:** SH's do not owe each other fiduciary duties; if minority needs protection, they can bargain for it before they decide to invest (race to the bottom)
 - 1. DE isn't really oppressive to SH, and isn't especially beneficial to directors, but it is efficient and predictable
 - 2. DE says that only people who owe fiduciary duties are agents; SH's aren't agents of the Corp
- 8. **Freeze-Out:** majority SH's prevent minority SH from receiving any monetary benefits from their investment in the corporation in an attempt to force the minority to sell their shares to the majority; terms of freeze-out are usually disadvantageous. Deprive minority SH of corporate offices and employment with the corp.
 - i. Majority/control group uses control to force out minority, usually on disadvantageous terms (Sugarman)
 - ii. **Test for Freeze-out under Mass. standard:**
 - 1. **Minority pleads & proves prima facie case of breach of duty of good faith by majority**
 - 2. **Control group must demonstrate legitimate business purpose for the action**
 - a. **MINORITY CAN'T BE DEPRIVED OF ECONOMIC BENEFIT W/O LBP**
 - 3. **Burden then shifts to minority to demonstrate a less harmful alternative**
 - iii. It isn't sufficient to show that the majority has taken excessive compensations or to allege that it has offered to buy the stock at an inadequate price
 - iv. **Test for improper freeze out**
 - 1. Utmost good faith & loyalty (Donahue)
 - 2. Improper to plan & act to pressure minority shareholders to sell out below the fair value of their shares, absent an agreement to the contrary (Jordan)
 - 3. Must show more than "excessive compensation" – but it still must be part of the freeze-out plan
 - 4. Must show more than offer to buy stock at low price - Offer must be part of the freeze-out plan
 - v. What is the **remedy** for an improper freeze out? *P's generally not entitled to force a buyout of shares*
 - 1. Generally only receive damages plus an injunction against future bad acts

3 different approaches

1. (MAJ) Wilkes puts employment and SH together and treats them under the fiduciary duty; fiduciary duty controls
2. (MIN) Ingle packages together employment and SH, but treats employment as controlling
3. Pedro treats them differently; can get damages for SH if no right to job

Wilkes (DOMINANT APPROACH):



W originally owned the land
Q, R, P voted W out

W Q R P

W founded a nursing home, they all invest; it becomes immediately profitable, they were each taking salaries; W had been director and officer receiving regular salary of \$100/week; firm paid no dividends; relations between W & others deteriorated; W gave notice of intent to sell his shares; he was then stripped of his salary and offices; he sued, alleging breach of fiduciary duties; maybe the other 3 wanted to keep the \$100/wk in the firm or pay themselves

- a. Court applied partnership-like fiduciary duties to SH's of close corps and invoked Cardozo's decision in Meinhard
- b. Court held that W was improperly frozen out; a legitimate business purpose could have been claimed if W had been negligent in failing to perform his duties or in failing to perform them w/ due care
- c. MA rule: majority must show some legitimate business purpose; if it does so, burden shifts to minority to show less harmful alternative; if it does so, court must balance legitimate business purpose against practicability of proposed alternative.
- d. Damages: he wanted \$100/week, but the salaries of others varied and their duties changed; need to determine proper amount
- e. Business judgment rule won't apply; courts more likely to scrutinize
- f. Is heightened duty necessary?
 - i. Partners owe a higher fiduciary duty than SH's but not than directors
 - ii. All the controlling SH's were directors; thus the court could have held that controlling SH's violated duty of loyalty they owed to W as directors
 - iii. If others had wanted to outsource to Z for \$50/week, this would be a legitimate business purpose, but before they could do that, would have to justify/explore outsourcing their own positions; could outsource all of their jobs and distribute dividends; pay yourself less salary; effect would have been the same, but the majority could say they are still working (need to be paid)
 - iv. Other causes of action Wilkes could have used?
 1. Shareholder derivative suit against the other three shareholders for paying themselves excessive salaries. Because of the conflict of interest, they would not have been protected by the business judgment rule. (but they would have been entitled to some compensation for their services. A court might have been reluctant to order dividends and this might have left Wilkes w/ an empty victory).
- b. What if the majority wants to expand and W doesn't? The majority is to managing according to what they want to do; W can't dictate to get equal treatment; court balances
 - i. "Majority have certain rights to what has been termed "selfish ownership" in the Corp which should be balanced against the concept of their fiduciary obligation to minority
- g. To the extent that the Wilkes line of cases makes any sense, it makes sense only in the context of freeze-outs and not shareholder deadlocks. In a freeze-out, a controlling shareholder earns a return at the expense of others. Where there is no self-dealing any more than any of the others – liability is not mandated based on Wilkes logic (See Smith v. Atlantic Properties)
- h. **Information asymmetry** example: one person owns a Bed & Breakfast; he wants to sell it; buyer asks why he wants to sell. Owner says he bought it for \$150K, but will sell for \$125K; then says would sell for \$100K; the buyer says that at \$50K, he is willing to take a risk; owner can take advantage of buyer; buyer will be aware of the asymmetry; but can't distinguish reasons why he wants to sell at such a low price
 - i. Information asymmetry can destroy the market
 - ii. The best market for a close corporation is other directors b/c they have information
 - iii. Should be added as a buyout provision
- i. **Freeze outs**: preventing sale of stock at price available to majority; depriving minority SH of employment

Ingle v. Glamore Motor Sales: ▲ owned an auto dealership; hired π to manage it and sold him 40/100 shares. Agreement under which if π should cease to be ▲'s employee for any reason, ▲ had the right to buy π's shares; ▲ brought his 2 sons into business and fired π, buying his shares for \$96K; π claims that as a SH, he has a fiduciary duty based protection against being fired; courts hold that π doesn't have such a right; π was mainly an at-will employee; stock repurchase K expressly confirms the unavailability of any protection

1. Dissent: cites Wilkes and majority ignores equities & fails to recognize that this is not just a suit of wrongful termination

- i. Maybe there wasn't an expectation that he would be terminated at will, otherwise wouldn't have agreed to that provision
2. Π was an employee first, then made a SH, then was fired at will; court is not willing to make a SH status affect employee status
3. No legitimate business purpose discussion
4. Π not completely frozen out b/c there is a buyout provision, though this is not decisive (look at equities)
5. Maybe NY encourages discretion in agreement making, you make your bed, and now you have to lie in it
6. "A minority shareholder in a close corporation, by that status alone, who contractually agrees to the repurchase of his shares upon termination of his employment for any reason, acquires no right from the corporation or majority shareholders against at-will discharge"

Brodie v. Jordan: where the issue was whether the π was entitled to the remedy of a forced buyout of her shares by the majority, court said no. Court looked at the reasonable expectations; courts have discretion in fashioning remedies, but remedy of forcing a buyout was inappropriate b/c it puts π in a better position; this is creating an artificial market for π 's minority of a close corporation, an asset that has little/no market value

- a. Rule: proper remedy for freeze out is to restore minority SH as nearly as possible to position she would've been in had there been no wrongdoing
- b. There was a breach of fiduciary duty; dysfunctional Corp; she's not getting any benefits, should be bought out, like in Wilkes.
- c. Court trying to restore minority SH to position he would be in (restitution)
- d. HYPO:



- A, B, C, can provide service to company and pay themselves a director's fee (which amounts to a dividend)
 - ▲ frozen out b/c not a director (not elected to board, oppressed)
 - If A, B, C would have gotten \$50, not \$50K, this is reasonable to reimburse them for their services
 - Π was the executrix of her husband, who was pres and director. In 1989, all were receiving \$100K; in 1993, they were receiving \$50K, but husband wasn't working. If directors were taking 50% of \$M; π would be entitled to 50% of M, whatever portion is the constructive dividend;
 - After the remand, they settled for \$100K b/c she has leverage; she demands to open up their books
- e. Practical implications: advise C to settle b/c we value certainty
 - f. If L had asked, have you been paying taxes, show us, this would've been burdensome
 - g. "Stockholders in [a] close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another"

Smith v. Atlantic Properties NOT GOOD LAW: After disagreements arose between parties who formed ▲, 3 of the 4 SH's, π , filed suit, seeking a determination of dividends and removal of the 4th SH as director; articles of incorporation gave any one of the original SH's veto power in corporate decisions (80% supermajority voting requirement), the effect of which was all 4 SH's had to consent

- a. MA rule: SH's owe one another fiduciary duties in close corporations
- b. Negative control itself will rarely rise to level that gives rise to agency relationship (unless it gets to the point of Cargill.)
- c. Here, all consented/contracted; no reason why court shouldn't uphold the K
- d. Not 100% b/c that would be suspect and 80% b/c in the future, the shares could be subdivided and it would be possible that each voter wouldn't have veto power.
 - ii. HOLDING: Wilkes line of cases applies not just to majority shareholders but to anyone who controls the firm. A minority shareholder, at least where he has a veto power over corporate action, has fiduciary duties to the majority. D's use of veto power was inconsistent with that duty because it subjected the corp to an unnecessary assessment of penalty taxes
 - iii. **Mass. Rule:** Stockholders in a close corporation owe one another the same fiduciary duty in the operation of the enterprise that partners owe one another
 - iv. Shareholders are being oppressed, so the statute says they can dissolve.

- v. Here, a clause required an affirmative vote of 80% - so the minority becomes the ad hoc controlling interest, and this reverses the usual roles of the minority/majority shareholders
 - 1. Court steps in and changes the meaning of the K
 - 2. The court creates a duty for ▲ to go along with the rest of the shareholders – why? *Possibly because he was acting for his own benefit, Closely held corporations are really more like partners – the court looks behind the corporate form and if partners were acting as partners, then court will treat them as partners (this is based in the Mass. Statutes)*
 - 3. Court creates a legal fiction & imposes liability on D, although they probably could have used the duty of good faith instead & got the same result
 - 4. Minority SH can have a fiduciary duty by virtue of having a veto; **this is not good law**
- c. How would Sinclair court have decided this case?
 - i. Shareholders owe a fiduciary duty only if they are controlling shareholders. If not controlling, then they cannot be liable. Hence, liability would be unlikely in this case.
 - ii. Even if the Sinclair Court were to consider D controlling shareholder, D still would only be liable if the transaction had involved self-dealing. B/c D gained no benefit at the expense of any of the others, there was no self-dealing and would be no liability.
 - iii. Could have argued that the director's breached their fiduciary duties of loyalty and care as directors. But they all breached these and would not justify imposing exclusive liability on D.
- 4. **Nixon v. Blackwell: Delaware Rule: SH's do not owe one another fiduciary duties in CHC**
- 5. In close corporations, where the corporation is buying its own stock back from an investor, there's a fiduciary duty to disclose material facts

UNIT VII- INSIDER TRADING:

- A. Insider: director, officer, agent, majority SH who, by virtue of their relationship w/ a securities issuer (corp.) acquires material non-public info about the securities issuer
- B. Insider trading under R. 10b & 10b-5: Rule: insider in possession of material, non-public information about the issuer for which insider is an agent, majority shareholder, etc. May not trade in the securities of the issuer w/o first disclosing that info (duty to disclose or refrain)
 - a. If you are a corporate insider /w non-public info, **you must abstain or disclose**
 - b. Duty to disclose under §10b doesn't arise from mere possession of non-public market info
 - c. The paradigmatic situation of insider trading is a director of a corporation who negotiates a confidential merger agreement with an acquirer. Knowing the price of the target corporation's shares will go up upon announcement of the merger agreement, the director buys the shares at the current (low) market price without disclosing the existence of the merger agreement. This is insider trading.
 - a. The duty to abstain (or disclose) arises from the relationship of trust between a corporation's shareholders and its employees. (Chiarella v. US).
 - b. There's a lot of discussion about whether insider trading should be illegal because it's hard to police.
 - c. **Elements for Insider Trading Cause of Action:**
 - i. D made a material misrepresentation or omission in connection with the purchase or sale of a security
 - ii. Reliance
 - iii. Scierter
 - iv. Causation
 - d. Tippee: anyone who received material, non-public information from an insider.

Goodwin v. Agassiz: Rule of Law. A purchaser of stock on the market does not owe a fiduciary duty to a seller to disclose the information that the purchaser may know, even when the purchaser is in a position that provides insider information.

Facts. Plaintiff owned shares in Cliff Mining Company, a mineral mining company, and Defendant was President of Cliff Mining. Using a geological survey, Cliff Mining conducted initial explorations to find copper, but were unsuccessful. An article was published, independent and unconnected to Defendant, which disclosed the failure of the initial exploration. Plaintiff reacted to this news by selling his shares. Unbeknownst to Plaintiff, Defendant was informed by a geologist that there was still a good probability that copper would be found. Defendant reacted by buying shares before this news became public. Plaintiff sought damages from Defendant, claiming Defendant, as president of the company and the

purchaser of Plaintiff's shares, owed Plaintiff a fiduciary duty.

Issue. The issue is whether Defendant, as president and the purchaser of Plaintiff's shares, owed Plaintiff a duty to disclose information that would affect the value of the shares.

Held: Defendant did not buy the shares from Plaintiff directly – they were purchased through a broker. Second, the information did not disclose an absolute certainty that copper would be found, but rather was only an opinion.

SEC v. Texas Gulf Sulphur Co.: TGS began drilling; geologists, execs, and directors find out that they have hit one of the biggest sulphur deposits; they all want to cash in, buy securities (stock + call options); the call options are cheaper in price; current stock price \$30; call option is \$20 (in the money); can buy one for \$0.50

- A. Market sees unusual market activity); there were 12 press releases, but no confirmation that much deposit were found
- B. Rule: anyone in possession of material inside info must either disclose it to the investing public or abstain from trading it or recommending the securities concerned while such inside info remains undisclosed: justification-equal information
 - a. Duty arises only in situations which are essentially extraordinary and reasonably certain to have a substantial effect on the market price of the security if disclosed

Anyone in possession of material inside information must either disclose it to the investing public or if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remained undisclosed.

- b. **Test of materiality:** whether a reasonable man would attach importance in determining his choice of action in the transaction in question: any fact which in reasonably and objective contemplation might affect the value of corp.'s stocks/securities
 - i. There is a presumption of materiality if you are buying stock; if not material, why are they buying?
 - ii. Materiality of the facts is to be assessed solely by measuring the effect the knowledge of the facts would have upon prudent or conservative investors.
 - c. **Material facts:** info disclosing the earnings and distributions of a co. and facts which affect the probable future of the co. and those which may affect the desire of investors to buy, sell, hold securities
- C. Who may have confidential information: those who owe a fiduciary duty to the company (execs)
 - a. Duty of loyalty breach; using info for their own gain
 - b. Here, the geologists are liable b/c there is an expanded definition of insiders to include anyone who possesses the information; execs and directors told geologists not to talk about it, so the fiduciary duty expands to them
 - i. There was an "explicit/implicit instruction not to disclose"
- D. Damages: will be forced to disgorge profits and pay a fine. Plaintiff must prove that defendant made a material misrepresentation or omission in connection with the purchase or sale of a security, reliance, scienter, causation
- E. Should insider trading be prohibited?
 - a. Victims-a lot of people benefit
 - b. Can't stop it-why try? Deterrence facts
 - c. Good way of compensating employees



nd *Dirks*?

- “A duty to disclose ... does not arise from the mere possession of nonpublic market information”



placed their trust and confidence.’ ” had

Dirks v. SEC: X works at Equity Funding and knows that the company is doing fraudulent stuff; he tries to report it but no one believes him; he calls Dirks, who investigates, confirms and discloses fraud; Dirks based on some nonpublic info he received & subsequent investigations; aided the SEC in convicting EF for corporate fraud and was then sued by SEC for violating §10b b/c he openly disclosed the nonpublic info to investors

- A. Tipper liability only applies when tipper must be getting some benefit & tippee must know or have reason to know of the fiduciary duty
- B. General rule on insiders: corp. insider who possesses material non-public info must disclose or abstain
- C. **But** Dirks is not an insider
- D. Tippee liability under 10b-5: individuals other than corporate insiders could be obligated either to disclose material nonpublic info before trading or abstain from trading altogether
 - a. Under Santa Fe, there must be some manipulation/deception to sustain violation of 10(b) and 10b-5
- E. Rule on tippee liability: T will be held liable for openly disclosing material, nonpublic info received from insider, if
 - a. Insider/tippee violates fiduciary duty to firm's SH in giving the tip **AND**
 - b. Tippee knew or should've known of the breach
- F. Here, insider (X) didn't receive benefit for disclosure; he did it only to help expose fraud by officers of EFA b/c insider didn't receive a benefit; he didn't breach his fiduciary duty to SH's
 - a. Court notes that X had every right to disclose fraud b/c he didn't personally benefit (implicates the duty of loyalty, not duty of care)

- G. If the whistleblower traded, he would be in trouble; he would be prohibited from trading if he had reason to know that it was confidential info
- H. **Holding**: if there is no fiduciary duty, then no problem
- I. If Dirks was X's friend, family member, there would've been a personal benefit
- J. Companies want equity analysts to come in b/c they will be able to sell their stocks (pass along info)
- K. **Dirks established a category of "constructive insiders"**: When does someone become a constructive insider?: FN14: where they (1) obtain material nonpublic information from the issuer with (2) an expectation on the part of the corporation that the outsider will keep the disclosed information confidential and (3) the relationship at least implies such a duty

U.S. v. O'Hagan: O'Hagan buys call options for Pillsbury stock at \$39/share; Grand Met (whom another member at ▲'s firm represents) publicly announces the tender offer & stock prices rise; O'Hagan sells call options & common stock for \$4.3M

Classical theory: applies not only to officers, directors and other permanent insiders of a corp, but also to attorneys, accountants, consultants and others who temporarily becomes fiduciaries of a corp.

- a. **Misappropriation theory** makes a person who has confidential info, but who has no duty to SH's liable for misappropriation; as soon as you get info that was given to you with an expectation of confidence, can't trade on it
 - a. Theory is analogous to breach of loyalty; if valuable & you appropriate info for your own gain after saying you wouldn't, it is a violation
- b. **Misappropriation Theory**: a person commits fraud in connection with a securities transaction, and thereby violates 10(b) and 10B-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. (doing so is a breach of duty of loyalty and confidentiality)
 - a. This extends liability to corporate outsiders who owe no duty to the shareholders of the corporation, but who have access to confidential information by virtue of their fiduciary position
 - b. Here, D didn't owe a fiduciary duty to the SH, he owed it to his law firm (and through firm to client) to refrain from trading on the basis of material, nonpublic information he may have acquired by virtue of his position at the firm – he had no right to that information
- c. This case broadens the scope of liability
- d. Section 10(b) requires deception "in connection with the purchase or sale of any security" not deception of an identifiable purchaser or seller: "[T]he fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide."
- e. Rule 10b5-2 provides a non-exclusive list of three situations in which a person has a duty of trust or confidence for the purpose of the misappropriation theory:
 - 1. Whenever a person agrees to maintain info in confidence;
 - 2. Whenever the person communicating info and the person to whom it is communicated have a history, pattern or practice of sharing confidences, such that the recipient of the info knows or reasonably should know that the person communicating the info expects the recipient to maintain confidentiality; or
 - 3. Whenever the info is obtained from a spouse, parent, child or sibling, unless recipient shows that history, pattern or practice indicates no expectation of confidentiality.
- f. Where a person trading on the basis of material, non-public information owes a duty of loyalty and confidentiality to two entities or persons for example, a law firm and its client but makes disclosure to only one, the trader may still be liable under the misappropriation theory.
- g. Under this theory, **Dirks** would've probably gotten in trouble
- h. **R. 14(e)**: "it shall be unlawful for any person...to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection w/ any tender offer"
- i. According to **Adler**, mere possession of material nonpublic info by inside trader isn't a per se violation; trading while in possession of such info merely raises a strong inference that insider traded on basis of that info; he can rebut this presumption by showing that he didn't use such info in making trading decisions, BUT

- j. R10b5-1 rejects this position b/c 10b-5 is violated whenever someone trades on the basis of material non-public info; one is deemed to have traded on basis if he was aware of such info at time of trade
- k. Deception through nondisclosure is central to the theory of liability....” *O’Hagan*
- l.

Target Firm (Lawyers)
Fiduciary duty to target firm

Acquiring Firm (Lawyers) No fiduciary duty to target firm

Rule 14e-3

- Prohibits insider trading during a tender offer and thus supplements Rule 10b-5.
 - Once substantial steps towards a tender offer taken, Rule 14e-3(a) prohibits anyone, except the bidder, who possesses material, nonpublic information about the offer obtained from the acquirer, the target, and officers, directors, employees, etc of either from trading in the target’s securities
 - Rule 14e-3(d) prohibits anyone connected with the tender offer from tipping material, nonpublic information about it
- Rule 14e-3 is not premised on breach of a fiduciary duty
 - *O’Hagan* upholds it anyway

UNIT VIII: MERGERS AND ACQUISITIONS:

Mergers & Acquisitions

- Available techniques
 - o Merger, sale of assets, proxy contest, tender offer, stock purchases
- Distinguishing characteristics
 - o Mergers and sales of assets require approval by the target’s BoD
 - o Proxy contest doesn’t require approval, though a SH vote is required
 - o Tender offer doesn’t require either board approval or a SH vote-if 50.1% of the shares are tendered to buyer, buyer wins (stock purchase has safe effect as tender offer)
- Mergers: Step by Step
 - o DGCL §251(b)
 - T & A boards adopt merger agreement

- 251(b)(3) A's charter can be amended at this point
 - 251(b)(5) Allows cash and securities in addition to acquiring common as consideration
- DGCL §251(c)
 - SH vote at A & T: majority of shares entitled to vote thereon
 - File articles of merger-effective at this point
- DGCL §261(b)(1)-no appraisal rights if stock of constituent corporation is listed

De Facto Merger Doctrine

- Acquisition of company by another w/o compliance w/ a requirement of statutory merger but treated by courts as such, (*law in a minority of jurisdictions*)
- Rights of shareholders in both the target and acquirer to vote on combination and force their corp. to buy out their shares at a (hopefully higher) FMV
 - Voting rights-when can they vote on the changes?
 - Appraisal rights-when can they force a buyout at FMV?
 - Generally, once you put in the money, it becomes the corp.'s capital & you don't get to pull it back out, unless the corp. engages in triggering event (merger, corporate reorganization)
 - What triggers a minority SH's appraisal rights?
 - MBCA: Merger, short form merger, sale of assets, some charter amendments
 - DEL 262: merger, short form merger ONLY
 - When corp. combines w/ another so as to lose its essential nature & alter the original fundamental relationships of SH's among themselves & corp., a SH who doesn't wish to continue his membership may treat his membership in the original corp. as terminated and have value of his shares paid to him
 - *Similar to partner exist in a partnership*
- Corporate combinations
 - Initial contract (informal, open, secret, in play, market test)
 - Negotiations (due diligence & valuations)
 - Merger agreement (can't be signed until there's approval from board)
 - Board approval
 - Fiduciary duties apply to ensure boards are protecting SH's
 - **Note:** countervailing incentives of boards
 - Glen Alden
 - Employed/retained by new entity
 - Major concern that target board/management gives away target SH value so management can retain position in new entity
 - "Fiduciary Out" Clause
 - SH approval-remember SH get to vote in
 - Fundamental change in corp. structure/governance (change to articles of incorporation, dissolution sale of substantially all assets)
 - Election of directors
 - SH proposals
 - Consummation (w/ mergers, target corp. files certificate of merger and old one is dissolved)
 - Who gets appraisal
 - Merger
 - MBCA-SH's of target entitled to vote
 - Del 262-All SH's of Target, usually Acquirer SH unless:
 - Whale-minnow merger (Farris) or
 - Market out-if shares relinquished are listed on national securities exchange or held of record by more than 2000 SH's and if share received have similar characteristics (voting, dividend rights)
 - Short form merger-SH of **subsidiary only**
 - Sale of assets
 - MBCA-SH of seller only
 - Del-No appraisal rights

- Appraisal Procedure: DELAWARE
 - Dissenting SH's must:
 - Give written notice of intent to dissent before SH's meeting
 - Must vote against proposed transaction
 - Corp. must notify dissenting SH's of their appraisal rights
 - Dissents must tender share to corp. and demand payment
 - Dissents must then sue for appraisal (if corp./SH disagree on fair price)
 - Dissents bear all their cost & only receive payment after final order
 - Makes for high standard to get any money back-for them to recoup money, they would have to have been paid pennies
 - Hard to find FMV, and ultimately value is going to be a range, not a finite number
 - Why have appraisals then? Large institutional investors who didn't own enough of shares to stop merger in first place, but they think it is worth it to go ahead
- 3 types of corporate reorganizations
 - Statutory merger
 - A (Acquirer) makes friends w/ B (Target) & offers merger agreement. Board recommends, SH approve, consummated, certificate of merger, B dissolves automatically upon filing of certificate of merger, A makes cash/securities payment to B's SH (generally absolute value of B or in a per share value)
 - Someone must do due diligence to make sure that cash/securities are worth what they say they are worth and that B in itself is worth what A is paying (evaluation of assets & liabilities)
 - A takes all assets, liabilities, rights & obligations of B-when you merge, you take over everything
 - Could be bad b/c you open yourself up to old lawsuits against old corp.
 - A will be stuck w/ all these things permanently after merger
 - Triangular merger
 - Time 1: A talks to B & spends \$ to create subsidiary (A')
 - A owns 100% of A' & they only dump in enough to fund B
 - Time 2: A' and B have a statutory merger, B dissolves
 - A runs the BoD, so they tell A' to do the merger
 - If B's a losing venture, A is only liable for the money sent to A'
 - Time 3: A can keep A' as a wholly owned subsidiary forever (optional)
 - A' BoD can make all the decisions
 - They can merger A' into A via a short form statutory merger (corporate parent owns 90%+ of subsidiary, 10 days notice will allow merger & A' can't dissent) – this is what happened in [*In re Silicone Breast Implants*](#)
 - Sale of Assets/Asset Acquisition
 - A wants what B has (i.e., name/good will, real estate, patents, etc.) & they don't really want the corporation as a whole
 - B's shareholders either dissolve B and distribute the money or stock, or they maintain B as a holding company
 - B generally uses money from A to pay all of B's liabilities - A doesn't buy any of B's liabilities
 - Statutory sale of assets is much more complicated than a merger – as a result, the mechanics of transferring control are more complex.
 - Tax Consequences
 - Double Taxation
 - Tax at the corp. level based on difference in depreciated tax book value of the assets sold and the sum of the purchase price and the liabilities assumed
 - Tax at the shareholder level (assuming liquidation) based on the difference between the tax basis of the shareholder's stock and the liquidating distribution.

- Target company remains in existence for at least a little while after the asset sale is completed. Only title to the assets change hands, both companies remain alive.
 - As opposed to a merger where, once effective, all corp. entities besides the surviving corp., come to an end.

Corporate Combinations		
Voting Rights on Combination (Del.)		
	A Corp	B Corp
Merger	Yes	Yes
Triangular Merger	No	Yes
Sale of Assets	No	Yes

Appraisal Rights (Del.)		
	A Corp	B Corp
Merger	Yes (§262)	Yes
Triangular Merger	No	Yes
Sale of Assets	No	Yes



Asset Acquisitions

✍️ “Substantially All”


✍️ Voting Rights of B Shareholders

✍️ “majority of the outstanding stock of the corporation entitled to vote” (Del 271(a))

✍️ Appraisal Rights for Dissenters? (Note Delaware’s position: None)


✍️ Voting Rights of A Shareholders

✍️ Delaware: None (unless share authorization required in charter if A stock used as consideration); also no appraisal rights



Statutory Mergers

- **Basic Procedure: Shareholders of Both Constituent Corporations Ratify (Del § 251)**
 - “[M]ajority of the outstanding stock of the corporation entitled to vote” (§ 251(c))
 - **Exceptions**
 - Short-Form Mergers: Del § 253
 - Small-Scale Merger: Del § 251(f)
-



Mergers: Step by Step

1. DGCL § 251(b)
 - ✍ T and A boards adopt Merger Agreement
2. DGCL § 251(c)
 - ✍ SH vote at A and T: majority of shares entitled to vote thereon; but note 251(f) and 253.
3. DGCL § 251(c)
 - ✍ File articles of merger; merger becomes effective at this point
4. DGCL § 262: Appraisal rights

Summary

	Asset Purchase (Del. 271)	Stock Purchase	Statutory Merger (Del 251, 253)
Target SH Vote	Yes	No	Yes (unless 253 exception)
Acquirer SH Vote (note NYSE Rules)	No (unless need to authorize more shares)	No	Yes (unless 251(f) exception)
Appraisal Rights (Del 262)	No	No	Yes (unless exception -Del 262)
Tax Implications	Turns on consideration paid	Same	Same
Liabilities Transfer	No (unless by agreement or judicial exception)	No	Yes (Del 259)
Transaction Costs	High	Low	Medium
Other		-Williams Act; -Often can't get 100% of shares; -State antitakeover provisions (DGCL 203)	Many variations -Forward Triangular -Reverse Triangular -Short Form (Del 253)

De-Facto Merger Doctrine

Farris v. Glend Alden Corp.: List & Glen Alden had a reorganization agreement where Glen Alden was to purchase the assets of List & Take over List's liabilities, while List SH's would get Glen Alden stock & List would dissolve; ▲ tried to structure it so that it was a sale of assets and not a merger

- i. Minnow swallows the whole whale case
- ii. If this was a merger, they could force the co. to buy them out (appraisal rights)
- iii. Original Glen Alden SH owned less of the company afterwards (before they had 100%, now 25%); although this has the same value, they have changed the structure of the corp.
- iv. Issue was whether the agreement fundamentally changes the corporate character that to refuse the SH the rights and remedies of a dissenting SH would in reality force him to give up his stock in one corp. and against his will accept shares in another? Court said YES
- v. A transaction which is in form a sale of assets but which is in effect a de facto merger must meet the statutory merger requirements in order to protect rights of minority SH's
- vi. Court says that they can structure transactions as either mergers or sale of assets, but in equity courts, they will look to effect of transaction
- vii. Standard de facto merger:
 1. Look to both terms of agreement & to "consequences of the transaction & to the purposes of the provisions of corporate law said to be applicable"
 2. [Ignore every explicit statutory provision permitting the corporation to structure a transaction to avoid appraisal rights]

3. Where steps (1) and (2) show that the transaction would “so fundamentally change the corporate character ... and the interest of the plaintiff as a shareholder therein”
4. **Note:** The real parties of interest are lawyers; shareholders are theoretically on notice that the company can change its nature of business because of a generic articles of incorporation
5. The court held that the plan was a de facto merger. Instead of looking at just the nature of the corporate transaction, the court looked at the consequences. If the plan did go through, Plaintiff would own shares in an entity that is very different than the original Defendant corporation, and the directorship would be completely revamped. Plaintiff’s percent ownership and the value of the shares themselves would be diminished by the transaction. Therefore Defendant should have notified shareholders of their right to dissent and appraisal.

Harition v. Arco Electronics: Loral Electronics & Arco had agreement that Arco was supposed to sell all its assets to Loral & then Loral was supposed to issue and transfer 230K shares to Arco, which were supposed to be distributed to Arco SH’s; π SH’s wanted to enjoin transaction on basis that it was a de facto merger and was subject to some regulations that transaction avoided not being called a merger.

1. A sale of assets involving dissolution of the selling corp. & distribution of shares to its SH’s is legal
 - i. Statutes controlling mergers & those controlling asset sales are independent of each other, and are equal in terms of validity
 - ii. If an asset sale meets the legal requirements of such a sale, the fact that it might be a de facto merger should not invalidate it any more than an otherwise legal merger should be invalidated b/c it is a de facto sale-to hold otherwise would be to create unnecessary uncertainty & litigation
2. DE explicitly permits corp. managers to choose the statutory form of a transaction
 - i. Sale of assets & dissolution of seller v. statutory merger—court doesn’t care which one the parties pick b/c they’ll accomplish the same thing
 - ii. Equal Dignity Doctrine-if you call it a sale of assets, it’s a sale of assets
3. **Holding here is opposite of Farris, which prevented the same type of transaction, except it was a SH from the purchasing co. that brought the action; this case did not present the same lopsided effects that Farris transaction provided**

Appraisal rights, Freeze outs and Control Persons:

APPRAISAL RIGHTS: **Five Things to Consider:** i) What shareholders are eligible for appraisal rights? ii) What are the procedural requirements of appraisal? iii) What method of valuation to use? ~~What~~ What’s the objective of valuation? v) Are appraisal rights exclusive?

Who gets the appraisal right?

1. Appraisal is available to A and T shareholders only in certain transactions (e.g., Del 251) (262(b))
2. Exceptions to appraisal
 - Market Out (262(b)(1))
 - A SHs if less than 20% shares issued (262(b)(1))
3. Exception to the market out exception (262(b)(2))
4. Appraisal always available to minority T shareholders in a Del 253 short form merger (262(b)(3))



Procedural Requirements: Shareholder's Obligation to Perfect the Right

- Shareholder must dissent (not vote yes) (Del. 262(a))
- Notify corp. with written appraisal demand before the date of the vote (Del. 262(d)(1))
- Must continuously hold shares from date of demand to effective date of merger (Del. 262(a))
- File a petition with a court after the effective date of the merger and notification: 120 day term (262(e))
- From and after the effective date of the merger or consolidation, no stockholder who has demanded appraisal rights shall vote such stock or receive payment of dividends or other distributions on the stock (Del. 262(k))
- Court determines fair value (Del. 262(h))
- Attorney's fees and costs (Del 262(j))

Freeze Out Mergers

- A. Freeze-outs are not necessary mergers
 - a. Majority abuses its control in a plan—evidenced by particular actions designed to bleed the corp. of value (w/ the value going to the controlling SH at the expense of a minority)—capped by an offer to buy out the minority at a low price
 - b. This is not necessary a merger
- B. Freeze out-squeeze out merger: pejorative description of the mechanism by which a controlling SH seizes corporate value for itself through a merger, while cashing out the minority at a low price
 - a. Courts use this term when they feel like there's something unfair going on
 - b. Majority breaches fiduciary duties to minority SH's
 - c. Also known as squeeze-out mergers
 - d. Freeze out mergers are tool for controlling SH's to gain 100% ownership & get rid of minority SH's
- C. Delaware test for freeze-out mergers
 - a. Entire fairness
 - b. Burden shifting-fair dealing, fair price (valuation methods)

Weinberger v. UOP: Signal (▲) used market purchase (\$21/share) and a tender offer to acquire the majority interest in UOP (another ▲)—Signal later decided to acquire all shares; A report by both companies found that \$24/share would be fair, offered \$21 in a back end tender offer, SH's approved at annual meeting & created a forced sale of all the shares; two directors that served on both the board of Signal & UOP prepared a memo for Signal's

exclusive use; they had a better idea of what was actually going on b/c they had access to insider info solely b/c of their positions on the board; π is a SH who voted against the sale & sued to enjoin the merger.

Approval of the merger is made contingent on approval by a (a) majority of the minority UOP shares voted at the shareholder meeting (b) two-thirds majority of all outstanding UOP shares. Neither is required by Delaware law, only a simple majority is required

- A. Del Standard: duty of loyalty & good faith by virtue of being a director
- B. For a freeze-out merger to be valid: inform SH's, give fair price; **ENTIRE FAIRNESS**
 - a. For freeze out merger to be considered fair and valid:
 - i. SH must be informed of all relevant facts prior to their vote
 - ii. Price given must be fair
 - b. Here, there was a report that shows that a share price of \$24 would be advantageous to S, and had the minority SH's known, they might not have voted to approve the merger
 - i. What did S do wrong?
 - 1. UOP directors got confidential information that they used for the benefit of S
 - 2. S rushing the deal through but not for any justifiable business reason for doing so
 - 3. UPO president had secret meetings w/ S's board and accepted \$21/share w/o any negotiations
 - 4. Unilateral deal similar to Van Gorkum
 - c. Rule for π 's challenging a freeze-out/squeeze out merger
 - i. Court first looks at how the deal was put together
 - ii. π in a suit challenging a cash-out merger must allege specific facts of fraud, misrepresentation, or other items of misconduct to demonstrate the unfairness of the merger terms to the minority
 - 1. π bears the initial burden to demonstrate some unfairness in the transaction
 - iii. What is the showing that forces the majority to prove the transaction was fair?
 - 1. Behavior suggesting a breach of duty of loyalty-they know how much S is willing to pay and didn't tell UOP's SH's
 - iv. If the transaction was approved by an informed majority of minority SH's, π retains burden to show unfairness-*generally, π loses here*
 - v. IF no such informed majority of minority SH approval/ratification, controlling SH bears the burden of proving the transaction was entirely fair
 - d. **Entire Fairness TEST:**
 - i. Fair Dealing + Fair Price
 - ii. Duty of Loyalty:
 - 1. Director (individually or through another entity she controls) may not engage in self-interested transaction w/ the corporation or its SH's, unless:
 - a. Director's self interest is fully disclosed to, and approved by, a majority of disinterested directors or if required SH's and/or
 - b. Transaction is entirely fair to corp/SH's at time of execution
 - 2. And/or-almost all states and judicial standards use the disjunctive, but almost all courts hold that proper approval or ratification merely shifts the burden to the plaintiff to prove that the transaction was not fair, making the conjunctive more accurate
 - 3. Signal did not deal fairly w/ minority UOP shareholders in this case b/c misuse of confidential UOP info; lack of candor; lack of arms-length negotiations
 - 4. Signal should have – appointed an independent negotiation committee to determine whether the deal was fair or not; disclosed the memo by A & C; used someone besides Lehman Bros – someone less interested; not rushed the time frame; kept the UOP/Signal directors out of negotiations altogether; also take UPO President out of negotiations b/c he is a Signal insider.
 - 5. What should the Signal board of directors have done?
 - a)Keep the Signal people on the UOP board out of any studies or discussions of Signal strategy
 - b)Appoint a special committee of the UOP independent directors to study the offer
 - c)Fairness opinion by outside financial advisor
 - d)Crawford withdraw from the negotiations

6. **Fair Dealing Issues:**

Would Signal have a duty to reveal a study on the value of the UOP shares if it was done solely by Signal employees who were not directors or officers of UOP?

Certainly NOT: Signal has no duty

Would Signal have a duty to reveal a study on the value of the UOP shares if it was done solely by Signal employees, but that used confidential information obtained from Crawford?

Probably NOT, if the disinterested directors approved the provision of the confidential UOP information to Signal

Maybe YES, if no such approval was obtained from the disinterested directors

1. Why was this not a fair price?

2. Timing: Valuation includes “elements of future value, known or susceptible of proof as of the date of merger & are not the product of speculation.”

3. This case got rid of business purpose test in DE and went back to entire fairness test.

e. Duty of loyalty: Standard of review-entire fairness

i. Signal has to prove that transaction was entirely fair, unless it was ratified by the board

1. Ratification: majority of independent board members and if needed SH’s

2. In the ordinary case, ratification gives safe harbor, but there is no safe harbor in a merger case (burden shifts to minority to prove unfairness)

f. Here, the entire fairness was breached

g. One of the following is fair dealing:

i. Arms length transaction/bargaining

ii. Duty of full disclosure (candor)

h. Without those two, there is no fair dealing

i. If there is an independent committee, there is no conflict of interest; would not constitute ratification b/c not fully independent

i. If you don’t do this, need to disclose all materials to SH’s that board relies on

ii. Majority of minority voted to approve merger, but that ratification was ineffective b/c not all proper materials were disclosed

iii. Ratification is effective only when the conflict is fully disclosed

j. Problem: 4 days left to make decision; what was lacking was that UOP didn’t do any independent negotiations; didn’t take their duty to minority SH’s seriously

k. Fair Price

i. Minority SH can still say price was inadequate in entire fairness test; then the court will determine what the fair price is via appraisal

ii. Often SH’s have an appraisal remedy if they voted against the appraisal remedy

iii. Difference between appraisal right as part of a statutory right of appraisal v. appraisal as remedy for unfairness

1. If you get an appraisal b/c you voted against merger, SH has to perfect the appraisal right (hire lawyer); it costs money and SH is not reimbursed; each SH has to do it individually; the amount of money distributed will go to minority who voted against

2. In unfair dealing, you can get a class action b/c the corp doesn’t suffer harm, but the individual does (not a derivative suit)


a. Advantages: company pays for lawyers, entire minority gets it; this is bad for Signal b/c they will now have to pay more for the transaction than they expected

b. This is a more severe remedy for a corporation but is better for individual SH’s

c. Business Purpose Test : Delaware, in 1977 (Magnavox) – held that the controlling shareholder cannot carry its burden of showing the entire fairness of the transaction if the merger was caused “for the sole purpose of eliminating a minority on a cash-out basis.”

d. Weinberger eliminates the Business Purpose test

6. CONTROL PREMIUM FOR SALE OF CONTROL BLOCK: Transfer of Control

- a. SH is controlling and sells his control to a 3rd party for a higher price than market value, called the **control premium**
- b. Control premiums are legitimate if there is no abuse and if majority isn't taking advantage of minority shareholders
- c. 3rd party can acquire shares at market price from the regular SH's, but since it wants control, must pay more
 - i. Majority share-typically, majority interest will give you the ability to control the company
 - ii. Control share
 1. Amount you determine comes from psychological benefit
 2. Amount comes from expertise that is brought into Corp
 3. Looting-willing to pay b/c if you control the premium, you can start milking the Corp for your own benefit; runs the risk of lawsuits
- d. Minority SH's not entitled to get a premium price b/c control is a valuable thing
- e. Concern- controlling SH has a legitimate interest in controlling, but he might abuse it
- f. When might majority not give control? (Smith v. Atlantic Properties)
 - i. Different classes of stock, not all of which have voting rights
 - ii. W/ big enough minority, you can elect a BoD—those directors now have free access to SH list & they can use the corporate stuff in the meantime
- g. Where does control premium come from?
 - i. Purchaser believes control shares permit extraction of special benefits
 - ii. Purchaser believes company is worth more in her hands than in current management's (i.e., firm currently badly managed, or Purchaser can create special synergies that add value)
 1. Everyone is better off:
 2. Minority is benefited because company becomes more valuable after change of management
 3. Current management is benefited by increased purchase price
 - iii. Buyer gets valuable company at premium that's still a bargain price
 1. Example: Roll-out corporations (start combining mom & pops & make it a more streamlined operation) – it costs less to do business, but you can still charge just as much for the product
 - vi. Minority shareholders are not entitled to share unless there is some sort of abuse
- h. HYPO: Wheelco-Spikeco
Bikeco  (now controlling Wheelco)
 - i. Wheels cost \$9.50/each to manufacture, but they sell at \$20 on the market
 - ii. Bikeco gets control of Wheelco & wants to require Wheelco to sell bikes for \$10
 - iii. Controlling SH of Wheelco has fiduciary duty to other SH's; self interested transactions
 - iv. Analyze intrinsic value unless there is safe harbor (ratification)
 - v. Here, this is not intrinsically fair
 - vi. If the bikes were \$18/wheel, but there was a long-term requirements K, would still analyze under intrinsic fairness; Bikeco has burden of proof; maybe fair, but he has to prove it is fair; for Bikeco, it is a good idea to have independent members on the board
 1. An easy ratification process is to go to 3 independent directors
 - vii. If 7 directors give Bikeco the chance to put in 4 & leave 3 seats for minority, 4 have cumulative voting
 - viii. Legitimate reasons why Bikeco would pay the premium (value)
 1. Lock up supply
 2. May want Wheelco to make their designs
 3. Could order Wheelco to invest in more production facilities
 - ix. Issue: control premium is ok in theory. If it is being sought for abusive reasons, if controlling SH seeking to benefit at the detriment of the minority, the minority can challenge it
 - x. Remedy: minority SH to sue Bikeco or the Board (derivative suit); don't include Spikeco; only way it will be challenged is if Spikeco anticipates this for lower price

Zetlin v. Hanson Holdings: π had 3% interest in Gable, while \blacktriangle & another family owned 44% each of the shares; \blacktriangle sold controlling interest at a premium price; π sued claiming that minority SH's are entitled to opportunity to share equally in any premium paid for controlling interest in Corp. The issue is whether Plaintiff is entitled to the premium share value that Flintkote paid to Defendants for their controlling shares.

- a. If π prevailed, would've been a radical change from existing law, & court says that legislature is best suited to make these types of radical changes
- b. Absent looting of corporate assets, conversion of a corporate opportunity, fraud, or other acts of bad faith, a controlling stockholder can sell, and a purchaser can buy controlling interest at a premium price
- c. Though minority SH's are entitled to protection against abuse by controlling SH's, they aren't entitled to inhibit legit interest of the other SH's; not a fiduciary breach
- d. **Controlling party has absolute right to sell; don't have to look out for minority unless they know the person buying is going to use it to abuse the minority**
- e. The Court of Appeals of New York declined to adopt Plaintiff rule which would effectively mandate that a purchaser give a tender offer to all shareholders when they are only seeking a controlling interest in a corporation.

Debaun v. First western bank: Rule of Law. A controlling majority shareholder must exercise good faith and fairness in selling its controlling shares in a company, which includes the duty to reasonably investigate whether a potential buyer is a looter

Issue. Whether Bank as the controlling majority shareholder had a duty to the Corporation and minority shareholders to act as a reasonably prudent person in selling its controlling shares?

If so, did Bank breach its duty?

If Bank breached its duty, whether the trial court properly awarded damages?

What counts as a red flag? Mattison looks pretty bad – past fraud, bankruptcies, outstanding delinquencies. Consider the following possibilities:

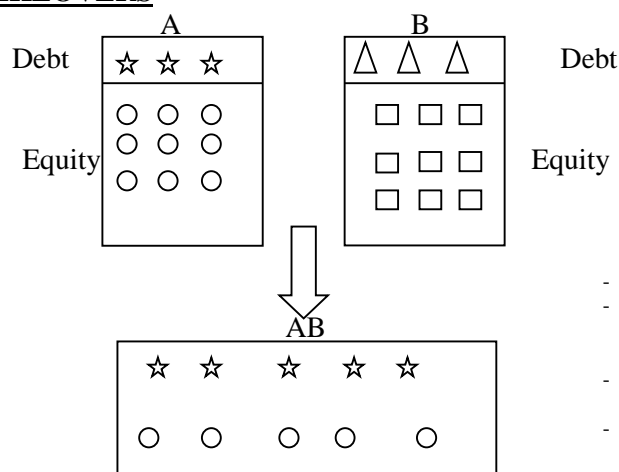
- (a) The buyer has a history of breaking up companies, selling the assets, and firing workers to increase corporate value
- (b) The buyer uses a loan from a third party to buy the company. The buyer plans on repaying the loan using corporate profits. Expected profits, however, are inadequate to service the loan.
- (c) The buyer has no definitive plan on what to do with the company.

Essex Universal Corp v. Yates: \blacktriangle contracted to sell his interest in Republic (28%) to π ; K called for a transfer of \blacktriangle 's shares (28% + voting shares- and for resignation of a majority of BoD, which were to be filled by π 's choices; \blacktriangle tried to back out claiming it would be illegal to deliver the Essex dominated board required by the sale agreement

- a. Agreement valid; doesn't violate public policy; π was receiving a sizable portion of the shares which would have eventually entitled them to elect reps to the board; agreement only accelerated that process; it was acceptable for majority SH to obtain a premium for selling the control of company in this case b/c unlike Perlman, there was no breach of fiduciary duty to minority SH
- b. When selling controlling interest, there can be immediate transfer of control. You can sell your shares, but you can't sell your office
- c. Sale of control block is permissible, but sale of office is illegal
- d. If Essex were buying a majority, it would be unobjectionable since it would eventually get control
 - i. Directors cannot obligate themselves to vote a certain way, it always has to use its independent business judgment
 1. Special provisions have developed "fiduciary out" – directors shall vote in favor of the merger unless doing so would be a violation of their fiduciary duties
 2. Stock you are selling must have ability to actually vote in a director
 3. Arrangement here permissible b/c 28% would still give Essex eventual control
 4. Burden on Yates to prove Essex could not gain control of the board
- e. Concurring Opinion:
 - i. Majority holding against public policy

1. Directors who automatically elect the purchaser's nominee violate the fiduciary duty to all shareholders and a contractual obligation to replace the old board w/ the new controlling shareholders' cronies violates public policy unless it was entirely plain that a new election would be a mere formality – i.e. when the seller owned 50% or more of the stock (clear majority)
- ii. Concurring judge said he would void the K that gave controlling majority of management to a Co. that held less than 50% of the shares; wanted legislature to determine what policy it would follow
- iii. Defining control: power to determine the policies and operations of a corp
 1. Can be majority
 2. Large minority
 - a. Zetlin 44%
 - b. Essex 28%
 3. Minority w/ veto power
- iv. Why is Yates 28% interest in Essex controlling?
 1. Large amount to have in publically held corp and gives Yates control of the board
 2. Has cost-free access to shareholder lists, corp records, can pass defensive measures (like staggered board).
 3. As an incumbent, Yates gets to fund proxy fight out of the corp treasury.
- v. Bribe v. legitimate transactions
 1. Is the director/shareholder enriching themselves at expense of the corp and minority?
 2. Potential breach of fiduciary duty claims (looting).
- vi. What if Yates owned only 3%?
 1. Would consider it sale of office (directorship) rather than shares – both the majority and concurrence would NOT allow this
- vii. Effect of staggered board?
 1. Means control cannot easily be given up and thus
 2. As time passes, will be able to institute control slowly
 3. Eventually Essex will get control of board
- f. HYPO: controlling SH sells control to A; A wants control, but Co. has a classified board; A can't get control by putting directors it wants for 2/3 years; controlling SH agrees to convince board members to resign & replace themselves w/ A's directors (resignation ad seriatim (one after another)
 - i. Court says there's nothing wrong with this; when controlling SH sells his control, A expects to get control. Who is harmed? SH's b/c they had an expectation on relying on a classified board
 - ii. What if controlling SH didn't sell the shares? If A had asked controlling SH to convince board members to resign after the purchase, then it would be ok. (IF resignation is combined w/ sale, then ok).
 - iii. If SH was controlling, why did they have expectation to elect SH's, if SH always control?
 1. If controlling SH has power over directors, then would look like resignation ad seriatim had more value than mere control

MERGER- HOSTILE TAKEOVERS



- Each had its own capital structure
- Under the operation of §251 (DE Corp law), there are allowed mergers; there is a procedural process corps have to follow, file forms, etc.
- The resulting corp assumes all the debt (liabilities) of A + B and their equity
- The stock of A + B's SH's cancelled and is replaced w/ the stock of AB

a. MERGER AGREEMENT

- i. Who gets how much of the stock is determined by the **Merger Agreement**
- ii. There can be no merger w/o a merger agreement
- iii. Board of D's has to make the agreement (K w/ buyer)
- iv. Merger agreement goes to the Board and then gets put to the SH's for their approval
- v. Who gets what shares in the co., ex. A Corp. gets 62%, B gets 38%
 1. Then these percentages are divided up and replace the original shares
- vi. This is a negotiation process

b. Entities

- i. Don't have to form a new company entirely
- ii. B can merge into A and A may continue to exist; the resulting corp would be A; A might need a new certificate
- iii. 3 options
 1. New Company: Both A's and B's shareholders vote
 2. Existing Company: if A is the surviving company, B's shareholders get to vote
 3. Modified existing Company: if A is the surviving company and is modified, A's and B's shareholders get it vote, if a new certificate is obtained (if there is a new governance structure)
- iv. Only if the existing company is left as is, that company's SH's don't get to vote; the Certificate has to be the same and the shares must be left unchanged
 1. Ex. If there are 1 million shares before the transaction and if A gives cash to B's shareholders so that there are 1 million shares after, then A's SH's don't get to vote; but if A issues stock to B's shareholders, A's SH's get to vote; this is equivalent of A getting B's assets and liquidating

c. Appraisal Rights

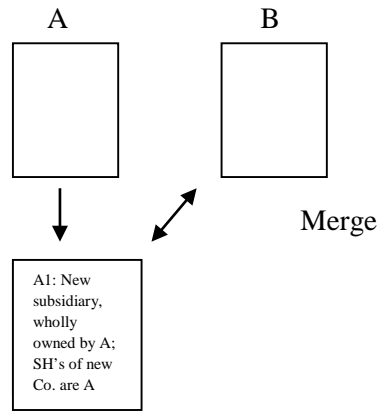
- i. Right to have to exist if you vote no on the merger
- ii. Majority determines what happens; for minorities, there's nothing you can do, unless you have an appraisal right/dissenter's right.
- iii. You ask the court to value your shares. You have the right to accept the \$ that the court orders that your shares are worth
- iv. Today, these rights are rarely used b/c people don't like to have courts measure the value of the company b/c there is a complicated formula; it is much better to rely on the market; if there is a public market, it is better not to mess around w/ appraisal rights; just sell your shares
- v. In DE, if a co. is publicly traded **or** has more than 2,000 SH's, there are no appraisal rights at all; you can vote, but if you vote down, just sell
 1. If there is no public market, there is a presumption that you will be protected by the wisdom of the crowd (that they voted right)
 2. It is not worth the trouble of asking for relief from the court; they may be useful in close corporations, where the court will value the shares, Pedro
- vi. The existence of an appraisal right can interfere/discourage a transaction b/c it may make the company pay more than it wants to pay

m. Sale of Assets

- a. B could just sell his assets to A, get consideration and liquidate
- b. Don't have to sell for cash; could be for A's shares of stock
- c. A sale of assets can be the same as a merger, **De Facto Merger Doctrine**
- f. In Glen Arden, (Penn), if they are equivalent, SH's get the same rights
 - (1) Court looked at substance over form; if it looks like and has the effect of a merger, it is a merger

- (2) Overruled by statute
- g. In DE, there are individual statutory provisions for both that govern S of A and mergers; they are of equal value; SH's get the rights that that provision provides
- d. The SH's of the company that's selling gets to vote but get no appraisal rights; the acquiring co gets neither a vote or an appraisal right
- e. The De facto merger doctrine died out b/c the appraisal rights were considered useless b/c they are so many other ways of doing transactions; it is difficult to predict what a court will consider a merger

n. TRIANGULAR MERGER



A + B want to merger, but A's SH's don't want to vote; A can get around this by creating a new subsidiary and put the merger consideration in A1. A's SH's don't get a say; it may not be politically wise for A's CEO to do this b/c they may oust him

- B gets a vote
- A1 gets a vote, which is cast by A's directors, who control the vote
- A's SH's get no vote

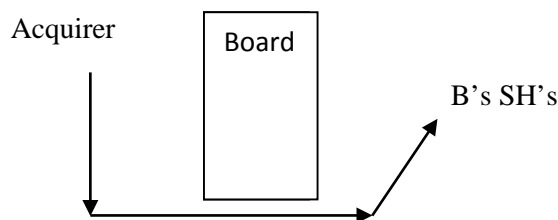
- a. What if B's board of directors don't want to sell b/c they like being directors? B wants \$30/share. A offers \$150/share for B. Can't have a merger unless the Board agrees; B's SH's who do want the deal can have a proxy contest to get new directors who will approve the deal. This takes a lot of time and is difficult to pull off. If B has a classified board, it may take several years and A's offer may not stick around
- b. A can try to go directly to B's shareholders; this is called a **tender offer**

o. TENDER OFFERS

- a. Acquirer will make public that he will buy shares at certain price; if SH's like it, they will submit to the tender; if the acquirer gets 50% or more, he'll buy it
- f. By law, tender offer has to be open for 2 weeks
- b. A makes a public offer to buy shares of B for a merger consideration. If B's SH's like the idea, they will sell to A and A will become the majority SH, gets its own board, and effectuates the merger
- c. Disadvantages
- f. Regulated by the SEC
- g. Defensive measures, such as poison pills, discourage/prevent tender offers; they have to be overcome
- d. They are sometimes used in friendly transactions (when both Boards of Directors approve the transaction, as opposed to a hostile takeover (when one board doesn't approve and it goes to the SH's); sometimes takeovers start out hostile but become friendly; if the tender offer is successful, A may go back to B, offer more \$, and B may give in
- e. In 2008, the SEC revised its rules to fix the problem; maybe tender offers will come back; (efficient, they close a lot faster w/ less paperwork)

p. HOSTILE TAKEOVERS

Classic Merger Construction (above); this is a hostile tender



- a. Normally, if Acquirer and Board reach an agreement, it goes to the SH for a vote

- b. If Board is disinterested, Acquirer may skip going to the board and goes directly to SH's, makes an offer to purchase and shares at a certain price. If SH's want to tender to that, they can go ahead and if enough of them sell, they get the company
- c. Boards don't usually like this and want to insert themselves in the process/block this route by putting in a proxy board.
 - i. Purpose (2 reasons)
 - 1. To entrench themselves and continue to keep their jobs b/c if acquirer comes in, board will be replaced; in this case, the SH's will vote in favor b/c the board must be doing a bad job
 - 2. More centralized negotiations; more bargaining leverage; get better outcome for shareholders
 - a. Ex. Tender offer terms: stock is trading at \$50/share; there is a 60% offer (will buy any and all shares at 60% (at \$60/share)); the real value of the stock is \$70/share
 - b. Whether SH's reject Acquirer's offer depends on what SH's think the other SH's will do. They each have their own personal value of corp; if they don't tender into offer, but the majority does, they become a minimum SH (undesirable position); in a follow up merger (if there is one (if A is acquirer only a majority share now, and later will acquire the rest)), they will get an even lower offer
 - c. **If co. is publicly traded, each share is worth x/n , but a control block value is $\$X$. If you already control the block, the value of the smaller shares will fall $MX/N \times$ Control Premium**
 - d. To have the board as a negotiator is beneficial b/c the Acquirer may otherwise take advantage of the SH's
- d. How a Board interferes/**Defensive Measures**
 - i. **Poison Pill**-prevents the acquirer from getting to the SH; it is a "warrant"/"option" that attaches to every common share; the "warrant" is dividended out to the SH's. It is unattachable (you can't get a stock w/o it)
 - ii. SH's can get an option to buy a large # of shares at a discounted price
 - iii. To enact poison pill, need a majority vote b/c it is dividended out
 - iv. The triggering event is the acquisition by any person of a certain number of stocks (ex. 10%).
 - 1. By the terms of the option, the option can't be exercised by anyone who pauses the triggering event from happening
 - 2. Acquirer buys 20% of the company; other SH's have the opportunity to quadruple the holdings b/c the more shares that are issued
 - v. The more an acquirer buys of a stock, the more \$ it loses
 - vi. No one has charged through the poison pill
 - vii. SH's will have the right to buy more shares at a discount, if one shareholder buys a certain percentage of the company's shares. The plan could be triggered, for instance, when any one shareholder buys up 20% of the company's capital, at which point every other shareholder (except the one who already possesses 20%/acquirer) will have the right to buy a new issue of shares at a discount. The plan is issued by the board as a warrant attached to existing shares, and can only be revoked at the discretion of the board of directors. The point is that the SH who could potentially reach the 20% threshold will be a takeover bidder. If every other shareholder will be able to buy more shares at a discount that will mean the bidder's interest will be diluted, and the cost of the bid will rise substantially. If the bidder knows that this will happen, the bidder will not attempt to take the corporation over without the board's approval. They will negotiate with the board so that the plan is revoked.
 - viii. Goal: force a bidder to negotiate w/ target's board and not directly w/ SH's
 - ix. Effects
 - 1. It gives management time to find competing offers that maximizes selling price.
 - 2. Higher takeover premiums than companies without poison pills. This results in increased shareholder value. The theory behind this is that an increase in the negotiating power of the target is reflected in higher acquisition premiums.
 - 3. To make it prohibitively expensive for an acquirer to buy the control of a co. The underlying assumption is that the board will always act in the best interest of the SH's, a

view that is rejected by agency theorists. They have argued that that practice of allowing management to adopt poison pill strategy has reduced the # of potential offers and actual takeovers; in doing so, they have protected incumbent management at the expense of SH's. Poison pills have the effect of perpetuating inefficiencies & poor management that ultimately is reflected in lower stock values

- x. Most poison-pill agreements are triggered when an outside company or individual acquires enough stock to gain a controlling interest in the target company. The term is often used as a catch-all for a variety of antitakeover measures, but in its most common form there are two primary tactics:
- xi. **Flip-over:** If a hostile takeover occurs, investors have the option to purchase the bidder's shares at a discount, thereby devaluing the acquirer's stock and diluting its stake in the company.
- xii. **Flip-in:** Management offers shares to investors at a discount if an acquirer merely purchases a certain percentage of the company. The discount is not available to the acquirer, and so it becomes extremely expensive for that acquirer to complete the takeover. Experts estimate that it would cost an unwanted bidder, on average, four to five times more to "swallow" a poison pill in order to acquire a target.
- xiii. There is no way around the poison pill; the ability of a company to modify the terms of the warrant makes it impossible to blow through the pill
- xiv. Why is it permitted?
 1. Protects the Board's ability to negotiate on SH's behalf
 2. Can't counter offer a tender offer; this deters a lot of tender offers
- xv. The poison is governed by the BJR. Board says this is a bad deal for their SH's b/c the company is devalued
- xvi. UNOCAL, DE set forth a standard-**enhanced judicial scrutiny** applied to defensive measure (measure taken in response to a perceived threat); rooted in change in control (sell off, break it off, etc.)

Cheff V. Mathes: Rule of Law. Directors have the burden of proof that a buyback of shares by a corporation in an attempt to remove a threat to the current corporate model is in the corporation's interests.

Facts. Defendants were directors of Holland, including the CEO. Holland manufactured furnaces and air conditioners, and it directly hired its retail sales staff (a practice that the directors believed was a key to Holland's success). Holland performed well during 1946 to 1948, but sales declined until 1956. In 1957 the company reorganized and cut some unprofitable stores and it resulted in a healthier bottom line. At the same time, shares of Holland were being bought on the open market by Arnold Maremont, which increased share price. Maremont was well-known for taking over companies and then liquidating their assets. At the very least, Maremont contacted the Holland CEO, P.T. Cheff, to inquire about a merger with his company and altering the sales model to only sell to wholesalers. Cheff discussed this with other directors, and they agreed to thwart Maremont's attempts to buy Holland in order to keep Holland running in its current state. Some directors agreed to personally buy the shares, but the board voted to use Holland funds to purchase the shares at a premium price of \$20 per share (the net quick asset value was \$14). Plaintiffs argued that the directors used Holland's funds to ensure that their positions with the company remained intact. The Vice-Chancellor of the lower court agreed, and therefore upheld the suit against the defendants that had a vested interest in the purchase as a result of their positions with the company.

Issue. The issue is whether the directors improperly agreed to purchase its own shares in order to keep their positions with the company.

Held. The Supreme Court of Delaware agreed with the Vice-Chancellor that the burden of proof was on the directors to prove that their conduct in purchasing the shares was proper, but the court here believed that the facts alleged demonstrated that they acted properly. There was a legitimate

Structural Coercion

- Suppose Target's secondary market price is \$20 per share. Acquirer puts forth the following tender offer: An offer for \$15 per share for 51% of the shares. The offer is conditional – if the Acquirer does not get the full 51% it will return all tendered shares. On the other hand, if the offer is successful, the Acquirer makes clear that minority shareholders that remain will not be treated well and their share value will drop to something like \$10 per share.

	Offer Wins	Offer Loses
Tender	\$15/SH	\$20/SH
Don't Tender	\$10/SH	\$20/SH

UNOCAL DUTIES APPLY TO ANY POTENTIAL CHANGE IN CONTROL TRANSACTION

- e. 2 prongs
 - i. Directors must show that they had reasonable grounds for believed that there was a threat
 - ii. Defensive response has to be in proportion to the threat posed
- f. If both are met, BJR applies
- g. Rationale-to assure that the Board is not acting in its self interest
- h. Usually, a tender offer is condition on 1) acquisition of x% of company and 2) redemption of the pill. At the same time, will launch a proxy contest. In the proxy context, the court will give some substance to the UNOCAL review
- i. How enhanced is this?
 - i. Reasonably perceived threat (PRONG 1)
 - 1. Threats recognized: opportunity loss (ex. Board is considering a strategic acquisition (wants to buy B Corp.); if acquirer does a leveraged buyout of A, the capital is capped and there is no consideration left for A to buy B. A would say the that there is a threat to

- the company b/c it will be prevented from buying B, which is a better deal for the company
2. Structural coercion-SH's would be encouraged at value they think is inadequate b/c worried about not participating in tender offer
 3. Substantive coercion-somehow SH's are going to be coerced @ inadequate price to sell the shares b/c they are deceived/misled as to the value of the Co.
- ii. Step one is deferential; all the board needs to do is find an investment banker and say that acquirer undervalued the stock's worth
 - iii. PRONG 2
 1. Requires that the defense mechanism be proportional
 2. Poison pill is proportional. If threat that SH's will be screwed to sell @ lower price, poison pill prevents this and is proportional
 3. Proportional
 - a. The opposite of proportional is **draconian, which means coercive OR preclusive**
 - b. If the Board has **breached its fiduciary duty, the remedy is the defense measure is void**
 - c. UNITRIN defines draconian. A defensive measure is not proportional when it is coercive or preclusive. Preclusive really means preclusive (need more than to make it hard; needs to be impossible to be preclusive); this happens when there is an interference w/ proxy
 - d. Coercive: White Knight Defense; what can acquirer do if there is a poison pill and a White Knight defense? Board will say this will preserve the long term interests of a corp to the extent that the other won't
 - e. General rule: the above is permissible, except when a change of control in Co. becomes inevitable; this occurs when
 - i. A + B are both public, each has its own SH's and SH's still control the co. There are no controlling SH before + after
 - ii. However if a friendly partner is dominated (if private entity), if there is a change in control, the Revlon duties attach
 - iii. Under Revlon, when change in control like it becomes inevitable, the Board has an obligation to get the best merger consideration possible
 - iv. What to do to get out of obligation?
 - v. Deal protection devices w/ friendly partner, sign merger agreement and try to protect the deal; this can occur in reverse (Board might engage in friendly negotiations, sign agreement, and then a hostile acquirer comes it)
 - vi. **Deal protection devices:** you agree to purchase us for \$10 million; if it doesn't close, we will pay you \$600K
 - vii. A reasonable lock up fee is acceptable
 - viii. If the lock up fee is excessive (100%), it is an unacceptable protective device, and SH's will be coerced into accepting the management friendly alternative b/c if transaction will go thru Acquirer & Co. would have to pay all the fees, this is coercive (forces SH's to accept/influence offer)
 - f. No talk/no shop provisions: I bid X; I don't want you to shop around for someone to overbid me; this is reasonable generally, but if a White Knight says you can't talk w/ anyone regarding the price, preventing you to do due diligence, this violates Revlon b/c directors no longer trying to set a higher price; settling for a lower price, not in best interests of corp
 4. →No shop is generally ok; no talk is not ok
 5. →Cannot fully protect a deal if fiduciary act is required, there must be some capacity in friendly transaction to exist the transaction if fiduciary duty so demands (if better transaction comes along, board has to be able to get out of it)
 - j. Board usually retains the right to redeem the share/warrant for a trivial amount (\$0.01)
 - k. It will redeem it when it wants to engage in a merger subsequent to the tender offer
 - i. When hostility has transformed into friendly negotiations

- ii. If it is engaged in another competing transaction (White Knight Defense)
 - 1. Board funds company run by the Board's friends and they will buy the company; probably make a promise that they won't replace the Board; doesn't have to be a complete sale; only a controlling bloc
- iii. The fact of redemption creates a way around the pill
- 1. **Dead Hand Poison Pill:** provision w/ a warrant that only incumbent directors may redeem the poison pill; provision stipulation that only persons who were members of the B of D at the time the antitakeover measure was put into place have the power to rescind the measure
 - i. In case of a proxy contest, only if a majority of directors left who were there at the time the measure is put in place, can they redeem the pill; if a majority is replaced, can't be rescinded
 - ii. **Dead Hand Poison Pill is completely preclusive and that is where the courts draw the line**
 - 1. Courts will more closely scrutinize interference w/ proxy than it will any financial mechanism that took place before proxy (Proxy, Shareholder Democracy are important)
 - a. Ex. Board can't postpone date of SH meeting when SH's vote on directors
 - b. Shareholder democracy is where the teeth of UNOCAL review come in
 - iii. The battle between A & B is the proxy and if the board enacts a preclusive measure, this is not ok
 - iv. Classified board is almost preclusive; classified boards are part of the certificate; not considered defensive measures are difficult to refute b/c to amend, need majority vote; to amend, acquirer has to launch 2 proxy contests (one this year and one next year)

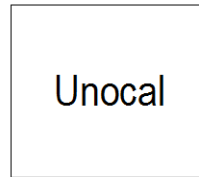


Unocal Corporation v. Mesa Petroleum Co. (Del. 1985)



13% of shares

\$33/sh
Mkt Price



Two-stage acquisition

1. Tender offer for 37% of stock at \$54/share cash
2. Second stage squeeze-out merger for \$54/share using Mesa "junk" bonds

Unocal announced that if Mesa bought a majority of Unocal Stock, Unocal would purchase each remaining share with notes (allegedly) worth \$72.



Must Unocal also purchase Mesa's shares too? Held: No.

m.

Facts. Plaintiff was a corporation led by a well-known corporate raider. Plaintiff offered a two-tier tender offer wherein the first tier would allow for shareholders to sell at \$54 per share and the second tier would be subsidized by securities that the court equated with "junk bonds". The threat therefore was that

shareholders would rush to sell their shares for the first tier because they did not want to be subject to the reduced value of the back-end value of the junk securities. Defendant directors met to discuss their options and came up with an alternative that would have Defendant corporation repurchase their own shares at \$72 each. The Directors decided to exclude Plaintiffs from the tender offer because it was counterintuitive to include the shareholder who initiated the conflict. The lower court held that Defendant could not exclude a shareholder from a tender offer.


Issue. The issue is whether Defendant can exclude Plaintiff from participating in Defendant's self-tender.

Held. The court held that Defendant could exclude Plaintiff from its repurchase of its own shares. The directors for Defendant corporation have a duty to protect the shareholders and the corporations, and one of the harms that can befall a company is a takeover by a shareholder who is offering an inadequate offer. The directors' decision to prevent an offer such as the one at issue should be subjected to an enhanced scrutiny since there is a natural conflict when the directors are excluding a party from acquiring a majority control. In this case the directors met the burden. There was evidence to support that the company was in reasonable danger: the outside directors approved of their self-tender, the offer by Plaintiff included the junk bonds, the value of each share was more than the proposed \$54 per share, and Plaintiff was well-known as a corporate raider.

Discussion. The burden of proof was on the directors to prove that there was a legitimate business interest at stake to rebut the presumption of their conflicting interest in denying the takeover. This was well-established, but the allowance by the court to allow the directors to deny the plaintiff from participating in the resulting repurchase was new ground.

Notes: "[The Unocal board's] resolution provided that if Mesa acquired 64 million shares of Unocal stock through its own offer (the Mesa Purchase Condition), Unocal would buy the remaining 49% outstanding for an exchange of debt securities having an aggregate par value of \$72 per share.


Scorched earth defense: It sucks more money out of the corp. and gives it to the remaining shareholders and nothing left in the corp. for the acquirer.



Unocal

“[The Unocal board’s] resolution provided that if Mesa acquired 64 million shares of Unocal stock through its own offer (the Mesa Purchase Condition), Unocal would buy the remaining 49% outstanding for an exchange of debt securities having an aggregate par value of \$72 per share.”

“On April 22, the Unocal board met again and was advised by Goldman Sachs and Dillon Read to waive the Mesa Purchase Condition as to 50 million shares. This recommendation was in response to a perceived concern of the shareholders that, if shares were tendered to Unocal, no shares would be purchased by either offeror. The directors were also advised that they should tender their own Unocal stock into the exchange offer as a mark of their confidence in it.”



Unocal Test

- Two Parts
 - Reasonableness Test: “Good faith and upon a reasonable investigation” the board determines that “reasonable grounds for believing that a danger to corporate policy and effectiveness”. Presence of majority outside independent directors materially enhances such evidence.
 - Proportionality Test: “If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.”
 - Failure: Entire Fairness Test, Burden of Proof on Target Board
-



Unocal on Threats

“Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange. While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.”




Possible Threats

- Structural Coercion: Partial Tender Offer with Lower Back-End Value (Price)
 - Substantive Coercion: Inadequate Price
 - Market has too short-term focus
 - Insider, confidential information
 - Antitrust Problems?
 - Harm to other groups (communities, employees)?
-




Poison Pills

- Board of Directors establishes a shareholder rights plan and issues a dividends of rights to the shareholders.
 - “Flip-Over” Poison Pill:
 - (a) triggered by a shareholder (the acquirer) obtaining over a specified amount of target company stock (e.g., 20% of stock) or upon the announcement of a tender offer for more than a specified amount of stock (e.g., 30% of stock).
 - (b) Available to all shareholders except the acquirer.
 - (c) Gives shareholders the right to purchase stock or notes of the acquirer at a (often extreme) discount upon a 2nd Stage Squeeze-out merger of the target into the acquiring company.
 - (d) Redeemable by the target board
-




Beating the First Generation Flip-Over Pill

- E.g., Sir James Goldsmith's takeover of Crown Zellerbach
 - Crown Zellerbach pill only kicked in if the bidder tried to effect a freeze-out merger
 - Goldsmith acquired a controlling interest in Crown Zellerbach but did not effect freeze-out
 - Goldsmith suffers no poisonous effects
 - On the other hand, since the rights were now exercisable in the event of a merger, Goldsmith precluded anyone from merging with Crown Zellerbach
-




Poison Pills

- Board of Directors establishes a shareholder rights plan and issues a dividends of rights to the shareholders.
 - “Flip-In” Poison Pill: Similar to the “Flip-Over” pill but gives shareholders right to purchase stock or notes of the target company and thus does not depend on a 2nd stage squeeze-out merger.
 - Chewable Poison Pills: Ways of making pills more palatable to shareholders (who understand their impact on hostile takeovers). For example, some pills provide that if a majority of shareholders approve a takeover offer that the target board must redeem the pill.
-



Shark Repellents: Classified Boards

- Divide board into classes (usually 3)
 - Each class serves a multiyear term (3 years in the case of 3 classes)
 - Only one class elected per year
 - Example:
 - Class A elected in 2000 for 3 year term
 - Class B elected in 2001 for 3 year term
 - Class C elected in 2002 for 3 year term
 - Hostile takeover in 2002. New controlling shareholder will not get control until 2004
-



Shark Repellents: Fair Price Provisions

- Fair price provision
 - No backend or freeze-out merger unless bidder pays a fair price (as determined per provision) or transaction approved by a majority of the disinterested shareholders (as defined)
- Redemption provision
 - Gives post-tender offer minority shareholders a put option to sell at a fair price (as defined)
- Business combination provision
 - Precludes a freeze-out merger for a specified period of time; and even then typically requires approval by disinterested shareholders

REVLON: The Revlon Doctrine:

"In certain limited circumstances indicating that the "sale" or "break-up" of the company is inevitable, the fiduciary obligation of the directors of a target corporation are narrowed significantly, the singular responsibility of the board being to maximize immediate stockholder value by securing the highest price available."

FACTS

- Pantry Pride wanted to acquire Revlon. Suggested price between \$40-50/share, later made hostile tender offer of \$45.
- Revlon's investment banker advised directors that \$45/share was grossly inadequate.
- Pantry Pride's strategy was to acquire Revlon through junk bonds and break up Revlon and distribute assets making a profit.
- Pantry Pride made a series of hostile moves, each rejected.
- Revlon used defensive measures, "note purchase rights plan" and note covenants.
- Board eventually agreed to leveraged buyout by Forstmann. Pantry Pride offered \$56.25, and Forstmann offered \$57.25 per share (time value of money made it less).
- Pantry Pride asked for an injunction barring the consummation of an option allowing Forstmann from purchasing Revlon (lock-up option) as well as bar a no-shop provision from Revlon to Forstmann, and payment of a \$25M cancellation fee to Forstmann if transaction was aborted.

RULES

- Ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors. Directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.
- When a board implements anti-takeover measures, there arises the omnipresent specter that a board may be acting

primarily in its own interests, rather than those of the corporation and its shareholders.

-The responsive action taken must be reasonable in relation to the threat posed.

ANALYSIS

-The court looks at the poison pill, asks if it is reasonable. At the time it was adopted, the poison pill was said to be reasonable. It achieved the proper result, which was the raised bidding.

Poison Pill: a plan by which shareholders receive the right to be bought out by the corporation at a substantial premium on the occurrence of a stated triggering event.

-*Did the board have power to adopt the measure?* (Yes).

-*Was the poison pill adoption reasonable and for a sufficient purpose?* (Yes)

-Rights plan, at time of adoption, afforded a measure of protection consistent with director's fiduciary duty in facing a takeover threat perceived as detrimental to corporate interests.

-Poison Pill spurred bidding to new heights, proper result of implementation.

-The court also looks at the exchange offer for 10 million of its own shares.

The court here uses Unocal standards: Requiring directors to determine the best interests of corporation/stockholders, and impose an enhanced duty to abjure any action that is motivated by considerations other than a good faith concern for such interests.

-Was reasonable in relation to threat perceived until Pantry Pride increased offer to \$50/share. Here it was apparent that breakup was inevitable.

-Obtaining the highest price for the benefit of the stockholders should have been the central theme guiding director action.

-Board cannot prefer noteholders to stockholders. "A board may have regard for various constituencies in discharging its responsibilities, provided that there are rationally related benefits accruing to stockholders."

Forstmann Little MBO

- Forstmann and its groups of investors would form a new holding company, called Holdings, with a subsidiary called the Forstmann Acquisition Co. (FAC).
- Forstmann would own most of the equity stake in Holdings and Revlon management would own the rest. Even in a MBO, the managers can't afford to buy on a larger scale.
- Holdings or FAC would then borrow a substantial part of the purchase price (but under Forstmann policy, no junk bonds).
- Using the money, it obtained from its own equity and borrowed funds, Holdings would offer to acquire Revlon by merging it with FAC. Revlon shareholders would receive cash (\$57.25 per share). If successful, Revlon would become a subsidiary of Holdings and Holdings would be owned by Revlon management and Forstmann Little (but subject to a LOT of DEBT)



Revlon

“The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the Unocal standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.”

Revlon and Threats

Did the Court find that the Revlon board could take into account the interests of the noteholders?

“A board may have regard for various constituencies in discharging its responsibilities, provided there are rationaly related benefits accruing to the stockholders. However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.” - *Revlon*

Paramount Communications Inc. v. Time Incorporated: Facts. Time decided to seek a merger or acquire a company to expand their enterprise. After researching several options, Time decided to combine with Warner.

-Time was known for its record of respectable journalism, and Warner was known for its entertainment programming.

-Time wanted to partner with a company that would ensure that Time would be able to keep their journalistic integrity post-merger. The plan called for Time's president to serve as CEO while Warner shareholders would own 62% of Time's stock. Time was concerned that other parties may consider this merger as a sale of Time, and therefore

-Time's board enacted several defensive tactics, such as a no-shop clause, that would make them unattractive to a third party. In response to the merger talks, Paramount made a competing offer of \$175 per share which was raised at one point to \$200.

-Time was concerned that the journalistic integrity would be in jeopardy under Paramount's ownership, and they believed that shareholder ~~se would no understand why Warner was a foe~~ to prevent the Time-Warner merger, arguing that Time put itself up for sale and under the Revlon holding the directors were required to act solely to maximize the shareholders' profit. Plaintiffs also argued that the merger failed the Unocal test because Time's directors did not act in a reasonable manner.

Issue: The issue is whether Time's proposed merger acts as a sale of Time that would trigger a Revlon analysis that would render the merger invalid.

Held. The Delaware Supreme Court affirmed the lower court's holding in Defendant's favor. The court distinguished the Revlon decision as concerning a company that already was determined to sell itself off to the highest bidder, and therefore the only duty owed at that point was to the shareholders. In this case, Time only looked as if it were for sale as it moved forward on a long-term expansion plan. Various facts, such as Time's insistence on ensuring the journalistic independence and its temporary holding of the CEO position, illustrated that the directors were not simply selling off assets. Once it was determined that the directors' decision passed the Revlon test, the Unocal test was applied. The directors also passed the higher standard called for in Unocal to directors who are rebuffing a potential buyer. The directors reasonably believed, after researching several companies, that a merger with Warner made the most sense as far as future opportunities and maintaining their journalistic credibility.

Discussion. The court has now applied a dual Revlon/Unocal test to determine if the directors acted reasonably. Once it is determined that a company is not simply putting itself up for sale, then the courts will apply the Unocal standard.


Notes: On June 16, Time applied Pacman technique in response to Paramount's \$175 per share offer. They decided to acquire Warner by outright cash and securities acquisition. The intention was if you swallow another company, you become large and difficult to be acquired.

-"[T]he Time board maintained that the Warner transaction offered a greater long-term value for the stockholders and, unlike Paramount's offer, did not pose a threat to Time's survival and its 'culture.'"

Paramount v. Time Threats

- "Time's board concluded that Paramount's eleventh hour offer posed other threats. One concern was that Time shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce.... [T]he timing of Paramount's offer to follow issuance of Time's proxy notice was viewed as arguably designed to upset, if not confuse, the Time stockholders' vote. Given this record evidence, we cannot conclude that the Time board's decision of June 6 that Paramount's offer posed a threat to corporate policy and effectiveness was lacking in good faith or dominated by motives of either entrenchment or self-interest."





Paramount v. Time

1. Held that Revlon duties did not apply because (a) no change of control and (b) merger was part of long-term business strategy and not effort to put Time up for sale
2. “[A]bsent a limited set of circumstances as defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term....”




Questions

Paramount increased its offer to \$200 per share. Paramount and some Time shareholders sue to enjoin Time tender offer for Warner so that they can consider Paramount offer.

6. What was the Revlon claim?

- Dispersed public shareholders? (wait for QVC opinion)
- Importance of prior strategy?

“Revlon duties may ... be triggered where, in response to a bidder’s offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company.”



Revlon Triggers

- Firm initiates active bidding
 - To sell
 - To break-up
- In response to bid, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company
- In agreeing to a deal, there is a change of control
 - Sale to firm with controlling shareholder (*Paramount v. QVC*)
 - Sale with cash consideration for T's shareholders

If there is friendly merger-Poison pills, No shop clause are called “deal protection devices” and not defensive tactics- Court applies BJR. When hostile takeover comes in- Court applies Unocal and not Revlon.

Paramount Communications v. QVC network inc.: Facts

This case involves a proposed merger between Viacom and Paramount

The agreement involved a number of defensive measures including: A No Shop provision, a Termination Fee provision, and a provision which granted Viacom an option to purchase approximately 19.9 percent of Paramount's outstanding common stock at \$69.14 per share if any of the triggering events for the Termination Fee occurred

QVC entered the picture when it made a friendly offer to buy Paramount for \$80 per share

Paramount rejected this offer

QVC subsequently made a hostile tender offer in two-tiered form offering to purchase part of Paramount's stock through an \$80 per share cash offer and then, in the second tier, buy the remaining stock from a combination of cash and QVC stock

Paramount amends their first merger agreement to compete with the new QVC tender offer

Viacom agrees to amend the agreement to offer Paramount \$80 per share for 51% of Paramount's stock and purchasing

the remaining stock through a combination of cash and stock, but Viacom kept the defensive measures in place

Viacom then unilaterally changed its offer to \$85 cash per share for Paramount stock

QVC responds to the amended Viacom offer by offering \$90 per share

Analysis

The court says that Revlon duties can apply in this situation because there is a “change in control”(Expands the rule that Revlon will only apply when there is the inevitable breakup of the company)

The court says that the shareholders of Paramount are entitled to a control premium because they are giving over control to Viacom(directors of Paramount have Revlon duty to maximize profits and therefore the directors need to get a control premium for their stock)

The court says that the Paramount board cannot enter into a contract that violates their fiduciary duty to the shareholders

The defensive measures adopted by Paramount are illegal and thus invalid

Conclusion

Viacom ends up acquiring Paramount for \$2 billion more than he originally wanted to pay

Extra Notes: This case can be distinguished from Time-Warner because in the Time case(where no Revlon duty kicked in) control was shifting from one fluid aggregation of stockholders to another, as where control is shifting from a fluid aggregation of stockholders to pretty much one individual in this case

This judgment provides a NEW TRIGGER FOR REVLON TEST: Sale of control- means that is the last chance for the shareholders to get the control premium.

Cash in a merger triggers Revlon-whether friendly or not.

Friendly merger-no hostile bid-No controlling shareholder-stock issued-no cash-NO REVLON TRIGGERS.

Fluid aggregation to Controlling Shareholder- Even stock triggers REVLON.

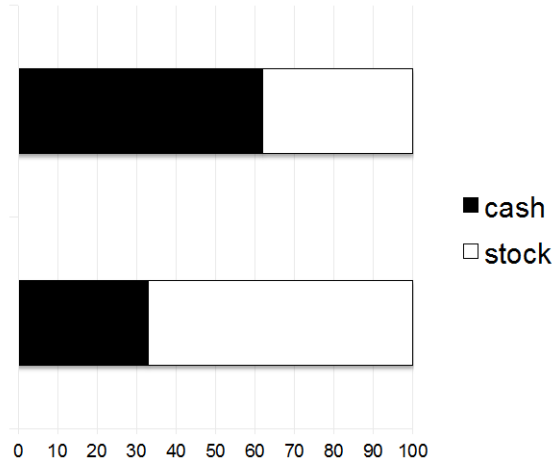
Stock v. Cash Consideration and Revlon

In re Lukens Inc. Shareholders Litig. (Del. Ch. 1999)


Revlon Applies

In re Santa Fe Pacific Corp. (Del. 1995)

Revlon Does Not Apply




*** In re Smurfit-Stone (Del. Ch. 2011) – Held that 50% cash and 50% stock consideration triggers Revlon duties



Revlon Triggers

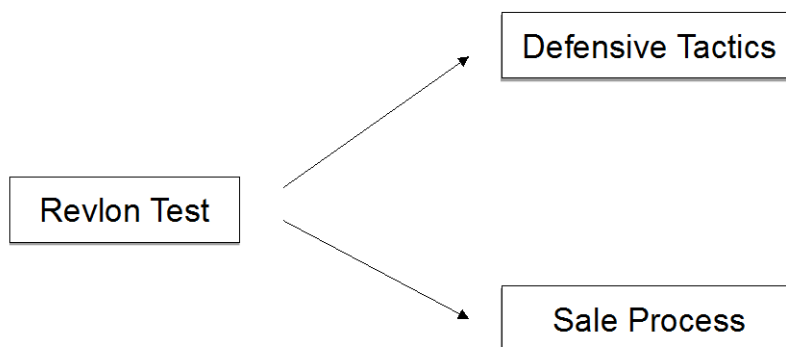
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 - Sale to firm with controlling shareholder (*Paramount v. QVC*)
 - Sale with cash consideration for T's shareholders
-



Paramount Communication v. QVC

- QVC discusses “methods by which a board can fulfill its obligation [under Revlon] to seek the best value reasonably available to the stockholders.”
 - “They include conducting an auction, canvassing the market, etc. Delaware law recognizes that there is ‘no single blueprint’ that directors must follow.”
-

Applying Revlon



Omnicare: NCS was insolvent, but the creditors didn't want to force it into bankruptcy b/c it had little assets; Omnicare wants to bid for NCS, but only in bankruptcy (thought is, they will pay off creditors but the SH's will get nothing), but their offer was rejected; Genesis comes in w/ an offer to buy shares at \$31/share, but it wants a **lock up**. Under **§251 of Delaware Law**, the board can commit itself to offering everything to SH's, which is what Genesis does

- A. First step was the board submitted the transaction to SH for a vote
- B. Second set was the irrevocable proxy from 2 directors, who control 65% of the shares; require the board to submit the proposal to shareholders (this was an absolute lockup b/c directors had to submit to SH & SH had to bid on it; no choice; merger will absolutely go through; **this is invalid b/c there is a potential for Board to breach its fiduciary duty of care if a better offer comes up**
 - a. DUTY OF CARE ANALYSIS
 - i. BJR
 - ii. Can get out of BJR if there is gross negligence
- C. When board takes a defensive measure that touches upon control of a company, UNOCAL duties apply (this is the exception to the BJR), but it doesn't go as far as entrenchment; UNOCAL is the middle ground
 - a. Analysis
 - i. Is there a threat?

1. Could be foregoing a better offer; the lockup is a defensive measure, which goes to a subsequent threat
- ii. Is the response proportional?
 1. **Proportionality:** dissent says a lock up is proportional and is ok b/c without it, Genesis would've have made the offer (didn't want to be a "stalking horse"); the fact that there is a lockup is proportional; the treat is that the deal/Genesis will go away w/o a lockup
 2. Majority thinks any deal protection measure (any measure in a merger agreement that is designed to dissuade a higher bid is a defensive measure) should be judged under UNOCAL.
 3. Dissent thinks the BJR should apply in some circumstances: **DISSENT IS WRONG**
- b. The defense was there before the hostile company came in; even so, UNOCAL still applies
- D. Has Genesis pre-committed by saying the offer will go away tomorrow?
 - a. There is no rational reason that Genesis would not have come back the next day with another offer; board & NCS were terrified that the threat was credible; perhaps otherwise, they would've committed an efficient breach if Omnicare or another company came with a more lucrative offer
 - b. **Board preferred Genesis b/c there was a sale of assets and the other deal was a merger**
- E. Why did Genesis want the lockup?
 - a. What's wrong w/ being a stalking horse?
 - b. **Stalking horse:** an initial bid on a bankrupt company's assets from an interested buyer chosen by the bankruptcy company; from a pool of bidders, the bankrupt company chooses the stalking horse to make the 1st bid; method allows distressed co. to avoid low bids on its assets; once the stalking horse has made its bid, other potential buyers may submit competing bids for the bankrupt co.'s assets; stalking horse sets the bar so that other bidders can't low ball the purchase price
 - c. **The deal protection plan provides protection to the stalking horse and gives an incentive to go first**
 - d. NCS can pre-commit to being amenable to a deal protection plan
 - e. How strong should the lockup be? It can't be absolute b/c there has to be a fiduciary out; the board has to put in a provision that they can get it if their fiduciary duties require
 - f. There is a general understanding that once shareholders vote, the fiduciary out has expired (if the board is to act, should do so before SH's vote)
 - i. *Everything is contingent upon SH approval; it is implied at law; no termination fee if it is not approved
 - ii. Post SH approval, fiduciary duty extends, but we don't know how fare
- F. Termination Fees: if someone tops Genesis's offer, Genesis will get \$3 termination fee, which increase the cost of the transaction b/c the winning company will in effect have to pay it
- G. The proxy and ratification
 - a. Board submits proposal to SH's
 - b. Irrevocable proxy from 2 directors promise to vote (owned majority vote), maybe fiduciary duties of controlling SH can permit fiduciary out
 - i. **Court didn't go there; this would be a huge leap**
 - ii. *Board ratified irrevocable proxies; if controlling SH breached duty to minority SH's, as a general principal, no safe harbor if directors ratified transaction*
 - iii. Board's decisions are ratified by SH; no liability
 1. Doesn't work the other way around
 - iv. Why did board ratify? Did this in their capacity as directors, which they didn't have to do; they were acting as SH's & we know that SH's can make agreements
- H. Take away: fiduciary out is required; deal protection can't be an absolute
- I. Deal protection measures are always subject to Unocal
- J. SH's fiduciary duties can't be ratified by Board

Hilton v. ITT: Hilton Hotels wants to acquire ITT in a hostile transaction; ITT puts in a poison pill and Hilton launches a proxy contest & tender offer; there was no classification board then, so Hilton could've gotten power quickly; ITT wanted to put in a classified board, but it need the approval of SH's (vote on classified board was the same as voting on the merger; effect would've been the same); there was a 80% voting provision which would be required to remove a director w/o cause and to remove the 80% majority requirement; ITT decides to split its company into 3 pieces, one piece having opportunity to determine the governance by themselves, not in a classified board + had the 80% voting provision; don't know why courts allow them to do this in NV

- A. In DE, a spinoff is not subject to SH votes; it is not a sale of assets
- B. Spinoff-company sells a piece of itself-can be publicly traded
 - a. Could be a good idea if the original company was poorly organized
 - b. It's a good opportunity to change corporate form w/o SH approval
- C. Court said that there was no legitimate purpose; the process of putting in a classified board interferes w/ SH franchise
- D. Under DE Law, outcome would've been different b/c DE law considers classified boards not to be preclusive
 - a. Need another theory, as in Blasius

Liquid Audio (not in syllabus): MM wants control, launches proxy contest to seat 2 members; wanted to amend bylaws to expand the board from 5 to 9 members; board does expand from 5 to 7 by Liquid Audio; they do this before the vote

- A. LA does have authority to expand seats via amending bylaws; the process could be wrong
- B. Classified board was already in place; the primary purpose to expand was to frustrate SH franchise
- C. Just having a classified board has another use (ensuring stability to a corporation)
- D. Post the transaction, MM was still a minority; it went from having 2/5 members on the board to having 2/7 members on the board; **the fact that this could've been done indefinitely (every year) is what made it preclusive**
- E. Blosius: SH franchise is a question of power between directors & SH's. Separation of ownership and control; ability to choose directors in the hands of shareholders
 - a. **It is not the board's business to tell SH's what to do; Board knows better than SH's generally, but when it comes to choosing directors, it is the SH's decision; if the board's primary purpose is to impede SH choice as to who board members are, it needs a compelling justification**
- F. Blasius within Unocal: at some point, the DE Supreme Court said that all defensive measures have to be analyzed under Unocal. Blasius is more stringer than Unocal, in which you only needed to show reasonableness and proportionality; under Blasius, need to show compelling justification
- G. RULE: Unocal always applies, but when you are testing proportionality, the proportionality of defensive measure will be assessed w/ compelling justification, not reasonableness

In practice, Unocal will probably only come up when there is a change in control; if it is not a merger situation, it wouldn't deprive SH's of their vote; Board is only important when there is a merger on the table