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Corporations Outline Allen Sragow and Peter Fante

I. Basic Corporations Concepts Revised Chapters 1-4

A. Introduction

1. Basic Ideas
   a. Existance - seperate and perpetual, purpose is to collect assets
   b. Liability - limited to assets, personal assets of shareholders protected
   c. Management- Bd. of dirs elected by Shhs, Bd. appoints managers
   d. Transfer of Ownership - transfer of shares
2. Allocation of Risks, part of choice of corporate structure
   a. monitoring
   b. litigation
   c. failure of venture
   d. controllable v. non-controllable
   e. agency costs
   f. Peter damages

3. Partner v. corporation
   a. Investor liability
      i. Partners are jointly liable contractual obligations, severally and jointly liable for tort. Can't effectively K out of tort liability.
         <u>Contractual obligations</u> - if partnership is short on loan, partners can be collected against, but they must all be joined in a suit - even if there are 50,000 partners. Would this deter the bank? What the real result is that its **impossible to get a decent loan** for a partnership.
         <u>Mutual agency</u> - all partners are agents of the partnership.
      ii. Corporation
         Shareholders only liable for stock price paid for K and tort. Risk is shifted to better--purpose of corporation is to gather assets together to be better risk bearer. Limited possibility of high transaction costs, so easy to get loans.
   b. Ability to transfer interest
      i. Partners - Interests are assets, partnership interest (right to participate in management, profits). Partner can sell parts, but not all, without agreement of remaining partners. But buyer of partnership interest is <u>not</u> entitled to full information. Deters transfer. No efficient market.

P. Fante, A. Sragow (1992).

ii. Corporation - Shares are all freely sold without anyone's 21.consent.. Different classes of shares, common stock generally has these chars:

1) right to specific interest per share
2) right to vote 1/share (no state law requires, but NYSE does)
3) restricted, but not negligible right to info

Stock markets are possible, efficient.

c. Legal personality

i. Each partner can cause dissolution, absent contrary agreement, and cause all assets to be liquidated.

ii. Corp can only be dissolved by gathering all shares and ripping them up.

iii. Peter has no personality, legal or otherwise.

d. Locus of managerial power

i. Partners are often owners and managers

ii. Shareholders voting rights include

electing directors (8.03)
approve mergers (11.01)
amendment of articles of incorporation (10.03)
amendment of bylaws (10.20)
approve sale of substantially all assets (12.02)
approval of voluntary dissolutions (14.02).
acting when board is kaput (8.63, 8.55(b)(4))
making non-binding recommendations (see 19.5.2)
inspection of corporate books and records (16.02)
enforcing shareholder rights (direct and derivative suits)

e. Taxation Considerations

i. corporation profits are doubly taxed, as income and as distribution

ii. limited partnerships that are freely tradeable can be taxed as corporations.

iii. corporations may avoid double taxation by paying out compensation in the form of bonus, salary, which are tax deductible.

iv. Transfer of assets to partnership or corporation not considered gain or loss if 80%.

v. no deduction for dividends, yes for reduction of debt and expenses including salary.

vi. "S" corporation is less than 35 shareholders, must be individuals, one class of stock, treated more like partnership.

B. Economics of the Firm

1. Financing the Corp
    a. Secured Debt \
    b. Unsecured Debt |--- In order of priority of payment
    c. Equity Offering /
    (you always need some equity in the corp to encourage investors)

C. Problem: Chesapeake Marine Services
1. Dillemma - NEED MONEY! Want to sell stock, but Apple can block with greater than 1/3 hold, where by-laws requires supermajority for issue of stock (anti-dilution measure).
2. Possible answer - Apple owns 50% of competing Co. Could be breach of loyalty.
3. Under *Gamble*, Apple can just be voted out.
4. Possible answer - Create sub for shipyard. Sub sells 2000 shares (20% stock) to Parent for shipyards assets (effective price of 225/share, since shipyard assets worth 450K). Shipyard sells 750 shares to family, 750 to public, at 100/share, none to Apple. Shipyard sub gives loan of 100K to parent, keeps 50K.
    Problem: shipyard sold out to this sub for cheap. Duty of Loyalty/Care?

5. *Schnell*: Compliance with statute may not be enough.

D. The Corporation and the Constitution
1. In politics (problem)
    a. Can corp have political opinions? In conflict with Shhs?
2. Policy Issues (problem)
    a. To whom does the corp have a duty? To the Shh. To employees? Not. So what decisions can Shh have a say in?
    b. Should takeovers be encouraged or discouraged? Anti-takerover statutes seek to protect Shhs by delaying process of sellout, give Shhs time to think.
    c. Williams Act - 20 day wait. Not enough to protect Shh, who need more time to evaluate.
    d. This encourages 3P bids. This is a good thing. Or maybe not. Judge Easterbrook, in *Amanda* doesn't seem to think so.
    e. Anti-takeover statutes prevent speculators from throwing market.

E. The Corporation in Society 158-67, Supp 12-13
RMBCA 3.01, 3.02, 3.04
1. Problem: Union Airlines
    a. ULTRA VIRES - Shhs can challenge K which the corporation purportedly does not have the power to enter into. K's entered

into must benefit the corporation.

b. *Occidental* - Benefit need only be barely benefitting the corporation.

c. *Theodore* - Even philantrophy is okay - justifies existance of corporation. Corporate gifts are fine.

2. Problems: Precision Tools 1313-29, 1333-37

II. Starting a New Business

A. The Choice of Organizational Form 72-73, 106-18, 119-127 (skim)

B. The Incorporation Process

Problem: Precision Tools Part IV 128-34, 148-151

RMBCA §§ 2.02, 2.06, 8.03, 10.03, 10.20

1. Forming a corporation involves 3 steps:
   a. articles of incorporation (RMBCA 2.02)
   b. one of more incorporators signing the articles (RMBCA 1.20(f))
   c. articles submitted to secretary of state of incorporation (RMBCA 2.01)
2. The Articles of Incorporation
   a. Name (4.01)
   b. Purpose, Powers (3.01)
   c. Registered Office and Agent (2.02)
   d. Capital Structure (6.01)
      i. # shares, classes, preferences, rights, par value (2.02, 6.01)
   e. Size and Composition of board of directors (min/max) (8.03)
   f. Optional Provisions (2.02(b)) such as
      i. voting provisions (such as greater than imple majority on some issues)
      ii. membership requirements
      iii. shareholder management provisions
   g. Peter Disciplinary Provisions

C. Choice of Securities 168-85, 185-93 (skim), 194-197, Supp 6-7

Problem: Precision Tools Part V

1. Choice based on risk aversity - can issue debt or stock, etc.
2. Debt v. Equity
   a. Equity issued in articles of incorporation
   b. Debt freely issued, generally no voting, participation rights
3. Common stock and preferred
   a. voting power in common only (generally) (direcotr election, certain big issues such as mergers, amendments to articles, sale of all assets)

b. must have common
c. preferred gets set dividends first
d. preferred often gets voting rights when dividends are not issued
e. preferred with dividends can accrue, and if so must be paid off before any common dividend is paid (S&P 8.1.2)
f. Distribution goes first to preferred in set amount, then rest to common (liquidation rights)
g. Common stock holders get to vote on
h. Both can have conversion rights (6.01(c)(2)) (right to convert to other form of security in corporation under specific events, such as if dividends are not paid).
i. Redemption Right - right of shareholder to get cash from corporation for shares
j. Pre-emptive Right (6.30) - right of shareholder to purchase new issues to prevent dilution
k. Distributions: may only be made if afterward assets exceed (liabilities + minimum distribution to preferred)

IV. Management and Control of the Corporation

A. Action by Executives, Directors and Shareholders

1. Problem: Agency Relations 270-80, 288-89, 290-92, 294-299

a. Foreman buys truck. Can directors repudiate? Can bank? Here's what to check:

i. get the corporation charter - is there such a corp?
ii. get certificate from Sec. of State - is corporation in good standing?
iii. Was their authorization from board of directors?
iv. Is signor authorized, is this the signor?

b. Officer's authority is generally actual (express and implied) and apparent. Express is from bylaws and resolutions or statutes. Implied is inherent in office held, recognized as custiomry corporate practice. Apparent authority binds corporation when 3P reasonably relies on authority which is not their but seems to be. Policy basis for "apparent authority" is least cost avoider, market efficiency.

2. Problem: Widget Corporation

B. Defining Directors and Shareholders Power

1. Allocation of Power in the Corporation

a. RMBCA spells out how to do things without permission. Committees, for instance, can be formed. Power can be delegated to these committees.
b. RMBCA 8.25(e) - what cannot be delegated to committee. Shhs are supposed to have control over amending charter, bigs

sales of assets, mergers.

c. Shareholders (except Peter) have certain limited rigths, all else to board and managers

i. Shareholders voting rights include
electing directors (8.03)
approve mergers (11.01)
amendment of articles of incorporation (10.03)
amendment of bylaws (10.20)
approve sale of substantially all assets (12.02)
approval of voluntary dissolutions (14.02).
acting when board is kaput (8.63, 8.55(b)(4))
making non-binding recommendations (see 19.5.2)
inspection of corporate books and records (16.02)

1) RMBCA - 16.01 requires corporation to keep certain records such as minutes, 16.02 allows automatic inspection of those. 16.04(c) gives remedy of costs and council fees for court order to allow inspection. 7.20 also allows list of shareholders.

2) DE - Doesn't matter how many shares you have, duration of holding.

enforcing shareholder rights (direct and derivative suits)

Under RMBCA 7.02a, certain special mmetings may be called by shareholders with requisite number of shares, but in DE 211d, by-laws must specify this right.

2. Problem: LaFrance Cosmetics, Q.1 301-08
DE §271, RMBCA §§12.01, 12.02

a. Cosmetic manufacturer expands to perfumes, initial public offering of stock. Now perfume is 34% of business, not so profitable. Labelle wants to buy perfume division.

b. Factors

i. RMBCA 12.01 - sales in course of business
RMBCA 12.02 - sales outside of regular business

ii. Is this regular business? Not really - business is selling perfume itself!

iii. Comment on 12.01 refers to amount of assets. Assets are large, but revenue is low. - Quantitative test - more than 75%, need shareholder approval. Substantially all is synonymous to nearly all. Statutory requirements cannot be avoided by keeping a little.

iv. Does not substantially effect the ongoing life of the corporation. - Qualitative test - nature of business is what? Would this change the nature of the business?

v. Most sales of all or substantially all of the corporations property are considered not in the course of regular business. Sales by real estate corporations, or liquidator larry, are regular business since their business is selling assets .

c. LaFrance will want to know if there is approval of the board of directors, if shareholder approval is required.

2. Problem: LaFrance Cosmetics, Q.2 308-19
DE 109, DE 211, DE 212, DE 213, DE 228 DE 229, DE 271

a. Can majority of shareholders push this past an objecting board of directors?

b. Special Meeting - 7.02(a)(2)

i. Need Notice

ii. Need quorum

iii. Need notice to secretary

iv. Proper purpose

c. Is directive to sell something a proper purpose? RMBCA allows just about anything. But what if by-laws or statute requires proper purpose? If this is a sale which requires shareholder approval, then it is proper purpose. Even if it is the shareholder initiative to sell, since they would have to be asked anyway (if its under 12.02).

d. Policy - do we want shareholders to make these decisions? *Auer* (p.308) seems to say yes. Resolutions are good purposes for calling shareholder meetings.

e. Vote to oust directors

i. 8.08(a) allows for removal even without cause (DE 141(k) also allows removal without cause)

ii. Check Articles of Incorporation. Model Articles are silent on this.

iii. If there were cause requirement, what would be proper cause? Breach of fiduciary duty, etc.

iv. Notice must be given to director before oust.

v. Replacing ousted directors - 8.10(a) (shareholder and director can replace)(S&P 13.2.3).

V. Control Problems in the Closely Held Corporation

A. Introduction, Cumulative Voting v. Straight 296, 342-45, 298-301

An Example: Total of 9 Directors. Three Directors must be elected?

P. Fante, A. Sragow (1992).

	Shareholder	Shares		A	B	C	D	E	F
Straight	X	199	199	199	199				
	Y	101				101	101	101	

Under straight voting, each of X's choices win.

Cumulative Under cumulative, can divide total votes for each.

Cumulative	X	199	x3	=	597
	Y	101	x3	=	303

Formula: No. Shares Needed = TOTAL Shares x No. Dirs Desired +1
to get majority Total Dirs +1

Here, there are a total of 597+303 = 900 Shares.

To get one director elected, you need: [(900 * 1)/ (8+1)] +1 = 101
True - there is no way the other 8 can be split to lock out 101 shares on one director.

To get a majority, you need: [(900 * 5)/(8+1)]+1 = 501

B. Restricting Shareholder's voting Discretion
Problem: Precision Tools Revisited I-II 345-68

1. Supermajority acts as power to minority to veto. Must be in articles. 7.25(a)(c), DE 216. Supermajority provisions added by amendment must be approved by similar supermajority decision. 7.27(b), DE 242(b)(4). If all parties agree, supermajority provision can be added in shareholder agreement.

2. Voting Pool Agreements
Shareholders formally or informally agree to vote as block because in closely held corporations, single shareholders generally do not hold majority power. Valid if related to matters on which shareholders can vote. **QUESTION - WHO CAN SEEK REMEDY? IF LOSING MINORITY WISHES TO CHALLENGE VOTING POOL, CANNOT THE WINNING POOL JUST REVOTE AS INDIVIDUALS, BUT THE SAME WAY? IF VOTING POOL MAY BE CHALLENGED FOR NOT BEING TRADITIONAL, WHAT IF ARTICLES PERMITS SHAREHOLDER INVOLVEMENT**

IN THIS ISSUE?

3. Voting Trust v. Voting Pool
   a. voting pool can only be specifically enforced.
   b. voting trustee can do whatever he wants. RMBCA 7.30:
      1) written, setting out trustees obligations
      2) shareholders must transfer shares
      3) may not be for more than ten years (unless agreement to extend is made)
      4) Trustee must prepare list of beneficiaries of trust, may be different from those who gave shares originally
   c. Voting trusts cannot generally be revoked, unless all beneficiaries agree.
4. *Lehrman v. Cohen* - De Facto Voting Trusts
   Facts: (Following *Ringling* and *Abercrombie*) : To avoid deadlock, stock created with voting power only. One shareholder joined with holder of voting only shares to vote together. π argued that that this was just voting trust, and since it was not limited to ten years, as voting trusts must be, no good. Court said that this voting power is not seperated from ownership interest since such never existed.
5. *Abercrombie* Test: Something is invalid voting agreement, as voting trust when
   a. seperated ownship and voting
   b. transfers voting power irrevocably and indefinitely
   c. principle purpose is to provide voting control

6. Irrevocable Proxy
   a. But proxy is agency thing, cannot be irrevocable. Irrevocable It must be coupled with an interest.
   b. Here, can be on specific issue only, not for time period like trust.
   c. Interests which support irrevocable proxy:
      i. stock (7.22(d)9(1))
      ii. economic interest in corporation, even if not in stock itself (7.22(d)(3), DE 212(c)).
      iii. Designation by shareholder agreement as one interested (7.22(d)(5)). This has been upheld in some courts because it promotes control flexibility.
   d. Revoked when interest in extinguished. (7.22(f))

7. Transfer Restrictions (S&P 16.6)

C. Restricting the Discretion of the Board
   Problem: Precision Tools Revisited III 369-90
   1. RMBCA (8.01, 7.32) allows restriction or elimination of directors if

done in the articles or in shareholder agreement.

2. DE also authorizes limitiing directorial discretion (DE 351)

3. Common law factors (S&P 16.7.2) valid if

   a. agreement relates to close corporation

   b. does not adversely affect nonparty shareholders or of creditors

   c. does not deviate much from statutory norm that directors manage corporation

D. Resolving Conflicts when Planning Breaks Down

Problem: Precision Tools Revisited V406-46, Supp 13-16

1. Freeze-out: when majority is closely held corporation gets minority out, literally, by divesting them of their shares, or by making them have no voice. Peter's brain is frozen out.

2. How this is done: Fire them, do not re-elect them, stop paying their salary, cancel their dividends, force them to sell out at less than market value, dilute their holdings by selling more shares.

3. Defense against this: Voting agreements, managing agreements (each restricting ability to do this), anti-dilution agreement, veto power.

4. *Wilkes*:(p.408) Test: whether controlling group can demonstrate reason. Majority can only act against minority with proper business purposes.

   Donahue said there was a higher standard: shareholders have duty to each other--utmost good faith and loyalty. *Wilkes* said that if there is legitimate business reason, then that is good enough reason. But - there must be no less harmful alternative. Note that this is different from normal decisions, where business judgement rule is sufficient. Why? Encourage investment.

5. Judicial/involuntary dissolution - can be done by creditor, shareholder, and Attorney General. Shareholder needs to show board deadlock, shareholder deadlock, or that controlling shareholders acted in breach of fiduciary duty.

VI. The Role of Shareholders in the Public Corporation

A. Proxy Contests and Regulation 447-456, 461-463, Supp 44-45

1. Background

   a. Why Securities Regulation

   b. The Underwriting Process

      Securities are created by an issuer, evaluated and purchased by underwriters to bring them into the market, sold to dealers for sale to consumers.

   c. The Securities Act of 1933

1) §5 requires disclosure document on file with SEC, that document must be effectively registered, and that investors get prospectus.
2) Idea - full disclosure, as opposed to substantive regulation. Make it easier to allow participants to get and use information, more efficient market.
3) Three periods when sale is forbidden, including advertising the security: prefiling, waiting (can be offers, no sales) and post-effective period (offers and sales may be made with prospectus)
4) Peter wears an underwire bra.

d. The Securities Exchange Act of 1934

2. Exemptions from the '33 Act

a. Intrastate offerings - §3(a)(11), see Rule 147.
1) must be in state seller and buyer
2) cannot be part of larger interstate sale

b. Non-public offerings - §4(2)
1) sold only to investors who can "fend for themselves". *SEC v. Ralston Purina* - doesn't matter how many people it is if they all can "fend for themselves". But investors must have access to information that would otherwise be in a prospectus.
2) Securities cannot be resold in secondary distribution to purchasers who cannot fend.
3) Offers for sale can only go to those who can fend.
4) Regulation D, Rules 504-506 - What qualifies for 4(2), depends on:
a) $ amount of offering
b) whether its part of larger offering
c) kind of advertisment used
d) number and kind of investors
e) kind of info provided investors

c. Small Offerings - §3(b) - less than $5 million

d. Rule 144 - Safe Harbor - okay for control persons to resell unregistered securities if:
1) current public info is available on the issuer
2) securities have been held for at least two years
3) sold through broker, not solicited
4) notice is given to SEC whenever more than 500 shares are sold or price exceeds $10,000.
5) Limit in any 3-month period is the greater of 1% of units of outstanding securities or the average weekly trading volume in the prior four weeks.
6) Volume rule is lifted for non-affiliate holder of three

years

e. Resale of restricted securities: private buyers

3. Civil Liabilities Under the Securities Act
   a. §12(1) - recision of sale for violation of §5 (unregistered security)
   b. §12(2) - recision for fraud
   c. §11 - damages for deceptive registration
      1) no privity requirement
      2) all needed for prima facie case is material untruths or ommisions (for issuer - other defendants can try to show due diligence)
      3) shareholder need not show reliance
      4) shareholder need not show reduction in value
      5) damages are limited
      6) can be sued - registration signers, accountants, engineers, appraisers, underwriters, issuers.
      7) Damages = price paid - current value or value at which sold
      8) Statute of limitations of 1 year
   d. Defense - Due diligence (for other than issuer, who is strictly liable)
      1) Expertised opinions must have reasonable investigation and reasonable grounds to believe that the investigations were true (and actually believe). Ignorance is no excuse.
      2) Nonexpert opinions just need reasonable ground to believe that expertised portions are not false or misleading. Good faith ignorance is an excuse (§11(b)(3)(C)).
      3) *Escott v. BarChris*
         a) Insider covers - liable for all
         b) Insider experts (familiar w/ company workings) - no ignorance defense as to expertised (financial statements) or nonexpertised opinions
         c) Insider nonexperts - ignorance defense works on finance statements, but must investigate nonexpertised opinions
         d) Outside directors - less duty of investigation, but still must investigate non-expertised opinions
         e) Underwriters - liable for not investigating nonexpertised opinions
         f) Accountant - Liable for not checking raw data, not reading minutes, not noticeing discrepencies in files
   e. Differences:

1) 12 is for any prospectus, 11 just for registration statements
2) 12 is for anyone who sold, 11 is just for directors, experts, etc
3) Standard of conduct - 11 requires showing of belief and investiagtion, 12 requires more - show that even if Δ had known, could not have helped mistake
4) no privity requirement, but 12 requires that securities must have been bought from Δ
5) different remedies - can get damages under 12 if π no longer owns it. Under 11, cant get recision.

4. Problem: National Metal Products, Part I

513-27, Supp 46-47
Securities Exchange Act § 14(a)
Rules 14a-9, 14a-11

a. The Regulatory Pattern
b. An Overview of Proxy Rules
See S&S p.513-516 for quick reference to Rule 14(a)(1-14). Generally, SEC rules require the following:
1) Disclosure of proxy statement (14a-3), which must be depoosited with SEC at least 10 (5, if management solicitation) days before sending to shareholders
2) No open ended proxies
3) shareholder access
4) Private remedies
c. Proxy Solicitation: Rule 14(a)(1) includes:
1) information accompanying the proxy
2) request to sign, even without proxy card
3) request not to sign or to revoke
4) being sly - not asking for signature, but reasonably calculated to get on (or prevent one)

c. RMBCA 7.22 and DE 212 also deal with proxies.

d. NYSE and AMEX require proxy solicitations fro all meetings.

c. *Long Island Lighting Co. v. Barbash*
1) Chain of Communications theory - news ad can be solicitation
2) Public interest group placed ad urging sale of corporation to the government
3) Ad was **reasonably calculated to influence shareholder votes**, was solicitation under proxy rules, even though proxy was never mentioned

4) New proxy rules: in order to better match Congressional intent, exemption provided for communication by broadcasts or published media

Note: In *Brown v. Chicago RR*, ad decrying merger was considered not proxy solicitation, where interest aimed at was not shareholders, but other interest groups, and not meeting was yet scheduled.

d. Under *Gitlin*, even if solicitor only gathers people to get list of shareholders for purpose of proxy solicitation, and has not solicited yet, the group must still register. Why? Because you must assume he has been discussing the issue, and the statute intends to prevent the spread of misinformation.

e. Civil Liabilities Under the Proxy Rules

1) Under *Borak*, implied right of action vests in shareholders, for damages for proxy solicitation which violates SEC regs. Purpose - protect corporation, of which shareholder are subpart, better fulfill statutory intent.

2) Can be direct or derivative

3) Can have prospective or retroactive relief

a) enjoining voting of illegally obtained proxies

b) enjoining the meeting

c) rescinding the transaction

d) awarding damages

4) For false or misleading statements:

a) must be material (*TSC Industries*) - one which thre is a substantial likelihood that a reasonable shareholder would consider it important

b) Under *Mills v. Electric*, no causation needed and no fault. Materiality is enough. Attorneys fees are authorized.

5. Problem: National Metal Products, Part II
502-511, 1033-1037, 1040-1052, Supp 141

a. The Role of the Shareholder in the Corporation

1) generally passive

2) passivity is good so management can run unimpeded

3) shareholders have control through voting

b. The Securities Market

1) Secondary markets account for 99% of share transactions

2) Stock Exchange - Specialist buys and sells, but

generally brings them together

3) Over the Counter - Dealers buy, sell for more

c. How Shareholders Act in Proxy Contests

d. Federal and State Interaction

1) SEC ensures info accuracy, etc. State statutes go entirely different thing. SEC rules seek to provide information about the vote, not control the vote itself.

6. Federal Securities Law Provisions

a. Identification of 5% Shareholders

b. Purchase by Issuer of Own Shares - 13e

c. Proxy Contests

i. Generally

Proxy Statement must be sent out for disclosure.
Scope of power and time limit on proxy is specified.
Some shareholder access to the proxy process.
Shareholders can sometimes seek private remedies.

ii. Costs - generally, corporation pays costs.

iii. *Rosenfeld v. Fairchild Engine and Airplane Corp.*

iv. Litigation

B. Shareholders and Social Concerns 563-73, 579-82, 584-90, 319-26
Supp 22-25, 72-82
Securtities Exchange Act 14a-8, DE 220

1. Shareholder Proposals

a. 14a-7: Under proxy rules, any shareholder may get list, but must defray the costs.

b. This works only if you have 1% or $1000 of stock for at lest one year.

c. Management may reject if:

1) improper subject (14a-8(c)(1))

2) *Auer v. Dressel*: precatory reccomendations are okay, even if it has no binding effect.

3) proposals requiring corporation to violate law

4) proposals affecting management of the corporation (not significantly related to corporation's business-though even ethical issues can be significant)

5) ordinary business operations. 14-a-8-c-7. This can be big exclusion.

6) proposals which relate to election of directors

7) See S&P 19.5.2 (p.276) for rest of list.

d. *Lovenheim v. Iroquois Brands, Ltd.* Forced geese feeding can be significant, even though it only accounts for 0.05% of business.

2. Shareholder's Right of Inspection
    a. common law right
    b. RMBCA 16.01, 16.02(a)
    c. Can get specific version of shareholder list, shareholders entitled to vote at meeting
    d. 14-a-7 forces corporation to give the list or do the mailing
    e. DE 220 makes no distinction based on size or duration of holdings. Proper purpose is needed.
    f. *State ex rel. Pillsbury v. Honeywell, Inc.* Pillsbury against Vietnam war, Honeywell was arms manufacturer. Court said that non-economic purpose is not enough for inspection of lists. Have to have proper purpose, limited to economic stake therein. Common law right is broader, but most statutes have there own codification of the right.

C. Limits on Federal Regulation Supp 62-72
    1. *Business Roundtable v. SEC* - read the case

D. Shareholder Litigation 51-52, 812-21, 902-05, 905-25 (skipped here)
    1. Historically
    2. Policy Objectives
        a. Correct board of directors oversight
        b. Direct lawsuits not enough since those are corporate interests, normally protected by the board of directors, who screwed up.
            1) Example of Derivitive lawsuit - merger is unfair, breach of fiduciary duty
            2) Direct - sue to enforce dividends, to enforce voting rights, to enjoin ultra vires action (rights in holders themselves)
            3) Can look like both - refusal to provide a shareholder list in a proxy fight may violate direct rights and also be breach of loyalty (entrenching management).
        c. Duty is to corporation, not shareholders.

    3. What a Derivative Suit is
        a. Asks management to sue itself
        b. Not class action
        c. All recovery to corporation
        d. Successful plaintiff is reimbursed
            1) percentage of recovery method
            2) lodestar method
    4. Procedure
        a. In most states, π must have been shareholders at time of wrongdoing

b. Some states require that π continue to be shareholder.
c. Complaint must be verified by π.
d. Cost of frivolous litiagtion shifted on π.
e. RMBCA 7.40 requires exhuastion of internal remedies first. Written demand to take suitable action must have been given to corporation, 90 days must have passed. Demand should be specific, set forth facts and remedy sought. Detailed pleading is not required.
f. Settlement must be court-approved.

5. Dismissal by Corporation
a. By court, upon request from corporation, if it is in the best interests of the corporation.
b. Majority of independent directors present at meeting, constutuing a quorum, must support this, or
c. Majority vote of committee consisting of two or more independent directors.
d. Court may appoint panel to make this determination.

E. Outside Directors as Shareholders' Representatives 1344-1369
1. The Role of Outside Directors
a. NYSE requires at least two on every board

VII. Fiduciary Duties

A. Duty of Care 592-683, Supp 83
1. Intro
a. Competing interests - management discretion and management accountability
b. shareholder wealth maximization is the rule
c. **Director should be informed as to the corporation's affairs. There should be a functioning management in place. There should be an effective internal information system. The board of directors should react to credible signals of serious trouble.**

2. The Standard of Care
a. Statutory Standards - RMBCA 8.30a - directors should perform their duties
1) in good faith
a) no conflict of interest
b) honest acting
c) no illegal activity
2) in a manner reasonably believed to benefit the corporation (substantive standard)

3) with the care of ordinary prudent person in like position and circumstances (procedural standard requiring informed decisions, minimial level of skill)

b. Common Law Standards - *Aronson v. Lewis*
   1) good faith
   2) honest belief that action was taken for best interests of corporation
   3) informed basis

c. Reliance on Experts and Committees
   1) RMBCA 8.30a, 8.42b extends this protection to directors and officers
   2) Directors may rely on experts but must reasonably believe the opinions to be reliable.
   3) If something seems suspicious, directors may not rely.

4. Business Judgement Rule

a. How it operates
   1) shields directors from personal liability
   2) shieled decisions from review

b. Purposes
   1) avoids judidicial meddling
   2) encourages directors to serve
   3) shield directors from dumb shareholders

c. Overcoming the Rule
   1) Fraud, Illegality, Conflict of interest all remove benefit of BJR. For Conflict of Interest, however, director is not automatically liable. See Duty of Loyalty.
   2) Lack of <u>any</u> Rational basis

d. Director Prerequisuite Responsibility - duty to supervise
   1) well-meaning mismanagement - nothing the director could have done anyway
   2) management abuse - failure to catch it is pretty bad.
      Francis v. UJB: Widow's sons were misappropriating funds from thr corporation. Widow, inactive board member, held liable for her lax supervision.
      Modern casses seem to only hold directtor liable when director actually knew of the abuse.
   3) Director may depend on assumption of legality of management action, does not have to install monitoring system. *Graham v. Allis Chalmers*. RMBCA 8.30b, DE 141e entitles directors to rely on corporate reconds.

e. Informed Decision Making: *Smith v. Van Gorkom*

Facts: Van Gorkom pushed through merger agreement which in the end seemed pretty fair, and was not clearly something which the board would not have, on an informed basis, gone for. But they didn't investigate at all, they didn't check any of his figures, and took his word that the share purchase price was good.
Held: Directors liable for being insufficiently informed. Note that this standard does not apply to conflict of interest; ie. fair deal is good defense.

f. Board inaction is only protected by BJR when it is concious.

5. Reliance Statutes
   1) DE 141(e) - can rely on well chosen person within professional comptence
   2) RMBCA 8.30(b)(1-3) - can rely on opinions of officers, employees reasonably believed to be competent or professionals within their profesional competence, or committee which has competence.
   3) If a director actually has contrary knowledge, director may not rely.

6. Remedies for Breach
   a. Personal liability for directors, unless meeting minutes show director's dissent or abstension. RMBCA 8.24d.
   b. DE 102 (b)(7) allows shareholders to shield directors from personal liability for breach of duty of care, but not for disloyalty. RMBCA 2.02(b)(4) has been proposed to incorporate this.
   c. For damages, must show hurt to the corporation. Directorial inattention has been held to be a proximate cause of damage.
   d. Since damage is to corporation, not shareholder, suggestion has been made that injunction should be easier to get than damages.

B. Duty of Loyalty 683-714, Supp 83-85, RMBCA 8.31, DE 144

1. Intro, Evolution of the Standard
   a. Basically worried about self-dealing transactions
   b. Two assumptions - director with outside interests will try to further his own, and he will be able to influence the rest of the board.

2. The Modern Standard

a. Basic Rule - RMBCA 8.31a - conflict of interest based decision is not automatically voidable as long as

1) approved by informed and disinterested directors, or
2) approved by informed shareholders, or
3) judicially determined to be fair.

a2. 8.60-8.63 - New RMBCA - transaction may not be enjoined per se

b. *Schlensky v. South Parkway* - was the transaction the kind that would have come from an arms length deal? Are the terms proper? Is it particularly valueable to the corporation?

c1. ALI Princlples - combined procedural and substantive test: transaction is okay if:

1) disclosure concerning conflict of interest
2) a) transaction is fair, or
   b) transaction is ratified by disinterested directors, could reasonably be believed to be fair, or
   c) ratified by disinterested shareholders, does not constitute a waste of corporate funds.

c2. DE Interested Director §144 - transaction okay if

1) material facts as to relationship are disclosed or are known and board in good faith ratifies, or
2) disclosure or known to shareholders who ratify, or
3) contract or transaction is fair

d. Shareholder Ratification

When shareholders ratify, courts generally only hold liable where

1) transaction was wasteful
2) directors or shareholders were grossly uninformed
3) transaction was illegal
4) transaction was ultra vires

Fliegler v. Lawrence - just because transaction was ratified by disinterested directors or shareholders, court still can look at its fairness to the corporation. The DE 144 defenses against conflict of interest are just to "remove the cloud", and not to, according to most cases, make the transation fair per se. Therefore, even when disinterested board of directors ratifies, transaction may still invalidated accused of being unfair. However, Fliegler seems to say

that ratification by disinterested, as opposed to interested directors, is a "safe harbor".

Question - if disinterested ratification does not create safe harbour, what keeps those disinterested directors from just dismissing the derivitive suit, in the best interests of the corporation?

e. Burden of proof falls on party seeking to uphold transaction after conflict has been shown.

Under new Part F, burden is left on challenger when disinterested directors or shareholders have ratified. RMBCA 8.61b

3. When is it better to challenge under Federal Proxy Rules? 527-563

a. If the transaction was the result of a proxy solicitation, a shareholder can bring suit in federal court if there was a violation of the proxy rules.

J.I. Case Co. v. Borak
Facts: Shareholders of a company that had been mergedinto another comany chalenged the merger on the ground that it was self-dealing and was accomplished by means of a false and misleading proxy statement.
Held: §27 of the SEC Act of 1934 permits implied cause of action for shareholders for violations of 14a. This suit can be direct or derivative. Relief can be damages or injunction.

TSC Industries v. Northway
Facts: TSC shareholder challenged sale of assets to National, who was a controlling shareholder in TSC. π accused that National's control had not been disclosed in the proxy.
Held: To be a violation, the fraud or misleading statement must be material. It must be something important that the voter would likely have considered, which depends on the issue voted on. Here, disclosure that National held 34% of TSC's stock was enough. Disclosure that the chairman and other board members were National-nominated was not material.

Mills v. Electric Auto-Lite
Held: Shareholder does not have to prove causation, though may have to prove that loss was caused, and that the proxy was part of the challenged transaction.

Virginia Bankshares v. Sandberg Supp. 48-62
Held: Directors' statement of belief in a disclosure about a recommended course of action can be materially significant, and

thus fall under 14a. *Virginia Bankshares v. Sandberg*. Proof of mere disbelief or undisclosed motivation is not enough under 14a. Where minority voters would not have been consulted anyway, no causation of damage.

4. Corporate Opportunity 719-733, Supp 85-86
   a. Basic Concept
      1) managers should not compete with the corporation for business opportunities
      2) managers should not be prevented from developing new business
   b. Interest-Expectancy Test - when corporation has special or unique opportunity, or is negotiating with someone. *Litwin* court asked -TEST - have the directoras profitted at the expense of their corporation; have they gained because of diloyalty to its interests and welfare?
   c. Line-of-Business Test - corporation does not need to have special interest or unique opportunity, just that its related to the function of the corporation.

VIII. Securities Trading

A. Common Law 1168-1189
   1. Tort law of fraud and deciet apply when 1189-1209
      a. insider affirmatively misrepresents a material fact
      b. insider knows its false
      c. the insider intends that the other party will rely on it
      d. the other party actually relies on it
      e. the other party is thereby harmed
   2. Special Facts Rule - do not need to show affirmative misrepresentations or actual reliance if:
      a. insider purchased from existing shareholders
      b. insider was in privity with shareholder
      c. insider actually knew of some unusual event
      d. secrecy was critically important to the sale

B. Rule 10b-5 - Materiality: Who is an Insider?
   1214-1244, 1260-1264, Supp 237-239
   1. Elements of 10b-5
      a. **False or misleading impression** - this can include complete silence, secret purchase campaign, etc.
      b. False impression must **relate to material facts** - would a reasonable investor consider this impression to alter the overall mix of relevant information?

c. False impresion must be made **intentionally or recklessly**. Negligence is not enough.

d. Must be **"in connection with" Trading of Securities**. The securities transaction need not have been accomplished by fraud, but if a scheme had fraud in it, its covered. Very broad. This also covers accountants and lawyers on the transaction.

e. **Reliance** - not where the impression had nothing to do with the decision to buy or sell. If it can be shown that the trader would have traded anyway, no liability.

   1) Omissions - materiality is enough.

   2) Fraud on the market (fraud which causes market prices to move, upon which investors rely) - rebuttable presumption of reliance.

   3) Face-to-face transactions - reliance must be shown.

f. **Causation** - must really be due to the prohibited action, not to market fluctuation, for example.

g. **Remedies**

   1) Recission, where stock has not been resold

   2) Recisionnal damages, if stock has been resold. Defrauded buyer can recover seller's profits.

   3) Out-of-pocket damages - difference between purchase price and actual worth.

   4) Cover damages - restore π to original position. Difference between what π sold for and what π could have sold for after fraud was revealed.

2. Possible Benefitting Defendants in Insider Trading

   a. Insiders - directors, officers, employees, controlling shareholders

   b. Constructive insiders - accountants, lawyers, bankers

   c. Tippees - person who recieves the tip

   d. Sub-tippees - informed by the tippee

   e. Strangers - no inside relationship to the corporation, but overhear

3. Duty to Abtsain or Disclose
   (S&P 29.5)

4. *SEC v. Texas Gulf Sulphur*
   Held: Where injunctive relief is insufficient, equitable remedies are available from the court.

   The court here established a fund from which protected shareholders could recover from insider traders.

   Note: Insider who wishes to trade must disclose and then wait for the information to be disseminated through the market.

5. *Chiarella v. US*
Facts: Printer sees info regarding corporation takeover, buys stock in target.
Held: Without duty to prospective seller (because he is not a responsible fiduciary), there is no duty to disclose material information, therefore no violation of 10b-5. This is like invitation to printers to inside trade.

Note: *Cady, Roberts* cited, where court held that if a person has speical access, and transaction is unfair, then liability.

6. *US v. Newman*
Held: Unlike *Chiarella*, employee held criminally liable, duty to corporation. This is for criminal liability, not civel, as this person had no duty to the corporation's shareholders whose stock was illegally traded.

7. More advantages of 10b-5
a. Federal jurisdiction
b. Federal discovery, service and venue
c. Covers omissions
d. No privity requirement, so trading on public markets is covered

8. Four notes about 10b-5
a. 10b-5 is generally limited by the language of 10b.
b. 10b-5 applies to sales and purchases.
c. Public and privately held corporations are under the rule.
d. Fraud "in connection with" securities is prohibited, regardless of whether the perpetuator is trading.

C. "Tipper-Tippee" Liability 1244-1260, Supp 219-237
1. get p.1245!!!!!
2. *Dirks v. SEC*
Facts: Brokerage house officer, tippee (Δ) investigated information that EFA was engaging in corporate fraud. He finds out from insurance person about fraud, causes EFA stock to drop. SEC, based on Δ's info, prosecutes Δ (for disclosure on non-public info) and EFA (fraud).
Held: Δ tippee not liable, since the tipper did not gain by the breach, and did not have a duty to the corporation. Where there is no gain, ther is no breach (and therefore no pain), but even <u>indirect</u> gain is still gain. And where there is no breach at the first tipper, then none of the tippees will be liable.

Tipper liable if for transmitting if he knows its confidential and if he knows it came from an insider who will benefit from the tipping.

Switzer v. US
Facts: Eavesdropper heard insider information in crowded restaurant.
Held: Insider had no idea, and no benefit, and therefore did not breach a fiduciary duty. Eavesdropper had no duty either.

SEC v. Lund (wrongly decided?)
Facts: Lund approached by Horowitz, asked if he might want to invest in a joint venture between P&F and Jockey. Lund bought 10,000 shares of P&F stock.
Held: Horowitz did not breach in approaching Lund, so Lund not liable as tippee. But Lund was "temporary insider", so liable as such.

Tippee liable if he knows or ought to know that the infomation is confidential, and have gotten it from someone who has a duty.

Chestman v. United States
Facts: Owner of Wallbaums told info to his family, including daughter and son-in-law. Son-in-law asked for advice from his broker, who said that he couldn't advise on this tip. Broker then traded on this information.
Held: Broker was knowing tippee. Uncle Ira's niece's husband (Keith) knew the tip was secret, had duty to his wife, who had duty to corporation, so Chestman, who knew Keith breached, was liable.

Willis v. United States
Facts: Psychiatrist made trades based on patient info, whose spouse was insider.
Held: Duty from psych to patient, from patient to spouse, so liable as insider (I think). Confidential relatioship seems to be key.

3. *Carpenter v. United States*
Facts: Wall Street Journal article published non-public information, but kept the corporation identity secret. The author told the identity of the corporation to his stock broker, who traded on these tips.
Held: Reporter convicted for misapproriation of the advance

information and tipping someone, though the court did this on a mail and wire fraud basis.

D. 10b-5 Liability v. State Fraud Action

Common Law Fraud	Rule 10b-5
Δ affirmatively misrepresented a material fact	Δ misrepresented or omitted to state a material fact which she had a duty to disclose
Δ knew (or recklessly did not know) of the misrepresentation	Δ knew (or recklessly did not know) of the misrepresentation or omission
Δ intended π to rely (no privity required)	Δ reasonably expected π, or other in π's position, to rely (no requirement of privity)
π did rely, reasonably	π relied, though in cases of omission, actual proof of reliance may not be needed
π actually damaged, damages measured under direct loss theory	π was damaged

E. Affirmative Duty to Disclose 1298-1312, Supp 241-245

1. NYSE Company Manual §2 - corporation must confirm or deny a rumour. No private right of action under the manual.

2. *State Teachers Retirement Board v. Flour*
Facts: Δ corporation did not disclose the signing of an important contract, despite rumours going around and unusual market activity in the stock exchange.
Held: Publicly traded corporation is under no duty to refute or substantiate rumours unless they are attributable to the corporation itself. Since this was a 10b-5 action, proof of scienter was also needed.

3. *Basic Inc. v. Levinson*
Facts: Management of BASIC falsely denied the existence of merger negotiations.
Held: An omission is considered material if a reasonable investor "would" (not might) consider it as altering the "total mix" of information in deciding a course of action.

When a significant corporate development is "certain

and clear," the corporation must disclose. But when the information may never come to pass, such as in a merger negotiation, the materiality test must balance the probability of it coming true, and its anticipated magnitude in light of other corporate activity. Timing of disclosure may involve the value of secrecy. However, when the corporation speaks, this balance does not apply, because such a test would be 1) paternalistic to the shareholders, and 2) will be over- and under-inclusive.

When a corporation is accused of "fraud on the market", the Δ corporation may defend by showing that there was no effect on the market, or by showing that the traders would have traded anyway.

IX. Duties of Majority Shareholders

A. Common Law 747-779, Supp 94-95, 98-103

DE §144 - Interested Director Statute - Presumption is that Controlling shareholder acts fairly. Complaining shareholder must show that Δ was on both sides of the transaction, etc. Only after this has been shown does the controlling shareholder have to prove fairness.

RMBCA 8.31, 8.60 - Director Conflict of Interest

1. Self Dealing 955-962, Supp 126-128

Sinclair Oil Corp. v. Levien

Facts: Sinven was a partial subsidiary of Sinclair. Minority shareholders of Sinven challenged three self-fealings, court held that only one, the third, was actionable.:

1) High dividend - Sinven was depleted. Court held that the polivy did not prefer Sinclair, since Sinven's minority **shareholders recieved a proportionate amount**. Absent such preferential dealing, Sinven would have to show that the transaction was not protected by the BJR.

2) Allocation of industrial projects away from Sinven, to other affiliates - Court held that these projects were **not corporate opportunities for Sinven**, so Sinclair was under no obligation to give these projects to Sinven.

3) Sinven was not enforcing oil contracts with other Sinclair affiliates. The court held that this was self-dealing (preferential dealing), and held Sinclair to the burden of showing that this was fair to Sinven.

Holding: In general, the subsidiary minority

shareholders have the burden to show that self-dealing transactions are unfair, ie. were not what would have been expected in an arms-length transaction.

b. *Trans World Airlines v. Summa Corp*.
Facts: Majority controlling shareholder forced TWA to buy and lease planes from them at expensive rates.
Held: NOT NICE. Peter is a potato head.

2. Mergers - Four types A, B, C and D
Example: P, larger corporation, (more assets, greater #s of stock, grerater profits, higher book value) wishes to swallow E. Here P stock goes to E 8:1, so P would have to issue more stock to complete a stock for stock deal.

	A	B	C	D
structure	merger / consolidation E+P = P/E+P = EP	stock for stock Ps <--> Es	reorganization 1) Ps issued to E in exchange for E's assets and liabilities. 2) E distributes this stock to its shareholders.	reverse (C) reorganization 1) Es issued to P for P's assets and liabilities. 2) P dissolves
legal mechanics	none- actual sale makes merger by operation of law	none		
board approval	RMBCA 11.01 requires from P and E	11.02 requires P approval, but E shh are just selling shares, none needed	Sale of all assets, need bd approval. Also, P board must approve issuance of stock	From P (12.02(a)) and E (authorization)
shareholder approval	RMBCA 11.03 requires absolute majority (maj. of all outstanding shares, as opposed to simple maj., which is half of votes cast). See 11.03(g)	Just merger, so none needed from P or E In DE, this can force out minority dissenters, since DE has no 11.02. Short Form merger can go if	Need E shh approval for sale of assets (RMBCA 12.02), P shareholder approval for for stock authorization.	P - yes (12.02) E - No. There is enough stock outstanding. If E is listed on NYSE, would need for 18% sale.

	exception.	90%.		

SEE S&P Chap 35 for info on mergers in general

2. Fair Dealing

a. *Weinberger v. UOP* - Squeeze Out Mergers

Facts: Directors involved in a transaction with a subsidiary were on boards of both parent and subsidiary, a fact they failed to disclose. Parent initiated takeover of subsidiary for $21 per share. Court found that $24 would have been a good investment for the parent. Also, parent initiated the cash-out, there were no meaningful negotiations, and the shareholders were not told that the $21 price was based on cursory review only.

Held: Mergers are subject to "entire fairness" test, which focuses on the fair price and the approval process. For price, **all factors must be considered**, such as historic earnings per share, asset value per share, market price, **discounted cash flow (anticipated future cash stream)**.

Also: For the cash out deal, factors such as timing, structure, initiation, negotiations, disclosure and method of obtaining approval are looked at. *Rabkin v. Phillip A. Hunt Chemical*.

Also: In NY, proper business purpose is a part of the fairness determination. *Alpert v. 28 William St.*. In DE, when it was inquiring into fairness,

Note: The later cases said that purpose of the merger is not a factor in fairness examination.

Rosenblatt v. Getty Oil - clarified *Weinberger*

Facts:

Held: 1) Disclosure of internally prepared valuations by the parent is only necessary if they are prepared by directors who are also on subsidiary board.

2) Negotiations by outside directors significantly defends procedural fairness.

3) Overwhelming approval by minority shareholders, after full disclosure, also defends procedural fairness.

4) Valuation need not be based on discounted cash flow.

Allen v. Peter

Held: Allen always wins.

b. Fairness

Jones v. H.F. Ahmanson & Co. - The California Approach

Facts: π, minority shareholder in United S&L complained that she and other shareholders had been forzen out of a public trading market. United S&L had only 7000 outstanding shares. Ahmanson, the Δ majority shareholder, created a holding company which acqiuired 85% of the shares. π argues that Δ should have split the stock down, 250:1.

Held: All transactions by controlling shareholders must be examined for fairness. Controlling shareholder must show that the transaction was 1) made in good faith, 2) inherently fair to minority shareholders. Controlling shareholder must show compelling business reason for the transaction.

Controlling shareholders may not use their control to their own benefit at the expense of the minority shareholders (CA). Δ had no compelling business interest for creating this holding company, and the court required that the shareholders be able to transfer their shares for shares in the holding company.

Note: Here, Δ's actions directly hurt π, not the corporation, so this may be a unique holding.

c. *Anadarko Petroleum Corp. v .Panhandle Eastern Corp.*

Held: Prospective shareholders do not have right of action against parent for spin off subsidiary.

3. Valuation of Fair Value

Past Performance

a. Market price
b. Past earnings
c. Book value
d. Liquidation value
e. Going concern value

Future Earnings (discounted future cash flow)

4. The Shell Oil Company Transactions and Litigation

5. Remedies for the Protection of Shareholders: injuction, appraisal

a. Appraisal Rights

1) Shareholders can vote on merger or

consolidation. RMBCA 13.02(a)(1), DE §262(a).

2) Shareholders can vote on compulsory share exchange. RMBCA 13.02(a)(2).

3) Shareholders can vote on sale of assets. RMBCA 13.02(a)(3), DE §262(c) (if provided in the articles).

4) Shareholders (under some statutes) who are significantly affected by an amendment to the articles may vote. RMBCA 13.02(a)(1), DE §262(c)(if provided in the articles).

5) General sole DE right, except for fraud, etc.

6) In DE, appraisal rights only exist in public traded corporations.

b. Exclusivity of Dissenters Rights (Supp)

1) Some state statutes (RMBCA 13.02(b), also CA and NY) allow challenge of a transaction for

a) fraud

b) breach of fiduciary duty

c) failure of approval to comply with procedural requirements

c. Procedural Requirements

Before these remedies may be had, shareholder must give notice of dissent, sell their shares, and request for fair price.

B. Federal Law790-808

SEC §10b, 10b-5

1. Fiduciary Standards Under Rule 10b-5

Santa Fe Industries, Inc. v. Green

Facts: Parent company merged with its majority owned subsidiary. Minority shareholders were given notice of the merger and their appraisal rights. The statement said that the value was $640/share, but the price paid was $125/share.

Held: 10b-5 is only available if there as been deception, not for unfair business transactions. There was no deception; a low price by itself is not fraud.

2. Post *Santa Fe* Development

Goldberg v. Meridor

Facts: Press release to minority shareholders failed to disclose that the transactions consideration was inadequate.

Held: Minority shareholders can bring a derivative action claiming that the directors failed to disclose the unfairness of certain self-dealing between the parent and the

corporation. Here, the minority shareholders could have used this information to enjoin the transaction under state law, so it was "material," and therefore actionable under 10b-5.

X. Transactions in Corporate Control

A. Sale of Control 996-1029, Supp 140-141

1. Introduction: The Consequences
   a. Controlling shareholder has direct power over his investment.
   b. It benefits economy in general to change control of poorly managed company.
   c. Incumbent has stock <u>and</u> control. For sale, he will want premium. But whose is the premium? His or the corporation's?
2. Management Accountability
   Manne, Mergers and the Market for Corporate Control
3. Duty of Care in Sale of Control
   Swinney v. Keebler
   Facts: Keebler bought stock in Meadors, operated it for five years, then decided to sell it off manufacture portion.
   Held: If buyer shows little interest in the company's business, and urges that the transaction be closed quickly, the seller may be required to investigate the buyers motives. **If sellers are in a position to forsee likelihood of fraud/harm at the hands of the buyer, there is a duty to investigate.**
4. Duty of Loyalty: Control As a Corporate Asset

   a. Controlling shareholders may not sell corporate opportunities.
   b. Controlling shareholders may not sell to looters.
   Signs to look for:
      1) Price is too good.
      2) Buyer cannot afford the company.
      3) Buyer is hurried.
      4) Buyer has bad business reputation.

   Perlmann v. Feldmann
   Facts: Derivative action brought to compel accounting for sale of control, an alleged asset of the corporation. The corporation had a scheme by which it was able to sell steel at higher than fixed prices. Sale price had been $20/share, though trial court found fair value to be $17, and market price was $12. Δ held 37% and sold to a buyer who would

then be able to get around the steel price freeze.
Held: "When the sale necessarily results in a sacrifice of this element of corporate good will and consequent unusual profit to the fiduciary who caused the sacrifice, he should account for his gains."

Ratio: Δ sold his office. Δ denied shareholders an equal opportunity to share in this control premium (this has been rejected elsewhere). Δ knowingly sold to a looter. Δ usurped a corporate opportunity, since there was evidence that someone else had approached who would have distributed the premium to all shareholders.

5. Sale of a Corporate Office
Essex Universal Trading v. Yates
Facts: As a condition of buying Yates controlling shares, Essex required immediate management replacement.
Held: An agreement to acclerate the transfer of control is legal (agreement for the seriatim resignation of the other directors). It is illegal to sell corporate office. But to prove that Δ's installation of a new slate was illegal, π must show that the buyer would not have been able to elect his own slate.

Treadway Companies, Inc. v. Care Corp.
Facts: Δ, largest shareholder, was approached by Care to sell his stock. Treadway asked him to sell his stock back to the corporation. He doubted the ability of the corporation to do this, and sold to Care for a 35% premium.
Held: Directors do not have to account for their premium per se. Treadway was not harmed, and Δ was not controlling shareholder. He did not transfer control, so is not liable to account for the sale.

6. Equal Opportunity
Andrews argues that other shareholders should have the same opportunity to get the premium from sale of control, since it is an asset of the corporation. A majority of courts have rejected this argument.

B. Contests for Control 1037-1039, 1052-1065, 1094-1106

1. Tender Offers
Glossary, page 1059.
Federal Rules:
a. 14D-1 Disclosure document
b. Opportunity for shareholders to evaluate

1) Open for minimum 20 days
2) Shareholders may withdraw while offer is open
3) Must be open to all shareholders
4) Everyone gets best (same) price
5) Pro rata purchase (everyone gets to sell some)
6) Bidder cannot purchase outside during offer

c. NO fraud (14e), as in 10b-5, but no "sale of purchase" language.

2. Defenses Against Takeovers

a. Self Tender
1) as above
2) outside purchases allowed
3) cooling-off period - wait 10 days after tender offer before buying
4) RMBCA 6.31a, DE 160 - buyback of own shares.
5) Incumbency is not a permitted purpose. Courts ask if the directors felt the corporation was threatened. This situation is a little like *Smith v. Van Gorkum* - to get the BJR, must first show good faith and reasonableness.

Cheff v. Mathes
Facts: Bidder threatened to get rid of the direct-marketing end of the business. Target paid greenmail to get rid of them. Directors were accused of trying to perpetuate control.
Held: Dominant-motive analysis: Target need only show policy dispute with bidder, proper business practice, to be allowed to defend. Here the bidder 1) in fact could have purchased controlling bloc, and 2) bidder threatened "the corporation in its current form."
Note: Looks like after good faith, BJR applies.

Unocal Corp. v. Mesa Petroleum 1107-1128, Supp 152, 192-193
Facts: Two tier tender offer. MESA, π, shareholder in Unocal (Δ) attempted takeover. Δ defended by issuing tender offer from which Mesa was excluded. Directors received expert opinions that Mesa offer was "wholly inadequate." Mesa argues that exchange offer must be good for all shareholders.
Held: Selective exchange offer is not per se illegal. Here the Mesa offer was no good, and to include Mesa in the buyback offer would screw defense, and finance Mesa's

proposal. Corporation may deal selectively with shareholders.

Here the defense precisely met the threat of coersion - 72/share = 54 /share value.

Note: Before you get BJR, must show

1) Reasonable grounds for believing ther is a threat to the corporation.

2) Defensive measure must be in reasonable proportion to the threat.

If you fail either of these, entrenchment is assumed to be the motive.

Note: Courts will no longer presume good faith, that entrenchment is <u>not</u> a motive. Paramount concern is shareholder welfare.

Note: "If the board of directors is disinterested, has acted in good faith and with due care, its decision in the absence of an abuse of discretion will be held as a proper exercize of business judgement."

Revlon, Inc. v. MacAndrews & Forbes Holdings
Facts: Offers, defenses, but eventually it was clear that the corporation was up for sale. Revlon offered lockups to Forstmann. **PP was trying to break up Revlon.**
Held: Revlon effectively ended an active auction by granting Forstmann certain lockup options. Lockups are okay without conflict iof interest. However, here the duty to the shareholders was to get the best price, not to preserve the corporation, and there must be a level playing field.

AC Acquisitions v. Anderson Clayton & Co. - **READ THIS!!!**

Hanson Trust v. SCM
Facts: Target gave management LBO group bidder "crown jewel" lockup options: could buy two of the prime divisions at 20-30 % discount if any other bidder bought a control bloc.
Held: Invalid - this reveals a **predisposition** toward one bidder. Inquiries into the prices of the divisions, the bestness of the LBO groups offer, how exercizing these

options would affect the company, were not made. There is a heightened duty of care in takeover fights.

Supp 152-192

In re J.P. Stevens
Citron v. Fairchild Camera
In re RJR Nabisco
Barkan v. Amsted

Mills Acquisition v. MacMillan
Facts: Maxwell (bidder) kept trying to give honest, and KKR (bidder) kept getting secret information.
Held: Lockup agreement for KKR invalidated. When management has interest in the bid (and pick their own financial advisor), an oversight by outside directors is lacking. Auction process must withstand rigourous scrutiny. There was no justification for the hostility to Maxwell.

Paramount Communications v. Time
Facts: Reverse triangular merger. Paramount timed a tender offer before Time-Warner proxies could be completed for their merger. So Time-Warner restructured to not require shareholder approval.
Held: Only when corporation is up for sale must the highest price be taken. When corporation wants to survive for later, bigger, better things, can use defensive measures.

Note: Warner shareholders became 62% owners of Time, yet the court did not consider this a sale, and did not trigger *Revlon* duties. This was because 1) Time kept half control, 2) there was continuity of ownership, and 3) still had the "Time-culture".

1132-1138, Supp 194-211

More Defenses
Blasius Industries v. Atlas

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