Business Associations Outline

I. CHOICE OF ORGANIZATIONAL

A. SOLE PROPRIETORSHIP

1. **Structure:**
    1. Single Owner
2. **Liability**
    a. Unlimited Direct Liability on owner
    b. Derivative and Vicarious Liability for acts of employees
    c. Respondeat Superior where the employer or principal is liable for the employee's or agent's actions committed during the scope of employment also applies
    d. Personal liability of owner may attach business and personal assets
3. **Control:**
    a. Full control to owner, but control may be delegated to agents
4. **Profits:**
    a. Owner collects all profits. Owner also liable for all debts (see liability)
5. **Tax:**
    a. Pass Through/Flow Through Tax – no separate filing; one level of taxation
    b. Sole proprietor puts business taxes on personal 1040
6. **Formalities:**
    a. Minimal; no filing required; created in law once business established
7. **Statutes:**
    a. None
8. **Other:**
    a. Vicarious liability premises upon Respondeat Superior in agency law.
    b. Restatement (2nd) of Torts – ruled by common law principles.

B. GENERAL PARTNERSHIP

1. **Structure**
    a. 2 or more owners; joint ownership
    b. **Definition of Partnership** (RUPA § 202(a), p.91): Except for associations formed under another statute, the association of two or more persons to carry on as co-owners a business for profit forms a partnership. *Partnerships may be formed inadvertently when two people decide to associate for a profit-making venture.*

c. **Factors to Determine Partnership** (RUPA §202(c)(3), p. 92):
   Person who receives share of net profits *presumed* to be partner, but can rebut that presumption. If portion of net profits received as payment of debts, for services as employee, of rent, of health benefits, of interest in a loan, or for the sale of goodwill of the business.
d. Courts look at how 2 people acted to see if acted like partners. Acting like partners can trump.

2. **Liability:**
   a. Except as provided in (b), all partners are liable jointly and severally for all obligations of partnership *unless otherwise agreed by claimant or provided by law* (partners may contract around or form LLP)
      (RUPA § 306(a), p.102)
   b. Each partner is an agent of the partnership and an act of a partner binds the partnership so long as act is in the ordinary course of business and the partner has authority (direct, inherent, apparent)
      (RUPA § 301, p. 96)
   c. Exception for LLP: obligation of a partnership incurred while the partnership is a LLP is solely the obligation of the partnership
3. **Control:**
   a. Unless otherwise specified by agreement of amount of capital invested, all partners share equal control (default)
   b. Each partner has equal rights in management and conduct of partnership business (default rule that profits shared per capita) (RUPA § 401(f), p. 107)
   c. See also UPA 18(a), p. 62
4. **Profits:**
   a. Each partner entitled to equal share of profits and is chargeable with share of partnership losses in proportion to share in profits (RUPA § 401(b), p. 107)
5. **Tax:**
   a. Pass Through Taxes – amount of taxes depends on amount of profits each partner receives according to partnership agreement: set forth in Chapter K of IRC
   b. Each partner must prepare information return (Form 1065)
6. **Formalities:**
   a. Minimal – no written agreement required (but preferred)
   b. See RUPA § 202(c)(1-3), p. 92 – outlines factors to show whether partnership formed
   c. Passive co-ownership does not establish partnership
7. **Statutes:**
   a. Uniform Partnership Act (UPA) (§§ 1-43)(1914)(p. 55)

b. Revised Uniform Partnership Act (RUPA) (1997 (p. 74)

8. **Smith v. Kelley** (1971)

Smith left business and claimed entitled to fixed % of profits b/c he was held to public as partner. No written partnership agreement existed. Court said that he didn't sign any important notes or documents and was not obligated to suffer any losses if there was liability found. Here you see the risks that one might have if you don't have writing. The status of this employee should be clear in his job title or job contract.

a. ***RULE***: You can be a partnership w/out meaning to be. Intent to form partnership shown by objective examination of parties' acts.

b. ***Objective Acts*** (none in this case):

i. Partnership Agreement
ii. Capital Contribution
iii. Management Authority
iv. Authority to hire, fire, make purchases
v. Authority to borrow money
vi. Obligation to stand losses of firm
vii. NOTE – RUPA § 202(a) – no need to determine subjective intent

9. **Young v. Jones** (1992)

TX investors deposited $550K in SC bank based on unqualified audit letter from Price Waterhouse-Bahamas that gave bank clean bill of health. Money and Def.'s disappeared. Investors couldn't get PJ over PWBA, so sued PW-US. Investors allege partnership, or partnership by estoppel b/c partnership would create joint & several liability. Court says no partnership…PW stopped short of creating one.

a. ***RULE***: Persons who are not partners to each other are not partners to 3rd persons.

b. ***Partnership by Estoppel*** (purported partner): if a person, by words or comment, purports to be a partner, or consents to being represented by another as a partner, in a partnership or with one or more persons not partners, the purported partner is liable to a person to whom the representation is made, if that person, relying on the representation, *enters into a transaction* with the actual or purported partnership.
(RUPA § 308, . 105; or UPA § 16, p. 61)

c. SC statute appears to operate like RUPA & UPA

d. Pl.'s point out letterhead identified PWBA only as PW, audit letter bore PW logo, and was signed PW

e. But, court rejected estoppel claim b/c no evidence that Pl.'s relied on any act or statement by any PWUS partner indicating creation of partnership nor did PWUS have

anything to do with audit letter

C. LIMITED PARTNERSHIP

1. **Structure:**
    a. Partnership formed by two or more persons having one or more general partners ***AND*** one or more limited partners. Mandatory general partner and at least one limited partner (ULPA § 101(7), p. 188)
    b. Created by statute, but in absence of statute (or failure to comply therewith), all partners are general partners no matter what their private understanding is or how they designated their partnership agreement
2. **Liability:**
    a. GP: Unlimited liability and must also maintain accounting LP: Liability limited to LP's investment into the company, but cannot participate in control or management
    b. Except as provided in (d), limited partner not liable for the obligations of a limited partnership *unless she is also a general partner or in addition to the exercise of her rights and powers as a limited partner, she participates in the control of the business* (ULPA § 303(a), p. 194)
    c. Limited liability of the limited partners to what they have invested in the business. Their personal assets are protected. LPs are used to finance short-term projects (movies, real estate ventures, etc.)
    d. **Safe Harbor Provision** – A limited partner does NOT participate in the control of the business by doing one or more of the following (ULPA § 303(b), p. 194):
        i. Being a contractor for the business or an officer, director or shareholder of a corporate general partner;
        ii. Consulting and advising a GP;
        iii. Acting as a surety for the limited partnership or guaranteeing or assuming specific obligations;
        iv. Pursuing any derivative actions;
        v. Requesting or attending a meeting of partners;
        vi. Proposing, approving or disapproving the following:
            1. Dissolution or winding up of partnership;
            2. Selling assets;
            3. Incurring indebtedness other than the ordinary course of business;
            4. Change in nature of business;
            5. Addition or removal of a GP;
            6. Addition or removal of a LP'
            7. Transaction involving conflict of interest;

8. Amending partnership agreement;
9. Matters related to the business of the LP but which partnership (in writing) allows limited partners may participate;

vii. Winding up the LP under § 803

viii. Exercising any right or power permitted to LPs not specifically enumerated

e. List in § 303(b) not exhaustive (ULPA §303(c), p. 195)

3. **Control:**
   a. GP – Unlimited Control
   b. LP – No control (except as allowed under ULPA § 303). If an LP participates in control, he becomes GP
4. **Profits:**
   a. Profits and losses of LP allocated among partners in the manner *provided in writing* in partnership agreement. If no agreement, allocated on basis of value of contributions of each (ULPA § 503, p. 200)
5. **Tax:**
   a. Pass Through for both LPs and GPs
   b. LP often used as a tax shelter b/c you can take losses and offset them against other types of income (as set forth in Chapter K of IRC). May offset losses completely or at least reduce the amount of taxes owed. Because of this, this type has been used in speculative ventures.
   c. LPs must file informational return (Form 1065)
6. **Formalities:**
   a. Need to file Certificate of LP with office of Secretary of State. Must set forth the following (ULPA §201(a), p.190):
      i. Name of LP;
      ii. Address of office and name and address of service of process;
      iii. Name and business address of each GP;
      iv. Latest date upon which LP is to dissolve; and
      v. Any matters GPs determine to include therein
   b. LP formed at time of filing in Secy of State's office, or at any later time specified in the Certificate of LO (ULPA § 202(b), p. 191)
   c. Partnership Agreement (not the Cert of LP) is authoritative document for most LPs. When looking for info, look to Agreement
7. **Statutes:**
   a. Uniform Limited Partnership Act (1976) w/ 1985 Amendments (p. 186)
8. **Other:**

a. Can have corporation be a GP to cure personal liability. See § 303(b)(1) (LP may be director, officer, or shareholder of corporation without being in control)
    i. Until 1/1/1997, IRS used Kinter regulations to determine taxation of LP and corporate GP
    ii. Regs identified 6 characteristics of pure corporation, distinguishing it from other org'ns:
        1. Associates
        2. Objective to carry-on business and divide gains therefrom
        3. Continuity of life
        4. Centralization of management
        5. Liability for corporate debt limited for corporate property
        6. Free transferability of interest
    iii. 1 and 2 are shared by both partnerships and corporations, and are disregarded for tax purposes. If entity lacked 2 of 4 characteristics, status of partnership is respected for tax purposes
    iv. **NO LONGER USED**. Now, entity elects at time of filing first tax return … Check the Box
    v. See Hamilton, p. 156-159

9. **Continental Waste v. Zoso** (1989)
LP b/w McKiel (GP) and Zoso Partners (LP – made up of general partnership b/w Ivo Zoso and Fred Cook). Creditors are owed money from the LP. GP has no money. Creditors look to Zoso.
    a. ***RULE***: Until proper certificate of LP filed, partnership not an LP and all partners treated like GPs
    b. A LP may be considered a GP if he exercises elements of control
    c. Look to indicia of control by LP's actions; or creditor's reliance
    d. First, look to defects in the limited liability corporation filing. If defective, all it is is a GP where partners are jointly and severally liable
    e. Second, if valid LP, try to find that LP (Ivo) is a GP … look for indicia of control. Remember § 303(b) of 1976 ULPA now creates safe harbors
    f. Finally, LP (Ivo) cannot use good faith exception to § 11 ULPA (1916) [oops, I thought it was filed correctly] b/c it is a fact-based inquiry not to be determined at summary judgment

10. **Corporate General Partner vs. Individual General Partner**
    a. CGP subject to someone else's control (shareholder, etc.)

b. CGP can transfer control w/out affecting the continuous existence of the CGP. Transfers b/w IGPs can be very difficult
c. CGP may be entirely acceptable and responsible as a GP even though its assets are minimal in comparison to the size of the business it is managing
d. CGP may enter LP with sizable corporate assets. CGP may lawfully "bleed away" corporation's assets. Thus, this may be to detriment of the LP who relied on the assets of the CGP to cover any liability
e. Conflicts of fiduciary duty exist when duties owed by the corporation to its shareholders. Duties owed by the CGP to the LP trump those owed by the CGP to shareholders

D. CORPORATION

1. **Structure:**
   a. Defined by STATE statute
   b. Artificial Person – has legal rights
   c. Must meet filing requirements for Articles of Incorporation (RMBCA § 1.20, p. 564)
   d. Articles of Incorporation must be filed (RMBCA § 2.02, p. 572)
   e. **Board Of Directors** – required by (RMBCA § 2.05(a), p. 577) either in Articles of Incorporation or elected later; responsible for policy, business decision, affairs of corporation and ultimate responsibility of management
   f. **Officer** – Agent of corporation appointed by Board of Directors according to corporate statute; carry out the day to day activities of the corporation
   g. **Shareholder** – Indirect claim on the capiral of the business (corporation has direct claim) and are owners in a limited sense.
2. **Liability:**
   a. Limited liability to those persons who participate in corporation. A corporation is a legal person, so it is liable for its own deeds and for its own taxes
   b. **Board of Directors:** Generally limited liability unless corporate veil is pierced
      i. May eliminate or limit the liability of a director except for receiving financial benefits, intentional infliction of harm on the corporation or the shareholders, a violation of § 8.33 (unlawful distributions), and intentional violation of criminal law (RMBCA § 2.02(b)(4), p. 572)
   c. **Officer:** Limited unless corporate veil pierced

d. **Shareholder**: No personal liability (RMBCA § 6.22(b), p. 593); Liability limited to assets invested in company (unless specified by Articles of Incorporation, RMBCA, § 2.02(b)(2)(v), p. 572)
e. **Insurance**: Reduces some of the risks of unlimited liability. Corporation needs to have insurance regardless of whether you as owner have limited liability under corporation law.

3. **Control:**
   a. **Board of Directors:** Manages corporation
   b. **Officer**
   c. **Shareholder:** Statutorily defined rights; e.g., elect, reelect and fire Board; voter on major issues like M&A, initiate derivative suits
4. **Profits:**
   a. Profits *may* be paid off as dividends (not automatic). Whether dividends received is determined by Board of Directors
5. **Tax:**
   a. **Double Taxation**: corporation pays a corporate income tax on its profits. If the after-corporate-tax profits are distributed as dividends, the individual shareholders pay a separate, second tax on the dividends
   b. Corporate Tax Form is Form 1120
   c. **Zeroing Out the Corporation:** When corporation shows it does not have any income. It pays out the sums to salaries, etc. in order to show it has expended all if its income, and thus, will not have to pay a corporate tax
      i. Hard to do if corporation makes lots of money
      ii. Bad business strategy to try and pay out all money in order to avoid taxes
6. **Formalities:**
   a. Need proper filing of Articles of Incorporation in proper office
   b. Must file annual report and fee
   c. Must keep records, minutes, listing of shareholders, etc.
7. **Statutes:**
   a. Revised Model Business Corporation Act (RMBCA, p. 556)
   b. Delaware General Corporate Law (p. 477)
8. **Other:**
   a. Two limitations on corporate limited liability:
      i. Piercing the Corporate Veil – when corporate form used for corrupt purposes, limited liability does not kick in

ii. Agent of corporation directly participates in a wrongful act
    1. More subtle case arises when other persons acted as supervisors. If supervision was direct and specific, supervisors may be held liable
    2. Does not apply often in tort cases
    3. Corporation can contract to indemnify an individual if held liable for doing the corporation's business, but indemnification K not allowed to exceed public policy

E. S-CORPORATION

1. **Structure:**
   a. The Internal Revenue Code allows a corporation to make a tax election of structured as follows:
      i. Fewer than 75 individual shareholders
      ii. May not have shareholders who are non-resident aliens
      iii. May not have issued more than one class of stock (except for classes of common stock different only in voting rights)
2. **Liability:**
   a. Liability, just like C Corporation
3. **Control:**
   a. Same as Corporation
4. **Profits:**
   a. Same as Corporation
5. **Tax:**
   a. Must make a tax election to be an S Corporation
   b. S-Corporation treated as a partnership for tax purposes (Pass Through). *No Double Taxation*
      i. Double Taxation of Corporations discourages small businesses to incorporate and the General Partnership is an unlimited liability vehicle. S-Corp was created by Congress to make it possible for small businesses to have limited liability and pass-through tax treatment
   c. Incentive for small businesses and aims to promote small business growth. Giving benefit of limited liability with pass-through taxation.
   d. If business fails to meet any requirements of S-Corp, then they will have to pay corporation back-taxes for all the years they miscategorized themselves
6. **Formalities:**

a. Very complex; high transactional costs b/c corporation must employ people to comply with highly-technical election requirements. Runs counter to the intent of S-Corp to save money

7. **Statutes:**
   a. Governed by tax code, not corporate law. Subchapter S on Form 1120

8. **Other:**
   a. When to change from S-Corp to Corp – when assets become very large and can't find enough personal deductions to offset assets … pass-through taxation then no longer beneficial

F. LIMITED LIABILITY PARTNERSHIP

1. **Structure:**
   a. LLP is partnership that has filed a statement of qualification under § 1001 (RUPA § 101(5), p. 76)
   b. May convert from LLP to partnership or vice-versa (RUPA §§ 902-903, p. 149)
   c. Limited Liability Partnership Statement of Qualification – (RUPA § 1001, p. 153)
   d. Think of it as a GP with extra provisions that protect partners that are not direct participants in the bad acts of other partners
      i. Elimination of personal liability of innocent partners for malpractice or negligence of co-partners may reduce their incentive to monitor the performance of other partners
   e. Not an LP b/c LPs cannot participate in operation or management … LLPs can
      i. Grew out of the S&L crisis
   f. Organized under STATE law

G. LIMITED LIABILITY CORPORATION

1. **Structure:**
   a. Hybrid of corporate and partnership forms
   b. 4 general characteristics:
      i. Limited liability among all partners, similar to a corporation (Del. Limited Liability Company Act § 18-303, p. 302)
      ii. Pass-Through Taxation like partnership
      iii. Chameleon Management – chooses corporate-type management, partnership-type management, or a hybrid (Del. Limited Liability Company Act § 18-402, p. 305)
      iv. Creditor-protection provisions

2. **Formalities:**
    a. Must file Articles of Organization with the State
3. **Downside of LLCs:**
    a. Statutory limitations – certain States may not uniformly recognize how to treat an LLC
    b. New legal animal and don't want to litigate on forefront of the law
    c. Different tax treatment of LLCs by State (not Federal)
    d. States usually have high filing fees for LLCs while corporate fees are significantly less
    e. No caselaw to definitively chart liability (e.g., piercing)
    f. See p. 135
    g. Old state statutes have not changed language to apply to LLCs, which did not exist at the time statutes created
        i. **<u>Meyer v. OK Alcoholic Beverage</u>**
            1. OK liquor license allowed to person, general, or limited partnership. Court held against including LLC in inclusions unless explicitly set forth, mainly concerned about limited liability issues
            2. Exemplifies problems of court trying to make decisions w/out case law to guide decisions
        ii. **<u>Poore v. Fox Hollow</u>**
            1. Question of how to treat LLC under Delaware law, which required representation of corporations in court. Court applied law requiring counsel to LLC, just like a corporation which must have an attorney b/c it is a fictitious entity. LLC's limited liability was deciding factor in treating it like a corporation with regard to this matter
4. **Other:**
    a. LLC is a way for a closely held corporation to obtain limited liability, but avoid the expense of incorporating

II. <u>DEVELOPMENT OF CORPORATION LAW</u>

A. Major Themes

1. BA law is creature of statutory and common law
    a. Shaped by federal and state policies
2. Evolution of society and economy may necessitate changes in business law
    a. E.g., creation of S-Corporation and LLC
3. Possibility of revenue to States is a strong factor in the way the law is shaped

a. E.g., Delaware corporate law caters to corporate management to attract revenue

4. Federal law fills gaps and provides rights and protections where States may have left off

B. Tensions/conflicts in policies

1. Tension b/w directors and officers (duty to control) and the protection of vulnerable players (shareholders and creditors)
2. Federalism: conflict b/w state and federal government about who should regulate in business arena
3. Government is regulator to protect public against cherished rights of parties to contract

III. FORMATION OF THE CLOSELY-HELD CORPORATION

A. Where to Incorporate

1. This decision has serious implications to the operation of the company and the manner in which major actors can have their objectives for the company met
   a. **External Affairs of a Corporation** – Type of law that applies is dependant upon where the violation took place (i.e. breach of K, bribery, etc.)
   b. **Internal Affairs of a Corporation** – Type of law that applies is dependent on where the corporation is incorporated (which state). See below, Internal Affairs Rule (Hamilton, p. 187)
2. **Internal Affairs Rule**
   a. Courts will apply the law of the state of incorporation to issues arising from the internal affairs of the corporation (does not apply to K or tort claims)
   b. Applies to:
      i. Declaration of dividends
      ii. Stockholder approval of merger
      iii. Sale of corporate assets
3. **Choices:**
   a. **Place of Principal Business** – usually best for smaller, closely-held corporation
      i. Jurisdiction – where they want to avail selves to suit
      ii. Inconvenience considerations if sued outside state
      iii. Avoid paperwork and filing fees for doing business in another state
      iv. Tax considerations – no double taxation (or double fees) with no foreign domocile
      v. Home States five flexibility to home corporate (e.g., proxy contests)
      vi. Smaller corporations may not need the special structuring and powers made available to Delaware corporations

b. **Delaware** – benefits for larger businesses
    i. Comprehensive, modern, flexible corporate law
    ii. Courts have substantial body of caselaw and considerable expertise
    iii. Lower franchise taxes
    iv. Expedited corporate incorporation process (simple forms; boiler plates)
    v. Directors have substantially more power to make decisions without votes of shareholders (e.g., leeway in fighting hostile takeovers)
    vi. Prestige for being a DE corporation
    vii. If there is a complex internal organization of the corporation, then it is probably better to incorporate in DE
c. Criticism
    i. DE will not change law for fear of losing revenue
    ii. Law favors officers and directors, and creates tension between them and the shareholders
    iii. Allows officers and directors to run company without much control by shareholders

4. Example of Where to Incorporate
    a. **Triton Energy Proxy Statement** (p. 184)
        i. Incorporated in TX, then went public
        ii. Shareholders nationwide
        iii. Board trying to sell shareholders on reincorporating in DE
        iv. Proxy statement says:
            1. More substantial body of case law construing DE General Corporation Law (DGCL)
            2. This gives greater predictability and reduces uncertainties (risks)
        v. DGCL most comprehensive and progressive state corporate statutes
        vi. Other reasons **Directors** want DE
            1. DE favors officers and directors over shareholders
            2. Allows officers and directors to run company without much shareholder control
            3. Hostile Takeovers:
                a. Directors probably won't like being taken over, but shareholders may
                b. DGCL gives directors more opportunity to fight hostile takeovers and protect themselves even against deal lucrative to shareholders

B. HOW TO INCORPORATE

1. **Articles of Incorporation** (Hamilton, p. 196)
   a. **Name**
      i. Must contain the words (in full or abbreviated):
         1. Corp.;
         2. Inc.;
         3. Co.; or
         4. Ltd.

(MBCA § 4.01(a), § 2.02(a)(1))

      ii. Must be distinguishable upon the records of the Secretary of State from other corporate names in order to avoid fraud, protect current businesses, anti-competition (shouldn't profit under goodwill of other corporations) (MBCA § 4.01(b))
         1. Many state statutes prohibit **deceptively similar** names
         2. Secretary determines whether name is deceptively similar to as to constitute anti-competitive nature
         3. Official Comment of MBCA says Secretary should not police the unfair competitive use of names and does not have resources to do so. Confusion is the appropriate test under the act, not the competitive relationship between corporations
      iii. Can use an indistinguishable name if consent by original user or decree of court
      iv. Corporations may generally conduct business under an assumed or fictitious name to the same extent that an individual may (MBCA § 4.01(e))
         1. Test for lawfulness is no purpose to defraud
         2. Fictitious or assumed name (**trade name**) statutes are not part of corporate law (just state law itself)
         3. Some states require a public filing disclosing the real identity
         4. Need formal name (**corporate name**) in order to sue
         5. May reserve name for a fee
      v. **DE General Corporation Law** (DGCL § 102(a)(1), p. 454)
         1. Wider variety of names; more flexible
         2. Also contains "club," union," "foundation," etc.
   b. **Purpose** (Not required in Articles of Inc. under RMBCA)

        i. "To engage in all lawful business activities"
        ii. "Every corporation incorporated under this act *has the purpose of engaging in any lawful business unless a more limited purpose is set for the in the Articles of Inc.*" (RMBCA § 3.01(a), p. 578)
        iii. Same standard in DE (DGCL § 102(a)(3), p. 454)
        iv. Trend from very specific purposes (*ultra vires* doctrine) to very broad; some States may not require it. See RMBCA
        v. Illegal activities are not allowed
    c. **Principal Office/Resident Agent and address**
        i. Must list person (or service company), no PO box
        ii. Designed to ensure every corporation has publicly stated a current place where it may be found for purposes of service of process, tax notices, etc.
        iii. §§ 5.01-5.04 of MBCA; § 5.01 of RMBCA, p. 581
        iv. § 102(a)(2) of DGCL, p. 454
    d. **Authorized Stock: Par Value**
        i. Most states require that corporation list number of shares, the class of shares, and their par value (initial worth)
        ii. RMBCA § 2.02(a)(2), p. 572
        iii. DGCL § 102(a)(4), p. 455
        iv. Number of shares should be substantially more than amount that is planned to be issued (issuing more stock later requires shareholder vote); but, could be taxed at higher rate depending on the amount of initial shares
    e. **Initial Directors/Incorporators**
        i. Need name and address of each (RMBCA § 2.02(a), p. 572
        ii. Under earlier versions of Model Act, had to list names of initial directors until 1st mtg held
        iii. List name and mailing address of the incorporator(s); if the powers of incorporators terminate upon filing of the certificate of inc., must also list initial directors until 1st annual mtg (DGCL §102(a)(5-6), p. 455)
    f. **Duration**
        i. Unless Articles of Inc. provide otherwise, every corporation has perpetual duration and succession in its corporate name. Note that duration is not required in Articles of Inc.(RMBCA § 3.02, p. 578)
        ii. Assumed perpetual but still not required in certificate of incorporation (DGCL § 102(b)(5), p. 456)

g. **Special Regulatory Provisions** (Optional)
    i. Corporation may choose to place in Articles of Inc. for proof in internal disputes should they arise
    ii. However, it reveals to competitors how the corporation functions

2. **Filing Articles of Incorporation**
    a. Corporate existence begins when Articles of Inc. filed (RMBCA § 2.03(a), p. 574)
    b. Secretary filing Articles of Inc. is conclusive proof that incorporators satisfied conditions precedent to incorporation (RMBCA § 2.03(b), p. 574)
    c. Relation back – Many state filing agencies treat the date of receipt as the date of issuance of the certificate even though delays and the review process may result in the certificate being back dated

3. **Steps After Articles of Incorporation are Filed** (Hamilton, p. 205)
    a. Prepare bylaws
    b. Prepare notice calling the mtg of the initial Board of Directors, minutes of meeting and waivers of notice if necessary
    c. Obtain a corporate seal and minute book
        i. Law requires annual mtg of shareholders
    d. Obtain blank certificates for shares of stock
        i. Arrange for printing and typing and proper insurance
    e. Open corporate bank account
    f. Prepare employment K, voting trusts, shareholder agreements, share transfer restrictions, etc.
    g. Obtain taxpayer identification numbers, occupancy certificates and other governmental permits or consents to the operation
    h. Evaluate whether the corporation should file as an S-Corporation

(See also RMBCA §§ 2.05-2.06, p. 577)

4. **Initial Meeting**
    a. Take minutes
    b. Establish bylaws
    c. Elect officers and Board of Directors
    d. Issue Shares
    e. Note: if corporation is small and closely held, it is not necessary to actually hold meetings of incorporators, directors and shareholders (MBCA §§ 2.05, 7.04, 8.21)

IV. <u>ULTRA VIRES DOCTRINE</u>

A. Definition – corporation acting beyond the scope of its purpose set forth in the Articles of Incorporation

1. It is now of little practical importance, b/c many inequities resulted; e.g., a corporation would repudiate an otherwise valid K and K would be found unenforceable b/c K fell outside purpose of which corporation was formed, meaning it lacked the power to enter into the K in the first place. A major loophole
2. In earlier times, it was taken seriously and relates to the concern of engaging in business with other people's money. There were also concerns of directors and officers of company having too much power
3. *See* <u>Ashbury Ry. Carrage and Iron Co. v. Riche</u> (1875) (p.213)

B. Corporate Purposes/Powers

1. Purposes (RMBCA § 3.01, p. 578)
   a. What the business specifically intends to do
   b. *Ultra Vires* ("beyond the power") usually goes toward purpose of the corporation
2. Powers
   a. What the business specifically is allowed to do
   b. Enabling authorities that a corporation needs to carry out its purposes
   c. See RMBCA § 3.02, p. 578 for list of powers corporation has
3. **<u>711 Kings Hwy Corp. v. F.I.M.'s Marine Repair</u>** (1966), p. 263
   K was to lease property of movie theater to Def. Purpose of corporation was marine activities (building boats, repairs). Pl. corp. is leasor and wants to break lease; seeks declaratory judgment to declare lease invalid. On Motion to dismiss or in alternative Motion for Summary Judgment
   a. ***RULE***: NY Statute (§ 203 NY Business Corp Law) limited use of *Ultra Vires* doctrine to 3 circumstances:
      i. In an action brought by shareholder to enjoin a corporate act
      ii. In an action by or in the right of a corporation against an incumbent or former officer or director of the corporation; or
      iii. In an action or special proceeding brought by the Attorney General
   b. If act is otherwise legal, it can't be held invalid based solely on a lack of capacity (except for 3 situations above)
   c. Example of legislatures limiting unfair use of *Ultra Vires*
   d. RMCBA § 3.04, p. 602 (very similar to the NY, NJ acts)
      i. Validity of corporate action may not be challenged on ground that corporation lacks power to act

ii. Corporation's power to act may be challenged → **When someone has standing to bring ultra vires case:**
    1. In a proceeding by a *shareholder* to enjoin the act;
    2. In a proceeding by the corporation, directly, derivatively, or through receiver, trustee, or other *legal representative* against an incumbent of the corporation
    3. Proceeding initiated by the *Attorney General*

iii. In a shareholder proceeding, court *may* enjoin or set aside the act *if equitable and if all affected persons are parties to the proceeding* (an extra requirement that the NY statute does not state). Many courts want to see that you have an internal corporation solution for this problem. They want to see that there is property authority for this act.

4. **<u>Theodora Holding Corp. v. Henderson</u>** (1969), p. 266
HC, that had power to make investments, makes charitable donation to charity established by majority holder of stock. Another stockholder sues.
    a. ***RULE***: Corporations can make donations to charities, as long as reasonable
    b. ***DGCL § 122(9)***, p. 463 (see also similar RMBCA § 3.02(13), p. 579) – *granted the power* of corporation to make donations for the public welfare or for charitable, scientific, or educational purposes
    c. The donation fell within the federal tax deduction limitation of 5% of corporation's income
    d. ***DGCL § 121***, p. 462 defines General Powers, ***DGCL § 122*** defines Specific Bowers
    e. Most shareholder *ultra vires* suits regard charitable donations
    f. Some family law (revenge) issues at play

V. <u>PREMATURE COMMENCEMENT OF BUSINESS</u>

This refers to the early stages of a business

A. Promoters

1. Any person who, acting alone or in conjunction with others, directly or indirectly takes initiative *in founding and organizing* the business or enterprise of an issuer (e.g., buying, leasing property, arranging borrowing of money, hiring employees)
2. Fiduciary Duty-
    a. **Promoter owes a fiduciary duty to the company and not toward herself personally**. Example, the promoter goes

out and buys property for 300K and then sells that property to the company for 350K. Here, the promoter used its power and information to work for himself and not for the company.

b. **Also owes duty to co-promoters**
c. **Full disclosure, which includes:**
    i. Duty to refrain from misrepresenting any material facts; and
    ii. Duty to make known any personal interests in any transaction relating to the company
d. Act in good faith
e. High standard of honesty and frankness
f. No self-dealing; secret profit-making
g. Command dedication of corporate funds to corporate purposes
h. Breach of fiduciary duty is in itself a cause of action. Could also be a tort (misrepresentation of material fact) or in contract (mischaracterization)
i. Promoter is liable for common law fraud in event of misrepresentation. Liable to subsequent investors, creditors, and co-promoters

3. **The Legal Relationships:**

a. ***Between Promoter and company to act in its best interest and to shareholders' interest (when added)*** **Fiduciary duty that the promoter owes to the company.**
    i. HYPO – Promoter buys land, paying $200K. Forms corp., gets investors and borrows money. He sells land to corp. for $250K
    ii. RULE – Promoter has duty to act in interest of the corporation, not his own personal interest. But, if promoter discloses personal interest and corporation accepts, no violation of duty
b. ***Between Promoter and 3rd Party***
    i. Promoter goes out acting on behalf of the business. He lines up all the resources
    ii. **Stanley J. How & Assoc. v. Boss** (1963), p. 274 Promoter Boss engaged Pl's services for architecture project. Pl. performed but was only partly compensated. Corp. never formed, project abandoned. Architect sues and Boss claims corp. is liable as obligor. Boss signed K as agent of yet-to-be-formed Corporation who will be obligor. Here, Boss tried to place himself neatly within the exception, but while the judge has to wrestle with

the fact that the rule says one thing, but to go along with that then How would have been tricked.

1. ***RULE***:
    a. **General**: Promoters are personally liable for Ks entered into on behalf of corporation yet formed. Risk of loss on promoter because he is instigating the business
    b. **Exception**: If K made on behalf of corporation and other party agrees to look to Corp and not Promoter
2. Here, language in signature ambiguous, so look to parties' intent. Both did not intend to hold corp liable
3. Investors have reasonable expectation that their money will be protected, so Promoter liable
4. ***Restatement (2nd) of Agency***
    a. § 330: A person who tortiously misrepresents to another that he has authority to make a K on behalf of a principal, whom he has no power to bind, is subject to liability to the other in an action of tort for loss caused by reliance upon such misrepresentation
    b. § 331: A person who purports to make a K, conveyance, or representation on behalf of a principal whom he has no power to bind thereby is not subject to liability to the other party thereto if he sufficiently manifests that he does not warrant his authority and makes no tortuous misrepresentation

iii. **Quaker Hill, Inc. v. Parr** (1961), p. 229
QH sold nursery stick to corp yet to be formed. K imposed no obligation to Def promoters to form corp, nor did it name them as obligors on the note or as promises on the K

1. ***RULE***: Court held that exception to general rule above applies here
2. Promoters not aggressors, Pl. well aware of facts

3. Regional bias at play … NY company pressuring Def's to make deal

c. **<u>Between Company and 3rd Party</u>**

i. **<u>McArthur v. Times Printing</u>** (1892), p. 280
Pl. (3rd Party) hired by promoter for one year. Worked as advertiser and fire. K b/w promoter and 3rd party Pl. (on behalf of corp.) made on 9/12. K was to begin 10/1 and run a year. Corp formed 10/16. Less than one year later, Def. was fired. Board never took any formal action with reference to the K made on its behalf, even though they knew of the K at the time of the incorporation and none of them objected or repudiated the K.

1. ***RULE***: Corporation must make affirmative steps to form the K. While a corporation is not bound by engagements made on its behalf by promoters before incorporation, it may, after its organization, make such engagements its own K
2. The corporation's adoption or acceptance need not be expressed and may be inferred from acts of or acquiescence on the part of the corporation or its authorized agents. Here it adopted it as its own due to knowledge, acquiescence, acceptance of benefits.
3. The corporation cannot ratify the K because it was not in existence at the K's formation
4. Corporation tried to void the oral K under the statute of frauds. Held, can't ratify something when Corporation didn't exist and had to adopt it when organized on 10/16, and not void by the statute of frauds. Here is an example of corporate and contract law intersecting.
5. This is a corporate law defense that will find its way into a contract law case.
6. The law sees the corporation as a separate legal person and it must make a contract in order for it to count.

VI. <u>DEFECTIVE INCORPORATION</u>

A. Definitions

1. ***De Jure* Corporation:** Corporation that is properly created under law. There has been conformity with mandatory legal conditions

a. Not subject to direct or collateral attack either by state or another person
b. May exist even though some minor statutory requirements have not been fully complied with

2. ***De Facto* Corporation:** A corporation that has been defectively incorporated
Requisite Elements:
a. A valid law under which the corporation can be lawfully organized;
b. An attempt to organize thereunder;
c. Acting as a corporation
    i. Good faith in claiming to be and doing business as a corporation is often further recognized
d. It is recognized for all purposes as a corporation except for direct attack by the state

State Proceeding challenging the entity's incorporation is called *quo warranto*

e. **RMBCA § 2.03(b)**, p. 574, and **DGCL §103(c)**, p. 458; **§ 160**, p. 460 – **eliminates *de facto* corporation** and holds that *filing* Articles of Incorporation cuts off personal liability.

3. **Corporation by Estoppel:** similar to above, but do not have to have the formal prerequisites that have to be met. Allows limited liability even thought there was an omission in creation of the corporation. *Based on equity, have to show reliance by 3rd party*
a. When those who deal with a company as though it were a corporation without knowing the entity's true business form would be estopped from denying the existence of a corporation
b. When estoppel has arisen:
    i. Where an association sues a 3rd party and a 3rd party is estopped from denying that the Pl. is a corporation
    ii. Where a 3rd party sues the association as a corporation and the association is precluded from denying that it was a corporation
    iii. Where a 3rd party sues the association and the members of that association cannot deny its existence as a corporation where they participated in holding is out as a corporation
    iv. Where a 3rd sues the individuals behind the association but is estopped from denying the existence of the corporation

v. Where either a 3rd party or the association is estopped from denying the corporate existence because of prior pleadings

B. Always Check State Statute to see if allows Corporation by Estoppel or De Facto

C. Robertson v. Levy (1964), p. 235 *(De Jure Corporation)*

On 12/22/61, Pl. and Def. entered into agreement whereby Levy was to form a corporation that would buy assets of Robertson's store. 12/27 Levy filed articles of incorporation. 12/31 Levy entered into the assignment of the lease. 1/2 Articles of Incorporation rejected, knowingly began to operate business. 1/08 Pl. executed bill of sale to Levy's "corporation." 1/17 Certificate of corporation was issued. Pl. sued Levy on basis he had no *de jure* corporation

1. ***HELD***: Due to strict statutory interpretation, there could not be a de fact corporation or corporation by estoppel in DC
2. ***RULE***:
   a. President of an ass'n that files its articles of incorporation which are at some point rejected, but later accepted, can be held personally liable on an obligation entered into by "corporation" before certificate of incorporation has been issued
   b. Creditor not estopped from denying existence of corporation, even though he accepted the first installment payment after the certificate of incorporation was issued
3. There was no corporation when documents signed, so Levy becomes party to the K
4. Court adopted MBCA §§ 50, 139, which when taken together have the effect of eliminating concepts of *de facto* and *estoppel* corporations because of DC's strict interpretation
5. **RMBCA § 2.03(b)**, p. 574, and **DGCL §103(c)**, p. 458; **§ 160**, p. 460 –holds that ***filing*** **Articles of Incorporation cuts off personal liability**. Conversely, here the rule is that the *issuance* of the certificate of incorporations provides the cut-off point … before issued, personal liability.

D. Cantor v. Sunshine Greenery (1979) (p. 287) (*De Facto Corporation)*

Def. properly submitted Articles of Inc with sec'y of state. Due to problems at state office, Articles not filed until long delay. Before actual issuance of certificate, Pl. entered into lease with Def.'s corporation; Def.'s "corporation" defaulted

1. ***HOLDING***: Def. not liable b/c there was a *de facto* corporation since they attempted to file in good faith and wasn't their fault certificate not issued
2. ***RULE***: If corporation has *de facto* status, no personal liability

3. Pl.'s knew they were dealing with a corporation, and not an individual; lease named corporation, not individual; Pl. was sophisticated party and didn't ask Def. for financial records/background; Pl. should have known no personal liability
4. Here the court doesn't refer to the corporate statute, instead it looks at the facts.

E. Reconciling <u>Robertson</u> and <u>Cantor</u>
See OFFICIAL COMMENT, RMBCA § 2.04, p. 575

1. These cases just show that Courts are grappling with these concepts and interpret statutes differently
2. In <u>Cantor</u>, the conclusive evidence of a corporation is the date of filing the Articles of Inv, rather than date certificate issues, according to NJ LAW, which is not a MBCA state. NJ had not adopted MBCA § 139 (joint and several liability for person acting w/out authority)
3. In <u>Robertson</u>, the conclusive evidence of the existence of the corporation is at the issuance of the certificate of incorporation rather than at filing.
4. **RMBCA says** "seemed appropriate to impose liability only on persons who act as or on behalf of corporations 'knowing' that no corporation exists" (RMBCA § 2.04 Official Comments, p. 577)

F. <u>Cranson v. IBM</u> (1964), p. 288 *(Corporation by Estoppel)*
Pl. invested in new corporation he believed was about to be created. Atty advised Cranson that corporation had been formed; he paid for a stock certificate; was shown corporate seal and minute book. Cransons made transactions, including dealing with IBM as new President. Due to atty oversight, Certificate of Inc. was not filed until 6 months after signed. IBM sued to hold Cranson personally liable for defaults on payments

1. ***HELD***: Cranson not liable b/c IBM dealt with the "corporation" as if it were properly formed and relied on its credit rather than Cranson's personally. **IBM is estopped from denying corporate existence**
2. ***RULE***: If participant honestly and reasonably, but erroneously, believes the Articles of Incorporation have been filed, there will be no personal liability – RMBCA § 2.04 Official Comment, p. 575

G. Notes

1. When all prerequisites for *de facto* do not exist, court can invoke doctrine of *estoppel* to create in effect a *de facto* corporation and ensure equitable results
2. In <u>Cranson</u>, MD statute seems to dictate result would be like <u>Robertson</u> (personal liability), but court opted not to use this. Shows that cases are very fact-specific and this is an equitable remedy

VII. DISREGARD OF THE CORPORATE ENTITY (Piercing the Veil)

A. General:

1. Situations in which the corporation has been properly formed, but due to certain circumstances a court may take away corporate liability protection and hold shareholders, directors, investors, etc. personally liable
2. Extremely harsh remedy; no hard and fast rules used to predict it
3. Courts more willing to grant in Tort than in Contract cases
4. This remedy is very rare.
5. **Factors**
   a. Fraud
   b. Proper Capitalization
   c. Failure to observe corporate formalities
   d. Non-payment of dividends
   e. Insolvency of debtor corporation at time
   f. Siphoning of funds of the corporation by dominant shareholders
   g. Non-functioning of other directors/officers
   h. Absence of corporate records
   i. Corporate façade for operations of dominant shareholders
   j. Alter ego

B. <u>DEFINITION OF TRADITIONAL AND REVERSE PIERCING</u>

1. **Traditional Pierce**

   Corp. commits wrong and has no money for damages. Pl. seeks to pierce to obtain relief from officers, shareholders, etc. Based on Equity.

   Plaintiffs have claim against corporation itself, not the individuals, but use pierce to get remedy deserved from individuals b/c not available from corp. itself

2. **Reverse Pierce**

   Individual in debt; fears suit and so hides all his money in 10% of a private corporation (note if public creditors could go after him); even if creditors obtained his 10% interest, still not enough of a vote to liquidate corporation and obtain money owed. So, creditors sue both individual and corporation and ask court to reverse pierce and disregard corporate entity. This way, creditors can get money they deserve from individual without hurting the other 90% shareholders.

   Pl.'s have a claim against the corporation insider and pierce the corporation to get to the individual and their money hidden in the corporation

C. **<u>Bartle v. Home Owners Coop</u>** (1955), p. 298

Def. was ass'n of veterans organized to provide low-income housing for veterans. Unable to secure contractors to build houses, it formed Westerlea (a wholly owned subsidiary). Westerlea went bankrupt. Def's coop had contributed lots of money to Westerlea. Pl. was bankruptcy trustee for Westerlea and attempts to hold Def. coop liable for K debts of Westerlea under piercing theory b/c Westerlea was part of the Def. The facts in this case that lead the court to rule in favor of now piercing are:

1. ***RULE***: Doctrine invoked to prevent fraud or to achieve equity
2. Here, no fraud, misrepresentation, illegality
3. Corporations often set up to protect liability of owners
4. Trustees were in charge of coop for over 4 years and coop went bankrupt under their control … so trustees estopped from disputing the two separate entities. They have acted like they are separate for years
5. ***HOLDING***: Veil not pierced, so long as:
    1. Proper corporate formalities are observed
    2. Public is not confused about whether dealing with parent or subsidiary
    3. Subsidiary operated in a fair manner with some hope of making a profit
    4. No other manifest unfairness
6. Law permits incorporation for the sole purpose of escaping personal liability
7. *Dissent*: Westerlea was set up not to make profit and would inevitably fail which in itself is fraudulent

D. **<u>Dewitt Truck Brokers v. W. Ray Flemming Fruit Co.</u>** (1976), p. 300

Flemming (Def.) formed fruit brokerage corp. transporting from farmer to market. He sells fruit, takes out transport and brokerage fees and gives rest to farmer. He breaches K with trucking company and keeps trucking money for himself that should have been paid to truckers. Trucking company sues corp. which is insolvent b/c Flemming paying self money that should be in the corp. to pay truckers. Pl. claim Def. was using corp. as "alter ego"

1. ***RULES:***
    a. Power to pierce corporate veil should be used reluctantly and cautiously
    b. Burden of proof is on party who seeks to pierce
    c. When substantial ownership of stock is in a single individual and is combined with other factors that clearly disregard the corporate function, courts will, on grounds of fundamental fairness and equity, pierce the veil be applying an **alter ego theory** or **instrumentality theory** to invoke personal liability
2. ***Holding*****:** veil pierced
3. Don't have to show fraud … just need fundamental injustice

4. Piercing may not rest on a single factor (e.g., under-capitalization, disregard of formalities, etc.), but must involve a number of such factors. Also must present element of injustice/fundamental unfairness
5. When substantial ownership of all the stock of a corporation in a single individual is combined with other factors clearly supporting disregard of the corporate fiction on grounds of fundamental fairness, courts have experienced "little difficulty" and have shown no hesitancy in applying what is described as the alter ego or instrumentality theory in order to cast aside the corporate shield and to fasten liability on the individual stockholder.
6. The Piercing analysis looks at capitalization, formalities, basic Injustice

E. Alter Ego Doctrine

1. **Factors**
    a. Substantial ownership of stock in single individual
    b. Undercapitalization
        i. Most important factor, even though not enough on its own
        ii. No set dollar amount … case-by-case
        iii. Questions to ask:
            1. Caused by economy or intentional behavior?
            2. Is capital proportional to the business to be done and the risks entailed?
    c. Injustice/Fraud – siphoning of funds by dominant stockholder
    d. Failure to regard the corporate entity – not observing corporate formalities (records, functioning officers, meetings, dividends, etc.)

F. **<u>Baatz v. Arrow Bar</u>** (1990), p. 308

Pl. injured by drunk driver who was sold drinks at bar even though he was drunk. Victims sue bar claiming negligence b/c driver has no money. Bar has no insurance so Pl.'s argue shareholders should be liable and veil should be pierced b/c they personally guaranteed the obligations of the corporation; alter ego, undercapitalization, etc.

1. ***RULE***: When recognition of a corporation as a separate legal entity produces injustice and inequitable consequences the court may pierce veil.
2. ***FACTORS*** that indicate injustice and inequality:
   a. Fraudulent representation by corporate directors
   b. Undercapitalization
   c. Failure to observe corporate formalities
   d. Absence of corporate records
   e. Payment by corporation of individual obligations (siphoning)
   f. Use of corporation to promote fraud, injustice, or illegalities
3. HOLDING: No piercing. Def.'s did not abuse the corporate form and set up the corporation to limit their liability
4. $5,000 was not so insufficient as to be considered undercapitalized, given the standard in business
5. Under formalities, there has to be a relationship b/w the defect and the harm (e.g., operating under a different name)
6. Note: when speaking of undercapitalization, it is not the actual financial balance sheet and dollar amount that is the factor, but rather how the corporation became undercapitalized

PARENT/SUBSIDIARY CASES

G. **<u>Radaszewski v. Telecom Corp.</u>** (1992), p. 266

Employee of subsid Contrux drove a co. truck into the Pl. Pl. attempted to pierce veil to get jurisdiction over parent, Telecom.

1. ***RULE***: Someone is injured by the conduct of a corporation or one of its employees can only look to the assets of the employee or the employer corporation for recovery. The shareholders of the corporation, including, if there is one, its parent company are not responsible
2. Piercing could be useful for getting jurisdiction over a parent
3. Piercing can be used in two ways:
   a. To establish jurisdiction
   b. Liability
4. ***TEST*** for piercing Subsidiary to get to Parent
   a. Complete domination not only of finances, but also of policy and business practices (no separate mind)
   b. Control was used by Def. to commit fraud or wrong

c. Control/breach of duty must proximately cause injuryHere, capitalization was adequate ($11 million in insurance; not their fault subsid. went bankrupt)

5. ***NOTE***: in order to pierce, must show more than error in business judgment (BJR)

H. **Minton v. Cavaney** (1961), p. 272 in notes

1. Attorney (or anyone) who assumes a temporary position as an Officer/Director cannot get out of liability simply on argument that the position was temporary

I. **Fletcher v. Atex, Inc.** (1995), p. 323

Pl. trying to recover repetitive stress injuries allegedly caused by Atex computer keyboards. Atex is a wholly owned subsidiary of Kodak

1. ***RULE:*** To prevail on this theory, must pass **2-Step "alter ego formula**: (Missouri test)
   a. Parent and Subsidiary operated as a single economic entity
   b. Overall element of unjustness or unfairness present
2. ***HELD***: no piercing
3. **Six Factors** of whether parent and subsidiary run as single economic entity (Harco):
   a. Adequate Capitalization
   b. Solvency
   c. Dividends
   d. Corporate formalities observed
   e. Siphoning off of corporate funds
   f. Corporation simply functioning as a façade
4. Cash management (directly moving money back and forth bw/ parent and subsidiary) in itself not enough to pierce. Rather, cash management is sound business practice and does not show undue domination or control; it is administrative convenience
5. Kodak's and Atex's Board of Directors overlapped; Kodak approved major Atex decisions; Kodak's logo appeared in Atex lit; But still no piercing. Atex never merged with or operated as Kodak (so no single entity)
6. Also, no injustice existed anyway

J. **United States v. Bestfoods** (1998) 337

This is a typical sort of superfund case: a company and an attempt to reach beyond the company to satisfy the clean-up costs. The theories that the US used were an attempt to reach beyond the corporation by invoking two concepts: while limited liability is one of the major features to investments there were certain limitations (pierce the corporate veil and direct or active participation). When the two theories are used many courts use the same words and this can be confusing. If you're working for a company in a legal

aspect and you do something liable, then you are first and foremost liable. The company is secondary liable.

- The focus here was a company that sued in a cost-recovery action for cleaning up the hazardous substances. The US sued in this situation.
- Direct participation and piercing are often used together to find more money.
- Although piercing is a rare remedy, there is a good chance that the courts would like to not get involved of the mess and confusion of this tactic. They would rather talk about direct or active participation: did you do it or supervise it directly? If you did, then you are liable. If you get to piercing then you have to answer questions like: what are the elements, and how did they play out, and what about formalities. So very often, the court will see if there is an easier theory then why not try it. ***He really likes this tactic, and suggests that this is another "level."
- In this case you see discussions about direct and active participation, and after all is said and done, they basically make the point that piercing has to do with domination of the subsidiary and if you did dominate the subsidiary then this could give rise to a piercing; but if you controlled the facility then you'll be seen to have directly participated. With direct participation you look at the scene of the crime and ask at the extent of which the shareholder set into motion an illegal act that resulted in economic harm.
- If you wanted to avoid a piercing theory, you could use the direct participation theory. You want to construct the theory that one of the shareholders directly and actively participated. You want to look at conversations; emails; letters, etc. You want to show that Y was leaning on people telling them what to do, and making them do the act. That is the same as Y doing the act.

K. **US v. Kayser-Roth Corp.** (1989), p. (this case may actual be the one above) Govt suing corp for clean-up of TCE spill. When suit brought, Stamina Co. no longer existed, so US went after parent

1. ***HOLDING***: Court finds Def. liable b/c of complete control it had over Stamina, qualifying Def. as operator under CERCLA statute. No need to pierce under operator theory. But Def. also liable as owner and pierces veil to find Def. liable under this theory too
2. Must look at statute and its interpretations as well as public policy arguments. A strong enough policy argument and the court will pierce the veil
3. Two themes for determining parent liability under CERCLA:
    a. When parent dominate subsid to such an extent that veil should be pierced
    b. Where stock owner participates directly in the management, although not to the extent that allows piercing

L. **<u>Stark v. Flemming</u>** (1960), p. 289

Stark put assets in newly-formed corp. Began getting $400/month salary to qualify for Soc Security benefits. Secretary found to be sham, but Stark adhered to normal corporate formalities

1. ***RULE***: As long as corporate statutory provisions observed, a motive such as this will be allowed
2. **Strict statutory construction**: If Congress wanted to prohibit this type of activity, it would have said so
3. Motive behind formation of corp. does not determine validity

M. **<u>Roccograndi v. Unemployment Comp. Bd. Of Review</u>** (1962), p. 290

Family sets up corp with family members as employees. When business slow, they'd lay each other off to collect unemployment

1. ***HOLDING***: They are self-employed b/c had sufficient control to lay selves off, so unemployment benefits not allowed
2. Distinguish from <u>Stark</u>: There, she was an old woman who legitimately deserved SS benefits

REVERSE PIERCING—the difference between reverse piercing and traditional is that reverse includes a lot of different types of cases that don't' take the traditional shape of piercing. While in traditional, some P is suing the corporation because of something to do with the injury, and the corporation has no money, the person is trying to reach through to get to the persons behind the company (parent, officers, shareholders). Reversing, which consists of everything else. One example is where the D tries to protect his assets from creditors by investing all his assets in the company which is a 10% interest. The creditors sue and the D says that he doesn't have any cash. The creditors find out that the D actually owns stock—which is property. How would the credit card companies get the money? You could try sue and get the stock (10% ownership, but no control). Or you could pierce the corporate veil and ask the court to award the property. This is a non-traditional form of piercing.

N. **<u>Carghill, Inc. v. Hedge (1985)</u>**, p. 291

Hedges bought land and assigned their interest in it to a family farm corp. Sam Hedge bought farm equip. from Pl. and upon default, Pl. sued Sam and corp. and won. Farm sold

1. ***HOLDING***: Sale of house not allowed
2. Court disregards corporate entity to further justice and equity
3. ***3 Factors in Determining Reverse Piercing***:
   a. Degree of identity b/w individual and corporation (alter ego)
   b. Whether other parties such as creditors or shareholders will be harmed by the pierce
   c. Strong public policy reasons – furtherance of Homestead Act exemption here

i. Homestead Act Exemption: Where creditor cannot seize a debtor's dwelling with the land it sits on. To protect family home and livelihood even in instance of legitimate debts

O. **<u>Pepper v. Litton</u>** (1939), p. 353

Pepper sued Dixie Co. for royalties due. During suit, Litton (sole shareholder of Dixie) forced corporation to confess judgment in his favor for backpay. Upon judgment, Litton caused execution where he bought the corporate assets. Litton then caused Dixie to file for bankruptcy and positioned himself first in line for the deficiency of confessed judgment. Appointed trustee sued to have confessed judgment in Litton's favor set aside and execution sale quashed

1. ***HOLDING***: Court placed Litton's debt behind Pepper's
2. ***RULE***: B/c bankruptcy courts are based in equity, salary claims of officers, etc. of closely-held corps can be disallowed or subordinated when allowing claims would not be fair or equitable to other creditors
3. Not piercing here, but equitable doctrine of subordination (Deep Rock Doctrine)
4. Same factors used as piercing
5. This is another theory that can be used to break into the corporate franchise to right some type of wrong.

VIII. <u>PARTNERSHIP ACCOUNTING</u>

A. General

1. Financial info is key in assessing status of corp
2. Financial info tells how well corp doing
3. Accounting sets out rules re: identification, layout, and presentation of certain financial info
4. Most important for investors and lenders to determine ass'n's financial health

B. Balance Sheet – snapshot of corporation's health at a point in time

1. ASSETS = LIABILITIES + EQUITIES
    a. *Assets* – WHAT you have acquired
        i. Resources of company
        ii. Money, property, certain rights (cash, accounts receivable, inventory, land, patents, etc.)
        iii. Does not include Human Resources
    b. *Liabilities* – HOW corporation acquired assets; Corporate debt
        i. E.g., accounts payable, notes payable, mortgages, bonds, etc. (A note payable is amount of money company owes a creditor. Accounts payable is an outstanding bill)

c. *Equity* – HOW corporation acquired it (shares of stock to investors, earnings)
   i. Investment
   ii. Making money – net income/profit
      1. Capitalization of the corporation. Includes shareholder's investment plus corporation's earnings

NOTE – What you've got must equal how you got it

C. Financial Statement (Income Statement)

1. Measurement of a period of time (quarter, month, week)

Revenue (Gross Revenue, Gross sales) – Expenses = Net Profit (Profit, Net Income, Income)

--see p. 68(1)

D. Capital Accounts

1. An account on a partnership's balance sheet representing a partner's share of the partnership capital
2. Represents a breakdown in that partner's capital account; gives more specific information

INCOME STATEMENT EXAMPLE:

ABC Corporation
Statement of Profit and Loss for Year Ending December 31, 2000

Sales	$417,000	
Cost of Sales	$270,000	-- where you list those expenses directly related to the corp.
GROSS PROFIT	**$147,000**	
Other Expenses		
Advertising	$8,000	
Rentals	$24,000	
Depreciation	$5,000	
Salaries	$32,000	
Miscellaneous	$18,000	
TOTAL	**$87,000**	
NET PROFIT	**$60,000**	(Net Profit = Gross Profit – Expenses

BALANCE SHEET EXAMPLE

ABC Corporation
Balance Sheet, Date (of snapshot)

WHAT (sources)	HOW (resources)

Assets		Liabilities	
Cash	$19,000	Accounts Payable	$73,000
Accounts Receivable	$93,000	Note Payable to A	$25,000
Inventory	$95,000		
Fixtures (net of depreciation)	$42,000	_	
Truck (net of depreciation)	$9,000	**Equity**	
		Partner's Capital	$160,000
TOTAL	**$258,000**	**TOTAL**	**$258,000**

CAPITAL ACCOUNTS FOR 2000:

	Opening	Income for Year	Drawing for Year	Closing
A	$100,000	$30,000	$0	$130,000
B	$0	$30,000	$0	$30,000
Total	$100,000	$60,000	$0	$160,000

Opening – A is only partner who invests money ($100K); B made no initial cash investment

Income – for 2000 was $30,000 each. It's a 50/50 partnership so they split net profit equally

Drawing for the Year – where the partner pulls money out of company for his personal use.

They want the business to grow so they don't draw any money out of company. They leave it in the company in an effort to make more money

Closing Capital – equals the "Partners' Capital" on the balance sheet

IX. FINANCIAL MATTERS AND THE CLOSELY HELD CORPORATION

A. Debt and Equity Capital (generally)

1. **Capital**
    a. Every business needs capital to conduct its operations
    b. Obtained by (sources):
        i. Borrowing funds from private sources, banks, credit cards
        ii. Capital contributions from the owners of business
        iii. Capital contributions from outside investors who thereafter become co-owners of business
        iv. Retaining business earnings rather than distributing them to the owners
    c. Basic distinction in raising of capital -- **Debt or Equity Capital**
        i. **Debt** (to be repaid) – associated with concepts that it must at some point be repaid and that interest is to be paid periodically and is not dependent on the earnings of the business
        ii. **Equity Capital** – contributions by the original entrepreneurs in the business, capital contributed by other investors in exchange for ownership interests in the business (stock), and retained earnings of the enterprise

B. Types of Equity Securities

1. **Shares, generally**
    a. *Class of shares* – all authorized shares of a corporation that have identical rights

b. *Shares* – units into which the proprietary interests in a corporation are divided (RMBCA § 1.40(21), p. 568)
c. *Dividends* – distribution from current or retained earnings (RMBCA § 1.40(6), p. 567)

2. **Common shares** (a.k.a. residual, basic stock) – ownership interest in the company and represents a property right. An owner has fundamental rights to the following:
    a. Right to vote for election of officers, directors, and on other matters coming before shareholders (RMBCA § 6.01(b))
    b. Right to receive dividends or a portion of the profits
    c. Right to excess of assets (e.g., if company goes bankrupt, the creditors are paid first, then preferred stock, then common stock owners (RMBCA § 6.03(c), p. 584)
3. **Preferred Shares**
    a. Preferred Shares entitle holders to some preference or priority in payment against holders of common shares. They are first to collect a *specified distribution* (doesn't change in value like common stock) before anything else is paid to the common shareholders; first in line after creditors, including when the corporation goes out of business
    b. Generally do not have voting rights
    c. More expensive b/c less risky
    d. Rights (traditionally listed in Articles of Inc.); actual preference received is contracted for:
        i. *Cumulative Dividend Rights* – any preferred dividend not paid within 1 year, accumulates and must be paid along with following year's unpaid cumulative dividends before any dividends can be paid to common shareholders. This is a way of limiting rights. In order to paid the contract must state that this is a cumulative right.
        ii. *Redemption* – company has right to redeem and buy back shares at any time for a fixed price. Shareholder has no choice, but to accept that price. This is to avoid unsolicited takeovers or to get quick money to expand the business. When a corporation elects to exercise the redemption privilege, it "calls" the stock for redemption
            1. Corps have redemption rights b/c they realize they may have to pay preferred dividends indefinitely, so to alleviate that problem they K for redemption rights
        iii. *Voting* – usually nonvoting, but can vote in an election of directors is preferred dividends have been omitted for a specified period

iv. *Conversion Rights* – conversion privilege allows holders of preferred shares to obtain a part of the long-term appreciation of the corporation's assets if the holders are willing to give up their preferred rights by converting their shares into common shares. Often used by venture capital companies. Stock holders will want to switch into the common stock category so that they can receive a larger dividend than the preferred stock dividend will pay
    1. When corp doing poorly or in its initial stages, preferred stock is better b/c safer; but when stick is going up in value (p/h with an IPO), common stock is more attractive

v. *Participating Preferred* – these shares are entitled to the specified dividend and, after common shares receive a specified amount, they share with the common in additional distributions on some predetermined basis

C. Issuance of Shares

1. Share subscriptions and agreements to purchase
    a. Traditional/historical approach – it is a K to promise to invest in a specified number of shares contingent on a specified amount of capital being raised
    b. Main problem: how do you make people pay?
    c. Eliminated with modern investment banking (RMBCA § 6.20, p. 585)
        i. Subscription for shares before incorporation
    d. DE has its own provision (§ 165, p. 484)
2. Authorization and issuance of shares under MBCA (Hamilton, p. 308)
    a. Note:
        i. DE corporation law has many different provisions and did not incorporate the model act (DGCL §§ 151-174)
        ii. Many corporations incorporated in DE, which has different provisions
    b. *Authorized Shares* – maximum number of shares the corp is allowed to sell (must have in Articles of Inc). If company sells more than the predetermined amount, the A-G or shareholders have standing to sue
        i. Company doesn't have to issue all authorized shares. They can hold onto some of the stock to issue at a later time

c. *Issued Shares* – number of shares available on market. Consists of outstanding and treasury stock (see diagram Hamilton, p. 308)

d. *Treasury Shares* – number of shares that company buys back under its redemption provision.

1. E.g., 100,000 authorized, 20,000 issued; corporation buys back 5,000, which become treasury shares with 15,000 shares remaining issued and outstanding

ii. *MBCA § 6.31 eliminates concept of treasury shares and treats re-acquired shares as authorized, but unissued*

iii. Many states, *including DE*, have not adopted this part of MBCA, though. So, treasury stock there still considered issued.

D. Par Value

1. Definition

a. Does not equal the initial starting price, nor the selling price of the share, but rather is whatever amount that is designated as par value by the drafters of the Articles of Inc

b. First implemented to prevent stock fraud

c. Stated Capital = Par Value x Number of Shares Sold

2. History

a. Promoters, trying to lure investors, would sell stock to outside investors (rr, auto business) at high value while selling stock to inside investors (people in company) for no or low value. Concept of *watered stock*

b. Legislatures implemented concept of par value, believing issuing price would equal true market value of stock and its worth to company. Companies required to state how many shares they were going to issue and state par value. Legislators made big mistake by not mentioning anything about selling price

c. If buyer paid less than par, she was personally liable to corp for diff b/w purchase price and par value

i. Par value ensured proportionality of treatment among diverse shareholders, increased confidence in market that the share had real value (not just piece of paper), and ensured company had in fact been capitalized

d. Promoters turned this system to their advantage. Articles of Inc would state low par value (e.g., $0.01) (**nominal par value**) and shift money that would have been in stated capital to another category on balance sheet (capital surplus, equity). Shares would have high market value for

outsiders while insiders would pay the low par value w/out becoming personally liable. *Law does not mention anything about the selling price*. Then, insiders could sell stock at higher market price. So, Par Value became useless tool against fraud

i. Lower Par Value allows greater flexibility in shifting assets on the balance sheet b/c stated capital sets the floor for which assets could be moved since the stated capital equaled par value

e. **RMBCA does not require a statement of par value** (§ 2.02(a)(2), p. 572 – only requires number of shares), but **allows** corp to state par value if it wishes (§ 2.02(b)(2)(iv))
f. **DE still requires par value** (DGCL § 102(4), p. 455)
g. To combat the current fraud, many states promoted state **blue-sky laws** (statutory attempts to eliminate stock fraud). The laws, predecessors to SEC, didn't work

3. **Balance Sheet and Par Value**

a. 3 shares at $10/share. Par value $1
b. Stated Capital: $3
   i. Stated Capital = Shares of Stock x Par Value
c. Capital Surplus: $27 (3 x $9 remaining)
   Capital Surplus = (Stock price – Par Value) x Shares of Stock

BALANCE SHEET:

ASSETS	LIABILITIES
	EQUITY 1) Investment --Stated Capital --Capital Surplus 2) Making Money

4. **3 Types of Shares sold for less than par value**
All typically known as "watered stock"
Recipients are all potentially liable to creditors of corporation

a. Bonus Shares
   i. Nothing was paid for them
b. Watered Shares
   i. Payment in property, but the property not worth the stock
c. Discounts

i. Issued for cash less than par

5. **<u>Hanewald v. Bryan's, Inc.</u>** (1988), p. 370

Bryans formed corp and listed 100 shares of common stock with par value of $1,000 each. Both Bryans received 50 shares of stock for free. Then they lent corp $10,000 and personally guaranteed a loan of $55,000 from bank. Corp bought assets and entered lease with Pl., signing $45,000 promissory note. Corp went insolvent; tried to avoid paying lease. Pl. trying to reach them personally

a. ***RULE***:

i. Shareholder liable for difference b/w par value and the amount actually paid and to such an extent only as may be necessary for satisfaction of creditor's claim

ii. Where loan was repaid by corp to the shareholders before operations abandoned, loan cannot be considered a capital contribution, but when a corp is undercapitalized (as in <u>Pepper v. Litton</u>) a shareholder's loans to his corporation may be treated as capital contributions when equitable

iii. Shareholders' initial capital investment protects their personal assets from further liability

iv. **Generally**, shareholders not liable for corporate debts beyond capital they have contributed to corp

v. **In some states**, when company reacquires previously-issued stock to place into treasury shares, they remain issued. Therefore, upon sale, it does not give rise to watered stock liability

vi. **But, States that adopt MBCA § 6.31** consider treasury shares unissued shares

vii. MBCA § 25 requires shareholders to pay for their shares to get limited personal liability

viii. **Here**, 100 shares of common stock authorized. Par value $1,000/share. Company issues 50 to each of Bryans without payment. Thus, each owed $50,000

1. They got greedy. Should have set par value very low so that they had to pay only a minimal amount to protect selves

6. **Eligible and Ineligible Consideration for Shares**

a. MBCA § 19 – No corp can issue stocks or bonds except for money, labor <u>done</u> or money or property actually received as legal consideration. Shareholders can sue because they have ownership in the company and don't want more shares given out. State also has standing because they want to maintain the integrity of their laws

b. Law changing to allow something less concrete than services already rendered (e.g., stock options based on receipt of future consideration)
c. RMBCA § 6.21(b), p. 586 – allows for stock to be given as future consideration (ties person to company)
d. DGCL §§ 151-53, p. 474 – Explains DE law on issuance of stock, par value and lawful consideration for stock

E. Debt Financing

DEBT FINANCING:

ASSETS	LIABILITIES 1) **Debt**
	EQUITY 1) Investment --Stated Capital --Capital Surplus 2) Making Money

1. **Leverage** – How much debt you have in relationship to equity
   i. Borrowing money from other people to earn more money than had the person not borrowed
   ii. Depends on interest rate on the loan and interest rate on principal
   iii. **Debt**: Company is lent certain amount of principal that it must pay back with interest. Less risky way to invest in a company b/c you'll get money back plus interest … and there is a schedule in which money will be repaid
   iv. **Example**:

Assume one is running business and if you make a $1000 investment, there will be a $100 profit

Assume for every $1000 invested, will get $100 profit

Scenario 1 --	Equity Investment - 1000 (from selling stock)	100 profit
Scenario 2 --	Equity Investment – 1000 (from selling stock)	100 profit
	Debt Investment – 1000 (loan from bank) (5 year – 5% interest)	$50 profit ($100 - $50 financing) $150 total

So, will generate $100 profits, but have $50 debt services

So, end up with $150 profit (with 1000 equity and 1000 debt investment)

So, scenario 1, you took 1000 of your money and ended up with 100 profit

In Scenario 2, took 1000 of your money and ended up with 150 profit

Scenario 3
15% interest
So, $150 per year to service $1000 debt
End up with only $50 profit at the end of the year with 1000 of your money invested
So, if interest rates that high, don't need bank
Leverage doesn't make sense here

2. **Bond / Debenture**
   i. Debenture: an unsecured corporate obligation
   ii. Bond: an obligation on corporate property secured by a lien or mortgage

3. **Tax Treatment of Debt**
   i. **Inside Debt** – Where people who are shareholders, directors, and officers lend money to corporation (diff. from money they buy stock with)
   ii. **Outside Debt** – Borrowing from bank, creditors
   iii. Advantages / Disadvantages of Inside Debt
      1. Advantages of Debt for Corp
         a. Investment advantages:
            i. Ability to choose safer and riskier methods of investment, allows corps to gain more capital and allows risk-adverse investors to participate
         b. Tax advantages
            i. Pay-out of interest is deductible from income whereas dividends are not deductible
      2. Advantages of debt for inside lender:
         a. Investment advantages:
            i. First in line in bankruptcy
            ii. Control over return of principle and interest
            iii. Control over your own personal finances
            iv. Legal right to sue for repayment as compared to stock where you don't have that right
            v. Predictable, safe, and stable; interest rates fixed at K, while dividends vary with amount and payment timing
         b. Tax advantages
            i. With dividends, insider pays taxes on entire amount of dividends received, where with inside debt, only pay interest on debt securities

ii. If loan goes bust, taxpayer can deduct entire loss as ordinary income rather than subject to limitations on deducting capital losses

3. Disadvantages of Inside Debt for Corporation
   a. Less Flexible – must pay interest and principle at certain dates
   b. Control – Creditors can get more control through entitlements
4. Bona Fide of Debt Structure – Is your debt structure realistic and does it represent reality?
   a. Terms of the K
      i. Did you use a promissory note? Have you established an interest rate that represents an arm's length process? Have parties acted as if this loan is real debt?
   b. Law is saying that as an inside creditor, you must give up some sort of equity in exchange for the interest of the business and then you have to really act like a creditor

iv. Why don't Corps characterize more of their equity as insider debt?
   1. Investor wants to be a shareholder so he can vote
   2. Investor also wants to be a share holder because if the company starts making big profits, he wants to capitalize on it as a common stockholder
   3. Law doesn't allow company to put all money into debt. Law will subordinate debt. Law will treat it as equity. It will take the principal and interest and combine whole amount which will be turned into a dividend that will then be taxed.

v. How should you structure a business from the inside so as to avoid tax penalties? The law certainly has an interest in how businesses are structured. The cases below say that you must have assets on the line, and if you don't then the law won't respect that debt. You have promissory notes, proper terms, interest being paid, and you have the parties acting as if they intend to be paid. Substantively, the most important factor is the inside debt/equity ratio (see below).

v. **Slappy Drive Industries v. U.S.** (pp. 383)
Investors have inside debt scheme where investors get interest and principle back and corporation gets a before-tax deduction. Adhered to formalities, but court didn't like debt/equity ratio
   1. ***RULE***: Law will recharacterize loan to corp from debt to capital investment (equity), treating it as a "constructive dividend" when either the debt/equity ratio becomes excessive or the corp fails to treat debt as debt. Tax deduction for corp wiped out, because dividends paid are not tax deductible
   2. Here, corp debtors regularly fail to meet due dates for debt payments. Looked fishy.

4. **Debt as a Planning Device**

   i. **<u>Obre v. Alban Tractor Co.</u>** (385)

   Obre and Nelson formed corp. Obre agreed to contribute cash and equip worth $65,000. Nelson agreed to contribute $10,000 cash and equip. Control split 50/50. They structure Obre's debt: $10,000 par value voting common stock, $20,000 par value non-voting preferred stock, $35,000 unsecured promissory note (debt). Nelson's: $10,000 par value common stock. Business failed and Obre wants to be first in line as a creditor

   1. ***RULE***: Court should not re-characterize debt as equity absent showings of undercapitalization (unreasonable debt/equity ratio), fraud, misrepresentation, estoppel
   2. Outside creditors argued court should adopt subordinating equity principle and treat equity as capital contribution rather than debt (see Pepper v. Litton and Deep Rock Doctrine)
      a. When company bankrupt and not enough money to pay debts, normal priority:
         i. Creditors
         ii. Inside debt, if exists
         iii. Shareholders
   3. ***HELD***: not undercapitalized b/c there was $40,000 of equity and only $35,000 debt
   4. Court noted that Obre's loan to corp was wither known to other creditors or could have easily been discovered

   ii. Debt / Equity Ratio

   1. As above, ½ debt, ½ equity fine
   2. 90% debt would be out of whack

F. Public Offerings – Securities Act of 1933

1. **General**

   a. Purpose – to protect investors and the market by making sure everyone informed
   b. History – in response to the '29 crash. Adopted full disclosure and rejected merit approach
   c. Requires registration of all securities being placed in hands of public for first time

   d. 2 Parts of Registration
      registration is expensive and complex, but designed to protect investors
      i. **Prospectus –** document distributed to potential and actual investors about financial health of company
      ii. Additional information must be submitted to SEC and is publicly available … but need not be in prospectus
   e. **Advantages** to a Public Offering

i. Creates market for shares
ii. Prestige of being publicly traded
iii. Opportunity for lots of capital
iv. Ability to use your securities in later acquisitions

f. **Disadvantages** to Public Offering
i. Once public, anyone can get lots of info on company
ii. Cost to unseasoned company can be extreme
iii. Need to hire people, esp. for SEC regs
iv. Potential for hostile takeovers
v. Potential to be sued for improper management of company

g. SEC minimum protections were necessary b/c States were not meeting need due to desire to attract business to state

2. **Securities Act of 1933 § 5 – Prohibitions Relating to Interstate Commerce and the Mails** (SA, p. 1274)—he finds the security laws very unhelpful

a. The Heart of the Act
i. § 5(a) – Sale or delivery after sale of unregistered securities – *can only make sale when registration statement is effective*. In effect, unless the registration statement is effective (5c) there can be no sales. From that you have to deduce whether or not you have meet with full disclosure.
ii. § 5(b) – Necessity of prospectus meeting requirements of § 10
iii. § 5(c) – Necessity of filing registration statement. While this section says that there can be no offers it follows that there can be no sales. From a business standpoint, they will pull together a team to bring this company to go public. You have to hire investment bankers, attorney's, etc…. to provide information and advice on timing, cost, etc.

b. **3 Phases of Business Process**
i. **Pre-Filing:**
1. NO offers to buy/sell (not even oral) … but can talk about corporation (SA §5(c))
2. NO sales (SA §5(a))
3. YES negotiations/agreements b/w issuer and underwriter who are/will be in privity with issuer (SA §2(3), p. 1267)
4. YES issuer may make announcement of proposed public offering (Rule 135, p. 1314)

5. YES broker/dealer may publish certain information re: specified issuers (Rule 137-139, p. 1317)

ii. **Waiting period** (b/w filing and effectiveness)

1. YES oral or written offers. If written, must be in form of a *prospectus* (Part I of registration statement) (SA §5(b)(1), §10, p. 1279)
2. YES newspaper ads containing very limited information about the offer
3. YES identifying statement
4. NO free writings
5. NO binding offers to buy/sell
    a. Be sure not to violate Rule 135

iii. **Post-Effective**

1. File Registration Statement Form S-1 (SA, p. 1376)
2. YES – underwriters and dealers may make offers to sell and make actual sales
3. YES – Preliminary prospectus must be sent before or at the time of sale (a prospectus delivery). **Prospectus should include:**
    a. Summary info, risk factors, and ratio of earnings to fixed charges
    b. Use of proceeds
    c. Determination of offering price
    d. Dilution
    e. Selling security holders
    f. Plan of distribution
    g. Description of securities to be registered
    h. Interest of named experts and counsel
    i. Information with respect to registrant

G. Exempted Securities of the Securities Act of 1933 (Private Offerings)

NOTE – If issuing securities must make registered public offering, OR find exemption for registration to make private offering

1. Exemptions under SA §§ 3,4
    a. Not as much scrutiny for private offerings
2. Exempted Securities and Exempted Transactions (SA §§ 3,4, p. 1270)
    a. **Intrastate Exemption (SA § 3(a)(11))**– if offer and sell securities within one state and use proceeds from sale primarily in that state, don't have to register with SEC

i. Local financing provided by local investors for local companies
ii. Idea is that if intrastate, easy to get info (but think of TX and CA … too big)
iii. And, states have own regs (but some fall down on this duty)

b. **Small or Limited Offering Exemption (SA § 3(b))** – sale offered only to small number of people
    i. $5 million cap
    ii. Idea is that investors protected because small amount and can't do much harm (but a couple million is still a couple million)
    iii. This is a way to make a small, limited offering w/o too much scrutiny and only a few expenses

c. **Exempted Transactions (SA § 4-2)** – offering to those shown to be able to fend for themselves … only to sophisticated investors
    i. SA § 5's registration requirements shall not apply to transactions by an issuer not involving any public offering
    ii. **<u>SEC v. Ralston Purina</u>** (Supreme Court case) Company offered stock to own employees and didn't ask who was buying. They claim only key employees bought and employees initiate sale, so should fall under § 4-2
        1. ***RULE***: Application of § 4-2 should turn on whether class of persons affected are sophisticated investors and thus don't need protection of the Act or not
        2. ***HELD***: This is a public offering, Ralston is wrong
        3. If only offered to executives, may fall under § 4-2, because they would be sophisticated investors. But, here, overseas employees can't get info, not all employees sophisticated, class of persons needs protection

H. THE REGULATORY FRAMEWORK (SEC RULES AND REGS)

1. General

a. Give regulatory safe harbor
b. Always check regs, safe harbor, case law, statutes
c. Even if outside safe harbor, may fall within statute (but riskier)
d. **3 elements making an Investment a Security**:
    i. Investment of Money

ii. Common Enterprise
iii. Profits solely from the efforts of others

2. **RULE 147**
   a. Outlines what's needed to properly structure an **intrastate private offering** (e.g., 80% of assets and gross revenues must be in-state)

3. **Regulation D**
   a. General
      i. Draws upon §4(2) (rule 5.06) and §3(b) (rule 5.04 & 5.05)
      ii. Provides basis on which there may be exemptions from registration
      iii. One of most frequently used bases for having exempt offerings
   b. **Rule 5.01** – Definitions; Common to all exemption rules
      1. E.g., Accredited Investor
   c. **Rule 5.02** – Disclosure Requirements to Investors (Integration Doctrine)
      i. Outlines general conditions to be met for offers and sales under Reg. D
      ii. NOTE – *Integration Doctrine*
         1. Can't cheat by breaking down offerings … selling to 30 investors one day and then 3 weeks later selling to 8 more
      iii. NOTE – 5.02 (d) limits re-sales (e.g. accredited purchaser turns around and sells right away to two non-accredited purchasers and that is more than 35 for Rule 5.05 purposes)
   d. **Rule 5.03** – Filing of Notice of Sales
   e. **Rule 5.04 – Exemption for Limited Offerings and Sales of Securities not exceeding $1 million**
      i. Draws from SA § 3(b)
      ii. Dollar amount limited to $1 million
      iii. Unlimited number of purchasers/investors
      iv. No investor qualification
      v. No disclosure requirements
      vi. **Agreement Requirement** – once the $1 million cap is hit, there is a 1 year limitation for offering securities under this exception
   f. **Rule 5.05 – Exemption for Limited Offers and Sales of Securities not Exceeding $5 million**
      i. Draws from SA § 3(b)
      ii. Dollar amount limited to $5 million
      iii. Number of purchasers limited to 35 (non-accredited)

iv. *But see* Rule 501(e), p. 1367, outlining **how to calculate number of purchasers** to determine who is excluded from being counted as a non-accredited purchaser. Can increase number of investors if they fir under one of the Rule 501(e)(1) excluded persons as an accredited investor
    1. Rule 5.01(e) calculating number of purchasers. People who don't count:
        a. Any relative, spouse, or relative of spouse of purchaser who has same residence
        b. Any Accredited investor
           --do not confuse with sophisticated investor
            i. Banks and investment companies, ERISA and other plans … regulated institutions
            ii. Any 501(c)(3) with assets in excess of $5 million
            iii. Any director, officer, or general partner of company
            iv. Person with net worth of $1 million
            v. Yearly income of $200,000, or with spouse $300,000

v. **Disclosure Requirement** – if one or more investors is non-accredited, disclosure is required by Rule 502(b)(2), p. 1369; but If all accredited, no disclosure required because assumed that they are sophisticated investors

vi. **Aggregate Requirement** – Once the $5 million cap his, there is a 1 year limitation for offering securities under this exception
    1. **Note**, if you have sold $1 million under 504, you can only issue $4 million under 505 before you hit the cap

g. **Rule 5.06 – Exemption for Limited Offers and Sales without Regard to Dollar Amount of Offering**
    i. Draws from SA § 4(2)
    ii. Unlimited dollar amount
    iii. Number of investors limited to 35 (non-accredited, but must be sophisticated); unlimited accredited investors (see definition 5.01(e))
        1. *Sophisticated Investor* – must meet both statutory and Ralston requirements

a. *Statute* – knowledge and experience in financial and business matters so that he is capable of evaluating merits and risks of perspective investment
b. *Ralston* – interpreting § 4(2) ,,, executive personnel who because of their position have access to the same kind of info available in a registration statement

iv. **Disclosure Requirement** – if one or more investor is non-accredited, disclosure required by 5.02(b)(2); but if all accredited, no disclosure required
v. **Aggregation Doesn't Apply** – only aggregate under §3(b) [relates to rules 5.04 & 5.05] not here [because relates to § 4(2)]

h. **Integration Information**
i. When determining if 2 offerings are of the same or similar class, note what code sections apply to each rule/reg exemption … because each code section applies to different classes of stock
1. Reg. A -- § 3(a)(11)
2. Reg. D
a. Rule 5.04 -- § 3(b)
b. Rule 5.05 -- § 3(b)
c. Rule 5.06 -- § 4(2)

ii. Significance:
1. Legitimate Reg. A offering can be made w/in 6 months of legit Reg D (5.04 or 5.05 or 5.06) offering
2. Legit Reg D (5.04 or 5.05) offering can be made within legit Reg D (5.06) offering

i. **Remember, all of these Rules are Safe Harbors. Can try to exceed their scope and still comply with § 3(b) or § 4(2), but riskier**

j. See Hypos … other outline pp. 39-40

4. **<u>Smith v. Gross</u>**

Smith bought earthworms from Gross with intent to breed and sell back with promise of easy profit. Failed, so sued Gross for Securities Exchange Act violations. Gross claimed not an investment security, but a franchise

a. <u>Howie Test</u> – transaction involves an investment security if there is:

i. An investment of money
ii. A common enterprise
iii. Profits to come solely from efforts of others

b. So, it's the K (the set of rights/duties/liabilities) that composes the security, not the earthworms themselves
c. The contractual agreement that creates the chance of a profit is the security
d. **Lots of types of financial arrangements can constitute securities**

X. PREEMPTIVE RIGHTS AND DILUTION

A. Definition and Purpose

1. **Preemptive Right**
    a. Rights sometimes given to existing shareholders permitting them to maintain their percentage of ownership in corp by enabling them to buy a portion necessary to preserve ownership of stock … e.g., if corp going to sell any more stock, I have right to preserve my present 5% ownership interest … of course I have to buy that portion of the new offering
2. Mechanism to prevent the dilution of shareholder's ownership interest
3. **RMBCA § 6.30** – shareholders do not have preemptive rights to acquire unissued shares unless right appears in Articles of Inc … so PR is bargained for or granted by the corporation in the Articles of Inc
4. **Safeguards the Stockholder's Interest**
    a. Protection against dilution of their equity in corp
    b. Protection against dilution of their proportionate voting control

B. <u>Katzowitz v. Sidler</u>

3 men invested as sole shareholders and directors with equal power. Falling out and two took more control while 3rd (Katzowitz) opted on a more limited role. Corp owes each $2,500. K refused to put more money in corp and takes cash rather than option to buy more shares for $2500. Offer at 1/18th market value. Two of the three, behind K's back, opt for bargain shares instead of cash knowing they could freeze out K. After K refuses to purchase, they buy up bargain shares.

1. ***RULE***: You waive Preemptive Rights if you don't exercise them, but must be waived with full knowledge of what shareholder giving up … can be waived expressly or impliedly (by refusing to buy shares…as long as have full knowledge)
2. A preemptive right waiver can't be gotten in ways that are unjust, unfair, and in breach of fiduciary duty … so waiver invalid

3. Fraud here because K's power greatly diluted and others paid very little for this extreme dilution
4. If shareholder has preemptive right, he has right not to purchase additional shares without being confronted with dilution of his existing equity of no valid business justification exists for the dilution

C. Note Re: Book Value

1. Book Value = (Assets – Liability)
2. Helps determine fair valuation of stock
3. See class notes p. 41

XI. DISTRIBUTIONS BY A CLOSELY HELD CORPORATION

A. General

1. Minority shareholders usually don't have the same benefits from stock ownership as owners in publicly held corporations
2. Because they have no market to trade these shares, usually have to sue to compel corporation to declare dividends
3. Unless bad faith by directors, courts usually apply judicial restraint
4. Characteristics of a Freeze Out:
   a. No dividends pay-out
   b. Money still being paid out by corp in form of salaries to the controlling group
   c. Other expenditures by the corp (e.g., meeting in Bahamas, fancy cars, etc.)
   d. No real market for minority shareholders to dump their stock

2. Minority shareholders are excluded from working in the corporation

B. 3 Types of Distributions

1. Dividends – Profits of the corporation paid out to investors
2. Expenditures – Salaries, bonuses, etc.
3. Repurchases – Where company buys back stock of owners

C. Distribution through Dividends

1. **Black-letter Law re: Obligation of Board to Pay Dividends**
   a. Decisions of Board are valid, up to their discretion, and only if there is impropriety or bad faith will court step in

2. **<u>Gottfried v. Gottfried</u>**
   Minority shareholders sue to have Board declare dividends … fear a freeze out. No dividends paid, large outflow of cash in salaries to directors who are also majority shareholders
   a. ***RULE***: If adequate surplus is available for the purpose, directors may not withhold the declaration of dividends in

BAD FAITH. But, mere existence of surplus does not mean bad faith

b. Here, no bad faith
c. **Factors connoting bad faith**:
    i. Intense hostility of controlling faction against majority
    ii. Exclusion of minority from employment by the corp
    iii. High salaries or bonus or corporate loans
    iv. Fact that majority may be subject to high personal income tax if dividends dispersed
    v. Desire by majority to acquire the minority stock as cheaply as possible
    vi. Policy of directors dictate by personal interests rather than corporate welfare (most important b/c fiduciary duty says no self dealing)
d. Court defer to **business judgment** of the company, refusing to substitute their judgment absent bad faith

3. **Dodge v. Ford Motor Co.**
    a. Dodge is minority shareholder in Ford, demanding further dividends. Ford not paying b/c wants to keep money to expand, hire, cut car prices. Ford espouses duty to public
        i. ***RULE***: Principle duty of company is to benefit shareholders, not the public
        ii. ***HELD***: Ford has enough $$ to meet business objectives and pay out dividends
        iii. Dodge was using dividends to build cars and that pissed Ford off and clouded its judgment

D. Distribution Through Expenditures

1. **Primary Concern**:
    a. Payments may be excessive and there may be insiders causing flow of cash to themselves and not in best interest of shareholders

2. **Wilderman v. Wilderman** 431
Husband and wife deadlocked (50/50 control). Husband exerting greater control, ugly divorce, he gives self big bonuses. Ex-wife sues for return of excessive payments and wants them treated as profits dispersed as dividends
    a. ***RULE***: If unreasonable expenditures paid out without Board approval, court will return excess amounts to corporation and treat as constructive dividends
    b. **4 Factors to Determine if Salary Excessive:**
        i. Relation to success of corp (he tripled salary while corp profits less than doubled)

ii. Relation to previous salary
iii. Salary increasee related to increase in services provided
iv. Comparisons to other salaries paid

c. Court influenced by IRS who had already audited Def.'s corporation. Only part of salary deemed reasonable and rest perceived a constructive dividend
d. When Board deadlocked and no approval for raise, breach of fiduciary duty
e. Burden of proof on husband to show reasonable

E. Distribution through Repurchases of Stock

1. **General**
   a. In closely held setting, provide a market for stock for shareholders who want to cash-in
   b. If not publicly held, profit from sale treated as capital gain
2. Benefits to Shareholder
   a. Get capital gains tax rate rather than higher tax on ordinary income
   b. Provides way of getting money back
   c. Access to corporate assets for personal use
3. Benefits to Company
   a. Gain more control for majority to strengthen the company
   b. Provides market for stock
4. **<u>Donahue v. Rodd Electrotype</u>** 438
   Donahue minority shareholder; got stock from husband's estate (he was former employee); company offered to buy back for $40-200/share; She refused … Harry Rodd who was retiring from company had his stock repurchased at $800/share. Donahue wanted same
   a. ***RULE***: in a closely held corp, there is a fiduciary duty to treat everyone equally.
   b. **Equal Opportunity Rule** – equal oppty to sell a ratable number of shares to corp at an identical price
      i. **Does not apply to Public Company**
   c. Stockholders in closely held corp owe one another substantially same fiduciary duty as partners owe one another – *utmost good faith and loyalty*
   d. Donahue wins – breach of fiduciary duty not to provide equal opportunity
   e. **Partnership vs. Corporate Fiduciary Duty**
      i. Partnership duty – utmost good faith and loyalty
      ii. Corporate duty – lesser standard of good faith and inherent fairness
   f. Because closely held, more like partnership, so higher fiduciary standard applies

5. **Note re: DE Law**
    a. DE flatly rejects equal opportunity rule, opting instead for entire fairness test

XII. LEGAL RESTRUCTIONS ON DISTRIBUTIONS (& REPURCHASES)

A. General

1. Provisions that try to protect creditors from unreasonable flows out of cash from company to shareholders
2. A limit, determined through formulas, on how much a company can pay out in dividends
3. Not equitable remedies, but hard-core formulas that set ceilings
4. Formulas vary from state-to-state

B. Categories

1. Earned Surplus Test
2. Balance Sheet Test (aka surplus test)
3. Insolvency Test
4. Nimble Dividends Test
5. RMBCA Test

NOTE – RMBCA is not only test, or even reigning test. DE has not adopted it These are formulas in state statutes separate from caselaw

C. Earned Surplus Test

1. TEST – if you made money and have accumulated earnings, you can pay them out as dividends up to shareholders. You cannot pay out any money that was raised as a result of a sale of stock
2. The aggregation of all income from all profit and loss statements going back to the time the corporation was organized
3. The retained earnings, the Earned Surplus, is the ceiling on what business can pay out in dividends
4. Limited to paying out dividends you've made and accumulated
5. Earned surplus is earnings retained in the business … nothing to do with stock
6. Intended to protect creditors who in good faith loaned money to corp
7. **Example**
    a. $2 million earned surplus. Have $1.5 million cash in assets. How much can be paid out? As much as $2 million. The cash on hand is only a snapshot of what the company has in cash on hand at any given time. Don't confuse the equity of the company with the amount that is found in the assets of the company at that time

ASSETS	**LIABILITIES**
	EQUITY --Stated Capital – par value times number of shares

	--Capital Surplus – value in excess of par --Earned Surplus – earnings by corporation yet to be paid out as dividends

NOTE – "Write Up" accounting practice for assets

1. Bought building for $2 million … now worth $5 million
2. Traditional accounting practices forbid write up of $3 million, but many states allow
3. If allowed, it goes into equity column of balance sheet as "Reevaluation Surplus" (not earned surplus b/c haven't earned anything)
4. Benefits the Balance Sheet test, because all surpluses get added together
5. No impact on Earned Surplus Test

D. **Balance Sheet Test** (aka surplus test; "impairment of capital dividend" statutes / non-impairment of capital test)

1. Takes all categories of surplus and adds them up
2. Where the corp can pay out the aggregate amount in the capital surplus and earned surplus
3. More money can be paid out in this test than in the Earned Surplus Test
4. You can spend everything except stated capital without having directors held personally liable
5. **Example**
    a. Earned surplus is $2 million. Capital surplus is $10 million. So, up to $12 million can be paid out as dividends (shows utility of a low par value)
6. Write-Up if allowed
    a. RMBCA § 6.40(d), p. 599 seems to allow it

NOTE – DE law (DGCL § 170(a), p. 484) allows 2 tests:

1. Surplus Test (balance sheet test)
2. Nimble Dividends Test (DE doesn't care about creditors)

E. **Insolvency Test**

1. Tries to limit flow of assets out of company in order to protect creditors
    a. Doesn't really work, so creditors usually protect selves though K
2. **2 Part Test** (must satisfy both)
    1. *Bankruptcy Insolvency* – Where you have more liabilities than assets. Can't be bankrupt!

       ASSETS – LIABILITIES > ZERO
    2. *Equity Insolvency* – whether corp able to pay debts as they come due in their ordinary course of business
        a. See RMBCA § 6.40(c)(1), p. 599
        b. Model Act adopted this test

F. Nimble Dividends Test

1. Based on income statement analysis, not balance sheet
2. When company has couple years of losses, they have negative capital surplus and earned surplus. Under all other tests, no dividends.
3. Here, if in any given year you have a net profit, you can use that money to pay off dividends
4. DE couples this with the Earned Surplus Test
5. Does not protect creditors … but is incentive for investors

G. RMBCA Test (remember that this did away with *par value*)

1. Two Tests:
    a. Equity Insolvency Test
    b. Balance Sheet Test (its own version)
        i. Remember, DE has eliminated par value
2. Notes
    1. Model Act accepts write-ups even though SEC has refused because prevented by GAP
    2. Problem: virtually all SEC-regulated companies write-up assets, even tough not recognized by SEC

XIII. MANAGEMENT AND CONTROL OF THE CLOSELY HELD CORPORATION

Discussing legal devices used to promote ability of small business owners and managers to control the company and promote its efficient operation while taking into account protecting constituents, especially shareholders, who do not control the company. This chapter looks at how the law deals with effective business management.

Legal vehicles that can aid management function

A. Traditional Roles of Shareholders and Directors

1. Directors – manage business, formulate policy, and appoint officers to carry out that policy
2. Officers – administer the day-to-day business affairs under the Board's supervision
3. Shareholder – elect and remove officers and directors, approve/disapprove of fundamental changes (e.g., M&A)

B. Shareholder Agreements

1. **<u>McQuade v. Stoneham</u>**
    a. Shareholder agreement void so far as it precludes Board of Directors, at the risk of incurring legal liability, from changing officers, salaries, or policies, or retaining individuals in office except by consent of K'ing parties

b. Board of Directors should manage business and affairs of corp, not the shareholders
c. This suit was brought to force specific performance

2. **Clark v. Dodge**
    a. Court will uphold shareholder agreement so long as it is not an usurpation or sterilization of the board and they still have power to manage affairs
    b. Here it was agreement to keep Clark employed (with contingencies) as long as he's faithful and competent

3. **Long Park v. Trenton**
    a. All shareholders entered into agreement to give one shareholder full authority and control to manage theater
    b. Agreement invalid because too much power vested in one person

4. **Galler v. Galler**
    a. A Shareholder agreement of closely held corporation may usurp the discretion of the Board of Directors as long as:
        i. No apparent public injury
        ii. No complaining of minority interest
        iii. No apparent prejudice to creditors
    b. Expressly limited to closely held corporations
    c. After case, courts began to codify this rule:
        i. RMBCA § 7.32, p. 626
            1. Shareholder agreement must be set forth in the Articles of Inc or bylaws
            2. Must be approved by all shareholders at the time of agreement or in a written agreement signed by all shareholders at time of the agreement and is known to corporation
            3. Only valid for 10 years unless expressly stated otherwise
        ii. DGCL § 350, 0. 548
            1. Broadly adopts shareholders agreements not to be void against public policy

5. **Zion v. Kurtz**

DE corp. Short-term corp set up just for basis to acquire another corp. DE says Shareholder Agreement not valid unless in Articles of Inc. Shareholders Agr not in Aof I. Zion (minority stock holder) provided financing of merger and acquisition of another corp, therefore made stockholders agree not to engage in business over his objections (veto power). He wanted to limit authority of the corp to only acquisition power. Two transactions went through w/out his approval and he sued for breach

    a. ***RULE***: The statute is a statement of public policy of a state and a shareholder agreement will be valid even if all formal steps not taken

b. Court finds for Zion b/c DE statute allows for these agreements (as codified in DGCL § 350, p. 548)
c. Even tough there were failures in formality, relief given because of bad faith of Kurtz

6. Progression of Court's Interpretation of Shareholder Agreements:
   a. In early says, courts would invalidate these agreements b/c they violated public policy (MacQuaid v. Stoneham)
   b. In Galler, court willing to adopt the rule that didn't care that shareholders were deciding in advance and making decisions that were traditionally those of the Board. No harm to public interest and all parties amenable. Law evolved
   c. RMBCA § 7.32 – can have shareholder agreement and use it as the constitution of company where shareholders make many structural decisions of the type traditionally delineated to Board
      i. § 7.32(a) – shows shareholders can basically run company
      ii. § 7.32(b) – provisions of what an authorized agreement shall have (Zion)

C. Shareholder Voting and Shareholders' Agreements

1. Generally
   a. Proxies necessary when corps are large enough that all shareholders can't make annual/voting meetings
   b. Proxies give shareholders oppty/means to vote while away from the meeting by placing their vote in someone else's hands
   c. 4 things proxy system does:
      i. Provides means for people to vote
      ii. Facilitates shareholder participation
      iii. Makes it possible to get to next level of approval needed for some actions … facilitates quorum
      iv. Provides way to obtain shareholders consent to use their vote to elect someone to office
2. **Salgo v. Matthews**
   a. ***RULE*** –
      i. Record owner defines who can vote the shares
      ii. Where record owner and beneficial owner different, beneficial owner can compel record owner to execute a proxy in the name of the beneficial owner so that he may vote the shares as he wants
      iii. Beneficial owner also has power to compel the record owner to turn over any distributions made by the corp and to re-register the share under their name

b. Record holder – person to whom shares are registered
c. Beneficial owner – actual owner of shares

3. **RMBCA § 6.25(b)(2)**, p. 625
Each share certificate must state:
    a. Name of issuing corp and that it is organized under state law
    b. Name of person to whom it is issued
    c. Number and class of shares and designation of the series, if any, the certificate represents
4. **RMBCA § 7.22**, p. 615
    a. While ordinarily revocable by principle or agent, a proxy is not revocable when you have a proxy with interest or security (when you pay for your vote, you can keep it)

5. **Cumulative vs. Straight Voting**
    a. *Straight voting*:
        i. Shareholders vote for directors by applying the number of votes per share, usually one per share to each open director position. E.g., someone with 5 shares can apply 5 votes to each director position up for vote
        ii. Person with more shares has greater voice
    b. *Cumulative Voting*:
        i. Allows you to take number of votes that you have and multiply it by the number of positions to be filled. Then can apportion those votes among candidates.
        ii. Increases possibility that minority might be able to elect at least one position
        iii. RMBCA § 7.28(b), p. 623 requires you opt in for cumulative voting
6. **<u>Ringling Bros.-Barnum & Bailey v. Ringling</u>**
With cumulative voting, two stockholders enter into pooling agreement to vote certain way to get enough votes to have a say. One holder refused to vote as agreed
    a. ***RULE***: A group of shareholders may without impropriety K to vote their shares in the future as they determine in order to get an advantage and may be held liable for failing to adhere to such agreements

7. **Voting Trust**
    a. Generally:
        i. RMBCA § 7.30, p. 624
        ii. A legal fiction where shareholder conveys shares to the trustee along with associated voting rights
        iii. Allows shareholders to be unified

iv. Places voting power in a person to administer the trust
v. May list out a general policy statement and fix a common plan of action
vi. Likened to Board of Directors
vii. Benefit is that you're putting voting in hands of person who understands corporation
viii. Trustee has fiduciary relationship to all shareholders
ix. Arranged by K
x. Shareholders assign stock to trust and get voting trust certificates that say they are the beneficial owners of stock
xi. Beneficial owners can sell their trust shares to others

8. **Bankruptcy**
    a. 2 Types
        i. Chapter 13 – Liquidation Bankruptcy
            1. Sell off assets and it's done
        ii. Chapter 11 – Reorganization Bankruptcy
            1. Company wants to continue on
            2. So, court regulates rights of creditors

    b. **<u>Brown v. McLanahan</u>**
        i. It's a railway company and this can affect their choice of bankruptcy
        ii. Chose Chpt 11, so submitted reorganization plan
        iii. Balance sheet:
            1. Assets stay constant
            2. Liabilities and Equities provided before and after organization instituted
        iv. Liabilities Before Reorganization
            1. 1st Lien bonds
                a. Are both liabilities and securities
                b. Bondholders have priority over stockholders
                c. This was the financing for the corp
                d. *Bondholders received Debentures and Preferred Stock*
            2. Unsecured creditors
                a. They were bank creditors, trade creditors like Xerox
        v. Liabilities After Reorganization
            1. Debentures

            a. Like bond, but no collateral associated … more risky loan than preferred stock
            b. Used to be first lien bond holders
        2. Preferred Stock
            a. Used to be first lien bond holders
            b. They agreed because something better than nothing

vi. This cleaned up Corp's debt/equity ratio
vii. Unsecured Creditors went down to Equity holders to get them common stock
viii. See p. 51 of other outline for balance sheet layout
ix. See also p. 52 for interplay with voting trusts
x. Here, the restructuring caused creation of 221,000 new votes (debenture holders) to be cast and deprived common stock holders of their right to vote in one director
xi. ***RULE***: Voting trustees are fiduciaries and owe a fiduciary duty to shareholders. So, court invalidated trust because the trustees cooked up the plan

9. **Lehrman v. Cohen**

Two families that shared ownership of Giant Food agreed to set up 3 classes of stock … one for each family and third for a fifth director to be tie breaker. But 3rd party sided with Cohen. Lehrman sued saying it was a voting trust

a. ***RULE***: Creation of new class of stock strictly for voting purposes does not separate the voting rights of the cumulative stock to create a voting trust. Each shareholder remains in complete control of his stock's voting rights
b. **Criteria for Voting Trust**:
    i. Voting rights of stock separated from attributes of ownership
    ii. Voting rights granted intended to be irrevocable for definite period of time
    iii. Principle purpose of grant of voting rights is to gain control
c. Both RMBCA § 7.20 and DGCL § 218 allow voting trusts

10. **Restrictions of Transfer**

a. Purpose to keep a balance and control within company by restricting alienation of stock
b. Restrictions on transfer also define ownership and control ownership to varying degrees of shareholders of company
c. Could prevent hostile takeovers and keep business small

d. **Different Types of Restrictions** (RMBCA §6.27, DGCL § 202)
   i. **Right of first refusal** – holder may not offer to sell shares to outside w/o first allowing corp. to buy for same price and terms
   ii. **First option as fixed price** – similar to above, but price determined by agreement creating option (usually a formula)
   iii. **Consent**
   iv. **Buy-back rights** – enable corp to buy back shares on happening of certain events, whether holder wants to sell or not (retirement, death, etc.)
   v. **Buy-sell agreement** – corp or fellow holders obliged to buy back stock in event of death, etc.
      1. Redemption agreement – when corp bound
      2. Cross-purchase agreement – where holders agree to buy back proportionate share

11. **<u>Ling v. Trinity S&L</u>** restriction on transfer
Bowman took out loan (seemed secured … aka collateralized); gave Ling stock as collateral to bank (Trinity); stock was issued with restriction on transfer; Issue arose about this
   a. ***RULE***: Restriction must be conspicuous and reasonable to be enforceable against 3rd party
   b. ***2 Levels of Controlling Law***
      i. State Corporate Code
         1. Restriction must be expressly stated in the Articles of Inc and copied at length or in summary on the face or back of certificate
      ii. Article VIII of UCC
         1. Test is conspicuousness
   c. Here, Trinity is sophisticated lender. Can't claim they did not know.
   d. Restriction passes State Corporate Code but fails UCC conspicuousness test

D. Deadlocks

1. General
   a. Occurs when corp is paralyzed and prevented from acting usually arising from shareholder-adopted control structure. Disagreement among parties usually halts (monkeywrenches) established control mechanisms
2. Dissolution
   a. RMBCA § 14.30, p. 797 – Grounds for dissolution
      i. Can be brought by A-G, shareholder, creditor, or corp

b. DGCL § 273
    i. If you have 2 stockholders with 50-50 interest, can petition for dissolution
c. Most important judicial remedy for dissention/deadlock
d. Extreme Remedy
e. Corporation *ceases to exist* as a legal entity
f. Assets sold off, debts paid and surplus distributed to shareholders

3. **Gearing v. Kelley**

In effort to prevent quorum and paralyze corp, shareholder did not attend meeting where board was going to fill vacancy with someone she didn't want. Two remaining directors held election anyway, and elected candidate. She sues to have election set aside

a. ***RULE***: Court won't allow Pl. to challenge election elected w/out quorum when she deliberately created lack of quorum
b. Unclean hands Doctrine
c. Dissent vigorous and Wallace likes it
    i. Majority essentially disenfranchised ½ the shareholders
d. DGCL § 216 – allows corp to require quorum
e. RMBCA § 7.25 – unless otherwise stated in Articles of Inc, 51% equals quorum

4. **In re: Radom & Neiforff**

Brother and sister each own 50%; brother not getting salary b/c sister refuses to sign off checks; brother sues for petition to dissolve company; NY statute allows for dissolution if deadlock

a. ***RULE***: Discretionary use of dissolution limited to only those situations when eternal conflicts are so bad as to prevent efficient management and the goals of corporation cannot be obtained
b. Court refuses dissolution here … business still profitable
c. Dissolution is extreme remedy
d. NOTE – if brother left company, could be breach of fiduciary duty b/c would take clients and taking goodwill of corporation which could be an intangible corporate asset

E. Modern Remedies for Oppression, Dissension, or Deadlock

1. General

a. RMBCA § 14.30(2), p. 797
b. Remedies available have broadened
    i. Appointment of custodian
    ii. Buyout
        1. One party has to purchase other party's shares at court-determined fair market price

c. As a lawyer, want to include mechanisms in corporate structure to prevent deadlocks, etc.
d. Oppression, significant misconduct, misapplication or wasting of assets may all spark remedy

2. **<u>Davis v. Sheerin</u>**
Minority shareholder not employed by corp sued majority holder for oppressive conduct. Trial court ordered Def. to buy-out appellant's stock
a. ***RULE***: Court of equity may order a buy-out when less harsh remedies inadequately protect rights of parties
b. Buy-out (at fair market value) appropriate when oppressive acts are attempt to squeeze out minority holder

3. **3 Ways of Finding Oppression**
a. Self-dealing – engaging in transactions that benefit the holder at the corp's expense
b. Squeeze-out/freeze-out – excluding minority of their economic benefits or decisionmaking process or rights
c. Violation of fiduciary obligation – e.g., refusal to pay salary

4. **<u>Abreu v. Unica</u>**
a. ***RULE***: Appointing provisional director is one way court can provide remedy in deadlock situation
b. No strict requirement of impartiality in appointing provisional director so long as made in best interest of corp

XIV. ACTIONS BY DIRECTORS

A. General

1. Directors have capability of acting on behalf of corporation – entering into Ks, buying/selling assets, steering the company
2. **Directors are not agents … so agency law does not apply**
3. **Officers are agents … so agency law does apply**
4. Directors and officers are not the same in the law
a. To the extent party acting as director, legal analysis is whether they acted directly enough
b. To the extend party acting as officer, have to look at agency law

B. <u>Baldwin v. Canfield</u>

King sole stockholder of MN ass'n, which owned valuable land. He borrowed $10,000 from Baldwin (bank) pledging his stock as security. So bank now holds stock. Corp's only asset was real estate. King then caused each Board of Directors member to authorize sale of property to Canfield for bonds payable to corp. King takes $10,000 and bonds and disappears. King defaults on loan. Baldwin/bank wants conveyance held invalid to it will remain in hands of corp (rather than Canfield). If held valid, bank will hold stock in corp with no assets. Baldwin sues to invalidate conveyance b/c not done

through board action, but by different directors at different times and different places

1. ***HELD***: Baldwin prevails
2. ***RULE***: Governing body of corp (board of directors) are agents of corp only as board and not individually
3. ***GIST of CASE***: Directors can bind company. And law cares about extent of formalities in these dealings
4. Actions didn't constitute official actions of corp since they acted separately and individually
5. Two innocent parties – court held for one more able to protect himself … Canfield could have insisted upon release from bank … no due dilligence

C. <u>Mickshaw v. Coca Cola</u>

During WWII Coke published newspaper article offering to pay employees current salary minus what earned while away at war. Pl. came back and wanted his money. Coke refuses, claiming not made through proper board action

1. ***HELD***: Relief granted
2. ***RULE***: Court looks to knowledge, acquiescence, and consent when determining if K existed
3. LOOSER than rule in <u>Canfield</u> … even though formalities not observed, relief granted
4. Mickshaw not sophisticated investor, was war veteran, etc.

D. <u>Cooke v. Lynn Sand & Stone</u>

Pl. is president of family corp. He thought company might be sold and wanted to secure his employment with K. The VP helped him draft employment K. Clause in corp saying Prez and VP could enter into binding K, so they swapped titles and signatures so they could have K valid without going through Board of Directors

1. ***RULE***: Authorization by board has to b sufficiently knowledgeable and has to reflect reasonable amount of reflection and knowledge of K
2. Court won't allow this kind of trickery

E. The Law Today

1. **RMBCA § 8.20(b)**, p. 650
   a. Meetings of Board can be with any means of communication where all directors can hear each other
2. **RMBCA § 8.21**
   a. Action by directors may be taken w/o a meeting so long as the action is evidenced by unanimous written consent signed by each director and included in the minutes or filed in the corporate records. Action not taken until last director signs. Same rule applies in **DGCL § 141(i)**, p. 466

XV. AUTHORITY OF OFFICERS

A. General

1. Part of Agency Law … Officers are Agents
    a. Directors aren't b/c they're at top of power pyramid
2. Agency law applies to actions of officers, other employees, and of course agents of corp
3. in deciding whether there is proper authority or power, here are certain ways in which an agent or principal can bind the corp
4. Under agency law there is a mutual relationship whereby agent agrees to act for the principal (master and servant relationship / principal-agent relationship)
5. Acts of agent are the acts of the principal when done with proper authority or power
6. Authority vs. Power
    a. Authority – Consensual (power is bestowed upon a person)
    b. Power – Legal capacity to act
7. Analysis of officer is completely different from analysis of director if person serves in both capacities on behalf of corporation

B. Four Categories of Power/Authority (used by an agent to bind principle to a K)

1. **Actual Authority**
    a. Principle *manifests* to agent that the agent has the authority to act
    b. Agent has *reasonable belief* that he is authorized to act on behalf off principle
    c. <u>Express Actual Authority</u>: If CEO says to agent "you are authorized to act on behalf of this company." Found in Articles of Inc., Employment Agreements, Shareholder Agreements, Bylaws
    d. <u>Implied Actual Authority</u>: Authority that is inherent based on express duties to an officer
    e. Key part is principle's manifestation and agent's reasonable belief
    f. Must have agency relationship
2. **Apparent Authority**
    a. Principle manifests to the *3rd party* that agent has authority to act on behalf of principle
    b. 3rd party has a *reasonable belief* that agent is authorized to act
    c. Not necessary to have an agency relationship in order to have apparent authority
    d. Focus is on 3rd party and that there is an agent and that agent is authorized to act
    e. **Difference b/w apparent and actual**

i. Actual authority flows directly from principle to agent
ii. Apparent authority flows from impression created by (or permitted to exist by) the principle in the mind of the 3rd party. This authority cannot be created by the mere representation of the punitive agent

f. Example:
   i. Principle allows agent to purchase items for $100 for 3 years. In 4th year, he reduces actual authority expressly granted to agent to $50, but doesn't tell 3rd party. Agent makes $100 purchase anyway. Principle has to pay full amount, even though he told agent otherwise b/c agent still has apparent authority
g. Up to principle to notify 3rd party of any changes in authority

3. **Estoppel Agency Power**
   a. Principle causes or allows *3rd party's reasonable belief* that agent has authority to act
   b. 3rd party changes position in reliance on that belief and relies on that belief to his detriment
   c. Principle fails to correct the misrepresentation or improper belief
   d. Derives from Equity and Tort Law (apparent authority from K law)
   e. Principle is estopped from claiming agent lacked authority
   f. More restrictive than apparent authority, b/c requires 3rd party to change position in reliance
   g. In apparent authority, focus on 3rd party's belief, here tilt responsibility to principle who fails to prevent harm
   h. Example
      i. Family stops in motel to spend night. Person behind desk checks them in and takes their valuables, puts them in storage. Person was actually a thief. Family sues hotel and wins. Motel held out stranger's authority by negligently allowing thief to pose as employee

4. **Inherent Agency Power**
   a. Arises from agency itself and without regard to either actual or apparent authority (e.g. *respondeat superior*)
   b. Principle is responsible for want of care on agent's part towards those to whom principle owes the duty to use care, provided failure of agent to use such care occurred in the course of his employment
   c. Must have agency relationship

d. The strength of the agency relationship is itself the basis for holding the principle liable
e. Fact-based inquiry
f. Different sets of events … harms resulting from another person setting actions into motion, or allowing such. Someone has to pay for harm
g. Clear allocation of risks. Risks shifted to party that is in the better position to avoid the harm
h. **A lot of courts refuse to apply Inherent Agency Power**
    i. It is amorphous
    ii. Hard to find elements of it

5. **<u>Black v. Harrison Home</u>** (actual authority)
    a. President can't bind corp any more than directors. Corp bound when K ratified
6. **<u>Lee v. Jenkins</u>** (apparent authority)
    a. President has authority to bind in the usual course of business, not for Ks in extraordinary circumstances
7. **<u>In re Drive-In Dev. Corp</u>** (apparent authority)
    a. President has apparent authority to make decisions in ordinary course of business

XVI. CONTROL AND MANAGEMENT OF PUBLICLY CONTROLLED CORPORATION

A. Definitions

1. **Public Corporation** – companies that have sold their securities to public and the stock is available for public trading; stock is widely held and traded over some medium/market
    a. Separation of ownership and control
    b. Vulnerability of shareholders b/c they are so far removed
    c. Always possibility of abuse even on part of directors even though shareholders are the owners
2. **Primary Market** – sale of stock b/w a corporation and a stockholder (e.g. IPO)
3. **Secondary Market** – stock sold b/w shareholders after the new stock was sold by the corp on the primary market
4. **Corporate Social Responsibility** – view of the corporation as social instrument tinged with a public purpose and not just a vehicle for shareholder wealth maximization
5. **Inside Director** – Someone who sits on the board of directors who is also an officer in the company
6. **Independent/Outside Directors** – People who sit on board who are not officers of company. As a matter of perspective, they might have different idea. Also, as a matter of fairness, the board is comprised of both inside and outside directors so as to balance interests of company

B. Corporate Responsibility Hypo

1. Mega corporation is owed $20,000 by small non-profit and refuses to collect. Stockholder gets pissed off and sues corp for failing to collect debt. Following statutes may protect board if holder sues claiming corp breached fiduciary duty to stockholders:
    a. American Law Institute Principles § 2.01(b)(3) – "The Objective and Conduct of the Corporation"
        i. Allows corp to devote reasonable amount of resources to public welfare; humanitarian; educational; etc.
    b. Ill. Bus. Corp. Act – may do socially responsible activities as long as w/in best interest of corp
    c. Penn. Bus. Corp. Act – ditto

C. Proxy Regulation

1. Proxy – document where shareholder appoints s-one (usually management) to cast his vote for or more specified actions
2. Separation of ownership and control – balance of power b/w shareholders and directors
3. Proxy regulation maintains balance of power
4. Proxy regulation process seeks to force management to tell all to shareholders b/c all of the shareholders can't go to annual meetings and make informed choice
5. Proxy regs prevent abuse
6. State law creates proxies, but regulated by Fed

D. Securities Exchange Act of 1934

1. As distinguished from 1933 Act – 1933 Act regulates IPOs and registrations on the primary market
    a. SA § 5 – defines public corp
    b. SA §§ 3,4 – defines private companies
2. 1934 Act regulates public companies in their trading of stock (brokerage firms) and the solicitation of proxies
    a. Created SEC; part of New Deal
    b. Requires periodic and continuous annual disclosures
    c. Regulates only public companies
    d. Some sections allow suit to be brought by both SEC and shareholders
    e. Must give full and fair disclosure info about company

3. **Test for Determining whether a Public Company** (all you need is one to be public)
    a. **SEA § 12(a)**
        i. If stock or securities listed on a national stock exchange (or even regional or local exchange)

b. **SEA § 12(g)(1) (was not a part of the original exchange act)**
    i. If securities are traded through mail or other interstate commerce, **AND**
    ii. Have 750 shareholders, **AND**
    iii. The issuer has more than $10 million in assets at the end of its most recent fiscal year (Was only $5 million until 1986)

c. **SEA § 15(d)**
    i. If a company does a SA 1933 Act registration for a public offering, also considered public under 1934 Act

d. If company never made a public offering under 1933 Act and never offered stock on the Exchange, but has made enough private sales so that there are more than 500 shareholders, then it is considered a public company even though there was never a public offering

e. Integration Disclosure Program – permits issuers that have filed reports under the 1934 Act for more than 3 years incorporate by reference this information in its 1933 Sct filing and therefore greatly simplify registration process

4. **Proxy Solicitation in a Public Company**

a. **SEA Rule 14(a)-1**, p. 1560 – No solicitation of proxy unless complies with fedal law
    i. Broad Definition – applies to every type of proxy, even oral consent to request
    ii. Solicitation defined:
        1. **SEA Rule 14(a)-1(k)** – solicitations can include:
            a. Oral requests
            b. Requests not to execute
            c. Advertisements

b. **SEA Rule 14a-1** – Solicitation Safe Harbor
    i. It is not a solicitation if:
        1. The statement by the security holder is telling how they intend to vote provided that the communication is made by a public speech, press release, published broadcasting, advertisement or any other bona fide publication disseminated on a regular basis
        2. Is directed to persons to whom the security holder owes a fiduciary duty in connection with the voting of securities of a registrant held by the security holder, or

3. Is made in response to an unsolicited request

5. **Other Relevant SEA 1934 Sections:**
   1. **Rule 14a-3** – Requires that proxy solicitation be accompanied by a proxy statement containing information set forth in Schedule 14A
   2. **Rule 14a-4 –** Form of Proxy; outlines what proxy form should be and what info should be included. E.g., can't provide broad grants of discretionary power to the nominee
   3. **Rule 14a-10** – Form of Proxy; proxy must be for a specified meeting and undated or postdated proxies prohibited
   4. **Rule 14A** – Independent Public Accountant … if you change accountant have to disclose and explain why
   5. **MD&A** – "Management's Discussion and Analysis of Financial Condition and Results of Operation" – found in **Rule 14a-3**
      a. If solicitation is by management and relates to an annual meeting at which directors are to be elected, the solicitation must be accompanied by an annual report containing financial information
         i. Safe Harbor – Future statements would not be deemed false or misleading unless they were made or reaffirmed without a reasonable basis or disclosed other than in good faith

6. **Studebaker Corp v. Gittlin**

   Shareholder of Company Gittlin was owner of 5,000 shares of stock. According to NY statute a shareholder may, with 5% of company stock, petition the court to require the company to produce certain records. Gittlin has been attempting to get corp to make certain changes with the board of directors and announces his intention to solicit proxies at the next meeting if the Board of Directors refused to make request of changes. Corporation refuses to make changes and so Gittlin acts on behalf of written authorization of 42 shareholders in excess of 145,000 shares, totaling more than 5% of the stock to obtain inspection of Corporation Studebaker's shareholder list. He was going to use this list to solicit proxies in hopes of implementing his changes. Corporation sued Gittlin argues that Gittlin's solicitation of the 42 other shareholders to access the shareholder's list was itself a proxy in violation of the proxy rules in SEA § 14(a)
      a. ***RULE***: SEA § 14(a) solicitation of a proxy is construed very liberally. Consents and authorizations of all types may constitute a solicitation if it is **<u>part of a continuous plan</u>** intended to end in solicitation and to pave the way to success
      b. A request to inspect stockholders lists are subject to the proxy rules and is defined as a solicitation under SEA § 14(a), if it is part of a **continuous plan** intended to end in

solicitation

7. **In re: Caterpillar**
Caterpillar company owns a Brazilian subsidiary which had an extremely profitable year in proportion to other years. They have to do their reports in a consolidated basis so that in their disclosure form they included the overall picture of the company, but failed to place in the MD&A form the non-operating items which effected the profit margin for that year that was the result of outside political and economic factors unrelated to the operation of the business. The non-operating item considerations that were included as resulted in the high profit were interest income, export subsidies, currency translation games (worth more in the exchange). Company predicted that the following year their subsidiary would suffer significant losses not likely to be balanced from profits of other subsidiaries they owned. The board of directors and the general counsel were aware of the significant loss predictions, but disregarded this when filling out the MD&A form for this Brazilian subsidiary
    a. ***HELD***: If you fail to disclose known uncertainties likely to have a material effect on a company's future results of its operations than you are in violation of SEA **§ 13(a),** p. 1462 (Rules 13a-1 and 13a-13, p. 1534) of the 1934 Act
    b. ***RULE***: The test for determining when disclosure is required for the Management's Discussion of Financial Condition and Results of Operations (MB&A) release:
        i. Where a trend, demand, commitment, event, or uncertainty is unknown, management must make two assessments
            1. Is the known trend, demand, commitment, event, or uncertainty likely to come to fruition? If not, no disclosure is required
            2. If management cannot make that determination it must evaluate objectively the consequences of the known trend, demand, commitment, event, or uncertainty on the assumption that it will come to fruition
    c. SEC requires that Form 10-K (p. 1541) be filed. Item 303(a) requires the registrant to "describe any unusual or infrequent transactions that materially affected the amount of reported income from continuing operations and indicate the extent to which the income was affected." Moreover, the registrant is to discuss "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material, favorable or unfavorable

impact on net sales or revenues or income from continuing operations"

d. SEC also requires that Form 10-Q be filed. Requires an analysis of the results of operations to enable the reader to access material changes in financial condition and results of operations that have occurred since the end of the preceding fiscal year

e. Company had deficient disclosure in two respects:
    i. It failed to discuss the impact of the subsidiary on its overall financial picture (Form 10-K)
    ii. It did not discuss future uncertainties regarding the subsidiaries operations and the possible risk that the company would have materially low earnings. It failed to comply with Regulation S-K, Item 303 (p. 1395)

f. Under Regulation S-K, Item 303, Caterpillar was required to discuss any known trends or uncertainties that have had or that the registrant reasonably expects will have a favorable or unfavorable impact on net sales or revenues, or income from continuing operations

g. What is the difference between what the MD&A requires and pure forward looking information
    i. MD&A – Identify certain trends and uncertainties that are known to the company. Must be specific, detailed, and revealing about the future of company from managers of company
    ii. Forward Looking – Superficial forecasts and predictions

8. **False or Misleading Statements (didn't cover in class)**

a. **SEA Rule 14a-9** – False or Misleading Statements in the Solicitation of Proxies
    i. **Rule 14a-9(a)** - No solicitation shall be made by means of any proxy statement written or oral which is false or misleading with respect to **any material fact** or which omits to state any material fact necessary to make the statements therein not false or misleading
    ii. **Rule 14a-9(b)** – Examples of misleading facts:
        1. Predictions as to specific future market values
        2. Material which impugns character, integrity or personal reputation or makes charges concerning improper, illegal or immoral conduct or associations, w/o factual foundation

3. Failure to so identify a proxy statement as to clearly distinguish it from soliciting material of any other person soliciting for the same meeting or subject matter
4. Claims made prior to a meeting regarding the results of a solicitation

b. **<u>J.I. Case Co. v. Borak</u>**

Π brought two counts based upon the alleged circulation of a false and misleading proxy statement by those proposing the merger between Δ and the American tractor corporation. There were two claims: 1) a breach of fiduciary duty (directors fiduciary duty to the shareholders) – state claim; this claim was dismissed b/c Π refused to post $75,000 bond required by Wisconsin Statute; and 2) alleged a violation of SEA Rule14a of the Securities Exchange Act with reference to the proxy solicitation. This is a federal claim and the Π wanted damages, but trial court said it could only grant injunctive relief because the statute did not expressly grant private right of action

i. ***RULE***: There is an implied private right of action for remedial relief under § 27 to bring suit for violation of SEA Rule 14a – Misleading Information in Proxy Statements
ii. Legislative intent behind the statute was for the protection of the public interest and for the protection for the investors and the language protection of the investors implies the availability of judicial relief where necessary to achieve that result
iii. Granting this private right of action makes sense b/c shareholders are likely to discover proxy regulations before the government
iv. *This case has not been overruled, but current SC not as willing to grant this right*

c. **Common Law Elements are Read Into 14a-9**

d. **<u>Mills v. Electric Auto-Lite Co.</u>**

Strengthened <u>Borak</u> private right of action

i. Where there is a finding of materiality a shareholder has made a sufficient showing of causal relationship b/w the violation and the injury for which he seeks redress if he proves that the proxy solicitation itself rather than the particular defect in the solicitation materials was an **essential link** in the accomplishment of the transactions

ii. The causal connection requirement for materiality also included an element of common law fraud of whether the injured party relied on the misrepresentation in the statutory anti-fraud provisions

iii. **To prove a fraud case under Rule 14a-9 you must show:**

1. **The materiality of the information and an essential link in the accomplishment of the transaction**
2. **That you relied on the misrepresentation**

e. **<u>TSC Industries v. Northway</u>**

i. ***RULE***: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote

ii. **Situations where materiality achieved**

1. Misstatements or omissions with annual election of directors
2. Self-dealing
3. Simple Mismanagement (difficult to achieve)

f. **<u>Virginia Bankshares v. Sandberg</u>**

Dispute revolves around a freeze-out merger in which minority shareholders were bought out w/o their consent. The Bank owned 85% of stock of FABI and wanted to merge and then become VBI. The bank wants the remaining 15%, which is in the hands of 2,000 shareholders. They wanted to acquire the entire 100% in order to prevent people from bringing shareholder derivative suits especially since the corporation has to disclose its financial situation. VBI was set up as the acquisition vehicle. The bank solicited proxies for votes to pass the merger agt. and the proxy statement claimed that the $42/share was a high value and fair price. It is important to note that they were not required to solicit these proxies since they owned 85% according to Va. law. In compliance with Virginia law they had a shareholder's meeting and the merger was passed (minority shareholder's did not have a choice since the 85% constituted a majority). Minority holders did not have a right to break up the merger, but did have a right to an appraisal and sue for a fair price. By using the securities laws and claiming that in the proxy there were material deceptions or omissions the shareholders had legal action

i. ***RULE***:

1. Issue 1
   a. Reasons, opinions and beliefs are statements with respect to material facts and fall under SEA § 14(a)
   b. Conclusory statements and opinions can be a subject of suit under fraud and misrepresentations under the securities act
2. Issue 2
   a. Once it is proven that the facts or conclusory statements are material it gives rise to a rebuttable presumption that there was reliance on it
   b. They limited the Borak rule of an implied right of action b/c there is no intent by Congress to recognize a private right of action as broad as Πs argue to recognize a cause of action or class of Πs as broad as the minority shareholders theory would entail. **Limiting Rule 14a-9**
3. This is a freeze-out merger b/c the minority shareholders have no way of preventing the merger from taking place.
4. Minority shareholders who do not have the power to block the merger in their votes are required to accept cash for their shares and have no right to a continuing ownership interest in the entity. If dissatisfied with the merger the only action they can take is to demand an appraisal to receive a fair price.
5. Merger statutes themselves do not allow for shareholders to have merger undone, but do provide for a remedy in the form of money damages if they insist on the court reviewing the price for share amount.
   a. The essential link test still applies, but it doesn't extend it to this class of people
   b. The price of the shares of the 15% owned by minority shareholders was not an essential link to the merger b/c as only 15% they were not

essential to the merger in the first place.

6. Undisclosed information motivation standing alone is not a sufficient basis to sustain a SEA § 14(a) cause of action.
7. **RMBCA § 11.04(a)** – merger of subsidiary (short-form merger); a parent corporation owning at least 90% of the outstanding shares of a subsidiary corporation may merge the subsidiary into itself w/o approval of the shareholders of the parent or the subsidiary
8. **DGCL § 253** – same as above

9. **Shareholder Proposals (resume reading)**
   a. **SEA Rule 14(a)(8)**, p. 1576 -
      i. Allows for procedure that a shareholder may use to get an item onto the agenda and encourage shareholders to support the proposal
      ii. Most shareholder proposals are rejected by management through the use of one of the 13 reasons stated in 14a-8(i)(1)-(13), p. 1579
         1. (7) – If the proposal deals with a matter relating to conduct of the ordinary business operations of the registrant. This constitutes the day-day mundane matters. Regarding employment practices – if tied to social issues it's excluded
         2. (4) – If it relates to a redress of a personal claim or grievance
         3. (5) – If the proposal relates to operations which accounts for less than 5% of its total assets as well as net earnings and gross sales for the most fiscal year
         4. (8) – Election of an officer
      iii. When a company denies a request it must forward a letter of explanation to the SEC within 80 days. See Rule 14a-8(j)(1), p. 1580
      iv. This is the newest rule and uses plain English language
      v. The Management of the company is usually not willing to accept proposals b/c they have the power and see it as a disruption. Active Institutional investors who do want to implement changes normally sit down and discuss their ideas with

management rather than going through this proposal process.

b. Who is eligible to Submit Shareholder proposals?
    i. You must have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year by the date you submit the proposal, and continue to hold them through the date of the meeting. Rule 14a-8(b)(1), p. 1576
    ii. The proposal has to be under 500 words – 14a-8(d), p. 1577
    iii. Can only submit one proposal per meeting – 14a-8(c), p. 1577

c. Difference b/w proxy contests and shareholder proposals:
    i. With *proxy contests/solicitation* a shareholder is looking for consent to take a certain initiative to the directors to be voted on; e.g. shareholders have an alternative agenda and want other shareholder's to change their vote to a different set of directors;
    ii. A *shareholder proposal* simply wants to place item on agenda and have shareholders themselves vote on whether they want that proposal or not; e.g. - you have social issues oriented shareholders who seek to affect corporate policy making by submitting proposals for shareholder's to vote on to change company's environmental or economic policies
    iii. Two broad categories of shareholders that make use of Rule 14a-8
        1. Economic/traditional shareholder – concerned with management and financial status of company
        2. Corporate social responsibility/ethical shareholder – environmental issues, stop war, child labor, etc.
    iv. **RMBCA § 10.03(b)**, p. 736 – in order to amend Articles of Incorporation the board of directors must recommend the amendment, therefore, a shareholder proposal to amend the Articles of Incorporation should be excludable since it is not proper shareholder action

d. **<u>Rauchman v. Mobil Corp.</u> (1984),** p. 655 -
Mobile refused to include in its proxy statement a shareholder's proposal, which would amend Mobile's

bylaws to prevent a citizen of an OPEC country from sitting on Mobil's board of directors b/c that citizen was Saudi Arabian and backed the Palestinian Liberation Organization. The SEC found Mobil was allowed to omit this proposal and the shareholder sued. This was an SJ motion.

i. ***RULE***: Shareholder's proposal falls within rule 14a-8(i)(8), p. 1580
ii. ***HELD***: Court holds that Mobil was fully within its right to decline to submit the proposed proxy material
iii. This proposal speaks to the kind of petty issues that are unrelated to the company's true business that arise in these shareholder proposals
iv. The court could possibly have excluded this proposal under (i)(2) – violation of state or federal law.

XVII. DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

A. General

1. ***Business Judgment Rule (BJR) –***
    a. When law presumes that fiduciaries acted with care and diligent, knowledge and the like; only in the instance of bad faith, fraud and gross negligence would a court inquire further from that presumption
2. Directors are not guarantors of the success of the business. As long as they are well informed and attentive and act in good faith thinking of the best interests of the shareholders, their acts are protected by the business judgment rule
3. Director and officer must exercise a degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances
4. Although some decisions turn out to be unwise or the result of mistaken judgment, it is unreasonable to reexamine these decisions with the benefit of hindsight. Therefore, a director is not liable for injury or damage caused by his decision, no matter how unwise or mistaken it may turn out to be, if in performing his duties he met the requirements of the duty of care
5. Due process is applied to the process used, and not necessarily to the result obtained, except maybe in cases of egregious conduct
6. In the absence of 1) wrongful conduct; 2) fraud; 3) gross negligence; and 4) conflict of interest the BJR applies and the court will exercise judicial restraint

B. RMBCA § 8.30(a), p. 656 – standards of conduct for directors:

1. Each member of the BOD, when discharging the duties of the directors, shall act:
    a. in good faith, and
    b. in a manner a director believes is in the best interest of the corporation.

Very broad – up to courts to determine

C. RMBCA § 8.30(b)

1. The member of the BOD to a committee of the Board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances
2. This entire section discusses what the standard should be for directors
3. **NOTE**: there is a huge comment for this entire section

D. RMBCA § 8.42, p. 682 – Standards for Officers

1. Similar to the standard for directors in 8.30

E. **<u>Litwin v. Allen</u> – FIDUCIARY DUTY**

Allegheny company had an article in its bylaws that allowed only up to a certain amount of debt. They had properties and needed to make payments and needed money for it, but couldn't borrow anymore. They created a loan, that wasn't really a loan in order to get around this debt provision. They sold convertible debenture (uncollateralized, unsecured debt) to Guaranty Trust company under the condition that it could repurchase the bonds back for the same price. Allegheny sells the bonds to Guaranty and gets cash for it, which can be used to make payments on the property. This cash received shows up as assets on the balance sheet. There was a repurchase option that allowed Allegheny to buy back the bonds at par plus interest (face value) or $1,000 = 100%. Each bond is worth $1,000 at face value. The bonds are being traded at $1,200 and Allegheny could buy back the bonds at 100% or $1,000 which is a good deal; on the other hand if the bonds are traded at 80% and worth $800 then they are paying more than they are valued. This occurs during the Depression. Guaranty's risk of loss was great - Allegheny will only buy the debentures back only when at or above 100% value and refuse to do so if below; therefore Guaranty has incurred all of the risk. Additionally, if value of stock increases Guaranty Trust doesn't get to receive the benefit of this stock increase as it would if it had common stock. The only advantage of the K for Guaranty was the fixed interest rate

1. ***RULE***: Directors are liable for negligence in the performance of their duties, however, are not liable for errors of judgment or for mistakes while acting with reasonable skill and prudence. Whether one is negligent depends on the facts of the case.
2. ***HELD***: The court held that the decision by the directors was so dangerous, so unusual and contrary to ordinary banking and against public policy so that they must be held liable; they breached the duty of care
3. It is not terrible in the sense that there was no evidence to indicate that any of the Δ officers and directors acted in bad faith or profited or attempted to profit or gain personally by any phase of the transactions
4. The directors are bound by all of those rules of conscientious, fairness, morality and honesty and purpose, which the law imposes as guides to fiduciary duties
5. Directors are held to the extreme measure of candor, unselfishness and good faith.
6. **<u>Elements of Fiduciary Duty</u>**:
    a. Loyalty that is undivided
    b. Allegiance that is influenced in action by no consideration other than the welfare of the corporation
    c. One cannot profit at the expense of the corporation and in conflict with its rights (self-dealing)
    d. Required to use independent judgment

e. Must act honestly and in good faith, but also exercise some degree of skill, prudence and diligence.

7. When you have a repurchase agreement it causes you to have a possible liability that is lurking which is not disclosed or accounted for

BUSINESS JUDGMENT RULE

F. Shlensky v. Wrigley

Minority stockholder of the Chicago Cubs brings suit for negligence and mismanagement by not installing light and scheduling night games while at the same time the Cubs were sustaining operating losses attributable to low attendance

1. ***RULE***: The directors are chosen to pass upon such questions and their judgment *unless shown to be tainted with fraud* is accepted as final. The judgment of the directors of corporations enjoys the benefit of a *rebuttable presumption* that it was formed in good faith and was designed to promote the best interest of the corporation they served
2. One reason for the Business Judgment Rule (BJR) is that judges are not business experts
3. There must be fraud or a breach of good faith in order to justify the courts entering into the internal affairs of the corporation. This is judicial self-restraint
4. Wrigley refused to allow lights in Wrigley field, not b/c he thinks this will benefit the corporation, but b/c he holds the personal, social, political opinion that baseball is a daytime sport and that the installation of lights will have a bad effect upon the surrounding neighborhood. The court finds that these non-economic reasons are also within the business judgment rule
5. Compare to Dodge v. Ford Motor Corp. where court dismissed Ford's social purposes argument whereas here the court accepts Wrigley's social argument

G. Francis v. United Jersey Bank

Company went bankrupt and trustee brought suit against the widow of the founder. The widow was a member of the board, but did not know how to run the business. Her sons ran the business into the ground

1. ***RULE***: Ignorance no excuse for poor business judgment
2. Court was hard on the widow because she was dead. The court was trying to open up the way for people to get money from her estates where the heirs were sons who actually were responsible for running the company into the ground

H. Smith v. Van Gorkom – STANDARD OF CARE

Van Gorkam was the CEO for Transunion and wanted to get his friend, Priztker, through New T., a wholly-owned subsidiary of the Marmon Group

Inc., to buy Tansunion's stock. His financial advisor told Gorkam that a $55 buyout of the majority stockholders could be easily supported by the corporation's cash-flow while a $60 buy-out would put too much strain on it. Gorkkam went with a $55/share price. Even though this price was much higher than the market price on NYSE, the process leading to the decision to approve the merger was seemingly unfair and improper. Leveraged buyout was done improperly. Gorkam made a 20-minute presentation and got all of the approvals he needed. The merger was never on the agenda and copies of the merger agreement were delivered too late for the board to review prior to approval. There was no real emergency and no need to the rush. This suit was a class action brought by shareholder's seeking to rescind the cash-out (leverage buy-out) merger of transunion into New T company

1. ***RULE***: The standard in Delaware for the breach of fiduciary duty is gross negligence, otherwise the court defers to the Business Judgment Rule. (Note: negligence is not a breach of fiduciary duty)
2. The following facts showing that the leveraged buyout was not done properly:
    a. Lack of disclosure
    b. All of the work was internal; little given to external investment bankers
    c. The number they came up with, $55/share, was arbitrary; other potential buyers were willing to give more
    d. There was no preliminary study conducted before the merger
    e. Van Gorkom was reaching age of 65 and will be forced to retire. He wanted to sell the company (and do it fast) to a friend so that he could roll back into the company later. This wouldn't happen if you simply let the market control and anyone could bid the price. Therefore, he wanted Pritzker in particular to buy Transunion. But even with a friendly purchaser, he had to make an offer attractive
    f. Gorkam did all of the promoting, not Pritzker
    g. Pritzker promised a $200 million down payment and a $490 million finance to be paid out of cash flow within 5 years. Gorkam suggested that Pritzker sell some of the assets of Transunion to raise some cash after the takeover
3. When advancing the cause of business everyone else's standard is negligence while directors standard is gross negligence
4. Gorkham should have conducted a diligent inquiry into what the actual price for the shares should be b/c the market value of the stock is not necessarily an accurate measure of the intrinsic value
5. It wasn't just the breach of duty of care, but a possible breach of loyalty b/c of Van Gorkam's personal benefit that convinced the court to find in favor of gross negligence and for the Πs

6. The BOD did not make an informed decision as a whole. They didn't use diligence or due care as the Business Judgment Rule requires
7. There were no allegations nor any proof of fraud, bad faith or self-dealing by the BOD so the Business Judgment Rule doesn't apply

I. Fall-out from Van Gorkum

1. DE added **DGCL § 102(b)(7),** p. 781 – eliminates or limits the personal liability of the director to the corporation or stockholders for monetary damages for breach of fiduciary duty, provided that the provision DOES NOT eliminate or limit the liability of the director
   a. For any breach of the director's duty of loyalty to the corporation or stockholders
   b. For acts or omissions not in good faith or which involved intentional misconduct or a knowing violation of the law
   c. Unlawful payment of dividends (willful or negligence)
   d. Any transaction from which the director derived an improper personal benefit
2. No provision in DGCL shall eliminate or limit the liability for any act occurring prior to the date it became effective. In order for this statute to apply it must be in the Articles of Incorporation
3. **This shows a breach of duty of care is of a lower standard than the breach of loyalty**
4. **RMBCA § 8.31**, p. 667 – Standards of Liability for Directors – very similar to DE statute above

Levels of Fiduciary Duty

- MOST OFFENSIVE -	
Crime	- Breach of law - Not covered by BJR or DE § 102(b)(7) - Jail
Fraud	- Breach of duty of loyalty - Not covered by BJR or DE § 102(b)(7) - Monetary damages
Bad Faith (misrepresentation)	- Breach of duty of loyalty - Not covered by BJR or DE § 102(b)(7) - Monetary damages/injunctive relief
Duty of Loyalty (self-dealing)	- Breach of duty of loyalty - Not covered by BJR or DE § 102(b)(7) - Monetary and injunctive damages
Gross Negligence	- Breach of duty of care **- Not covered by BJR** **- Covered by DE § 102(b)(7)** - No monetary damages but possible

	injunctive relief
Negligence	- No breach of the duty of care **- Covered by BJR** - No liability
Accident	- No breach of the duty of care **- Covered by BJR** - No liability
- LEAST OFFENSIVE -	

J. Derivative Suits

1. Difference b/w a Direct or Derivative Lawsuit:
    a. Direct Suit - a shareholder suing on his own behalf; if remedy provided, it is given to shareholder, not corporation. Brought by minority holder alleging some wrongdoing by the majority holder that caused minority holder harm → usually in a class action suit (FRCP Rule 23)
    b. Derivative Suit – a suit that is initiated by a shareholder brought on behalf of the corporation; if remedy provided it is given to the corporation, not the shareholder. More stringent rules apply to derivative suits than direct suits. If brought by minority shareholders in a class action suit must follow FRCP Rule 23.1
        i. Two causes of action in one:
            1. Primary cause of action (breach of K)
            2. Second cause of action is against the directors for failure to sue to act of behalf of the corporation

2. **Gall v. Exxon– REBUTTABLE PRESUMPTION OF BJR**
Exxon's Board of Directors appointed an independent committee to conduct an investigation into alleged illegal payments by directors and officers to foreign officials. The committee decided that although there was some basis for prosecution of the action, it was not in the best interest of the corporation to prosecute. Shareholders brought an action to compel the corporation to prosecute action. Court limited its inquiry to whether the corporation made a valid business judgment in failing to pursue litigation
    a. ***RULE***: Since it is the interests of the corporation which are at stake it is the responsibility of the directors to determine in the first instance whether an action should be brought on the corporation's behalf; that decision rests within the sound business judgment of the management
    b. This special committee in reaching the decision not to pursue the litigation focused upon the following:

        i. Unfavorable prospects of success
        ii. The cost of conducting litigation
        iii. Interruption of corporate business affairs
        iv. The undermining of personal morale

    c. The BJR creates a rebuttable presumption that the board had acted properly and that the litigation should not be pursued.
    d. The litigation committee device adopted by Exxon to seek dismissal of the Gall suit has become the standard response of publicly held corporations to derivative suits brought or threatened by shareholders which the corporation does not want to pursue. What this does in effect converts a discussion of the merits of the Πs suit into a discussion of the bonafides of the business judgment of a special committee of the board to discontinue inconvenient litigation.
    e. Absent allegations of fraud, collusion, self-interest, dishonesty or other misconduct of a breach of trust nature and absent allegations that the business judgment exercised was grossly unsound the court should not at the instigation of a single shareholder interfere with the judgment of the corporate officers

3. **<u>Zapata Corp. v. Maldonada</u> (1981) – MUST MAKE DEMAND** Maldanado, a stockholder of Zapata corporation, brought a derivative suit against officers and directors alleging breach of fiduciary duty. **Maldanada did not first demand** that the board bring the action, stating instead that such demand's **futility** b/c all directors were named as Δs and allegedly participated in the acts specified. 4 years after the action had been brought, four of the Δ/directors were no longer on the board and the **remaining directors appointed two new directors and formed an independent investigation committee**. The committee consisted of the 2 new directors and was **to determine whether the corporation should pursue the litigation**. The committee concluded that the litigation should not be pursued and moved on behalf of the corporation for dismissal/summary judgment. Court refused to dismiss the suit.
    a. **<u>In order to establish a cause of action in derivative suits you must:</u>**
        i. Make a **Demand (Required)** – this is to exhaust administrative remedies
            1. Shareholder demands that the board take legal action
            2. BOD appoints a Special Litigation Committee to conduct an investigation on

the merits of the action in anticipation of asserting a BJR defense in future litigation (if they do not appoint a committee they weaken their defense of the BJR)

3. Committee more likely than not determines no action should be taken
4. Shareholder sues claiming breach of fiduciary duty
5. Board then seeks dismissal. Court applies the BJR rule, which is a rebuttable presumption that the business judgment of the corporation not to assert action is sound.
6. Court usually finds for the corporation b/c of the shareholder's lack of ability to obtain specific information required to overcome the rebuttable presumption. Because this is a motion to dismiss discovery has not begun therefore information is difficult to obtain

b. Exception to Demand Requirement where the **Demand is Excused for Futility**

i. Shareholder sues (skips step a above)
ii. Board appoints Special Litigation Committee
iii. Corporate files a motion to dismiss on grounds of the Business Judgment Rule
iv. Court Applies the **Two-Step Modified Business Judgment Rule**:
    1. Court looks into the independence and good faith of the Committee and whether the committee used reasonable procedures in conducting its investigation
        a. **Burden is shifted to the corporation** to prove sound business judgment. (Takes away the rebuttable presumption.) This is the key difference to when demand is required
        b. If the court determines that the committee is not independent or has not shown a reasonable basis for its conclusions or is not done in good faith the court shall deny the corporation's motion and the case proceeds
        c. On the other hand, if the court is satisfied that there was in fact

independence and good faith then the court goes to step two below

2. Court applies its own independent business judgment (objective)
   a. **NOTE**: this second objective step is not granted to courts in NY like in Exxon v. Gall

4. **Aronson v. Lewis (1984)**, p. 721 - Π alleged Δ, a 47% shareholder of the corporation, had personally handpicked each of the directors, who had then approved a very generous retirement/consulting package for the Δ
   a. ***RULE***: Court must determine whether there is a reasonable doubt that the directors are
      i. disinterested and independent; and
      ii. the challenged transaction was otherwise the product of a valid exercise of business judgment
   b. A Π needs to allege facts with sufficient particularity to overcome the presumption of independence and a proper exercise of the Business Judgment Rule, in which case the directors could not be expected to sue themselves
   c. In determining whether the demand is futile, the court must determine whether under the **particularized facts alleged** a reasonable doubt is created that:
      i. The directors are disinterested and independent; **AND**
      ii. The challenged transaction was otherwise the product of a valid exercise of business judgment
   d. Π needs to allege some sort of direct self-interest of a director. This is not proven by the mere fact that a majority of directors voted to approve the transaction or by the mere threat of personal liability, but rather it is defined in terms that the director had a direct financial interest in the challenged transaction
   e. In a derivative lawsuit where the demand is not required and is futile, the Business Judgment Rule is modified and the burden is shifted to the corporation. The rebuttable presumption of the Business Judgment Rule is taken away from the Board of Directors
   f. You have to lay out the facts as to why the directors were bad actors. You have to substantiate your allegation with facts
   g. Court allowed the shareholder to amend his complaint in order to comply with FRCP Rule 23.1, p. 1073

5. **<u>Cuker v. Mikalauskas</u> – SOCIAL RESPONSIBILITY**

Shareholder was suing because the directors of the company were not collecting on overdue accounts. He wanted the company to cut off the utility service to those people who haven't paid. Company can't cut off power because they have a social responsibility to the community

a. ***RULE***:
    i. PA Court adopts the ALI rule. Demand is required, but there is an exception if there is an <u>*irreparable*</u> injury to the corporation
    ii. DGCL is different from the ALI Principles because they see a difference between futility and irreparable injury. The standards are different with regard to the demand requirement
    iii. DGCL law fails to provide a procedural framework for judicial review of corporate decisions under the BJR b/c they only require the courts to apply an independent business judgment rather than the ALI's § 7.10, p. 1158, which provides a detailed standard of judicial review

6. **Statutes and Common Law Rules Governing Derivative Lawsuits**

a. <u>DE Common Law</u>
    i. Demand is required in a stockholder derivative suit unless the Π can show beyond a reasonable doubt that demand would be futile. See <u>Zapata</u> and <u>Aronson</u>

b. <u>Standards for Derivative Action</u> - ALI § 7.02 – 7.13, p. 1152
    i. Standing to Commence and Maintain Derivative Actions – ALI § 7.02, p. 1152
        1. § 702(a) – Gives standing requirement for a shareholder
        2. § 702(b) – Allows a shareholder to intervene
        3. § 702(c) – Allows a director of a corporation to maintain a derivative action so long as they fairly and adequately represent the interest of the shareholders
    ii. Exhaustion of Intracorporate Remedies: The Demand Rule – ALI § 7.03, p. 1153
        1. § 7.03(a) – Requires demand unless excused under § 7.03(b)
        2. § 7.03(b) – Demand on the board **should be excused only if** the Π makes a specific showing that **irreparable injury** to the

corporation would otherwise result and demand should be made promptly after commencement of the action

a. Demand is excused upon a showing of irreparable injury of corp; after suit filed the Π then may make demand, but is not required to

c. Note: Distinguish from Delaware:
    i. Must demand unless you can show irreparable injury
    ii. Cannot be based futility like Delaware
d. Derivative Proceedings - RMBCA § 7.40, p. 632
    i. Demand RMBCA § 7.42, p. 633
        1. No shareholder may commence a derivative proceeding until:
            a. A written demand has been made upon the corporation to take suitable action; and
            b. **90 days have expired** from the date the demand was made **unless** the shareholder has earlier been notified that the **demand has been rejected or** unless **irreparable injury** to the corporation would result by waiting for the expiration of the 90 days
        2. Purpose –requiring demand eliminates the time and expense of the litigants and the court involved in litigating the question of whether demand is required
    ii. Dismissal – RMBCA § 7.44, p. 636
        1. A court shall dismiss by motion, if determined by the corporation's special committee in good faith and after having conducted a reasonable inquiry upon which its conclusions are based, that the derivative proceeding is not in the best interest of the corporation
        2. Similar to DE law except there always **must be demand**
    iii. ***NOTE***: There is no modified business judgment rule b/c there is no futility examination since demand is never excused

XVIII. DUTY OF LOYALTY AND CONFLICT OF INTEREST

A. Two Types of Fiduciary Duty:

1. **<u>Duty of Care</u>** –
    a. Business Judgment Rule - Duty to act in good faith prudently and responsibly.
        (1) If they acted with gross negligence then they are protected by the business judgment rule.
        (2) Pre-Trial/Motion for Summary Judgment – Could get rid of the lawsuit on the merits. This is where the committee determines whether the derivative lawsuit will be filed. Use either the Business Judgment Rule or the Modified Business Judgment Rule as a test for dismissing the case based on futility.
2. **<u>Duty of Loyalty</u>** – Putting the interests of the corporation and shareholders ahead of the personal interests of the director. Usually involves some type of cash or money.
    a. **Intrinsic Fairness Test** – Burden is on the directors to demonstrate that they acted fairly and that they didn't act to their own benefit where there was a conflict of interest with the company.
    b. **Self-Dealing** – the main way of proving a breach of duty of loyalty. Three conditions of self-dealing:
        (1) Key player and corporation are on opposite sides
        (2) Key player has helped influence the corporation's decision to enter the transaction
        (3) Key player's personal financial interests are at least potentially in conflict with the financial interest of the corporation, to such a degree that there is reason to doubt whether a key player is acting in the corporation's best interest
    c. Being on both ends of a business deal alone is not enough to constitute self-dealing
    d. There is an increased tolerance to **allow certain types of "self dealing"**:
        (1) When actions of director are fair
        (2) Even though the director receives profit, the corporation also receives profit
        (3) The only way the corporation can receive economic stimulus is through dealing with the director

B. Self-Dealing:

- Def. of Subordination - moving one creditor's priority below another's
- Self-dealing usually involves establishing a new company to lend money to your company, especially when you're lending money to a third corporation at a lower interest rate

1. **<u>Marciano v. Nakash</u> (1987),** p. 753 - The Ms and Ns were 50-50 owners of a corporation. They were deadlocked and thus filed for liquidation. The Ns had made a loan to the corporation and upon liquidation, the Ms attacked it saying that the Ns could not be on both sides of the deal as both shareholders and creditors. The Ms invoked the *per se* voidability for interested transactions under Delaware law and argue that the only way you could avoid *per se* voidability was to comply with DGCL

§ 144 statute. Trial court rejected the old common law *per se* voidability test and instead applied a new common law **intrinsic fairness test** and held for the Ns

a. ***RULE***: Applies the combination of DE statute § 144, p. 470 and the intrinsic fairness test
b. The court rejects the common law per se voidability rule (if you're on both sides of deal, it's void), but at the same time doesn't solely rely on the DE statute § 144 either, but rather integrates both the statute and common law rule – the intrinsic fairness test. This places the ***burden of proof on the directors***
c. **DGCL § 144** does not preempt the common law duty of director fidelity, but rather clarifies that duty of loyalty
d. **DGCL § 144(a)** – Interested Directors:
    (1) No K or transaction b/w a corporation and one or more of its directors or officers shall be void solely b/c of this reason or b/c the director or officer is present at or participates in a meeting of the board that authorizes the K or solely b/c the directors or officers votes are counted for such purposes.
    (2) Three safe harbor (immunization) categories:
        (a) Material facts disclosed and known and approved
        (b) Material facts disclosed and known to shareholders
        (c) Transaction is fair when made.

2. **Disinterested v. Uninterested Parties**
    a. Uninterested – doesn't care either way
    b. Disinterested – a party, which didn't realize there was a problem; doesn't have a financial interest in this deal so he can vote with impartiality.

3. **Fundamental Elements of the Fiduciary Duty Analysis** (regardless of how states present their analysis these 3 elements are always present):
    a. Full disclosure
    b. Disinterested approval
    c. Fairness

4. **Three Aspects of the Intrinsic Fairness Test which is used where there is Self-Dealing (Breach of Loyalty)**:
    a. Fair price
    b. Fair procedures
    c. Adequate disclosure

C. Self-Dealing - Executive Compensation:

1. <u>**Sinclair Oil Corp. v. Levien**</u> **(1971),** p. 773 - Sinclair owned 97% of his company's subsidiary, Sinven and forces them to pay out dividends in excess of Sinven's earnings. Minority stockholder of subsidiary sued claiming dividend policy violated Sinclair's fiduciary duty to Sinven. Minority stockholder claimed the following: 1) Caused the subsidiary to pay out dividends in excess of Siven's earnings; 2) That Sinclair's expansion policies didn't allow the subsidiary to pursue business opportunities; and 3) Breach of K – Sinclair was receiving a benefit from delaying the payments owed to the subsidiary.

a. ***RULE***:
   (1) A parent owes a fiduciary duty to its subsidiary when there are parent-subsidiary dealings. This alone will not invoke the intrinsic fairness test. The **intrinsic fairness will be applied only when the fiduciary duty is accompanied by self-dealing** – when a parent is on both sides of a transaction of a subsidiary.
   (2) Self-dealing is when a parent has received a benefit to the exclusion and at the expense of the subsidiary.
b. The basic situation for the application of the intrinsic fairness test is when the parent has received a benefit to the exclusion and at the expense of the subsidiary.
c. By using the intrinsic fairness test the court is placing the burden on the parent (the bad guy).
d. <u>First Claim</u> – No breach of loyalty b/c all shareholders benefited equally from dividends. Business Judgment Rule is applied.
e. <u>Second Claim</u> – No breach b/c there was no proof of usurping business opportunities from the subsidiary. Business Judgment Rule is applied.
f. <u>Third Claim</u> – There was a breach of K that was not enforced since the parent was on both sides of the K and this constitutes self-dealing and violates the Intrinsic Fairness Test.
g. This case shows that **a parent breaches a fiduciary duty of loyalty of a subsidiary when the parent receives opportunities disproportionate to its interest**

2. **<u>Weinberger v. UOP, Inc.</u> (1983),** p. 778 - Signal owned 50.5% of UOP, with the balance owned by public shareholders. 4 key directors of UOP were also directors to Signal and owed their primary loyalty to Signal. Two of these directors did a feasibility study, which concluded that anything up to $24/share would be a fair price for Signal to acquire the balance of the UOP shares. Signal eventually offered to buyout the UOP minority holders for just $21/share. This price was based on a hurriedly-prepared fairness opinion by UOP's investment bankers. UOP's BOD approved the $21/share price, but there was never any real negotiation b/w Singal and UOP on this price and the non-Signal affiliated UOP directors were never shown or told about the feasibility study indicating the $24 as a fair price. The acquisition by Signal of the non-Signal owned share at $21 (by means of a **cashout merger**) was approved by a majority of the UOP shareholders, including a bare majority of the minority UOP shareholders. The merger was consummated, and some minority UOP stockholders who opposed the transaction (or at least the price paid by Signal for the shares) brought a class action for damages based on the transactions alleged unfairness.
   a. ***RULE***: Individuals who act in a dual capacity as directors of two corporations, one being the parent and the other a subsidiary, hold the same duty of loyalty to both corporations and in the absence of negotiating structure or total abstention from any participation in this matter the director must exercise this duty based upon fairness in terms of fair dealing and fair price (Note that the test for fairness is not bifurcated but rather examined as a whole).

b. Relevant factors that relate to the fairness aspect of proposed mergers include the following: assets, market value, earnings, future prospects and any other elements that affect the intrinsic value of the stock.
c. Proponents of the transaction have burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny of the courts.
d. Breach of the duty of loyalty usually involves cash – in this case the $21 price verses the $24 price saved the parent $17 million in the cashout merger.
    - ***Cash-out Merger***: when a parent corporation owning more than 50% of the stock of subsidiary corporation compels the minority shareholders of the subsidiary to accept cash for their shares in an amount determined by the parent.
e. **Delaware Intrinsic Fairness Test**:
    (1) Fair Dealing – Deals with the questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to directors, and how the approvals of the directors and the stockholders were obtained. Three elements are at the heart of the duty of fairness analysis:
        (a) Disclosure
        (b) Disinterested Approval
        (c) Fairness
    (2) Fair Price – Economic and financial considerations of the proposed merger, including assets, market value, earnings, future prospects, and other elements that affect the inherent value of the stock.

3. Key Facts to Look for with Regards to Parent-Subsidiary Dealings:
a. Directors serving on the board of both the parent and subsidiary
b. Process done hastily and with little to no outside advice
c. Fixes a share price
d. Parent receives a substantial financial benefit at the expense of the subsidiary

D. Corporate Opportunity

- Court recognizes that opportunities are important and they belong to the company per a fiduciary. The rule states that the fiduciary may not use what he/she learns from the business and harm the company with it.
- This may apply in an instance where on quitting the company and has gone on and goes back to get clients from the old company.
- There is a tension going on, and a conflict in these interests.

1. **Northeast Harbor Golf Club (1995**), p. 794 - President of a golf club bought several plots of land adjoining the golf club. The President learned that the properties were available from a listing broker who contacted the president believing the corporation would be interested in buying the property to prevent the development. The BOD occasionally discussed the development of the golf club, but normally shied away from it. After President bought the properties, she would tell the board that she had purchased them. Each piece of property was bought in piecemeal and they were told each time. President says she is buying the property to prevent development, but later

she decided to develop it. BOD filed suit to prevent the President from developing the property.

a. ***RULE***: Corporate fiduciaries must disclose and not withhold relevant information concerning any potential conflict of interest with the corporation, and must refrain from using their position, influence or knowledge of the affairs of the corporation to gain personal advantage.
b. Court **rejects the *line of business test*** (if there is presented to a corporate officer a business opportunity which the corporation is financially able to undertake, in the line of the corporation's business, is of practical advantage to it, is one in which the corporation has an interest or expectancy, the law will not permit the corporate officer to seize the opportunity for themselves) because:
   1) It is difficult to determine what activities are in the line of business.
   2) Financial ability should not be part of the test because it favors the company insider who has information relating to the finances of the corporation.
c. Court adopts the ALI doctrine, which emphasizes full disclosure and uses a much broader definition in what constitutes corporate responsibility. Court finds this to be the most fair and open process.
d. **ALI §5.05**, p. 1140 - **"Taking of Corporate Opportunities by Directors or Senior Executives"**
   (1) A director may not take advantage of a corporate opportunity unless:
      (a) He first offers that opportunity to the corporation and makes disclosure concerning a conflict of interest and the corporate opportunity; **AND**
      (b) The corporate opportunity is rejected; **AND**
      (c) Either:
         (i) The rejection by the corporation is fair; and
         (ii) The opportunity is rejected by a disinterested director or satisfies the BJR; or
         (iii) It is rejected by disinterested shareholders
   (2) Corporate opportunity means the director becomes aware of the opportunity either through a connection with the performance of functions as director or through the use of corporate information.
   (3) *Burden of proof* is on the person challenging the corporate opportunity – ALI **§ 505(c)**, p. 1141
   (4) Under the ALI standard the director (always) first offers the corporate opportunity to the corporation and makes disclosure of the conflict of interest and the corporation must reject by a vote of disinterested directors the opportunity in order for the director to avoid the corporate opportunity doctrine.

XIX. TRANSACTIONS IN SHARES

A. Rule 10b-5 – Manipulative and Deceptive Devices and Contrivances (p. 1524)

1. **Generally**
   a. Developed under the 1934 Securities Act.
   b. Anti-fraud provision which is to help make sure that there are proper actions in the market in regard to the issuance and trading of securities.
   c. Derived from common law fraud and breach of duty principles.
   d. **Required Elements** for a Cause of Action under Rule 10b-5:
      1) Applies to securities of PUBLIC and PRIVATE companies (Kardon).
      2) Implies a private right of action to sue (Kardon)
      3) To have standing must be a purchaser or seller of securities (Bluechip Stamps)
      4) Scienter requirement (i.e. fraud, misrepresentation, causation, etc.) (Ernst & Ernst)
      5) Rule 10B-5 liability is not equal to state fiduciary duty law (Santa Fe Industries)

2. **Rule 10b-5 - "Employment of Manipulative and Deceptive Devices"** p. 1524.
   "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ a device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act practice, or course of business which operates or would operate as a fraud or deceit upon any person, **in connection with the PURCHASE OR SALE OF ANY SECURITY**."

3. **Example**: Two people own a corporation own 50% of the stock each. One of the owners is asked how much they paid per share when they opened. Estimated at $10/share, now valued at $20/share. Outsider offers $50/share, but they want to own all 100% of the stock in the company. This shareholder goes and offers to buy his shares for $25/share. Other partner agrees and pays by check. Then the original shareholder sells 100% of the stock to the outsider for $50/share. Old partner finds out what went on and sues under Rule 10b-5. Deceiving shareholder files a motion to dismiss claiming that this is a private company. How can this company come under the Securities Act? **Rule 10b-5 applies to the purchase or sale of ANY security**.

4. **Kardon v. National Gypsum Co. (1947),** p.912 - 50/50 split of stock in private ownership of company. Kardon and Slavin each own 50% of the stock in the Western Bd. Co. and Michigan Paper Co., a closely held corporation. Slavin agreed to sell a portion of the corporation (Western) to National Gypsum for $1.5 million. Slavin purchases all the stock that Kardon has in the two corporations, for $504,000. Slavin does not disclose to the Kardon's his negotiations with National Gypsum.

a. ***RULE***:
   (1) While Rule 10b-5 does not provide in express terms a remedy, the existence of a remedy is implicit under general principles of law and applies to closely held corporations.
   (2) Rule 10b-5 applies to private/closely held corporations as well as publicly-held corps.
b. This creates/Court implied a **private right of action**, which creates federal subject matter jurisdiction. Rule 10-B created an exception by Congress.
c. No later Supreme Court case has limited the availability of the rule.

5. **<u>Blue Chip Stamps v. Manor Drug Stores</u> (1975**), p. 915 – **Purchaser seller rule**
First case in which the Supreme Court started interpreting the Rule 10b-5 statute more narrowly. A person who was offered an opportunity to purchase securities, but failed to do so because of materially misleading and overly pessimistic statements in the prospectus tried to sue under Rule 10b-5.
   a. ***RULE***: Πs in Rule 10b-5 suits should be **limited to actual purchasers and sellers** of securities at the time of sale (Birnbaum Rule).
   b. This case establishes standing.
   c. If not limited to actual buyers and sellers, it would create problems of proof because of uncorroborated oral evidence.

6. <u>Ernst & Ernst v. Hochfelder</u> (1976), p. 922 - E&E is an accounting firm that was retained by First Securities Company to perform audit of the firm's books and records. E&E would prepare all the filing forms under the 1934 Act. Hochfelder and others invested in fraudulent securities perpetrated by the president of First Securities who later committed suicide. *Illegal escrow* accounts were not reflected on the filings. After suicide, it was discovered that First Securities were bankrupt, and the Πs filed suit against E&E alleging 10b-5 violations through aiding and abetting first securities president by E&E's failure to provide adequate audits. Hochfelder stipulated that E&E were negligent. Why would they concede the lack of scienter? So they can get money from the insurance company who will not pay outside the realm of negligence.
   a. ***RULE***: Rule 10b-5 connotes intentional or willful conduct designed to defraud investors. Rule 10b-5 does not extend to negligent conduct, but rather requires that **scienter** be found or else the case will be dismissed.
   b. President conducted this activity from 1942-1966➔ "That is too long to be that dumb." – Perry Wallace
      c. You got to prove more than "oops." Not just negligence but **knowing or intentional misconduct.**
      d. **Common law elements are part of the test as are the scienter issue.**

7. **<u>Santa Fe Indus., Inc. v. Green</u> (1992),** p. 827 - There was a **short form cash-out merger** in Delaware allowing a company that owns 90% or more of a company to effectuate a merger transaction without first securing a minority shareholder's approval. Under this short form merger, all a company needs to do is notify the

minority within 10 days. Rather than pursuing their appraisal remedy, minority shareholders sought to set aside the merger, claiming that the majority had breached their fiduciary duty of loyalty and violated Rule 10b-5 (because they felt the price was unfairly low).

a. ***RULE***: As long as there was no omission or misstatement in the information given to the minority shareholders there is no fraud, and thus no Rule 10b-5 violation. You **have to show manipulation or deception within the meaning of Rule 10b-5**.
b. Because they disclosed everything, even though it was not necessarily fair, it was not manipulative or deceptive.
c. The fundamental purpose of the act was to implement full disclosure, and once full disclosure has occurred, the fairness of the terms of the transaction a tangential concern of the statuary.
d. Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.
e. ***What would make for a cause of action under state fiduciary law may not qualify as a case under (federal) Rule 10b-5.*** They do overlap though so in some cases you might have two claims.

B. Insider Trading

1. **Generally**:
   a. A person engages in insider trading if he buys or sells stock in a publicly traded company based on **material non-public information** about the company.
   b. Inside Trader is trying to gain a certain advantage that the law feels is unfair. Thus, if the information is public, then it really is of no use to the inside trader anymore.
   c. Insider Trading is **just one kind of Rule 10b-5 violation**.
   d. ***Insider*** - one who obtains information by *virtue of his employment* whose stock he trades in. It may include any employee, even temporary one, such as a consultant, attorney, accountant, investment banker, or other temporary fiduciaries.
   e. Defense to Insider Trading is that you haven't made out all the elements that are listed under Rule 10b-5.
   f. **NOTE** – cases are very important here, cite to them!

2. **Traditional (classic) Theory of Insider Trading**
   a. Company has insiders who have access to important information as to the future of their company which may reflect in the future value of the shares
   b. Insiders have duty of Trust and Confidence (fiduciary) **to the company**

   b. **<u>SEC v. Texas Gulf Suphur Co.</u>** (1968), p. 837 - Tex Gulf after conducting some geological surveys, determines that it is on the brink of finding a huge ore deposits. Company insiders with knowledge of the upcoming ore find purchase

stocks and stock calls in Tex Gulf. Purchase represented a dramatic increase in their holdings. They made a shit load of money.

(1) ***Rule***: Anyone in possession of material information must either disclose it to the investing public or if he is disabled from disclosing it or chooses not to, he must abstain from trading or recommending the securities. The information must be effectively disclosed in a sufficient manner to insure its availability to the general public.

(2) They violated Rule 10b-5 as well as the duty of loyalty.

(3) An insider's duty to disclose information or to abstain from dealing in company securities arises only in those situations which are essentially extra ordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if the extra-ordinarily significance.

c. **<u>Chiarella v. United States</u> (1980),** p. 947 - Potential hostile takeover. The takeover documents are sent to an outside printing company. An employee decodes what is about to happen from the documents about to be printed. Based upon this information he buys and trades a security, making $30,000 plus. Indicted on 17 counts.

(1) ***RULE***: You need to be an insider of the company whose securities are being traded (**old rule**).

(2) Commission emphasized that the fiduciary duty arises from the existence from a relationship affording access to insider information to be only available for a corporate purpose and the unfairness of allowing a corporate insider to take advantage of their position in the corporation.

(3) Supreme Court **followed the Classic Theory of Insider Trading** and reversed the printer's conviction because he was not an insider.

(4) Social issues that he was a minimum wage printer, not a big-wig corporate insider

(5) **<u>Dissent</u>** (Burger): Identifies the misappropriation rule described below expanding the reach beyond insiders.

(6) In order to be liable for insider trading, you must have a relationship based upon trust and confidence with the company whose stocks are being traded (i.e. a fiduciary duty to that company).

d. **<u>Charpenter v. United States</u> (1987),** p. 857.

(1) Wall Street J. reporter who starts getting information for his articles.

(2) Starts giving early information to his friend.

(3) Don't convict him under Rule 10b-5, instead he gets convicted under federal mail & wire fraud statutes.

(4) Before SEA Rule 14e-3 in O'Hagen, you could be prosecuted on mail and wire fraud if you were not an insider. This was their only option b/c <u>Chiarella</u> limited prosecutions to insiders.

3. Misappropriation Theory

(a) General:

(1) Requires a relationship based upon trust or confidence (fiduciary duty) ***to the source of the information*** and not to the company
(2) This is a broader theory than the classical/traditional theory—applies to classical/traditional insider trading scenarios as well as settings in which information is obtained by outside sources
(3) The holdings in <u>Chiarella</u> and <u>Texas Sulfur</u> fueled insider trading in M&A situation
(4) These cases show how the Supreme Court had impaired the SEC's enforcement tool by limiting insider trading to certain relationships
(5) As a result the SEC promulgated Rule 14e-3

(b) SEA Rule 14e-3, p. 1615
(1) Imposes a duty of disclosure on any person who trades in securities being sought in a tender offer (T.O.) while in possession of material information which he knows or has reason to know is non-public and has been acquired in some manner from the issuer; or to abstain from trading
(2) This is a specific duty to abstain or disclose from trading without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information (<u>Chestman</u>)
(i) **Disclosure** – means to the entire public, and not just to the seller
(ii) **Tender Offers** – mergers and acquisitions
(3) Narrower than Rule 10b-5 (in subject matter) - **limits insider trading only in the context of tender offer**
(4) Broader than Rule 10b-5 because it does not impose a fiduciary duty requirement
(5) Tender Offer is a public offer made by an acquiring company to the shareholders to put forth their shares of stock to be purchased by that company for a certain amount of money.

c. **<u>United States v. O'Hagen</u> (1997),** p. 958- O'Hagen was an attorney with a firm which was handling a hostile take-over. O'Hagen had previously embezzled money, and decided to use inside information regarding the hostile take-over as a means of recouping the client funds that he had embezzled. He made $4.3 million, the SEC got suspicious and prosecuted
(1) ***RULE***:
- A person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, is guilty of violating Rule 10b-5
- Rule 10b-5 liability can be based upon the misappropriation of confidential information from a person other than the issuer
- The SEC did not exceed its rule-making authority by adopting Rule 14e-3(a) which proscribes trading on undisclosed information in the tender offer setting, even in the absence of a duty to disclose

(2) Significance of this case is that the **Supreme Court adopts Misappropriation Theory**
(3) There are actually **Two Theories of Misappropriation**

(a) Rule 10b-5
(b) Rule 14e-3
(4) The misappropriation at issue in this case was properly made the subject of a SEA § 10(b) charge because it meets the statutory requirement that there be *deceptive conduct in connection* with securities transactions
(5) Court found Rule 14e-3(a) to be a means reasonably designed to prevent fraudulent trading on material, non-public information in the tender offer context, and gave great deference to the SEC's rule because Congress authorized the SEC to promulgate Rule 14e-3
(6) The Court also found that the defendant violated Rule 14e-3 and mail-fraud laws

d. **Hypothetical**: Thief breaks into corporate building and steals confidential information which will have bearing on future stock values. He uses it to invest and make a profit.
(1) Under Chiarella and O'Hagen (Rule 10b-5): Thief is not liable for insider trading
(2) Under Rule 14e-3 (assuming a tender offer is involved): Thief is liable because of the lack of a fiduciary duty requirement

e. **Dirks v. SEC (1983),** p. 873 - Dirks, a stockbroker, got information from a former officer of a corporation, stating that the company was "full of crooks" and that when the hidden financial fraud was finally discovered and disclosed the value of the corporation's stock would plummet. Dirks tried to inform the SEC, the Wall Street Journal, etc., but no one responded. Dirks then told his clients who sell off their stock in the company. California finally discovers the fraud and the corporation is put into receivership. Then it comes out that Dirks has informed the SEC who had not acted, so the SEC goes after Dirks for insider trading for receiving a tip and passing it on.
(1) ***RULE***: A **tippee** can be liable, but first the tippee's liability must be derivative from the tipper
(2) Tipper liability exists when:
(a) The Insider (tipper) breached a fiduciary duty; AND
(b) The tippee knew or should have known that a breach was going on; AND
(c) The Insider (tipper) was receiving some sort of personal benefit (not necessarily financial in nature)
(3) The classical theory not only applies to insiders of a corporation but also to others who temporarily become fiduciaries of the corporation
(4) The Court found no breach of fiduciary duty here because as a tipper, Dirks' friend received no monetary or personal benefit for revealing the secrets and was motivated by a desire to expose the fraud. Failed the third prong of the test. This rule does not apply to the tippee.
(5) The Court focuses on **objective** criteria when determining whether the insider receives a direct or indirect personal benefit from the disclosure.

f. **<u>United States v. Chestman</u> (1991),** p. 881 - Controlling Shareholder of Walbaums told his sister about a future buyout by A&P, who tells daughter, who tells husband, who goes to his broker.

(1) ***RULE***: Although spouses, who by their conduct may become fiduciaries, the marriage relationship alone does not impose fiduciary status. More than a gratuitous divulgence of a secret to another who happens to be a family member is required to establish a fiduciary relationship of trust and confidence. **SEC HAS CHANGED RULE** (see below)

(2) Because no fiduciary relationship could be established, no Rule 10b-5 violations occurred

(3) **Note** <u>Reed</u> (which the court cited):

(a) Dependency and influence are necessary factual prerequisites to a relationship of trust and confidence (fiduciary duty)

(b) The repeated disclosure of business secrets between family members may substitute for a factual finding of dependence and influence and thereby sustain a finding of the functional equivalent of a fiduciary relationship

g. **POST-<u>Chestman</u> SEC RULE 10b-5(2)**

Now there is a rebuttable presumption that a duty exists BETWEEN A HUSBAND AND SPOUSE...so rebuttable presumption that wife has duty to the company.

g. **Hypothetical**: Directors (insiders) found out some information and make trades based on that information. These insiders are fiduciaries as well. They are engaged in self-dealing. So the shareholder can sue the Insiders in federal court: Under Rule 10b-5 and the breach of duty of care.