Table of Contents

I. Sole proprietorships 7

II. Agency 7

A. Forming an agency relationship 7

B. Principal’s liability for the authorized acts of the agent 8

1. Actual authority 8

2. Determining the scope of actual authority 8

3. Apparent authority 9

C. Principal’s liability for the agent’s unauthorized acts 9

1. Ratification 9

2. Estoppel 9

III. Entities 10

A. Sole proprietorship 10

B. Partnership 10

1. Termination of the partnership 10

2. Limited partnership 11

3. Limited liability partnership (LLP) 12

C. Limited Liability Company (LLC) 12

D. Corporation 12

IV. Corporation Law in General 13

A. Sources of Law 13

1. State corporation statutes 13

2. Federal statutes 13

3. Stock Exchange listing standards 14

4. State securities laws 14

B. Functional Classification of Corporations 14

1. Closely held corporations 14

2. Publicly held corporations 14

3. Significance of the distinction 14

C. Alternatives to the Corporation 15

V. Forming a Corporation 15

A. State of Incorporation 15

B. Documents Filed in the Office of the Secretary of State 16

C. Articles of Incorporation 16

1. Mandatory requirements 16

2. Discretionary provisions 16

3. Name 16

4. Duration 17

5. Purpose 17

6. Authorized shares 17

7. Registered office and agent 17

D. Completing Formation 17

E. Initial Capitalization 18

1. Current trend 18

2. Failure to meet minimum initial capital requirements 18

F. Bylaws 19

G. Corporate Powers 19

1. Enumerated powers 19

2. Acts in excess of powers 19

VI. Pre-incorporation Transactions 19

A. Promoters 19

B. Promoter Contracts 20

1. Contracts in the name of a corporation to be formed 20

2. Contracts in the corporate name 20

3. Liability of corporation on promoter’s contracts 21

C. Fiduciary Duties 22

1. To corporation 22

2. To fellow promoters 22

3. To subsequent investors 22

VII. Piercing the Corporate Veil 22

A. General Considerations 22

1. Nature of liability 22

2. Publicly held and closely held corporations 23

3. Inactive stockholders 23

B. Factors to consider 24

C. Legal Tests 25

1. Alter ego and instrumentality 25

2. Misrepresentation and fraud 25

3. Personal guarantee 25

4. Undercapitalization 25

5. Operation on the edge of insolvency 26

6. Commingling and confusion 26

7. Artificial division of business entity 26

8. Mere continuation 26

9. Failure to follow corporate formalities 27

D. Liability of Parent for Obligations of Subsidiary 27

1. Confusion of affairs 27

E. Alternative to Piercing 27

F. Successor Liability 27

1. Tests for successor liability 27

2. De facto merger 28

VIII. Corporate Finance 28

A. Shares and Stock 29

1. Common stock 29

2. Preferred stock 29

3. Authorized shares 29

4. Issued shares 29

5. Par value and stated capital 29

6. Book value of outstanding shares 30

B. Common Stock 30

C. Preferred Stock 30

1. Distributions 30

2. Other features 31

3. Preferred issued in series 31

4. Alteration of rights 31

D. Issuing Shares Under the Model Act 31

1. Amount of consideration 32

E. Issuing Shares in Par Value States 32

1. Par value 32

F. Permissible Consideration 32

G. Watered Stock 32

H. Issuance of Shares by a Going Concern 33

1. Preemptive rights 33

2. Fiduciary Restrictions on Oppressive Issuance of Shares 34

I. Thin Incorporation and Subordination 34

IX. Corporate Governance 35

A. Statutory Scheme in General 35

1. Stockholders 35

2. Directors 35

3. Officers 36

B. Stockholder Meetings & Voting 36

C. Quorum and Voting Requirements 36

1. Quorum requirements 36

2. Shares entitled to vote and class voting 37

3. Vote required 37

4. Action by majority consent 38

5. Multiple or fractional votes per share 38

D. Amendments to the Articles of Incorporation 38

E. Amendments to the Bylaws 38

F. Elections of Directors 38

G. Proxy Voting 40

H. Stockholder Voting Agreements 40

1. Formal requirements 40

2. Enforcement of voting agreements 41

I. Voting Trusts 41

J. Classes of Shares 42

X. Fiduciary Duties of Directors, Officers, & Stockholders 42

A. Duties in General 42

1. Directors 42

2. Officers and agents 42

3. Stockholders 43

B. Duty of Care 43

1. General tests 43

2. Business judgment rule 43

3. Reliance on experts and committees 44

*4.* *Smith v. Van Gorkon* 44

5. Director liability statutes 44

C. Duty of Loyalty 45

1. In general 45

2. Self-dealing 46

D. Good Faith 47

E. Corporate Opportunities 47

1. What is a corporate opportunity? 48

2. Rejection of a corporate opportunity 49

3. Inability or incapacity of corporation 50

F. Competition with the Corporation 50

G. Executive Compensation 50

1. Test for excessive compensation 50

2. Compensation based on stock performance 50

H. Controlling Shareholders 50

1. Sale of control 51

XI. Corporate Authority 52

A. Functions and authority of shareholders 52

1. Scope of shareholders’ powers 52

2. Exercise of shareholders’ voting rights 53

B. Functions and authority of directors 55

1. Source of directors’ authority and powers 55

2. How boards function 56

C. Functions and authority of officers 56

1. President 57

2. Chair of the board 58

3. Vice president 58

4. Secretary 59

5. Treasurer 60

XII. Shareholder Derivative Litigation 60

A. Derivative actions generally 60

1. Derivative claims and creditors 61

B. Distinguishing derivative actions and direct actions 61

C. Prerequisites for maintaining derivative action 61

1. Demand on the corporation or board of directors 61

2. Contemporaneous ownership 62

D. Defending a derivative action 62

1. Dismissal by the corporation 63

E. Alternative dispute resolution 64

F. Indemnification generally 65

G. D & O liability insurance 66

1. Policy Exceptions 66

XIII. Proxy Regulation 66

A. False and misleading statements in proxy communications 66

1. Private cause of action 66

2. Materiality 66

3. Shareholders’ Proposals 68

B. Proxy contests 69

XIV. Securities Fraud & Insider Trading 69

A. State Insider trading 69

1. Majority 70

2. Minority 70

B. Federal Law and Rule 10b-5 70

1. Materiality: reliance 70

2. “In connection with” requirement 71

3. Standing 72

4. Scienter 72

C. Insider Trading 73

D. Section 16 of Securities Exchange Act – disgorgement of “short-swing” profits 74

1. Four main points 75

2. Comparison to Rule 10(b)(5) 76

3. Who is an “officer”? 76

4. Deputization 76

5. Beneficial Ownership 77

# Sole proprietorships

The sole proprietorship is the most popular business organization from in the US, particularly for small start-up ventures.

A sole proprietorship is a business owned directly by one person who has sole decision-making authority, an exclusive claim to business profits, and direct ownership of all business assets. A sole proprietorship having employees is a business organization. Although there is only one owner, the organization is comprised of more than one person.

Since the legal identity of the sole proprietorship and its owner are one and the same, there is no business entity to form. Equally important, no formalities are required to operate the business – this translates into a direct cost-saving for the business owner. The absence of legal requirements gives the owner maximum flexibility in structuring and operating the business.

The sole proprietorship suffers from serious disadvantages: (1) its single owner management structure is suitable only for small businesses with a few employees; and (2) there is unlimited liability of the owner of the company’s obligations. In a business in which the owner is the sole decision-maker and worker, unlimited liability is not much of a detriment if the owner’s main fear is tort liability because tortfeasors can always be sued in their individual capacity. As the operation of the business becomes complex, with a broad array of managers and workers, the sole proprietor becomes subject to an expanding risk of vicarious liability for the acts of others. In some circumstances, the risk of responsibility for the acts of others can be significantly reduced by insurance or through contract.

# Agency

## Forming an agency relationship

Agency law creates a standard form contract that applies to the members of business associations and to their interactions with third parties. When a company employs another person to act on the company’s behalf, the common law of agency applies to the relationship. The company is the principal, on whose behalf the action is to be taken. The person acting on the behalf of the principal is the agent.

Employers and employees may enter into a principal/agent relationship. So may people who have independent businesses, as for example, attorneys and their clients. An agency relationship may be created expressly by an agreement between the parties or may arise as a matter of law when the parties enter into an association that has the legal attributes of an agency relationship.

## Principal’s liability for the authorized acts of the agent

A principal is liable for authorized acts of the agent. Thus, in order to prevail in a claim a principal, a plaintiff must establish that the agent was authorized to engage in the conduct in question. A principal will be liable if the agent had actual or apparent authority. The creation of both types of authority originates with the principal. ***Actual authority is created by the principal’s manifestations to the agent. Apparent authority is created by the principal’s manifestations to a third-party.***

### Actual authority

Restatement (Third) of Agency (§2.01) – ***an agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal’s manifestations to the agent, that the principal wishes the agent so to act***.

### Determining the scope of actual authority

The terms “express authority” and “implied authority” refer to the manner in which the agent’s authority is created.

* ***Express authority*** refers to authority created by the principal’s oral or written communications to the agent concerning the scope of the agent’s authority.
* ***“Implied authority”*** refers to the scope of the agent’s authority as determined by the principal’s conduct, acquiescence, or other related circumstances.
* ***“Incidental authority”*** commonly means that the agent has the authority to do whatever is required and appropriate in the usual course to accomplish the agent’s responsibilities.
* If a principal’s manifestation to an agent expresses the principal’s wish that something be done, it is natural to assume that the principal wishes, as an incidental matter, that the agent take the steps necessary and that the agent proceed in the usual and ordinary way.
* *Koval & Koval v. Simon Telelect, Inc.*
  + The issue was whether, in the context of an ADR proceeding, an attorney's settlement of a claim without the clients consent was binding on the client.
  + ***General rule in Indiana is that the retention of an attorney does not without more carry implied authority to the attorney to settle***.

### Apparent authority

As a general rule, if an agency relationship exists and the agent’s acts were authorized by the principal, third parties who have dealt with the agent may hold the principal liable for the agent’s act. The principal may establish the agent’s authority by communicating with the agent directly (actual authority), by communicating with the third party dealing with the agent (apparent authority) or both.

* *Fennel v. TLB Kent Co.*
* The issue was whether an attorney’s apparent authority in making a settlement precluded the client from backing out of settlement and getting case back on court calendar. The court held there is no apparent authority for attorney to agree to settlement
* ***Rule: A client does not create apparent authority for his attorney to settle a case merely by retaining the attorney.***

## Principal’s liability for the agent’s unauthorized acts

Agency law has developed doctrines that apply when a third party has been harmed by an agent’s unauthorized acts. Depending on the circumstances, an aggrieved person may base recovery on theories of ratification or estoppel.

### Ratification

Ratification occurs when the principal accepts the conduct of the agent, even if the conduct exceeds what the principal authorized the agent to do. ***The sole requirement for ratification is a manifestation of assent or other conduct indicative of consent by the principal***.

Example: principal tells agent to buy a basic phone (~$50) but comes back with a smart phone (~$600). The principal ratifies the action by keeping the phone. *This may also include ratifying the hiring of an employee*.

### Estoppel

A principal may be estopped from denying the existence of an agency relationship if the principal caused a third party to believe that an unauthorized act was done on behalf of the principal and the third party detrimentally relied on that understanding.

Estoppel differs from apparent authority:

* Apparent authority is used to impose liability on a principal by establishing that an agent’s act was authorized
* Estoppel is used when the agent’s act was response for inducing the third party’s detrimental reliance based on an incorrect understanding that the act in question was done on behalf of the principal.

# Entities

## Sole proprietorship

* Liability: unlimited
* Transferability: may sell assets but may not sell the “goodwill” of your business
* Lifespan: terminates when the owner dies, becomes incapacitated, or goes bankrupt.
* Management: based on the owner’s will (Han says don’t forget the spouse).
* Tax: taxed as ordinary income on personal filings
* Cost/time of formation: no formalities (but some may be implied by law – what?)
* Profit and loss distribution: all to sole proprietor

## Partnership

***Just need an intent to share profits in the venture***.

* Liability: joint and several liability, unlimited
* Transferability: requires unanimous consent of all partners; however, may assign profits without consent
* Lifespan: partnership dissolves upon the death, incapacity, bankruptcy of *a single partner*,or by express intent. *Under RUPA*, a partner can disassociate without dissolving partnership (the law under which the partnership was formed is the law that is governs, if re-formed under RUPA, then RUPA governs).
* Management: each partner has a vote per capita, majority rule unless otherwise specified
* Tax: partnership itself pays no taxes; however, the percentage each partner makes is added to their personal income so taxes depend on each partner’s income.
* Cost/time of formation: no formalities (but may be expensive to write up agreement as there each is individualized, no set template).
* Profit and loss distribution: profits/losses are divided equally among every partner unless otherwise specified. Profits may be assigned

### Termination of the partnership

* Disassociation: withdrawal of a partner; remaining partners have the option of continuing the partnership; withdrawing partner has the right to be paid his interest in partnership (pertains to the partner’s estate when a partner dies)
* Dissolution: occurs when the partners decide or are forced to close down the partnership entirely. Once dissolution begins, the partnership continues only for the purpose of concluding business.
* Winding up: this refers to the process of closing down the business. During this time, the partnership concludes work in progress and proceeds to sell partnership assets to pay creditors and distribute the net balance, if any, according to the partners’ respective interests.

#### Asset distribution

At the dissolution of a corporation, its assets are distributed in the following priority. First, secured creditors are paid to the extent their obligations are secured. Second, unsecured creditors are paid (if a secured creditor’s collateral is insufficient to satisfy the obligation owed, she becomes an unsecured creditor for the balance). Third, preferred shareholders are paid in accordance with their rights and preferences. Finally, the other shareholders receive whatever remains.

* *Mienhard v. Salmon*
* Co-venturer signed a new lease upon the termination of their current lease, without including partner. Court found this inequitable and in violation of partner’s fiduciary duty to the other. Remedy was to divide the new lease in half and include both partners.
* ***RULE: Partners owe a fiduciary duty to each other; standard: utmost good faith (very high).***
* *Casey v. Chapman*
* Rule: a winning bidder at a UCC foreclosure sale of a partnership only receives the profits allocable to the partnership interest, not the voting rights.

### Limited partnership

* Liability:
* General partner: (those with control), unlimited liability
* Limited partner: (those without control), limited to the extent they contributed capital to the partnership, there may be a “safe harbor” under RUPA 303
* NOTE: liability may be limited by agreement (*McConnell v. Hunt Sports*)
  + - Note: the old rule stated if LP acted as GP and took control, they became unlimitedly liable, the new rule states there is no conversion
* Transferability: a GP’s interest is not transferable unless all other GPs and LPs agree. A LP’s interest (profit/loss) may be assigned *or* publicly traded.
* Lifespan: the limited partnership dissolves through agreement, or death, incapacity, or bankruptcy of the GP(s). Changes in the LPs do not impact the partnership unless the GP is the LP.
* Management: the GP manages ordinary matters, an LP may vote on certain things
* Tax:
* Cost/time of formation: must file with Secretary of State
* Profit and loss distribution: determined by agreement, usually GP(s) take a percentage and the LP(s) share based on capital contribution

### Limited liability partnership (LLP)

Note: the LLP is deemed to be a citizen of each state of which a partner is a citizen

Votes regarding partnership business is divided *per capita* (one each) unless otherwise specified.

* Liability
* Transferability
* Lifespan
* Management
* Tax: may elect to be taxed as either a corporation or as a partnership
* Is the above correct?
* Cost/time of formation
* Profit and loss distribution

## Limited Liability Company (LLC)

* Liability: limited, unless piercing occurs
* Transferability: may assign income to creditors, shares may be publicly traded
* Lifespan: stated in the Articles of Incorporation; may be for a specified duration or unlimited duration
* Management: may be (1) member managed or (2) manager managed. If member managed, members treated as partners (agents of the LLC) and LLC treated as partnership.
* Tax: when forming the LLC, founders may elect to be taxed as a partnership or as a corporation.
* ***NOTE***: if LLC is publicly traded, it ***must*** be taxed as a corporation
* Cost/time of formation: must file a certificate of organization with the Secretary of State; now single member LLCs possible in some states
* Profit and loss distribution: usually based on agreement but may be equally split among members; default is by percentage of LLC each member holds

## Corporation

* Liability: unlimited unless piercing occurs
* Usual factors include (1) inadequate capitalization, (2) comingling of funds, and (3) lack of corporate formalities (see *Sea-Land* *infra*)
* Transferability: freely transferrable; for closely-held corporations or small corporations, transferability may be restricted by agreement.
* Lifespan: unlimited duration
* Management: centralized with clear structure (3 tiers – shareholders, directors, and officers); CEO runs day-to-day but the board of directors determines the policies.
* Tax: “double taxation” – the profit of the corporation is taxed first and then the amount paid to the employees, board, and officers is taxed via their personal income.
* Example: 3 employees, total profit 90k, if taxed 18k, 72k remains divided by 3 (assuming no cost to run business), each employee makes 24k which is taxed as personal income.
* Cost/time of formation: must file with Secretary of State; must maintain corporate formalities; and must pay franchise tax.
* Profit and loss distribution: distributions to the shareholders based on percentage of shares owned but officers and directors may be compensated in other ways (e.g., salaries and bonuses).

# Corporation Law in General

## Sources of Law

### State corporation statutes

Every state has a general corporation statute that describes the incorporation process, defines generally the rights and duties of stockholders, directors, and officers and provides rules about fundamental corporate changes.

These statutes vary from state to state but there is a trend toward liberalization with the result that variations are declining in importance. The Model Business Corporation Act (the Model Act) and the Delaware General Corporation Law have been very influential.

### Federal statutes

The Securities Act of 1933 and the Securities Exchange Act of 1934 are the major federal statutes applicable to broad categories of corporations. Under these statutes the SEC has broad rule making power.

The Sarbanes Oxley Act is one substantive general regulatory statute. It was adopted in response to the collapse of Enron, WorldCom, and several other major corporations. It focuses primarily on the accounting profession which sets the rules by which financial reports are prepared and which is responsible for auditing the reports of publicly traded companies to assure their accuracy.

Note that there is ***no federal common law of corporations***.

### Stock Exchange listing standards

In addition to state and federal law, a publicly traded company must comply with elaborate rules adopted by stock exchanges as a condition of being listed for trading.

### State securities laws

Every state has enacted statutes that regulate the public distribution of securities within that state. Many of these statutes are similar to, and overlap, the federal Securities Act of 1933.

Congress reduced such overlap with passage of the National Securities Markets Improvement Act, which preempts state law to the extent that they impose duplicative regulation of securities offerings. State law continues to apply in wholly intrastate offerings.

## Functional Classification of Corporations

The basic distinction underlying much of the law of corporations is between the *closely held corporation* and the *publicly held corporation*.

### Closely held corporations

A closely held corporation is a corporation with most of the following attributes:

1. It has a few stockholders, all or most of whom are usually active in the management of the business;
2. There is no public market for its shares; and
3. Its shares are subject to one or more contractual restrictions on transfer.

### Publicly held corporations

A publicly held corporation is a corporation with most of the following attributes:

1. Its shares are widely held by members of the general public and the overall number of stockholders is large;
2. There is a public market for its shares; and
3. The corporation is subject to reporting and disclosure requirements under federal law.

### Significance of the distinction

While many publicly held corporations are relatively large in terms of assets and many closely held corporations are relatively small in terms of assets, the importance of the distinction is not size as much as the number stockholders and the marketability of shares.

1. ***The presence or absence of a public market for the corporation’s shares is the most important difference between the two types of corporations***.
2. In a closely held corporation, most of the stockholders are likely to be employed by the corporation while in a publicly held corporation, most of the stockholders are not connected with management and have only a limited say in the policies adopted by the corporation. As a result, ***ownership and control are likely to be separated in a publicly held corporation but closely interconnected in a closely held corporation***.
3. The presence of public stockholders unconnected with the business of a publicly held corporation is thought to present a strong case for governmental regulation of internal affairs, while in a closely held corporation, there is usually thought to be only a relatively weak (or nonexistent) case for governmental regulation of the internal affairs of the corporation.

## Alternatives to the Corporation

Publicly held businesses are almost always corporations. Traditional alternative business forms for closely held businesses are the partnership and limited partnership.

A major disadvantage of these forms was that they did not provide limited liability for all participants.

However, the limited liability corporation (LLC) provides limited liability for all members, flexibility in internal operation similar to that provided by partnerships, and, of paramount importance, partnership tax treatment. Note that because the LLC provides limited liability for all members, it is probable that many corporate principles, such as piercing the corporate veil, will be applicable to LLCs. Similarly, in a manager managed LLC, principles applicable to directors of corporations may be applied by analogy.

# Forming a Corporation

## State of Incorporation

The first question that must be resolved is what state should be the state of incorporation.

* For small enterprises planning to transact business primarily in one state, the corporation should usually be incorporated in that state.
* For larger enterprises transacting business in many states, incorporation in any one of several states is usually feasible.
  + Incorporating in Delaware is attractive for these businesses (mainly for the case law today, as variations in states’ corporate laws are minimal)

## Documents Filed in the Office of the Secretary of State

Articles of incorporation conforming to the statutory requirements of the specific state must be filed in a specified gov’t office and be accompanied by the appropriate filing fee. The state official charged with accepting corporate filings is usually the Secretary of State.

## Articles of Incorporation

### Mandatory requirements

There is a trend toward simplifying the mandatory disclosure requirements for articles of incorporation.

Older state statutes generally require the following minimum information to appear in the articles:

* Name of the corporation
* Its duration, which may be perpetual
* Its purpose or purposes – today typically: “the conduct of any lawful business”
* The stock it is authorized to issue (classes and number)
* The name of its registered agent and the street address of its registered office
* The names and addresses of its initial board of directors
* The name and address of the incorporator(s)

***Virtually all corporations elect the duration to be perpetual and their purposes to be the conduct of any lawful business*.**

### Discretionary provisions

In addition to the required minimum provisions, state statutes permit additional provisions to be included in the articles of incorporation at the election of the corporation.

### Name

Under most state statutes, a corporate name must:

1. Contain a reference to the corporate nature of the entity (using the words Corporation, Incorporated, Inc., etc.)
2. Not be the same as or deceptively similar to a name already in use or reserved for use, and
3. Not imply that a corporation is engaged in a business in which corporations may not lawfully engage.

The state maintains lists of names that are reserved or currently in use (and hence unavailable) and also may have internal rules about name availability. ***Consequently – the state filing authority should be consulted about a name before it is used***.

### Duration

***Most statutes authorize a corporation to have perpetual existence***. Although it is possible to specify a shorter period of existence, it is almost never desirable to do so.

A shorter period of existence creates the risk that the corporate existence may expire without renewal with uncertain rights and liabilities of participants thereafter.

### Purpose

Most statutes authorize very general purposes clauses, e.g., the purpose of the corporation is to engage is any lawful business or businesses. The use of such clauses is a recent thing.

**NOTE**: The Model Act and several states provide that every corporation automatically has a broad purpose to engage in any lawful business unless a narrower purpose is specified in the articles of incorporation.

### Authorized shares

The articles must state the number of shares that the corporation is authorized to issue. If shares with special rights are to be issued (such as shares that carry a fixed dividend), those special rights must be described in detail. If no special rights are specified, each share is entitled to one vote per share on each matter put up to a stockholder vote and to a pro rata share of each distribution made to the stockholders generally. Such shares are called *common shares* or *common stock*.

### Registered office and agent

The registered office and registered agent must be specified in the articles. They serve the purpose of providing a location where the corporation may be found for service of process, tax notices, and the like and a person on whom process may be served.

## Completing Formation

The filing of articles is only the first step in forming a corporation. ***In most jurisdictions the existence of the corporation begins at the moment of the filing***. A filed copy of the articles is deemed to be conclusive proof of corporate.

The law of most states provides that an organizational meeting ***must*** be held after the filing of the articles.

1. If initial directors are named in the articles, those directors shall hold an organizational meeting to complete the organization by appointing officers, adopting bylaws, and carrying on any other business brought before the meeting;
2. If initial directors are not named in the articles, the incorporator(s) shall hold an organizational meeting: (i) to elect directors and complete the organization; or (ii) to elect a board of directors who shall complete the organization.

These actions may be taken without a meeting in most states if all of the directors or incorporators sign written consents describing the actions taken.

The following additional steps may also be necessary to complete the formation of a corporation:

* Prepare bylaws;
* Prepare minutes of the various organizational meetings, including waivers of notice or consents to action without formal meetings;
* Obtain a minute book and seal;
* Obtain blank share certificates and make sure they are properly prepared and issued for the consideration specified for those shares;
* Prepare stockholders’ agreement, if any;
* Obtain necessary tax identification numbers and comply with other state and federal legal requirements;
* Determine whether the S corporation tax election should be made;
* Make sure the directors and officers understand the nature of their duties and responsibilities.

***Note***: although the organizational meeting is mandatory under a literal reading of the statute of many states, failure to hold such a meeting does not affect the existence of the corporation. Thus, it is unlikely that failure to hold the meeting carries any negative consequences.

## Initial Capitalization

***Prior to 1970, many states required that a corporation have a minimum amount of capital (often $1,000 in cash or property) before it could commence doing business***.

### Current trend

***The modern trend is clearly in the direction of eliminating such requirements***. Most states today have eliminated all minimum capitalization requirements. The theory is that minimum capitalization requirements are arbitrary and unrelated to the true capital needs of the corporation, and therefore do not provide meaningful protection to creditors.

### Failure to meet minimum initial capital requirements

In states that retain minimum capitalization requirements, directors are usually personally liable if business is commenced without the required minimum capital. This liability is limited to the difference between the minimum required capitalization and the amount of capital actually contributed.

***Note: there is no requirement that a corporation maintain any specified minimum capital after incorporation***.

## Bylaws

The bylaws of a corporation are a set of rules for governing the internal affairs of the corporation. They are typically adopted as part of the formation of a new corporation, and generally ay be modified thereafter either by the board or stockholders subject to (1) limitations on the ability of the directors to change bylaws adopted by the stockholders; and (2) supermajority requirements that may be imposed in the case of bylaws that themselves require a supermajority for action.

## Corporate Powers

The Model Act provides that every corporation has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including without limitation a list of specific powers.

### Enumerated powers

Some of the enumerated powers in the Model Act and state statutes include:

* To sue and be sued;
* To have a corporate seal;
* To purchase, receive, lend, sell, invest, convey and guarantee the indebtedness of 3rd persons;
* To elect or appoint officers or agents, define their duties and fix their compensation;
* To purchase shares in, or obligations or, any other entity;
* To indemnify directors and officers against liabilities imposed on them while acting on behalf of the corporation, and to provide liability insurance for them.

### Acts in excess of powers

If a corporation performs an act which it does not have power to do, it is acting *ultra vires*.

At common law, either the corporation or the other party to the contract could repudiate an *ultra vires* contract that was fully executor. This must take place *before* either side commences performance of the agreement.

At common law, when there was part performance of, or reliance upon, a transaction by either party, the other party was ordinarily estopped from asserting the *ultra vises* doctrine.

# Pre-incorporation Transactions

## Promoters

A ***promoter*** is someone who undertakes to form a new business. Actions by a promoter may include arranging for the necessary business assets and personnel; obtaining or renting space, assembling work and sales forces, finding sources of raw materials and supplies, finding retail outlets, making long term commitments, etc.

A promoter may also obtain the necessary capital to finance the venture. Sources of initial capital include (i) equity capital contributed by investors, (ii) loans from third parties, and (iii) loans from the investors supplying the equity capital.

## Promoter Contracts

Promoters may enter into contracts on behalf of the venture being promoted either before or after the articles have been filed. Most problems are created by pre-incorporation contracts because under modern statutes the corporate existence begins with the articles are accepted for filing, and contracts entered into by the promoter in the corporate name after that date will normally bind only the corporation. The legal consequences of pre-incorporation contracts entered into by promoters vary, depending in part on the form of the contract itself.

Note that those entering into a contract with a promoter may repudiate his or her obligations under the contract at any time prior to (1) formation of the corporation and (2) acceptance by the corporation.

### Contracts in the name of a corporation to be formed

In this type of pre-incorporation contract, it shows on its faces that the corporation has not yet been formed.

Here, the promoter is personally liable on the contract and is not relieved of liability if the corporation is later formed and *adopts* the contract. If the corporation adopts the contract, both the corporation and promoter are liable.

#### Novation

A promoter may be released from liability through ***novation*** (simple agreement). Here, the party that entered into the contract with the promoter (e.g., a landlord) must release the promoter.

Note: the corporation likely must “sweeten the deal” with the landlord for him/her to release the promoter – otherwise, why release someone that is personally liable?

#### No ratification

Note that groups of promoters working together may be construed as a partnership and agreeing to an action by another partner ratifies the action (i.e., signing the contract). However, ***a partnership cannot ratify an act (i.e., contract) for the corporation if entered into before the corporation was formed***.

### Contracts in the corporate name

In these cases, a contract is entered into in the name of a corporation even though it has not been formed. One or both of the parties to the contract erroneously believe the corporation has been formed.

If a promoter represents that she is acting on behalf of a corporation when she knows no steps have been taken to form it, she is personally liable (as above).

***Common law created concepts of de facto and de jure corporations. In a suit brought by a privative plaintiff, a finding that either a de facto or de jure corporation existed absolves the promoter of liability***.

#### De jure corporations

***A de jure corporation exists if there is compliance with all mandatory statutory requirements (must file articles with Secretary of State)***; failure to comply with less important requirements (e.g., obtaining a corporate seal) does not affect the *de jure* status of a corporation.

#### De facto corporations

A *de facto* corporation is a corporation that is partially but defectively or incompletely formed. ***Note this is no longer a valid concept***.

In order to establish a de facto corporation, three things must be shown:

1. There is a law under which the purported corporation could have been incorporated;
2. There was a good faith attempt to incorporate under that law; and
3. There was a use of corporate power in the honest belief that a corporation existed (e.g., elected directors, officers appointed, stock issued, business conducted).

#### Corporation by estoppel

Both parties have dealt with each other and viewed each other as corporations (or just one as a corporation) but there was a misunderstanding or clerical error that prevents one (or both) party from being a corporation.

* Very fact specific
* Used to force parties to *keep* the contract with the would-be corporation
* Cannot be used to allow the would-be corporation to weasel its way out of contracts

***Corporation-by-estoppel is only applicable when a plaintiff believes, or has reason to believe, that she has transacted business with a corporation (i.e., not applicable in torts cases).***

### Liability of corporation on promoter’s contracts

The corporation is not automatically liable on contracts made for its benefit before it came into existence. ***A newly formed corporation may accept or reject pre-incorporation contracts***.

***An acceptance of a pre-incorporation contract by a corporation is an adoption not a ratification***. *Ratification assumes that the principal was in existence when the agent entered into the unauthorized contract*. When a principal ratifies a contract, the principal is deemed bound on the contract from the time the contract formed (therefore because a corporation is not in existence when a pre-incorporation contract formed, ratification is not the proper term).

* ***Know this distinction***

Adoption may be express or implied and presupposes knowledge of the terms of the contract.

## Fiduciary Duties

Promoters of a venture owe fiduciary duties to each other and to the corporation. The duty is essentially the same as the duties owed by a partner to a partnership or other partners. A duty of full disclosure is owed to subsequent investors.

### To corporation

After the corporation is formed it may obtain from the promoter any benefits or rights the promoter obtained on its behalf.

### To fellow promoters

Promoters are essentially partners in the promotion of the venture, and any benefits or rights one promoter obtains must be shared with co-promoters.

### To subsequent investors

A major issue relating to promoters’ fiduciary duties is the extent to which *subsequent* stockholders or investors are protected by fiduciary duties.

***There must be full disclosure to public investors at the time they decided to make their investments***.

# Piercing the Corporate Veil

Piercing the corporate veil (PCV) occurs when a court refuses to recognize the separate existence of a valid corporation and holds the stockholders personally liable for the obligations of the corporation.

## General Considerations

### Nature of liability

It seems that PCV would be more likely to occur in tort cases where the plaintiff cannot perform a credit check or require payment upfront, studies show it is more likely PCV occurs with contractual relationships.

* Study unlikely to have considered that insurance will pay for tort situations and PCV regarding contractual relationships usually entails fraud by the shareholders

### Publicly held and closely held corporations

***PCV is exclusively a doctrine applicable to closely held corporations***. However, it may be applied to subsidiary corporations owned by a publicly held parent corporation.

PCV more likely to occur with corporations having few shareholders, it may be applied to corporations with many shareholders too.

### Inactive stockholders

PCV is not an all-or-nothing principle. In appropriate cases, active stockholders may be held liable for corporate debts on a piercing theory but inactive stockholders may be found not to be personally liable on such obligations.

* *Baatz v. Arrow Bar (South Dakota – 1990)*
* B suing Arrow Bar, Inc. for serving intoxicated man alcohol who then caused an accident while driving, injuring B.
* Man in accident has no money/insurance, so B is suing the corporation that owns the bar. B wants to PCV and get to the owners who personally guaranteed the corporate debt.
* The court did not PCV because (1) the personal guarantee of a loan is a contractual agreement and cannot be enlarged to impose tort liability, (2) B failed to demonstrate how the owners were transacting personal business through the corporation, and (3) B did not produce evidence supporting his claim that the corporation was undercapitalized.
* *Walkovszky v. Carlton (NY – 1966)*
* D is a stockholder of 10 corporations, each which has 2 taxi cabs registered in its name (keeping the liability insurance D must purchase for each corporation at a minimum – more cars = more insurance required). W was hit by a taxi and is suing to PCV claiming all 10 corps are actually a single entity and therefore W should be entitled to more money via insurance.
* The court held no PCV because there was no evidence that D was conducting business in his individual capacity. Note that the insurance D had under his set-up was the amount mandated by the state; this leaned in favor of no PCV.
* *Sea-land Services, Inc. v. Pepper Source (7th Cir. – 1991)*
* Sea-land (SL) bringing PCV suit to get at sole shareholder of PS, who is also a sole shareholder of several other companies. These companies are run from the same office, same phone number, and bank account. Funds are used for sole shareholder’s personal needs.
* Court holds no PCV however because SL must show both (1) shared control/unity of interest and (2) that honoring the existence of separate entities would sanction fraud or promote injustice. The court held (1) was satisfied but there wasn’t sufficient evidence brought forth to show (2).
* ***The court also stressed 4 factors: (a) failure to maintain corporate assets, (b) the commingling of funds, (c) undercapitalization, and (d) one corporation treating the assets of another as its own***.

## Factors to consider

1. Commingling of funds and other assets of the corporation with those of the individual shareholder;
2. Diversion of the corporation’s funds or assets to non-corporate uses (to the personal uses of the corporation’s shareholders);
3. Failure to maintain the corporate formalities necessary for the issuance of or subscription to the corporation’s stock, such as formal approval of the stock issued by the board;
4. An individual shareholder representing to persons outside the corporation that he or she is personally liable for the debts or other obligations of the corporation;
5. Failure to maintain corporate minutes or adequate corporation records;
6. Identical equitable ownership in two entities;
7. Identity of the directors and officers or two entities who are responsible for supervision and management (a partnership or sole proprietorship and a corporation owned and managed by the same parties);
8. Failure to adequately capitalize a corporation for the reasonable risks of the corporate undertaking;
9. Absence of separately held corporate assets;
10. Use of a corporation as a mere shell or conduit to operate a single venture or some particular aspect of the business of an individual or other corporation;
11. Sole ownership of all the stock by one individual or members of a single family;
12. Use of the same office or business location by the corporation and its individual shareholder(s);
13. Employment of the same employees or attorney by the corporation and its shareholder(s);
14. Concealment or misrepresentation of the identity of the ownership, management or financial interests in the corporation, and concealment of personal business activities of the shareholders;
15. Disregard of legal formalities and failure to maintain proper arm’s-length relationship among related entities;
16. Use of a corporate entity as a conduit to procure labor, services, or merchandise for another person or entity;
17. Diversion of corporate assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors, or the manipulation of assets and liabilities between entities to concentrate the assets in one and the liabilities in another;
18. Contracting by the corporation with another person with the intent to avoid the risk of non-performance by use of the corporate entity; or the use of a corporation as a subterfuge for illegal transactions;
19. The formation and use of the corporation to assume the existing liabilities of another person or entity.

## Legal Tests

There is no widely agreed test. Rather the courts tend to refer to goals such as to prevent fraud or oppression, to avoid illegality, or to achieve equity. These tests are ***result-oriented*** and give little indication of the circumstances in which a court will refuse to recognize the separate existence of a corporation.

### Alter ego and instrumentality

The phrase *alter ego* literally means *other self*. Courts hold that piercing is proper under the alter ego doctrine where:

1. Such unity of ownership and interest exists between corporation and stockholder that the corp. has ceased to have a separate existence, and
2. Recognition of the separate existence of the corporation sanctions fraud or leads to an inequitable result.

A corporation becomes the *instrumentality* of a stockholder where there has been an excessive exercise of control by the stockholder that leads to wrongful or inequitable conduct that in turn causes the plaintiff a loss.

### Misrepresentation and fraud

PCV may be ordered if information about the corporation is misrepresented or if a third party is in some way misled or tricked into dealing with the corporation. An affirmative misrepresentation by a stockholder might also constitute actionable fraud independent of the piercing doctrine.

### Personal guarantee

PCV may also be ordered if the stockholder orally promises to be personally responsible for corporate obligations under circumstances where it is inequitable to permit the stockholder to rely on the statute of frauds.

Note that holding an individual stockholder personally liable is not PCV (think banks requiring a personal guarantee for a loan), but only when there was a reliance on the statute of frauds to avoid an agreement.

### Undercapitalization

***Lack of adequate capitalization is a major factor in tort cases***, but in most cases there is also some additional justification for PCV. If capital was originally adequate but has been reduced by business operations, a PCV argument is likely to be rejected. A PCV argument is more likely to be accepted where the original capital is nominal or clearly inadequate in light of contemplated business risks.

* ***Piercing is more likely to be ordered where the corp. is formed with minimal capital specifically to engage in hazardous activities that caused the injury***. To recognize the separate corporate existence of a nominally capitalized (judgment proof) corporation engaged in a hazardous activity in effect shifts the risk of loss or injury to random members of the general public who happen to be injured by the activity.
* ***Liability insurance should be viewed as the equivalent of capital for purposes of piercing in torts cases***because such insurance provides readily available funds to tort victims.
* ***Inadequate or nominal capitalization should not usually be a factor in contract cases***. Absent unusual circumstances, a contract creditor assumes the risk that the corporation will be unable to meet its obligations when dealing voluntarily with the corporation and in the absence of a personal guarantee from the stockholder.

### Operation on the edge of insolvency

PCV may be ordered if the corporation is operated so that it can never make a profit, or available funds are siphoned off to the stockholder without regard to the needs of the corporation, or it is operated so that it is always insolvent.

### Commingling and confusion

PCV may be ordered if the stockholder conducts business in such a way as to cause confusion between individual and corporate finances. For example, if a stockholder pays off a personal debt from corporate funds or if the stockholder pays a corporate debt with personal funds.

### Artificial division of business entity

In many PCV cases, an important factor is whether a single business is artificially divided into several different corporations to reduce exposure of assets to liabilities. The normal response to an artificial division of a single business entity should be to hold the entire entity responsible for the debts of the business rather than to hold the stockholders personally liable for such debts. Two alternative theories for holding the entire business liable: (1) treat corporations as if they are in a partnership and (2) *sibling corporations* – parent subsidiary corporations

### Mere continuation

A situation that is closely related to artificial division may arise if a stockholder conducts a single business under a succession of corporations, abandoning one and forming the next whenever he needs a fresh start. Again, the logical result should be to hold the successor corporation liable for the debts of the predecessor corporation(s). But in some cases, the courts hold the stockholder personally liable, possibly on a theory of abuse or misuse of the corporate form.

### Failure to follow corporate formalities

A PCV argument is somewhat more likely to be accepted if the plaintiff can show (in addition to other factors) failure to follow corporate formalities. However, ***it is unlikely that failure to follow corp. formalities alone will suffice for a PCV holding.***

## Liability of Parent for Obligations of Subsidiary

Many piercing cases involve corporations as stockholders. These issues involve the responsibility of a parent corporation for the actions of a subsidiary (or vice versa).

### Confusion of affairs

A parent corporation may be held liable for its subsidiary’s obligations if it fails to maintain a clear separation between parent and subsidiary affairs. A failure to maintain a clear separation between affairs of different subsidiary corporations may result in the separate existence of those corporations being ignored as well.

***Conduct that may lead to parental liability includes***:

* Referring to the subsidiary as a dept. or division or the parent;
* Mixing business affairs, such as using parental stationary to respond to inquiries addressed to the subsidiary;
* Having common officers who do not clearly delineate the capacity in which they are acting;
* Transferring funds from one entity to the other without the formalities normally involved in a loan (interest, regular payment schedule, etc.), or having a common bank account,

## Alternative to Piercing

Ways to hold individual stockholders liable for unsatisfied claims against a corporation other than piercing include:

* By statute;
* By fiduciary duty (for mismanagement or misappropriation);
* *Respondeat superior*, if the actor was acting as an agent of the corporation.

## Successor Liability

Piercing of a sort may arise if a business is transferred from one corporation to another particularly by means of a sale of assets in which the seller corporation retains the long-term liabilities of the business and where the seller stockholder then distributes the proceeds to himself.

### Tests for successor liability

***The courts generally recognize four situations in which a successor business may be held liable for the obligations of the transferor business:***

1. Contract: the successor corporation agrees to assume the liabilities of the transferor.
2. Merger: the successor corporation assumes the liabilities of the transferor by operation of law.
3. Mere continuation: the successor corporation is so similar to the old business (in terms of stock ownership, control, employees, etc.) that it is deemed to be the same business and is therefore liable for the obligations of the old business.

* Note: in such cases, there will not likely have been a formal transfer and the original business may remain in existence as a formal matter in order to bolster the argument that the two businesses are separate.

1. Fraud: fraud comes in many forms but one example is the scenario above where the parties agree to transfer the business for what appears to be a bargain price. In effect, the parties conspire with each other to the detriment of future creditors. In a good faith transaction, the buyer will presumably seek some form of assurance from the seller that the proceeds will be held in escrow or insurance obtained so as to guard against subsequent allegations of fraud. Thus, the absence of any such assurance or efforts to enforce such provisions may be evidence of a conspiracy.

### De facto merger

The *de facto merger* doctrine states that the two companies in fact engaged in a merger even though the transaction was structured as a sale of assets. If the transaction is ruled to be a merger *de facto* the successor corporation is liable for the debts of the transferor.

# Corporate Finance

***Capital is the money or property that must be invested in order for the business to operate. Capital may take the form of (1) equity or (2) debt. The mix of debt and equity is often called the capital structure of the business*.**

***Note that a corporation’s net worth is equal to its total assets minus its aggregate liabilities.***

##### Equity

Capital that is contributed by stockholders in exchange for shares of stock is equity capital. Equity holders are generally thought of as the owners of the business, whereas debt-holders have no ownership interest in the business.

There is no maturity date for equity and return is dependent on the profitability of the business. ***Equity is paid after all debts are paid***. Equity is therefore riskier then debt and generally requires a higher rate of return.

##### Debt

Capital that is borrowed is debt capital. Debt-holders have no ownership interest in the business but are generally considered third-party creditors. ***Debt is paid before equity, must be repaid at some point and the periodic return is fixed***. Payment of interest is mandatory. ***Default may trigger bankruptcy (unlike the failure to pay a return on equity investments)***.

## Shares and Stock

Shares and stock are synonyms for the basic units of ownership of a corporation. If a corporation is authorized to issue more than one class of shares, the number of shares of each class and a detailed description of each class must be set forth in the articles of incorporation.

### Common stock

When shares are authorized in the articles of incorporation without any specified rights, such shares are common shares. Such shares are entitled to (1) one vote per share on any matter submitted to a vote of the stockholders and (2) a pro rata share of any distribution of cash or property to the stockholders generally. These rights are automatic and need not be described in the articles of incorporation.

### Preferred stock

***Preferred means that shares have preference over common shares either as to dividends or on liquidation or both***. A *preference* simply means that the preferred shares are entitled to a payment of a specified amount before the common shares are entitled to anything.

### Authorized shares

The articles of incorporation define the *authorized shares* the corporation may issue. The MBCA provides that the articles must prescribe the classes of shares (with descriptions if multiple) and the number of shares of each class that the corporation is authorized to issue.

### Issued shares

Issued shares are the shares of one or more classes actually held by stockholders as distinct from merely being authorized but unissued. It is customary to authorize more shares than the number planned to be issued initially. *Additional capital may be needed at a later date, and authorized shares may be issued to raise that capital without amending the articles of incorporation*. Shares authorized but not issued may be issued at a later date by the board of directors acting alone without approval of the stockholders.

### Par value and stated capital

***Par value is the minimum price for which shares may be issued by the corporation – it is an arbitrary number. Shares may always be sold for more than par value. Par value rules apply only to the original issue of shares by the corporation – a stockholder may resell for any amount, whether more or less than par value***.

After shares are issued, the aggregate par value of the outstanding shares constitutes the ***stated capital*** or ***legal capital*** of the corporation. As a general rule, the corporation may not invade stated capital to make a distribution to stockholders.

### Book value of outstanding shares

The book value of outstanding shares is ordinarily determined by dividing the sum of the stated capital and any surplus by the number of outstanding shares.

Example: Stated capital = $150k; retained earnings surplus = $50k, 1k outstanding shares – book value = (150k+50K)/1K = $200/share.

## Common Stock

Common shares reflect the ownership of the residual interest in the corporation. ***The two basic rights of common shares are:***

1. ***Entitlement to vote for directors and on basic corporate matters, and***
2. ***Entitlement to the net assets of the corporation when distributions are made or upon dissolution***.

All corporations must have at least one share outstanding with such rights. Common stock may be issued in different classes. ***There are virtually no restrictions or limitations on the rights that may be varied from class to class***. For example, Class A shares may elect 2 board members while Class B and Class C elect 1 board member each. Furthermore, Class A may have twice the dividend right per share of Class B and Class C.

Note: in most jurisdictions, all shares of a class must have identical rights with those of other shares of the same class.

## Preferred Stock

Besides common shares, corporations may also issue classes of shares that have rights that must be satisfied before the common shares are entitled to distributions – *preferred* (or *preference*) shares or *preferred stock*. Preferred stock and debt securities have many similar characteristics and may be used to achieve similar results.

### Distributions

Preferred shares typically have a preference over common shares either as to dividends or on liquidation or both – i.e., ***preferred shares are entitled to a payment of a specified amount before the common shares. Most traditional preferred shares are nonvoting shares that are limited to a right to receive a specified amount and no more, no matter how profitable the corporation may be***.

* Preferential rights must be defined in the articles of incorporation, and the attributes of preferred stock may include some rights normally associated with common shares.
* A dividend preference may be ***cumulative***, ***non-cumulative***, or ***cumulative-to-the-extent-earned***.
  + Cumulative shares: a dividend that is not paid in one year carries over to the next (and all following), until paid
  + Non-cumulative: a dividend that is not paid (declared) is lost
  + Cumulative-to-the-extent-earned: a dividend that is cumulative only to the extent of earnings in a specified period. If earnings fail to cover the preferred dividend, the portion of the dividend that is not covered does not cumulate and is gone.

### Other features

A corporation may issue multiple classes of preferred shares just as with common shares. One class of preferred shares may be junior to another but it is nevertheless preferred in comparison to common stock.

### Preferred issued in series

Most state statutes authorize the creation of preferred shares ***in series***, with terms that may vary from series to series. ***Specific authorization to create one or more series of preferred shares out of a larger class of preferred shares must appear in the articles of incorporation***.

Note: the term series refers in effect to a subset of the class of stock specifically authorized in the articles of incorporation.

If series issue is authorized, the board has the authority to set terms of each series by a board resolution. Preferred shares that may be issued in series are often called *blank check stock* because the board may fill the terms.

### Alteration of rights

***The rights attaching to preferred shares (or any class or series of shares) may be changed by amendment to the articles of incorporation***. Such alteration of rights is sometimes called a ***recapitalization*** because in effect it constitutes a change in the capital structure of the business.

## Issuing Shares Under the Model Act

The Model Act authorizes shares to be issued for consideration consisting of any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, etc.

### Amount of consideration

The traditional par value requirement has been eliminated by the Model Act – there is no minimum issue price for shares. The price at which shares are issued is set by the board and any price may be set.

## Issuing Shares in Par Value States

Several states retain the concept of par value to some extent. In these states, the articles must state the par value of the shares of each class. Note: the current trend is toward the elimination of par value.

### Par value

Par value is an arbitrary value associated with shares. The par value of shares is set forth in the articles and appears on the face of certificates for shares. In states with par value statutes, the board may set the price at which shares are issued, but shares may not be issued for less than par value. Shares may always be issued for more than par value.

It is customary to use *low par* shares rather than high par shares. Par value, once set in the articles, cannot be changed except by formal amendment to the articles.

The requirement to pay at least par value for shares only applies to the purchase of newly issues shares directly from the corporation. It does not apply to a purchase of shares from an existing stockholder (unless the purchaser knows the shares are not fully paid). ***When the full agreed consideration equal to or greater than par value is paid, the shares are said to be fully paid and nonassessable***.

## Permissible Consideration

Under many state statutes, only certain types of property qualify as valid consideration for shares. ***A typical statute provides that consideration may be paid, in whole or in part, in cash, in other property, tangible or intangible, or in labor or services actually performed for the corporation.***

***Many statutes add that neither promissory notes nor future services shall constitute payment or part payment for the issuance of shares of a corporation***.

## Watered Stock

***Watered stock*** is a term generally used to describe the issuance of shares at a price below par value. Under common law and state statutes that still follow the par value system, one who purchases stock directly from an issuing corporation and pays less than par value is liable to the corporation (or creditors) for the difference between the price paid and the par value.

***If stock is issued in good faith and with the reasonable belief that the stated par value is equal to the value of the property received in exchange, the shares are not watered.***

The “watered amount” of shares can ordinarily be recovered by judgment creditors of the corporation. Under the ***trust fund theory***, all judgment creditors can usually recover the watered amount measured at the time of issue. Under the ***misrepresentation theory***, only persons who extended credit to the corporation after the transaction may recover the difference.

***Shareholders cannot personally recover the watered amount***. Instead, the shareholder would have to file a derivative suit to rescind the transaction.

## Issuance of Shares by a Going Concern

### Preemptive rights

***A preemptive right gives holders of outstanding shares the right to buy a proportionate part of any new issue of securities by the corporation***.

Preemptive rights protect existing stockholders against dilution of their control interest or financial interest in the issuing corporation. If all stockholders exercise their preemptive rights no dilution occurs and the additional capital needed by the corporation is raised entirely from its present stockholders.

***Preemptive rights are more important in closely held corporations because (a) it is way to protect a shareholder’s ownership interest, which is likely to be his employment, (b) there is generally no market for which to buy other shares, or sell one’s preemptive right to buy those shares, therefore there’s no way to be compensated for that right without exercising it***. Preemptive rights serve little purpose in publicly held corporations because they complicate the raising of capital. Also, the availability of a public market for shares renders preemptive rights less important because any stockholder may add to shareholdings by purchasing shares in the open market.

State corporate statutes take three approaches to grants of preemptive rights: 1) the grant of rights is mandatory; 2) preemptive rights are granted unless the corporate charter provides to the contrary (opt-out provision); or 3) the rights are granted only if the corporate charter elects them (opt-in provision). The Model Act adopts the opt-in approach.

* *Katzowitz v. Sidler (1969)*
* The court held S and L should not benefit from their conduct, voided the issuance of 25 shares to each, and split the corporation equally between K, S, and L.
* K, S, and L each invested $500 and received 5 shares of the corporation’s stock – S and L wanted to oust K. The men entered into an agreement: K would withdraw from managing day-to-day activities but remain on the boards of the corporations, the three were equal shareholders, and K would receive the same pay.
* S and L passed a vote to issue 75 shares of stock at $100/share with K, S, and L each able to buy 25. K did not buy but S and L did – the shares were issued at 1/18 of their value, diluting K’s share substantially.
* RULE: A fiduciary duty may preclude issuance of shares in the absence of a compelling business purpose even where preemptive rights exist but circumstances are such that it is unreasonable to expect some stockholders to exercise their preemptive rights.

### Fiduciary Restrictions on Oppressive Issuance of Shares

Where preemptive rights are unavailable (either because the transaction falls within an exception to the preemptive right or because the right itself has been eliminated by the corporation), the power of the board of a *closely held corporation* to issue new shares on terms that are unfair to minority shareholders may be limited by a general fiduciary duty.

## Thin Incorporation and Subordination

***Too much shareholder debt or poor management of a debtor-creditor relationship may result in a finding of a “thin incorporation.”*** The consequences of “thin incorporation” fall into two categories:

1. The IRS may consider debt to be equity for tax purposes (i.e., interest treated as nondeductible); and
2. A court may subordinate the shareholder’s debt to that of other creditors.

* *Obre v. Alban Tractor Co. (1962)*
* The court held the capitalization set forth by O was *debt* and should not be subordinated to equity.
* ***O and N pooled equipment and cash to form a corporation in the business of construction. O transferred equipment and cash ($65k) and N transferred same ($10k). They wanted to have equal control so O and N each received common stock worth $10k par and O received $20k preferred (nonvoting) stock and a note for $35k***.
* Remember this is a way to create equal voting when shareholders commit different amounts
* The court held that the expressed intent of O and N to be equal owners lead to O’s note; the note was to repaid be after 5 years, *not through dividends annually* like equity would have been.
* *Fett Roofing and Sheet Metal Co. v. Moore (1977)*
* Fett was the sole stockholder and president of his “one-man” corporation. He transferred $5k upon incorporation and the stated capital was never increased. Fett would transfer money to the business as needed and took out personal loans that were then transferred to the business in exchange for demand promissory notes. He recorded 3 deeds of trust to secure the notes with the property, equipment, and receivables of the business.
* The court held Fett’s notes should be subordinated to the claims of other creditors. The court found the purpose of the deeds was to delay and defraud creditors and as well as give Fett preference over them.
* ***When the corporation is of the type that requires a large amount of capital and is incorporated with only a minimal amount, the lack of capitalization favors the subordination of the shareholders’ debt to equity***. Also, look at whether the loans were to be paid in the ordinary sense (on a date payable) as opposed to an unclear deadline or annually (both weigh in favor of equity).

# Corporate Governance

## Statutory Scheme in General

### Stockholders

Stockholders’ power is limited to:

1. The power to elect directors,
2. The power to remove (and replace) directors,
3. The power to make recommendations to the board of directors about business and personnel matters,
4. The power to amend or repeal bylaws,
5. The power to approve fundamental corporate changes as proposed by the board of directors, including amendments to articles of incorporation, mergers, consolidations or share exchanges with other corporations, sales of substantially all the assets of the corporation and dissolution,
6. The power to inspect corporate books,
7. The power to maintain a derivative action on behalf of the corporation subject to numerous substantive and procedural restrictions,
8. Standing to attend and participate in a meeting of the stockholders (in person or by proxy).

### Directors

The role of directors is specified by statute. The board is entrusted with the power of management of the business and affairs of the corporation. The board may delegate authority to make decisions to officers and agents. *Individual directors are not agents or representatives of stockholders. They may only act as a board or as a subcommittee of the board*.

The board selects officers and has the power to remove them. The board also may employ employees or agents, or create new officers and employ persons to fill them.

* ***The board may not delegate fundamental management decisions (e.g., creation of officer positions and salaries) and the appointment of officers.***

The directors are not agents of the stockholders and may not be compelled to approve transactions merely because a majority or even all the stockholders wish. Some actions must be made by the board and may not be delegated to officers or a subcommittee of the board.

### Officers

Officers of the corporation have a limited statutory role. ***They carry out the policies and decisions of the board***. They are not themselves formulators of policy.

## Stockholder Meetings & Voting

***Annual meetings are required to be held for the purpose of electing directors and conducting other business***. The time and place may be specified in accordance with the bylaws.

All meetings other than the annual meeting are *special* meetings. Special meetings may be called by the board, and under many state statutes by the President, the holders of a specified number of shares (often 10%), and other persons named in the bylaws.

Stockholders who are entitled to vote must be given written notice of annual or special meetings as provided by statute or in the bylaws.

## Quorum and Voting Requirements

In order for action to be taken at a stockholders’ meeting, there must be a quorum at the meeting and the action must be approved by the required percentage of the votes of stockholders.

### Quorum requirements

***A quorum is typically a majority of voting shares although some statutes allow quorum to be specified by the articles***. Quorum may also be increased up to unanimity. ***By default, quorum is 50% + 1 vote***. This means that not all shareholders must show at meetings – only those such that 50% of the shares + 1 share are present.

Unanimity ensures minority participation but allows any stockholder (even with 1% ownership of the company) to block action.

* *Jones v. Wallace*
* A provision of the bylaws was not valid but because this was a closely-held corporation, it was held to be a contract
* Why would a corporation want a quorum requiring 100%?
* To protect the minority, it allows even a shareholder with 1% to block the vote
* In this situation, Wallace was the original owner and owned 100% so the drafter stated 100% was required because it was only W and therefore 100% would be present if he was present.
* This is bad drafting because if he ever wants to sell the company to more than 1 person, it requires all owners to be present to do anything

#### Supermajority

***If “supermajority” used on the exam, Han will have to define the percentage for us – no default.***

Supermajority requirements may be imposed in closely held corporations to ensure that a minority stockholder has a veto power over matters coming before stockholders.

***Note: shares represented by proxy are deemed present for purposes of a quorum***.

### Shares entitled to vote and class voting

All shares are entitled to vote one vote per share on any matter to be voted on by the stockholders unless the articles specify a class of shares shall have no voting rights.

Generally, ***shares other than common shares are non-voting***. A corporation may issue non-voting common shares (must be permitted by and stated in the bylaws).

***A class or series of nonvoting shares may be entitled to vote on specific matters as specified by the articles – this is often called class voting***. Where class voting on a specific matter is required, that matter is approved only if it receives the necessary affirmative votes from stockholders of that class.

Authorization for non-stockholders to vote may appear in the articles.

### Vote required

The traditional rule is that the affirmative vote of a majority of the votes present at which quorum is necessary to adopt a measure.

* ***Note: that in order to take action at a meeting, quorum of those present needs to affirmatively vote but in that situation quorum is determined differently. Each person present represents 1 vote and therefore quorum is 50% + 1 vote***.
* E.g., A (20% shares), B (29%), C (51%) – A and B can take action opposing that of C if all are present (each represents 1 vote and quorum for to take action would be 2 people).

Quorum is also a perquisite for action at a board meeting. In regards to board meetings, quorum is determined by the number of seats on the board (e.g., if there are 13 seats on the board, quorum is 7. Even if a board member is removed and there are currently only 12 directors appointed to a board which has 13 seats, quorum is still 7).

### Action by majority consent

Delaware and a few other states provide that a consent signed by the percentage of shares needed to approve a transaction is effective. This majority consent procedure may be used in both publicly held and closely held corporations and permits a purchaser of a majority of the shares of a publicly held corp. immediately to replace the board and take control of operations.

### Multiple or fractional votes per share

The traditional rule is one vote per share. A number of state statutes now permit multiple or fractional votes per share. In these states all computations including quorum counts must be based on aggregate votes rather than aggregate shares.

### Attendance of meetings by directors

Aside from the quorum requirements, a few other principles apply. Regarding directors’ meetings, unless otherwise specified, there is no obligation to give the directors specific notice of a regular meeting if the time of such is stipulated in the articles of incorporation or bylaws. Directors are ordinarily deemed to be on constructive notice of their corporation’s articles and bylaws.

A corporation cannot use as a defense against parties with whom it has contracted and who acted in good faith that it failed to give adequate notice to its directors for a meeting at which the transaction was approved.

If a meeting is improperly noticed, any action undertaken by the board at the meeting is invalid (even if it appears that votes of the absentee directors would have had no impact on the resolution. It is possible that if the non-noticed directors had attended, they would have been able to persuade the other directors to vote in a different manner.

## Amendments to the Articles of Incorporation

The articles of incorporation are a public document and may be viewed by potential investors. ***The articles are amended by the shareholders***.

State statutes relating to the amendment process vary widely. In most states, the board must initiate a proposal to amend the articles. After the proposal by the board, the proposed amendments must be submitted to the shareholders for approval.

Note, after an amendment is approved, the new articles must be filed with the secretary of state.

## Amendments to the Bylaws

The bylaws are private documents and cannot be viewed by potential investors. ***The bylaws are typically amended by the board of directors***.

## Elections of Directors

Elections of directors may be by straight or cumulative voting. State statutes may mandate one or the other for all elections. In most states a corporation may elect by appropriate provisions in its articles of incorporation whether or not to have cumulative voting. Under the Model Act, the default is straight voting but companies may elect cumulative voting by putting it in their articles.

***NOTE: California states that cumulative voting is mandatory for all closely held corporations.***

In elections for directors, all directors run at large and not for a particular seat. Thus, stockholders may not vote against a candidate excepting by voting in favor of other candidates.

#### Straight voting

In straight voting, a stockholder may cast the number of votes equal to the number of shares held for candidates for each position to be filled on the board.

***Under straight voting, stockholders holding a majority of the voting shares can always elect the entire board***.

Example: 5 seats, shareholder has 100 shares, shareholder may vote 100 shares for each seat.

#### Cumulative voting

In cumulative voting, each stockholder determines the aggregate number of votes by multiplying the number of shares held by the number of positions to be filled. Each stockholder may cast that number of votes for one or more candidates.

Example: 5 seats open, shareholder has 100 shares, shareholder may vote aggregate shares and vote all for one seat (i.e., 500 shares for 1 seat).

Cumulative voting permits minority stockholders to elect one or more directors in certain circumstances.

*The formula for determining the number of* ***shares*** *required to elect one director under cumulative is*:

* N equals the required number of shares.
* S equals the total number of shares outstanding.
* D equals the total number of directors standing for election.

Example: If there are 1000 shares outstanding and 4 directors to be elected, the formula shows that the number for shares required to elect one director is (1000/5)+1 or 201.

*The formula for determining the number* ***votes*** *to be cast at the meeting is:*

* N equals the required number of votes.
* V equals the total number of votes to be cast at the meeting.
* D equals the total number of directors standing for election.

Example: If there are 1000 shares outstanding and 4 directors to be elected, there are 4000 total votes to be cast in an election. The formula shows that the number of votes required to elect a single director is (4000/5)+1 or 801.

#### Advantages and disadvantages of cumulative voting

The primary advantage of cumulative voting is that it is more democratic in that it permits minority representation on the board. However, using staggered terms may be used to dilute the effect of cumulative voting.

Although the general rule is that a director may be removed without cause by a majority vote of the stockholders, most states limit the power to remove a director elected by cumulative voting to situations in which the vote to retain the director is insufficient to have elected him if the vote were cast in an election of directors in which cumulative voting was used.

The effects of cumulative voting can be minimized in several ways:

* In states where it is not mandatory, stockholders may amend the articles to eliminate cumulative voting.
* The board may be reduced in size to reduce the impact of cumulative voting.
* The wok of the board may be delegated to a committee that does not have a minority-elected member.

#### Staggered terms for directors

Under many state statutes, the board may be staggered or classified so that members are elected for two or three year terms with one half or one third being elected each year. ***Many state statutes require a minimum of 9 board seats***; under the Model Act there is no minimum size board required.

## Proxy Voting

A ***proxy*** is the grant of authority by a stockholder to someone else to vote the shares. The relationship is one of principal and agent.

***A proxy appointment must be in writing. The general rule is that a proxy is revocable.***

## Stockholder Voting Agreements

Agreements among stockholders to vote their shares cooperatively or as a unit are generally enforceable. These are sometimes called *pooling agreements*.

### Formal requirements

In most states, a voting agreement is seen as a simple private contact subject to few limitations.

A few states have adopted statutes regulating voting agreements, limiting the period during which a voting agreement may continue (e.g., 10 years), requiring that copies of the voting agreement be deposited at the principal of the office of the corporation, and so forth.

### Enforcement of voting agreements

Enforcement of a voting agreement creates special problems because the shares are registered in the names of the individual stockholders on the books of the corporation.

In *Ringling Brothers-Barnum & Bailey v. Ringling*, the Delaware Supreme Court enforced a voting agreement by disqualifying the shares sought to be voted in violation of the agreement.

Some states enforce such agreements by authorizing specific performance.

## Voting Trusts

***A voting trust is a formal arrangement by which shares have voting power and usually the holders do not obtain any economic benefit from the shares***.

State statutes uniformly recognize the validity of voting trusts that meet statutory requirements. The most common requirements are:

* The agreement may not extend beyond 10 years
* The agreement must be in writing
* A copy of the agreement must be deposited with the corporation at its registered office and be available for inspection by stockholders and holders of the beneficial interests in the trust
* A voting trust that fails to comply with all statutory requirements is typically considered invalid in its entirety.

Note: A voting trust may be set aside if later events frustrate its essential purpose.

* *Lehrman v. Cohen*
  + Lehrman and Cohen have 2 classes of stock (AL and AC) where each elect 2 members of the board (risk deadlock)
  + Create a 3rd class (AD) to elect a 5th member, 1 share of AD issued (only voting power, no economic benefits, not in writing)
    - Note that AC and AL transferred 10% of their voting power to AD through dilution
    - AD held *not* to be a voting trust because it wasn’t in writing
  + Han disagrees because *in form* the AD class was a voting trust – AC and AL gave it voting power but kept all of the economic benefits
  + Was this a smart move by AC and AL?
    - Not entirely because there are no remedies set up to protect against AD “going rogue” and voting for only one side (AC or AL) all of the time
    - Going to court as a remedy is not good because it is time consuming and expensive

An agreement between two or more shareholders of a close corporation, if in writing and signed by the parties thereto, may provide that in exercising any voting rights the shares held by them shall be voted as provided by the agreement, or as the parties may agree or as determined in accordance with a procedure agreed upon by them.

* *Ramos v. Estrada (CA Ct of Appeals – 1992)*
* RULE: A corporate shareholders’ voting agreement may be valid even though the corporation is not technically a close corporation.
* R owned 50% of corp and the rest was issued in equal amounts to five other couples. Shareholder voting agreements were signed providing for block voting for directors – votes were to be cast for directors upon whom a majority of those signing the agreement had agreed; if they voted against the majority, they must sell their shares.
* When one couple voted against the majority, the court upheld specific performance of the agreement such that the others could buy out the couple’s shares.

## Classes of Shares

The simplest and most effective device by which the control rights of particular shares may be assured is to create multiple classes of shares. This is a particularly useful device in cases in which it is necessary to allocate voting power in different proportions from financial interests, as when one stockholder contributes cash and one contributes services but both desire equal control rights.

Classes of shares may be created without voting rights, with fractional or multiple votes per share, with power to select one or more directors, or with limited financial interests in the corporation.

The Model Act provides that the articles of incorporation may authorize shares with special voting rights and if the company’s articles authorize dividing shares into classes, the articles may also authorize the election of all or a specified number of directors by the holders or one or more classes.

# Fiduciary Duties of Directors, Officers, & Stockholders

## Duties in General

### Directors

Directors owe both a duty of care and a duty of loyalty to the corporation.

### Officers and agents

The duties owed by officers and agents depend on the position occupied by the officer or agent. A full-time, high-level managing officer may owe substantially the same duties to the corporation as a director. Agents or employees in subordinate or limited position owe a correspondingly lesser degree of duty, though even the lowest employee owes a duty of care, skill, propriety in conduct, and loyalty in matters connected with his employment or agency.

***Each corporate officer has the implied authority to enter into transactions that are reasonably related to the performance of the normal duties of his office***.

### Stockholders

A number of states hold that controlling stockholders in closely held corporations owe a duty to other stockholders that is akin to that owed by partners to each other.

Controlling stockholders may, in *extreme situations*, owe a duty to minority stockholders when transferring control of the corporation to a third party (*Perlman v. Feldman*).

## Duty of Care

***Directors and officers owe a duty to the corporation to exercise reasonable care in performing their duties with respect to the corporation’s affairs.***

This means that directors must make a reasonable effort to inform themselves of the facts necessary to make a proper decision.

* Example: Prior to acquiring a lease, a reasonably prudent businessperson would verify whether there were any delinquencies or outstanding liabilities by the transferor-lessee. This is even more so when the directors are aware of a prior breach by the tenant. Thus, the directors who approved the transactions are probably liable for the losses that may be sustained by the corporation.

***ADD IN RE CAREMARK***

### General tests

MBCA 8.30 states that the standard test for directors’ duty of care is that the duties must be discharged (1) in good faith (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and (3) in a manner he reasonably believes to be in the best interests of the corporation.

Policy: A stricter test might unduly discourage individuals from serving as directors. And the courts are reluctant to second-guess corporate managers with the benefit of hindsight.

### Business judgment rule

The business judgment rule is a common law principle that provides that honest business decisions made in good faith and on the basis of reasonable investigation are not actionable, even though the decision is mistaken, unfortunate or even disastrous.

* *Shlensky v. Wrigley (Ill.App.1968)*
* Shareholders of the corporation which owned the Chicago Cubs brought an action for mismanagement against the board of directors for deciding not to install lights and schedule night games.
* The court held that the decision was a business judgment and therefore the directors faced no liability. Plaintiff’s argument that 19 of 20 MLB teams had and had seen an increase in attendance was not grounds for such an action.
  + Furthermore, consideration of the surrounding neighborhood was OK as it is relevant such that it plays into whether those living there would attend and the long-term property value of the stadium.

It is ordinarily unreasonable to neglect to carry insurance on a substantial corporate asset. Therefore, if the board members decide *not* to carry such insurance, the directors who voted against the insurance are likely to be jointly and severally liable for any damage incurred that would have been prevented by insurance. The business judgment rule is unlikely to shield the directors in this situation, especially if they chose to retain the funds for dividends instead of purchasing insurance.

### Reliance on experts and committees

The Model Act 8.30(b) permits directors to ***reasonably*** rely on information, opinions, reports, or statements, including financial statements and other financial data prepared or presented by responsible corporate officers, employees, legal counsel, public accountant, or committees or the board of directors. Liability *cannot* be imposed on directors if the conditions of MBCA 8.30 are met.

Reliance is justified only if the director reasonably believes that the officers, directors, or committee presenting the information are reliable and competent on the matters presented. In the case of legal counsel, public accountants, and other professionals, the director reasonably believes that the matters are within the person’s professional or expert competence.

If the director makes a judgment that the source of information on which she proposes to rely is reliable and competent, then the decision to rely is itself protected by the business judgment rule.

### *Smith v. Van Gorkon*

Prior to 1985, relatively few cases imposed liability upon directors for failure to comply with their duty of care.

* *Smith v. Van Gorkom (Del. 1985)*
* The Delaware Supreme Court imposed liability upon the directors of TransUnion Corp. for accepting an outside offer to purchase TransUnion without investigating whether a higher price might be obtained and without making an investigation into the value of the company.
* The directors relied on the opinion of Van Gorkon (the CEO) that the price being offered was a reasonable one and approved a sale of the corporation within a 3-day period with virtually no discussion of possible alternatives and no assistance from outside experts.
* TransUnion sold at $55/share; while the sale was pending it received an inquiry that indicated that a sale at $60/share might be possible. This difference resulted in a potential of $60 million because there were 12 million shares.
* ***RULE: The test for applying the business judgment rule is gross negligence.***
  + Here, the directors had been grossly negligent in not adequately informing themselves of the transaction they approved.

Note: All directors, officers/employees as well as those from outside the company, are responsible for the potential loss to stockholders.

### Director liability statutes

In 1986, in direct response to *Smith v. Van Gorkon*, Delaware (and today virtually all states) enacted a statute which authorized, in a certificate of incorporation, a provision eliminating the personal liability (even by gross negligence) of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that liability still existed for (1) breach of duty of loyalty, (2) acts not in good faith or misconduct, (3) unlawful distributions, or (4) acts from which the director derived improper benefits.

Note: This statute only applies to *monetary damages*. This does not preclude an action for equitable relief to enjoin a transaction.

Note: MBCA 20.2(b)(4) permits a provision in the articles eliminating liability for *gross negligence* (as stated above), but it is slightly more narrow. It may not limit or eliminate liability for: (1) the amount of a financial benefit received by a director to which he is not entitled, (2) an intentional infliction of harm on the corp. or stockholders, (3) illegal distributions, or (4) an intentional violation of criminal law.

## Duty of Loyalty

Whereas the duty of care focuses on the responsibility of directors and officers to manage a corporation competently, ***the duty of loyalty (sometimes called the duty of fairness) focuses on the responsibility of directors and officers to avoid or at least scrutinize conflicts of interest***. Conflicts of interest may take many forms:

* In a self-dealing case, a director or officer (or corporation he is also a board member of) enters into a transaction with the corporation. For example, a director may sell a piece of property to the corporation. The obvious danger is that the director may use his position to cause the corporation to overpay.
* In a corporate opportunity case, a director or officer may come across a valuable business opportunity in his capacity as a director or officer and may seek to exploit the opportunity for his own benefit rather than offering it to the corporation. The harm to the corporation is lost profits.
* In a competition case, a director of officer engages in a new business venture that seeks to exploit the same market as the old corporation. The harm to the corporation comes in the form of reduced profits.

### In general

***If a transaction is tainted by a conflict of interest that triggers a duty of loyalty analysis, the burden shifts to the defendant to prove that the transaction is fair to the corporation***.

* Note that the plaintiff has the initial burden of showing that a conflict exists.

Generally speaking, the remedy in a duty of care case is damages, whereas the remedy in a duty of loyalty case is rescission or the equivalent.

### Self-dealing

A self-dealing transaction is one between a director and corporation. Generally speaking there are two ways that a tainted transaction may be upheld or ratified.

Courts generally hold that if no safe harbor statute is satisfied, the common law test of fairness is applied, with the burden of proof on the directors.

#### Safe harbor

***Under the majority position, if directors can demonstrate that the statutory requirements were met, then the transaction enjoys a safe harbor from judicial review as to the claim concerning the interested person’s conflict of interest.***

Note that a safe harbor does not extinguish other claims shareholders may be able to assert – gross negligence, waste, fraud, lack of board authority, or procedural deficiencies.

* *Marciano v. Nakash (Delaware – 1987)*

#### Fairness

Transactions that do not meet the “safe harbor” requirement not necessarily void. Such transactions may be challenged or sustained based on a judicial assessment of their fairness to the corporation. *The burden of proving fairness is on the directors and the business judgment rule does not apply*.

* *Lewis v. SLE (2nd Cir. – 1980)*
* Derivative suit was brought by shareholder of SLE; SLE and LGT were small, closely-held businesses. 5 children held stock in SLE while 2 of the 5 owned LGT. SLE owned real property which it rented to LGT – SLE essentially became it exist solely to rent property to LGT.
* Suit claimed that the 2 owners of LGT (also board members of SLE) failed to assess whether the lease was in the best interest of SLE and that they wasted corporate assets – the 2 owners of LGT claimed protection under the business judgment rule.
* The court held (1) no waste because the standard is *very* low, (2) business judgment rule does not apply when there is a conflict of interest, and (3) the 2 owners of LGT could not show the deal with fair – therefore they were liable.
* 2 owners of LGE provided no evidence that the lease was fair – did not show what the market value was, no appraisals were made, and no thought was made to “test the market” to see what other companies would have paid. The 2 owners of LGT attempted to show the lease is all LGT could afford – that does not show it was in the best interest of *SLE*.

Note – Waste: a defendant (director or officer) only needs to show that there was ***some business purpose*** in the action taken or decision made to avoid being liable for waste. This is ***an extremely low standard*** (see *In re The Walt Disney Company* infra).

## Good Faith

Good faith appears to be an element of one of both of the duties of care and loyalty, not as an independent duty.

When a director rejects a bona fide offer made to all the shareholders in order to obtain a greater personal profit (i.e., from a different offer solely to him), the rejection is a violation of the duty of good faith (note this would also be violation of the duty of loyalty).

* *In re The Walt Disney Company (Delaware – 2006)*
* *Stone v. Ritter (Delaware – 2006)*

## Corporate Opportunities

As a fiduciary, a director owes a duty to further the interest of the corporation and to give it the benefit of her uncorrupted business judgment. She may not take a secret profit in connection with corporate transactions, compete unfairly with the corporation, or take personally profitable business opportunities which belong to the corporation.

However, if the opportunity is not a corporate opportunity the director may take advantage of it personally for his or her own private gain and need not share it with the corporation or with other participants in the corporation.

Note: the corporate opportunity doctrine is part of the duty of loyalty.

### What is a corporate opportunity?

Classic definition from *Guth v. Loft* is seen below in the Delaware approach. This is often termed the ***line of business test***.

Several factors are considered in evaluating the status of an opportunity as a corporate opportunity:

* Whether there were prior negotiations with the corporation about the opportunity
* Whether the opportunity was offered to the corporation or the director as an agent of the corporation
* Whether the director disclosed the opportunity to the corporation or took advantage of it secretly
* Whether the director learned of the opportunity by reason of his position with the corporation
* Whether as a result of taking advantage of the opportunity the director is competing with the corporation

#### Delaware approach

Delaware laws holds an opportunity is a corporate opportunity if:

* 1. The corporation is financially able to exploit the opportunity,
  2. The opportunity is within the corporation’s line of business,
  3. The corporation has an interest or expectancy in the opportunity, and
  4. By taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inconsistent with his duties to the corporation.
* *Broz v. Cellular Information Systems, Inc. (Delaware – 1996)*
* Broz was Pres. of RFB and a director of CIS. RFB and CIS were competitors in the cellular communications business. PriCellular was looking to acquire CIS – RFB and PriCellular were both looking to purchase a license for a communications line in Michigan. CIS claims Broz breached his duty of loyalty by purchasing the license for the benefit of RFB.
* The court held there was no breach because (1) the opportunity came to Broz in his *personal* not corporate capacity, (2) the seller did not consider CIS as a candidate, (3) no misappropriation of corporate information, (4) CIS was not financially able to undertake the opportunity, (5) it was not clear CIS has a recognizable interest in the license as CIS was, at the time, actively engaged in *divesting* licenses, and (6) Broz only competed with an outside company, PriCellular (had not actually acquired CIS).

#### ALI approach

The central feature of the ALI test is the strict requirement of full disclosure prior to taking advantage of any corporate opportunity. If the opportunity is not offered to the corporation, the director has not satisfied the test. The corporation must then formally reject the opportunity through a vote of the disinterested directors after full disclosure. ***Full disclosure is an absolute condition precedent to the validity of any forthcoming rejection as well as the defense of fairness***.

* 1. Did the director offer the opportunity to the corporation?
     + If no, no defense available to director – liable
     + If yes, did the disinterested directors, after full disclosure, formally vote to reject the opportunity?
       - If no, no defense available to director – liable
       - If yes, director may defend her actions on the basis of fairness

The ALI test defines corporate opportunity broadly – ***such opportunities include those closely related to the business in which the corporation is engaged and any opportunities that accrue to the director because of his position with the corporation***.

* *Northeast Harbor Golf Club, Inc. v. Harris (Maine - 1995)*
* While Harris, as president of the club, was offered an opportunity to purchase land adjacent to the club. She purchased the land in her name, only telling the club after the fact.
* The court remanded the case after adopting the ALI test, the trial court held Harris breached her duty of loyalty.
* Harris was approached in her capacity as president of the club, it is uncertain whether the club could afford the land (for trial court to decide), uncertain whether the opportunity was in the same business as the club (running a golf course v. developing adjacent land – the club made the policy decision it was in its best interest to prevent development).

#### Other approaches

A simple test of fairness was set forth in *Durfee v. Durfee (Mass. 1948)*.

The court in *Miller v. Miller (Minn. 1974)* elected to combine the ‘line of business’ test with the ‘fairness’ test which has a two-step analysis: (1) determine whether a particular opportunity was within the corporation’s line of business, and (2) scrutinize the equitable considerations existing prior to, at the time of, and following the officer’s acquisition.

### Rejection of a corporate opportunity

Even if an opportunity is a corporate opportunity, directors may take advantage of it if the corporation elects not to do so.

The corporation may voluntarily relinquish a corporate opportunity, though such a relinquishment is a self-dealing transaction and is scrutinized by the courts. A persuasive reason for the relinquishment helps to make it clear that the corporation voluntarily decided not to pursue the opportunity.

As is the case with self-dealing transactions generally, effective approval by the disinterested board members after full disclosure helps protect the director taking personal advantage of the opportunity.

### Inability or incapacity of corporation

Most courts will permit directors to take advantage of a corporate opportunity if the corporation is financially unable to capitalize to the opportunity. However, courts require a convincing showing that the corporation indeed lacks the independent assets to take advantage of the opportunity.

## Remedies regarding usurpation of a corporate opportunity

If a director or officer usurps a corporate opportunity, the corporation can obtain either equitable relief (e.g., rescission of a contract entered into) or damages equal to the profits derived by the wrongdoer.

## Competition with the Corporation

Judicial notions of fairness or fair play seem dominant in this realm, and cases require a close appraisal of the fiduciary’s conduct in light of ethical business practice.

## Executive Compensation

Decisions regarding executive compensation by their very nature raise duty of loyalty issues. The board of directors must approve the compensation paid to the CEO, who is invariably a director. Most publicly held corporations have created compensation committees composed of independent directors to review all compensation issues for highly compensated executives.

### Test for excessive compensation

Courts are reluctant to inquire into issues of executive compensation in publicly held corporations. However, in such instances, the test for excessive compensation is whether the payments are so large as to constitute spoliation or waste.

*See In re The Walt Disney Company* *supra*.

### Compensation based on stock performance

Courts have upheld arrangements based on the price or value of shares. Economists generally favor these arrangements because they tend to align management interests with the maximization of stockholder wealth.

## Controlling Shareholders

If the transaction involves a proportionate distribution of assets by the subsidiary to all of its stockholders, the minority has no basis for complaint on the ground of domination of management by the parent corp.

The proper standard for evaluating transactions between parent and subsidiary is that is must be entirely fair or intrinsically fair.

Allocation of asset problems occur when dealing with tax benefits resulting from the consolidation of a return, when parent and subsidiary share officer space, and when the parent provides services to the subsidiary.

* *Sinclair Oil Corp. v. Levien (Del. – 1982)*
* Sinven is a subsidiary of Sinclair and all of Sinven’s directors are employees of Sinclair and owns 97% of Sinven, therefore Sinclair owes a fiduciary duty to Sinven.
* When a parent contracts with a subsidiary and the parent is on both sides of the contract, self-dealing is involved. When self-dealing is involved, *business judgment does not appy – apply intrinsic fairness.*.
* Sinclair, as 97% owner of Sinven, caused Sinven to pay out annual dividends in excess of its earnings causing harm to the minority shareholders. The court held that because Sinclair did not gain anything to the exclusion of the minority stockholders of Sinven, the situation was not self-dealing (min. stockholders received proportionate dividends).
* When Sinclair caused Sinven to contract with Sinclair Int’l (a second Sinclair subsidiary), Sinclair was on both sides of the deal so self-dealing was involved and the *intrinsic fairness test should apply*. Sinclair caused Sinven to sell its entire product to Sinclair Int’l – min. stockholders of Sinven did not share in receipt of these products. When Sinclair breached the contract by failing to pay, the min. stockholders were harmed.
* Rule: Transactions between a controlling stockholder and the corporation must be fair to the corporation and the controlling stockholder has the burden of proving entire fairness unless the transaction has been ratified by the stockholders after full disclosure of all material facts.

ALI states that in transactions between parents and party-owned subsidiaries, a controlling shareholder may not, without proper disclosure and approval by disinterested min. shareholders, utilize the corporate property, its controlling position, or material non-public corporate information to secure a pecuniary benefit unless the controlling shareholder sustains the burden of proving its conduct falls within an exception to the rule.

### Sale of control

Some courts have found that in selling shares constituting a controlling interest in voting power, the seller has a fiduciary obligation to protect that corporation and the other shareholders.

However, absent extraordinary circumstances of the sort in *Perlman* (extreme shortage of product the corporation produced giving it a lot of market leverage therefore a large premium was paid for controlling interest), majority shareholders may sell controlling interest and retain the entire premium (amount over market value for that block of shares due to the controlling interest).

* *Perlman v. Feldman (2nd Cir. – 1955)*
* Perlman was majority shareholder, chairman of the board and president of the corp. He sold his controlling interest in the company, which produced steel, at a time when steel was in great demand.
* Perlman used the fact the controlling interest in the corporation gave the purchaser a great advantage in the market of steel to obtain a high premium (money over price of block of shares).
* The court held that due to the unusual market leverage Perlman commanded for the controlling interest, his fiduciary duties to the corporation and min. shareholders prevent him from obtaining this premium and not splitting it among the min. shareholders.

# Corporate Authority

In terms of who can take action, there are usually three choices: (1) the shareholders, (2) the directors, or (3) one or more of the officers.

In a general corporation, the members of the board of directors, acting collectively, have oversight responsibility for managing the corporation and making important policy decisions. The board appoints officers, who supervise the day-to-day operations of the company. The shareholders elect directors and approve fundamental corporate changes, such as mergers with other companies, amendments to the articles of incorporation and the like.

In closely held corporations, the shareholders may take a more active role in company management.

## Functions and authority of shareholders

### Scope of shareholders’ powers

***The universal rule in corporation law is that shareholders have no general power to manage a corporation***. Rather, shareholders have only those powers specifically given them by the corporation statute, by shareholders’ agreements authorized by statute, or in some instances by common law. ***The overwhelmingly important power of shareholders is to elect directors.*** Shareholders also have the ability to remove directors at any time with or without cause and the ability to elect new directors to fill any vacancies. Typically, all directors are elected annually (note, terms may be staggered).

Some corporation statues give the shareholders the power to amend the corporation’s bylaws, unless the charter provides that the directors have that power. The Model Act requires the board of directors to first vote on the action and then send it on to the shareholders for their consent (charter amendments, mergers and share exchanges, certain dispositions of corporate assets, and voluntary dissolution).

Originally, shareholders were typically individuals. Today, stock is predominantly held by institutional investors, such as mutual funds and pension funds.

* *Gashwiler v. Willis*
* Trustees of corp. wanted to convey the corp. to another company but plaintiffs opposed and stated trustees did not have the authority to act in such a way. Shareholders had approved such conveyance and trustees (all being shareholders) were present and then signed the conveyance with their names.
* No statute gave trustee’s such authority so the authority had to come from a corporate act – namely the shareholders’ meeting.
* The state’s corporate statute required such an act (approval of a conveyance) to be exercised by the board of trustees in their capacity as trustees. Although the trustees were present at the shareholders’ meeting, they were not acting within their capacity as trustees – ***the corporation could only act through the medium prescribed by law, and that is its board***.

Is a deposit trust company (a holding company for shares to provide an efficient way to exchange shares at a central location) viewed as a “person” under corporate statutes?

* NO

### Exercise of shareholders’ voting rights

Shareholders generally exercise their powers at meetings. ***They elect directors at the annual meeting which is held at the time and place specified by or in accordance with the bylaws***. Special meetings may be called by the board of directors, any person(s) authorized by the charter or bylaws, or the holders of, in the usual case, at least 10% of shares entitled to vote. ***A notice containing the date, time and place of a meeting must be given to shareholders unless they waive the notice requirement***.

For a meeting to be properly convened, a quorum must be present. The Model Act sets quorum at a majority of shares entitled to vote on the particular matter, unless a different requirement is included in the articles of incorporation. In order to vote, shareholders must own their shares as of a specified date. Shareholders may vote either in person or by proxy. Ordinary matters before the shareholder will be approved if the votes cast in favor of an action exceed the votes in opposition.

Directors are usually elected by a plurality of votes cast, which means that the directors with the most votes are elected even if they did not receive a majority of votes. The articles of incorporation may include provisions requiring a majority or super-majority vote for the election of directors as well as for the approval of ordinary or extraordinary matters. ***Extraordinary matters, such as fundamental corporate changes (i.e., mergers or sale of the business), require approval by a majority of shareholders entitled to vote on the matter***.

Shareholders may also take action by obtaining the written consents of all shareholders entitled to vote.

Although shareholders elect directors, directors may make an interim appointment of a director prior to a shareholders’ meeting. This interim appointment may be superseded by the shareholders.

***Finally, shareholders do not normally participate in management decisions (e.g., whether to enter into a contract) but when a quorum of disinterested directors does not exist, the shareholders may vote to ratify the contract.***

#### Electronic meetings and written consents

In Delaware, shareholder meetings may now be convened electronically – stockholders and proxy holders may use electronic technology to “attend” the meeting and will be deemed to be present and have their votes counted as such. This is *not available* under the Model Act.

For written consents, the Model Act requires unanimous consent of all shareholders for an effective vote via that medium (thought is that group discussion allows shareholders to form a majority opinion, unless everyone is in the same frame of mind already). However, Delaware only requires the same percentage of shareholders as if the vote was to be approved in person (e.g., majority required in person, then majority required for written consent).

#### Voting rules in director elections

The statutory default rule providing for election of directors by plurality vote is intended to prevent failed elections. A failed election may occur when a majority or super majority vote is required to elect directions and one or more positions may be left vacant because some candidates did not receive the required vote. To mitigate this problem, corporate codes typically contain what is referred to as the “holdover rule,” which provides that a director continues to serve until a successor is elected and qualifies.

* Under the default plurality vote system, shareholders may either vote for the proposed candidates or withhold their votes in protest against one or more members of the slate. Withheld votes are not counted and shareholders do not have the option of casting negative votes against candidates.

##### The Model Act, Uncontested Elections, and Public Companies

The Model Act permits public companies to use bylaw provisions to change certain procedures used in uncontested elections for directors. Bylaw provisions authorized by the Model Act permit shareholders to vote for a director, against a director, or abstain. In order to hold office, a director must receive a plurality of cotes, with more votes cast in favor of the director’s election than against it.

Note: ***the option does not apply in contested elections***. Thus, in contested elections “against” votes are not counted and the candidates with the most votes win.

Such uncontested elections within public companies not using the plurality voting system may only be made by those companies whose charter does not prohibit such a modification and does not require a higher than plurality vote or provide for cumulative voting in the election of directors.

##### The Model Act and Closely Held Corporations

***Such elections are not available to closely held corporations***. Instead, the Model Act grants shareholders of closely held corporations significant flexibility in modifying the traditional governance structure through the use of shareholder agreements signed by all shareholders or included in the company’s charter or bylaws.

##### Delaware and Election of Directors

Like the Model Act, Delaware uses an opt-in approach to dealing with the issue. In Delaware, the election of directors by a plurality vote continues to be the default rule, with shareholders having the option to increase the required vote in either the company’s charter or bylaws.

## Functions and authority of directors

### Source of directors’ authority and powers

Manson shows that the directors’ power is derived from state statute, not the shareholders, and that the directors are charged with managing the corporation.

* *Manson v. Curtis (NY Ct of Appeals – 1918)*
* The affairs of every corporation shall be managed by the board of directors, subject to the corporate bylaws. The powers of the board are not conferred by the shareholders, nor can they revoke the powers.
* The directors, convened as a board, are the primary possessors of corporate power. ***All powers directly conferred by statute, or impliedly granted of necessity, must be exercised by the directors***.
* Directors are the exclusive, executive representatives of the corporation and are charged with the administration of its internal affairs and the management and use of its assets.

Note: such powers may be restricted by the articles of incorporation.

To be sure, ***directors have no power individually*** – their power is only collectively. However, remember directors may act as a subcommittee of the board (established by the entire board). The typical statutory provision on board committees provides that the board may designate from its members any committees it wishes, and may delegate to a committee any of the board’s powers, except for certain powers prohibited by the statute.

The first committee the board usually appoints is the ***executive committee***. This traditionally is a committee having all the powers of the board when the board is not in session, except those prohibited by statute. It is common for an executive committee’s members to be all or almost all of the inside directors.

### How boards function

It is necessary to distinguish between corporations whose directors are substantial shareholders and those whose directors are not, because in the former, directors can be expected to take an unusually active role in decision-making.

* Typically, those with directors as substantial shareholders are closely held corporations.
* In large corporations, outside directors typically do three things: (1) serve as a source of advice and counsel, (2) offer some soft of disciple value, and (3) act in crisis situations. The also typically elect senior management. However, unlike in closely held corporations, directors in large corporations did not establish objectives, strategies, or major policies, but rather left those jobs to the corporation’s officers.

Different models for the board of directors have existed. Initially, boards followed an “advisory board” model such that they were elected by the CEO, acted as passive directors, and had some business connections with the company (e.g., outside counsel, consultant, supplier) which made it difficult for the board to be truly independent.

Today, boards typically follow a “monitoring board” model. Under this model, the board takes a more active, monitoring role in setting corporate policy and overseeing management.

## Functions and authority of officers

Officers are agents of the board. The Model Act does not prescribe either the number or position that the company have specific officers, although it does require one officer to have “responsibility for preparing minutes of the directors’ and shareholders’ meetings and for maintaining and authenticating the records of the corporation.” Instead, the offices to held be are described in each corporation’s bylaws or designated by the board in accordance with the bylaws.

* Note that a minority of states require specific offices that must be held.

The same individual may simultaneously hold more than one office in a corporation.

The Model Act also states that each officers’ duties shall be set forth in the bylaws, or to the extent consistent with the bylaws, the duties prescribed by the board or an officer with the authority to delegate such via the board. The Model Act does not discuss other types of authority:

* 1. Implied authority
  2. Incidental authority

Incidental authority of an officer is the authority to perform acts that are incidental to acts for which the officer has actual or implied authority.

* 1. Apparent authority

Apparent authority is authority not explicitly given, a 3rd party is not aware the power is not explicit but is inherent in the position. Acts completed with apparent authority bind the corporation.

### President

***The president has the power to bind the corporation in the usual course of its business***. For matters outside the usual course of business, the president’s authority to act must be granted by: a state statute, the corporation’s charter or bylaws, a board resolution, or after-the-fact ratification by the board.

* *Molasky Enterprises v. Carps, Inc. (MO Ct of Appeals – 1981)*
  + Two officers of a corporation took out a personal loan and signed that the corporation would back the loan. The corporation refused to back to the loan – the issue is whether the officers had the authority to bind the corporation.
  + In determining whether an action is within the company’s usual course of business, look at the history of the company.
  + Along with the title of president, the person is given ***apparent*** authority.
  + The title is a communication to the world stating that he/she has the authority to act on before of the company.
  + The title “president” gives the individual the apparent authority to bind the corporation to acts within the ordinary course of day-to-day business.
* If the corporation wanted to back the loan, the board could have voted to approve the act.
  + Note that the interested board members cannot vote – they are “conflicted out.” However, the interested members may be count for purposes of quorum.
  + In order to get the sick board member’s vote, the other members could have gotten written consent or done an electronic meeting with the sick member.
* The Court held that pledging corporate assets for personal loans was not in the day-to-day business therefore, because the corporation did not ratify the acts, the corporation was not bound.

Note: A corporation’s president ***does*** have the power to hire an attorney if such a step is necessary in the defense of litigation prosecuted against the corporation in order to preserve the corporate assets. Likewise, a president may hire counsel to take proactive steps in initiating litigation if it is to preserve corporate assets (e.g., sue for trademark or patent infringement).

* *Bresnahan v. Lighthouse Mission (Ga. Ct. App. – 1998)*
* The president signed the purchase agreement but the by-laws and past history of the business always required two signatures – therefore the president did not have actual authority.
  + Note: the by-laws are internal documents and were not accessible to the sellers
  + Distinguish from the situation if the provision requiring 2 signatures was in the Articles and therefore available to the public – the company (seller) would then have a good argument that the transaction was void
* There was no apparent authority because no manifestations of indications the president had the authority by the company to the buyer (no interaction at all therefore there can not be apparent authority)

General rule: when the board is deadlocked, the officers gain a tremendous amount of power because there is no one to tell them what not to do.

* Almost, always ask for a board resolution and if the officers are hesitant to get one, rethink the situation and figure out why the officers refused.

### Chair of the board

Most corporations do not have a chair of the board. The use of the title becomes increasingly common as the size of a corporation increases (i.e., only large corporations have a chairman). The person with this title is usually an officer, but not always.

When the chair of the board is an officer, it is not possible to identify with certainty the powers associates with the position.

* CEO as Chair – position has same implied powers to bind the corporation as the president

It is not unusual for the position of the chair to be largely ceremonial. In such cases (e.g., former CEO as chair) there are probably no powers that are implied in the office.

### Vice president

***Vice presidents have no actual or apparent authority***.

The VP has one inherent power: to serve in the place of the president, most commonly in the event of the president’s death, incapacity, or absence. In that connection, there are two problems: (1) if there is more than one VP, do they share the power or is there an order of succession?, and (2) what constitutes “incapacity” or “absence”?

1. If no bylaw or board action, there is no basis for distinguishing between VPs, and so each would seem to have the same power to substitute for the president. The usual way to set apart VPs is with different titles, “executive VP,” or “senior VP,” in order to establish an order of succession.

* Certain VPs may be given implied authority by virtue of their specialized titles – e.g., VP of purchasing could bind the corporation for contracts to purchase materials in the ordinary course of the business.
* *Anderson v. Campbell (Minn. SC – 1929)*
* When it came time to sign a deed, the president was absent so the VP signed the deed as if he was the president – no designation that he was the president or VP (although the deed left a blank line for “president”).
* The court held that the distinction didn’t matter and the deed was valid.
* The bylaws did not define or limit the duties of the VP

### Secretary

***The office of the secretary is required by statute***.

Unlike the implied authority of the president and VP, the power associate with the secretary relates only to the internal affairs of the corporation and not to its business. They are powers to keep minutes of meetings and other nonfinancial corporate records, to have custody of the corporate seal, to attest the seal, to certify corporate records, etc. The secretary’s functions are ministerial in nature and do not vest the secretary to transact business on behalf of the corporation. ***The secretary has the implied power to deliver those certifications and attestations***. A corporate secretary does not have the implied authority to enter into contracts.

* *In re Drive in Development Corp. (7th Cir. – 1966)*
* The secretary certified a board resolution but it is unclear as to whether the resolution actually happened. The company that allegedly certified the resolution claimed that the resolution never happened and that the secretary didn’t have the authority to certify the resolution.
* The court held the company was estopped from arguing the secretary did not have the authority
* Rule: The secretary has the ability to certify board resolutions and third parties dealing with the company can rely on such
* *First Securities Company v. Dahl (IO SC – 1997)*
* Secretary signed an easement to restrict use of land. The company later argued that the secretary did not have the authority to sign the easement.
* The court held that the company was estopped from arguing the easement was invalid because they did nothing for years when they had notice of the easement because it was recorded (did not develop land). The court also stated the company may have ratified it by not developing the land (similar to above).

### Treasurer

A corporation may have one or more officers with fiscal responsibilities. They are the treasurer and comptroller (also referred to as the controller). The treasurer and controller may report directly to the board or in a large company, to a CFO, who in turn reports to the board.

Although corporate statutes do no usually refer to the officer of the comptroller, the statutes often provide for the officer of treasurer, the position responsible for the receipt and disbursement of company funds and for company loans and their repayment. Treasurers are often responsible for investing a company’s funds, and creating and monitoring a company’s budget.

* The treasurer or controller has no authority to pay debts of the company unless by order of the directors. Nor can they cancel, compromise or set off claims due from the company by those due to it.

Absent a grant of authority originating with the board or bylaws, the treasurer also lacks the implied or apparent authority to bind the corporation in contracts or other transactions with third parties. Appropriate authorization is also required for a treasurer to dispose of corporate assets. ***Simply put, the treasurer has the power to care for the funds of the corporation. That includes depositing the funds in the proper depositories and disbursing them in accordance with orders from the board or an authorized senior officer, maintaining records of the funds, and rendering reports on the corporation’s funds to the board***.

# Shareholder Derivative Litigation

## Derivative actions generally

***A derivative action is a lawsuit brought by one or more stockholders to remedy or prevent a wrong to the corporation, rather than a wrong to the stockholders individually***.

In contrast, a direct action involves the enforcement by a stockholder of a claim based on injury to the stockholder as an individual as an owner of shares.

In a derivative action, a stockholder sues in a representative capacity on a cause of action that belongs to the corporation. Accordingly, ***the stockholder must be an adequate representative of all the stockholders*** – the real party in interest is the corporation.

In a derivative suit, the claim belongs to the corporation and recovery if any should usually go to the corporation rather than to the stockholders individually.

A derivative action may be settled or dismissed only with the approval of the court because of the danger that in a privatively negotiated settlement, the corporation may in effect bribe the plaintiff shareholder to drop the action.

Often times, plaintiff attorneys may look for and find possible litigation situations and then seek to find a plaintiff in whose name the action may be brought. These attorneys usually advance the cost of litigation and have a substantial interest in the litigation. Most derivative actions are dismissed or settled. When the settlement is in the form of changes in management practices, the plaintiff attorney is still entitled to recover a fee from the corporation (i.e., all plaintiff shareholders benefit from the change so the attorney should benefit and the shareholders pay equally).

### Derivative claims and creditors

Because the recovery in a derivative action goes to the corporation, creditors and others having a stake in the corporation benefit financially from a derivative action and not from a direct one.

## Distinguishing derivative actions and direct actions

One of the key questions in many cases is whether the action is derivative or direct, because if the action is derivative, the corporation is the real party in interest and the board of directors may be able to assume control of the action.

Personal direct actions are those brought by shareholders to enforce their own rights or to remedy their own injuries.

Derivative actions are brought by shareholders, in the name of their corporation, to enforce a right of the corporation or to remedy a corporate injury.

## Prerequisites for maintaining derivative action

### Demand on the corporation or board of directors

Under both federal and state laws, shareholders in a derivative action are required to ask the directors to pursue the lawsuit on the corporation’s behalf.

The shareholder plaintiffs may get around the demand requirement by showing that the demand is futile.

* An example of such a showing would be that the board of directors is interested in the transaction in question and a demand would in effect require the directors to sue themselves.

#### Delaware

In Delaware, the distinction between cases in which demand is required and cases in which demand is excused often determines the outcome of the case.

If demand is required, the board of directors or a committee thereof (usually called a ***special litigation committee*** *- infra*) may decide whether to pursue the action and its decision will usually be protected by the business judgment rule.

#### Universal demand

MBCA and the statutes of several states require that demand be made in all cases. The FRCP requires that a plaintiff must allege with particularity the efforts, if any, made by the plaintiff to obtain the action he or she desires from the directors and the reasons for his or her failure to obtain such action or for not making the effort.

Note: this approach *has not* been adopted by the courts.

### Contemporaneous ownership

***One may not bring a shareholder derivative action unless he or she was a shareholder of the corporation at the time the cause of action arose or become a shareholder through transfer by operation of law from a person who was a shareholder at that time.***

Similarly, a shareholder plaintiff who sells or disposes of his shares during the pendency of derivative litigation thereafter loses the right to maintain or continue the action.

***NOTE: when a derivative action is based on SEC Rule §16(b), it is not necessary for the plaintiff to have been a shareholder at the time of the alleged wrong.***

## Defending a derivative action

The corporation may show that the action is barred by virtue of a statute of limitations, show that the nominal plaintiff (complaining shareholder) is not an adequate representation of the stockholders based on laches, participation in the fraud, or conflicts of interest.

***The mot common defensive tactic is for the board of directors to seek dismissal of the lawsuit on the grounds that the action ultimately belongs to the corporation and may be voluntarily dismissed because it is contrary to the best interests of the corporation to pursue it***.

### Dismissal by the corporation

#### Protection by the business judgment rule

Typically, the entire board or a portion of the board is named as the defendant in the derivative suit. In this case, a ***special litigation committee (SLC)*** is appointed to determine whether pursuing the lawsuit is in the best interest of the company. ***As long as those appointed to the SLC are independent of the defendant directors, the decision by the SLC is protected by the business judgment rule***.

#### Special litigation committee

***The SLC is appointed by the defendant directors but must be comprised of individuals independent of said directors.*** This may be other directors that are not named or anyone who would not be influenced by those that appointed them (***Han recommends directors of corporations in an unrelated market that have been sued before as they will be considerate of the directors’ position***).

*Note*: 97-99% of the time, the SLC advises that the corporation should dismiss the lawsuit.

***If the SLC does recommend dismissal, the plaintiff shareholders may argue that the SLC was not independent of the defendant directors.***

#### Independence of the SLC

* *Aronson v. Lewis*
* F ink was 73 and retiring after years of leading the company. He owned 47% of the shares, had previously appointed the current board members (and had the shares to keep them there), and those directors voted on his compensation package.
* ***How can we show a person controls the board (because mere appointment is not sufficient)?***
  + Voting records – if they always vote with the person suspected of having control
  + Whether the directors are employees (i.e., officers) because the position as officer is where they make money
* *Auerbach v. Bennett*
* A SLC determined the lawsuit would not be in the best interest of the company although the company was found to have given bribes and kickbacks of 11 million dollars. Some defendant directors were personally involved.
* Auberbach set a low standard for finding independence:
* Decision by SLC is protected if the business judgment rule was used to appoint the SLC.
* *Zapata v. Maldonado*
* SLC decided against pursuing the derivative lawsuit. Instead of looking at whether the business judgment rule was used to appoint the SLC, the court considered whether the underlying claim was that of a breach of fiduciary duties.
* If the underlying action is a breach of duty of fiduciary duty, the court may look into the SLC’s motion to dismiss and assess whether it is fair.
* *Alford v. Shaw*
* The court lowered the standard from *Zapata* holding that the court may look into any recommendation by the SLC to dismiss the derivative lawsuit.

## Alternative dispute resolution

It is common for corporations to include in any contracts a stipulation requiring that disputes arising under the contract to be resolved using these alternative dispute resolution (ADR) procedures (e.g., arbitration or mediation). With ADR, there is less discovery, juries are not involved, proceedings are more private, costs are lower and results may be more focused and accurate.

Arbitration usually involves two sides submitting contending arguments to a panel of experts whose decision, they agree beforehand, is deemed binding on them.

Mediation usually involves an expert encouraging two contending sides to appreciate weaknesses in their stance and strengths in the other with a view toward reaching a negotiated settlement.

* *Elf Altochem North America, Inc. v. Jaffari*
* A contract was entered into which contained a provision stating that any and all disputes must be brought in California in an arbitration clause.
* Elf, a shareholder, brought a claim in the courts of Delaware, which he characterized was a derivative claim. The Delaware court dismissed the claim and stated that the arbitration clause was valid and enforceable.
* Note that Malek, LLC is not a signatory to the arbitration agreement. The court is treating Malek LLC as a partnership and bounding the LLC to what Elf agreed to.
* Furthermore, the court held the clause did not distinguish between derivative and direct actions, but that any and all must be brought in CA in arbitration.
* *Mission Residential v. Triple Net Properties*
* Mission and Triple formed an LLC named Holdings in order to take advantage of tax benefits and signed an operating agreement which included an ADR provision requiring the use of good faith to settle otherwise resort to arbitration for any issues between the two.
* Triple brought a derivative claim against Mission on behalf of Holdings. The court held the operating agreement (and therefore the ADR provision) did not cover derivative claims brought on behalf of Holdings because Holdings is a separate entity apart from Mission and Triple and was not a party to the operating agreement.
* **NOTE**: be mindful of the parties to the operating agreement – only the parties to the agreement will be bound to the ADR provision. *Know the true plaintiff in a derivative suit – it is the corporation, not the complaining shareholder*.
* *Parfi Holding v. Mirror Image Internet*
* Mirror Image entered into an agreement with Xcelera and Plenteous regarding the funding of Mirror Image and shares of stock each party would receive. The agreement contained an arbitration clause requiring any dispute “arising out of or in connection with this Agreement…to be settled by arbitration.”
* Xcelera became majority shareholder and initiated transactions the minority shareholders felt were only benefiting Xcelera. Parfi brought claims for breach of contract to arbitration and claims for breach of fiduciary duty in the Delaware court.
* The court determined the arbitration clause had a broad scope but that Xcelera’s fiduciary duties to Mirror Image were rights independent of any contract but attach to the majority shareholder automatically upon obtaining such a position.
* **Rule**: absent a clear expression of an intent to arbitrate breach of fiduciary duty claims, parties to an arbitration agreement may bring them in court.

The court in *Parfi* set forth the steps for determining whether the claims are arbitrable:

* + 1. Determine the scope of the arbitration clause;
    2. Determine what the claims are (from what issue do they arise);
    3. Determine whether the issue is within the scope.

For example: An arbitration agreement that states “any dispute, controversy, or claim arising out of or in connection with” the agreement is to be settled by arbitration has a *broad scope*.

## Indemnification generally

In the context of corporation law, indemnification refers to payment or reimbursement by the corporation of a director, officer, or agent for expenses incurred in defending against a civil claim or criminal prosecution that arises in connection with service to the corporation, including claims by the corporation itself in a derivative suit.

If indemnification is permitted or required, it normally covers legal fees and other expenses. It may also cover a monetary award or settlement, amounts needed to satisfy a judgment entered against defendant officers or directors, or even a criminal fine. Liability insurance for directors and officers is also available.

***Note: a corporation is not required to indemnify directors or officers when the director or officer acts in bad faith***.

## D & O liability insurance

Most publicly held corporations provide indemnification and director and officer (D&O) liability insurance.

### Policy Exceptions

Policy allows some conduct to be excluded from D&O insurance.

* Conduct exclusions deal with conduct that is sufficiently self-serving or egregious that it is not insurable.
* Reckless, willful, or criminal conduct may not be insurable as a matter of law.

# Proxy Regulation

## False and misleading statements in proxy communications

Rule 14a-9 makes it unlawful to solicit proxies by means of communication that contains any statement that is false or misleading with respect to any material fact, or which omits to state any material fact.

### Private cause of action

The broad prohibition created by rule 14a-9 creates an implied private cause of action by stockholders (*J.I. Case Co. v. Borak*).

This private right may take the form of either a derivative action or direct action (usually class action). In either case, federal law applies to the procedural aspects of the case. Thus, a state law requirement that a bond be posted in connection derivative action does not apply.

### Materiality

The Securities Exchange Act of 1934 looks to protect shareholders of publicly held corporations form being asked to give their proxies to persons they do not know and for purposes that are not fully explained. The regulation essentially requires full and detailed disclosure of prescribed information anytime proxies are solicited in respect of securities that are registered under the Exchange Act.

* *Mills v. Electric Auto-Lite Co. (US – 1970)*
* ***The Court held that it is not necessary to show that the omission of a material fact actually influenced votes. Rather, it is enough to establish that the materiality itself was an essential link in the accomplishment of the transaction***.
* Shareholders of Electric Auto-Lite complained that the corporate merger with Mergenthaler was accomplished through the use of a proxy statement that was materially false or misleading. The proxy statement stated that the board of directors of Auto-Lite recommended approval of the merger without also informing them that all of the directors were nominees of M and that the directors were under the control of M (M owned over 50% of Auto-Lite but the merger required 2/3 affirmative votes of outstanding shares).
* *TSC Industries v. Northway, Inc. (US - 1976)* ***– KNOW THIS CASE***
* ***The Court held that a fact is material if there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote***. The Court also held that in order to be material a fact must change the total mix of information available to stockholders.
* *Virginia Bankshares, Inc. v. Sandberg (US – 1991)*
* ***The Court held (1) that a statement couched in opinions or conclusory terms purporting to explain directors’ reasons for recommending certain corporate action is materially misleading unless true statements discredit the other so obviously the risk of real deception is nonexistent (high standard); and (2) there is no private right of action for a member of a class of minority shareholders whose votes are not required by law or corporate bylaw to authorize the transaction***.
* There was a proposed merger between “Bank” and VBI – VBI was a wholly owned subsidiary of FABI. VBI owned 85% of Bank’s shares. FABI hired an investment banking firm to quote the price of the 15% of the shares the min. owned. The proxy statement stated the director’s urged the adoption, that the min. shareholders were receiving a “high value” and a “fair price” for their shares. Sandberg refused the proxy.
* The Court held that shareholders give weight to such opinions and conclusory statements because directors usually have knowledge and expertness far exceeding the normal investor’s resources, and the directors’ perceived superiority is magnified even further by the common knowledge of directors’ fiduciary duties.
* (2) Contrasting from *Mills*, the min. votes were required to authorize the merger because 2/3 affirmative votes needed; here, the majority owned 85% (not given requirement but know majority alone could authorize). The min. approval wasn’t needed and even though there was a conflict of interest with 1 director, other ways existed to insulate action from later attack such as ratification of merger by directors after full disclosure.

### Shareholders’ Proposals

Rule 14a-8 sets up an elaborate mechanism by which a shareholder may, if certain conditions are met, have a proposal of shareholders’ action included in the proxy statement. If a shareholder’s proposal is included in the proxy statement, management will also have to provide a means by which all shareholders can instruct the proxyholder how to vote on the proposal.

If management opposes a shareholder’s proposal, and it usually does, the shareholder must be given the opportunity to include a supporting statement in management’s proxy materials.

* *American Federation of State, County & Municipal Employees v. American Int’l Group (2nd Cir. – 2006)*
* Shareholder submitted a proposal for inclusion in the company’s proxy statement that would amend the bylaws to require the company, under certain circumstances, to publish the names of shareholder-nominated candidates for director positions together with any candidates named by the current board. The company excluded such and a lawsuit followed.
* The SEC had recently promulgated an interpretation of the “relates to an election” exception. This states a corporation may exclude a shareholder proposal if the proposal relates to an election for membership on the company’s board.” The court followed the initial interpretation promulgated when the regulation was last amended and held the proposal should not be excluded.

***However***, in response to AFSCME, the SEC amended the rule to authorize exclusion of a shareholder proposal that “relates to a nomination or an election for membership on the company’s board of directors or analogous governing body or a procedure for such nomination or election.”

* *Roosevelt v. E.I. Du Pont (Dis. of DC – 1992)*
* The court held that shareholders have a private right of action to enforce Rule 14a-8. The court also stated that shareholders’ proposals may be excluded from proxy statements unless they concern measures taken by the company that have a significant policy, economic, or other implication.
* The court held that the difference of year in a phase-out plan of CFC’s was not significant enough and excludable. However, a 5-10 year difference in timing would likely be, as would a differing view on whether to phase out a substantial revenue source.
* Example: whether to build a nuclear power plant would satisfy the significant policy requirement due to the economic and safety considerations that need to be weighed.
* Example: it is unlikely a request for a report from management detailing research and development efforts would meet this standard but with proper evidence from the shareholder it may be.
* In considering whether the issue is significant, look it: (1) timing, (2) does the issue concern day-to-day activity, (3) is careful planning involved, (4) is there a gov’t policy/regulation on point, (5) is this a highly technical field, etc.

## Proxy contests

In a proxy contest, an insurgent group competes with management in an effort to obtain proxy appointments by sending proxies and statements to the shareholders. In the classic proxy fight the goal of insurgents is to elect a majority of the board and thereby claim control. But in some cases, contests are waged solely to obtain representation on the board.

* *Kennecott Copper Corp. v. Curtiss-Wright Corp. (2nd Cir. – 1978)*
* CW acquired a 9.9% min. share of Kennecott and proposed to have a minority position on the board. K refused and a proxy fight was started. The district court held CW’s statements violated Rule 14a-9 (materially misleading), and K subsequently won the election.
* The court here reversed and held that CW’s statements were not in violation of 14a-9 but that K’s statements were.
* CW’s statement not misleading b/c “detailed study” is essentially equivalent to what the dis. court stated should have been used, “thorough investigation.” There was no major harm done.
* K’s 1st statement (giving a substantial distribution to shareholders would not allow K to remain viable) was materially misleading b/c nothing in the board minutes or report or investment banking firm indicates a conclusion of non-viability was reached.
* K’s 2nd statement (CW’s program would trigger default of loans) was materially misleading b/c this outcome was not certain (banks could OK move) and K was unable to get the banks to sign a statement saying they would not OK the sale of a subsidiary.
* Remedy: the court stated that another election will be held and K and CW can re-solicit their proxies in accordance with rule 14a-9.

# Securities Fraud & Insider Trading

## State Insider trading

A director, officer or manager of a corporation may have material non-public information about corporate affairs that will likely affect the price of shares when it is disclosed. As a result, an insider may be tempted to purchase or sell shares without publicly disclosing the information. Such trading is called insider trading.

### Majority

* *Diamond v. Oreamuno (NY – 1969)*
* The court held officers and directors breached their fiduciary duties owed to the corporation by trading in its stock on the basis of material non-public information acquired by virtue of their official positions and that they should account to the corporation for their profits from those transactions.
* The court reasoned that inside information was corporate property and an insider should not be permitted to profit from the use of that property even though the corporation was not itself hurt.

### Minority

* *Freeman v. Decio (7th Cir – Indiana law – 1978)*
* The court refused to follow *Diamond* and instead maintained traditional common law that stated a corporate insider did not ordinarily violate his fiduciary duty to the corporation by dealing in the corporation’s stock, unless the corporation was thereby harmed.

## Federal Law and Rule 10b-5

Anyone in possession of material inside information must either abstain from trading or disclose to the investing public (*SEC v. Texas Gulf*).

The Court has stated that any person in the possession of material, non-public information has a duty to disclose the information, or abstain from trading, if the person obtains the information in a relation of trust and confidence.

***10(b)(5) IS NOT IMPLICATED IF THERE IS NO TRANSACTION (i.e., if the shareholder abstains from selling or a person abstains from buying).***

***10(b)(5) is applicable to trading by individuals and therefore constitutes a broad prohibition against trading on the basis of inside information by anyone who receives the information from the issuer in connection with a relationship to the issuer that gives rise to a duty not to use the information for personal gain***.

### Materiality: reliance

***Rule 10(b)(5) applies only if there is failure to disclose a material fact.***

***The test of what is material is whether a reasonable person would regard the information as important in deciding how to act (TSC v. Northway)***.

* *Basic, Inc. v. Levinson (US – 1988)*
  + The Court rejected the bright-line test that, regarding disclosure of pending merger negotiations, disclosure was required only when an agreement in principle had been reached and that prior to that time a general denial was not misleading.
  + The Court also held that in the case of misrepresentation relating to a publicly traded security, a purchaser or seller may be able to recover without establishing reliance on the misrepresentation.
  + The Court adopted the market fraud theory to the extent of creating a rebuttable presumption of reliance, thereby placing the burden of showing a lack of reliance upon the defendants.
    - The “fraud on the market” theory is that investors rely on the efficiency of the securities markets in establishing an appropriate price for the shares.

### “In connection with” requirement

***In order to implicate 10(b)(5), the fraud must be “in connection with” the transaction. This just means that the fraud had to somehow “touch” or contribute to the transaction involving securities.***

* *Superintendent of Insurance of NY v. Bankers Life & Casualty Co.*
  + B bought all of M’s stock with a loan from IT. B sold M’s bonds to pay for the loan – essentially using M’s assets to pay for the purchase of M’s shares
  + ***The fraud was held to “be in connection with” the sale of securities – therefore implicating Rule 10(b). The fact that the transaction did not occur through a securities exchange is irrelevant – 10(b) covers all public and private transactions (includes contracts for sale of securities).***
* *Brown v. Ivie*
  + B was an officer, director and 1/3 shareholder in a closely held corp. The other 2 shareholders (I and L) fraudulently induced B to sign an agreement requiring shareholders no longer employed by the corp. to sell back his shares for book value (under fair market value). One week after the signing, B was forced out of the corp. by I and L and required to sell his shares for less than fair market value.
  + The court held the connection of the fraud with the sale of securities sufficiently implicated the “in connection with” requirement of 10(b). ***The “in connection with” requirement is flexible – the plaintiff need not establish a direct relationship between the fraud and the purchase/sale of securities but only that the transaction touch the fraud***. This is to be judged on a case-by-case basis.
  + ***When considering whether the fraud “touches” the sale of securities, look at when the agreement to purchase/sell was entered into and when the fraud took place.*** A 7-year difference was held *not sufficient* but a 1-week difference did.
  + ***A contract for purchase/sale of stock constitutes a sale of security for purpose of 10(b)***.

### Standing

* *Blue Chip Stamps v. Manor Drug Stores (US – 1975)*
  + ***Only the corporation involved, purchasers or sellers of securities may sue under Rule 10b-5.***

### Scienter

* Ernst & Ernst v. Hochfelder

A director, officer, agent, or major stockholder of a corporation may have material non-public knowledge about corporate affairs that will likely affect the price of shares when it is disclosed. As a result, such an insider may be tempted to buy or sell shares, depending on the nature of the information, without first disclosing the information – such is *insider trading*.

* *Texas Gulf Sulphur v. SEC (2nd Cir. – 1968)*
* TGS had discovered an unusually rich deposit of ore in Ontario. The corporation itself issued a false press release essentially denying the rumors about the ore strike.
* ***The Court held that officers, directors, and employees of an issuer who know of a favorable (or negative) development as a result of their position with the corporation violate Rule 10b-5 if they purchase or sell shares or options before the information is released.***
* ***The Court also held that insiders must wait until the information has been reasonably disseminated to the investing public before they trade and suggests that tippees (persons who obtain material information before it is publicly released) have an obligation not to trade on that information***.
* Note: the court recommended waiting 24-48 hours after information is publicly disclosed before trading on it.
* *Chiarella v. US (Fed. Cir. – 1980)*
* Chiarella was employed in the composing room of a financial printer. Using his access to confidential takeover documents his firm printed for corporate raiders, he figured out the identity of certain takeover targets. Chiarella then bought stock in the targets, contrary to explicit advisories by his employer. He later sold at a profit when the raiders announced their bids.
* The Court held there was to be no criminal penalty under 10(b)(5) because merely trading on the basis of nonpublic material information could not trigger a duty to disclose or abstain. Chiarella had no duty to the shareholders with whom he traded because he had no fiduciary relationship to the target companies or their shareholders.
* ***“Upstream duty” – duty to holder of the information – what?***
* *Dirks v. SEC (US – 1983)*
* Dirks was a securities analyst whose job was to follow the insurance industry. When he learned of an insurance company’s massive fraud and imminent financial collapse from Secrist, a former company insider, Dirks passed on the information to his firm’s clients – they dumped their holdings before the scandal became public.
* The Court held that Dirks did not violate 10(b)(5) because Secrist’s reasons for revealing the scandal to Dirks were not to obtain an advantage for himself. For Secrist to have tipped improperly, there had to be a fiduciary breach.
* ***Such a breach occurs when the insider gains some direct or indirect personal gain or a reputational benefit that can be cashed in later*.**
* Because Secrist had exposed the fraud with no expectation of personal benefit there was no fiduciary breach, therefore Dirks could not be liable for passing on the information to his firm’s clients.
* ***The Court held that a tippee violates Rule 10b-5 only if the tipper breaches a fiduciary duty in disclosing the information to the tippee and the tippee is aware of the breach***.
* Here, the tipper was an employee of the insurance company that had fraudulently overstated its assets, and the employee was apparently motivated by only a desire to expose the fraud and not by the prospect of any monetary gain.
* *United States v. O’Hagan (US – 1997)*
* Affirmed *Chiarella*
* O’Hagan was a partner in a law firm retained by a company planning to make a tender offer for a target company. He purchased common stock and call options on the target’s stock before the bid. Both the bidder and law firm had taken precautions to protect the bid’s secrecy. When the bid was announced, O’Hagan sold for a profit of more than $4.3 million.
* O’Hagan was convicted under 10(b)(5) because his trading operated as a *fraud on the source* in connection with securities trading.
* Because O’Hagan owed a fiduciary duty to his client - ?

## Insider Trading

Remember, 10(b)(5) is only implicated if a transaction has taken place – abstaining from a transaction does not implicate 10(b)(5).

Insiders who obtain material, nonpublic information because of their corporate position – directors, officers, employees, or controlling shareholders – have the clearest 10(b)(5) duty not to trade (*Chiarella*).

* An insider is generally one who is advised of material, nonpublic information as a consequence of (1) his or her position with the corporation, or (2) being retained by the corporation to perform a confidential function.
  + Note this is different than a simple employee overhearing a conversation (i.e., not purposefully being advised of facts)

Constructive insiders who are retained temporarily by the company in whose securities they trade – such as accountants, lawyers, and investment bankers – are viewed as having the same 10(b)(5) duties as corporate insiders (*Dirks*).

Outsiders with no relationship to the company in whose securities they trade also have an abstain-or-disclose duty when aware of material, nonpublic information obtained in a relationship or trust or confidence (*O’Hagan*). The outsider’s breach of confidence to the information source is deemed a deception that occurs “in connection with” his securities trading.

**Tippers**. Insiders and outsiders with a confidentiality duty who knowingly make improper tips are liable as participants in illegal insider trading (*Dirks*). The tip is improper if the tipper anticipates reciprocal benefits – such as when she sells the tip, gives it to family or friends, or expects the tippee to return the favor. The liability extends to *sub-tippers* who know (or should know) a tip is confidential and came from someone who tipped improperly. The tipper or sub-tipper can be held liable even though she does not trade, so long as a tippee or sub-tippee down the line eventually does.

**Tippees**. Those without a confidentiality duty inherit a 10(b)(5) abstain-or-disclose duty if they knowingly trade on improper tips (*Dirks*). A tippee is liable for trading after obtaining material, nonpublic information that he knows (or has reason to know) came from a person who breached a confidentiality duty. In addition, *sub-tippees* tipped by a tippee assume a duty not to trade, if they know (or should know) the information came from a breach of duty.

* Example: A janitor asks an officer “what is wrong?” and the officer replies, “corp. X just lost a lot of money.” Janitor *has no liability* as a tippee because a tippee is only liable if the tipper would be culpable. An insider (officer) is liable for tipping material, nonpublic information to someone who purchases or sells without disclosing the tipped facts ***if*** disclosure was made by the tipper to (1) acquire some type of personal gain or advantage, or (2) bestow a gift upon the tippee. Because officer was not doing either (1) or (2), there is no liability.

**Strangers**. A stranger with no relationship to the source of material, nonpublic information has no 10(b)(5) duty to disclose or abstain. Strangers who overhear the information or develop it on their own have no 10(b)(5) duties.

## Section 16 of Securities Exchange Act – disgorgement of “short-swing” profits

Section 16 addresses trading by directors, officers, and shareholders with *more than 10%* of shares of SEC registered companies.

* 16(a) requires reporting of all transactions in issuer stock by such persons and prohibits their engaging in any short sale of issuer stock.
* ***Section 16(b) provides that the gain (or loss avoided) from a purchase and sale (or sale and purchase) of equity securities within a 6 month period may be recovered by the issuer***.

***Rule statement of 16(b): A director, officer, or >10% shareholder of a corporation that (1) is traded on a national exchange, or (2) has a net worth of at least $5 million and at least 500 shareholders, is strictly liable to that corporation for any profits derived from (a) a sale and purchase, or (b) a purchase and sale, of the corporation’s securities within any period of less than 6-months.***

§16 applies to ***any*** securities of a registered company, whether or not the particular securities are traded on the stock.

* Example: The buying and selling of a director’s preferred stock (which is not traded on a stock exchange) is still subject to 16(b) if the company’s common stock is traded on a stock exchange.

Note: The 10% ownership must be of a single class of stock.

Note: Suit by the corporation or by a shareholder in a derivative suit must be brought within two years of the date the profit was realized.

§ 16(b) imposes automatic, strict liability. There is no proof of intent, scienter or knowledge that §16 (b) was triggered. The recovery is to the corporation and may be brought by either the corporation or by a shareholder in a derivative suit.

### Four main points

1. ***Match any transactions that produce a profit***

§16(b) liability it predicated on the matching of any purchase with any sale, regardless of order, during any 6-month period in which the sales price is higher than the purchase price. There is no tracing of shares, and recovery is frequently measured by matching later lower-cost purchases with earlier highest-cost sales.

1. ***No offset is necessary***

There is no need to offset any losses – that is, any purchases and sales in which the sales price is *lower* than the purchase price need not be matched and can be disregarded.

1. ***Officer or director status must exist at either sale or purchase***

***For officers or directors (but not 10% shareholders), officer or director status at the time of either purchase or sale is sufficient – not necessarily both***. The theory is that by trading when he was an officer or director, the insider had access to nonpublic information and was in a position to manipulate the price of the stock.

***The SEC has stated that a director or officer is not subject to §16(b) with respect to transactions that occurred prior to becoming a director or officer. But the director or officer remains subject to §16(b) if there are any matchable transactions up to 6-months after he leaves office.***

1. ***Shareholder status (>10%) must exist “immediately before” both transactions***

***For 10% shareholders, it is necessary that the person have held more than 10% immediately before both the purchase and the sale that are to be matched***. The rationale is that 10% shareholders are less likely to have access to inside information or to corporate control than directors or officers. Their insider status and presumed access to inside information and the control must exist at both ends of the matching transactions.

### Comparison to Rule 10(b)(5)

§16(b) is broader and narrower than the insider trading prohibitions of 10(b)(5). Limited to trading in securities of registered companies during a 6-month window, it is narrower than 10(b)(5) – which applies to all companies and regardless of holding periods. Yet, by covering any trading during a 6-month period, whether or not based on inside information, §16(b) is broader than 10(b)(5) – which requires a showing that trading was based on material, nonpublic information.

### Who is an “officer”?

For purposes of §16(b), an officer is any employee who has a position in the corporation that gives her access to confidential inside information that is not freely circulated. An official title may help identify these persons, but is not determinative. Determination of whether a person is an “officer” is based on title and policy-making functions.

For example: a “vice president” is not necessarily an officer for §16(b) if the title is merely honorary in recognition of sales accomplishments.

### Deputization

The deputization theory applies to entities that hold stock in a corporation and are also represented on the corporation’s board.

Example: Suppose H is a managing partner of Trout, an investment bank with a securities trading department, and that H also sits on the board of B Corp., the subject of a takeover speculation. If Trout purchases 5% of B Corp.’s stock, §16(b) does not literally apply. However, under the deputization theory, H is treated as Trout’s “deputy” and any Trout transactions in B Corp. stock are brought under the §16(b) rules.

### Beneficial Ownership

Example situation in which this arises – if the spouse of an officer of Company X owns shares in the company, can transactions by the spouse be attributed to the officer?

#### 10% shareholders

Spouses and others in the immediately family with stock in the same class may have their percentages aggregated such that if the family has a greater than 10% shareholding, their transactions will be covered by §16(b).

#### Directors and officers

Families of directors and officers implicate §16(b) if the director or officer stands to profit directly or indirectly from the transaction.

Example: first page of book