BUSINESS ENTERPRISES
Bean Fall 2010

A. Introduction to Corporate Strategy

- Types of business organizations
  - Sole proprietorships
  - Partnerships
    - Almost malpractice to let your client be in a general partnership
  - Limited Partnership
  - Corporations
  - LLC's & LLP's
- Agency
  - Facets of Agency
    - Principal
    - Agent
    - Third Party

B. Fiduciary Obligations of Agents

- "servant and master" and "employee and employer"
  - a servant is accountable to his master for profits he obtains because of his position
    - if servant takes advantage of his position and violates his duty of good faith and honesty to make profit for himself
- an agent owes his principal the duty of good faith and loyalty not to act adversely to his principal's business interests in furtherance of his own (Singer)
- agents usually violate the duty of loyalty in one of three ways:
  - receiving money from a third party in connection with some transaction between the principal and the third party
  - making a secret profit from the agency relationship by secretly transacting with the principal
  - using his position to make personal profit for someone who has no relationship whatsoever to the principal (General Automotive)

C. Fiduciary Obligations of Partners

- Joint adventurers like partners owe one another the duty of loyalty (Meinhard)

D. Raising Additional Capital

- Businesses often need additional funds to finance their activities
  - Sometimes funds can only be raised from the equity investors

E. Partnerships

- A majority of districts (including Michigan and Delaware) have adopted some form of the either the Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA)
- Characteristics of a partnership
  - Personal liability of partners
  - Limited duration

    - Dissolution on exit of partner
    - Limited transferability of ownership interest
    - Pass-through taxation
- Partnership income is actually the income of the partners

- Partnership- An association of two or more person to carry on as co-owners a business for profit
    - Partnership by estoppel
        - Must show four things:
            - Plaintiff must establish that there was a holding out of a partnership
            - The making of the representation of the person sought to be charged as a partner or with his consent
            - A reasonable reliance in good faith by the third party upon the representation
            - A change of position, with consequent injury, by third person in reliance on the representation
- UPA Sec. 40
    - In settling accounts between the partners after dissolution, the liabilities of the partnership shall rank in order of payment, as follows:
        - those owing to creditors other than partners
        - those owing to partners other than for capital and profits
- UPA Sec. 15
    - All partners are liable:
        - jointly and severally for everything chargeable to the partnership under sec. 13 and 14
            - e.g. torts and breaches of fiduciary duty
        - jointly for all other debts and obligations of partnership
            - e.g. contracts
- A partner's interest is his share of the profits and losses
    - A partner who has transferred his interest remains a partner
- Every partner is an agent of the partnership for the purpose of its business
- A partner has full personal liability for debts of the partnership
- Sec 9(1) and 9(4)
    - A partner cannot have apparent authority with a third party if the third party knows he has no authority to make the contract
- Partnership matters are decided by a majority votes (unless there is an agreement to the contrary)
- If partner is sued for tortuous conduct may be able to throw vicarious liability upon partnership if:
    - Partner acting either in the ordinary course of business; or
    - With authority from the partnership
- Dissolution- a change in relationship of the partners caused by any partner ceasing to be associated in the carrying on of the firm's business
    - After dissolution, the partnership must be wound up, usually involves distributing assets to partners
    - Could continue with an agreement effectively creating a new partnership
        1. creditors of old partnership would automatically become creditors of new partnership

2. departing partner is entitled to accounting
3. fair value of partnership
4. still remains liable on all firm obligations unless released by creditors

- if a new partner joins after dissolution
  1. liable for firm's old debts but only out of partnership property
  2. cannot be held personally liable for old debts unless he agrees to be held so
- dissolution of a "term partnership" before the term is up is "wrongful"
- UPA Sec 29, 31: the old partnership is dissolved by the retirement of any partner and when the remaining partners continue their practice a new partnership is formed
- RUPA Sec 601, 701: if a partner retires pursuant to an appropriate provision in the partnership agreement, there is a "dissociation" instead of a dissolution; the partnership continues and the dissociated partner is entitled to be paid

F. **The Nature of the Corporation**

- Delaware is the front runner for corporate incorporations
  - New York and California are big too (Nevada up and coming)
- Why Delaware?
  - Predictability- a lot of case law on what Delaware statutes mean
  - Flexibility- substantial management flexibility
  - Judicial expertise- corporate law in Delaware is quick, easy, and judges are incredibly skilled
  - Strong legislature is active- Delaware legislators work closely with the Delaware bar to constantly reform their corporate law
  - Specialized court- Delaware chancery is the court for corporate matters
- A Majority of states (not including Delaware) have adopted some version of the American Bar Association's Model Business Corporation Act (MBCA)
- Corporate law follows the internal affairs doctrine (MBCA 15.05)
  - The law of the state of incorporation governs the relationships among the parties within the corporation
    - Does not apply to corporate relations with third parties
    - According to this doctrine state and federal courts must adopt corporate law rules of incorporating state, even if inconsistent with forum state
    - 50% of public corporations and 60% of fortune 500 are incorporated in Delaware
- Characteristics of a corporation
  - Perpetual existence
  - Separate existence

        - Corporation is a legal person, have some constitutional rights, e.g. due process, equal protection, commercial speech
        - Double taxation
    - Limited liability
    - Centralized management- board of directors
        - Separation of ownership and management
        - Officers manage day to day affairs in accordance to policies of the board
        - Directors and officers are agents of the corporation, but owe fiduciary duty to both corporation and the shareholders
    - Passive ownership by stockholders
    - Freely transferable ownership interests
- All corporations need 2 documents
    - Articles of incorporation
        - Name
        - Registered office and agent
        - Capital structure
        - Purpose and powers
        - Initial capitalization
        - Size and composition of board members
    - By-laws
        - Provide details on internal operations

G. Promoters and the Corporate Entity

- Promoter- person who has original idea who is pushing project before incorporation
    - May enter into contracts pre-incorporation
    - After corporation is formed the corporation may, but does not have to, adopt the pre-incorporation promoter contracts
    - Promoter is still personally liable for contract unless the third party releases him
    - If the corporation is never formed the promoter is liable
        - Investors may also be found to have formed a general partnership pre-incorporation
- De facto corporation- a court may treat a firm not properly incorporated as though it were if the organizers:
    - In good faith tried to incorporate
    - Had legal right to do so
    - Acted as a corporation
- Corporation by estoppel
    - Plaintiff has recognized corporation and acted as if the corporation exitsts
- A contract is not unenforceable because a corporation has not yet been incorporated (Southern-Gulf)

H. The Corporate Entity and Limited Liability

- Piercing the corporate veil- to treat the rights or duties of the corporation as the rights or liabilities of its shareholders or directors
- In order to pierce the corporate veil a plaintiff must show:
    - That there was such a unity of interest between the individual and the corporate entity that separate identities no longer existed
    - That a failure to do so would promote injustice in some way beyond leaving a creditor unable to satisfy its judgment (Sea-Land)
- Alter ego liability is imposed only when:
    - There is such a unity of interest and ownership that the separateness of the corporation has ceased
    - The facts are such that corporate protections sanction fraud or promote fraud (Roman Catholic)
- If a parent corporation basically controls a subsidiary, the parent corporation may be liable for claim against subsidiary (In Re Silicone)
- Limited partners will not be personally liable so long as they keep their personal business separate from corporate business and there is no fraud etc. (Frigidaire)

I. Shareholder Derivative Actions

- DGCL Sec. 141(a):
    - "the business and affairs of every corporation…shall be managed by or under the direction of a board of directors…"
- in any suit, a plaintiff must show that a director:
    - had a duty to disclose and did not
    - stood on both sides of a transaction and did not disclose it
    - improperly seized a corporate opportunity for himself
- if a plaintiff cannot show one of the things above or something similar the claim is essentially that the director made a really, really bad decision
    - courts protect directors against liability for negligent breached of the duty of care through the business judgment rule
- Business judgment rule (BJR)- means that courts will not second-guess directors' disinterested, informed, good faith exercises of business judgment
    - This is a central doctrine of corporate law
    - If BJR applies, the plaintiff loses on a breach of duty of care claim
- Derivative claim- seeks to require corporation to bring a cause of action on behalf of the corporation against a third party
- Direct claim- shareholder has suffered direct injury
- Indemnification
    - Directors are indemnified against most liabilities
    - Corp will reimburse them if they are held liable for an action
        - But they are not indemnified against breaches of loyalty
- Derivative litigation- standing
    - A nominal plaintiff must have contemporaneous ownership with a breach of fiduciary duty
    - A nominal plaintiff may have continuing interest throughout lawsuit

- Double derivative action- where shareholder of a parent corporation suing derivatively to enforce a right of a subsidiary corporation
- Jurisdiction may make a shareholder who brings a suit pay for the costs if it is unsuccessful (Cohen)
    - Ex. court in diversity jurisdiction applied NJ statute requiring plaintiff who owned less than 5% of outstanding stock to post a bond
    - Delaware does not require any security
- Attorneys fees for successful settling
    - Derivative litigation is almost always lawyer driven
- Typical derivative actions
    - Misfeasance or misappropriation of corporate property
    - Enforcement of corporate contracts with third parties
    - Actions against corporate directors for competing with corporation/ appropriation of corporate opportunity
    - Excessive salary suits
    - Third party torts against corporation
    - Correction of false entries in corporate records by directors
- Typical direct actions
    - Interference with right to vote
    - Interference with preemptive rights
    - Dilution of voting rights
    - Enjoin improper voting of shares
    - Compel dividends
    - Improper uses of corporate machinery
    - Oppression
    - Compel dissolution
    - Challenge improper expulsion of shareholders
    - Compel holding of shareholder meetings

J. State Law Disclosure Standards

K. The Requirement of Demand on the Directors

- Demand on the board (Grimes)
    - A shareholder must make a demand upon the board to pursue corporate rights
    - Two types of jurisdictions:
        - Demand futility- when demand is made the board has a reasonable time to analyze the claim
            - If the demand is rejected and BJR applies it is a complete bar of the suit
            - Plaintiff can try to show that the rejection was self interested, made in bad faith, or uninformed
        - Universal demand (MBCA Sec. 7.42)
            - Written demand must be made on board for all cases
            - Precludes shareholder from bringing suit for 90 days after making demand unless shareholder will suffer irreparable injury
            - 11 states have this including MI

- A plaintiff does not have to make a demand if:
    - The majority of the board is interested/ benefiting
    - Board did not inform itself of facts
    - If the action was so egregious that it could not be under BJR
        - This would be a breach of loyalty not care

L. The Role of Special Committees

- Dismissal of derivative action by corporation
    - A corporation may appoint a special litigation committee (SLC) composed of disinterested, outside directors who were not involved in the wrongdoing to determine whether to go forth with the derivative claim (Auerbach, Zapata)
- Creation of SLC's is pursuant to a corporation's bylaws and DGCL Sec. 141(c)

M. The Role and Purpose of Corporations

- Ultra vires- outside the powers
- Intra vires- inside the powers
- A corporation can make reasonable charitable contributions even without express statutory provisions (A.P. Smith)
- Ordinarily a court will not force a corporation to pay dividends but:
    - Directors cannot withhold dividends from shareholders (Dodge)
    - Courts will interfere if the refusal to issue dividends amounts to "such an abuse of discretion as would constitute a fraud, or breach of…good faith"
- A shareholder does not state a cause of action unless it alleges that the corporation's directors' conduct was:
    - causing financial loss to the shareholder; and
    - was based upon fraud, illegality, or conflict of interest (Shlensky)

N. The Duties of Officers, Directors, and Other Insiders

- Importance of fiduciary duties- basic check on director actions
    - Duty of care (bad decision, pretty stupid decision, very stupid decision, so stupid something else must be going on)
    - Duty of loyalty (candor, undisclosed conflict of interest, taking advantage of a corporate opportunity)
        - Duty of a fiduciary to act on behalf of beneficiary and to place the beneficiary's interests ahead of the interests of the fiduciary
    - Duty of candor- duty to provide information to beneficiary
    - Duty of good faith and fair dealing-no real definition

O. The (Phantom?) Duty of Care

- It is not enough for a shareholder to allege that they would have taken different action than the board (Kamin)
- 141(e)- directors can rely on expert's reports
- 102(b)(7)- a provision limiting or eliminating the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director

- waste- an exchange so one sided that no business person of ordinary sound judgment would consider adequate consideration
- a person can't breach the duty of care before he is an employee
- description of bad faith:
    - intentional deriliction of duties (actual intent to do harm)
    - deliberate indifference (duty to act but did not)
    - director acts with the intent to violate law

P. The Duty of Loyalty

- DGCL Sec. 144- an interested transaction is not void or voidable if:
    - Material facts were known to the board
    - Material facts were known to the shareholders
    - Contract or transaction is fair to the corporation
        - Ex. it is ok for a board member's wife, who is a singer, to sing in a radio commercial for the corporation (Bayer)

Q. Directors and Managers

- BJR does not apply to directors and managers when dealing with loyalty question or conflict present or interested transaction

R. Corporate Opportunities

- Corporate opportunity doctrine
    - Rule that a corporation's directors, officers, and employees are precluded from using information gained in corporate capacity to take personal advantage of any business opportunity that the corporation has an expectancy right or property interest in, or that in fairness should otherwise belong to the corporation
- The fiduciary duty of loyalty requires directors and officers to offer investment opportunities derived from corporate business to the corporation before acting on them individually (eBay)
- Corporate opportunity exists where:
    - Corporation is financially able to take the opportunity
    - Opportunity is in the corporation's line of business
    - Corporation has an interest or expectancy in the opportunity
        - Something that would come to corp in the ordinary course of things
    - Embracing the opportunity would create a conflict between the director's self interest and that of the corporation

S. The Intersection of Loyalty and Good Faith

- To excuse the requirement of demand on a board, the court must determine whether the facts create reasonable doubt as to whether, at the time the complaint was filed, the board could have properly exercised its independent and disinterested business judgment in responding to the demand (Stone)
- Without red flags, the directors have no reason to suspect wrongdoing (Stone)

T. Dominant Shareholders

- DGCL 141(k)- "any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors"
- DGCL 228(a)- "any action…which may be taken at any annual meeting of the stockholders, may be taken without a meeting without prior notice and without a vote, if a consent in writing, setting forth such action, shall be signed by the holders of outstanding stock having not less than the minimum number of votes necessary to authorize or take such action as a meeting…"
- DGCL 223(a)(1)- vacancies on a board may be filled by a majority of the directors then in office, although less than a quorum, or by a sole remaining director
- Controlling shareholders owe a fiduciary duty to minority shareholders
- A transaction between a parent and subsidiary company must be intrinsically fair (Sinclair Oil)
    - Under intrinsic fairness test dominant company must prove that the transaction was objectively fair
    - Test only invoked when the parent company is on both sides of the transaction and self dealing is suspected

U. Ratification

- A majority of disinterested shareholders must ratify corporate transactions with an interested director (Fiegler)
    - Stockholders must be fully informed when they ratify an interested transaction (Wheelabrator Technologies)

V. Indemnification and Insurance

- A corporation must indemnify its officers, directors, and employees against legal expenses related to the defense of any legal action brought against them by reason of their position (Waltuch)
    - They must have acted in good faith
- Reimbursement- pay back
- Advancement- pay before suit
- Indemnification- compensate for loss or damage sustained
- A corporation may advance a director the costs of defending a lawsuit (Citadel Holding Corp.)
- Most statutes permit advancement of legal fees upon the defendant director giving an "undertaking" to repay the expenses if he is later determined not to be eligible for indemnification
    - DGCL 145(e) and MCL 450.1564(1) require and "undertaking" to repay
        - Usually legal fees are never repaid
        - If the indemnitee is successful, there is already a right to those fees
        - If unsuccessful, he is probably in jail or judgment proof
        - Often corporations will waive repayment once the action is finished

- DGCL 145(g) and MCL 450.1567
    - A Delaware corporation has the power to purchase insurance on behalf of directors and officers that will pay their expenses and liabilities even in situations where the corporation could not indemnify
    - Moral hazard- corporation is asking for director to be insured against breaches of their fiduciary duty

W. The Limited Liability Company

- LLCs require and operating agreement
    - You can have almost anything you want in it as long as it does not violate law
    - Bound to the operating agreement even if the LLC fails to execute it (some one did not sign) (Elf)
- Corporate law is used to fill in the blanks with LLCs
    - A court may "pierce the corporate veil" with an LLC (Kaycee)
- If an operating agreement permits competition, LLC members can engage in competing ventures (McConnell)
    - Ex. if operating agreement states that you can engage in "any other business venture of any nature" you could start a competing business

X. Organizing a Limited Liability Company

Y. The Securities Acts

- Securities Act of 1933 governs the offering and sales of "securities" to the public
    - Requires filing of a registration statement and making of an "initial offering"
- Securities Exchange Act of 1934 focuses on public reporting and other obligations of public companies and upon secondary trading markets
    - Sec. 10b- states that it is illegal for anyone to use "any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange…to use or employ…any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe…"
    - Sec. 10 b-5
- Purpose of '33 and '34 Acts:
    - Full disclosure
    - Prevention of fraud
- Courts have created a private cause of action with respect tot he provisions of the '34 Act, thereby creating federal common law
    - Two primary issues:
        - Material misstatement or omission in connection with the sale or purchase of any security
        - Insider trading- trading while in possession of material non-public information
- To make a claim for fraud one must establish:
    - Economic loss

    - Scienter (wrongful state of mind)
    - Proximate cause of loss by misrepresentation
    - In connection with a purchase of sale of a security
    - Reliance on the transaction
- SEC Rule 14e-3 Transaction in securities on the basis of material, nonpublic information in the context of tender offers

Z. Disclosure and Fairness

AA. The Registration Process

- If false statements are made or information is omitted and the information is material, then a registration statement will be considered misleading (Escott)

BB. Rule 10b-5

- Sec. 10b-5- states that it is illegal to "employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact necessary in order to make the statements made…not misleading, or to engage in any act, practice, or course of business which operates…as a fraud or deceit upon any person, in connection with the purchase or sale of any security"
- An omitted fact is material if the average, reasonable shareholder would have considered it important knowledge to have before deciding how to vote (Basic)
- Test for materiality:
    - Materiality will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity
- Fraud on the market theory:
    - Based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business
    - Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements
- Fraud on the market theory does not apply to non-public statements
    - Ex. this would not apply if a broker told a few of his clients that a company was going to be merged and that was not true because that information would not be reflected on the market (West)
    - If just one guys says it, the information is not really "out there"
    - If there is no change in the market then the market did not absorb the information
- Short-form merger statute
    - Allows parent company to merge with subsidiary if the parent owns 90% of the subsidiary's stock and the parent's board approves the action; parent company must:
        - Pay minority shareholders cash for their stock
        - Give notice of the merger within 10 days of when it becomes effective

        - This is not prohibited under 10b-5 unless it can be fairly viewed as ”manipulative or deceptive”
- A holder of an option has standing to sue under 10b and 10b-5 (Deutschman)
- Call- the right to purchase a specified number of shares of a particular security at an agreed price

CC. Problems of Control

DD. Proxy Fights

- DGCL 211 and MCL 450.1402 say that shareholders must have an annual meeting and may also have special meetings
    - Vote on few matters:
        - Elect directors
        - Big decisions: mergers, reorganization
        - Amendments to Article of Incorporation
- For small corporations no problem getting shareholders together, for large corporations this is not practicable
    - Large shareholders may send a representative to meeting
    - Most shareholders give a “proxy” to an agent to cast their vote
- DGCL 212 and MCL 450.1421 gives authority for shareholders to vote in person, by writing, or by proxy
- Most stockholders are not interested in voting and would rather sell stock than try to change company

EE. Strategic Use of Proxies

- Incumbent management may use corporate money to inform shareholders of its position in a proxy contest involving corporate policy issues (Levin)

FF. Reimbursement of Costs

- A corporation may reimburse factions for costs associated with a proxy fight involving a policy contest, but not one involving a personal power contest (Rosenfeld)

GG. Private Actins for Proxy Rule Violation

- It is illegal to solicit a proxy using false and misleading statements (J.I. Chase)
    - A court may enforce private action for rescission or damages if this happens
    - ’34 Act Sec. 27 gives courts jurisdiction over violation of the rules

HH. Sec. 14 of The Securities Exchange Act of 1934, Proxy Rules

- Proxy solicitations are governed by Exchange Act Sec. 14
    - Proxy statements must fully disclose major issues
    - Statements reviewed by SEC
    - Sec. 14(a) prohibits people from soliciting proxies in violation of SEC rules
    - Rules requires people who solicit proxies to furnish each shareholder with a “proxy statement”
    - 14a-7 gives management a choice
        - mail insurgent group’s material to all the shareholders; or

        - give a copy of the shareholder list and let group distribute the information themselves
- to establish a cause of action under Sec. 14, plaintiff must show only the misstatement's or omission's materiality and its ability to influence a shareholder's vote (Mills)
    - not that their actual vote was influenced
- put- an option contract giving the owner the right, but not the obligation, to sell a specified amount of an underlying asset at a set price within a specified time
- TSC Industries new materiality test:
    - An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote
- Failure to disclose value on the stock options granted to directors in proxy statement does not constitute a materially false and misleading statement under Rule 14a-9 of SEC (Seinfeld)

II. Shareholder Proposals

JJ. The Route to Corporate Social Responsibility

- Under Sec. 14(a) shareholders can include information in a company's proxy statement that have limited, if any, economic impact on the company so long as they are "otherwise significantly related" to the issuer's business (Lovenheim)
- A shareholder proposal may not be excluded under SEC Rule 14a-8(i)(8) on the basis that it relates to an election
    - Proposals that relate to elections in general are non excusable (AFSCME)
    - Rule 14a-8(i)(8) is known as the town meeting rule- it regulates shareholder proposals
        - A proposal must be included unless it fits into one of the 13 exclusions

KK. Shareholder Inspection Rights

- State corporate law always provides that shareholders have a right to inspect certain books and records
    - Financial reports: generally corporate financial records (at least those required by SEC) for public companies are available from the SEC disclosure filings required under the Exchange Act, The Securities Acts, and Sarbarnes-Oxley Act.
- Close corporations (30-50 shareholders) generally do not have to publicly disclose their financial statements
    - The only public notice of the existence and operation of a close corporation is an annual filing with the Secretary of State to identify the corporation and identify its address and registered agent
- MBCE Sec. 16.20 requires corporations to provide shareholders with an audited annual report of the financial status of the corporation that complies with Generally Accepted Accounting Principles (GAAP)

    - MCL Sec. 450.1487(1) only requires upon shareholder written request
- DGCL Sec. 220 Inspection of books and records
    - For production requires:
        - Written demand under oath
        - By a stockholder of record (not held in "street name" by a broker)
        - Stating proper purpose
    - May inspect articles of incorporation, bylaws and minutes of shareholder meetings
        - A of I and bylaws are available online fore public companies
- Proper purpose
    - MBCA Sec. 16.01(e), 16.02(a): if you seek the shareholder list to sell them to marketers, given them to creditors, or use them for political purposes, that's not a proper purpose. Seeking the shareholder list to solicit proxies from fellow shareholders, or seeking financial records for the purpose of valuing the investment are proper purposes
- Corporation must grant shareholder who wants to discuss tender offer's terms directly with shareholders the list unless corporation can establish a wrongful purpose (Crane)
- Not a proper purpose to buy stock and request list in order to further agenda (Pillsbury)
- NOBO list- beneficial owners; non-objecting
    - Requiring an out-of-state corporation to produce a shareholder list and a list of non-objecting beneficial owners violates the commerce clause (Sadler)

LL. Shareholder Voting Control

- Voting trust- A trust used to hold shares of voting stock in a closely held corporation and the trustee can exercise the right to vote
- an agreement among shareholders under which all of the shares owned by the parties are transferred to a trustee, who becomes the nominal, record owner of the shares
- A company may have stock with voting rights that is not entitled to dividends (Stroh)

MM. Control In Closely Held Corporations

- Close corporation- small number of shareholders
    - DGCL Sec. 342(a)(1) specifies a maximum of 30
        - Most corporate codes have specific statutory standards for determining what is a close corporation
    - May be managed by stockholders like an LLC
    - Limitations on the power of the Board may be imposed
- Close corporation characteristics:
    - Few shareholders (often family owned)
    - Significant shareholder participation
    - Primary source of income for shareholders

    - Illiquidity of shares
- Shareholders can enter into agreements to vote their stock in a particular way (Ringling Bros.)
    - Shareholder agreement cannot control a director's exercise of judgment (McQuade)
    - If directors are the sole shareholders, then they may enter into a shareholder agreement to ensure that certain individuals are officers (Clark) because any limitation on their discretion would only impinge upon themselves
- A shareholder agreement relating to the management of a close corporation will be upheld even if it violates corporate norms (Galler)
- Voting agreements between shareholders are enforceable even if the corporation is not a close corporation (Ramos)
- Shareholders may structure control of a corporation however they like
    - Basic structure issues only one class of stock with one vote for each share
    - Principal issue in close corporation is oppression of minority
    - Tools for avoiding oppression:
        - Stock classes with varying degrees of control (Stroh)
        - Supermajority voting requirements on certain issues (DGCL 102(b)(4))
        - Prohibition on director interference with shareholder vote
        - Cumulative voting (Ringling)
            - Each share carries a number of votes equal to the number of directors to be elected
        - Class voting
            - Articles of incorporation divide shares into class and give each class a right to elect a specified number of directors
        - Voting trusts
            - An agreement provides that legal title to the shares subject the trust be transferred to a trustee pursuant to a voting trust agreement
        - Irrevocable proxies
        - Vote pooling agreements (Ringling, McQaude, Clark)
        - Shareholder agreements (Galler)
        - Involuntary dissolution & forced sale agreements (Galler, Ramos)
- Massachusetts considers shareholders in closely held corporations more like partners and owe each other a fiduciary duty of loyalty, good faith, and candor
    - Test for minority freeze-out standard (identical to director's breach analysis):
        - Minority pleads and proves prima facie case of breach of duty of good faith by majority

        - Control group must demonstrate a legitimate business purpose for its actions
        - Burden shifts to minority to demonstrate a less harmful alternative
- Delaware does not believe that shareholders owe each other fiduciary duties
    - If minority needs protection they must bargain for it (Nixon)
    - Articles of incorporation must identify as close corporation

NN. Abuse of Control

- Duty on plaintiff to rebut BJR
- Duty on Defendant who has a conflict to show intrinsic fairness
- In a close corporation, majority shareholders may not freeze out a minority by terminating employment without a valid business purpose (Wilkes)
    - This would be a breach of their duty to one another as fiduciaries (Mass.)
- Courts will not rewrite clear agreements, even if one party ends up with the short end of the stick
    - Delaware law favors freedom of parties to make their own agreements
    - In a shareholders' agreement allows the corporation to buy back his stock upon termination, the employment is treated as at will so no claim for damages upon termination (Ingle)
- The remedy for a freeze out is to restore the minority shareholder as nearly to the position she would have been in had there been no wrongdoing
    - Ex. court won't force corporation to buy back shares as a remedy for a freeze out if there is not obligation to do this in the articles or bylaws (Brodie)
    - Delaware believes that when a shareholder buys into a close corporation they have the opportunity to bargain for terms so no need for court to force things the parties did not contract for (Nixon)
- DGCL (or other state corporate codes) are just default rules, a corporation can adopt other rules
- A minority shareholder breaches his fiduciary duty to fellow by intentionally locking up shareholders (even if this power comes from a provision in the corporate documents (Mass.) (Smith)
- A close corporation buying its stock back has a duty to disclose relevant information (info with a substantial likelihood that a reasonable shareholder would have wanted to know it) (Jordan**)**

OO. Control, Duration, and Statutory Dissolution

- A partner can usually withdraw at any time and dissolve firm, shareholders generally have no right to force corporation to buy them out
    - In a corporation that sort of right would have to be created in the Articles
- Close corp exit strategies:

    - Articles or bylaws provision for repurchase upon contingent event (death, transfer)
    - Involuntary dissolution under state statute
    - Appraisal rights or merger, sale of all/substantially all assets or de facto merger
    - Equitable remedies for breach of fiduciary duty by majority to minority
- All states have provisions under which a shareholder may seek an involuntary dissolution
    - Extreme remedy, plaintiff would have to show something like fraud, oppression, waste, or illegality
    - Most statutes also allow dissolution for:
        - Deadlock among shareholders
        - Deadlock among directors
- Conditions for deadlock among directors:
    - Directors must be evenly divided and therefore unable to make corporate decisions
    - Shareholders must be unavailable to resolve deadlock
    - Situation must threaten irreparable injury to the corporation or prevent the corporation from conducting business to benefit shareholders
- Conditions to shareholder deadlock:
    - Must be evenly divided
    - The division must make it impossible to elect board for two years
- Oppression- conduct that substantially defeats a minority shareholder's reasonable expectations
    - Reasonable expectations:
        - Reasonable under circumstances
        - Known or should have been known to the majority
        - Central to plaintiff's reasoning for joining venture

PP. Mergers, Acquisitions, and Takeovers

- Merger- target shareholders get cash or other value and only one of the corporations involved survives
    - Acquirer gets all assets and liabilities
    - Sales tax avoided (may have some other tax implications)
- Sale of assets- target corporation remains but their corporation will have only the cash or shares which the acquiring co. exchanged
    - Sales tax may be due
- Generally ok for shareholders to get a premium price for the sale of a controlling block of stock (Zetlin)
- If a majority shareholder gets a premium for stock that is attributable to a sale of corporate assets, he must account to the premium to the other shareholders (Perlman)
- Most states preclude selling corporate office without also transferring stock sufficient for voting control

QQ. Mergers and Acquisitions

RR. The De Facto Merger Doctrine

- De facto merger- If a transaction would accomplish the same result as a merger the court will generally treat it as a merger even if it does not meet the statutory requirements
    - If target company's stockholders would have the right to dissent and receive market value for their shares in merger same applies in de facto merger (Farris)
    - Pensylvania case, Pa. known for being shareholder friendly whereas Del. is director friendly

	Pa. Law	Del. Law
Sale of Assets	Yes appraisal	No appraisal
Merger	Yes appraisal	Yes appraisal

    -
- Appraisal right- statutory right of shareholders who oppose some extreme corporate action (ex. merger) to have their shares judicially appraised and to demand the corporation buy their shares
- Two corporations may agree to reorganization that results in de facto merger but use the statutory provisions pertaining to sale of assets (Hariton)
- DGCL 262
    - Merger or short form merger triggers appraisal rights
    - All shareholders of target get appraisal and usually acquiring shareholders unless:
        - Whale-minnow merger
        - In listed on sec exchange
        - More than 2000 stockholders
        - Short form only subsidiary gets appraisal
    - MBCA allows for shareholders of seller only to get appraisal rights in sale of assets
- Appraisal procedure
    - Dissenters must:
        - Give written notice of intent to dissent before shareholder meeting
        - Vote against proposed transaction
    - Corporation must notify dissenters of appraisal rights
    - Dissenters must tender share to corp and demand payment
    - Dissenters must sue for appraisal
    - Dissenters must bear all the costs and only receive payment after the final order

SS. Freeze-Out Mergers

- If a transaction is approved by the majority of minority shareholders then the burden is on plaintiff to show unfairness
- Entire fairness- fair dealing + fair price
- Directors can't engage in interested transaction unless:
    - Self-interest disclosed and approved by majority of disinterested directors or shareholders (if required)

    - Transaction is entirely fair
- Del. court adopted rule requiring Chancellor to employ "proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court
- Del. Test for freeze-out mergers
    - Entire fairness
    - Burden shifting
    - Valuation methods
- Tender offer- a public offer to buy a minimum number of shares directly from a corporation's shareholders at a fixed price (usually at a premium in an effort to take over)
- A controlling stockholder who is also a director and stands on both sides of a transaction has the burden of showing it is fair
- Majority shareholders owe a fiduciary duty to minority
    - Ex. could not unfairly manipulate a merger to avoid paying minority price agreed upon in an earlier transaction (Rabkin)

TT. De Facto Non-Merger

- Independent legal significance doctrine-If a corporation chooses to commence an action under one provision of law, the action is totally independent of any other statutory provision and cannot be subject to the validity test of another section (Rauch)

UU. LLC Mergers

- Managers that fail to give one board member notice of a meeting violate their fiduciary duty to one another even if it supposedly in the company's best interest (VGS)
    - BJR does not apply to duty to loyalty allegations
- Predicting Delaware law is like watching clouds or trying to catch a greased pig

VV. Takeovers

- In takeover can deal with stockholders or with the firm itself
    - May negotiate with board for a "friendly" merger where board approves and recommends to shareholders and shareholders ratify
- Defensive measures against takeovers:
    - Poison pills (shareholder rights plans)
        - Flip in provision (right to buy target shares at half price upon triggering event
        - Flip over provision (right to buy acquirer shares at half price upon back end merger)
        - Redemption of pills (by Board only)
    - Corporate machinery
        - Staggered/classified board
        - Good cause requirement for director removal
        - Supermajority voting requirements
    - Corporate restructuring
        - Finance extraordinary dividend with debt (eliminate overcapitalization)

- White knight/ defensive mergers/ lock ups
- Pac man (not common)
- Crown jewels, self-tenders, leveraged recapitalizations and other "scorched earth" actions
- Issuance of stock to an Employee Stock Ownership Plan
- Greenmail-practice of purchasing enough shares of a firm to threaten a takeover and thereby forcing the owners to buy those shares at a premium in order to stay in business
- Del Sec. 201 (statutory protection on back-end mergers)
- Golden Parachutes/ Employment Agreements
- Acquire competing company to create antitrust problem
- Interfere with acquirer's financing

- Director's duties in change of control transaction
  - 3 relevant time periods (triggers)
    - Defensive measures adopted by the Board before hostile bid
      - BJR
    - Response to hostile bid
      - Defensive measures
      - Put company "in play"
      - Unocal- Enhanced BJR
      - Revlon- maximize shareholder value if company in play
    - Actions once company is "in play"
      - Revlon
      - Paramount- preservation of long term corporate strategy (Enhanced BJR)
- A corporation may buyout a dissident stockholder if they sincerely believe that it is necessary (Cheff)
  - Courts require more than bare allegations to support a board's action when it is defending against a threat from outsiders raiders

WW. Development

- There is an inherent conflict of interest when board employs a takeover defense to keep someone from taking over the corporation
  - Primary purpose of their action cannot be entrenchment
  - Their defense mechanism may be allowed under the Enhanced Business Judgment Rule
  - Must meet 2 criteria:
    - Reasonable grounds to believe that a danger to corporate policy and effectiveness exists; and
    - Defensive measure adopted is proportional to the threat posed
- Burden on directors to show "reasonable grounds for believing that a danger to corporate policy and effectiveness existed)
  - Satisfied by showing that defensive measures were adopted in good faith and following reasonable investigation
  - If directors carry burden then burden passes to plaintiff to rebut BJR

    - If directors do not pass their burden then they must pass muster under the intrinsic fairness standard of the duty of loyalty
- Unocal test
    - Determines whether action was within the power of the board:
        - Does the statute authorize this defense?
        - If it's ok under statute, does the firm's charter impose any restrictions on the use of this defense?
- Methods of prohibiting hostile forces from acquiring the company must not breach fiduciary duties
    - Once a sale appears inevitable, the board must work to maximize the company's value to ensure the highest possible price (Revlon)
- Revlon duties:
    - Board must ignore other constituencies
    - Corporate long term goals are irrelevant
    - Duty changes from preservation of the corporate entity to maximization of corporate value at sale for shareholder's benefit
- If a company is not up for sale, the board may choose to engage in one a transaction even if there is a second transaction that may yield higher price (Paramount)
    - Revlon duties not triggered until company is for sale
- Shareholders will always get to vote on:
    - Director elections
    - Certificate of incorporation amendments
    - Mergers
    - Consolidations
    - Sale of substantially all the assets
    - Dissolution

XX. Extension of the Unocal/Revlon Framework

- Director's defensive measures to protect a merger must be reasonable under the circumstances and may not limit the board's fiduciary duties (Omnicare)
- A corporation's attempts to restructure itself to prohibit being acquired by another company cannot take away shareholder's right to vote for directors (Hilton)

YY. State and Federal Legislation

ZZ. Williams Act

- State law may impose restrictions affecting a company's ability to acquire control of another without contradicting federal law or the commerce clause(CTS)
- Williams Act- a federal statute, enacted in 1968, that amended the Securities Exchange Act of 1934 by requiring investors who own more than five percent of a company's stock to furnish certain information to the SEC and to comply with certain requirements when making a tender offer