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Course Guidebook

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Professor Geis teaches courses on contracts, corporations, agency and partnership, accounting, and corporate finance. He has won numerous teaching awards, including the UVA School of Law's 2019 All-University Teaching Award. He has also taught courses as a visiting professor at The University of Chicago, Georgetown University Law Center, the Indian School of Business in Hyderabad, India, the University of Auckland in New Zealand, and the University of Trento in Italy.

Professor Geis is the coauthor of *Digital Deals: Strategies for Selecting and Structuring Partnerships*, a book on business partnership and alliance strategies. His articles include "Traceable Shares and Corporate Law," published in the *Northwestern University Law Review*; "Internal Poison Pills," published in the N*ew York University Law Review*; and "Ex-Ante Corporate Governance," published in *The Journal of Corporation Law*. His work has also appeared in many other leading academic journals.

Professor Geis's research focuses on problems related to business alliances, merger transactions, shareholder litigation, and other topics involving the intersection of law and business.■

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LAW SCHOOL FOR EVERYONE
CORPORATE LAW

Today, corporations permeate nearly every part of our society; they have a tremendous influence on our lives. Some celebrate this fact, recognizing that corporations produce amazing products that make our lives easier and more comfortable. Others worry about the darker side of corporations, envisioning ravenous international conglomerates or loutish corporate leaders. The truth, of course, is that corporations offer both benefits and costs. How, then, should we set rules to govern corporations, and what role should the law play in regulating corporate activity?

This course examines the legal treatment of corporations in the United States. We will study how to create and run a corporation, and we will examine how the law deals with the complex network of relationships that arises in the modern corporation—the relationships between shareholders, directors, managers, employees, and others. Corporate law is society's means of facilitating the good that corporations do while reining in bad behavior, so we will explore ways to set the boundaries of fair play so the different players can focus their energy and resources on productive activity.

Along the way, we will examine laws that help make corporations so incredibly powerful as engines of innovation and wealth, as well as some of their shortcomings. We will study the major points of conflict among the key parties within corporations and how corporate law tries to manage them.

Other topics include the duties of corporate leaders to run their organizations responsibly and the powers of shareholders to take them to task when they don't. We will also look at the rules governing some of the most controversial events in the corporate world: insider trading, proxy fights and control battles, hostile takeovers, and corporate attempts to influence politics. Taken together, the course provides an understanding why corporations do the things they do and offers some valuable insights into American society along the way.■

QUESTIONS AND CONFLICTS IN CORPORATE LAW

Corporations produce amazing products that make our lives easier and more comfortable. They sell us basic food and necessities that we need to live. They employ us and pay our salaries. And, in many cases, they work for us. But corporations can also have a darker side, and human nature sometimes causes corporate leaders to behave badly. Corporate law affects everyone, and understanding it is very much in our interest.

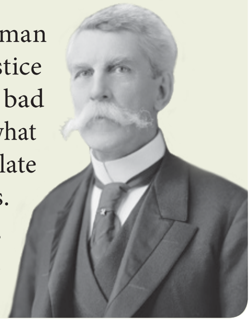
STARTING A CORPORATION

To understand how a corporation works and to learn the goals of corporate law, a hypothetical example can be helpful. Suppose you want to start a company. The first thing you will need is money. No firm can get going without seed capital, an initial investment to support its chosen activities.

Practically, many ventures have several different choices about where to get this money—or, in corporate terminology, about what capital structure to choose. You could tap into your own reserve savings or solicit your friends and family for the initial investment. Or you might walk down to the local bank to meet with a loan officer. Perhaps you could even call up your favorite investment banker to launch an initial public offering of stock or sell some corporate bonds.

Imagine now that your corporation has raised some money. Next, you will need to make a series of decisions about how to spend this money. You might hire some workers, or build a factory, or purchase some products to resell. Perhaps you will even buy another company and take over its business activity.

THE BAD-MAN THEORY AND CORPORATE LAW



Law students often study a theory of law called the bad-man theory, which was developed by the Supreme Court justice Oliver Wendell Holmes Jr. The justice claimed that a bad person's view of the law represents the best test of exactly what the law is because that type of person will carefully calculate what the rules allow and operate right up to those limits. Though this is not the only way to view corporate law, much of corporate law can be described in a similar way.

As your company spends its money, the wheels of commerce begin to turn. The business ticks along, and you sell products or provide services to customers. Your investments in the various business inputs will hopefully begin to generate profits as operations ensue. These proceeds can eventually be returned to the firm's financial backers in the form of interest payments, cash dividends, and the like.

This entire process is known as the business system. As long as the money produced from operations is a larger amount than the money from the initial investment, then everyone should be happy. The company is creating value and investors are making money. The cycle can begin anew.

ACADEMIC QUESTIONS

With this business system in mind, consider how several academic subjects relate to the overall framework. Corporate finance deals with the "where" question—that is, the choices firms make about where to get or where to spend their money. A class on accounting deals with the question of how the venture is performing by measuring all the results.

In this course on corporate law, by contrast, we will often be dealing with the "who" questions including: Who is empowered to make and execute the various decisions? Will stockholders have the final say on a given matter, or will the board of directors call the shots? When might someone else step in to decide what the corporation will do?

KEY PLAYERS

It is important to be familiar with the key players in a corporation, and some of the problems that can arise from the relationships between and among them.

Investors in a corporation fall into two major categories: stockholders and creditors. The investors are the ones who give the firm some money and hope to earn even more money after the business system generates profits.

Stockholders are also known as shareholders. They receive stock—also known as shares—for their investment dollars, and are considered the residual holders of the firm. This means they have a claim on whatever is left over after the corporation meets its other commitments.

Creditors, by contrast, are investors who loan the corporation money. This might be in the form of a bank loan or via a corporate bond investment (which is just another type of loan to the firm). Creditors receive interest payments and will eventually have the right to get repaid on their loan, but they are not typically entitled to more of the profits.

Stockholders will very rarely weigh in on most corporate decisions. Instead, stockholders elect a board of directors to serve as their representatives. These directors are the ones who set the firm's overall strategy and make most of the high-level decisions.

However, even the directors are not able to do everything, and they will typically appoint full-time managers to run the day-to-day business. Senior managers, like the CEO or CFO, are called officers, and lower level managers and staff are simply called employees. There are also some other parties in most corporate ecosystems, including suppliers, customers, advisors, government regulators, and so on.

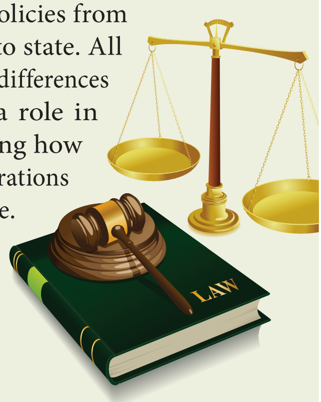
STANDOFFS

Several classic disputes can arise in corporate law among the players introduced above. First, consider the relationship between the managers and the stockholders. Managers get to make decisions about how to spend other people's money, and trouble might arise.

This problem is known as the agency cost problem, and it raises many different concerns. For example, managers might decide to take on too much risk with a corporation's money. It can be tough for investors to know when managers are not spending the firm's money as prudently as they would spend their own cash.

LEVELS OF LAW

US law is divided between federal law and state law. Most corporate law is state law. State and federal policies can differ, as can policies from state to state. All those differences play a role in shaping how corporations behave.



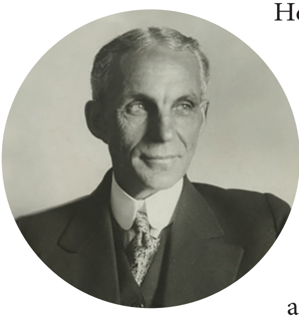
The second potential standoff is between stockholders and creditors. Though stockholders do not make most corporate decisions, they might still influence the board of directors or senior managers through their voting power. Accordingly, stockholders might be able to get the firm to engage in some activities that take money away from the debt investors and put it into the pockets of the stockholders.

The third potential conflict results from disagreements between a very large stockholder—sometimes called a controlling or majority stockholder—and smaller stockholders who lack power because they are always outvoted. In corporate law, one share usually means one vote, rather than one person meaning one vote. This can present some very interesting problems in merger deals and voting control battles. It is also central to this course's first legal case.

DODGE V. FORD MOTOR COMPANY

Even though *Dodge v. Ford Motor Company* was decided in 1919, it is still studied in law schools across the country because it addresses some fundamental questions in corporate law: What is a corporation for? How much freedom does it have to run itself as it sees fit? And which of the key players in the corporation get to make that decision?

The dispute arose in the early glory years of the automobile industry. Ford Motor Company, run by Henry Ford, had become a goldmine. The corporation had paid out tens of millions of dollars in dividends during recent years, it still had over $50 million in cash, and profits continued to soar.



Henry Ford owned 58 percent of the common stock and had complete control over who gets elected to the board of directors. The two Dodge brothers were among the other shareholders, and they owned about 10 percent of Ford's stock. They were interested in starting a rival car company of their own.

One day in 1916, Henry Ford made a big announcement: Ford was no longer going to pay out large dividends to the shareholders. Instead, it was going to build a new factory, boost employee wages, slash the prices of cars for consumers, and start running the company as a semi-charitable organization.

The Dodge brothers were upset, and they sued to compel a larger dividend distribution. The question became: Does Ford have to keep up its dividend payments as a matter of corporate law? More fundamentally, must Ford (and by extension, any corporation) be run to maximize shareholder profits, or can it try to benefit other parties like employees or customers or the broader public?

THE COURT'S RULING

The Michigan Supreme Court, where this case was ultimately decided, started by acknowledging that dividend payment decisions fall squarely within the authority of the board of directors. That principle remains widely accepted in corporate law today.

However, the court went on to immediately order Ford's board to reinstate the much higher dividends that had been paid in recent years. After reviewing the massive profits that the firm had generated—and after listening to Henry Ford testify about his goals for the company—the court held that "a refusal to declare and pay further dividends appears to be not an exercise of discretion on the part of the directors, but an arbitrary refusal to do what the circumstances require to be done."

The court went even further by insisting that a corporation had to be run for the purposes of maximizing shareholder profits. This principle, too, remains widely accepted—and yet, the kind of intervention that the court made is highly unusual.

There are several possibilities for what motivated Ford's change and caused the court to step in. It is possible Ford was trying to limit the payouts to the Dodge brothers so they could not raise money for a competitive automotive venture. There may be something to this, but it is likely that the Dodge brothers could find some other place to raise money.

A second possibility is taxes. Tax rates at the time were high, and Ford might have encouraged his board to halt dividend payments as taxes rose in order to keep the money in the company and wait until tax rates came back down to distribute the profits to stockholders.

But it is possible there was still more underlying Ford's moves. Ford was a savvy executive, and he wanted to protect Ford's lead in the automotive industry. First, he needed to drop car prices dramatically to fend off a slew of competitors. Second, Ford needed to double employee wages in order to fight off rampant absenteeism.

Moreover, Ford may have been motivated by pride. He appears to have been worried about looking like a robber baron, so he tried to position his canny corporate strategy as altruism. For example, in a newspaper interview, he was quoted as referring to "awful profits" for the company. That came up in court, which was damaging to Ford and his side of the case. The court went on to overrule the board on the dividend reductions and redirect the firm to focus on shareholder interests.

CONCLUSION

Shareholders cannot usually force their boards to pay out large dividends. But as *Dodge v. Ford Motor Company* suggests, a corporation must generally be run to maximize shareholder profits. The case is also a great example of some tricky corporate governance problems in the law and of the tensions that can arise when one group is trying to second-guess the actions of another group in a corporate ecosystem.

Much of corporate law seeks to help actors obtain the benefits of centralized business activity while minimizing the conflicts and other problems. This, in a nutshell, is the primary goal of corporate law.

Suggested Reading

- Dodge v. Ford Motor Co.
- The Financial Crisis Inquiry Commission, Inquiry Report.

CORPORATIONS AND THEIR AGENTS

The law of agency may be the most important area of law that most people have never heard of. It is just as critical as subjects such as constitutional law, criminal law, and civil procedure. Agency law is the area of law that governs agents, such as Hollywood agents and sports agents. However, anyone can have an agent.

OVERVIEW OF AGENCY

Agency is a legal concept that gives rise to a fiduciary, or special, relationship between parties when three general factors are present:

1. There is an agreement between the parties, one of which is known as the principal and the other as the agent.

2. The agent shall act on behalf of the principal.

3. The agent shall be subject to the principal's control.

The control exercised by the principal implies a degree of responsibility for the agent's actions. The principal does not need to micromanage every detail of the agent's actions, but a principal must have a general right to direct what the agent is doing.

For example, realtors will often serve as agents for someone who is buying or selling a house. They may make contracts for their clients or conduct other activities that will be charged to that principal party.

AGENCY LAW

Organizationally, agency law is usually broken down into four main topics. The first topic is the formation of an agency relationship, covered above. The other three topics all involve implications that can arise once you do have an agency relationship.

The second topic covers situations where the principal may be responsible for the torts, or legal wrongs, that an agent commits on a third party. The third topic involves situations where the agent can bind the principal to a third party in contract law.

The fourth topic involves special, heightened legal obligations that agents owe to their principals. These are called fiduciary duties, and they also play a very significant role in other areas of corporate law.

AGENCY-RELATIONSHIP LAWSUITS

Many lawsuits in agency law test the gateway issue of whether an interaction between two people has created an agency relationship. The plaintiff is usually trying to argue that an agency relationship has been created, so that the principal will be responsible for something the agent has done. The defendant is usually trying to deny an agency relationship and characterize the interaction as something else.

In corporate law, it is often easy to see whether someone is an agent of the corporation: Just look at whether they were properly hired as an officer or employee of the company. With more informal working arrangements, it is not always clear, but many corporate jobs continue to be performed by agents. The rest of this lecture will assume that an agency relationship is present and turn to consider the other implications: torts, situations where the agent can bind the principal to a third party in contract law, and fiduciary duties.

TORTS

An important consideration is under what circumstances will a principal be responsible for the torts, or legal wrongs, of an agent. This known as vicarious liability, and the main legal rule is called *respondeat superior*. This is a Latin term that means "let the master answer" or "let the employer answer for torts of the employee."

In most respondeat superior lawsuits, a third party has been harmed by an agent, and that injured party is trying to recover directly from the principal. Take, for example, a driver whose car is rear-ended by a delivery truck. The rear-ended driver may seek to recover from the delivery company rather than the truck's driver.

Importantly, even when an agency relationship is created, a principal or corporation is not going to be automatically liable for all torts of their agents. Rather, to win a respondeat superior case, the plaintiff needs to prove two extra things:

- ✭ First, the agent must be an employee and not just an independent contractor.
- ✭ Second, the tort must be committed within the scope of employment.

Imagine three possible legal regimes. In the first, there is no tort liability for the principal when an agent does something erroneous. In the second, principals are liable for all torts committed by their agent, no matter what.

Respondeat superior seeks to establish a middle ground between the first two regimes by asking if the misconduct of an agent is related closely enough the business activity of the principal. If so, the law holds the principal responsible in an effort to have them internalize the risk of harm and take sensible precautions to minimize accidents.

BINDING THE PRINCIPAL TO A THIRD PARTY

The lecture's next topic asks this question: What does it take for an agent to bind a principal, such as their corporation, to a third party in contract law? This is often why firms will hire agents. For example, a corporation cannot really do anything on its own, so it needs to hire salespeople and managers to conclude deals with others and make money for the firm.

Yet any given employee cannot bind a corporation to every conceivable type of contract. For example, a low-level employee at Apple cannot agree to purchase another company on behalf of Apple.

The reason is that the low-level employee lacks authority for this deal. There can be several different types of authority in agency law, but for this lecture's purposes, it is enough to say that the agent must usually have instructions or permission—either express or implied—to make the deal.

Sometimes implied authority is good enough for an agent to make a contract. Consider the case of *Karl Rove & Co. v. Richard Thornburgh*. Thornburgh was the US attorney general, but he resigned in 1991 to run for a Senate seat. He hired a longtime aide named Murray Dickman to help direct his campaign, and Dickman, in turn, made an agreement with a young political consultant named Karl Rove to perform some direct mailing services.

Thornburgh unexpectedly lost the race. His campaign committee was broke, and it did not paid Rove most of money that he was owed (about $200,000). Rove decided to sue Thornburgh personally for breach on the contract.

It was clear that the contract had been established between Rove and the Thornburgh committee. However, the committee was just an unincorporated association. This meant that Thornburgh would still be liable personally if he assented to the contract. He had not.

Rove argued that Dickman had acted as Thornburgh's agent and had executed the contract within the scope of his authority. If so, Thornburgh should be bound personally, just as if he had assented to the deal himself. The court bought this argument and ruled for Rove. In other words, Dickman had implied authority to contract under Thornburgh's name.

FIDUCIARY DUTIES

Fiduciary duties are an important aspect of corporate law, but they were born in agency lawsuits. Looking at what is required here can provide an introduction to the topic.

Agency relationships give rise to several special obligations on the part of the agent. The big ones are a duty of care and a duty of loyalty. Essentially, agents must act carefully in their duties, and they must not put their own interests ahead of those of their principals.

One clear example of a of loyalty violation arises when an agent receives a bribe or a payment from a third party in connection with some transaction between the principal and that third party. However, this duty can be even broader, which brings this lecture to the case of *Reading v. Regem*. Even through it is a British case, it is still studied in law schools today because the facts are amusing and the law remains the same in the US.

Reading was a sergeant in the British Army. He was stationed in Cairo, Egypt right at the end of World War II, where he managed the medical supplies. The court tells us that Reading's background was modest and that he "had not had opportunities, in his life as a soldier, of making money."

But the entrepreneurial Reading found a way to make some money. He fell into some bad company and met a group of smugglers in Cairo. Reading worked out an arrangement where he would dress up in his full military uniform after hours, hop into the front passenger seat of the smugglers' truck, and ride with them through the city. Because of his presence, the British guards would just let the truck pass through the various city checkpoints without conducting a search. Later, Reading would connect with one of his smuggler buddies in a bar, where he would receive cash.

Eventually, the British Army caught wind of his scheme, and when it investigated, it found out that Reading had about £20,000 and a very nice new car. The British government took the money, and Reading sued to get it back.

The army argued that Reading breached his fiduciary duty of loyalty as an agent. But Reading responded that this wasn't so: "I didn't take any opportunity away from the army. The Army would never have wanted to be a part of any transaction like this, so I haven't breached any duty. I should get my money back."

He was incorrect. The duty of loyalty is broader than that. The court held that if an agent takes advantage of his position to make a profit for himself by using the assets of the principal or by taking an opportunity that he only got because of his position as an agent, then that is not OK.

Reading only had this opportunity because of his role as a sergeant, and he used his army uniform to "earn" his £20,000. It did not matter that the army lost no profits because it would have never launched a smuggling business. Reading could not keep the cash.

This is generally still the case in corporate law today, though employees can sometime ask for permission in advance to do things that might otherwise violate their duty of loyalty.

Suggested Reading

- Manning v. Grimsley.
- Reading v. Regem.

Lecture 3

THINGS CORPORATIONS CAN AND CANNOT DO

This lecture looks at the history and nature of the corporation. It examines questions such as: How did corporations begin in the United States? What does it take to create a corporation today? What sort of things can a corporation legally do after it has been established?

THE BEGINNING OF CORPORATIONS

Corporations existed well prior to the birth of the United States, and they were an important part of life in the early United States. However, a person who wanted to create a corporation had to get an act of state legislature granting permission to do so.

This meant that many US corporations in the early 1800s were focused on centralizing resources to complete some public service or infrastructure project. For example, a state might approve a corporation to build a canal, bridge, or some other endeavor that was too large to be funded by any one individual.

Additionally, a corporation was not historically granted permission to do anything that it wanted. Its focus was limited to some specific endeavor. This also meant that a corporation would not typically last forever. Once the canal was built or the bridge completed, then the corporation would wind up its business affairs and dissolve. Some corporations, however, were permitted to engage in ongoing manufacturing and commerce.

THE EAST INDIA COMPANY

The powerful East India Company was a British trading corporation formed in 1600 that eventually conducted about half of the world's total trade. At the height of its power in India and China, the East India Company generated profits approaching 1,000 percent on its spices and cotton and tea.

THE PROCESS TODAY

The need to petition state legislators for approval to create a corporation led to some corruption. Competing parties might do whatever it took to get their local politicians to approve their corporate petition—or to block a rival petition from being granted or renewed.

This corruption, or perhaps just the perception of corruption, led to a massive change in the approval process during the mid-1800s. States began to establish general incorporation laws, under which any group of businesspeople who met the requirements of these laws could automatically create a corporation.

This remains the situation today. If you wanted to create a corporation tomorrow, it would be very easy to do so. It might take you 30 minutes or so to fill out the key form (called the corporate charter or, in some states, the articles of incorporation) and file this with the appropriate state administrative agency.

You will probably have to meet a few other requirements, such as naming a state agent to receive notices and drafting supplemental rules, known as the bylaws, for how the corporation will operate. You might want legal help to do all this, but it is still a pretty easy process.

Your new corporation will not be limited to carrying on a specific type of activity. Most corporate charters just state that the firm will engage in any type of activity that is permitted by law. Finally, your new corporation is presumed to be immortal—you do not need to ask for any special permission to renew your corporation.

ALTERNATIVES

Two alternative legal entities to the corporation are partnerships and LLCs, short for limited liability companies. A partnership is essentially an arrangement where two or more people go into a business together and share in the profits and losses.

The basic form of partnership is called a general partnership. Using a partnership structure can provide tax advantages over a corporation because corporate profits are taxed twice: first at the corporate entity level and then at the individual level when the profits are paid out as dividends to shareholders. Partnership profits, by contrast, are only taxed once, at the individual level, so there might be more take-home pay.

But a corporation has a huge advantage over a general partnership because investors in a corporation enjoy limited liability. This means that if the firm's business turns into a disaster, the most that stockholders can lose is the amount that they invested in the corporation. With a partnership, by contrast, each partner can become individually liable for business obligations.

This choice between lower taxes or limited liability had historically driven the choice of entity decision. If you want lower taxes, take the partnership; if you want limited liability, go for a corporation.

More recently, however, an alternative type of entity, the LLC, has offered entrepreneurs the best of both worlds. With an LLC, you can have limited liability and single-level taxation. There are also some other types of business entities, like a limited partnership, that can behave in a similar manner.

Although it's true that the LLC has surged in popularity in recent decades, the corporation remains incredibly important to this day. Many large firms want to have their stock traded on public markets, and it is usually much easier to trade the securities of a corporation.

Additionally, it is not a simple matter to convert an established corporation over to an LLC. Investors like the standardization that corporate law provides. LLC governance, by contrast, can be more varied than corporate governance, and investors may be worried about hidden terms or the fact that the law relating to LLCs is still relatively new and undeveloped. The bottom line is that corporations are still the most important legal entity.

LIMITED LIABILITY IN THE CORPORATE CONTEXT

For many people, limited liability is the driving reason to create a corporation. For example, an investor would be much less likely to invest in a venture if their personal savings were at stake should the business fail.

In the early days of the US corporation, this was incredibly important for the development of the railroad industry, which required the mobilization of large amounts of capital but also presented significant risks of business failure or tort liability. Yet a grant of limited liability also imposes social costs. Externalities—that is, costs to outside parties that nobody has accounted for—can arise as risk is pushed outside of a venture.

Consider the case of *Walkovszky v. Carlton*, decided by the New York Court of Appeals in 1966. It involved a taxicab magnate named William Carlton who had discovered a way to take advantage of limited liability protection. Carlton had about 20 taxis, but instead of creating just one corporation to handle the business, he decided to create 10 different corporations. Each one would have just two taxis and would carry only the minimum liability insurance of $10,000. Carlton also had each corporation pay out almost all of its assets as dividends on a regular basis.

The plaintiff Walkovszky was hit by one of Carlton's taxis, and he sought to recover damages for his injuries. By setting up 10 different corporations and pulling out all the assets of each on a regular basis, Carlton had engineered a structure where each corporation has almost nothing to take if an accident like this occurs.

PIERCING THE CORPORATE VEIL

One important doctrine in corporate law can be used to hold a shareholder personally liable in rare cases. It is called piercing the corporate veil. The logic goes that if someone, as a shareholder, does not respect the formalities of a corporation and uses the corporate form to perpetrate a fraud or injustice, then the shareholder will lose the protection of the corporation by abandoning their limited liability.

Walkovszky decided to sue Carlton personally for his damages. The court said no. While it was true that Carlton seemed to have taken advantage of the limited liability law to make it very unlikely that there would be money left in any of the 10 corporations to pay damages in a case like this, the majority opinion essentially said that it was too bad. That was how the game was played, and Carlton had figured out a sneaky strategy that worked.

Notably, the dissenting judge was furious. He wanted to hold Carlton personally liable. The majority opinion rejected this.

WHAT CAN A CORPORATION DO?

Today, if a corporation's founders want to limit a firm's activity, then they can do this in the articles of incorporation. For example, one could form a company and expressly limit its purpose to selling old knick-knacks on eBay.

However, most new corporations today do not tie their hands by restricting future activity. They usually adopt a very broad statement of purpose, saying that the firm can engage in any lawful activity. Any limits on corporate activity, then, will only arise as a matter of corporate law or other legal restrictions.

The law treats a corporation as separate legal person. This means that it has the right to do all sorts of things in its own legal capacity. It can enter contracts and own property. It can sue or be sued. It can lend money, borrow money, buy insurance, and so on.

CORPORATE CONTROVERSY: PHILANTHROPY

Most corporate activity is not too controversial, but occasionally something arises that tests how far the law is willing to take the concept that a corporation is a separate legal person. One example is the right of a corporation to engage in philanthropy.

In 1951, the board of directors of a New Jersey fire hydrant maker named A. P. Smith Manufacturing Company adopted a resolution that approved a corporate gift of $1,500 to Princeton University. Some shareholders objected to this, and they filed a lawsuit claiming that making this charitable gift was beyond the power of a corporation.

On the one hand, philanthropy could be understood as a smart corporate investment. By giving Princeton money, the company might attract new customers who like Princeton, gain access to new employees, and obtain other less tangible benefits. On the other hand, if the leaders of a fire hydrant company want to support Princeton, then why did they not pull out their own wallets instead of spending cash that could have otherwise gone to the firm's shareholders? (The court in the fire hydrant case said that the gift was fine.)

Additionally, the legal permissibility of corporate charity may differ from state to state. Delaware, which is a major player in corporate law, allows for charitable donations as long as they are made in pursuit of the basic ends of the corporation. This is usually taken to mean maximizing shareholder profits.

Pennsylvania goes even further than Delaware, by explicitly permitting corporations created under its laws to consider the interests of broader stakeholders in making donations, including shareholders, employees, suppliers, customers, creditors, and even the communities where the corporation operates. Of course, the directors might still face some hot water the following year if enough shareholders are upset about the gift that they vote the directors out of office.

THE BUSINESS JUDGMENT RULE

Under a doctrine known as the business judgment rule, a court will almost never second-guess the decisions of corporate leaders. There can be some exceptions to this, usually when firm leaders seem to have violated a fiduciary duty. However, a peculiar corporate decision based on personal whims will almost never be second-guessed by a court.

CORPORATE CONTROVERSY: POLITICS

More recently, the hot legal questions about permissible corporate activity have started to center around our political process. The laws continue to evolve, but as of the time of this course's release, corporations are not able to contribute directly to political candidates.

They are able to contribute indirectly, however, by funding a political action committee (or PAC) and having the PAC spend money on its preferred candidates. Corporations are also able to engage in lobbying and to conduct issue campaigning.

The influence of corporate activity on our political process is controversial. Many corporations do not disclose how much they spend in these areas, so it is difficult to know whether corporate influence is pervasive or episodic. There have been recent calls to have the Securities and Exchange Commission require new disclosures about corporate political expenditures, but so far this has not happened.

Moreover, the laws governing this type of activity arise from a complex array of federal election law, constitutional law, and corporate law. It is probably fair to assume, however, that many corporations try to make some investments in the political process to skew a business or regulatory climate in their favor. This area of corporate activity will likely continue to receive heavy scrutiny—and possibly a complete reorientation—in the coming years.

Suggested Reading

- A. P. Smith Mfg. Co. v. Barlow.
- Walkovszky v. Carlton.

Lecture 4

BOARDS OF DIRECTORS AND THE DUTY OF CARE

To gain the protection of the business judgment rule, under which a court will almost never second-guess the decisions of corporate leaders, a board of directors needs to meet its fiduciary obligations to the firm. There are a number of different obligations in corporate law. This lecture focuses on the first fiduciary requirement, which is known as the duty of care.

DEFINING THE DUTY OF CARE

As a general matter, the duty of care means what it sounds like: Directors need to behave carefully when they make decisions about what their corporation will do. They need to pay attention, give decisions some thought, consider alternatives, run numbers, and so on.

Over the years, however, courts have struggled with the exact contours of the duty-of-care requirement and what it takes to uphold it. The law has also changed over time.

Generally speaking, if a company's directors are careful and thoughtful when they make decisions, then they should not owe the corporation anything—even if the decision turns out poorly. If the directors are sloppy, however, then it is possible that these leaders might have breached a duty of care that they owe to the corporation itself. Shareholders might cause the firm to sue the offending directors to recover damages from them personally.

FRANCIS V. UNITED JERSEY BANK

An infamous case in corporate law was *Francis v. United Jersey Bank*, in which one of the directors had a drinking problem. The board member stayed at home in bed, drinking gin and skipping the board meetings. She had no real idea what the corporation was up to. The other directors were causing the corporation to do some bad things, like siphoning off funds, and the gin-loving director was found to have violated her duty of care: She was not paying attention.

KAMIN V. AMERICAN EXPRESS COMPANY

There are many famous cases related to the board's duty of care. The first one this lectue covers is called *Kamin v. American Express Company*. This is a New York case that was decided in 1976.

At the time of this case, the American Express corporation owned about 2 million shares of an investment bank named Donaldson Lufkin and Jenrette (or DLJ). The investment had worked out badly for American Express: It bought the DLJ stock in 1972 for a total of $29 million, and it was only worth $4 million a few years later.

The board of directors for American Express decided to declare a special dividend, under which the firm would distribute all the shares of DLJ to the shareholders of American Express. On first glance, it would appear the American Express shareholders would be happy to receive a dividend. But by giving them the shares, American Express would lose the opportunity to obtain a tax benefit under the laws in place at the time of the case. If American Express sold its DLJ stock and recognized the $25 million loss on the investment, then this loss could be used to offset some other investing gains that the company had generated that year. This would then reduce its total tax bill.

However, if American Express gave the DLJ stock to its shareholders, they would take the stock with a $4 million basis, and all the tax savings from realizing the loss would disappear entirely. It was as if AMEX's board had decided to take millions of dollars and shovel this money into the incinerator.

A shareholder named Kamin thought this was a particularly bad decision and decided to file a lawsuit alleging a breach of the board's fiduciary duty of care. However, the court said the board's decision did not violate the duty of care.

It reasoned that that was not a situation where the directors had behaved carelessly or failed to evaluate what to do. The board of American Express seemed to worry that booking the loss within the firm would cause it to report lower income for the period, which was true, and that these poorer earnings would cause American Express's own stock to drop. By sending the DLJ stock directly up to shareholders as a dividend, the firm could sidestep this concern and report higher earnings.

It was still a lousy decision, and Kamin was justifiably upset. But it wasn't a breach of the board's duty of care to American Express. The board may have made a poor decision, but it had given the situation some thought and evaluated the different alternatives.

Perhaps some investors would not look favorably upon lower net income figures, and the court was not willing to second-guess the board on this decision. This case nicely illustrates this historical approach to the duty of care: It was very difficult for a board to violate this obligation, and it probably did not carry that much weight as a matter of corporate law.

SMITH V. VAN GORKOM

Matters changed in what is probably the most important duty-of-care case in all of corporate law. It is called *Smith v. Van Gorkom*, and it was decided by the Delaware Supreme Court in 1985. The case transformed the duty of care from something that almost no one worried about into the hottest topic of the day in corporate law.

Jerome Van Gorkom was CEO of a large corporation named TransUnion. The company was based in Chicago, and while it engaged in a variety of activities, most of TransUnions profits were generated by leasing out railcars. The firm's stock was trading in the $30 to $40 price range. Van Gorkom was approaching retirement age, and one day, he spoke with his chief financial officer and some other senior executives about conducting a leveraged buyout of TransUnion.

A leveraged buyout is the purchase of a company with a low amount of equity and a high amount of debt. If the buyer can find a bank or financial institution that is willing to extend credit secured by the target company's assets, then that buyer can often take over the company using very little personal funds.

VAN GORKOM'S ACTIONS

Van Gorkom and his senior officers were contemplating selling TransUnion via a leveraged buyout at a premium to its stock market price. Current shareholders should be happy to sell out at a profit, and the buyer might also make a great deal of money very quickly if he could cut costs or boost firm performance.

They concluded that a price of $50 to $60 per share would work for this type of deal. This did not mean that this was a fair price for the company, only that payments on the debt needed to execute a buyout at that price could be supported by TransUnion's expected future operations.

Without consulting his board, Van Gorkom decided to pitch the idea to a social acquaintance named Jay Pritzker. Pritzker was a well-known takeover artist in Chicago financial circles, and he had experience with deals like this. One Saturday in 1980, Van Gorkom talked through the numbers and financial projections with Pritzker and suggested that a buyout at around $55 might make sense. Pritzker responded that $50 would be "a more attractive figure" and agreed that he would think it over.

On Monday, Pritzker called Van Gorkom to say that he was interested in the $55 cash merger proposal. He asked for more information about the firm. Three days after that, Pritzker was ready to pounce. He wanted to execute the deal at $55 per share, but he also insisted that that the TransUnion board approve the deal within the next three days.

That Saturday, Van Gorkom held a special meeting of TransUnion's board. In a 20-minute proposal, he outlined the key terms of Pritzker's offer. Copies of the actual merger agreement arrived too late for the meeting. Van Gorkom suggested that another buyer could still come along if the firm was worth more and that stockholders should be given the chance to accept or reject the $55 buyout. The board discussed this offer and approved the proposed buyout.

That same Saturday night, Van Gorkom hosted a social event at the opening night of the Chicago Lyric Opera. During an intermission of the opera performance, he caught up with Pritzker, and they executed the merger agreement in an alcove of the theater. At that time, neither Van Gorkom nor any other board member had even read the merger agreement.

AFTER THE DEAL

After that deal became public, a few other possible suitors considered making a higher bid for the company, but no one made a formal offer. TransUnion's shareholders approved the deal with a 70 percent vote, and the LBO went through.

However, one group of shareholders, led by the plaintiff Smith, was unhappy with this outcome. They filed a lawsuit against Van Gorkom and the other TransUnion directors, alleging a breach of the duty of care. The problem, as the plaintiffs saw it, was that the board did not have a good idea what the company was really worth; rather, they just plucked $55 out of the air. Additionally, the board was "grossly negligent in approving the 'sale' of the company upon hours' consideration, without prior notice, and without the exigency of a crisis or emergency."

The Delaware Supreme Court said the TransUnion board had violated its duty of care to the corporation. In short, the deliberation was sloppy, careless, and a violation of the board's fiduciary duty. The Delaware Supreme Court sent the case back down to the lower court for a determination of damages, and the defendants settled for $23 million.

AFTER THE DECISION

The decision in *Smith v. Van Gorkom* generated massive incentives for a board to obtain professional support for major decisions. In a case like this, hiring an investment banker to offer a fairness opinion on the valuation would eliminate any personal risk of director liability for a duty of care breach. Board processes became much more deliberate after the case.

In fact, the case was such a big deal that some people begin to worry that highly qualified directors might not be willing to work at Delaware corporations. This could cause large firms to evade Delaware law entirely by reincorporating their companies in another state. This concerned state Delaware lawmakers and politicians, who rely on the recurring—and not insignificant—franchise fees that corporations pay to maintain their status as Delaware firms.

The Delaware legislature decided to act to alleviate this anxiety. It amended the state's corporate statute to effectively allow corporations to scale back the risk of personal director liability for a duty of care breach.

Overall, the duty-of-care pendulum swung from a relatively unimportant board obligation to a critical obligation of corporate law. However, more recently, the pendulum has swung back the other way: With the ability to disclaim personal board liability in the corporate charter, the duty of care now does not concern too many boards. Blockbuster duty-of-care cases are rare in the current era of corporate law.

The issue is not dead. Some corporations, for instance, may not adopt charter provisions to protect directors from personal liability relating to the duty of care. But it is fair to say that the duty of care has become less important in recent years. This means that the most important constraints on board activity now arise through different types of obligations.

Suggested Reading

- Kamin v. American Express Company.
- Smith v. Van Gorkom.

Lecture 5

BUSINESS OPPORTUNITIES AND THE DUTY OF LOYALTY

The fiduciary duty of loyalty is a very important obligation for board members and senior executives of every corporation. In essence, the duty of loyalty says that agents cannot undermine the interests of their principals by, for example, taking bribes to bring a deal to a third party or by using their principals' assets for their own benefit. This lecture looks at how the duty of loyalty works in corporate law.

IMPLICATIONS OF THE DUTY OF LOYALTY

The duty of loyalty is most clearly implicated when a leader engages in a self-dealing transaction with the corporation itself. That is an obvious context for when the law should worry about an executive's failure to remain loyal to the company. There is another important variant of this problem, however, that often arises in corporate law. It is known as the corporate opportunity doctrine.

Imagine that the head buyer for a large department store, who is in charge of deciding what products the store will offer, meets a fashion designer with an amazing line of sweaters at a low price. However, instead of having the department store buy the line of sweaters, the head buyer convinces the designer to go into business with him personally.

This is a clear duty-of-loyalty problem. The head buyer was an executive at the department store, and he usurped a corporate opportunity for himself. The store trusted him to find good items for it to sell, and he should not be able to pick the best deals for personal gain. He has to give this opportunity to the department store.

That is a straightforward example of wrongdoing, but sometimes it can be more difficult to decide whether an opportunity really belongs to the corporation. Corporate law often looks to four factors to sort out gray-area cases:

1. Is the firm financially able to take on the new opportunity?
2. Is the new opportunity in the firm's current line of business?
3. Does the firm have an interest or expectancy in this type of business opportunity?
4. Will the self-interest of the officer or director be brought into conflict with that of the firm?

These factors might help, but it still can be tricky to know whether something is an opportunity that belongs to the corporation. When deciding whether to take on a business opportunity for oneself, the safest thing to do is probably to ask for permission. If a person can get the CEO—or even better, the board—to say that the firm most definitely does not want to take on a business opportunity (after disclosing all the relevant facts), then a person is probably fine taking on the business opportunity.

A CASE OF SINGING

In 1942 and 1943, the Celanese Corporation of America paid the CEO's spouse, Jean Tennyson, thousands of dollars for singing as part of an advertising venture. A number of stockholders of Celanese did not think this was acceptable, and they sued. The New York County Supreme Court ruled on the matter in the case of *Bayer v. Beran*.

After carefully scrutinizing the situation, however, the court found no breach of the duty of loyalty. Tennyson was an established professional opera singer, and the contract was viewed as fair to the firm.

THE CORPORATE OPPORTUNITY DOCTRINE

Sometimes, a corporate opportunity problem emerges in slow motion when the same person sits on the board of two different firms. If the firms operate in relatively different industries, then there should not normally be grounds for concern. Indeed, it can be valuable to have a director bring best practices from one type of company or industry into the boardroom of another corporation.

However, sometimes two firms that start out as disparate ventures will begin to move toward each other to become closer competitors. For example, in 2006, Eric Schmidt, a member of Google's board (and Google's CEO at the time) was elected to serve on the board of directors at Apple.

Back in 2006, this probably did not raise any legal problems: Google was mostly an internet search company, and Apple focused primarily on computers and other consumer products. But over time, the two firms started to become very direct competitors, as Google moved into the mobile phone business, and both companies focused increasingly on rival software application platforms.

Schmidt's position on Apple's board became untenable due to the corporate opportunity doctrine. Suppose that a software engineer demonstrates an amazing new golfing app to Schmidt one day. If Schmidt brings the idea to Google, then Apple shareholders will immediately have a strong corporate opportunity lawsuit against him. But if he brings it to Apple, then the reverse is true; his action has cost Google an opportunity. Recognizing this, Schmidt decided to resign from Apple's board three years later in 2009.

IN RE EBAY, INC. SHAREHOLDERS LITIGATION

This lecture now turns to an important case involving the duty of loyalty and the corporate opportunity doctrine: a Delaware Court of Chancery lawsuit from 2004 called *In re eBay, Inc. Shareholders Litigation*.

The background of this case goes back to the late 1990s and involves a phenomenon known as spinning—that is, an investment practice where investment banks might give senior business executives at favored firms the right to buy shares in an initial public offering (IPO). IPOs occur when a corporation decides that it is going to sell stock on the public markets for the first time.

When a company is ready to complete the IPO, it will set a price at which the initial shares are sold to buyers. Those shares will then trade on public exchanges like the New York Stock Exchange or the NASDAQ. Theoretically, the price of a stock can go up or down during the first day of trading as markets sort out what the company is worth.

CASE TERMINOLOGY

In the case *In re eBay, Inc. Shareholders Litigation*, the first two words, *In re*, are a Latin phrase that means "in the matter of." Lawsuits will sometimes use this designation when there is a proceeding where formally designated adversaries are not named.

In the late 1990s, IPO markets were very hot, and it was common to see huge jumps in a tech company's stock price on the very first day of trading. Gains of 400, 500, or even 600 percent in a single day were not unheard of. Many day traders and other investors would try to flip shares in hot IPOs, purchasing the shares initially and then reselling them just a few hours later for a massive profit.

It became difficult to obtain shares in some IPOs, and the rights to purchase them started to be allocated more strategically among all the interested buyers.

CHANCERY COURTS

The institution of chancery courts derived from England, which featured a distinction between courts of law and courts of equity. Courts of equity, often known as chancery courts, had more flexibility, and they could sometime step in to render a just decision that might not be consistent with the harsh results that would otherwise arise under common law.

In the United States, many states eventually combined their courts into just one system, but a few states still have a chancery court. Delaware is one such state, and the Delaware Court of Chancery maintains jurisdiction over corporate law matters.

The investment banks who controlled the deals were not very transparent in the way that they would parse out hot IPO allocation rights—and that is where spinning came in.

Some banks were thought to award IPO allocations to senior executives at important client companies in order to win or maintain their banking business in other areas. Something like this might have been going on between the investment bank Goldman Sachs and the senior leaders at eBay.

GOLDMAN SACHS AND EBAY

Goldman Sachs had served as the lead underwriter of eBay's stock IPO in 1998, which had done very well. The bank also earned eBay's business for follow-on stock offerings, and it served as the firm's lead advisor when eBay decided to acquire PayPal. Around this very time, Goldman Sachs also allocated shares in many other IPOs that the bank was running to Pierre Omidyar, eBay's founder and chairman; Meg Whitman, its CEO; and several other senior managers at eBay.

Some shareholders thought this seemed off, and they decided to sue. However, at the time, spinning was a relatively common practice. Additionally, the price on any given IPO was not certain to go up—there was always a risk that some new stock issue would flop.

The plaintiff shareholders came up with the very clever argument that this arrangement violated the corporate opportunity doctrine and that Omidyar and the other senior executives had therefore violated their fiduciary duty of loyalty to eBay. In other words, the opportunity to invest in the IPOs should have gone to eBay and not to the individual corporate leaders in their personal capacity.

This was an intriguing argument, but the question remained: Wasn't eBay in the online-auction business rather than the stock-investing business? Why should the opportunity belong to eBay? The defendants described these allocations as "'collateral investment opportunities' that arose by virtue of the inside directors' status as wealthy individuals."

They also said "this is not a corporate opportunity within the corporation's line of business or an opportunity in which the corporation had an interest or expectancy."

The court disagreed. It started by recognizing that eBay, a cash-rich company, had the financial wherewithal to take advantage of these IPO investments. The court then said that eBay was in the investment business. According to eBay's own financial statements, it "had more than $550 million invested in equity and debt securities." This suggested that investing was a line of business for the firm. Accordingly, the defendants' conduct seemed problematic.

The court clearly thought that the whole scheme violated the directors' duty of loyalty to the firm. They were taking advantage of their positions to pocket money for themselves at eBay's expense. The directors settled the case by paying several million dollars back into eBay. Interestingly, Goldman Sachs contributed to the settlement as well.

Suggested Reading

- Bayer v. Beran.
- In re eBay, Inc. Shareholders Litigation.

Lecture 6

EXECUTIVE PAY AND THE DUTY OF GOOD FAITH

It is common to hear concerns about bloated executive compensation in the United States, but it is difficult to establish a precise framework for evaluating how much is too much. Today, courts analyze the issue by means of a doctrine known as the duty of good faith.

BACKGROUND ON THE DUTY OF GOOD FAITH

One way to assess the situation regarding executive pay is to construct a ratio of CEO pay to that of the average corporate employee. For example, if the CEO earns $1 million at a firm while the average worker earns just $50,000, then the compensation ratio is 20:1.

A few years ago, one academic study measured this number for large corporations in the Unites States between the years 1965 to 2013. The most recent number from the study was about 300:1 for the largest firms. In that case, if the average employee salary is $50,000 per year, then a CEO might pocket around $15 million each year.

That certainly seems like a lot of money, but the question remains: Is it legally wrong for a CEO to earn 300 times as much as the average worker? Executive compensation has proven to be a very difficult area for corporate law to tackle. There is no magic number that a judge can latch on to as a trigger for an excessive paycheck. Courts cannot easily say that $5 million is OK, but $15 million is illegal.

This is because the business judgment rule will usually protect a carefully considered board decision from judicial second-guessing. Yet the topic attracts widespread attention, and corporate law has occasionally waded into executive compensation disputes.

One conceivable limit arises though a legal doctrine known as waste. A shareholder can try to bring a claim that a huge executive salary essentially amounts to a waste of the firm's resources. This is a very difficult argument to pursue, however, and it rarely succeeds.

THE ORIGINS OF GOOD FAITH

The duty of good faith has interesting, and relatively recent, origins. Corporate law has always been understood to support the notion that directors have to act in good faith. However, the meaning of good faith was not precisely defined, and most people simply assumed that that a board decision that satisfied the duty of care and the duty of loyalty would not be subjected to a third inquiry relating to good faith.

In Delaware, this all changed when the state's supreme court dropped what some have called the "triad bomb" of 1993. The court's opinion stated:

> [A] shareholder plaintiff challenging a board decision has the burden at the outset to rebut the [business judgment] rule's presumption. To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty, or due care.

As a practical matter for corporate law, Delaware courts seemed to be carving out some additional space to create new legal obligations. The duty of care was less likely to serve as a reliable constraint on corporate executives due to legislative amendments passed in the wake of *Smith v. Van Gorkom*—the case in which a CEO and board of directors approved a leveraged buyout of their company without even reading the agreement.

Additionally, while the duty of loyalty still had teeth, it was only implicated by self-dealing transactions. It did not cover leadership problems that did not amount to self-dealing but still raised potential concerns. The nebulous and open-ended concept of good faith could conceivably be used by lawmakers to manage these types of problems.

EXECUTIVE COMPENSATION AND THE DUTY OF GOOD FAITH

The contours of the duty of good faith in corporate law have been slowly evolving ever since. This lecture focuses on two of the most important contexts for understanding what it means: executive compensation and the obligation of a board to monitor its firm's activities.

One of the most interesting and important executive compensation cases in all of corporate law involves The Walt Disney Company during the 1990s. Michael Eisner took over as Disney's CEO in 1984. Under his leadership, along with that of President Frank Wells, Jeffrey Katzenberg, and some other key managers, the company flourished.

Wells died in a tragic helicopter crash in 1994, and Eisner was forced to undergo major heart surgery just a few months later. Katzenberg had left the firm a few months earlier to form DreamWorks with filmmaker Steven Spielberg and music industry impresario David Geffen. Accordingly, hiring someone to take over for Wells and setting up a new executive succession plan was one of the top tasks for the Disney board.

A leading candidate for this number two position at Disney was an outside executive named Michael Ovitz. Ovitz was the cofounder of a prominent talent agency in Los Angeles, and he was extremely well connected in the entertainment industry. Eisner thought that Ovitz might be a good fit as president of Disney.

Disney's board and Ovitz entered into negotiations, but it soon became clear that Disney might not be able to pay Ovitz enough to lure him. The chairman of Disney's compensation committee eventually devised a plan, with many different option grants and other financial guarantees. However, he cautioned that the plan's stock options "would exceed the standards applied within Disney and corporate America and would 'raise very strong criticism.'"

After bringing in a consultant and some discussion, the entire Disney board approved the deal. Ovitz's tenure as Disney's president, however, was a disaster. Within a year, Eisner and the Disney board decided to fire Ovitz. Under his compensation contract, however, Ovitz was entitled to a whopping $130 million payout as long as the termination was not considered "for cause." The board paid him this money, and an angry group of shareholders sued. The case went all the way up to the Delaware Supreme Court.

THE CASE IN COURT

The plaintiffs started with a claim that Disney's decision making violated the board's duty of care. The court, however, said there was no breach of the duty of care. The board may have played fast and loose with the compensation details, but it certainly had a good reason to make the decision and gave it sufficient attention.

The plaintiffs then argued that the board's decision making had been conducted in bad faith. The Delaware Supreme Court was now forced to wrestle with what this really meant in the executive compensation context. It considered several possibilities. First, a board could breach its duty of good faith by actually intending to harm the corporation, but there was no evidence the board actually meant harm.

The court also accepted a second definition of bad faith behavior: an "intentional dereliction of duty, [or] a conscious disregard for one's responsibilities." The court concluded, however, that there was also no evidence that Disney's board had violated this standard.

CORPORATE PAY AND GOOD FAITH

As of this course's taping, the duty of good faith has not served as a major legal check on corporate pay.

OTHER MEASURES

The Disney case was not the end of the story. The US Congress was also concerned by executive pay, and it decided to wade into the issue by implementing a federal law in this area when it enacted the sweeping financial reform legislation known as Dodd-Frank following the financial crisis of 2007–2008. Importantly, Congress did not set maximum pay rules for corporate officers.

The primary strategy of the federal approach was to offer information to shareholders about executive salaries and provide a way for shareholders to tell the board whether they approved or disapproved of current pay practices.

The upshot of this was something called a say-on-pay vote. Every few years, shareholders at corporations that file reports with the Securities and Exchange Commission (usually larger companies) can review the pay packages of top corporate executives and vote on whether they approve or disapprove of the firm's compensation.

Importantly, this vote is only advisory—shareholders cannot annul a compensation contract, even if every one of them is furious. Still, a large group of disgruntled shareholders could conceivably kick out the current slate of directors during the next election cycle if they do not amend executive pay. It is not clear, however, if say-on-pay laws have had much of an impact on executive compensation.

CORPORATE ACTIVITY

Another important context for the duty of good faith involves a board's obligation to monitor corporate activity. This is sometimes known as the board's *Caremark* obligation after an important Delaware case establishing such oversight duties. In *Caremark*, the Delaware Court of Chancery held that the duty of good faith requires corporate directors to establish some type of monitoring system that tries to ensure that the firm is not engaging in illegal activity.

In a 2006 case called *Stone v. Ritter*, the Delaware Supreme Court adopted the *Caremark* standard. Essentially, the court ruled that a board cannot ignore corporate activities, but it does not have to catch absolutely everything, either.

Along the way, the *Stone v. Ritter* court also changed its mind about good faith as a third board obligation. Instead, it described the failure to act in good faith as a subset of the duty of loyalty.

The full extent of a board's *Caremark* obligation is still unfolding. There was an important case brought in the wake of the 2007–2008 financial crises, for example, where shareholders at Citigroup sued for failure to monitor the firm's business investments closely enough.

Like many companies, Citigroup lost a lot of money. The plaintiff shareholders argued that red flags had existed in a way that should have raised concerns about the firm's business strategy. They felt that the board had ignored the firm's risks in a way that violated *Caremark*.

The court rejected this expansion of monitoring duties. Instead, it returned to the business judgment rule. Citigroup's leaders, it held, were entitled to make decisions about where to invest and how business risk should be embraced.

This was an interesting clash between oversight duties and the business judgment rule, and the case might have led to a significant expansion of a board's monitoring obligations. However, the business judgment rule won the day. For now, a board's monitoring duties are limited to preventing illegal behavior within the shadows of a corporation.

Suggested Reading

- In re the Walt Disney Co. Derivative Litigation.
- Stone v. Ritter.

Lecture 7

SHAREHOLDER LAWSUITS: GOALS AND LIMITATIONS

This lecture explores shareholder lawsuits. Though it may seem counterintuitive, shareholders sometimes sue their own company. The answer to why they might do so is rooted in that most fundamental aspect of the corporation: representation.

SHAREHOLDERS AND REPRESENTATIVES

Shareholders are the residual owners of a company, but they do not collectively vote on every firm decision. Rather, they cede power to a small group of representatives who are entrusted to call most of the shots.

Being human, these representative managers are flawed, and human nature sometimes causes corporate leaders to behave badly. For this reason, suing one's company is a plausible strategy for promoting sound governance and for stopping the mischief of a rogue leader. As such, it is a way for a shareholder to protect his or her investment.

While corporate law accepts a role for shareholder lawsuits, establishing rules to govern these claims effectively has proven difficult. Lawsuits by shareholders have several key features that raise complicated legal questions, both with respect to other shareholders and to the corporation as a whole.

First, the litigation itself is representative, because a single shareholder can assert claims on behalf of, and therefore purporting to represent, the entire body of shareholders. Second, the litigation is usually preclusive, because any given resolution to a claim will typically bind all other shareholders.

Third, the litigation can be self-funding and therefore relatively easy to initiate. This is because the plaintiff's lawyers are often entitled to receive payment for their services through contingency fee arrangements, or even payments from the corporation itself through settlement.

TYPES OF SHAREHOLDER LAWSUITS

It is impractical to require a unanimous shareholder vote as a trigger to any lawsuit, but a firm's full roster of shareholders can run into the tens of thousands or more. This is often a diverse group. Someone will disagree with almost any corporate action, and certainly the legal system cannot be used second-guess all business decisions.

Likewise, some shareholders have private grievances or worldviews that may not be shared by most other owners. One way to solve this coordination problem is to empanel a single shareholder to represent the entire group of equity owners.

This plaintiff essentially takes over all the corporate decisions for a given legal claim. This is called a shareholder derivative lawsuit, and it is a technique that has become an important part of corporate law.

Shareholder derivative lawsuits are not the only type of large-scale shareholder claim. It might also be possible for a group of shareholders to get together to file a direct class action lawsuit against their firm. This lecture, however, focuses on derivative litigation.

Sometimes it is not easy to determine whether a given lawsuit is a direct suit—in which an individual owns the claim and is free to make any decision desired in their personal capacity—or a derivative suit that really belongs to the corporation. To determine whether a suit belongs to the corporation, a court will ask two related questions to sort this out: Who is injured? Who would receive relief?

If a shareholder is harmed personally, then the claim is direct. Shareholders cannot claim direct harm, however, just because the price of their stock drops as the result of firm mismanagement. By contrast, if the corporation itself has been harmed, then the legal claim is probably derivative.

The second question is whether any recovery would go directly to the shareholder or be paid into the corporation. If the shareholder would receive the relief—either in the form of money damages or some other remedy—then the claim will likely be direct. If, on the other hand, any recovery would belong to the corporation, then the claim looks derivative.

DECISIONS ON PURSUING CLAIMS

In the case of a derivative claim, just because a corporation has suffered a legal slight, it does not automatically follow that it is in the firm's best overall interest to pursue the claim. Corporate law allows top officers to decide whether the company should pursue most legal claims.

However, in a very limited set of circumstances—where the legal problems relate directly to top managerial action or inaction—corporate law does not trust the inside representatives with unqualified discretion. The governance compromise is the shareholder derivative lawsuit: the right of an individual shareholder to prosecute a claim on behalf of the entire company when something seems bad in the boardroom.

Additionally, in the most important corporate law jurisdictions, the question of who should decide whether to pursue a claim is governed by something called the shareholder demand requirement. Under this requirement, unless the demand requirement is excused as futile, a shareholder who discovers a possible claim is expected to approach the board and demand that it file the lawsuit on behalf of the firm.

EXCUSING THE DEMAND REQUIREMENT

When the demand is made, control of the lawsuit passes to the board of directors, which is now entitled to decide whether to pursue the litigation. One might expect that the typical board response would be to not pursue the litigation.

However, nearly every shareholder derivative claim involves allegations of wrongdoing by the top corporate leaders. Shareholder-plaintiffs are not interested in calling out breach of contract claims or other routine business litigation; they want to police corruption or recklessness in the boardroom. But if a concerned shareholder has to file a demand notice that immediately transfers control of the claim to the insiders, can we really trust the board of directors to make a sound decision about whether to sue themselves?

For this reason, informed shareholders almost never file demand with the board. Rather, a shareholder-plaintiff tries to keep control of the lawsuit by arguing that the demand requirement is excused under the facts and circumstances of the case. In response, the corporation will typically file a motion to dismiss the case for failure to make demand. Accordingly, for all practical purposes, the seemingly technical issue of whether demand must be made assumes central importance in the litigation dynamics.

The exact rules on excusing demand differ slightly from state to state, and some jurisdictions even use different systems. Generally, however, courts will excuse the demand requirement if a shareholder-plaintiff can offer detailed evidence about one of the following three concerns:

1. A majority of directors are self-interested in a transaction at issue.

2. A majority of directors are unable to evaluate the dispute with independence because they are controlled or dominated by a self-interested insider.

3. The challenged transaction is so egregious on its face that it could not have been the product of a sound business judgment of the directors.

BOARD DELEGATION

A corporation that loses on the demand motion has one last move that might allow the corporation to reassert decision-making authority over the lawsuit and tug back control from a shareholder-plaintiff.

To see how this works, it is necessary to start with the more general topic of board delegation. A board of directors can usually delegate governance over an explicit decision to a smaller committee of directors.

This possibility of board governance through subcommittee raises a tricky question for shareholder derivative litigation. In a situation where demand is excused, the board might nevertheless create a special committee of the remaining, disinterested directors to wrest control of the litigation back from a plaintiff-shareholder.

This move, if executed with proper procedure, would seem to shield any subsequent decisions from the taint of conflicted directors. But even directors with the highest integrity may still be tempted to protect their friends and co-directors from a lawsuit.

Corporate law has concluded, perhaps a bit uncomfortably, that a special committee can indeed yank back control of the litigation from a plaintiff shareholder. However, judges will not give the committee carte blanche. Rather, it must leap at least two hurdles.

First, the special committee must truly be comprised of disinterested directors. Second, the committee must conduct a full and reasonable investigation of the matter. If these steps are followed, then any ultimate decision to drop the lawsuit can be clothed in the protection of the business judgment rule.

THE ORACLE CASE

One case shows how the dynamics of a special litigation committee can play out. In 2002, the Oracle software company had an awkward legal problem. Some shareholders believed that Oracle's CEO, Larry Ellison, along with several other board members, had engaged in insider trading by selling some Oracle stock in advance of a poor earnings announcement by the firm.

Specifically, the shareholders thought that Ellison and the others obtained inside knowledge of poor sales results throughout the quarter from weekly sales reports. They were then allegedly able to use this info to dump some stock for roughly $30 per share that would later fall to $16 per share when bad news came out at the end of the reporting quarter.

Oracle decided to stave off the problem by bringing on two new directors, who had not been around during any of the allegedly problematic behavior. These directors, both professors at Stanford University, would comprise a new special litigation committee (or SLC) that was granted full authority to decide whether Oracle should press the plaintiff's claims, settle the case, or call it all off. In short, Oracle's board wanted to take back control of the lawsuit from the outside shareholders.

The SLC launched a full-blown investigation. The two professors hired a large law firm to help them investigate, and they brought on a consulting firm to help with the analysis. They interviewed more than 70 witnesses and pulled together a 1,100-page report. Ultimately, the SLC concluded that the lawsuit was just not worth it.

This would normally have been the end of the matter, but here is where the case took an interesting turn. Recall that for the SLC to take back control, it needed to have conducted a thorough review and be independent. Its review certainly looked thorough, but the judge took a close look at the relationship between Oracle and Stanford. He did not like the pressures that such a cozy relationship might put on the Stanford professors.

He noted, for example, that one of the defendant directors was also a Stanford professor. Another defendant had given Stanford a research grant that supported work by one of the SLC professors. The court also noted Ellison was quite wealthy and had made charitable contributions to Stanford.

For these and other related reasons, the court concluded that the SLC was not sufficiently independent and that it could not reassert control of the case. This is an unusual and debatable outcome, but the Oracle situation does nicely illustrate how the dynamics of shareholder derivative lawsuits can work.

Suggested Reading

- In re InfoUSA, Inc. Shareholders Litigation.
- In re Oracle Corp. Derivative Litigation.

Lecture 8

SECURITIES REGULATION AND FRAUD

Federal law has stepped in to regulate corporate fundraising and trading activity. Ever since its birth in the 1930s, the Securities and Exchange Commission has set rules to disseminate information and try to halt fraud in connection with the stock markets. Private shareholder suits have also played a significant role in policing fraud that might impact trading markets.

THE EARLY 1930s

In the early 1930s, Congress was particularly worried about some shady practices that were thought to permeate Wall Street. These included conflicts of interest, the sale of worthless stocks and bonds, and outright lies. Federal lawmakers sought to remedy these problems with two comprehensive pieces of legislation: The Securities Act of 1933 and the Securities Exchange Act of 1934. These laws created the US Securities and Exchange Commission (SEC), became part of the New Deal, and continue to serve as the backbone of securities regulation in the United States.

In spite of its substantial intervention in the markets, Congress did exercise some self-restraint. Some people were pushing for merit reviews, or substantive business requirements for the sale of stock, bonds, and other securities. Congress rejected this approach in favor of a comprehensive disclosure regime. Lawmakers were not going to judge the substantive quality or risk of a given financial investment.

Rather, a firm that wanted to sell stock now had to go through a registration process under the 1933 act in which it provided comprehensive information about the firm's historic and expected future activity. Investors could then make up their own minds about the risk that an investment in that firm might pose and whether they wanted to buy into the company.

If Congress's policy choice in establishing the registration process was an instance of self-restraint, however, it still has had a powerful and lasting effect. Indeed, this disclosure-oriented framework has greatly influenced corporate fundraising ever since.

ACTING IN CRISIS

Congressional temptation to act has always been strongest following a financial crisis. The financial reform legislation known as Dodd-Frank, for example, was passed in the wake of the Great Recession.

A FOCUS ON FRAUD

Given this focus on information disclosure, securities laws are especially concerned about fraud. If a firm lies in its registration statement to attract new stockholders, then it will be in serious trouble under the 1933 act. The 1934 Exchange Act, by contrast, does not focus on initial fundraising activity. It tries to protect trading in secondary markets like the New York Stock Exchange or the NASDAQ.

However, fraud can still be a serious concern for ongoing trading markets as well. For example, one day in 2018, Elon Musk, the CEO of Tesla, typed nine words on his Twitter account that would cost him $20 million. Those words were: "Am considering taking Tesla private at $420. Funding secured." The automaker's stock had opened that day at about $340 per share. The stock was up to $380 by the end of the day.

Yet as time passed, people began to wonder whether funding really had been confirmed. Musk hinted that he had held discussions with financial backers, but the proof that a commitment was reached seemed thin. Some Tesla directors said they were blindsided by the idea.

Tesla had not hired investment bankers to raise this money. It did not help that the price of the buyout, $420, appeared to have been chosen in part because it has a special significance for marijuana smokers. That is what the SEC maintained when it sued Musk for fraud. Over the next month, the price of Tesla stock began to plummet, first to $300 and then down to $265.

RULE 10B-5

The Tesla incident matters because hypothetically, a person could plow their money into Tesla stock, expecting a buyout at a higher price that never comes. This is exactly that type of problem that Congress wanted to address in the 1934 Securities Exchange Act.

The specific law, Section 10b, states that "It shall be unlawful for any person … [t]o use or employ, in connection with the purchase or sale of any security … any manipulative or deceptive device." This does not offer much guidance about what is really prohibited, but Congress also directed the SEC in 1934 to make more specific rules to flesh out section 10b.

The SEC quickly complied, adopting Rule 10b-5, which makes the following actions unlawful:

- ✯ Employing "any device, scheme, or artifice to defraud."
- ✯ Making "any untrue statement of a material fact."
- ✯ Engaging "in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."

These are unlawful as long as one of these acts is made "in connection with the purchase or sale of any security." Over time, federal courts have fleshed out what this rule means for false statements. A plaintiff suing under 10b-5 now needs to demonstrate four main things:

- ✯ First, the fraudulent statement was made with intent to deceive, or at a minimum, with a reckless disregard for the truth.
- ✯ Second, the plaintiff must show that the fraudulent statement caused the harm.
- ✯ Third, the plaintiff needs to show that the statement was material—that is, a reasonable investor would likely consider the statement important.
- ✯ Fourth, the plaintiff must show that he or she relied on the misstatement in taking the action that proved harmful, like buying into the stock.

TESLA VERSUS THE SEC

The SEC certainly thought Musk did something illegal in his tweet. Its complaint argued that he knew or was reckless in not knowing that his tweet was false. It also alleged that "in truth and in fact, Musk had not even discussed, much less confirmed, key deal terms, including price, with any potential funding source."

Musk pushed back against this characterization, and some thought that he was prepared to fight the charges. But the SEC threatened one of its strictest penalties: a lifetime ban on serving as an executive or director at any public company. Eventually Musk decided to settle the case by paying $20 million and resigning as chair of Tesla's board. He stayed on, however, as CEO.

PRIVATE RIGHT OF ACTION

The SEC's action against Musk to protect trading markets had a significant impact on Tesla. However, it did not preclude aggrieved shareholders from suing the company directly. Courts have also embraced something called the private right of action for 10b-5 claims, allowing individual investors to sue under the statute to try to recover their own losses in court. In effect, it is a way to leverage the power of 10b-5 laws to enforce them beyond the limited resources of the SEC.

This private right of action brings up the important development in this area—a doctrine known as fraud on the market. One of the problems with a private 10b-5 lawsuit is that one person's loss may not be enough to make it worthwhile to press charges. However, 10b-5 claims can also be brought as class actions.

A case called *Basic Inc. v. Levinson* paved the way for broad class action lawsuits in 10b-5 fraud claims. That case very much upped the ante on securities fraud litigation. High-powered plaintiff's lawyers began to file class action lawsuits any time there was a large price drop coupled with possible misinformation.

They would then explore the facts more closely and press the firm to settle the case. Many firms felt great pressure to do so. Some subsequent legal changes have made it more difficult to do this, but fraud on the market is still the law. The Supreme Court revisited the theory back in 2014 and again upheld it.

In the wake of *Basic Inc. v. Levinson*, many important shareholder fraud lawsuits have explored how far fraud on the market should go. Following his Twitter statement, Elon Musk was actually sued by short sellers who had placed bets that Tesla's stock would go down.

Short sellers borrow stock they do not own and sell that stock. They then hope to buy the stock later, if and when the price declines, so they can return the shares to the lender and make a profit. Musk and other CEOs often complain that these investors put unwanted pressure on their firm's stock and drive down the price of shares.

Tesla's stock jumped in value in the immediate aftermath of Musk's Twitter post. Short sellers who had to close their positions during that period thus lost money because they needed to buy the stock (known as covering their position) at a higher price. The question at hand is if these traders are protected by 10b-5. Recent cases have said yes, so they decided to file a lawsuit against Musk. As of this course's taping, that suit is still undecided.

Suggested Reading

- Basic v. Levinson.
- Goldstein, "Elon Musk Steps Down as Chairman in Deal With S.E.C. Over Tweet About Tesla."

INSIDER TRADING LAWS AND THEIR COMPLEXITIES

Some countries have enacted very explicit laws that simply say you cannot trade the stock of a company if you possess important inside information. The United States, however, takes a different approach. Instead of a blanket prohibition on insider trading, America uses a strange and often ambiguous patchwork of laws that allow some trades while prohibiting many others. This lecture looks at how federal lawmakers and the Securities and Exchange Commission (SEC) approaches insider trading.

SECURITIES AND EXCHANGE COMMISSION V. TEXAS GULF SULPHUR

A good starting place in federal law is the case of *Securities and Exchange Commission v. Texas Gulf Sulphur*. In the early 1960s, the mining firm Texas Gulf Sulphur (TGS) was exploring some land in eastern Canada. The firm's stock was trading at about $19 per share. By late 1963, TGS came across a very promising location: exploratory drilling revealed massive deposits of copper. TGS wanted to keep this news secret so it could buy up the surrounding land at a good price.

Over the next few months, the firm succeeded in purchasing all the land for this new mine. Several leaders at TGS also succeeding in buying stock and stock options in their firm for around $20 per share. By April of 1964, the rumors were starting to fly.

In response, TGS's president and some other leaders decided to put out a statement dampening enthusiasm about a potential copper discovery. The statement seemed to calm the markets. This also allowed several insiders to buy more stock in TGS at an attractive price.

Four days later TGS issued an official announcement: The firm had indeed struck a massive deposit of copper. It estimated a discovery of more than 25 million tons. TGS's stock price skyrocketed on the news, soon jumping to $58 per share.

The insiders made a lot of money, but the SEC discovered the trades and decided to prosecute these executives for insider trading violations. The specific law was Rule 10b-5. This rule prohibits any person from engaging "in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" in connection with a trade.

The SEC thought that insider trading constituted deceit and pursued the case through an appeal to the US Court of Appeals for the Second Circuit. In short, the court said that the insiders either should have abstained from trading or disclosed their information to the public. Additionally, they had to give the public enough time to act on the information, too.

The ruling was a foundational decision on insider trading, and it set out the traditional rule of abstain or disclose. However, the case used noble rhetoric about establishing a level playing field for all investors, which swept farther than the US Supreme Court has ultimately been willing to go.

CHIARELLA V. UNITED STATES

The next big opinion on insider trading law came about 10 years later in a case called *Chiarella v. United States*. Chiarella worked for a Wall Street printing company. Other companies and their advisors would hire the company when they needed to produce documents that would be used to make a buyout offer for another firm.

This was obviously highly sensitive information, and recognizing this, the firms would use code names as they prepared the materials for printing. For example, the buyer might be disguised as Sharkey, and the target company might be code-named Minnow. The real company names would only be substituted at the very last minute.

Chiarella knew how this game was played, and he was also smart enough to make some educated guesses about who Sharkey and Minnow might really be. One day, he decided to buy a bunch of Minnow's stock, using the inside information from his printing job. He became rich when his guess proved correct. However, when the SEC brought a case against Chiarella for insider trading, the US Supreme Court was unwilling to embrace a level playing field theory that would have deemed his behavior illegal.

Instead, it said that the duty to abstain came from a relationship of trust between a corporation's shareholders and its employees. However, Chiarella had no relationship with Minnow's shareholders; he worked for a different printing company that had been hired by the acquiring firm Sharkey. With no duty to Minnow, Chiarella was free of responsibility. This type of activity did not count as illegal insider trading in the eyes of the Supreme Court.

TIPPER-TIPPEE INSIDER TRADING

The next piece of the insider trading puzzle involves a problem known as tipper-tippee insider trading. The US Supreme Court has agonized over when to prohibit this activity, and there have been many important insider trading cases about tipping.

The foundations of tipper-tippee criminality were created in a 1983 opinion named *Dirks v. Securities and Exchange Commission*. It established the general framework for determining whether a tip would count as insider trading.

Dirks worked for a brokerage firm that provided investment analysis to its clients (mostly large institutional investors). One day, Dirks got a call from someone named Ronald Secrist. Secrist had worked at a Los Angeles insurance company named Equity Funding, and he was calling to tell Dirks that Equity Funding was lying about its financial performance. Secrist had already provided this information to several regulatory agencies, but they had all failed to investigate.

Dirks decided to dig a little deeper. He flew out to LA to interview some of the employees at Equity Funding. The senior leaders denied any wrongdoing at the firm, but several lower-level employees corroborated Secrist's story of fraud.

Neither Dirks nor his firm owned any Equity Funding stock, but they advised several large clients who did. On the basis of Dirk's advice during this investigation, these clients dumped about $16 million in stock. Over the two-week period of the investigation, the price of Equity Funding fell from $26 to $15 per share. Shortly thereafter, trading on the stock was halted, and the California insurance authorities investigated.

They seized the firm's records and found widespread evidence of fraud. *The Wall Street Journal* published a front-page article, and the company went bust. Secrist had been right all along.

DIRKS V. SECURITIES AND EXCHANGE COMMISSION IN COURT

The SEC decide to "reward" Dirks for rooting out the fraud by bringing criminal charges against him for insider trading. The theory was that Secrist and other insiders had tipped Dirks, and that he had wrongfully tipped off his clients so they could sell with inside information. The SEC thought this behavior violated 10b-5. Essentially, it wanted a rule that any tippee would simply inherit the duty of an inside tipper as soon as the tipper gave the tippee confidential information. If Secrist could not trade under TGS, then neither could anyone else down the chain.

The Supreme Court refused to go this far. Instead, it held that tippers and tippees would only violate insider trading laws if two factors were present. First, the tipper must have breached a duty to the firm when disclosing the information to the tippee. Related to this, the court said that a breach of the tipper's duty only arose if he or she obtained a personal benefit or gain. Second, the tippee must have known (or should have known) about this breach of duty.

Having set out these critical requirements, the court then concluded that illegal insider trading had not occurred under the facts of *Dirks v. Securities and Exchange Commission.* Secrist and the other Equity Funding employees who gave Dirks the information did not spill the information for personal gain. Rather, they did so to expose and stop the fraud. Because they breached no duty, there was no derivative breach by Dirks.

Even if there had been a problem—for instance, if Dirks had bribed Secrist to get the info—the clients of Dirks's advisory firm would probably be OK. If they had no reason to know about the bribe, then they would not have known about the breach—the second requirement under the Dirks test.

PERSONAL BENEFITS

The Supreme Court weighed the question of what counts as a personal benefit under the *Dirks* test during 2016, with the case of *Salman v. United States.* It involved a banker who gave confidential inside information to his brother who then passed it on to their future brother-in-law, Salman.

The court said this: "By disclosing confidential information as a gift to his brother with the expectation that he would trade on it, [the tipper] breached his duty of trust and confidence to [his employer]." The court then said that the trading brother-in-law acquired the duty and breached himself by trading "on the information with full knowledge that it had been improperly disclosed."

Yet the court answered the question in a narrow way, as it so often does, by focusing on a family member or close friend who might be given a gift of information for trading. It is not so clear that any subsequent trades from other types of interactions would break the law set out by *Dirks* and *Salman*.

MISAPPROPRIATION

The SEC has been pursuing another angle—the misappropriation theory—to try to close some gaps in the classical theory. It tried to use it in *Chiarella*, but the Supreme Court declined to hear the argument back then because it had not been presented earlier to the jury when the case was at the trial court level. Finally, in 1997, the court considered this theory directly in a case called *United States v. O'Hagan*.

The case involved an unethical attorney named James O'Hagan. O'Hagan was a partner at a large law firm in Minneapolis. He had embezzled millions from a pool of funds that the law firm held in trust for several of its clients. However, O'Hagan had an idea for repaying these funds before his theft was discovered.

Late one night, he decided to prowl around his law firm, poking into the offices of his partners to try to find some useful information. He soon found this information: One of his partners was helping a company called Grand Met develop a buyout offer for the Pillsbury Company.

O'Hagan figured that the stock price of Pillsbury would go up when the buyout offer was announced, so he purchased a huge amount of stock and some options to buy Pillsbury stock in the future. He soon became the largest owner of Pillsbury options in the world. When the deal became public, the price of Pillsbury's stock nearly doubled, and O'Hagan netted over $4.3 million in profits—more than enough to conceal his earlier embezzlement.

When the SEC noticed that the largest Pillsbury option holder happened to be a partner at the law firm that advised Grand Met on the buyout, it decided to go after O'Hagan for insider trading. However, under the traditional theory, O'Hagan's actions didn't seem to violate the law. He was not an insider at Pillsbury, which was the company whose stock was traded. Although the law also treats lawyers and other professional advisers as temporary insiders when they get confidential information from their clients, O'Hagan was not working on the Grand Met buyout. Even if he was, it was Pillsbury's stock that he purchased.

The SEC needed to use a misappropriation theory. It argued that 10b-5's prohibition on "deception … in connection with a trade" could be satisfied by stealing or misappropriating information from one company and using it to trade stock in another. This might be a bit of a stretch for the language of 10b-5, but the Supreme Court accepted the theory, and misappropriation is now illegal.

Suggested Reading

- Dirks v. Securities and Exchange Commission.
- Securities and Exchange Commission v. Texas Gulf Sulphur Co.
- United States v. O'Hagan.

Lecture 10

CORPORATE CONTROL BATTLES AND THE LAW

This lecture explores internal shareholder fights for control. The lecture covers how they work, what rules can tilt the balance of power, and how a shareholder might still influence corporate activity even if he or she cannot fully vote out the current board.

FIGHTS IN SMALL FIRMS

Control battles spring up at firms of all sizes, but they can be especially contentious in smaller firms where the shareholders sometimes have personal relationships with one another. For example, take the case of *Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling*. The most famous circus in the world had a brutal shareholder control battle in 1947 that continues to be studied closely by law students today.

The Ringling family started its circus back in 1882, and it bought out the Barnum & Bailey in 1907. The circuses eventually combined and grew into an enormously popular form of entertainment.

By 1936, the last original brother has passed away, and control was split into a trio of different family groups. There were 1,000 total shares of stock. Group 1, headed by Edith Ringling, held 315 shares. Group 2, headed by Aubrey Haley, held 315 shares. Group 3, headed by John North, held the remaining 370 shares.

During the economic struggles of the Great Depression, North negotiated a $1 million loan from a bank and used this capital to keep things going. As a condition of the loan, the bank demanded that all three factions set up something called a voting trust.

A voting trust is an agreement in which the shareholders temporarily transfer their stock to a separate legal entity, known as a trust. The trust will then vote all the shares together under the terms of the trust agreement.

There were seven total director slots on Ringling Brothers' board. The terms of the trust dictated that family members from groups 1 and 2 would receive three director slots and family members from group 3 (John North's group) would also receive three director slots. The bank would appoint the last director. Thus, John North, with three seats, plus the bank, with one seat, could outvote the other three directors on any decision.

With this deal in place, the $1 million came in from the bank, and John North saved the circus from financial ruin. However, the other two family groups soon grew to resent this arrangement. When the trust expired in 1943, Edith Ringling and Aubrey Haley decided that they wanted to set up a different voting arrangement to wrest control of the circus back from John North.

A CIRCUS DISASTER

Ringling and Haley realized that if they committed to voting together, they could elect five out of the seven directors. They consulted with their lawyer who said that the best way for them to commit to voting with each other was to set up a new voting trust, with just their 630 shares.

After the two pushed back, their lawyer then recommended an alternative idea, known as a vote pooling agreement. This was a contract in which they agreed to vote with each other during director elections. With this new deal in place, group 1 and group 2 grabbed back control of the board and took over the circus.

Again, the year was 1943, and the United States was in the middle of World War II. The new leadership team soon faced a tough decision: The circus could no longer obtain flame-retardant canvas because it was needed for the war effort.

North, who was still a minority board member, counseled that they should shut operations down until flame-retardant canvas was available. However, John was no longer in control, and the rest of the family decided to press ahead using normal canvas for the circus tents.

On July 6, 1944, the circus held an afternoon performance in Hartford, Connecticut. Flames leaped to engulf a circus tent, spreading rapidly because a mixture of paraffin wax and gasoline had been used to waterproof the canvas. Two exits were blocked by chutes used to bring lions in and out of the ring. In the end, 167 people died and more than 700 were injured. It remains one of the worst fire disasters ever in the United States.

As the authorities investigated, they decided to charge some Ringling employees with involuntary manslaughter. One of these defendants was James Haley, the husband of group 2's leader, Aubrey Haley. He was convicted, allegedly without much support from group 1.

THE GROUPS GO TO COURT

Just a year or two after striking a voting deal with group 1, the family in group 2 was no longer interested in working with this side of the family whom they felt treated James Haley so poorly. In 1946, group 2 decided to break their deal with group 1 and rejoin John North and group 3.

They cast their shares together, and the new faction received five directors. Group 1 then sued, arguing that group 2 had to vote with them under the terms of their vote-pooling contract. The case presented an interesting clash of corporate law and contract law.

Ultimately, the Delaware Supreme Court upheld the legality of the pooling contract but said that the court would not order group 2 to vote in a specific way. Instead, it annulled all the votes cast by this group. This actually had the effect of giving John North's group and group 1 a 3-3 tie, but by the time the case was actually decided, the company was ready for another shareholder vote, and groups 2 and 3 could take back over.

The moral to this story is that voting trusts and vote-pooling agreements are OK, but they have limits. Many shareholders are nervous about pre-committing to vote in a certain way or with another group, and that is not an irrational fear. As the circus case illustrates, things can change.

PROXY FIGHTS

In larger corporations, shareholder control battles often play out with proxy fights. Here is how it works: Imagine a shareholder of a company, named Elizabeth in this example, does not like the current board of a company. A few months before the next annual meeting, when shareholders will vote on the company's directors, Elizabeth could announce that she will be promoting a rival slate of directors.

All shareholders who agree with her vision of the firm's best strategy can then support her slate of directors over the incumbents. If her group gets enough votes, it will take over the board and start running the company.

One important consideration relates to the number of votes needed to win a board election. The rules for each corporation will be set in the firm's bylaws, but many firms use plurality voting. This means that whoever receives the most votes wins—even if the candidate does not obtain a majority.

Proxy fights can become very expensive. Both sides will usually need to hire advisors and lobbyists to argue their cases to the other shareholders. In highly contested fights, this can run into millions of dollars. Accordingly, one of the key considerations in proxy fights involves who pays for the expenses.

ONLINE PROXY VOTING

Many companies run corporate elections via the internet. If you have a broker, you might have received emails from him or her telling you that firm materials are ready for your review. Any rival team will need to develop its own proxy materials, which are detailed and highly regulated by federal law. If you like the rival team's candidates more, then you can send your proxy materials in to them. If you want to change your vote after you have sent your materials in to one team, you can usually just submit a new proxy to the other team—as long as you do this before the voting is closed.

The cases of *Levin v. Metro-Goldwyn-Mayer, Inc.* and *Rosenfeld v. Fairchild Engine & Airplane Corp.* have shaped how payment in these cases work. To sum up, assuming the debate relates to a matter of policy and that the expenses are reasonable, the firm may reimburse incumbents, win or lose. It may also reimburse challengers, but only if they win and the shareholders ratify this payment

This clearly offers an advantage to incumbents, who can escalate control battles without the risk of pulling out their own wallets. However, it is difficult to design a better rule. If there were no reimbursement for anyone, then it might undermine the interest and ability of qualified managers to serve on a board.

If automatic reimbursement were available for all sides, win or lose, then thousands of insurgent groups may spring up to use the corporation's resources to throw so-called campaigning parties.

NELSON PELTZ

A person does not need to run a proxy contest for the entire board. An activist shareholder named Nelson Peltz, for example, has held very public proxy contests at many companies, including DuPont and Procter & Gamble, for a limited number of board seats.

THE SHAREHOLDER PROPOSAL

The shareholder proposal is one other legal option that a shareholder might use to influence managerial decision making. A shareholder proposal is the legal mechanism for invoking broader participation in a firm's activity. A shareholder can put a proposal on the firm's proxy statement so all the shareholders can vote on whether they want to support it. The political analogy is a voter proposition that seeks to amend the state constitution or present some other issue for a popular referendum.

The rules for getting something on the ballot are relatively strict. Shareholder proposals are mostly governed by federal law, not state law, because they appear on a firm's proxy statement, which is a field covered by the 1934 Securities Exchange Act.

When a company receives a proposal, it has a choice. It might just add it to the proxy, but often managers want to resist shareholder intrusion on decision making. Under federal law, there are more than a dozen different reasons why insider managers can reject a shareholder's proposal.

For example, the board can exclude a proposal that is illegal or one that is beyond the firm's power to bring about. Additionally, one of the most important federal provisions says that a firm can exclude a shareholder proposal that relates "to the company's ordinary business operations."

In many cases, a firm may not know for sure whether an exclusion applies, but it can write to the SEC for clarity. A firm can do this by drafting a request for a no-action letter to the SEC.

The SEC will study the proposal, the law, and the firm's arguments for why the proposal should be excluded. It will then do one of three things: issue the no-action letter, refuse to issue the letter, or say that it will do nothing at present.

If the SEC refuses to issue the letter, then the company will probably add the proposal and let shareholders vote on the issue. Conversely, if the company obtains a no-action letter, then it will probably exclude the shareholder proposal. The angry shareholder might still file a lawsuit seeking a federal court order to get the proposal added.

Suggested Reading

- Levin v. Metro-Goldwyn-Mayer, Inc.
- Ringling Bros.-Barnum and Bailey Combined Shows v. Ringling

Lecture 11

CORPORATE LAW OF MERGERS AND ACQUISITIONS

Mergers and acquisitions are extreme events in the life of a corporation. This lecture takes a close look at merger and acquisition activity. Corporate law has adopted special rules to deal with these extraordinary events.

TERMINOLOGY

Many people use the terms *merger* and *acquisition* synonymously. Sometimes, a merger is used to refer to something called a merger of equals, where two similarly sized firms come together. An example of this is the combination of Daimler and Chrysler in 1998.

However, mergers of equals are rare, and it is more common for one larger firm to take over a smaller company. In the Keurig/Dr Pepper deal, for example, Dr Pepper shareholders wound up with only 13 percent of the combined company, while Keurig shareholders received 87 percent of the shares.

A deal like Keurig/Dr Pepper might be called either a merger or an acquisition. This was a friendly deal, where both parties thought it made sense. Sometimes, there occurs a hostile situation where the target does not want to be bought. These are almost always called acquisitions (not mergers).

BUSINESS SYNERGIES

From a strategic standpoint, two merging firms will usually want to obtain business synergies. The firms hope to get more out of the combination than either firm could get on its own.

REASONS FOR MERGING

Companies can merge for many reasons. Perhaps a small firm has discovered a new technology that the buyer wants to access and control. Alternatively, perhaps a corporation wants to buy a company in a different industry to serve customers in some new or better way. Another reason can be that two competing companies in the same industry might want to join forces to become bigger, which is known as a horizontal merger.

Merger synergies are sometimes divided between cost synergies and revenue synergies. Cost synergies occur when the combined firm can cut out redundancies. Revenue synergies are different, in that the firms seek to boost sales with newly opened markets and products.

EXECUTING THE DEAL

At a high level, mergers generally involve four steps. First, the firms will engage in strategic planning where they sketch out a rationale for the merger. Second, they will conduct negotiations about the buyout price, leadership issues, and other key considerations. Third, they will form a contract and execute the deal. Fourth, they will try to pull off the goals of the merger by implementing the deal, a process known as post-merger integration. Lawyers can become involved in each of these stages, but they usually play their biggest role in the middle two steps: negotiation and execution.

STRUCTURING A MERGER

Legally, a firm will have several different options for structuring a merger. For instance, corporate law provides for something called a statutory merger. Two firms conducting this type of deal will file a plan of merger with the state authorities. Among other details, this sets out what the shareholders of each company will get when the deal is over.

Under most state laws, the boards at both firms and the shareholders at both firms all need to vote their approval. For friendly deals, this may not be difficult, but there can be situations where selling shareholders are unwilling to go along.

In other cases, the shareholders may want to do the deal, but the board will resist. In a case like this—where the target's board resists, but the firm's shareholders seem willing—then the acquiring firm can propose a different legal structure called a stock purchase deal.

Under this arrangement, the buying firm makes an offer, called a tender offer, directly to the target firm's shareholders. Because there is no need for target board approval, this makes tender offers a common method for hostile deals. On the buyer side, board approval is needed, but shareholder approval may not be necessary because corporate laws do not always require this in a stock purchase (unlike the statutory merger structure).

The third type of merger is an asset purchase deal. This is an arrangement where a buyer agrees to purchase the target's assets for a certain price. The target can keep the purchase payment or may simply distribute everything to its shareholders and dissolve. Board approval is needed at both firms, and approval from the target shareholders is also required if the firm is selling substantially all of the assets. Buyer shareholder approval is not usually needed.

APPRAISAL RIGHTS

Depending on how the deal is structured, a minority shareholder who disagrees with a merger may have something called appraisal rights. In corporate law, appraisal statutes permit minority shareholders to dissent against a merger, file a lawsuit, and receive the judicially determined fair value of their shares. The doctrine dates from the early 1900s, when state lawmakers granted appraisal rights to shareholders in exchange for an easing of merger voting requirements.

Lawyers will sometimes try to structure a merger to eliminate appraisal rights. One good example of this can be seen in the 1963 Delaware case of *Hariton v. Arco Electronics*. Arco and another company named Loral Electronics Corp. were both in the electronics industry. They decided to do a deal where Loral would acquire Arco.

Both boards approved the deal, and most shareholders seemed happy as well. However, the planners worried about some dissenting shareholders at Arco who might object and file an appraisal lawsuit.

If they used a statutory merger, then dissenting shareholders would indeed be entitled to seek appraisal. They decided to do an asset sale deal instead. Arco's board agreed to sell the firm's assets to Loral for 283,000 shares of Loral stock. It then called a shareholder meeting to approve the deal. About 80 percent of the shareholders voted yes, and the merger went through.

Soon thereafter, Arco dissolved itself and distributed all the Loral stock (which it now held) to the Arco shareholders. The effect of this was almost the exact same as a statutory merger. However, because dissenting shareholders in an asset sale structure did not receive appraisal rights under Delaware law, Arco hoped to avoid the risk of a lawsuit on that issue.

THE DE FACTO MERGER DOCTRINE

The plaintiff Hariton was furious. He felt his company had undermined him by structuring the deal to remove appraisal. He filed a lawsuit under the de facto merger doctrine, arguing that this was really a statutory merger and that he should therefore get appraisal rights.

The Delaware Supreme Court disagreed. It stated:

> We now hold that the reorganization … is legal. This is so because the sale-of-assets statute and the merger statute are independent of each other. They are, so to speak, of equal dignity, and the framers of a reorganization plan may resort to either type of corporate mechanics to achieve the desired end

Under this holding, known as the rule of independent legal significance, the plaintiff was out of luck.

From a practical perspective, this means that lawyers can often structure mergers to avoid appraisal lawsuits. Some people have used this fact to conclude that corporate law is often ridiculous. However, appraisal law has rebounded in recent years because corporations may need to worry about other considerations. For example, an asset purchase, like the one in *Hariton*, may lead to a higher tax bill, so the planners might prefer to risk appraisal lawsuits to paying more in taxes.

FREEZEOUT MERGERS

This lecture concludes with a special type of merger known as a freezeout merger or a cash-out merger. Imagine the following situation: Your favorite NFL football team, in this example the New England Patriots, is a public corporation also known as Patriots Company. The owner of the team holds 70 percent of the shares and elects all the board members. The other 30 percent of shares are distributed widely among investors and fans.

You and your family have owned some shares for decades. It is not a huge stake, but you are proud to say that you are a co-owner of the team. One fateful day, however, the Patriots' owner decides that he wants to own all the shares of the Patriots.

He sets up a new corporation called Better Patriots Company. Mr. Greedy invests $10 million in cash in this new company and takes 100 percent of its stock. He also appoints all the board members. Then, he decides to execute a statutory merger between the Patriots Company and the Better Patriots Company All the shareholders of Patriots Company will get $10 per share in the merger. All the shareholders of Better Patriots Company will get a share in the continuing firm.

The Patriots' owner will own 100 percent of the football team, and you and all the other minority shareholders will be cashed out at $10 per share. Will this deal get approved? Perhaps. The owner controls the board at both companies. He owns 100 percent of Better Patriot Company's stock and 70 percent of Patriot Company's stock, so a positive shareholder vote at both firms is guaranteed. The owner has conducted a cash-out merger, and you are the one being cashed out.

DEALING WITH FREEZEOUTS

It does seem a bit strange however, to allow the owner to set the price at which you must sell him your shares. One legal approach to dealing with this might be to prevent or limit a controlling shareholder's ability to conduct cash-out or freezeout mergers.

This was the strategy taken in Delaware for a short period of time: From 1977 to 1983, the court required majority owners to demonstrate that a freezeout merger served a "valid business purpose." Naked plots to take over a firm were forbidden. However, this type of standard is exceptionally difficult to administer, and the business purpose rule was quite sensibly abandoned.

A second legal approach might be to require unanimous shareholder approval for freezeout mergers. However, assigning this much power to minority shareholders can lead to a holdout problem.

Yet, despite the gut reaction that something improper is occurring, there is a justifiable rationale for using these transactions to break the holdout problem described above. Not all freezeout transactions are legally sanctioned theft. There are legitimate reasons to conduct these deals. For example, a majority owner who does business with the firm may run into conflicts of interest with contract pricing. Taking full ownership will eliminate these conflicts.

In recent times, lawmakers have relied on three loosely related requirements to strike a balance here. First, controlling shareholders have an obligation to provide various disclosures to minority shareholders during a freezeout transaction. Second, minority investors can pursue appraisal claims if they believe that the price of the deal is unfair.

Finally, freezeout transactions can be challenged via fiduciary duty lawsuits by minority owners. After all, this is a self-dealing transaction where the controlling shareholder is involved in the purchase. A freezeout statutory merger might lead to an intrinsic fairness review.

Yet most controlling shareholders are nervous about having their deal reviewed under such an intrusive legal standard. The law offers an alternative. First, Patriots Company could set up a special committee of disinterested directors to make decisions about this deal. Second, it could subject the deal to approval by a majority of the minority shareholders.

In other words, the owner would not vote at all, and more than half of the 30 percent minority shareholders would need to approve the buyout. If structural protections like this are put in place, then the deal decision will enjoy the protection of the business judgment rule—a highly deferential standard.

Suggested Reading

- Hals, "Court Reverses Dell Buyout Ruling That Alarmed Dealmakers."
- Hariton v. Arco Electronics, Inc.

Lecture 12

HOSTILE TAKEOVERS, DEFENSES, AND THE FUTURE

This lecture focuses on hostile takeovers and defenses against them. Corporate law recognizes that mergers are extreme events, and it often imposes a high standard of behavior on senior leaders of a target firm that seeks to fend off a hostile takeover. To hone in on such situations, the lecture looks at two cases in particular: *Unocal Corp. v. Mesa Petroleum Co.* and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*

BACKGROUND ON *UNOCAL CORP. V. MESA PETROLEUM CO.*

By the 1980s, business magnate T. Boone Pickens had built his company, Mesa Petroleum, into a hostile takeover firm. In 1981, he took over a company 30 times the size of Mesa. By 1985, Pickens was ready to take on one of the largest oil companies in the country: Unocal Corporation.

Unocal launched a series of antitakeover defenses that would ultimately end up in court. The resulting legal opinion, issued in 1985, established the modern corporate law framework for deciding what a company can do to fight off raiders like Pickens. *Unocal Corp. v. Mesa Petroleum Co.* is a famous case for that reason.

Typically, the board and top managers of the target firm of a takeover do not want to lose control of the company. However, the shareholders of the target firm might not object. If the hostile raider can convince enough shareholders to sell their stock, perhaps by dangling a large price in front of them, then the raider can indeed take control of the company, fire the board, and execute a new strategy.

The legal mechanism for hostile takeovers is usually something called a tender offer. Someone like Pickens might buy up a small stake in the company. In the Unocal case, for example, he had amassed 13 percent of the shares.

Then, he might make an open offer to buy the rest of the stock, conditional upon having at least 37.1 percent of the total shares tender, or he might agree to be bought out. If shareholders holding at least that percentage of shares agree to sell to Pickens, the deal will close, and he will have majority control. Because the target firm's board does not have any say over whether each shareholder decides to sell, they cannot automatically stop this transaction.

In the Unocal situation, Pickens did not make an open offer to all shareholders. He was more devious. Pickens said that he would be willing to buy approximately 37.1 percent of the stock for $54 in cash per share. (It was trading around $46 at the time of the deal.)

If more than 37.1 percent of the shareholders tendered, then the right to sell would be determined on a pro rata basis. (For example, if 74 percent of the stock was tendered, then everyone could sell half their shares to Pickens for the cash.)

Then, once he had majority control, he threatened to buy out the rest of the shares, the back-end 49.9 percent of the stock, for $54 apiece in bonds with a freezeout merger. However, the bonds would be junior to the company's other debt, making them junk bonds, so named because they have a higher risk of default. Everyone recognized that $54 in junk bonds might actually be worth much less than that amount.

UNOCAL'S RESPONSE

Unocal's board saw what was going on, and it was extremely distressed. The directors expected to be fired if Pickens took over, and they also thought that Pickens was trying to grab the company for a cheap price. Their investment bankers told them that the minimum price that shareholders could expect in an orderly sale or liquidation was $60 per share. Pickens's offer of $54 seemed both inadequate and coercive.

One option for Unocal's directors might have been greenmail—that is, offering to buy Pickens's 13 percent at a higher price, such as $60, to get him to move on to another company. However, Unocal's directors instead executed a self-tender strategy. They offered to buy out the 49.9 percent of back-end shares for $72, conditional upon the Pickens offer going through and excluding Pickens from participation in the back-end offer.

Unocal's self-tender would only kick in if 37.1 percent of the shareholders tendered into Pickens's offer. However, the idea was that no one would tender into a $54 offer when they can just hold out and wait for the $72 self-tender. At the end of the day, nothing happens: Nobody sells shares to Pickens, the board's $72 cash offer is never triggered, and the price of Unocal shares stays at $46. That may seem like a lousy deal for shareholders, but it was a way for the board and current managers to keep their positions without having to buy any shares.

Eventually, enough large shareholders complained about this to Unocal's board. When they threatened to support Pickens in a proxy fight to elect a new board, Unocal dropped the condition that Pickens's offer go through. In other words, it would just make a large buyout for 49.9 percent of the shares at $72 per share, but exclude Pickens.

THE CASE IN COURT

Pickens sued to prevent Unocal's move, and the resulting case established the new legal standard for determining whether a given hostile takeover defense is legal. The Delaware Supreme Court said that a board had to prove two things.

First, it must show that the defense it employs was enacted in good faith and after a reasonable investigation. Second, it must show that the defense is proportional or reasonable in relation to the threat posed. In the case, the court determined that Unocal's defense was acceptable.

Given the effectiveness of the discriminatory self-tender strategy, one might think that this has become the gold standard for antitakeover defenses. However, the SEC recognized the checkmate aspect of this defense and its potentially negative impact on shareholders. It demonstrated its disapproval by quickly enacting a new rule that prohibited issuer tender offers not made to all shareholders. Accordingly, defending firms and their advisors have been forced to create new antitakeover defenses. Like the old ones, these, too, must meet *Unocal*'s legality standard.

TRENDS TO WATCH FOR

Here are five topics in corporate law worth keeping an eye on in the coming years:

1. Lawmakers are likely going to continue tinkering with the duties that directors owe to their firms, especially in the area of oversight and monitoring.

2. We may see new frameworks in the law for evaluating or limiting executive compensation. There might also be more laws or standards for clawing back senior-leadership pay when things do not go so well at a corporation.

3. It is worth watching the balance of power between a firm's directors and its shareholders. Directors often call most of the shots, but activist shareholders are starting to influence corporate activity to a greater extent.

4. We may continue to see changes in the types of activities that are legally permissible for corporations. Examples may involve religious liberty protections, political activity, and speech rights.

5. Finally, it is always worth watching whether the source of corporate laws changes, and if so, how and why. State statutes and case law provide the majority of rules, but federal lawmakers have also weighed in for some areas of corporate activity, such as securities regulation.

BACKGROUND ON *REVLON, INC. V. MACANDREWS & FORBES HOLDINGS, INC.*

Another major development came with a different case decided just a year after *Unocal*: that of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* This case establishes a second key legal standard for hostile takeovers.

This case involved an investor named Ron Perelman. Over the years, Perelman had kept his eye on the cosmetics company Revlon. Eventually, he decided to pounce. Revlon's shares had been trading in the $35–$40 range. Perelman hired a famous takeover lawyer at the law firm of Skadden Arps, and he set up a meeting with Revlon's CEO—a man named Michel Bergerac.

At the meeting, Perelman expressed interest in buying Revlon for a price in the $40 to $50 range. Bergerac dismissed the offer as too low. In its opinion, the court surmised that this refusal was also "perhaps in part based on Mr. Bergerac's strong personal antipathy to Mr. Perelman."

As Perelman continued his overtures, threatening a hostile takeover at $45 per share, Bergerac decided to bring in some big guns to help with Revlon's defenses. He hired Marty Lipton, one of the premier lawyers in the area, along with several prominent investment bankers. The bankers reviewed Revlon's business and concluded that $45 per share was a grossly inadequate price for the company. They estimated that just breaking up the company and selling it off would net $60 to $70 per share.

This finding meant that Bergerac could deem Perelman's overtures as inadequate and dangerous to shareholders, and justify defensive measures under the *Unocal* standard. Following Lipton's advice, Revlon adopted something called a poison pill.

POISON PILLS

Poison pills change the circumstances facing a potential hostile acquirer by causing something good to happen to all shareholders except the raider if the pill is triggered. For example, a pill could give all the other shareholders the right to receive another share of stock for free. This right would only kick in if someone should happen to buy, for instance, 20 percent or more of the stock.

If the pill is triggered and takes effect, the raider is not allowed to receive the free shares. This means that the raider's ownership share is diluted because the other shareholders now own twice as many shares of stock. Importantly, however, the target's board can redeem or get rid of the pill if it decides that this antitakeover defense is no longer in the firm's best interest.

The effect of a poison pill, then, is to force most would-be raiders to negotiate with the target firm's board to get it to redeem the pill. The poison pill had been judged legal in Delaware right before the Revlon case.

Perelman recognized that this was a real impediment. He raised his tender offer a little, to $47.50 per share, but this was conditioned on Revlon's removal of the pill. He was trying to create shareholder pressure on Revlon's board. The firm's directors brushed off Perelman, and they implemented a couple other antitakeover defenses.

Perelman kept raising his offer price, first to $50, then to $53, and finally to $56.25. As the pressure on Revlon's board grew, the company decided to look for a white knight—that is, another potential buyer who might be willing to take over the firm while also behaving in a more friendly way toward the current directors or managers.

Revlon's white-knight plan seemed to work. The company found a friendly buyout firm named Forstmann Little and induced them to make a bid for Revlon with some favorable terms. With these inducements in place, Forstmann was willing to make a nice buyout offer of $57.25 per share—just above Perelman's offer.

PERELMAN SUES

Perelman then decided to sue Revlon, subjecting the firm's defensive efforts to new legal scrutiny. After an extensive review, the court said that Revlon's early antitakeover defenses were OK because they met the two-tiered test that was established in the *Unocal* case. However, the later defenses that tilted the playing field heavily towards Forstmann were not OK. The firm had gone too far.

The court explained that the "The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was up for sale." Recognizing that the company was up for sale made the directors' role change from being "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."

With this in mind, the court found that the final measures taken by the board went too far because they essentially amounted to a showstopper. Without these favorable offerings to Forstmann Little, Perelman might have been willing to bid even higher. The board had not sought to get the highest price and therefore had not met what have become known as its *Revlon* duties.

Unocal and *Revlon*, then, offer bookends for much of the law relating to hostile takeovers and antitakeover defenses. If a situation is unclear, then a raider will try to argue that the higher *Revlon* standard has been implicated and that a firm's defenses go too far. The firm, by contrast, might try to argue that it is still within the *Unocal* standard of review and that everything is a reasonable and proportionate response. Some lawyers have made careers working in this area of law.

Suggested Reading

- Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.
- Unocal Corporation v. Mesa Petroleum, Inc.

QUIZ

1. **Which of the following statements is accurate?**

   A. Bond investors are typically allowed to vote on director elections.

   B. Shareholders typically vote on whether a corporation will make new dividend payments.

   C. Bank lenders are typically considered the residual holders (or ultimate owners) of a corporation.

   D. None of the above.

2. **What is the primary source of corporate law in the United States?**

   A. Mostly state laws with an occasional contribution from federal laws.

   B. Mostly federal laws with an occasional contribution from state laws.

   C. Mostly international law.

   D. None of the above.

3. **What are the legal requirements to create an agency relationship?**

   A. An agency relationship is formed by an agreement that the agent will serve as an employee for compensation.

   B. An agency relationship is formed by agreement that the agent shall act on behalf of the principal and be subject to his or her control.

   C. An agency relationship is formed by an agreement that the agent and the principal will go into business together and share the profits.

   D. None of the above.

4. **After an agency relationship is created, what legal implications follow?**

   A. The agent may bind the principal to a third party in contract law.

   B. The principal may be responsible for the torts of the agent.

   C. The agent may owe the principal heightened legal duties.

   D. All of the above.

5. **Which of the following statements is accurate?**

   A. Corporations were first established in the early colonial United States.

   B. Corporations are usually entitled to make charitable contributions.

   C. One of the benefits of a corporation is that profits paid to investors are only taxed once.

   D. None of the above.

6. **Piercing the corporate veil allows a third-party plaintiff to do the following:**

   A. Obtain private information about the corporation's recent operating activities.

   B. Sue the firm's senior managers for breach of fiduciary obligations to the firm.

   C. Recover directly from the equity investors of a corporation in a lawsuit.

   D. None of the above.

7. **A corporation seeking to influence the political process may not engage in which of the following activities?**

   A. Lobbying.

   B. Contributing to a political action committee.

   C. Contributing directly to a political candidate.

   D. None of the above.

8. **Which statement correctly describes the application of the business judgment rule in corporate law?**

   A. Corporate directors are not normally subject to liability for a failed business outcome so long as they satisfy their fiduciary duties.

   B. Corporate directors are not normally subject to liability for a failed business outcome so long as their business judgment is deemed reasonable under the circumstances.

   C. Corporate directors are not normally subject to liability for a failed business outcome so long as a court agrees with the soundness of their business judgment.

   D. None of the above.

9. **The case of** *Smith v. Van Gorkom* **was so important in corporate law because of which reason?**

   A. It established that courts will not second-guess mindful decisions by a firm's board of directors.

   B. It annulled the duty of care for corporate directors in Delaware.

   C. It seemed to increase a board's duty of care for corporate directors in Delaware.

   D. None of the above.

10. **If a CEO enters into a personal contract with his or her corporation, then which of the following results will follow?**

    A. The transaction will be understood as self-dealing but can still be legally OK if it is fair to the corporation.

    B. The transaction will be understood as self-dealing and is legally void under the duty of loyalty.

    C. The CEO may be fired within the next three months by a majority vote of the shareholders.

    D. None of the above.

11. **What is the business opportunity doctrine in corporate law?**

    A. A legal rule stating that the board must voice its approval of new business opportunities before a firm may move forward with an extraordinary investment.

    B. A legal rule stating that directors and top corporate officers need to consider new business opportunities carefully before a firm may move forward with an extraordinary investment.

    C. A legal rule stating that directors and top corporate officers need to present new business opportunities to the firm and may not take these opportunities for themselves.

    D. None of the above.

12. **What are the three primary fiduciary duties of directors in corporate law?**

    A. Duty of care, duty of loyalty, and duty of good faith.

    B. Duty of loyalty, duty of frugality, and duty of monitoring.

    C. Duty of good faith, duty of oversight, and duty of avarice.

    D. None of the above.

13. **Which of the following statements is accurate?**

    A. If a CEO earns more than 300 times the compensation of a median employee, then a corporation will have presumptively violated the waste doctrine.

    B. Judges often rule that a pay package for a senior executive is excessive and adjust the firm's compensation to more reasonable levels.

    C. Public outcry over high levels of executive compensation have grown so loud that federal lawmakers have stepped in to set maximum compensation levels for corporations that must file reports with the SEC.

    D. None of the above.

14. Under Delaware law, stockholders may keep control of a derivative lawsuit under which of the following circumstances?

A. Demand is excused because a majority of directors are self-interested in a transaction at issue.

B. The firm tries to take control of the litigation with a special committee, and this committee is comprised of an independent director who makes a thorough investigation.

C. Under any circumstances, because shareholders always keep control of derivative lawsuits.

D. None of the above.

15. The US Congress enacted federal laws relating to corporate activity after which historical event?

A. The stock market crash of 1929 and the resulting Great Depression.

B. The Enron and WorldCom accounting scandals in the early 2000s.

C. The financial crisis of 2007–2008.

D. All of the above.

16. Which of the following statements best describes the doctrine of fraud on the market?

A. Managerial fraud at one corporation dissuades potential investors from investing in other corporations due to concerns that the entire market is corrupted.

B. Because the price of a company's stock is determined by the available material information regarding the company, misleading statements defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.

C. The risk of fraud is already priced into stock prices, so specific instances of fraud are unlikely to harm diversified investors.

D. None of the above.

17. Which of the following actions are not illegal under insider trading laws?

- **A.** You learn about an upcoming buyout offer at your corporation and buy 1,000 shares before the deal is announced.
- **B.** You learn about plans to increased purchases of oil at your firm and buy several thousand barrels of oil on the open market.
- **C.** You uncover secret plans at your company to buy another corporation and buy 1,000 shares of that other corporation before the deal is announced.
- **D.** All of the above.

18. Is a tippee who trades on material nonpublic information given to him or her by an inside employee liable for insider trading?

- **A.** Always.
- **B.** Never.
- **C.** Only if the tippee pays for the inside information.
- **D.** Only if the insider receives a personal benefit and the tippee knows about this benefit.

19. Which of the following statements is accurate?

- **A.** During a proxy fight for corporate board control, the firm is not entitled to pay for any costs relating to the election battle.
- **B.** During a proxy fight for corporate board control, the firm may wind up paying the costs of both sides in the election battle.
- **C.** Corporate proxy fights are no longer used because apathetic shareholders rarely vote their shares for either side.
- **D.** None of the above.

20. Shareholders who dislike a merger buyout price are entitled to do which of the following?

A. Launch a competing bid to buy out the other shareholders.

B. File a lawsuit seeking appraisal of the share's value.

C. Grumble about the lousy corporate managers to their spouse.

D. All of the above.

21. Under the *Unocal* standard, an antitakeover defense must generally meet the following legal requirements to be permissible as a matter of law:

A. It is fair, does not waste the corporation's assets, and serves as a meaningful deterrent to consummation of the deal.

B. It is reasonable, easy for the average shareholder to understand, and leaves the firm open to competing takeover bids.

C. It is enacted in good faith after a reasonable investigation and is proportionate to the threat posed.

D. None of the above.

QUIZ ANSWERS ON PAGE 106

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QUIZ ANSWERS

1. **Which of the following statements is accurate?**
    - **A.** ~~Bond investors are typically allowed to vote on director elections.~~
    - **B.** ~~Shareholders typically vote on whether a corporation will make new dividend payments.~~
    - **C.** ~~Bank lenders are typically considered the residual holders (or ultimate owners) of a corporation.~~
    - **D.** None of the above.

2. **What is the primary source of corporate law in the United States?**
    - **A.** Mostly state laws with an occasional contribution from federal laws.
    - **B.** ~~Mostly federal laws with an occasional contribution from state laws.~~
    - **C.** ~~Mostly international law.~~
    - **D.** ~~None of the above.~~

3. **What are the legal requirements to create an agency relationship?**
    - **A.** ~~An agency relationship is formed by an agreement that the agent will serve as an employee for compensation.~~
    - **B.** An agency relationship is formed by agreement that the agent shall act on behalf of the principal and be subject to his or her control.
    - **C.** ~~An agency relationship is formed by an agreement that the agent and the principal will go into business together and share the profits.~~
    - **D.** ~~None of the above.~~

4. **After an agency relationship is created, what legal implications follow?**

   A. ~~The agent may bind the principal to a third party in contract law.~~

   B. ~~The principal may be responsible for the torts of the agent.~~

   C. ~~The agent may owe the principal heightened legal duties.~~

   D. All of the above.

5. **Which of the following statements is accurate?**

   A. ~~Corporations were first established in the early colonial United States.~~

   B. Corporations are usually entitled to make charitable contributions.

   C. ~~One of the benefits of a corporation is that profits paid to investors are only taxed once.~~

   D. ~~None of the above.~~

6. **Piercing the corporate veil allows a third-party plaintiff to do the following:**

   A. ~~Obtain private information about the corporation's recent operating activities.~~

   B. ~~Sue the firm's senior managers for breach of fiduciary obligations to the firm.~~

   C. Recover directly from the equity investors of a corporation in a lawsuit.

   D. ~~None of the above.~~

7. **A corporation seeking to influence the political process may not engage in which of the following activities?**

   A. ~~Lobbying.~~

   B. ~~Contributing to a political action committee.~~

   C. Contributing directly to a political candidate.

   D. ~~None of the above.~~

8. **Which statement correctly describes the application of the business judgment rule in corporate law?**

   A. Corporate directors are not normally subject to liability for a failed business outcome so long as they satisfy their fiduciary duties.

   B. ~~Corporate directors are not normally subject to liability for a failed business outcome so long as their business judgment is deemed reasonable under the circumstances.~~

   C. ~~Corporate directors are not normally subject to liability for a failed business outcome so long as a court agrees with the soundness of their business judgment.~~

   D. ~~None of the above.~~

9. **The case of** *Smith v. Van Gorkom* **was so important in corporate law because of which reason?**

   A. ~~It established that courts will not second-guess mindful decisions by a firm's board of directors.~~

   B. ~~It annulled the duty of care for corporate directors in Delaware.~~

   C. It seemed to increase a board's duty of care for corporate directors in Delaware.

   D. ~~None of the above.~~

10. **If a CEO enters into a personal contract with his or her corporation, then which of the following results will follow?**

    A. The transaction will be understood as self-dealing but can still be legally OK if it is fair to the corporation.

    B. ~~The transaction will be understood as self-dealing and is legally void under the duty of loyalty.~~

    C. ~~The CEO may be fired within the next three months by a majority vote of the shareholders.~~

    D. ~~None of the above.~~

11. What is the business opportunity doctrine in corporate law?

A. ~~A legal rule stating that the board must voice its approval of new business opportunities before a firm may move forward with an extraordinary investment.~~

B. ~~A legal rule stating that directors and top corporate officers need to consider new business opportunities carefully before a firm may move forward with an extraordinary investment.~~

C. A legal rule stating that directors and top corporate officers need to present new business opportunities to the firm and may not take these opportunities for themselves.

D. ~~None of the above.~~

12. What are the three primary fiduciary duties of directors in corporate law?

A. Duty of care, duty of loyalty, and duty of good faith.

B. ~~Duty of loyalty, duty of frugality, and duty of monitoring.~~

C. ~~Duty of good faith, duty of oversight, and duty of avarice.~~

D. ~~None of the above.~~

13. Which of the following statements is accurate?

A. ~~If a CEO earns more than 300 times the compensation of a median employee, then a corporation will have presumptively violated the waste doctrine.~~

B. ~~Judges often rule that a pay package for a senior executive is excessive and adjust the firm's compensation to more reasonable levels.~~

C. ~~Public outcry over high levels of executive compensation have grown so loud that federal lawmakers have stepped in to set maximum compensation levels for corporations that must file reports with the SEC.~~

D. None of the above.

14. **Under Delaware law, stockholders may keep control of a derivative lawsuit under which of the following circumstances?**

    A. Demand is excused because a majority of directors are self-interested in a transaction at issue.

    B. ~~The firm tries to take control of the litigation with a special committee, and this committee is comprised of an independent director who makes a thorough investigation.~~

    C. ~~Under any circumstances, because shareholders always keep control of derivative lawsuits.~~

    D. ~~None of the above.~~

15. **The US Congress enacted federal laws relating to corporate activity after which historical event?**

    A. ~~The stock market crash of 1929 and the resulting Great Depression.~~

    B. ~~The Enron and WorldCom accounting scandals in the early 2000s.~~

    C. ~~The financial crisis of 2007–2008.~~

    D. All of the above.

16. **Which of the following statements best describes the doctrine of fraud on the market?**

    A. ~~Managerial fraud at one corporation dissuades potential investors from investing in other corporations due to concerns that the entire market is corrupted.~~

    B. Because the price of a company's stock is determined by the available material information regarding the company, misleading statements defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.

    C. ~~The risk of fraud is already priced into stock prices, so specific instances of fraud are unlikely to harm diversified investors.~~

    D. ~~None of the above.~~

17. Which of the following actions are not illegal under insider trading laws?

A. ~~You learn about an upcoming buyout offer at your corporation and buy 1,000 shares before the deal is announced.~~

B. You learn about plans to increased purchases of oil at your firm and buy several thousand barrels of oil on the open market.

C. ~~You uncover secret plans at your company to buy another corporation and buy 1,000 shares of that other corporation before the deal is announced.~~

D. ~~All of the above.~~

18. Is a tippee who trades on material nonpublic information given to him or her by an inside employee liable for insider trading?

A. ~~Always.~~

B. ~~Never.~~

C. ~~Only if the tippee pays for the inside information.~~

D. Only if the insider receives a personal benefit and the tippee knows about this benefit.

19. Which of the following statements is accurate?

A. ~~During a proxy fight for corporate board control, the firm is not entitled to pay for any costs relating to the election battle.~~

B. During a proxy fight for corporate board control, the firm may wind up paying the costs of both sides in the election battle.

C. ~~Corporate proxy fights are no longer used because apathetic shareholders rarely vote their shares for either side.~~

D. ~~None of the above.~~

20. Shareholders who dislike a merger buyout price are entitled to do which of the following?

- **A.** ~~Launch a competing bid to buy out the other shareholders.~~
- **B.** ~~File a lawsuit seeking appraisal of the share's value.~~
- **C.** ~~Grumble about the lousy corporate managers to their spouse.~~
- **D.** All of the above.

21. Under the *Unocal* standard, an antitakeover defense must generally meet the following legal requirements to be permissible as a matter of law:

- **A.** ~~It is fair, does not waste the corporation's assets, and serves as a meaningful deterrent to consummation of the deal.~~
- **B.** ~~It is reasonable, easy for the average shareholder to understand, and leaves the firm open to competing takeover bids.~~
- **C.** It is enacted in good faith after a reasonable investigation and is proportionate to the threat posed.
- **D.** ~~None of the above.~~

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