Business Associations classnotes, Fall 2004. Professor Anderson.

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<u>Monday, August 23</u>

Introduction to the course

<u>Tuesday, August 24</u>

Introduction to the course, cont'd

"Team-specific investments": investments which can't (often) have any value anywhere else. (Note how this gives one impetus for well-crafted exit rules.)

- Each BA comes with certain characteristics out of the box:
    - To form the best BA, then, you have to determine how changeable each one is, and then figure out which one can be changed to the customized BA that you actually want. (When people don't get the characteristics they want, then we get to examine what went wrong in the litigation—the cases we'll read.)

Agency

- In these first cases we're going to read, we'll have:
    - a principal
    - an agent
    - a third party

    The question is: whose liability are we talking about?

- *Blackburn v. Witter* (p37)
    - Here, Long is clearly an agent, because the principal told Long to go sell stock to widows—that's <u>express authority</u>.
        - But, what if P *didn't* explicitly tell A to do whatever it was that A did? E.g., if Long had sold municipal *bonds* to widows?
            - Then A may have <u>implied authority</u>. Ask, What does A reasonably believe—based on P's conduct—that he has the authority to do?
            - Implied authority could arise where A is given a title (e.g., assistant manager, salesman).
            - Implied authority can be foreclosed, though, by explicit orders from P to *not* do something (e.g., sell bonds). But, ask:
                - Did A do something that P ratified? If so, that's <u>ratification</u>.
                - Did P find out what A did in time to stop the third party from performing? If so, that could be <u>estoppel</u>.

        - Did P make use of the benefit A reaped from the third party? If so, that could be either implied ratification or unjust enrichment.
    - If A is beyond his real authority, then A is liable to whomever he shafts—P or the third party.
        - So, now, what about *co-owners*, as opposed to principals and agents? . . .

Wednesday, August 25

Agency, cont'd

Inherent authority (which Anderson hates): this is where someone has a status that a third party could reasonably believe comes with a certain authority. Anderson says this is just a version of apparent authority.

Business associations taxonomy

- There used to be just two BAs—the general partnership and the corporation—and each had three characteristics:
    1. Limited liability (corp.) or not (GP).
    2. Centralized management (corp.) or fractionalized management (GP).
    3. Double taxation (corp.: corporate earnings + shareholders' distributions) or pass-through taxation (GP).
- But then people wanted more choices:
    - We still have the corporation and the general partnership.
    - The limited partnership: which have two categories or partners—general and limited.
    - The limited liability company: which has:
        - Limited liability.
        - *Either* centralized management (i.e., manager-managed) *or* fractionalized management (i.e., member-managed).
        - Pass-through taxation.
        - Almost no immutable rules.
    - The limited liability partnership: which, for management and taxation purposes is the same as the general partnership (fractionalized and pass-through, respectively), *but* has limited liability.
        - So, there's absolutely *no* reason not to make a general partnership and LLP instead. The only people who have a general partnership rather than an LLP are (1) badly-advised people and (b) people who don't realize they're partners.
    - (The S-corporation: which is a corporation, but has pass-through taxation. This is pretty much a manager-managed LLC.)

PARTNERSHIPS

Figuring out whether you have a partnership

- *Bailey v. Broder* (p53)
  - First, how do we know they aren't a corporation, an LLP, or an LLC? Because they didn't file anything with the state, which you have to do for any of those BAs.
  - RUPA § 202(a): "... the association of two or more persons to carry on as *co-owners* . . . ." It *co-owners* that's the problem itc.: is it co-ownership that these guys wanted?
    - Consider: what if you and I have an agreement to share the money that comes into the till? Do I look like a co-owner? I don't share in any losses that way, so that's not an agreement about *what's left.* A co-owner shares gains and losses alike.
    - Are Bailey and Broder itc. sharing profits here (see RUPA § 202(c)(3))? Well, Anderson says, what they're sharing is what's coming into the till. Broder, after the sharing's done, still has to pay for his overhead.
      - So, why is the book confused? Maybe because they're sharing the *net* of the litigation expenses. But that's answers the wrong questions—because they're sharing the *gross* of the business expenses, and that's what matters.
    - Now, if you share in the profits and have more control than you're companion, that will make you look more like a partner.

Next time: if you become a GP, a whole bunch of things happen. (Is the remedies aspect of *Meinhard* just about remedies? I.e., is *Meinhard* about more than just sharing?

<u>Thursday, August 26</u>

- Last class: we talked about how to become a partner, and when you are one.
  - N.b., being a partner? A good thing if things go well, a bad thing if things go poorly. (Compare this with contractual relationships, especially wrt. efficient breach.)
- This class: we'll talk about the legal relationships that exist between partners.

The fiduciary duty of loyalty

- *Meinhard v. Salmon* (p57)
  - We're asking ourselves, here:
    - Does the duty of loyalty mean what people say it does?
    - If not, what *does* it mean?

    - Does UPA/RUPA change it?
- Itc., Salmon is the skills guy, Meinhard is the money guy.
    - What were they thinking at the beginning of their venture wrt. twenty years in the future? It's a leasehold, remember, so they were probably thinking "who cares—we'll make our money in twenty years anyhow."
    - When the end of the twenty years was nearing, what did Meinhard want Salmon to do? He wanted to keep the money coming—to get in on the new deal.
- So, the basic question is: "When are we together, and when are we separate?"
    - Itc., Salmon wants to be selfish, but Meinhard wants him to be selfless. The fiduciary duty of loyalty doesn't require selflessness, but itc. says Salmon *does* have to share.
- Now, is the remedies point itc. just a remedies point?
    - What would be the outcome here if Salmon had gone to Meinhard witht he new proposal and said "I'm not going to share with you." That is, does Salmon have to share because he's a partner? Or does Salmon have to share because it's a *remedy* to make up for something else he did wrong?
        - Anderson doesn't think Salmon has to share because he's a partner. I.e., sharing isn't actually his fiduciary duty.
    - If Anderson is right, then, is this a case about *information*?
        - UPA § 20: "Partners shall render *on demand* true and full information of all things affecting the partnership."
            - It doesn't look like Meinhard would have an argument under UPA then, since he never demanded anything.
        - RUPA § 403(c): "Each partner and the partnership shall furnish to a partner . . . :"
            - (c)(1): "*without demand*, any information concerning the partnership's business and affairs *reasonably required for the proper exercise of the partner's rights and duties* . . . ."
                - Meinhard's only argument would lie here, since he made no demand.
            - (c)(2): "*on demand*, any *other* information concerning the partnership's business and affairs . . . ."
        - RUPA § 404(b)(1): "A partner's duty of loyalty to the partnership and the other partners is limited to the following . . . to account to the partnership and hold as trustee for it any property, profit, or benefit . . . *including the appropriation of a partnership opportunity*."
            - Meinhard could point to this provision. (Too? Is itc. a § 403 or a § 404 case?)

N.b., are these §§ mutable? See RUPA § 103(b)(3), which says that partners can't eliminate the § 404(b) duty of loyalty . . . *except*, they can identify specific types of activities that don't violate the duty, and they can ratify an act that would otherwise violate the duty.

- See Problem 2-2 (pp64-65): the problem here is that the agreement doesn't *explicitly exclude* particular acts, like § 103(b)(3) requires.

The fiduciary duty of care

- First of all, n.b., there's a question about whether there should be a duty of care in partnerships *at all*.

- What's *Ferguson v. Williams* (p66) saying to the plaintiff? "You should have done your research—that way you could have either (a) not done business in the first place or (b) exercised more of your management rights to keep things from going sour." I.e., "It was your own dumb fault."

Monday, August 30

The fiduciary duties: a review:

- The duty of loyalty
- The duty of care

Make sure to distinguish these. But remember the bigger fights—Is there a duty of care at all? And, what is the duty of loyalty, exactly?

The partnership while it's going along normally

- RUPA § 401 (UPA § 14, approximately)
    - § 401 gives the cookie-cutter version you get if you don't change anything by agreement.
        - Consider, e.g., § 401(h): "A partner is not entitled to remumeration." What if, later, nine out of ten partners want to give one of the partners a salary? The lone dissenter can block that decision since § 401(j) requires unanimity among the partners for them to do anything "outside the ordinary course of business" (or to amend the partnership agreeement).
        - Also, consider § 401(b), providing that partners will split profits and losses equally. This is the default rule, so you have to change it if you don't want it like that.

(N.b., that you don't have to *know* about a default rule to change it.)

- *Covalt v. High* (p69)
  - The corporation here, CSI, is split 75/25, whereas the partnership is presumably under the default, 50/50, rule.
  - Now, under the default rule, in order to raise the rent the partnership has to decide to do it, either:
    1. In an agreement in advance; or
    2. By a majority decision (§ 401(j)).

    <u>RUPA § 401(j)</u>: scenarios:
    1. Ordinary course of business: majority.
    2. Outside the ordinary course of business: unanimity.
    3. Amendment to the partnership agreement: unanimity.

    What does "ordinary" mean? It has a meaning extrinsic to the RUPA. It's a question for the trier-of-fact. (Consider, e.g., the interests of a third party, such as a contractor.)

    What if it's an ordinary course of business decision, but there's no majority?
    - *Summers v. Dooley* (¶2p71) says that the decision as between partners is governed by § 401(j); but that the decision as between the partnership and an employee is governed by § 301 ("Partner Agent of Partnership").
    - *Summers* looks like a reasonable result, since it says that in the ordinary course of business, where there's no majority, the partner acts *alone*. *But wait . . .*

Authority questions when the partnership is going along normally

- <u>RUPA § 301, UPA § 9(1)</u>
  - *RNR Investments* (p72)
    - How do we deal with someone who does something they're not supposed to do?
      - The common law agency result? Apparent authority—the third party gets his from the principal, but the principal can probably get his back from the agent.
      - But now we're asking, What if the agent is also a partner? I.e., how much authority do you have as a partner-agent?
        - § 301: in the "ordinary course of business" or "business of the kind carried on by the partnership," a partner-agent's act binds the partnership *unless*:
          1. He actually had no authority, and
          2. The third party knew that.

Itc., the partner-agent had no real authority, but that doesn't effect the third party because the third party didn't know that.

Is there anything the limited partners itc. could have done to prevent the general partner from doing what he did? Yes—they could:

1. File a statement of partnership authority (§ 303), or
2. Tell the bank that the general partner has no real authority (in a *provable* manner).

Now, what if the third party here (the bank) didn't sue to foreclose, but instead sued *only* on the note itself?

- Then, see § 303(f): *no* constructive notice of a statement of partnership authority wrt. limited authority not dealing with real property. So, the bank has no notice here, since the note itself isn't real property.

<u>Tuesday, August 31</u>

- *Haymond v. Lundy* (p77)
    - The § 301(1) "unless" clause: if the first part (no authority) is satisfied, but the second part (third party didn't know that) isn't. So, in that case the third party wins.
    - Itc., though, the partner is suing the partnership for reimbursal. So, why doesn't ther partner win?
        - First, consider what the result would be if there wasn't a partnership (that is, where pure agency common law applies).
        - Now, if there is a partnership and a partnership agreement, like we have here, then *Haymond* is rightly decided.
        - But, what if there is a partnership but there's no partnership agreement?
            - Recall *Summers* (¶2p71): we have a P, an A, and a 3P. A will try to argue, using § 301, that he had real, implied authority (which, n.b., was agreed away in *Haymond*).
            - N.b.: the comments to § 301 say that it applies to third-party claims—but there isn't anything in the actual text of § 301 that suggests that. (See also § 401.)

Torts when the partnership is going along normally

- Okay, so that, above, covers contractrual relations. Now, what about torts?
    - Are you liable because of respondeat superior? (E.g., your employee negligently kills someone.)
    - Are you liable of a tort yourself? (E.g., you negligently selected that employee.)

    - *Vanacore* (p80)
        - Are there direct tort claims here against the innocent partner? Yes—failure to supervise (because of the prior grievance that he knew about).
        - Are there indirect tort claims? Yes—even if there was no direct, failure to supervise claim, the innocent partner is *still liable* under § 305 ("Partnership Liable for Partner's Actionable Conduct").
            - § 305: was it in the "ordinary course of business"? Well, stealing money wasn't the ordinary course of business, but *receiving* money surely was. So, yes.

<u>Dissolution</u>: what usually happens? Usually, people agree about what will happen—either before the dissolution event, or right after it.

<u>Wednesday, September 1</u>

Dissociation and dissolution

- The <u>entity</u> (RUPA) theory versus the <u>aggregate</u> (UPA) theory of partnership.
    - With the aggregate, UPA theory, there's a big confusion about partnership ownership of property, because there's no entity to own it. So, courts have said that the partners owned it in a special tenancy ("tenancy at partnership"), where they can only use it for partnership purposes and only creditors of the partnership (*not* of individual partners) can get at it.

- <u>The default rule</u> about partnership property: if it becomes partnership property, we split the profit made with it. (But, n.b. how partners don't have to contribute property to the partnership before the partnership can use it—a partner can *lend* property to the partnership.
    - So, how do we figure out whether something is a loan or a contribution to capital?
    - *Kessler* (p88)
        - (N.b. that the partnership here is for a term.)
        - UPA § 40(b): ranking liabilities in partnership.
        - UPA § 18(a): each partner has to contribute to losses, whether capital *or otherwise*.
            - (UPA § 18(a) is like RUPA § 401, which intends to make *no* changes from § 18(a).)

- The court itc. doesn't like the § 18(a) outcome. (But is that outcome at all unfair, Anderson asks? After all, the partners could have (a) provided for a salary, or (b) characterized the one partner's labor as a loan. Also, consider that after all the losses, the money has lost his money, while the skills guy still has his skills.

- *Dreifuerst* (p93)
    1. UPA § 31: if this is a dissolution, what kind would it be?
        - Itc., it would be a § 31(1)(b): express will of a partner (§ 29 tells what that expression of will has to be for it to be a dissolution).
    2. UPA § 29: did dissolution in fact occur?

    - RUPA § 601(1): express will of a partner.
        - Itc., this is only a *dissociation* (an idea not in UPA) so far. We have to go on to . . .
    - RUPA § 801(1): express will is a *dissolution*, too.

<u>Thursday, September 2</u>

- *Creel v. Lilly* (p96)
    - Here, the event we're wondering about is a *death*. What happens?
        - First, though, why do we care? You get either a liquidation (and half the stuff) or an apportionment (and half the stuff), right? Well, without a liquidation, it's just a *guess* about what half actually *is*. And appraising a small business is extremely hard. Plus, if the business is sold, you might be able to capture its going-concern value. And further, in a liquidation you get to bid—so you might get to have *all* the assets, *and* the stream of income.
        - Okay, good—now, what happens with a death?
            - UPA § 31(4): death is an event of dissolution.
            - Then what? Liquidation ("pay in cash"), says § 38(1) (non-wrongful dissolution (however, n.b. that you can contravene the agreement but *not* cause a dissolution)).

            - RUPA § 601(7)(i): death is an event of dissociation.
            - RUPA § 801: death is *not* an event of dissolution—so, *no* liquidation. Rather, there's, by default at least, a buy-out under § 701 (which we'll discuss later).

- Now, that above is for partnerships at will. What about partnerships for terms?
    - *Page v. Page* (p112)
        - What if we have: UPA, expression of will, for a term. So . . .

        - Dissolution? Yes, says § 31(c).
        - What consequences? See § 38(2) (we're in contravention here, because the term was not over).
            - UPA § 38:
                - (a): all rightful partners have all § 38(1) rights (which include forcing a liquidation). Plus, rightful partners have a cause of action for damages caused by the wronful partner.
                - (b): rightful partners can continue the partnership if they secure a bond for the wrongdoer for the value of his interest less any damages he caused.
                - (c): which is the mirror image of (b), this time laying out the wronful partner's rights and responsibilities.
    - Now, what if we had: *RUPA*, expression of will, for a term?
        - § 601 dissocation? Yes.
        - § 801 dissolution? Kind of, but not really—see § 802(2)(i).

<u>Tuesday, September 7</u>

- *Meyers v. Cole* (p107): this is a property case, really, set in the context of a dissolving partnership.
    - First, ignore the copyright stuff.
    - Pretend, instead, that the partnership built some tangible object. So, the partnership would be buying components of the object. So, then Anderson thinks that the case would come out the other way—that is, the court would say the components are partnership property. (And, Anderson says, maybe the case should have come out the other way anyhow.)

- *Horizon* (p115)
    - Remember *Page v. Page*, where there was no term, not even an implied one.
    - So, what about dissociation events (like expression and death) where there *is* a term?
        - Note the differences between UPA and RUPA. (The *Horizon* courts get totally confused over RUPA.)
        - RUPA: what happens under the default rules?
            - § 601(1): we have a notice of a partner's express will to withdraw. That's a dissociation event. And it's wrongful under § 602(b)(2), which kicks off § 801(2)(i) . . .
            - Now, dissolution? § 801(2) answers this for partnerships for terms. § 801(2)(i) has a 90 day period, or window, if you like.
            - During this window, we have to figure out whether there is express will of at least half of the *remaining partners* (per

capita, n.b., not per interest).

- If we have more than half, per capita, the partnership has to dissolve.
- But what about, say in a four-person partnership, you have one wrongful partner who dissociates and only one of the remaining partners wants out after that?
    - See § 602(b)(2)(i): that one of the remaining three can't force a liquidation, but he *can* get out under this provision.
    - (What would happen under UPA? That one of the remaining three *could* force a liquidation, because under UPA continuation has to be unanimous.)
- What happens when the 90 days pass?
    1. You can't force a liquidation, even with half of the remaining partners.
    2. You can't bail out without being wrongful.

(Now what about death? [same thing, I think])

<u>Wednesday, September 8</u>

So, on dissociation and dissolution, we've got these two 2x2 matrices now, one for UPA and one for RUPA. Each has two events (expression and death) by two partnership types (at will and for a term).

- You'll always know whether you're in the UPA or RUPA matrix.
- You'll always know if there's a death or not.
- But you *won't* know if the partnership's at will or for a term, always. E.g., is there an implied term? Or not?
- And you *won't* know, always, whether there's an expression. E.g., when did the expression occur? And who did it? A trier-of-fact will decide these questions.

N.b. that there's more on the event list than just expression and death. E.g., there's court-ordered dissolution and expulsion.

<u>Expulsion</u>

- *Bohatch* (p120)
    - What if they didn't have an agreement here?
        - Then, any partner could leave (it's a partnership at will, here) and cause a dissolution. That means that if they wanted to, all the partners besides her could leave and reform their own partnership, without her.
        - That would effectively be an expulsion—so what does the agreement get us? It get us so that the reforming partners don't

have to wind up the business when they leave. And winding up, since she will definitely force a liquidation, would be bad.

- So, the agreement provides that an expulsion can be just a dissociation and not a dissolution, is what it does. (Notice how each partner, then, is taking the risk of being expelled himself, in exchange for the power to cleanly expel someone *else*.)

Withdrawal

- *Meehan* (p127)
    - Is this a partnership at will or for a term? Well, it's kind-of-for-a-term. There's a three-month notification required. (Which, that was waived here. And when it was, all kinds of other rights were waived, too. Was that worth it?)

Thursday, September 9

- *Meehan* (p127)
    - If we have a client, C1, who contracts with the partnership, who's responsible to pay C1? The partnership is.
    - But what happens if some of the partners later leave, and take some of the partnership's cases? Itc., they have to pay the partnership for the value that the partnership *already contributed* to those cases—a "fair charge."

    - UPA § 35, RUPA § 701
        - These lead to slightly different results, n.b.
        - RUPA § 701:
            - (a): Partners owe the leaving partner a buyout.
            - (b): Specifying how much buyout.
                - N.b., "going concern": this is intending to change the § 38(2) rule not allowing payment for goodwill. But it doesn't change it in real life, because to actually work—for the buyer to actually capture the goodwill—it would involve lots of noncompete agreements.
            - (c): Buyout amount is less damages.
            - (h): Partners only have to pay the leaving partner . . .
                - Wrongful: not until the end of the term (unless it wouldn't be an undue hardship for them to pay earlier). (If they want to pay later than that, they have to secure the buyout amount (but the security doesn't have to be a court-approved bond, like in UPA.)

- Okay, now what about third party claimants? What rights do they have when a dissolution event occurs?

- That is, going back to client C1, is leaving partner A liable to C1 after he leaves? What about a client C2 who contracts with the partnership *after* partner A leaves? Is A liable to C2?

Monday, September 13

Third party claimants

- Credit extended pre-dissolution? That's easy—those creditors have a claim.
- Credit extended post-dissolution? This is harder.
    - By pre-dissolution creditor?
    - By a new, post-dissolution creditor?

  (Although note that there's some easy stuff here, too, like respondeat surperior with tort claimants, and what to do with the remaining partners.)

    - Is a leaving partner indemnified? Well, a leaving partner is still *liable*, it's just that the remaining partners have to reimburse the leaving partner for his liability payments (if any).
    - And what happens with a transferee of partnership rights? The transferee doesn't get everything. In fact, he only gets a right to any distributions the partnership makes. He doesn't get a vote, and he doesn't get a management interest. See UPA § 25 *et seq.* (especially § 27) and RUPA article 5 (especially § 503).

    - *King v. Stoddard* (The *Walnut Kernel* case) (handout)
        - What happened with the pre-dissolution credit that the accountants itc. extended to the newspaper? They *had* claims to this, but they lost it them in probate.
        - Now—the post-dissolution credit:
            - We're dealing with UPA § 35(1) ("After dissolution a partner can bind the partnership . . .")
                - And, specifically, we're dealing with (a): "by any act appopriate for winding up partnership affairs or completing transactions unfinished at dissolution."
                    - (Why not (b), "By any transaction which would bind the partnership if dissolution had not taken place, provided the other party to the transaction (I) had extended credit to the partnership prior to dissolution and *had no knowledge or notice of the dissolution*." Here, the accountant-creditors had knowledge of the dissolution, since they knew about the parents' (the partners') death. (N.b. that

they don't have to know that death causes dissolution in the law—just knowing about the death is enough for “knowledge” here.)

- Also, note that under (b)(II) you can publish notice of a dissolution in a general circulation newspaper and press constructive notice of the dissolution on creditors.)
- And, remember that in RUPA, § 704, you can file a statement of dissociation and everybody's deemed to have notice of the dissociation 90 days after the statement is filed.

Tuesday, September 14

N.b. that the 2003 exam is the only one that's based on a course taught out of our casebook.

- Dissociatied partner's power to bind a partnership under RUPA (§ 702): this looks at the third parties reliance—using a test with both subjective and objective aspects.

So, having looked at this third party claimants stuff, what do you do...

- if you're a partnership?
  - UPA: you give personal notice to your creditors and you publish notice in a general circulation newspaper.
  - RUPA: you file a notice of dissociation (§ 704).
- if you're a creditor?
  - UPA: you read the papers and you *ask* what's going on.
  - RUPA: you check the filings and you *ask* what's going on.

Wednesday, September 15

[Discussion of the sample exam problem.]

Thursday, September 16

CORPORATIONS

The adaptability of partnerships? High. The adaptability of corporations? Low.

If you've got a small corporation, make sure you don't trip into the big corporation rules. They are a bitch.

Introduction to the corporate world

<u>The corporate world</u>. It's not (quite) magic.

- Corporations involve lots of pretending:
  - Pretend existence.
  - Pretend limited liability.
    - And the pretend limited liability doesn't always work. E.g., what happens to a broke corporation that goes to the bank for some money? The bank will want a personal guarantee. And anyhow, you might have a bunch of your own assets in the corporation in the first place.
      - But note who *does* get the shaft with limited liability—tort victims.
      - (Also note that everybody has limited liability nowadays, in a way, since there aren't debtor's prisons anymore.)
- How do we divide power up in the corporate world?
  - Well, recall that in a partnership we bunched it all up together (but let it be divided up by agreement, pursuant to certain rules).
  - In the corporate worlds, there are lots of ways to divide up the power. So, you have to know all the different ways you can divided it up—all the bits.
- Important documents:
  - Articles of incorporation (like a constitution)
  - Bylaws (like statutes)

  And these each have different processes for changing them:
    - Articles: article changes have to be approved by the directors. So, if you want something in the articles that the directors won't like, you better get it in at the beginning, as the corporation is formed, *before* you give up your money.

  - Articles can be very simple. Should they be? No. You need to get everything exactly like it's going to need to be.

(Note on MBCA:

- Chs. 2 – 4: the process of incorporation
- Chs. 5ff: the people involved in a corporation
- Ch. 14: dissolution)
  - See the articles sample on p143—these articles would be rejected:
    - “The Soft Drink Association” doesn't satisfy MBCA § 4.01, because “Inc.” has to be in there. That indicates limited liability

to third parties.

- (But n.b. that just because you incorporate under a certain name doesn't mean that you'll be able to use that name in commerce—it may already be being used.)
- There's no agent. Note that in a small corporation, the registered agent should be you, the lawyer. Why?
  - Because this makes it harder for them to change lawyers.
  - Because the agent is their to be served *process* on—you, the lawyer, will know what to do with process.
  - And because you, the lawyer, won't be going on vacation, unlike a director.

Monday, September 20

Problem 3-4 (The Charlotte problem)

- What you have to do is get in mind—when you're creating this thing—what's going to happen to the *power* and what's going to happen with the *money*. And, ask, Where are the fights going to be?
  - Consider both:
    - What happens if things go bad?
      - In this case, it's the *pool* of money that's going to be important, and you're going to have a priority of creditors problem.
    - What happens if things go really well?
      - Here, it's the *stream* of money that's going to be important, and you're going to have a money allocation (i.e., dividends) problem.

How can we solve this?

- Multiple classes of stock:
  - Common
  - Preferred. With preferred stock, it moves the holder up in priority—so, the holder is better off if things go badly and worse off if things go well.
    - You spell the nature of preferred stock out in the articles (how much do the preferred holders get before the common get anything?)
      - Liquidation preference
      - Dividence preference
        - (Note that with dividend preferences, we need to know whether they're

cumulative or not—if cumulative preferred holders miss x years of dividends, the corporation has to pay x times the dividence before paying anything to the common.)
        - How do you solve things for preferred holders who are worried about things going well? Offer convertible stock (and set a conversion rate). Or, besides convertibility, you could give preferred holders options for common stocks. That way, if things go well, preferred holders can get into the common stream if they want to.
        - Why isn't the preferred stock just called a loan?
            1. Because creditors trump the preference.
            2. Because a loan is eventually paid up, and the money stream stops. Not so with preferred stock.
            3. A dividend is a choice—the corporation doesn't have to decide to issue them.
    - Redeemability: the corporation can force redemption of redeemable shares. If you're getting these, you're going to want them to be convertible—that way there's never a forced redemption, just a forced conversion.

    Note that an underwriter helps you figure out how to define the stock so that it will be attractive to investors.

- That's the money, now what about the power?
    - Cumulative voting? Well, in Charlotte's case, cumulative voting will get her on the board, but, since it's the directors that choose the officers, it won't get her to be an officer—she just has one vote on the board.

Adlerstein (p158)

- What could Adlerstein have done? He could have removed the other two directors as soon as he realized—at the board meeting—that they were trying to get rid of him. (The removal would have been by consent resolution.)
    - But note that if he did do this, the other shareholders would be mad—

they would sue him, in fact, for breach of his fiduciary obligations.

So, who do the other directors (besides Adlerstein) owe *their* fiduciary obligations to?

<u>Tuesday, September 21</u>

- Recall, Adlerstein is:
    - An officer (and wants to stay one)
    - A majority shareholder
    - A director

  But he's *not* a majority on the (three-person) board.
- How would this be different if it was a partnership?
    - Adlerstein could be designated as the managing partner. If the other partners wanted to remove him, unanimity would be required (because that wouldn't be an ordinary course of business thing to do).
    - However, the partnership's decision to have a managing partner could be structured so that a majority vote for removal would suffice.
        - So, that's to say that even in a partnership, the agreements could be structured to make the partnership look like a corporation.
            - To get to the corporation-style partnership here, you'd have to save Adlerstein's power as a majority shareholder. How could you do this? By an agreement that partners vote by percentage interest in the firm.
            - Also, you'd have to have a partnership executive committee, so that' you'd have centralized management like a corporation (this would, of course, be changing the default fractionalized management of partnerships).
            - And note that in the partnership setting, Adlerstein could express the will to dissociate, whereas in a corporation you can quit but you can't take your ownership interest with you.
- Now, back to the actual case—in the corporate setting:
    - The question is—did the other directors breach their fiduciary obligations to Adlerstein?
        - Who did they owe their fiduciary duties *to*?
            - Well, when can a shareholder sue directly, rather than derivatively? If you sue derivatively, you don't have to prove that you were owed a fiduciary duty, just that the corporation was owed a fiduciary duty.
    - Why would *Adlerstein* (or *TSI*) *not* arise in a MBCA jurisdiction?
        - Because of § 7.04—unanimity of shares is required for an action

to be taken without a shareholder meeting.

- In other words, the minority has some power—why is this good? Because a single person can force a meeting —and so a single person who knows something can force the others to stop and think about a decision before it's made.

<u>Wednesday, September 22</u>

Modifying statutory defaults

- *Centaur Partners* (p169)
  - (Note how, if a staggered board can be removed without cause (as it can be under the MBCA, but not under the DGCL), then it's not much of an anti-takeover device.)
  - Here, we're in Delaware, so:
    - An insurgent can't remove a director without cause.
    - An insurgent can't unstagger the board.

    What *can* an insurgent do? He can make the board *bigger*.
      - The bylaws here say that:
        - Directors pick the size of the board.
        - And 80% supermajority is required to change the bylaws.

        So, lacking a supermajority, the insurgent here has to invalidate these bylaw provisions by showing that they conflict with the articles. (Here, the insurgent's argument is that the bylaw is not "similar to" article 8, as article 8 requires.

        (N.b., why couldn't the insurgent just amend the articles? Because an amendment to the articles has to be proposed by the board (so, again, get what you want in the articles *before* you give up your money and cede power to the board).)

Federal securities laws

- These laws don't just apply to corporations—they apply to all securities.
  - Note that you might be exempt from the 1933 Act's registration requirement, but you are *still* subject to its anti-fraud provisions.
- So, what is a security?
  - *Landreth* (p179)
    - The statute defines "security" as including "any note, stock, treasury

stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, tranferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral right, . . . or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

- One possibility here is that it's "stock." And, truly, how can you have stock that's not "stock"? Well, they're arguing that they bought 100% of the stock—so they're buying the *business*, not the stock, really, they say.
    - It matters, because if it's not a security that they bought here, then only the common law of fraud applies, and registration isn't required. If it is, then they may have to register and affirmative disclosures are required.

    Why do we have extra protection for securities? Because usually when you buy securities you don't inspect, as you would do with most anything else.
        - So, that means that here there's a policy argument that the buyer doesn't *need* the extra protection because he's buying 100% of the business and so he *did* inspect.

<u>Thursday, September 23</u>

- (Note that both issuing and *subsequent* transactions are subject to the anti-fraud (affirmative disclosure) provisions.)
- What's the broadest category of "security" from the 1933 definition? "Investment contract." You have to be careful with this one—you don't know what could be an investment contract. E.g., you buy part of a jojoba orchard—ask, Can you go in and kick the tires? I.e., Does the buyer need the protections of the acts?

- Exemptions from registration:
    - Why do we have exemptions?
        - Well, consider *Landreth*: why wouldn't the buyer need the registration statements? Because he has the bargaining power to get his questions answered.
        - Who actually reads the registration statements, by the way? Investment advisors, do, for one.
        - Who's protected by the statements? Well, the stiff on the loading dock buying stock in *Ralston* is, for one.

So, when we wuild these exemptions, we're going to consider these kinds of things, and require registration when the securities are being sold to *unsophisticated* buyers.

- Market systems:
  - The Efficient Market Hypothesis: the semi-strong version suggests that you should get in the market for the minimum amount of overhead. That is, don't pay for advising—you can't pick somebody who can react fast enough to beat the market. (But see Warren Buffet, though.)

Fiduciary duties

- *Wrigley* and *Dodge*
  - These are duty of care cases, basically, but could you characterize them as duty of loyalty cases, somehow?
    - Well, to do that you'd have to show that the fiduciary is trying *not* to benefit the company (the shareholders) and instead trying to benefit somebody *other* than the company.
  - In both of these cases the courts try and "stretch and stretch and stretch and stretch," Anderson says, to find some way that these decisions could actually benefits the respective corporations.
  - Note that in *Dodge*, if the court actually *believed* Ford—that he was just trying to benefit the employees—then the court would have to say, "No, that's not your job."

Monday, September 27

The business judgment rule

What *is* the BJR?

- Is it a burden shift?
- Is it substantive liability?

Anderson says, think of it just as the zone of judgment outside which you've breached your duty of either care or loyalty.

- There's:
  - The duty of care, which is split up into:
    - The non-decisional setting
    - And the decisional setting, which itself is split into:
      - Decision procedure
      - Decision substance
  - The duty of loyalty settings:
    - Self-dealing

            - Opportunity-taking
            - The "nobody would think" category, where you're not trying to benefit the corporation, but you're also not trying to benefit yourself (e.g., Wrigley or Ford *if* we believed them). This category is pretty rare.

        And the BJR is *everything else*.

        So, you can't start at the BJR—you have to start by making sure you're not in any of the other places.

- *Hoye v. Meek* (p234)
    - Why is this such a risky business endeavor?
        - Well, if you have $10K, are you better off
            1. just investing the $10K?
            2. or borrowing $90K and investing the whole $100K?

            Well, if it's a good bet, then the $100K is better. But what if you're not so sure?
            - If things go well, and you gain at a rate greater than loan interest rate, you'll get:
                - the gain on the $90K you borrowed less the interest you have to pay, plus
                - all of the gain on your $10K
            - If things go not as well, and you gain, but only a rate less than the loan interest rate, then you suffer a loss on the $90K you borrowed, and only gain on your own $10K.

            So, leverage isn't good or bad inherently—it just *amplifies* the risk of an endeavor.
        - Itc., we have the corporation borrowing to buy GNMAs.
    - Who could you sue here on DoC in the decisional setting? The son—he's the one who decided to do these stupid things (but he's broke, and so no good).
    - Why didn't the semi-retired director-father not resign? Because if he quits, investors and depositors lose trust in the bank—they realize they're just dealing with the good-for-nothing son.
    - Why did the son keep making these margin calls? Why would it be rational for him to do that?
        - Well, maybe the equity was gone. Once the equity's gone, he's just playing with the depositor's money. And it's actually pretty rational to gamble with other people's money.
    - Wait! What happened to limited liability? We still have that—but that's just for shareholders. Directors have a *personal* obligation—the DoC and DoL.

<u>Tuesday, September 28</u>

- *Van Gorkom* (p241)
  - How is this different than *Meek*? Because in *Meek* we had a failure to decide. Here, we have an actual decision.
  - What' the deal, here?
    - (First, realize how different folks here have different motivations.)
    - We have a merger: New T, a subsidiary of Marmon (owned by Pritzker), is going to acquire Trans Union.
      - First of all, Pritzker gets 1M new-issue shares for about market price. This serves as a kind of commission for Pritzker and acts to dissuade any other bidders (because it's now $60M more expensive for anybody else to do what Pritzker's about to do).
      - Why doesn't Trans Union just convince Pritzker to buy its shares?
        - Why not issue enough new shares that Pritzker's a majority owner? Because Trans Union doesn't need more cashflow—they need more income.
        - Why doesn't Pritzker just buy from shareholders? Because P wants *all* the shares—he doesn't want there to be any minority shareholders. And so, because there'd be holdouts, P couldn't buy all the shares (this is why we let the government condemn property).
        - What P could do is buy up a majority from the other shareholders and then do a merger—but this would cause him a DoL problem.
        - With the merger as it's done here, only a majority of the existing shareholders have to approve, not all of them as it would be if P tried to buy all the shares.
      - In most mergers, the old shareholders (those of the target) get to be shareholders of the new, merged corporation. Here, though, TU's shareholders are going to disappear. They're paid case for their shares (they get the specified amount, but have a right to sue for an appraisal if they think the amount is too low).
  - Note that itc. involves a *direct* class action—not a derivative action, as usual.
  - In a merger, directors have to initiate it. The shareholders can't just up and decide to have a merger. That's why the directors had to have the Saturday meeting itc.
  - What did the court itc. *want* the directors to do at the Saturday meeting?
    - At the very least, it wanted them to ask some questions, do some research, or something.
      - Note that if a lawyer came in an gave a presentation, the directors could *rely* on him (unless there's some reason to doubt him). Same with an accountant and a report, e.g.

        - So, what's wrong with relying on Van Gorkom, here? Well, they *can* rely on what VK *said*. But VK didn't say any of the things they needed to have heard.
    - The shocking thing here—the thing that set off a lot of statutory amending—is that the directors weren't *not* overseeing things (like in *Meek*) or trying to line their own pockets (DoL) but the court *still* said they were grossly negligent.
    - What could the directors have done to really help their litigation position?
        - They could have asked, in the meeting, "Where did that $55 figure come from?" That's a pretty basic thing to ask, Anderson thinks—and there's no reason not to ask it.
- So, since the directors *did* screw up at the meeting, the next thing we have to ask is whether they did anything later that will protect them:
    - What about the market test?
    - What about the shareholder vote?

(Note that buying a large corporation is a pig in a poke problem—you want to see the pig, and that requires some proprietary information to be disclosed.)

<u>Wednesday, September 29</u>

- Committees: committees of directors could breach the DoC, but then the other directors, who are relying on the committee's report, do *not* breach it.
- Also, outside directors could point the finger at inside directors—and say they were relying on them.
- Also, expertise: e.g., a finance person that's a director might be held to a higher objective standard itc. That is, it's an objective standard but it's *considering* your expertise.
    - (Note that this has implications for lawyers who are directors.)

- The statutory response to *Van Gorkom*:
    - *VK* scares directors, and, more importantly, potential directors.
    - So, both the MBCA and DGCL allow a majority of shareholders to give up their DoC and DoL claims...

- *Caremark* (p267)
    - So, if a majority of shareholders can give up DoC and DoL claims, why is this action even going on? Because there are exceptions to that mutability:
        - No exceptions for shareholder actions for money damages.
        - But there is an exception for claims seeking injunctions. We have this exception because injunctions aren't what directors are scared of—they're just scared of losing their house.

Thursday, September 30

- Note the attorney's fees award here—even though it's a derivative claim, the corporation has to pay because the corporation benefitted.
- Did the shareholders get their money's worth here? Well, they got an injunction, but it was only for what the corporation was going to do anyhow. And that wasn't worth the $800K the corporation had to pay in attorney's fees, Anderson says.
- Is this a non-decision (oversight) or decision case? It doesn't neatly fit into either category.

Loyalty

- This is a little easier than DoC. There are two types of questions:
    1. Opportunity-taking (corporate opportunity)
    2. Self-dealing

    And the two can combine—e.g. you could grab an opportunity and then sell it to the firm.

- Corporate opportunity
    - Recall *Meinhard v. Salmon*.
    - Variables:
        1. Status (e.g., director?, officer?)
        2. How the opportunity arose
        3. What you did after it arose
    - *Northeast Harbor Golf Club* (p276)
        - Status: officer and director
        - How the opportunity arose:
            - Well, it would be best for the Δ here if it arose totally outside the context of the firm.
            - But, here, at least one of the parcels arose totally *inside* the context of the firm. And as an officer, the seller wants to sell to the firm.
        - What you did after it arose:
            - It would be best for the Δ if she had offered the opportunity to the firm *first*.
        - The ALI principles, as employed itc.:
            - "Corporate opportunity": § 5.05(b) defines it.
                - Note that status will detrmine whether (1), (2), or both apply.
                - (b)(2): basically, this is the "line of business" test broadly phrased.
            - So, if it is a corporate opportunity, what do you have to do?

- The ALI is very strict—even stricter than the *Northeast Harbor* court thinks it is. The rule is set out in § 5.05(a).

Monday, October 4

- Common law approaches to coporate opportunity:
  - Fairness test: there's lots of factors to be considered here—both procedural and substantive.
  - Line of business test
  - Two-prong test:
    1. Line of business: figuring out which side of the line you're on.
    2. Fairness: making sure you're not so close to the line that it doesn't matter.
- *Broz* (p283)
  - Under the ALI principles, how would itc. come out?
    - (A possibility is that Broz could present the opportunity to the "other" corporation's board (where he's only a director).)
    - Is it a corporate opportunity?
      - § 5.05(b)(2): this can't apply to Broz because he's not a senior executive of the corporation that he's not offering the opportunity to.
      - § 5.05(b)(1): this could apply to Broz because he *is* a director—but it doesn't apply under these facts.

      So, § 5.05(a) and (b) are saying that you owe *most* of your loyalty to the company you are a senior executive of. So, it tells you which one to hand an opportunity to.
  - Now, what about under the line of business and/or fairness tests? The, this may actually be a corporate opportunity.
- *Shapiro* (p301)
  - Anderson thinks the court here is wrong—this is both a corporate opportunity *and* a conflict case. Why? Because he both:
    1. Took the opportunity (corporate opportunity)
    2. Completed it (conflicting interest transaction)

    ?????????????????????????

- Conflicting interest transactions

- We can't flat out prohibit CITs—we want some of them to happen. For instance, we *want* there to be outside directors.
- But we can't flat out allow CITs either—some of them we *don't* want.

So, we need a complicated test of some kind:

1. Is it a CIT?
2. If so:
    - Is there disinterested approval by the board? (With prior disclosure?) OR
        - (And even if so there still may be a DoC problem.)
    - Is there disinterested approval by the shareholders? (With prior disclosure?) OR
    - Fairness?

- *Globe Woolen Mill Co.* (p298): note how this is kind of like *Van Gorkom*, with how things are sprung on the board.
- *Shapio* (p301)

<u>Tuesday, October 5</u>

(N.b. the timeline for derivative litigation:

1. Alleged violations
2. Shareholder walks into his lawyer's office
3. Then, a fork:
    * You can send a demand letter
    - You can file a complaint:
        1. Move to dismiss for failure to make a demand
        2. Move to dismiss for failure to state a claim
        3. Anything else?
        4. Move for summary judgment

- (*Shapiro*(p301))
    - (The bigger shopping center is clearly a corporate opportunity problem, Anderson thinks (even though the court doesn't).)
    - But, the deal also creates a new business association—a limited partnership.
    - The problem is: does Charles violate the DoL by doing this deal?
        - Under the MBCA it's obvious—Charles is all over the place, and so it's a conflicting interest DoL breach.
    - How detached would Joan have to be to be disinterested enough so that her approval on CPI's board would isolate Charles from

liability?

- MBCA § 8.60
  - (i) versus (ii): is it a big enough deal that it should have been brought before the board?
    - Yes—then (ii).
    - Otherwise, (i).
  - (i):
    - Is a sibling enough? No—see (3), which says a sibling is a "related person."
    - What about a cousin? Yes, as long as they don't live with you. And this is so even if you have a real close relationship with them!! (However, in that case note that there could be a DoC problem.)
- MBCA § 8.62(d) director approval:
  - Is a sister enough? No—that would satisfy (1), a conflicting interest.
  - What about a cousin? Still no—that satisfies (2), a familial relationship.
    - But note that § 8.63 shareholder approval does *not* have this "familial" language.

<u>Wednesday, October 6</u>

- Is a fiancee a "related person"? Could be, if she shares the Δ's home.
  - If she is a "related person," what does that mean"? Is she a party to the transaction? No. Does she have a financial interest? Probably.
- Required disclosures: normally, you have to disclose all material facts (we'll deal more with the complicated aspects of these disclosures when we study mergers, later.)

Derivative actions

- On an exam, when do you talk about this stuff?
  - First off, there are some settings where a derivative action *won't* happen:
    1. The corporation is into bankruptcy or insolvency. There, the trustee in bankruptcy can assert all claims which would otherwise be derivative claims.
    2. Some derviative strategies won't work unless there's a whole lot of money floating around.
    3. The people controlling the corporation could be sufficiently unhappy that they'll cause the corporation to bring a *direct* action.

- Procedure: we'll find that the substative law is different depending on whether demand was excused or required (this, even though it shouldn't differ, Anderson thinks).
    - The demand-futility doctrine:
        - It looks backward—just like 12(b) and 56 motions—to whether the complained-of conduct *will be held* BJR-protected.
        - So, the decision to *not* send a demand is made in contemplation of resisting the 12(b) motion, where you'll have to plead with particularity that the conduct isn't going to be protected by the BJR (the *Aronson* two-prong test).

<u>Thursday, October 7</u>

- We're searching for a middle ground between:
    1. Plaintiff shareholders running amok.
    2. Defendant directors shutting down meritorious litigation.

- N.b.: DoL situations:
    1. One person/entity is on both sides of the transaction.
    2. One person/entity on one side of the transaction is dominated by someone/entity on the other side of the transaction.

- *Disney* case (p334)
    - N.b. the amended complaint, in the supplement, at ¶45: they allege that the expert wasn't retained to give advice about Ovitz's compensation.
        - Is this sufficiently pleaded? It looks like it, Anderson thinks, and so it eliminates the board's argument that they relied on the expert.
    - Executive compensation decisions are almost never second-guessed using DoC. E.g., itc., even though Ovitz is getting paid *not* to work out for Disney, that may have been what was needed to entice him to work there in the first place.

- *In re The Limited* (p353)
    - What does the corporation get for terminating the options?
        - $350M of reserved cash is freed up.
        - The corporation gets out of a potentially unfavorable option obligation (namely, it would be unfavorable if the market price went below the put price).

<u>Monday, October 11</u>

<u>Special litigation committees</u>
- Creation:
    - First, check three things:

1. Statute
2. Articles
3. Bylaws

   and ask, Can I create this committee?

- If you can, then you need a fully-empowered committee—you have to create that with a *resolution*.
    - In the meantime, if you're the Δ, you should go to court to get a stay pending creation of the committee.
- Once the committee is resolved, you have to staff it—with people who are squeaky clean, independent directors. Expand the board with these people if necessary.
- Then... you do nothing, if you're the Δ's attorney. You don't want to taint the independence of the committee.
- The committee, while you're doing nothing:
    - Follows a perfect process.
    - "Deposes" corporate functionaries, and otherwise investigates the underlying "bad" conduct.
    - Produces a report, with appendices.
- The court then decides whether the decision in the report was "grossly grossly negligent" or not. And the committee can almost *always* satisfy the grossly grossly negligent standard.
    - Note that the committee's decision could be "There's a claim here, but there's a good, clean reason not to pursue it." What kind of good, clean reason could there be? Maybe the maintenance of good intra-corporate relationships, e.g.

So, if the corporation can afford to do a special litigation committee, Π will lose, and so the derivative action will *never be brought*.

- Note that MBCA § 7.44 lets the special litigation committee technique *always* work—demand is universally required.
- But Delaware wants to preserve the derivative action...

- *Zapata* (p364)
    - Where the court decides to do what no other court we've seen yet has: to use its *own* business judgment!!!
        - Why is this understandable? Because the court is trying to blaze a middle trail between no derivative actions and Πs running amok.
        - This is unattractive for Πs—but it's slightly less unattractive than MBCA § 7.44.
            - What else could Π do? Sue directly. But then he'd have to find some duty owed directly to shareholders (e.g. federal securities laws).

<u>Tuesday, October 12</u>

Close corporations

Transitioning from large to close corporations:

- The standard corporate paradigm is unattractive for close corporations:
    - There's no easy exit for shareholders.
    - Fiduciary duties don't protect the shareholders because the award goes to the corporation—and in that case it's earnings are already drained by the employees (there aren't any dividends, usually).

    So, what to do?

    1. Argue that there's another kind of fiduciary duty.
    2. Get the rules you want before giving up your money.
        - (But then management gets concerned about opportunistic behavior by shareholders—the tables turned from their usual case.)

- Getting the rules you want:
    - *McQuade* (p386, in text)
        - The agreement:
            - One aspect of it affects the director role.
            - Another aspect of it affects the shareholder role.
        - What would you ask here based *just* on K law?
            - You'd ask all the usual K questions, and you'd find that the K is otherwise enforceable.
        - So now what about BA law?
            - You'd ask about "public policy"—public policy BA-style, though. This kind of public policy is all about directors being pulled in to different directions:
                1. One by the K.
                2. The other by their fiduciary obligations.

                This is "public policy" because traditionally, we want directors to do what is *best*, not waht the K says, even if doing what the K says would not breach a fiduciary obligation.

                So, the question is: do we want to back off this traditional position? Well, we have. So, how far do we want to back off of it?

                - (N.b.: compare this to pooling agreements, like the Ringling Bros. case and *Estrada*, where we don't have *this* specific concern.)

- How does a K like this affect you:
  - in your shareholder role?
  - in your director role?
- Even so, if everyone in the corporation signs the K, why do we care?
  - Because creditors and third parties didn't have the chance to accept or reject the K.
- If everyone does sign, should we require that it be in the articles?
  - That is, if the statute says that you can do this by putting it in the articles, does that mean that you can't do it any other way? Well, there is the "expressio unius" canon.

Shareholder agreements

- MBCA § 7.32:
  - (a): the kinds of things you can do in an agreement.
  - (b): requirements for validity:
    - Must be unanimous.
    - Must be written.
  - (e): liability (i.e., fiduciary duties) shifts when the power shifts. So, you can't have your cake and eat it to—if you get the power, you get the obligations.
  - Note the other provisions here about subsequent shareholders (this is another important problem in this area).
- How do you change the agreement? That's pure K law.

- Now, what about if you affect someone *only* in their shareholder role?
  - You can change the power to elect directors, for instance.
  - *Zidell* (p408)

<u>Wednesday, October 13</u>

- N.b. the Fischel and Easterbrook article—Anderson talks a lot about this.
- N.b. how the remedy is almost always money. And a lot of times, that's not really what the Π actually wants.

<u>Shareholder agreements about shareholder decisions</u>

- Agreements on how to vote shares:
  1. You could agree to vote X.
  2. You could agree to set up a process for deciding how to vote (e.g., the Ringling Bros. case).
  3. You could set up a voting trust (thus removing the right to vote from some shareholders).
  4. You could give an irrevocable proxy (this also removes voting rights).

        - Note that there are limits on who can hold irrevocable proxies—usually you have to have some kind of stake in the company (e.g. a director, a shareholder, a creditor).

    So, one question is, because of the "expressio unius" canon, should we hold the first two methods to the requirements set out in statute for the second two methods.

    And if we can use these methods, what's the remedy? (I.e., whenever you have a K, always ask: "What happens if I breach it?" and "How bad is that?"
        - In *Estrada*, the party carefully constructed a specifically enforceable remedy—the other party has to sell them their shares.

But what if there isn't a shareholder agreement? Then... you have to start talking about fiduciary duties.

The partnership analogy

- *Donahue* (p413): how would traditional approaches work out?
    - CIT: you would have to argue inherent fairness, to the corporation. And there isn't anything indicating unfairness to the corporation here.
    - Note, itc., that if we really took the partnership analogy *all the way*—to true partnership law—she would have an even stronger position.

<u>**Thursday, October 14**</u>

In the partnership analogy cases (*Donahue*, *Wilkes*, and *Nixon*), ask:

1. What would happen under the corporate paradigm?
    - In *Wilkes* and *Donahue*, we have some self-dealing. So, we'd apply the inherent fairness test—and find that it's fair.
2. What would happen under the true partnership paradigm?
    - Then, we'd come out even more radically pro-Π than we do.
3. What happens under the rule the court actually applies?

- In *Donahue*, there's an added complication—Mrs. D didn't *purchase* her shares. That is, she never got to make a choice; so, the contractarian argument is weaker than usual.
    - But, note that there still is *some* choice involved—the devisor could have made the choice to protect his devisee.
- *Wilkes*: what if itc. the Π was acked for a good reason—not because the other employees were pissed at him?

        - What would the remedy be under the *Donahue* equality of treatment rule? Maybe you could create three part-time positions.
        - Under the *Wilkes* rule, though, you only have to do equality of treatment if you don't have a legitimate business purpose.
    - *Nixon* (p429)
        - (Note that repurchase is just a way of eliminating some share—and so, usually, some shareholders.)
        - What happens here in the conventional corporate paradigm? We have a self-dealing transaction. We apply the inherent fairness test and find not unfairness.

Monday, October 18

With all this close corporation stuff, ask:

1. What do they want?
2. What theory are they using? Will that theory get them what they want?
3. Do the facts match the theory?

Involuntary dissolution

- What do you get with involuntary dissolution?
    - Would involuntary dissolution would have worked in *Donahue* (p413), assuming Π had the facts?
        - If there was a liquidation, the buyers would be the majority—and everyone knows that. So, if liquidation was ordered, Δs would just pay Π instead of actually liquidating. So, there would still be a buyout, in reality.
    - Would ID would have worked in *Wilkes* (p418), assuming Π had the facts?
        - Π here wanted to be *employed*—ID won't do that for him.
        - Is there any way he could keep his job with ID? Well, he could buy the company in the liquidation sale. The problem for him would be coming up with the money to outbid the others. (And another problem, often, is that inactive shareholders don't usually have the skills to run the company.)
            - How can you get the company goodwill? I mean, the money person is worries that he'll pay for the goodwill, but then the skills person will open a new business. So, what the money person needs to do is get a noncompete agreement (which much be reasonable wrt. duration and region). But in a court ordered dissolution, the default rule is *no* noncompete agreement; if there's no noncompete agreement, the value of the business will go down dramatically.
                - Also, note that even if you buy the goodwill and get a

noncompete agreement, you might not actually get the goodwill—clients and employees might not like you.
            - (Note that wrt. noncompete agreements there are two types of jurisdictions:
                1. Blue pencil rule
                2. All-or-nothing rule
    - Would ID have worked in *Nixon* (p429)? Yes—these Πs could get what they wanted with ID.
- Now—how do you *get* an ID?
    - (N.b., all the oppression test that can apply to the majority can also apply to the minority. See *Stoneham*.)
    - (Recall *Page v. Page*, the partnership case, that had a squeeze-out type thing using liquidation in a partnership at-will situation—the majority can injure the minority through a voluntary dissolution.)
    - Remember that in the partnership setting, we asked: Do you actually get a court-ordered liquidation (which would give you a better bargaining position), or just a court-ordered buyout (which could be better for the minority in some cases)?
    - *Kemp* (p441)
        - Assume that this case arose under the (pretty similar) MBCA § 14.30.
            - MBCA § 14.30:
                - (2): proceeding for ID by shareholders:
                    - (i): director deadlock + harm.
                    - (iii): shareholder deadlock.
                    - (ii): "illegal, oppressive, or fraudulent"

                    So, what's "oppressive"?
                        - Itc., the court looks at reasonable expectations.

<u>Tuesday, October 19</u>

- *Gimpel* (p444)
    - This is a real surprising outcome, here, Anderson thinks—how does this guy win?! He wins because of harshness. So that shows how far a court is willing to go to protect even an unsympathetic Π.
    - N.b.: what bargaining power could you have as a minority shareholder who inherited? Well, at the beginning of things, you don't know who it is that's going to gang up on whom. This isn't the best bargaining chip, but it's at least something.
- Penalty default rules: these are used to induce people to K around the default. They have two benefits:
    1. That way, we know what it is they wanted.

2. They force selfish people to reveal themselves (sometimes).

Now... how could we fix these problems that minority shareholders have?...

Share repurchase agreements

Make sure you ask: "Where am I without an agreement?" and "What would an agreement get me?"

- Sometimes, the clarity an agreement can provide just isn't worth it.

- Share transfer restrictions: with these, you don't need a mandatory buyback provision—you just need either an (a) approval, (b) option, or (c) right of first refusal provision.
- If you're promising to buy shares back, you'll need to be able to come up with the money.
  - If death is the triggering event, then that's easy—you just take out an insurance policy on that person's life.
- Determining the price:
  - You could just write down a number (e.g., *Concord* (p453)).
  - You could use a formula (e.g., book value, as in *Gallagher*).
  - You could use a process for picking a number (e.g., appraisal).

  - *Concord* (p453)
    - (Distinguish itc. from *Wilkes* on the grounds that in *Wilkes* there was no agreement. Here, we've got an agreement.)
    - If everything had worked out, what would have happened? They would have held the meetings—but they only *maybe* would have adjusted the price. There was no agreement to adjust the price; just an agreement to reconsider the price. (If there was such an agreement, then the court could have come down on the Π's side, here.)

<u>Wednesday, October 20</u>

- *Pedro* (p460)
  - What are the different things that are going on in this case?
    - Well, the shareholder agreement stuff, obviously.
    - There's also some fiduciary duty stuff.
      - Corporate paradigm analysis: they're stealing from the corporation:
        - This claim would have to be brought derivatively. So you have the demand analysis. In any case, the remedy goes to the corporation.
        - You could get a judicial order removing the directors (and this would get Π approximately

what he wants here (his job back)).
        - You could try for involuntary dissolution. But then Π would have to bid against his brothers at the liquidation sale.
    - Partnership analogy analysis:
        - There's the equality of treatment argument (*Donahue*).
        - There's the equality of treatment because no legitimate business purpose argument (*Wilkes*).
        - There's the oppression argument.
        - And the reasonable expectations argument.

LLCs

- Note that there just aren't that many LLC cases yet.
- With LLCs, you've got all of the same basic concerns that you have with other entities (e.g., immutability, power allocation, money allocation), in addition to the LLC-specific stuff.
- There are some LLC issues that we're not going to talk about:
    - Regulatory issues (e.g., can you get a liquor license?)
    - Securities issues specific to LLCs
- Also, there's not much uniformity across LLC statutes. Both across jurisdictions (the uniform LLC statute hasn't been popular) and across time (it keeps changing, anyhow).

- *Elf Atochem* (p468): Elf argues, for one thing, that the LLC itself never signed the agreement including the arbitration provision. But the court itc. is willing to look past the corporation/LLC fiction to see the real "people" involved. This, even though, Anderson notes, that if you think private ordering is a big deal in the corporate worlds, it's a *huge* deal in the LLC world.

<u>Monday, October 25</u>

- *Castiel* (p475)
    - This is the LLC equivalent of *Adlerstein* (p158).
    - To succeed, Π itc. must show a fiduciary duty owed directly to *him*—he has to find a partnership-type fiduciary duty. And he gets one, here, even though that's wrong, Anderson thinks.

<u>LLC exit</u>

- *McGee* (p480)
    - This is just *Wilkes* (p418) in the LLC setting.
    - What bad agreements did Π enter in to?

            - The employment at-will K.
            - The termination clause: this allows a majority of the *others* to decide. And do it without a meeting.
        - The question in this case is whether termination was "for cause" or not. If it was for cause, Π gets the lesser of two amounts. If it wasn't, he gets the greater of those two amounts.
        - The court here concludes that the fiduciary duties go to the *entity*. Not to the individual. So, the court comes out opposite *Castiel*.

Corporate limited liability

How can a creditor contract around corporate limited liability? With a personal guarantee. So, this means that limited liability is just a default rule.

- However, the tort victim can't contract around it, note.

But, anyhow, what do you get, as a creditor, in exchange for dealing with limited liability? You get to rely on the existence of a certain amount of capital.

<u>Tuesday, October 26</u>

Recall that before we were talking about power allocation within corporations. Now, we're talking about money, and so third parties start to become important.

- Some jurisdictions prohibit payment for shares by promises to perform future services, or by promissory notes. Why are they concerned about his?
    - Because we don't know *if* these things are going to end up being performed.
    - But, that's not too sensible—some promises are actually worth a whole lot just as promises (e.g., you get a promise from Steven Spielberg saying he'll do a movie for you.)

- Distributions
    - How can we make capital surplus bigger? Big enough that we can make the distribution we want to?
        - One thing we can do is like in *Klang* (p493): we can recognize that some assets are worth more than the balance sheet shows, due to appreciation and/or unrealistic depreciation write-offs.
        - MBCA § 6.40
            - The equity insolvency test ((c)(1)): this looks at the stream of money.
            - The bankruptcy insolvency test ((c)(2)): this looks at the pool of money.

For these tests, non-balance sheet valuations are allowed (§ 6.40(d)) (like are used in *Klang*).

When you use these tests, as of what moment in time do you apply them? This is what § 6.40(e) answers.

<u>Wednesday, October 27</u>

Veil piercing

- *Consumer's Co-op* (p504)
  - Control?
    - The alter-ego doctrine
    - In a close corporation, there will always be a lot of "control." There won't be any independent directors of any significance.
  - Undercapitalization?
    - Is the mere fact that a creditor doesn't get paid an injustice? No. That's not enough.
      - Courts are especially unsympathetic to K creditors, because they can protect themselves. E.g., by:
        - Getting a personal guarantee.
        - Not extending credit in the first place.
        - Looking at the prospective debtor's bottom line.
    - What *is* undercapitalization?
      - This is not the same question as "Did you have enough capital to start the corporation?" That's the initial capitalization question —not this one.
      - N.b.: why did the Π co-op here keep selling to the defaulted debtor here?
        - Sometimes debtors are worth more alive than dead.
        - Sometimes salesmen have different motivations than the creditor corporation (i.e., they want their commission).
        - Sometimes, a creditor doesn't want to admit that it made a mistake. This is a psychological problem.
  - Follow the corporate formalities?
- *K.C. Roofing* (p510)
  - What did the Δ do here that the Δ in *Consumer's Co-op* didn't do? Because, here, we've got veil piercing and there, we didn't have it.
    - (Well, for one thing, here we're getting close to—but we're not quite yet at—fraud.)
    - Mainly, it was the formalities:
      - Lack of formality wrt. financials itc.
      - Lack of formality wrt. corporate name itc.

Thursday, October 28

Note that you can get limited liability without having a limited liability entity. How? By contracting work out. That way, if the contractor commits a tort, you can only be touched if you're found to be the master in a master-servant relationship.

Veil piercing with torts

- *Western Rock Co.* (p518)
  - What if there just weren't any veil piercing. Would there be any other theory of recovery here?
    - Fiduciary duty breach? But that's owed to the corporation. This theory goes after the people in their directors' hats (unlike veil piercing, which goes after them in their shareholders' hats).
    - Negligent supervision. This goes after the people in their tortfeasors' hats.
    - Equitable subordination (the *Deep Rock* doctrine): where a corporate insider's K claim against his corporation gets pushed down, in equity, on the priority list.
      - (A note on the priority list:
        - Bad news: you want to be high on the priority list.
        - Good news: you want to be low on the priority list—there's higher returns there.

        But what's better? Having convertible debt. That way, you can adjust where you are on the list.
- *Arrow Bar* (p520)
  - Why would a corporation buy liability insurance? Because the corporation itself has assets, that it doesn't want to lose. Limited liability (and veil piercing) doesn't even come up if the corporation still has assets.
  - Note that when we *don't* pierce the veil, we're encouragin investment in too-risky enterprises.

Monday, November 1

What about this veil piercing empirical research they have in the casebook? Well, Anderson is skeptical of this kind of thing...

- *Bestfoods* (p531)
  - The point itc. is that there's more than veil piercing available to you if you want to get to someone inside the corporation. Here, for instance, we have the

situation that another body of law (CERCLA) allows you to get at them.

What will you do if you're well-advised? You'll follow the corporate formalities—even when it seems like play-acting.

Piercing into LLCs

- Because the LLC world is more contractarian, should the rules for LLC piercing be different than in the corporate world? Hmm... At any rate, what we actually end up with is veil piercing rules in the LLC worlds that are basically the same as the corporate veil piercing rules.

Tuesday, November 2

Pre-formation issues

So far, we've been studying the period of time, with corporations, *after* the articles have been filed. Now, we'll study the period before they're filed.

- But note that sometimes there are *two* distinct periods before filing:
    1. Before *anyone* thinks the articles have been filed.
    2. After somebody thinks the articles have been filed.

    During each of these periods, you might want to hold:
    - the corporation liable; or
    - the individuals liable.

- Corporate liability
    - Corporations can adopt a transaction that occured before it was born. And by doing so, it binds itself.
        - Also, it can ratify some transactions. But you can only ratify something that you *could* have actually authorized. That means it had to have happened at a time when you existed.
        - With ratification, the transaction date relates back to the original date of the transaction. With adoption, there's no relation back.
    - A corporation can also bind itself if it evidenced its intent to be bound. To do so, the corporation has to *know* about the transaction. If the corporation doesn't know about it, then there's only unjust enrichment claims.
- Individual liability
    1. During the first period, when everyone understands there's no corporation:
        - *RKO* (p550)
            - The default position in this scenario is that the signer, as an individual, is bound. An intent-based test is used,

with the presumption that the individual is the one liable.
- The intent-based test. These are the kinds of intents out there:
    - Intent for immediate liability
        1. with continuing individual liability.
        2. with the corporation later to replace the individual as liable.
    - Intent for no immediate liability
        1. by making a revocable offer to the corporation.
        2. by making a firm offer to the corporation.

2. During the second period, when some think that the articles have been filed.
    - Here, we've got five basic possible outcomes:
        1. Absolute liability (a partnership rule)
        2. De facto corporation
        3. Corporation by estoppel
        4. The *Timberline* rule
        5. The MBCA rule

      and combinations of these.
    - MBCA § 2.03
        - (a): this is an attempt at getting rid of the de facto corporation doctrine—where it says "corporate existence begins when the articles of incorporation are filed." This implies there's no existene before that time.
    - *Timberline* (p553)
        - ORS 57.793 (p554): this is trying to get rid of the de facto corporation doctrine. But the court doesn't buy it, exactly—it makes the individual liability decision based on *participation*:
            - Active people are liable.
            - Passive people are not liable.

          "What a silly interpretation," Anderson says.
    - Corporation by estoppel: this is the only of the five doctrines that distinguishes among *claimants*.
    - De facto corporation: to have one:
        - There has to be a statutory provision allowing for incorporation of the particular type of business in question.
        - There must have been an attempt at incorporation (some jurisdictions require actual mailing of the articles; others do not).
        - The business must have used the corporate form in the

transaction.
- There must be good faith on all those things.

If you've got all those, you've got a shield good against everyone but the state itself.

<u>Wednesday, November 3</u>

Note that *Timberline* can be layered on top of the MBCA approach.

Unauthorized actions

- *General Overseas* (p559): itc. tells us that if the transaction is unusual, you're going to need *real*—not apparent—authority.

<u>Thursday, November 4</u>

- *Menard* (p566)
  - Inherent authority:
    1. Usually accompany?
    2. Reasonable belief? (Note that this isn't exactly the same as the apparent authority reasonability test.)
    3. Notice?

    Anderson thinks this test is silly:
      1. You can almost always satisfy it, if you stretch.
      2. There's better ways to protect third parties. Like requiring them to verify authority with the corporate secretary. At the very least, requiring them to do that in major transactions like the one itc.

    Note, with this test, can you ever have notice *and* a reasonable belief??

  N.b., apparent *agency* (as distinguished from apparent authority (of an existing agent)).

<u>Ultra vires</u>
- This is *not* an agency doctrine—here, we're asking if the *principal* has the authority to do some act.
- What establishes a corporation's authority?
  - Purposes: you can include a "purposes clause" in the articles.
  - Powers: e.g., the power to sue and be sued; the power to give money

away to charities. These might be in the articles.

- Nobody like ultra vires. (But why don't the contractarians like it?! Shouldn't they?!)

Mergers

Mergers: a preview:

- Appraisal rights: do you get them? Are you stuck with them—is that all you get?
- What *is* a merger? What's not a merger? E.g., what about purchases of assets —what happens if these end up in the same place as a merger would have?

- *Hewlett* (p582)
  - The merger here is pretty archetypal:
    - It's got typical form (it's not triangular, or a consolidation).
    - It involves large, public corporations.
    - Both corporations are in the same business.
    - It's not a cash-out merger.

    So, this merger lets you see how the law works in the situation is was set up for.

- Legal steps for merger:
  1. Directors must approve.
  2. Directors must disclose all material facts to shareholders.
  3. Shareholders must approve.
  4. (Regulatory steps.)

<u>**Monday, November 8**</u>

- *Hewlett* (p582)
  - There's an objective standard wrt. materiality, but it could be a *subjective* standard wrt. what management knew.
    - See p590: "whether HP management knowingly and intentionally..."
    - HP management argues that it *intended* to put out conflicting reports, so to make low-level managers uncomfortable and thus work harder.
  - A lot of the problems here comes from the non-standard timeline in which the merger was done:
    1. Notice.
    2. Shareholder vote.
    3. Integration.

If they'd done the integration either before the notice or after the notice but before the shareholder vote, they could have solved some of the problems —things wouldn't be going sour only after notice and the vote.

- Dissenter's rights
    - The questions here are:
        1. If I want appraisal rights, do I get them?
        2. If I get them, is that all I get?

    - Note on short form mergers: these are allowed in certain cases where the parent has enough shares by itself to do the merger. And so we allow these mergers without a vote—this means that we have to have special dissenter's rights rules here since the dissenter's never had a right to vote in the first place.

    - Appraisal rights in Delaware:
        - The dissenter might get *less* than the corporation's offer.
        - The court can make the dissenter pay appraisal costs.
    - Appraisal rights under the MBCA:
        - The corporation must pay the dissenter right away.
        - The dissenter is more likely (than in Delaware) to get more than the corporation's offer.
        - The dissenter is less likely (than in Delaware) to have to pay appraisal costs.
        - But your shares have to actually be disappearing to get appraisal rights (see § 13.02(a)(1) and comment 1).
    - The "market out" exception (in both Delaware and MBCA): appraisal is expensive, so we don't want it if there's a market that allows for cheap, easy adaptability.

    - Contracting around dissenter's rights:
        - De facto mergers: *Applestein* (p602) and *Arco* (p606).

<u>Tuesday, November 9</u>

- *Applestein* (p602): is there any way a majority of United's shareholders could have prevented this merger-esque transaction from occurring? Yes—they could have authorized fewer share, so that United couldn't have been able to issue so many new shares to Epstein.

- Cash-out mergers
    - *Coggins* (p611)
        - Why does Sullivan want to get rid of the nonvoting shares??

        - The cash-out merger provision was created to allow certain specific classes of shares to get cash in a merger. It is *exploited*—by creating a corporation just for merger purposes—in order to get rid of big blocks of shares, to keep them from voting (and suing).
            - Note, also, that the cash-out mechanism doesn't arise from a statutory provision—the merger statutes themselves usually just provide that "cash" can be consideration in a merger. They *don't* usually provide, explicitly, that you can effectively redeem a whole bunch of shares for an appraised value. But the courts have allowed this.

        So, because of this exploitation, we have to decide whether w'er going to apply a business purpose test.

    - *Weinberger* (p619)
        - Note that the merger here is constructed in such a way to require a majority vote from the minority shareholders not for pure-of-heart reasons—it's done this way so that the burden will be shifted away from the corporation when the fairness test is applied.
        - Self-dealing
            - We have a self-dealing transaction here. Are we going to use the regular self-dealing rules? *No.* We're going to create special rules for the particular case of mergers.
            - Fairness test:
                - Fair dealing: what's unfair here?
                    - Signal's in control, and
                    - the decision was made in a short amount of time, and
                    - some of the directors are directors of both companies.
                - Disclosure: note comments to MBCA § 8.60.

<u>Wednesday, November 10</u>

- Self-dealing in *Weinberger*, again:
    - What's the normal self-dealing analysis?
        - Disinterested director approval? OR
        - Disinterested shareholder approval? OR
        - Fairness?
    - But, we alter this test for mergers involving controlling

parents. The alteration? Even with disinterested approval(s), you still have to show fairness. Disinterested approval, however, shifts the burden of proof on the fairness analysis.

- What can you get if you're not suing for an appraisal, and you can show a breach of a fiduciary duty?
    - If you're fast enough, you can get a recission of the merger.
    - If not, you might can get recissory damages (what the sahares would have been worth if you could have stayed in).
    - Else, you can get appraisal-like damages (as of the point in time immediately before the merger).

- Are you stuck with appraisal?
    - *Glassman* (p643)
        - Note the cases that are *described* in this case:
            - *Weinberger* (see p629)
            - Post-*Weinberger*, pre-*Glassman* cases
            - *Glassman*
        - Itc. says that you're limited to the appraisal remedy when it's a short-form merger.
    - What do you get if you're in an appraisal proceeding?
        - *Cede & Co.* (p633)
            - This is a two-step merger:
                1. Tender offer
                2. Merger

                Why do this? One reason is that the tender offer provides pretty good evidence of what a fair price for the shares is.

<u>Monday, November 15</u>

[Skipped class.]

<u>Tuesday, November 16</u>

SECURITIES

- Recall the "what's a security" stuff we did earlier.

The anti-fraud provisions:

- There has to be an interstate means of commerce (it doesn't matter, though, if it's only an intrastate use of that means).
- There has to be a purchase of sale (so, the provisions don't apply to fraud used to make someone *not* sell).
- The private right of action under 10(b) is implied (but it was implied real early on).
- The typical 10(b) claim is *direct*, not derivative. (Although note that you could have a derivative claim on top of a direct 10(b) claim.)

- How can non-traders be implicated here—how could that be?
    - Because what you say (or omit) as a non-trader might cause someone to rely. One solution, then, is to never say anything—there's nothing in 10 (b) itself that induces a duty to speak.

Wednesday, November 17

With this securities fraud stuff, we've got three main questions:

1. What's common across all of 10b-5?
    - You've got to have:
        - A security
        - A transaction
        - Standing—i.e., you have to be a buyer or seller
        - Means of interstate commerce
        - Materiality
2. What affects traders, specifically?
3. What affects non-traders, specifically?
    - Omission alone won't be enough (as it would be for a trader, who will have a duty to speak).
    - But, a statement may *become* misleading if it's not updated later. That's where duty-to-speak bumps up against materiality—you must update if the thing being omitted is material. That is, having spoken, you now have a duty to not omit something related to it that's material (whereas, otherwise, non-traders have no duty to speak).

Scienter

- *Ernst & Ernst* (p905)
    - Note Blackmun's dissent (n1p907): this reflects the older jurisprudence on these matters, where the only thing that mattered, really, was whether you lost your money. Now, beginning with itc., SCOTUS tells Π to start using state remedies, rather than 10b-5 for this kind of thing.
    - Why? The Court looks at words lik "manipulative" as indicating that something more than negligence is required.

Thursday, November 18

- *Novak* (p908)
  - Where's the misstatement here? I.e., how's the "box and hold" policy a problem?
    - The inventory is misstated because of the box and hold policy.
    - Also, Δ misstated its markdown policy to the SEC.

Pleading standards

- *Novak* (p908):
  - The court provides a list of of pleading requirements—you have to allege that:
    1. The Δs enefited in a concrete and personal way from the fraud;
    2. They engaged in deliberately illegal behavior;
    3. They knew facts or had access to information suggesting that their public statements were not accurate; or
       - This one is scary since if people told you stuff, it could look in hindsight like you had "access to information."
    4. They failed to check information that they had a duty to monitor.
       - This one is even more scarier because here, they didn't even have to *tell* you that stuff.

Reliance and causation

- Here, the efficient market hypothesis actually comes out pro-Π!!
- *Levinson* (p919)
  - Note that we only have a majority (4) of 6 here (three justices didn't participate).
  - Rebuttal: can you rebut the presumption without doing any discovery on the Πs? Yes—you can show that the market didn't believe the company's statements, but instead believed the analysts (in the newspaper, e.g.).

Monday, November 29

Insider trading

What would we do with insider trading if 10b-5 didn't exist?

- Fiduciary duty breach? Well, a breach of the duty of loyalty is what it could be.
  - The "majority rule" says there's no harm and so no breach—at least for people who trade on anonymously on an exchange.
  - Or, you could ignore the corporate fiction and say that the fiduciary

duties are owed directly to the shareholders.
        - But some of the people protected from insider trading are just holding options—how can you find a duty there??
    - So, some courts adopt the "special facts" rule, which is just where there's something particularly compelling that allows recovery.

<u>Tuesday, November 30</u>

- *Texas Gulf* (p986)
    - What do the call options purchases tell us here?
        - With regular shares, if there's a mineral strike like itc., the shares would go up. If there wasn't a mineral strike, they'd stay the same.
        - But with call options, they're only valuable if the share price goes above the exercise (or "strike" price). So, the fact that the people itc. bought call options shows that they were pretty sure that the share price was going to rise dramatically.
    - Now—one of the questions we have to answer is: when should we actually let insiders trade?
    - N.b. § 16(b): for some insiders, there's a presumption that they're trading on inside information.

Why don't we let insiders trade like this?
- *Texas Gulf* takes the parity of information theory—that's an unfairness complaint. So, if it's public information, and you're just analyzing it, that's okay. Because it's *public*. And we *want* you to analyze it.
    - (But, it takes time, effort, and money to analyze even public information —and we might have to draw a line where we say that it's so expensive to analyze it that we can't really call it "public.")
- *Chiarella* (p998) changes the theory—we lose the policy. Now, you have to find a *duty* between the trader and the purchaser/seller.

<u>Wednesday, December 1</u>

- *Chiarella* (p998)
    - The Δ itc. is an employee of the printing company hired by the law firm hired by the third-party that's acquiring the issuer. The Court says there's no duty between Δ and the issuer's shareholders. So Δ hasn't broken 10b-5.

Insider trading theories that we've talked about:
1. Fairness/parity of information (*Texas Gulf*)
2. Preexisting duty requirement (*Chiarella*)
3. Misappropriation

- *Dirks* (p1004)
  - Secrist, an insider, can't trade. So, is everyone he tells barred from trading?
    - No. Because the Court doesn't want Dirks to be liable.

    So, how are we going to tell who can trade and who can't?
      - Well, for one thing, for some people we're not going to even do a tipper-tippee analysis. These is the *Dirks* fn.14 constructive (or temporary) insiders.
        - Temporary insiders being the people in the chain of confidential relationships running down from those who can't trade. (And, combining fn.14 with misappropriation, this chain works if it goes to *either* the issuer *or* a connected third-party.)
      - But, if there's no "relationship of trust or confidence," then what?
        - The the Court says that the tipee inherits the tipper's liability if the tipper violated an obligation, by tipping, *for improper personal benefit.*
          - And that includes gifts. Because, the Court says, gifting a tip is just like trading and giving the proceeds to the tippee. And also because the tip-gift could have been done for the tipper's reputational benefit (but isn't that what Secrist did??).

<u>Thursday, December 2</u>

- *O'Hagan* (p1022)
  - Note how the facts here are basically the same as in *Chiarella*.
  - Itc. would be a Reg. FD problem only if someone actually *spoke*.
    - (There's nothing in FD about trading. Rather, Fd is an equality of treatment theory regulation. But with a limit—speaking. After *Chiarella*, equality of treatment dies, only to return in situations where the SEC puts a limit on it.)
- *Carpenter* (p1032n1)
  - Even though the WSJ reporter is reporting on public information, he knows something that is material and nonpublic—the fact that he's going to publish the story on the front page of the WSJ.
  - But, itc., actually, the reporter tips his roommate, who trades. So, you have to do *Dirks* on top of misappropriation.
    - There's a relationship of trust or confidence down from the issuer to the reporter.

        - But there's none between the issuer and the roommate. So you do *Dirks* at this point: ask whether the tip was for personal benefit. It looks like it—it looks like it was a gift.
- *O'Hagan*
    - Who's the victim of the fraud? The *third-party*. Not, n.b., the person he traded with.
        - So, the jurisprudential controversy is whether the fraud is *in connection* with the securities transaction.
            - That is, are we just federalizing state law fiduciary duty here? Not exactly, because:
                - He could make the information public.
                - He could tell the third-party that he's going to trade, the Court says. (And then the third-party could get an injunction pretty quickly, for the imminent state law violation.)

                And so, since there's ways to breach your state law fiduciary duty but *not* breach federal securities laws, we're not just federalizing state law fiduciary duty.