**INTRODUCTION**

**I. CHOOSING A FORM OF ORGANIZATION**

**A. Partnership vs. corporation:** Choosing a form of organization usually comes down to choosing between a ***partnership*** and a ***corporation***.

**B. Nature of partnerships:** There are two kinds of partnerships: "general" partnerships and "limited" partnerships.

**1. General partnership:** A "***general*** partnership" is any association of two or more people who carry on a business as co-owners. A general partnership can come into existence by operation of law, with no formal papers signed or filed. Any partnership is a "general" one unless the special requirements for limited partnerships (see below) are complied with.

**2. Limited partnerships:** A ***"limited"*** partnership can only be created where:

(1) there is a ***written agreement*** among the partners; and

(2) a formal document is ***filed*** with state officials.

**a. Two types of partners:** Limited partners have two types of partners:

(1) one or more ***"general"*** partners, who are ***each liable*** for all the debts of the partnership;

and

(2) one or more ***"limited"*** partners, who are ***not liable*** for the debts of the partnership beyond the amount they have contributed.

**C. Limited liability:** Corporations and partnerships differ sharply with respect to ***limited*** liability.

**1. Corporation:** In the case of a corporation, a shareholder’s liability is normally ***limited to the amount he has invested.***

**2. Partnership:** The liability of partners in a partnership depends on whether the partnership is "general" or "limited."

**a. General:** In a ***general*** partnership, ***all partners are individually liable for the obligations of the partnership***.

**b. Limited:** In a limited partnership, the general partners are personally liable but the limited partners are liable ***only up to the amount of their capital contribution.***

(But a limited partner will lose this limit on his liability if he ***actively participates*** in the management of the partnership.)

**D. Management:**

**1. Corporation:** Corporations follow the principle of ***centralized*** management. The shareholders participate only by electing the board of directors. The board of directors supervises the corporation’s affairs, with day-to-day control resting with the "officers" (i.e., high-level executives appointed by the board).

**2. Partnership:** In partnerships, management is usually ***not*** centralized.

- In a general partnership, all partners have an equal voice (unless they otherwise agree).

- In a limited partnership, all general partners have an equal voice unless they otherwise agree, but the limited partners may not participate in management.

**E. Continuity of existence:** A corporation has "perpetual existence." In contrast, a general partnership ***dissolved*** by the ***death*** (or, usually, even the ***withdrawal***) of a general partner. A limited partnership is dissolved by the withdrawal or death of a general partner, but not a limited partner.

**F. Transferability:** Ownership interests in a corporation are readily transferable (the shareholder just sells stock). A partnership interest, by contrast, is not readily transferable (all partners must consent to the admission of a new partner).

**G. Federal income tax:**

**1. Corporations:** The corporation is ***taxed as a separate entity.*** It files its own tax return showing its profits and losses, and pays its own taxes independently of the tax position of the stockholders. This may lead to "double taxation" of dividends (a corporate-level tax on corporate profits, followed by a shareholder-level tax on the dividend).

**2. Partnership:** Partnerships, by contrast, are ***not separately taxable entities***. The partnership files an information return, but each individual pays the actual tax.

Therefore, double taxation is avoided. Also, a partner can use losses from the partnership to shelter from tax certain income from other sources.

**3. Subchapter S corporation:** If the owner/stockholders of a corporation would like to be taxed approximately as if they were partners in a partnership, they can often do this by having their corporation elect to be treated as a Subchapter S corporation. An "S" corporation does not get taxed at the corporate level, unlike a regular corporation; instead, each shareholder pays a tax on his portion of the corporation’s profits.

**H. CHOOSING**

**1. Corporation superior:** The corporate form is superior:

(1) where the owners want to limit their liability;

(2) where free transferability of interests is important;

(3) where centralized management is important (e.g., a large number of owners); and

(4) where continuity of existence in the face of withdrawal or death of an owner is important.

**2. Partnership superior:** But the partnership form will be superior where:

(1) simplicity and inexpensiveness of creating and operating the enterprise are important; or

(2) the tax advantages are significant, such as avoiding double taxation and/or sheltering other income.

**LC 2 - THE CORPORATE FORM AND ITS EFFECTS**

**I. THE INCORPORATION**

**A. Where Delaware vs. headquarter state**

The incorporators must choose between incorporating in their headquarter state, or incorporating somewhere else (probably Delaware or Nevada).

**1. Closely held:** For a ***closely held*** corporation, incorporation should usually take place in the state where the corporation’s ***principal place of business*** is located.

**2. Publicly held:** But for a ***publicly held*** corporation, incorporation in Delaware is usually very attractive (because of Delaware’s well-defined, predictable, body of law, and its pro-management bias.)

**B. Mechanics of incorporating:**

**1. Articles of incorporation:** To form a corporation, the incorporators file a document with the Secretary of State. This document is usually called the ***"articles of incorporation"*** or the "charter."

**a. Amending:** The articles can be amended at any time after filing. However, any class of stockholders who would be adversely affected by the amendment must ***approve*** the amendment by majority vote.

**2. Bylaws:** After the corporation has been formed, it adopts ***bylaws***. The corporation’s bylaws are rules governing the corporation’s internal affairs (e.g., date, time and place for annual meeting; number of directors; listing of officers; what constitutes quorum for directors’ meetings, etc.). Bylaws are usually not filed with the Secretary of State, and may usually be amended by either the board or the shareholders.

**II. ULTRA VIRES AND CORPORATE POWERS**

**A. *Ultra vires:***

**1. Classic doctrine:** Traditionally, acts beyond the powers given by the corporation’s articles of incorporation were held to be ***"ultra vires,"*** and were unenforceable against the corporation or by it. (But there were numerous exceptions.)

**2. Modern abolition:** Modern corporate statutes have generally ***eliminated*** the *ultra vires* doctrine.

**B. Corporate powers today:** Most modern corporations are formed with articles that allow the corporation to take ***any lawful action***.

**1. Charitable contribution:** Even if the articles of incorporation are silent on the subject, corporations are generally held to have an implied power to make ***reasonable charitable*** ***contributions***.

**2. Other:** Similarly, corporations can generally give bonuses, stock options, or other ***fringe benefits*** to their employees (even retired employees).

**III. THE PROMOTERS**

**A. Definition and Liability of promoter:**

A ***"promoter"*** is one who passes legal acts in founding and organizing a corporation.

A promoter is ***liable*** for debts he contracts on behalf of the to-be formed corporation.

**1. Promoter aware, other party not:** If the promoter enters into a contract in the corporation’s name, and the promoter ***knows*** that the corporation has not yet been formed but the other party does ***not*** know this, the promoter will be ***liable*** under the contract.

See RMBCA § 2.04.

**I**f the corporation is later formed and ratifies the contract, then the promoter may escape liability. It means that the creditor has the choice to sue the promoter or the corporation. In a normal situation, the corporation is going to be sued. But, if the corporation is insolvent, then the creditor is going to sue the promoter, still liable.

Promoter and the other party aware: If the promoter enters into a contract in the corporation’s name, and the promoterknows that the corporation has not yet been formed and the other party knows this and agrees to put the name of the corporation on the contract, then there is a presumption that the corporation will be held liable. The reason is that the other party, by signing the contract, accepts to look to the assets of the corporation-to-be-formed and not those of the promoter.

**2. Contract says corporation is not formed:** If the contract entered into by the promoter on behalf of the corporation ***recites*** that the corporation has not yet been formed, the liability of the promoter depends on what the court finds to be the parties’ ***intent***.

**a. Never formed, or immediately defaults:** If the corporation is ***never formed***, or is formed but then immediately ***defaults***, the promoter will probably be ***liable***.

**b. Formed and then adopts:** But if the corporation is formed, and then shows its ***intent to take over*** the contract (i.e., ***"adopts"*** the contract), then the court may find that both parties intended that the promoter be released from liability (a ***"novation"***).

**B. Liability of corporation:** If the corporation did not exist at the time the promoter signed a contract on its behalf, the corporation will not become liable unless it ***"adopts"*** the contract.

Adoption may be ***implied***. (*Example*: The corporation receives benefits under the contract, without objecting to them. The corporation will be deemed to have implicitly adopted the contract, making it liable and perhaps making the promoter no longer liable.)

**C. Promoter’s fiduciary obligation:** During the pre-incorporation period, the promoter has a ***fiduciary obligation*** to the to-be-formed corporation. He therefore may not pursue his own profit at the corporation’s ultimate expense. (*Example*: The promoter may not sell the corporation property at a grossly inflated price.)

**IV. DEFECTIVE INCORPORATION**

**A. Common law "de facto" doctrine:** At common law, if a person made a "colorable" attempt to incorporate (e.g., he submitted articles to the Secretary of State, which were rejected), a "de facto" corporation would be found to have been formed. This would be enough to shelter the would-be incorporator from the personal liability that would otherwise result. This is the ***"de facto*** ***corporation"*** doctrine.

**Modern view:** But today, most states have ***abolished*** the de facto doctrine, and expressly impose personal liability on anyone who purports to do business as a corporation while knowing that incorporation has not occurred. See RMBCA § 2.04.

**B. Corporation by estoppel**

The common law also applies the "corporation by ***estoppel***" doctrine. Whereby a creditor who deals with the business as a corporation, and who agrees to look to the corporation’s assets rather than the shareholders’ assets will be estopped from denying the corporation’s existence.

The "corporation by estoppel" doctrine probably survives in some states, as a judge-made doctrine.

The MBCA has abolished the *de facto* doctrine. It is not clear if the MBCA has abolished the *corporation by estoppel* doctrine. But the article 2.04 decides that any person acting on the behalf of the corporation will be held liable if it is not sure, at the time of the contract, that the corporation is defective.

**V. PIERCING THE CORPORATE VEIL**

**A. Generally:** In a few very extreme cases, courts may ***"pierce the corporate veil***,***"*** and hold some or all of the shareholders ***personally liable*** for the corporation’s debts.

**B. Individual shareholders:** If the corporation’s shares are held by ***individuals***, here are some factors that courts look to in deciding whether to pierce the corporate veil:

**1. Tort vs. contract ("voluntary creditor"):** Courts are more likely to pierce the veil in a ***tort*** case (where the creditor is ***"involuntary"***) than in a ***contract*** case (where the creditor is "voluntary").

**2. Fraud:** Veil piercing is more likely where there has been a grievous ***fraud*** or ***wrongdoing*** by the shareholders (e.g., the sole shareholder siphons out all profits, leaving the corporation without enough money to pay its claims).

**3. Inadequate capitalization:** Most important, veil piercing is most likely if the corporation has been ***inadequately capitalized***. But most courts do not make inadequate capitalization ***alone*** enough for veil piercing.

**a. Zero capital:** When the shareholder invests ***no money whatsoever*** in the corporation, courts are especially likely to pierce the veil, and may require less of a showing on the other factors than if the capitalization was inadequate but non-zero.

**b. Siphoning:** Capitalization may be inadequate either because there is not enough ***initial*** capital, or because the corporation’s profits are systematically ***siphoned out*** as earned. But if capitalization is adequate, and the corporation then has unexpected liabilities, the shareholders’ failure to put in ***additional*** capital will generally ***not*** be inadequate capitalization.

**4. Failure of formalities:** Lastly, the court is more likely to pierce the veil if the shareholders have ***failed to follow corporate formalities*** in running the business. (*Example*: Shares are never formally issued, directors’ meetings are not held, shareholders co-mingle personal and company funds.)

**5. Summary:** In nearly all cases at least ***two*** of the above four factors must be present for the court to pierce the veil; the most common combination is probably inadequate capitalization plus failure to follow corporate formalities.

**C. Parent/subsidiary:** If shares are held by a ***parent corporation***, the court may pierce the veil and make the parent corporation liable for the ***debts of the subsidiary***.

**1. No liability generally:** Again, the ***general*** rule is that the corporate parent shareholder is ***not liable*** for the debts of the subsidiary (just as individual shareholders are not liable for the corporation’s debts).

**2. Factors:** But as in the individual-shareholder case, certain acts by the parent may cause veil piercing to take place. Such factors include:

(1) failure to follow ***separate corporate*** ***formalities*** for the two corporations (e.g., both have the same board, and do not hold separate directors’ meetings);

(2) the subsidiary and parent are operating pieces of the ***same business***, and the subsidiary is undercapitalized;

(3) the public is ***misled*** about which entity is operating which business;

(4) assets are ***intermingled*** as between parent and subsidiary; or

(5) the subsidiary is operated in an unfair manner (e.g., forced to sell at cost to parent).

**D. Brother/sister ("enterprise liability"):** Occasionally, the court may treat ***brother/sister*** corporations (i.e., those having a common parent) as really being one individual enterprise, in whichcase each will be liable for the debts of its "siblings." This is the ***"enterprise liability"*** theory.

**VI. INSIDER CLAIMS IN BANKRUPTCY (INCLUDING EQUITABLE SUBORDINATION)**

**A. Disallowance in bankruptcy:** A bankruptcy court may ***disallow*** an insider’s claim entirely if fairness requires. (*Example*: The insider claims that his entire capital contribution is a "loan," but the court finds that some or all should be treated as non-repayable "equity" in the bankruptcy proceeding.)

**B. Equitable subordination:** Alternatively, the bankruptcy court may recognize the insider’s claims against the corporation, but will make these claims come ***after*** payment of all other creditors.

Many of the same factors used for piercing the corporate veil (e.g., inadequate capitalization) will lead to this ***"equitable subordination"*** in bankruptcy.

**Chapter 3.** **THE CORPORATE STRUCTURE**

**1. THE DIFFERENT POWERS**

**1.1. Traditional scheme**

**1.1.1. Shareholders**

The shareholders act principally by: (1) electing and removing **directors** and (2) approving or disapproving **fundamental** or non-ordinary **changes** (e.g., mergers).

**1.1.2. Directors**

The directors **"manage"** the corporation’s business. That is, they formulate policy, and they **appoint officers** to carry out that policy.

**1.1.3. Officers**

The corporation’s officers administer the **day-to-day affairs** of the corporation, under the supervision of the board.

The corporation usually may modify this allocation of powers where appropriate. This is often done in the case of closely held corporations.

**1.2. Powers of shareholders**

**1.2.1. Directors**

The shareholders have the power to **elect** and **remove directors**.

**a. Election:** Shareholders normally elect the directors at the **annual meeting** of shareholders. In other words, directors normally serve a one-year term.

See Revised Model Business Corporations Act (RMBCA) § 8.05(b)

**b. Vacancies:** Shareholders usually have the right to elect directors to **fill vacancies** on the board, but the board of directors also usually has this power.

**c. Removal:** At common law, shareholders could not **remove** a director during his term of office.

But today, most statutes allow the shareholders to remove directors **even without cause**.

**1.2.2. Articles and bylaws**

The shareholders can amend the **articles** of incorporation or the **bylaws**.

**1.2.3. Fundamental changes**

The shareholders get to approve or disapprove of **fundamental changes** not in the ordinary course of business (e.g., mergers, sales of substantially all ofthe company’s assets, or dissolution).

**1.3. Power of directors**

The **directors** "manage" the affairs of the corporation.

**1.3.1. Shareholders can’t give orders:** Thus shareholders usually **cannot order the board of directors to take any particular action**.

**1.3.2. Supervisory role:** The board does not operate the corporation day to day. Instead, it **appoints officers**, and **supervises** the manner in which the officers conduct the day-to-day affairs.

**1.4. Power of officers**

The corporation’s **officers** are appointed by the board, and can be removed by the board. The officers carry out the day-to-day affairs.

**2. BOARD OF DIRECTORS**

**2.1. Election**

The shareholders elect members of the board of directors.

**Straight vs. cumulative**

The vote for directors may either be **"straight"** or **"cumulative."** (In most states, cumulative voting is allowed unless the articles of incorporation explicitly exclude it.)

**a. Cumulative:** In cumulative voting, a shareholder may **aggregate his votes** in favor of fewer candidates than there are slots available.

Example: H owns 100 shares. There are 3 board slots. H may cast all of his 300 votes for 1 candidate.

This makes it more likely that a minority shareholder will be able to obtain at least one seat on the board.

**Removal of directors:** If cumulative voting is authorized, a director usually may not be **removed** if the number of votes that would have been sufficient to elect him under cumulative voting is voted against his removal.

**2.2. Number of directors**

The number of directors is usually fixed in either the articles of incorporation or in the bylaws. Most statutes require at least three directors. Most statutes also allow the articles or bylaws to set a variable (minimum and maximum) size for the board, rather than a fixed size. (If variable size is chosen, then the board gets to decide how many directors within the range there should be.)

**2.3. Filling vacancies:** Most statutes allow **vacancies** on the board to be filled **either** by the shareholders or by the board.

**2.3.1. Term**

Statutes vary as to the term of a replacement director: some let him serve the full-unexpired term of his predecessor; others make him stand for reelection at the next annual meeting. (This only matters if the predecessor’s term was for more than one year).

**2.3.2. Classes of stock**

The articles of incorporation may give each separate **class of stock** the power to elect one or more directors.

**2.3.3. Holdover director**

A director holds office not only for the term for which he is elected, but **until his successor is elected and qualified**. A director serving beyond the end of his term is called a **"holdover"** director.

**2.4. Removal of directors**

Most modern statutes provide that directors may be removed by a majority vote of **shareholders**, either **with or without cause**. Modern statutes also generally say that a **court** may order a shareholder removed, but only for **cause**.

**No removal by board:** But in most states his fellow directors, even for cause, may not remove a director.

**2.5. Directors’ meetings**

**2.5.1. Regular vs. special**

There are two types of board meetings: **regular** and **special**. A regular board meeting is one that occurs at a regular interval (e.g., monthly). All other meetings are "special." The frequency for regular meetings is usually specified in the bylaws.

**2.5.2. Notice**

No notice is necessary for a regular meeting. But prior notice (e.g., two days notice under the RMBCA) is required for a special meeting.

**2.5.3. Quorum**

The board may only act if a **quorum** is present. Usually, the quorum is a **majority** of the total directors in office. (Example: If there are nine directors, at least five must be present for a meeting.)

**a. Lower number:** Some states allow the articles or bylaws to set a percentage for a quorum that is **less than a majority**.

**b. Super majority:** Conversely, most statutes permit the articles or bylaws to make the quorum **more** than a majority (useful as a control device in closely-held corporations).

See RMBCA 8.24(a).

**c. Present at vote:** The quorum must be present **at the time the vote is taken** in order for the vote to constitute the act of the board. Thus even if a quorum is present at the start of the meeting, a director may leave and thereby remove the quorum.

**2.6. Act of board**

The board may normally take action only by a **vote of a majority** of the directors **present** at the meeting.

**2.6.1. Higher number**

In most states, the articles of incorporation may set a **higher percentage** than a majority for all or certain board actions.

**2.6.2. Requirement for meeting**

The board may normally take action **only at a meeting**, not by individual action of the directors. (Example: A contract cannot be executed by the board merely by having a majority of the directors, acting at separate times and places, sign the contract document.) But there are some exceptions:

**a. Unanimous written consent:** Nearly all states allow directors to act without a meeting if they give their **unanimous written consent** to the proposed corporate action. See RMBCA § 8.21(a).

**b. Distance meetings:** Many states now permit the directors to act by means of any **device for conference call**.

**c. Ratification:** Also, if the board learns of an action taken by an officer, and the board does not object, the board may be deemed to have **"ratified"** this action, or the board may be **"estopped"** from dishonoring it. In either case, the result is as if the board had formally approved the action in advance.

**2.6.3. Objection by director**

A director may **disassociate** himself from board action by filing a written dissent, or by making an oral dissent that is entered in the minutes of the meeting. This will shield the director from any possible liability for the corporate action.

**2.7. Committees**

The full board may appoint various **committees**. Generally, a committee may **take any action** that could be taken by the full board. (But there are exceptions. For instance, under theRMBCA, committees may not fill board vacancies, amend the articles of incorporation or thebylaws, propose actions for shareholder approval, or authorize share repurchases.

**3. OFFICERS**

**3.1. Meaning of "officer"**

The term **"officer"** describes only the more important executives of the corporation, typically those **appointed directly by the board of directors.** Most states leave it up to the board or the bylaws to determine what officers there shall be.

**3.2. Right to hire and fire**

Officers can be both **hired** and **fired** by the board. Firing can be with or **without cause** (and can occur even if there is an employment contract, though the officer can then sue the corporation for breach).

**3.3. Authority to act for corporation**

The officer is an **agent** of the corporation, and his authority is therefore analyzed under agency principles.

An officer does not have the **automatic right** to bind the corporation. Instead, one of four doctrines must usually be used to find that the officer could bind the corporation on particular facts:

**3.3.1. Express actual authority:** Express actual authority can be given to an officer either by the corporation’s **bylaws**, or by a **resolution** adopted by the board.

Example: A board resolution authorizes the Vice President to negotiate and sign a contract to dispose of a surplus plant.

**3.3.2. Implied actual authority:** "Implied actual authority" is authority that is **"inherent in the office."** Usually, it is authority that is inherent in the **particular post** occupied by theofficer.

**a. President:** The **president** is generally held to have implied actual authority, merely by virtue of his office, to engage in **ordinary** business transactions, such as hiring and firing non-officer-level employees and entering into ordinary-course contracts. But he does **not** usually have implied actual authority to bind the corporation to **non-ordinary-course** contracts such as contracts for the sale of real estate or for the sale of all of the corporation’s assets.

**b. Secretary:** The **secretary** has implied actual authority to **certify the records of the corporation**, including **resolutions** of the board of directors. Therefore, asecretary’s certificate that the board duly adopted a given resolution is **binding** on the corporation in favor of a third party who relies on the certificate.

**c. Removal:** The board may always explicitly **remove** implied actual authority that would otherwise exist (e.g., by notifying President that he may not hire anyone.)

**3.3.3. Apparent authority**

An officer has **"apparent authority"** if the corporation gives observers the **appearance** that the agent is authorized to act as he is acting.

There are two requirements:

(1) The corporation, by acts **other than those of the officer**, must **indicate to** **the world** that the officer has the authority to do the act in question; and

(2) The plaintiff must be **aware** of those corporate indications and rely on them.

In the case of a president, apparent authority will often flow merely from the fact that the corporation has given him that title — he will then have apparent authority to enter into ordinary course arrangements.

**3.3.4. Ratification**

Under the doctrine of **"ratification,"** if a person with actual authority to enter into the transaction learns of a transaction by an officer, and either expressly affirms it or fails to disavow it, the corporation may be bound. Usually, P will have to show that the corporation either received benefits under the contract, or that P himself relied to his detriment on the existence of the contract.

**4. SHAREHOLDER PARTICIPATION**

**4.1. Meetings**

Nearly all states require a corporation to hold an **annual meeting of shareholders**.

**4.1.1. Special meeting**

Corporations may also hold a **"special"** shareholders’ meeting. A special meeting is any meeting other than the regularly scheduled annual meeting.

**a. Who may call?**

The board may call a special meeting. Also, anyone authorized by the bylaws to call a meeting (e.g., the president, under many bylaws) may do so.

Finally, some statutes allow the holders of a certain percentage of the shares to call a special meeting.

Example: RMBCA § 7.02(a)(2) allows the holders of 10% of shares to call a special meeting. But in Delaware, shareholders may not call a special meeting.

**b. Quorum**

For a vote of a shareholders’ meeting to be effective, there must be a **quorum** present.

Usually, this must be a **majority of the outstanding shares.** However, the percentage required for a quorum may be **reduced** if provided in the articles or bylaws.

**1. Minimum:** Some states don’t allow the percentage for a quorum to be reduced below a certain number (e.g., the number cannot be reduced below one-third in Delaware). But the RMBCA sets no floor.

**2. Higher percentage:** Conversely, nearly all states allow the articles or bylaws to set a **higher percentage** as the quorum.

**c. Vote required:** Once a quorum is present, the traditional rule is that the shareholders will be deemed to have approved of the proposed action only if a majority of the **shares actually present** vote in **favor** of the proposed action.

**1. Traditional rule:** In other words, under this approach, an abstention is the equivalent of a vote against.

The RMBCA, in § 7.25(c), changes this by treating abstentions like votes that are not cast.

**2. Breaking quorum:** Once a quorum is present, the quorum is deemed to exist for the rest of the meeting, even if shareholders **leave**.

**3. Written consent:** Nearly all states allow shareholders to act by **unanimous written consent** without a meeting.

**a. Non-unanimous written consent:** A minority of states allows shareholder action in the form of **non-unanimous** written consent. (Example: Delaware § 228(a) allows shareholder action by the written consent of the same number of votes as would be needed to approve the action at a meeting.)

Chapter 4

**SHAREHOLDERS’ INFORMATIONAL RIGHTS AND THE PROXY SYSTEM**

**1. SHAREHOLDER INSPECTION OF BOOKS AND RECORDS**

**1.1. Generally**

State law generally gives shareholders the right to inspect the corporation’s books and records.

**1.1.1. Common law:** In most states, shareholders have a common-law right of inspection if they show a "proper purpose" for doing so.

**1.1.2. Statute:** Also, many states have enacted statutes codifying the shareholder’s right of inspection.

**1.2. Who may inspect**

Usually "beneficial owners," as well as holders of record, may inspect.

Some statutes restrict the right of inspection to shareholders who either have held their shares for a certain time, or hold more than a certain percentage of total shares.

(Example: New York BCL § 624 gives the statutory right of inspection only to one whom: (1) has held for at least six months; or (2) holds at least 5% of a class of shares.)

**1.3. What records may be examined**

Under most statutes, the holder has a right to inspect not merely specified records, but the corporate records **in general**.

But other statutes are more limited.

The RMBCA does not give shareholders an automatic right to inspect sensitive materials like the minutes of board meetings, the accounting records, or the shareholders list. For these, he must make a demand "in good faith and for proper purpose," he must "describe with reasonable particularity" his purpose and the records he wants to inspect, and the records must be "directly connected with his purpose."

**1.4. Proper purpose**

The shareholder generally may inspect records only if he does so for a **"proper purpose**.**"**

**1.4.1. Evaluation of investment**

A shareholder’s desire to **evaluate** his **investment** will usually be "proper." A holder will usually be allowed to examine accounting records to determine whether the stock’s market price fairly reflects its true value.)

**1.4.2. Unrelated personal goal**

Pursuit of unrelated **personal goals** will generally **not** be a proper purpose. A holder may not inspect if his purpose is to get access to trade secrets, which he can sell to a competitor or use himself.)

**1.4.3. Deal with other shareholders**

If the holder wants to get access to the shareholder’s list to contact his **fellow shareholders** to take group action concerning the corporation, this will usually be proper. A holder will usually be given access to shareholder lists to solicit proxies in connection with an attempt to elect a rival slate of directors.)

**1.4.4. Social/political goals:** If the holder is pursuing only **social or political goals** that are not closely related to the corporation’s business, this purpose will usually be improper.

Example: P wants to stop D Corp from making munitions for the Vietnam War because he thinks the war is immoral; P’s purpose is not "proper," so he cannot have D’s shareholder list or its records of weapons manufacture.)

**1.5. Financial reports**

In most states, the corporation is **not** required to send an **annual report** or other annual financial information to the shareholder. Federal law requires publicly held corporations to send a report, and some states require this for all corporations.

**Director’s right of inspection:** A **director** in most states has a very **broad**, virtually automatic, right of inspection. Most states deny him the right of inspection if he is acting with "manifestly improper motives."

**2. SPECIFIC REQUIREMENTS FOR PUBLICLY HELD COMPANIES**

**2.1. Definition of "publicly held"**

Certain reporting requirements are imposed on "publicly held" companies.

These are companies which either:

(1) have stock that is traded on a national securities exchange; or

(2) have assets of more than $5 million and a class of stock held of record by 500 or more people. These companies must make continuous disclosures to the SEC under § 12 of the Securities Exchange Act of 1934 (the "’34 Act"), and must comply with the proxy rules.

**2.2. Proxy rules generally: t**he SEC’s **proxy solicitation** rules

If a company is covered, any proxysolicitation by either management or non-management (subject to some exemptions) must complywith detailed SEC rules. Basically, this means that whenever management or a third party wants topersuade a shareholder to **vote** in a certain way (whether the persuasion is written or oral, andwhether it is by advertisement or one-on-one communication), the solicitation must comply with theSEC proxy rules.

**2.3. Disclosure and filing requirements**

**2.3.1. Filing**

Any proxy solicitation documents that will be sent to shareholders must first be **filed with the SEC**.

**2.3. 2. Proxy statement**

Every proxy solicitation must be accompanied or preceded by a written **"proxy statement**.**"** This must disclose items like conflicts of interest, the compensation given to the five highest-paid officers, and details of any major change being voted upon.

**2.3.3. Annual report**

The proxy rules require than an **annual report** be sent to every shareholder.

**2.3.4. Anti-fraud**

Any **false** or **misleading** statements or omissions in a proxy statement are banned by SEC rules.

**2.4. Requirements for proxy**

The proxy itself is a **card** which the shareholder signs, and on whichhe indicates how he wants to vote. SEC rules govern the format of this card.

**2.4.1. Function**

Most commonly, the proxy will be the method by which the shareholder indicates to management that he is voting for management’s slate of **directors**. The proxy card will also be the shareholder’s way of indicating how he votes on some major non-election issue, such as whether the company should merge with another corporation.

The proxy is the method of casting shareholder votes in all situations except where the shareholder attends the shareholder’s meeting.

**2.4.2. Broad discretion**

The proxy form may not confer unduly broad discretion on the recipient. (Example: The card must list exactly what nominees’ management is proposing for election to the board; it may not confer on management the right to vote for unnamed candidates that management desires.)

**2.4.3. Must be voted**

The recipient of the proxy (e.g., management or a group of insurgents waging a proxy contest) **must** vote the proxy as the shareholder has indicated, even if the shareholder has voted the opposite of the way the person who solicited the proxy would like.

**2.5. Revocation of proxies**

Generally, a proxy is **revocable** by the shareholder, even if the proxy itself recites that it is irrevocable.

**Coupled with an interest**

However, if a proxy states that it is irrevocable **and** the proxy is **"coupled with an interest"** then it is **irrevocable**. A proxy is "coupled with an interest" when the recipient of the proxy has a property interest in the shares, or at least some other direct economic interest in how the vote is cast.

**3. IMPLIED PRIVATE ACTIONS UNDER THE PROXY RULES**

**3.1. Generally**

The Supreme Court has recognized an **"implied private right of action"** on behalf of individuals who have been injured by a violation of proxy rules. [J.I. Case Co. v. Borak].

There are THREE requirements, which the plaintiff must satisfy:

**3.1.1. Materiality**

First, the proxy must show that there was a **material misstatement or omission** in the proxy materials. In the case of an omission, the omitted fact is material if it would have "assumed actual significance in the deliberations of a reasonable shareholder."

**3.1.2. Causation**

Second, the proxy must show a **causal link** between the misleading proxy materials and some damage to shareholders. However, the proxy does not have to show that the falsehood or omission directly "caused" the damage to shareholders; he only has to show that the proxy solicitation itself (not the error or omission) was an essential part of the transaction.

If holders have to approve a merger, any material defect in the proxy materials will be deemed to have "caused" damage to the holders, since the entire proxy solicitation process was an essential part of carrying out the merger transaction.

**Minority class whose votes are not needed:** If the proxy is a member of a **minority class** whose votes were **not necessary** for the proposed transaction to go through,the proxy may not recover no matter how material or how intentional the deception in theproxy statement was. [Virginia Bankshares, Inc. v. Sandberg].

**3.1.3. Standard of fault – duty of care**

Third, P must show that D was **at fault** in some way.

**3.1.4. Remedies**

If P makes these three showings, he can get several possible types of relief:

(1) he may be able to get an **injunction** against a proposed transaction (where the proxy solicitation was for the purpose of getting shareholder approval of the transaction, such as a merger);

(2) he may very occasionally have an already-completed transaction **set aside**;

and

(3) he may obtain **damages** for himself and other holders, if he can prove actual monetary injury (e.g., he shows that due to lies in the proxy statement, shareholders approved the sale of the company at an unfairly low price.)

**4. COMMUNICATIONS BY SHAREHOLDERS**

**4.1. Two methods**

A **shareholder** may solicit her fellow shareholders to obtain their proxies in favor of her own proposed slate of directors or her own proposal. Depending on the circumstances, there are two methods for her to do so, in one of which the shareholder bears the expense and in the other of which the corporation bears the expense.

**- Shareholder bears expense:** Under SEC Rule 14a-7, a shareholder who is willing to **bear the expense** of communicating with his fellow shareholders (e.g., printing and postage) has the right to do so. Management must either mail the shareholder’s materials to the other stockholders, or givethe soliciting shareholder a shareholder list so that he can do the mailing directly.

There are very few restrictions on when and how this method is used.

For instance, there is no length limit on the materials the shareholder may mail, and management has no right to censor or object to the contents.

**- Corporation bears expense:** Alternatively, a shareholder may sometimes get a "shareholder proposal" submitted to fellow shareholders entirely at the **corporation’s expense**.

Under SEC Rule 14a-8, shareholder proposals may sometimes be required to be included in management’s own proxy materials.

Example: An activist shareholder may be able to get management’s proxy materials to include the activist’s proposal that the company cease doing business with China.

Many kinds of proposals are **excluded** from Rule 14a-8, so management can refuse to include them. Some of the important exclusions are:

**There is the theory of “Improper subject under state law”:** A proposal may be excluded if "under the law of the [state where the corporation is incorporated, the proposal is] not a proper subject for action by security holders." This usually means that the proposal must be phrased as a **recommendation** by the shareholders that management consider doing something, rather than as an **order** by shareholders that the corporation do something (since under state law shareholders usually cannot order the corporation to do anything).

**b. Not significantly related to corporation’s business:** A proposal may be excluded if it is **not significantly related to the company’s business** (i.e., if it counts for less than 5% of the corporation’s total assets and less than 5% of its earnings and gross sales, and is "not otherwise significantly related to the [corporation’s] business").

Example: A proposal calls for Corp’s widget division to be divested because it has a poor return on equity; if the widget division accounts for less than 5% of Corp’s assets, earnings and sales, the proposal may be excluded.

**Ethical** or **social** issues may usually **not** be excluded for failure to meet these 5% tests, if the issues are otherwise related to the corporation’s business.

Example: The Corporation’s alleged force-feeding of geese to produce pate de foie gras may not be excluded, even though it accounts for less than 5% of earnings, assets and sales.

**c. Routine matters:** A proposal may be excluded if it relates to the **"conduct of the ordinary business operations"** of the company.

Example: A proposal thatthe company charge 10% less for one of its many products would relate toordinary business operations, and thus be excludible.

Proposals concerning **senior executive compensation** are **not** matters relating to the "ordinary businessoperations" of the company, and may therefore not be excluded.

Example: A proposal suggesting that the board cancel any "golden parachute" contracts it has given to senior executives must be included in the proxy materials.)

**d. Election of directors:** A proposal may be excluded if it relates to "the **election of directors**." In other words, a holder who wants to propose his own slate ofdirectors, or to oppose management’s slate, must pay for the dissemination of hisown materials, and may not require the corporation to disseminate for him.

**5. PROXY CONTESTS**

**5.1. Definition**

A "proxy contest" is a competition between management and a group of outside **"insurgents"** to obtain shareholder votes on a proposal. Most proxy contests involve the election of directors, but there can be proxy contests over some non-election proposal as well.

Example: A proxy contest over whether the corporation should adopt a proposed "poison pill" takeover defense.

**5.2. Regulation**

The SEC tightly regulates proxy contests.

**5.2.1. List access**

The SEC rules do not give the insurgent group access to the shareholder’s list. The SEC rules do allow the insurgents to force management to choose between mailing the insurgents’ materials and giving the insurgents the list so that the insurgents can do this themselves.

**5.2.2. Disclosure required**

Both sides must comply with all disclosure regulations. Any "solicitation" (including oral solicitation) is preceded by a **written** proxy statement, and in the case of an election they must file special information about any "participant" in the solicitation.

**CHAPTER 5. THE DUTY OF CARE AND THE BUSINESS JUDGMENT RULE**

**1. NOTION OF DUTY OF CARE**

The law imposes on a director or officer a duty of care with respect to the corporation’s business. The director or officer must behave with that level of care which a reasonable person in similar circumstances would use.

If a director or officer violates this duty of care, and the corporation consequently loses money, the director/officer will be personally liable to pay money damages to the corporation.

If the board of directors has approved a transaction without using due care (and the transaction has not yet been consummated), the court may grant an injunction against the transaction.

It is very rare for directors and officers to be found liable for breach of the duty of due care.

The same duty of care is imposed on both officers and directors. However, what is "reasonable" conduct will often be different for an officer than for an outside director (since the officer normally has a better understanding of the corporation’s affairs).

**2. THE STANDARD OF CARE**

**2.1. Basic standard**

The basic standard is that the director or officer must behave as a reasonably prudent person would behave in similar circumstances.

There is no such thing as an "accommodation" or "dummy" director. If a person sits on a board, he automatically (and non-waivably) bears the burden of acting with due care.

However, liability for breach of the duty of due care is generally imposed only when the director or officer behaves "recklessly" or with "gross negligence."

**2.2. Objective standard**

The standard of care is an objective one: the director is held to the conduct that would be exercised by a "reasonable person" in the director’s position.

So a director who is less smart or less knowledgeable about business than an "ordinary" reasonable director nonetheless must meet this higher objective standard.

On the other hand, if the director has special skills that go beyond what an ordinary director would have, he must use those skills. Thus a trained accountant, lawyer, banker, real estate professional, former business school student etc., if he learns of facts that would make a person in that profession suspicious, must follow through and investigate even though these facts would not make a non-professional suspicious.

**2.3. Reliance on experts and committees**

Directors are generally entitled to rely on experts, on reports prepared by insiders, and on action taken by a committee of the board. But all such reliance is allowed only if it is "reasonable" under the circumstances.

A director may rely on the financial statements prepared by the corporation’s accountants; therefore, unless the director is on notice that the accountants are failing to uncover wrongdoing, the director will not be liable for, say, embezzlement that is not reflected in the financial statements.

**2.4. Passive negligence**

A director will not be liable merely for failing to detect wrongdoing by officers or employees. However, if the director is on notice of facts suggesting wrongdoing, he cannot close his eyes to these facts. Also, in large corporations, it may constitute a violation of due care for the directors not to put into place monitoring mechanisms (e.g., stringent internal accounting controls, and/or an audit committee) to detect wrongdoing.

**2.5. Causation**

In many states, even if a director or officer has violated the duty of due care he is only liable for damages that are the proximate result of his conduct. For instance, if the loss would have happened anyway, even had the directors all behaved with due care, there will be no liability in these courts.

However, other states, including Delaware, allow plaintiff to recover without a showing of causation against a director who violated his duty of care.

**2.6. Joint and several**

If a board member violates his duty of due care, at least some courts hold him jointly and severally liable with all other directors who have violated that duty, so long as the board collectively was a proximate cause of the loss.

**3. THE BUSINESS JUDGMENT RULE**

**3.1. Presentation of the Rule**

The "business judgment rule" saves many actions from being held to be violations of the duty of due care.

1. The duty of due care imposes a fairly stern set of procedural requirements for directors’ actions;

2. Once these procedural requirements are satisfied, the business judgment rule then supplies a much easier-to-satisfy standard with respect to the substance of the business decision.

The business judgment rule basically provides that a substantively-unwise decision by a director or officer will not by itself constitute a lack of due care.

However, there are three requirements which a decision by a director or officer must meet before it will be upheld by application of the business judgment rule:

1. No self-dealing: First, the director or officer will not qualify for the protection of the business judgment rule if he has an "interest" in the transaction. In other words, any self-dealing by the director or officer will deprive him of the rule’s protection.

2. Informed decision: Second, the decision must have been an "informed" one. That is, the director or officer must have gathered at least a reasonable amount of information about the decision before he makes it.

The "gross negligence" standard applies to the issue of whether the decision was an informed one. In other words, even if the director or officer is somewhat (but not grossly) negligent in failing to gather all reasonably available information, he will not lose the benefit of the rule. But if he was grossly negligent, he will lose the protection.

3. "Rational" decision: Finally, the director or officer must have "rationally believed" that his business judgment was in the corporation’s best interest. So the decision does not have to be substantively "reasonable," but it must be at least "rational" (i.e., not totally crazy).

**3.2. Exceptions**

Even where these three requirements for the business judgment rule are satisfied, there are one or two situations where the court may find the rule inapplicable:

1. Illegal: If the act taken or approved by the director or officer is a violation of a criminal statute, the defendant will lose the benefit of the business judgment rule.

Example: The Ds, directors of a major corporation, approve the corporation’s making of illegal political contributions. Held, the directors will not be protected by the business judgment rule, because the transaction in question violated a criminal statute.

2. Pursuit of "social" goals: Some courts may hold the business judgment rule inapplicable if the director is pursuing his own social or political goals (unrelated to the corporation’s welfare). But other courts do not agree.

**CONCLUSION**

Some approaches: Some states have tried to restrict the liability of directors for breaches of the duty of due care.

1. Amendment

Some states allow the shareholders to amend the articles of incorporation to eliminate or reduce directors’ personal liability for violations of the duty of due care (e.g., Delaware § 102(b)(7));

2. Looser standard: Some states have made the standard of care looser, so that only more outrageous conduct will be covered;

3. Limit on money damages: Some states limit the money damages that may be recovered against the officer or director; and

4. Indemnification: Most states now allow the corporation to indemnify directors and officers for liability for breach of the duty of due care.

**Chapter 6. DUTY OF LOYALTY**

**1. SELF-DEALING TRANSACTION**

A "self-dealing transaction" is one in which three conditions are met:

- an officer, director or controlling shareholder and the corporation are on opposite sides of a transaction;

- the Key Player has helped influence the corporation’s decision to enter the transaction; and

- the Key Player’s personal financial interests are at least potentially in conflict with the financial interests of the corporation.

Courts will frequently intervene to strike down (or award damages for) a self-dealing transaction.

In most states, the approach to self-dealing transactions is as follows:

a. Fair: If the transaction is found to be fair to the corporation, the court will uphold it. This is true regardless of whether the transaction was ever approved by disinterested directors or ratified by the shareholders.

b. Waste/fraud: If the transaction is so unfair that it amounts to "waste" or "fraud" against the corporation, the court will usually void it at the request of a stockholder. This is true even though the transaction was approved by a majority of disinterested directors or ratified by the shareholders.

c. Middle ground: If the transaction does not fall into either of the two above categories — it’s not clearly fair, but it’s not so unfair as to amount to waste or fraud — the presence or absence of director approval and/or shareholder ratification will make the difference. If a majority of disinterested and knowledgeable directors have approved the transaction (or if the transaction has been ratified by the shareholders) the court will probably approve the transaction. If neither disinterested-director approval nor shareholder ratification has occurred, the court will probably invalidate the transaction.

There are three different ways that a proponent of a self-dealing transaction can probably avoid invalidation:

- by showing approval by a majority of disinterested directors, after full disclosure;

- by showing ratification by shareholders, after full disclosure; and

- by showing that the transaction was fair when made.

**2. EXCEPTIONS**

**2.1. Disclosure plus board approval**

A transaction may not be avoided by the corporation if it was authorized by a majority of the disinterested directors, after full disclosure of the nature of the conflict and the transaction.

2.1.1. What must be disclosed

Two kinds of information must be disclosed to the board before it approves the transaction: (1) the material facts about the conflict; and (2) the material facts about the transaction.

Example: If D, a director of XYZ Corp, wants to sell XYZ an office building he owns, he must disclose not only the fact that he owns the office building, but also any material facts about the deal, such as whether the price is a fair one in light of current market conditions.

Courts are split about when this disclosure must be made. Some courts require it to be made before the transaction. Others allow it to be "ratified" after the fact (e.g., by a resolution in which the board says that it has no objection to the transaction).

2.1.2. Who is "disinterested" director

The approval must be by a majority of the "disinterested" directors. A director will be "interested" if either: (1) he or an immediate member of his family has a financial interest in the transaction; or (2) he or a family member has a relationship with the other party to the transaction that would reasonably be expected to affect his judgment about the transaction.

2.1.3. Quorum

A quorum for the vote by the disinterested directors merely has to consist of a majority of the disinterested directors, not a majority of the total directors.

**2.2. Immunization of unfairness**

The fact that a majority of the disinterested directors (acting after full disclosure) have approved or ratified the transaction does not necessarily immunize it from attack, if the unfairness is very great. But the existence of such approval/ratification shifts the burden of proof to the person attacking the transaction, and the transaction will only be struck down if the unfairness is so great as to constitute fraud or waste.

**2.3. Disclosure plus shareholder ratification**

A self-dealing transaction will be validated if it is fully disclosed to the shareholders, and then ratified by a majority of them.

The courts are split about whether the ratification must be by a majority of disinterested shareholders, or merely by a majority of all shareholders (including, perhaps, the one who is doing the self-dealing).

Under RMBCA § 8.63, a majority of the disinterested shareholders must approve the transaction.

2.4. Fairness

A self-dealing transaction can be validated by a showing that it is, under all the circumstances, fair to the corporation. Such "overall fairness" will suffice even if the transaction was neither approved by the disinterested directors nor ratified by the shareholders. Fairness is generally determined by the facts as they were known at the time of the transaction.

**3. Indirect conflicts**

A self-dealing transaction will be found not only where the Key Player is directly a party to the transaction, but also where he is indirectly a party, i.e., he owns an equity position in the other party to the transaction. The test is whether the Key Player’s equity participation in the other party is big enough to expect his judgment to be affected.

If the Key Player is merely a director (not a shareholder) of the other party to the transaction, this will usually not make the transaction a self-dealing one unless the transaction is a non-ordinary-course one requiring board approval.

**4. Remedies for violation**

If there has been a violation of the rule against self-dealing, there are two possible remedies.

- Rescission: Normally, the court will rescind the transaction, where this is possible.

- Damages: If because of passage of time or complexity of the transaction it cannot be rescinded, the court will award restitutionary damages. That is, the Key Player will have to pay back to the corporation any benefit he received beyond what was fair.

**5. EXECUTIVE COMPENSATION**

5.1. Business judgment rule

If an officer or director influences a corporation’s decision about his own compensation, this is technically a self-dealing transaction.

However, courts are reluctant to strike down decisions about executive compensation. Such decisions receive the protection of the business judgment rule: the director’s decision will be sustained so long as it is rational, informed, and made in good faith.

5.2. Consideration

In the case of deferred compensation plans, courts sometimes insist that the plan be set up in such a way that an executive will receive the deferred compensation only if he remains with the company. Thus a grant of stock options to all executives (regardless of whether they stay with the company) might be struck down as lacking in consideration.

5.3. Excessive compensation

Even if a compensation scheme has been approved by a majority of the disinterested directors, or ratified by the shareholders, the court may still overturn it if the level of compensation is "excessive" or "unreasonable." That is, the compensation levels must be reasonably related to the value of the services performed by the executive.

1. Few cases: But courts very rarely strike down a compensation plan as excessive. One exception may be where a plan makes use of a formula which is not amended even though conditions change. (Example: If XYZ enacts a formula paying its president 10% of pre-tax profits, and the corporation’s profits increase so much that the president is earning $25 million a year, the court might strike the plan as excessive.)

**III. THE CORPORATE OPPORTUNITY DOCTRINE AND RELATED PROBLEMS**

**A. Competition with corporation**

A director or senior executive may not compete with the corporation, where this competition is likely to harm the corporation. (Example: Corp operates department stores in a particular city. A, B, and C, senior executives of Corp, secretly purchase a controlling interest in another department store in the same city. This is competition which is likely to harm Corp, so A, B, and C are violating their duty of loyalty to Corp.)

1. Approval or ratification: Conduct that would otherwise be prohibited as disloyal competition may be validated by being approved by disinterested directors, or by being ratified by the shareholders. The Key Player must first make full disclosure about the conflict and the competition that he proposes to engage in.

2. Preparation to compete: Usually, courts will find that a Key Player has violated his duty of loyalty even if he just prepares to compete (rather than actually competing) while still in the corporation’s employ. The court often will order the insider to return all salary he earned during the period of preparation.

3. Competition after end of employment: But if the executive first leaves the corporation, and only then begins preparations or actual competition, this does not constitute a violation of the duty of loyalty. (However, the insider may not use the corporation’s trade secrets. Also, the insider will be barred from competing if he has signed a valid non-competition agreement.)

**B. Use of corporate assets**

A Key Player may not use corporate assets if this use either: (1) harms the corporation; or (2) gives the Key Player a financial benefit. "Corporate assets" include not only tangible goods, but also intangibles like information. (Example: D, the president of XYZ, lives rent-free in a house owned by XYZ; this is a violation of the duty of loyalty to XYZ and to its other shareholders.)

1. Approval or payment: Use of the corporate assets will not be a violation of the duty of loyalty if: (1) it is approved by disinterested directors (after full disclosure); (2) it is ratified by shareholders (after full disclosure); or (3) the Key Player pays the fair value for any benefit he has received.

**C. The "corporate opportunity" doctrine**

A director or senior executive may not usurp for himself a business opportunity that is found to "belong" to the corporation. Such an opportunity is said to be a "corporate opportunity."

1. Effect: If the Key Player is found to have taken a "corporate opportunity," the taking is per se wrongful to the corporation, and the corporation may recover damages equal to the loss it has suffered or even the profits it would have made had it been given the chance to pursue the opportunity.

2. Four tests: Four different tests are used (depending on the court) to determine whether an opportunity is a "corporate opportunity":

a. Interest or expectancy: The oldest test is the "interest or expectancy" test. The corporation has an "interest" in an opportunity if it already has some contract right regarding the opportunity. (Example: Corp has a contract to acquire Blackacre; it therefore has an "interest" in Blackacre, so if its president buys Blackacre instead, he has taken a corporate opportunity.) A corporation has an "expectancy" concerning an opportunity if its existing business arrangements have led it to reasonably anticipate being able to take advantage of that opportunity.

b. "Line of business" test: A more popular test is the "line of business" test, under which an opportunity is a "corporate" one if it is "closely related to the corporation’s existing or prospective activities." (Example: ABC bottles Coca-Cola. President buys the then-bankrupt Pepsi-Cola company, and builds it into a successful competitor to Coca-Cola. President has taken a corporate opportunity from ABC under the "line of business" test.)

c. The "fairness" test: Under the "fairness" test, the court measures the overall unfairness, on the particular facts, that would result if the insider took the opportunity for himself.

d. Combination: Some courts adopt a two-step test, under which they combine the "line of business" and "fairness" tests (with the opportunity being found "corporate" only if both the tests are satisfied).

3. Other factors: Regardless of which test is used, here are some factors that courts find important in determining whether an opportunity was a "corporate" one:

a. whether the opportunity was offered to the insider as an individual or as a corporate manager;

b. whether the insider learned of the opportunity while acting in his role as the corporation’s agent;

c. whether the insider used corporate resources to take advantage of the opportunity;

d. whether the opportunity was essential to the corporation’s well being;

e. whether the parties had a reasonable expectation that such opportunities would be regarded as corporate ones;

f. whether the corporation is closely or publicly held (the case for finding a corporate opportunity is stronger in the case of a publicly held corporation);

g. whether the person taking the opportunity is an outside director or a full-time executive (more likely to be a corporate opportunity in the case of a full-time executive); and

h. whether the corporation had the ability to take advantage of the opportunity (but not all courts will use this factor; see below).

4. Who is bound: Generally, courts seem to apply the corporate opportunity doctrine only to directors, full-time employees, and controlling shareholders. Thus a shareholder who has only a non-controlling interest (and who is not a director or employee) will generally not be subjected to the doctrine.

5. Rejection by corporation: If the insider offers the corporation the chance to pursue the opportunity, and the corporation rejects the opportunity by a majority vote of disinterested directors or disinterested shareholders, the insider may pursue the opportunity himself. The insider must make full disclosure about what he proposes to do. (Some but not all courts allow ratification after the fact.)

6. Corporation’s inability to take advantage: Courts are split about whether it is a defense that a corporation would have been unable (for financial or other reasons) to take advantage of the opportunity.

7. Remedies: The usual remedy for the taking of a corporate opportunity is for the court to order the imposition of a constructive trust — the property is treated as if it belonged to the corporation that owned the opportunity. Also, the Key Player may be ordered to account for all profits earned from the opportunity.

**IV. THE SALE OF CONTROL**

**A. Generally**

In some (but not most) situations, the court will prevent a "controlling shareholder» from selling that controlling interest at a premium price.

1. "Control block" defined: A person owns a "controlling interest" if he has the power to use the assets of the corporation however he chooses. . A majority owner will always have a controlling interest. But the converse is not true: a less-than-majority interest will often be controlling (e.g., a 20-40% interest where the remaining ownership is highly dispersed and no other shareholder is as large).

2. Generally allowed: The general rule is that the controlling shareholder may sell his control block for a premium, and may keep the premium for himself.

a. Exceptions: However, there are a number of exceptions (discussed below) to this general rule, including: (1) the "looting" exception; (2) the "sale of vote" exception; and (3) the "diversion of collective opportunity" exception.

**The "looting" exception**

The controlling shareholder may not sell his control block if he knows or suspects that the buyer intends to "loot" the corporation by unlawfully diverting its assets.

1. Mental state: Clearly if the controlling shareholder either knows or strongly suspects that the buyer will loot, he may not sell to him. Also, if Seller recklessly disregards the possibility of looting, the same rule applies. Most, but probably not all, courts would also impose liability where the seller merely "negligently" disregards the likelihood that the buyer will loot.

2. Excessive price: In many courts, excessive price alone will not be enough to necessarily put the seller on notice that the buyer intends to loot. But an excessive price combined with other factors (e.g., the liquid and readily saleable nature of the company’s assets) will be deemed to put the seller on notice.

**The "sale of vote" exception**

The controlling shareholder may not sell for a premium where the sale amounts to a "sale of his vote."

1. Majority stake: If the controlling shareholder owns a majority interest, the "sale of vote" exception will not apply. Thus even if the controlling shareholder specifically agrees that he will ensure that a majority of the board resigns so that the buyer is able to immediately elect his own majority of the board, this will not be deemed to be a sale of vote (since the buyer would eventually get control of the board anyway merely by owning the majority stake).

2. Small stake: If the seller has a very small stake (e.g., less than 20%) in the corporation, and promises to use his influence over the directors to induce them to resign so that the buyer can elect disproportionately many directors, then the "sale of vote" exception is likely to be applied.

3. "Working control": Where the seller has "working control," and promises to deliver the resignations of a majority of directors so that the buyer can receive that working control, courts are split about whether this constitutes a sale of vote.

4. Separate payment: Also, if the contract of sale explicitly provides for a separate payment for the delivery of directors’ resignations and election of the buyer’s nominees to the board, this will be a sale of vote.

**D. Diversion of collective opportunity**

1. Business opportunity: A court may find that the corporation had a business opportunity, and that the controlling shareholder has constructed the sale of his control block in such a way as to deprive the corporation of this business opportunity. If so, the seller will not be allowed to keep the control premium.

2. Seller switches type of deal: If Buyer proposes to buy the entire company, but Seller instead switches the nature of the deal by talking Buyer into buying just Seller’s control block (at a premium), a court may take away Seller’s right to keep the premium, on the grounds that all shareholders deserve the right to participate.

**E. Remedies**

If one of these exceptions applies (so that the seller is not entitled to keep the control premium) there are two remedies which the court may impose:

1. Recovery by corporation: Sometimes, the court will allow the corporation to recover. (But this has the drawback that the purchaser who paid the control premium gets a windfall.)

2. Pro rata recovery: Alternately, the court may award a pro rata recovery, under which the seller repays to the minority shareholders their pro rata part of the control premium (thus avoiding a windfall to the buyer).

**V. OTHER DUTIES OF CONTROLLING SHAREHOLDERS**

**A. Possible general fiduciary duty**

Almost no courts have held that a controlling shareholder owes any kind of general fiduciary duty to the minority shareholders. (A few courts have recognized such a fiduciary duty limited to the case of a close corporation. See, e.g., Donahue v. Rodd Electrotype

1. Jones case: Only one major case seems to say that controlling shareholders have a general fiduciary obligation to minority holders. See Jones v. H.F. Ahmanson & Co.

(controlling shareholders could not form a separate publicly-held holding company for their control block, thus drying up any public market for the minority shares).

**B. Duty of complete disclosure**

When a controlling shareholder or group deals with the non-controlling shareholders, it owes the latter a duty of complete disclosure with respect to the transaction, as a matter of state common law.

Example: Controlling shareholders in ABC give notice of the proposed redemption of a minority block, without telling the minority holders that due to secret developments the minority holders would benefit by exercising certain conversion rights. Held, this failure to give complete disclosure violated the majority’s common law obligation to the minority. See Zahn v. Transamerica Corp.; Speed v. Transamerica Corp.

**C. Parent/subsidiary relations**

When the controlling shareholder is another corporation (the parent/subsidiary context), essentially the same rules apply.

1. Dividends: When the parent corporation controls the parent’s dividend policy, this is in theory self-dealing. But so long as dividends are paid pro rata to all shareholders (including the parent), courts will rarely overturn the subsidiary’s dividend policy even though this was dictated by the needs of the parent.

2. Other types of self-dealing: Other types of self-dealing transactions between parent and subsidiary will be struck down if they are unfair to the minority shareholders of the subsidiary, and were entered into on the subsidiary’s side by a board dominated by directors appointed by the parent. (Example: Subsidiary and Parent agree to a price and terms under which Subsidiary will sell to Parent the oil it produces. If Subsidiary’s board is dominated by directors appointed by Parent, Parent will have to bear the burden of proving that the transaction is fair to Subsidiary and to the minority holders of Subsidiary.)

3. Corporate opportunities: If the parent takes for itself an opportunity that should belong to the subsidiary, the court will apply the "corporate opportunity" doctrine, and void the transaction.

4. Disinterested directors: The parent can avoid liability both for self-dealing transactions and for the taking of corporate opportunities by having the truly disinterested directors of the subsidiary form a special committee which negotiates at arm’s length with the parent on behalf of the subsidiary.

**Chapter 7. INSIDER TRADING**

**I. INTRODUCTION TO INSIDER TRADING**

The term "insider trading" has no precise definition, but basically refers to the buying or selling of stock in a publicly traded company based on material, non-public information about that company.

1. Not all illegal: Not all insider trading (as defined above) is illegal. In general, only insider trading that occurs as a result of someone’s willful breach of a fiduciary duty will be illegal (at least under the federal securities laws, which are the main source of insider trading law). [267]

2. Illustrations: Either buying on undisclosed good news, or selling on undisclosed bad news, can be insider trading (and will often be illegal).

a. Buying before disclosure of good news: Thus if an insider at Oil Corp buys stock at a time when he knows, and the market doesn’t, that Oil Corp has just struck a huge gusher, this is illegal insider trading.

b. Sale before disclosure of bad news: Similarly, if an insider at Oil Corp sells his stock at a time when he knows (and the market does not) that Oil Corp is just about to report an unexpected large loss, this too is illegal insider trading.

3. Harms: The possible harms from insider trading include: (1) harm to the reputation of the corporation whose stock is being insider-traded; (2) harm to market efficiency, because insiders will delay disclosing their information and prices will be "wrong"; (3) harm to the capital markets, because investors will stay away from what they think is a "rigged" market; and (4) harm to company efficiency, because managers may be induced to run their companies in an inefficient manner (but one that produces large insider trading profits). [270]

4. Bodies of law: There are three bodies of law which may be violated by a particular act of insider trading:

a. State common law: A few states impose common-law restrictions on insider trading.

b. 10b-5: The federal SEC Rule 10b-5 prohibits any "fraudulent or manipulative device" in connection with the purchase or sale of security; this has been interpreted to bar most types of insider trading.

c. Short-swing profits: Section 16(b) of the federal Securities Exchange Act makes insiders liable to repay to the corporation all profits they make from "short swing trading profits" (whether based on insider information or not).

Note: Of these three bodies of law, SEC Rule 10b-5 is by far and away the most important limit on insider trading.

**II. STATE COMMON-LAW APPROACHES**

**A. Suit by shareholder**

A shareholder can in theory bring a state common law action against an insider trader for "deceit."

1. Face-to-face: If the insider buys from the outsider in a face-to-face transaction, the rule is that the insider has no duty to disclose material facts (e.g., good news) known to him. So usually, even in this face-to-face situation, the plaintiff outsider will not be able to recover in deceit even though he would not have sold at the price he did had he known the undisclosed good news. But there are some exceptions:

a. Fraud: If the insider knowingly lies or tells a half truth, he will be liable under ordinary deceit principles.

b. Special facts: Many states recognize a "special facts" exception to the general rule that silence cannot constitute deceit. (Example: If the insider seeks out the other party, or makes elaborate attempts to conceal his own identity, the "special facts" doctrine may be employed.)

c. Minority rule: A minority of states impose a more general rule that in face-to-face transactions, the insider has an affirmative obligation to disclose material facts known to him.

2. Garden variety impersonal insider trading: If the insider trading takes place in an impersonal rather than a face-to-face way (i.e., it occurs by means of open-market purchases on the stock market), virtually no states allow the outsider to recover on common-law principles.

**B. Suit by corporation**

A very few states have allowed the corporation to recover against an insider who buys or sells based on undisclosed material information.

1. Diamond case: The best known example is Diamond v. Oreamuno, where the corporation was permitted to recover against the insiders who sold before disclosing bad news; recovery was allowed even though there was no direct tangible harm to the corporation.

2. ALI: The ALI follows the approach of Diamond, by making it an actionable breach of loyalty for the insider to use "material non-public information concerning the corporation" to either cause harm to the corporation, or to secure a pecuniary benefit not available to other shareholders.

**III. SEC RULE 10b-5 AND INSIDER TRADING**

The principal proscription against insider trading is SEC’s Rule 10b-5, enacted pursuant to the Securities Exchange Act of 1934.

1. Text: SEC Rule 10b-5 makes it unlawful: (1) to "employ any device, scheme, or artifice to defraud"; (2) to make any "untrue statement of a material fact or to omit to state a material fact. . . ."; or (3) to engage in any "act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." All three of these types of conduct are forbidden only if they occur "in connection with the purchase or sale of any security." [281]

2. Disclose-or-abstain: The insider does not have an affirmative obligation to disclose the material, non-public information. Rather, he must choose between disclosure and abstaining from trading.

3. Misrepresentation: If an insider makes an affirmative misrepresentation (as opposed to merely omitting to disclose information), he can be liable under 10b-5 even if he does not buy or sell the stock.

4. Nature of violation: Violation of 10b-5 is a crime. Also, the SEC can get an injunction against the conduct. Finally, a private party who has been injured will, if he meets certain procedural requirements, have a private right of action for damages against the insider trader.

5. Private companies: Rule 10b-5 applies to fraud in the purchase or sale of securities in privately-held companies, not just publicly held ones.

**B. Requirements for private right of action**

An outsider injured by insider trading has a right of action for damages under Rule 10b-5, if he can meet certain procedural requirements:

1. Purchaser or seller: P must have been a purchaser or seller of the company’s stock during the time of non-disclosure.

2. Traded on material, non-public info: D must have misstated or omitted a material fact.

3. Special relationship: If the claim is based on insider trading, D must be shown to have had a special relationship with the issuer, based on some kind of fiduciary duty to the issuer.

4. Scienter: D must be shown to have acted with scienter, i.e., he must be shown to have had intent to deceive, manipulate or defraud.

5. Reliance and causation: P must show that he relied on D’s misstatement or omission, and that that misstatement or omission was the proximate cause of his loss. (In cases of silent insider trading rather than misrepresentation, these requirements usually don’t have much effect.)

6. Jurisdiction: There is a federal jurisdictional requirement: D must be shown to have done the fraud or manipulation "by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange." In the case of any publicly-traded security, this requirement will readily be met. But where the fraud consists of deceit in a face-to-face sale of shares, especially shares in a private company, then the jurisdictional requisites may well be lacking.

**C. P as purchaser or seller**

P in a private 10b-5 action must have been either a purchaser or seller of stock in the company to which the misrepresentation or insider trading relates. Blue Chip Stamps v. Manor Drug Stores.

1. Non-sellers: Thus one who already owned shares in the issuer and who decides not to sell because the corporation or its insiders makes an unduly optimistic representation, or fails to disclose negative material, may not sue.

2. Options: Some courts hold that this "purchaser or seller" requirement also means that a plaintiff who buys or sells options on a company’s stock has no standing to sue an insider who trades on the company’s stock.

**D. "Material" non-public fact**

D must be shown to have made a misstatement or omission of a "material" fact.

1. "Material": A fact is "material" if there is a "substantial likelihood that a reasonable shareholder would consider it important" in deciding whether to buy, hold, or sell the stock.

a. Mergers: The fact that the company is engaged in "merger" discussions is not necessarily "material." This is a fact-based question that depends on how far along the negotiations are, whether a specific price is on the table, whether the investment bankers have been brought in, etc.

b. Fact need not be outcome-determinative: To be "material," a fact does not have to be one that, if known to the investor, would have changed the investor’s decision. The "total mix" test means that "a material fact is one that would affect a reasonable investor’s deliberations without necessarily changing her ultimate investment decision."

2. Non-public: If the claim is that D traded silently rather than made a misrepresentation, the omission must be of a non-public fact. But "non-public" is interpreted broadly: even if a fact has been disclosed, say, to a few reporters, it is still non-public (and trading is not allowed) until the investors as a whole have learned of it.

**E. Defendant as insider, knowing tippee or misappropriator**

In the case of silent insider trading, D will not be liable unless he was either an insider, a "tippee," or a "misappropriator." In other words, mere trading while in possession of material non-public information is not by itself enough to make D civilly liable under 10b-5.

1. Insiders: An "insider" is one who obtains information by virtue of his employment with the company whose stock he trades in. One can be an insider even if one is a low-level employee (e.g., a secretary). Also, people who do work on a contract basis for the issuing company (e.g., professionals like accountants and lawyers) can be a "constructive" insider.

2. Knowing tippee: A person will be a "tippee," and will be liable for insider trading, if he knows that the source of his tip has violated a fiduciary obligation to the issuer. Conversely, if the tippee does not know this (or if the insider has not breached any fiduciary obligation), the tippee is not liable.

3. Misappropriator: A "misappropriator" is one who takes information from anyone — especially from a person who is not the issuer — in violation of an express or implied obligation of confidentiality.

**F. Scienter:**

A defendant is liable under 10b-5 only if he acted with scienter, i.e., with intent to deceive, manipulate or defraud. Probably this is met if D makes a misstatement recklessly. (In silent insider trading cases, the scienter requirement means that the defendant must have known that the information to which he had access was material and non-public.)

**G. Causation; reliance:**

1. Misrepresentation: If the case involves affirmative misrepresentation (not just silent insider trading), P will be given the benefit of a presumption that P relied on the misrepresentation and that it caused P’s injury. In other words, because of the fact that the stock market is usually "efficient," D’s misstatement will be presumed to have affected the price at which the plaintiff bought or sold. (Example: D, an insider at XYZ, falsely says, "Profits will be up this quarter." P buys for $20 per share. Profits go down, and the stock drops to $10. The misstatement will be presumed to have affected the market price, and P will be presumed to have relied on the fairness of that price.) But this presumption may be rebutted.

2. Silent insider trading: If the case involves silent insider trading, the requirements of reliance and causation are not very important (and probably are ignored by the courts) so you can safely ignore them.

**H. "Contemporaneous trader’s" right to sue**

In 1988, Congress specifically allowed any insider-trader to be sued civilly by any "contemporaneous trader" who traded in the other direction. The plaintiff can recover his own losses up to the amount of gain achieved, or loss avoided, by the defendant. P does not have to prove that the insider trading "caused" P’s loss. (The statutory provision creating this right of action doesn’t define "insider trading"; that’s left to the courts, as it has always been.)

1. Information not from issuer: This express private right of action applies even though the inside information does not derive from the issuer, but rather, from some third party.

**I. Damages**

If P meets all of these requirements for a private 10b-5 action, there are various ways that the measure of damages might be calculated.

1. Misrepresentation: If D has made a misrepresentation, P generally receives damages that would be needed to put him in the position he would have been in had his trade been delayed until after the misrepresentation was corrected.

2. Silent trading; P is "contemporaneous trader": If D is a silent insider-trader, and P is a "contemporaneous trader," P may recover the lesser of: (1) P’s own losses (probably measured by how much gain P would have made, or how much loss he would have avoided, had the inside information been disclosed before P traded); and (2) D’s gains made, or losses avoided, from the transaction.

3. P is acquirer who has to pay more: If P is an acquirer who as the result of D’s insider trading or tipping in the target’s stock is forced to pay more to acquire the target, P’s liability is probably not limited to the gains made by D.

4. SEC civil penalties: Also, the SEC may recover civil penalties against an insider trader. The SEC may recover a civil penalty of up to three times the profit gained or loss avoided by the insider trader. See ’34 Act, § 21A(a)(3) and 21A(b).

a. "Controlling person’s" liability: Furthermore, as the result of changes made by Congress in 1988 to the Securities Exchange Act, a person or organization who "controls" an insider trader, and carelessly fails to take steps to prevent foreseeable insider trading, may be liable for the same three-fold SEC civil penalties as the insider. (Example: D insider-trades based on information he learned while working as an associate in the mergers and acquisitions department of Law Firm. Law Firm can be liable for three-fold civil penalties if the SEC shows that Law Firm recklessly disregarded the risk that D might insider trade and failed to take reasonable steps to limit this risk of such trading.)

**IV. WHO IS AN "INSIDER" OR "TIPPEE"?**

Remember that only a person who is either an "insider" or a "tippee" is covered by 10b-5.

1. Who is "insider": A person is an "insider" only if he has some sort of fiduciary relationship with the issuer that requires him to keep the non-public information confidential. [310]

2. Who is "tippee": A person is a "tippee" only if: (1) he receives information given to him in breach of the insider’s fiduciary responsibility; (2) he knows that (or, perhaps, should know that) the breach has occurred; and (3) the insider/tipper has received some benefit from the breach (or intended to make a pecuniary gift to the tippee).

**Acquired by chance**: Thus if an outsider acquires information totally by chance, without anyone violating any fiduciary obligation of confidentiality, the outsider may trade with impunity. (Example: The outsider randomly overhears inside information in a restaurant without any fiduciary violation by the speaker or by the outsider.)

**Acquired by diligence**: Similarly, if an outsider acquires non-public information through his own diligence, he may trade upon it. (Example: A security analyst ferrets out non-public information by interviewing former employees and others who when they speak to the analyst are not receiving or intending to confer any pecuniary benefit.)

**Intent to make a gift**: If an insider gives an outsider information with the intent to make a gift of pecuniary value to the outsider, the outsider will be a "tippee," and both insider and outsider will be liable. (Example: A gives an inside stock tip to his mistress, B, with the intent that B be able to make some money by buying the stock. Even though A doesn’t expect or get any profit himself, A and B are both liable under 10b-5.)

**"Constructive" insider**: A person who is given confidential information by the issuer so that he can perform services for the issuer will be a "temporary" or "constructive" insider. Thus an investment banker, accountant, lawyer, or consultant will be a constructive insider (and thus may not trade, or tip others to trade).

**Disclosure between family members**: If the tipper learns information from a close relative, this relationship is not by itself enough to give the tipper a fiduciary responsibility. This is true even if the relative or the relative’s family control the issuer, the information "belongs" to the issuer, and the tipper knows all this.

**Confidential information from other than issuer (the "misappropriation" problem):**

Where an outsider receives confidential information but not from the issuer, the situation is trickier. [

1. Criminal liability under other provisions: Often, trading by the outsider in this situation will constitute mail or wire fraud. This will be the case if the outsider has "misappropriated" the information.

Example: D is a reporter for the Wall Street Journal. He learns that company XYZ will be the subject of a favorable news story in the Journal. He buys XYZ stock. Held, even though D’s information did not come from the issuer (XYZ) he has "misappropriated" it from his employer, so he will be criminally liable under federal wire and/or mail fraud statutes. Carpenter v. U.S.

**2. 10b-5**

There is confusion about whether Rule 10b-5 is violated when the outsider trades based on confidential information from someone other than the issuer.

a. SEC action: Courts are split on whether the SEC may bring a civil or criminal action in this situation, but most courts would probably allow such an action.

b. Civil liability to investors: Even if one who trades on confidential information not derived from the issuer is civilly or criminally liable in an SEC enforcement action, this does not necessarily mean that investors may successfully bring a private damage action against him (in the absence of any statute on point).

c. Suit by acquiring corporation: If the outsider learns the information in breach of his fiduciary obligation to the would-be acquirer of a target, and then trades in the target’s stock, there is a good chance that the acquirer will be able to recover damages against the outsider under 10b-5.

**3. Rule 14e-3**

SEC Rule 14e-3 prohibits trading on non-public information about a tender offer, even if the information comes from the acquirer rather than the target, and even if the information is not obtained in violation of any fiduciary duty. There may be (this is not yet certain) an implied private right of action on behalf of the offeror and/or other investors in the target for a 14e-3 violation.

**One’s own trading plans**: It is not a violation of 10b-5 for one who is about to launch his own tender offer to buy shares on the open market without disclosing his plans. (Example: Raider secretly buys 4% of Target Corp stock on the New York Stock Exchange, without announcing that he plans to institute a tender offer. He then institutes a tender offer at a much higher price. Raider has not violated 10b-5 by his open-market purchases, even though he was concealing the material fact that he would soon be taking an action which would raise the price.)

**V. RULE 10b-5: MISREPRESENTATIONS OR OMISSIONS NOT INVOLVING INSIDER TRADING**

**A. Breach of fiduciary duty**

The fact that an insider has breached his state-law fiduciary duties may occasionally (but rarely) constitute a violation of 10b-5.

**1. Lie to directors**: For instance, if an insider lies to the board of directors and thereby induces them to sell him stock on favorable terms, this would be a 10b-5 violation. (Example: The chief scientist of XYZ Corp falsely tells the board of directors that there have been no new developments, when there has in fact been a major scientific breakthrough that will improve the company’s prospects. The board then issues stock options to the scientist. The scientist will be held to have violated 10b-5, because he violated his state-law duty of disclosure to his corporate employer.)

**2. Breach of duty without misrepresentation**: But if an insider violates his fiduciary duties to the corporation or its shareholders without making a misrepresentation, this will not constitute a 10b-5 violation. In other words, there is no doctrine of "constructive fraud" to trigger a 10b-5 violation. (Example: The controlling shareholder of XYZ Corp carries out a short-form merger on terms that are substantively unfair to the minority stockholders. Even though this violates a controlling shareholder’s fiduciary obligations to the minority shareholder, there will be no 10b-5 violation because there has been no fraud or deception. See Santa Fe Industries v. Green.)

**B. Misrepresentation without trading**: If a corporation or one of its insiders makes a misrepresentation, it/he will be liable even though it/he does not trade in the company’s stock. (Example: D, the president of XYZ, falsely tells the public, "Our profits will be up this quarter." D can be liable under 10b-5 even though he has never bought any XYZ stock.)

1. Scienter: However, remember that D will not be liable for misrepresentation in a 10b-5 suit unless he acted with scienter, i.e., he knew his statement was false or recklessly disregarded the chance that it might be false. That is, D will not be liable for mere negligent misstatement.

**2. Merger discussions**: If a company is a company is engaged in merger discussions, and its insiders knowingly and falsely deny that the discussions are taking place, this may make them liable under 10b-5. (Therefore, they should say, "No comment," instead of falsely denying.)

**3. Fraud by one not associated with issuer**: Even a person not associated with the issuer can commit fraud by knowingly or recklessly making a false statement about the issuer or the issuer’s stock.

**C. Omission by non-trader**

Where the company or an insider simply fails to disclose material inside information that it possesses, it/he will not be liable as long as it/he does not buy or sell company stock. (Example: D Corp signs a huge contract which improves its prospects enormously. It keeps the deal quiet for 10 days. So long as neither the company nor its insiders buys or sells any D Corp stock during this period, no violation of 10b-5 has occurred.)

**Exceptions**: But there are two exceptions to this general rule that there is no duty to disclose:

a. Leaks: If rumors are the result of leaks by the company or its agents, the company probably has an obligation under 10b-5 to correct the misapprehension.

b. Involvement: If the company heavily involves itself with outsiders’ statements about the company, it may thereby assume a duty to correct errors in those outsider’s statements.

**D. Defenses based on plaintiff’s conduct**: In cases involving misrepresentations (rather than silent insider trading), D may have two defenses based on P’s conduct:

1. Due diligence: Under the due diligence defense, if D can show that his own misstatements were contradicted by documents in P’s possession, and that P recklessly failed to read the documents, this will be a defense.

2. In pari delicto defense: Under the in pari delicto defense, if D can show that P’s conduct was at least as culpable as D’s, this may be a defense. Sometimes a tipper will assert this defense when sued by a tippee for having given a misleading tip. However, the defense will rarely succeed in this situation.

V**I. SHORT-SWING TRADING PROFITS AND § 16(b)**

**A. Generally**

Section 16(b) of the Securities Exchange Act of 1934 contains a "bright line" rule by which all "short-swing" trading profits received by insiders must be returned to the company.

1. Gist: The gist of § 16(b) is that if a statutorily-defined insider buys stock in his company and then resells within six months, or sells and then re-purchases within six months, any profits he makes must be returned to the corporate treasury. This rule applies even if the person in fact had no material non-public information.

2. Who is covered: Section 16(b) applies to any "officer," "director," or beneficial owner of more than 10% of any class of the company’s stock. [333]

3. Public companies: Section 16(b) applies only to the insiders of companies which have a class of stock registered with the SEC under § 12 of the ’34 Act. Thus a company’s insiders are covered only if the company either: (1) is listed on a national securities exchange; or (2) has assets greater than $5 million and a class of stock held of record by 500 or more people.

4. Who may sue: Suit may be brought by the corporation or by any shareholder. But any recovery goes into the corporate treasury. (The incentive is to the plaintiff’s lawyer, who gets attorney’s fees out of the recovery.)

a. P must continue to be stockholder: P must not only be a stockholder in the corporation at the time she files suit under 16(b), but she must also continue to be a stockholder as the suit progresses. However, if P is forced to exchange her shares for shares in a different corporation as the result of the target corporation’s merger, P may continue her suit as long as she keeps the shares in the surviving corporation. Gollust v. Mendell.

5. Public filings: To aid enforcement, any officer, director, or 10%-owner must file with the SEC (under 16(a)) a statement showing any change in his ownership of the company’s stock. This must be filed within 10 days after any calendar month in which the level of ownership changes.

**B. Who is insider:**

**1. "Officer**": Two groups of people may be "officers" for § 16(b) purposes: (1) anyone who holds the title of "President," "Vice President," "Secretary," "Treasurer" (or "Principal Financial Officer"), or "Comptroller" (or "Principal Accounting Officer"); (2) anyone (regardless of title) who performs functions that correspond to the functions typically performed by these named persons in other corporations.

**2. "Beneficial owner**": A person is a beneficial owner covered by § 16(b) if he is "directly or indirectly" the beneficial owner of more than 10% of any class of the company’s stock (he need not own 10% of the overall equity).

a. Attribution: Stock listed in A’s name may be attributed to B. A person will generally be regarded as the beneficial owner of securities held in the name of his or her spouse and their minor children (but usually not grown children). Thus a sale by Husband might be matched against a purchase by Wife; similarly, a sale and purchase by Wife might be attributed to Husband if Husband is a director or officer.

**3. Deputization as director**: A corporation may be treated as a "director" of another corporation if the former appoints one of its employees to serve on the latter’s board. (Example: ABC Corp owns a significant minority interest in XYZ Corp. ABC appoints E, its employee, to serve on the board of XYZ. ABC will be deemed to have "deputized" E to serve as director, so ABC will be treated as a constructive director of XYZ, and any short-swing trading profits reaped by ABC in XYZ stock will have to be returned to XYZ.) [337]

**C. When insider status required:**

1. Director or officer at only one end of the swing: If D is a director or officer at the time of either his sale or his purchase of stock, § 16(b) applies to him even though he does not have the status at the other end of the trade.

2. 10% owner: But the same rule does not apply to a 10% owner. A person is caught by the "10% owner" prong only if he has the more-than-10% status at both ends of the swing. [338]

a. Purchase that puts one over: The purchase that puts a person over 10% does not count for § 16(b) purposes. (Example: D has owned 5% of XYZ for a long time. On January 1, he buys another 10%. On February 1, he sells 4%. There are no short-swing profits that must be returned to the company.)

b. Sale that puts one below 10%: In the case of a sale that puts a person below 10% ownership, probably we measure the insider status before the sale. (Example: D already owns 15% of XYZ. He then buys another 10% on January 1. On February 1, he sells 16%. On March 1, he sells the remaining 9%. Probably D has short-swing liability for 16% sale, but not for the second 9%, since we probably measure his insider status as of the moment just before the sale.)

**D. What is a "sale," in the case of a merger**

If the corporation merges into another company (and thus disappears), the insiders will not necessarily be deemed to have made a "sale." D will escape short-swing liability for a merger or other unorthodox transaction if he shows that: (1) the transaction was essentially involuntary; and

(2) the transaction was of a type such that D almost certainly did not have access to inside information.

**E. "Profit" computed**

If there is a covered purchase/sale or sale/purchase, the courts will compute the profit in a way that produces the maximum possible number. In other words, the court takes the shares having the lowest purchase price and matches them against the shares having the highest sale price, ignoring any losses.