

CORPORATIONS

LAW AND POLICY MATERIALS AND PROBLEMS

Second Edition

Lewis D. Solomon
Donald E. Schwartz
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American Casebook Series



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Kuntz, Lowe, Anderson and Smith's Cases and Materials on Oil and Gas Law, 857 pages, 1986, with Forms Manual (Casebook)

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Miller and Davis' Intellectual Property—Patents, Trademarks and Copyright in a Nutshell, 428 pages, 1983 (Text)

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Noel and Phillips' Cases on Products Liability, 2nd Ed., 821 pages, 1982 (Casebook)

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AMERICAN CASEBOOK SERIES



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Preface to the Second Edition

All students and teachers of corporate law realize that there are many valid and varied ways to present the subject. The case method, standing alone, cannot fully encompass the diverse influences which are brought to bear on the field. We believe that a casebook which uses the problem method as an organizing principle is more effective for the task than a more traditional casebook. Using such a method also permits greater use of non-case materials which illuminate the questions which invariably arise in the study of corporate law, regardless of the depth in which such study is undertaken. Thus the emphasis in this edition of the book, as it was in the first edition, is on the development of the skill of learning how to solve problems. Because corporate lawyers most often engage in counseling rather than litigation, we believe that our approach is especially suitable for a course in corporate law. Hopefully, it will also enable the student to appreciate where matters of judgment become paramount.

We appreciate that not all of our colleagues in the field share our view on the use of problems. We respect their approaches and we have designed the book so that it may be used in a more conventional form, making little or no use of the problems. We are aware of many splendid teachers who use the book in precisely that way.

We should also note that while cases do comprise the largest part of the materials, we also have made extensive use of other materials. To integrate problems of public policy, legal ethics, accounting and economic analysis, we rely heavily on non-case material, consisting of secondary sources or our own textual notes. All of these subjects are vital to the understanding of corporate law and its place in our legal, economic, political and cultural system.

We have attempted to address some root problems in learning corporation law in our early chapters. Corporate law professors have found that many of their students lack even a rudimentary understanding of corporations and how they function. The Chesapeake Marine Services problem in Chapter 3 is intended to introduce some of the fundamental concepts of corporate law, including the duty of care and the duty of loyalty; to illustrate judicial attitudes toward the interaction of the common law with a corporate statute; and, perhaps most important, to provide the student with a basic understanding of the overall structure of the corporation. The decision in *First National Bank of Boston v. Bellotti* in Chapter 2 also permits the teacher an opportunity to explore the role of the corporation in society and how it is regulated. Taken together, these early chapters provide an overview

of the entire course, which may be especially helpful for a subject matter so distant from the experience of many students.

Like most of our colleagues, we have found that accounting and financial concepts are among the most foreign to many of our beginning students. Although we neither can nor wish to provide a detailed study of such concepts, we do introduce some basic ideas in the first part of the Precision Tools Corporation problem in Chapter 5. Our intent is to examine what a corporation consists of through a study of a relatively simple balance sheet and income statement. Thereafter, we raise questions as to the value of the enterprise. In this connection, we use a simple parable that professors and practitioners alike tell us has been a helpful instructional tool to novices.

In addition to the material that is familiar to an experienced teacher of corporate law, we have found it desirable to present economics analysis throughout the book. In Chapter 4 we employ a problem, simple in its facts, that calls for an economic analysis of a business enterprise. In basic terms we look at questions of risk-bearing, monitoring and incentives as they affect the parties to the enterprise. The analysis of these questions provides a reference point to which recurrent use may be made. We remind students of that analysis when we study the creation of the financial structure of the corporation, the duties of directors and officers, the governance of the corporation, derivative suits and changes in control. Thus we use the lessons from this early chapter throughout the course. When we reach the study of publicly held corporations, we present additional materials on agency costs, market efficiency and the concept of the corporation as a nexus of contracts among competing interests.

This is not advanced economics material. We do not employ sophisticated graphs or calculus. Rather we seek to present fundamental economic concepts in order to develop in our students a deeper understanding about the nature of the corporation and the role of law and lawyers. Some of the material, particularly in the later chapters, is controversial, and we have provided ample space to the trenchant criticisms of the law and economics viewpoint. Corporate law is increasingly influenced by these ideas; they may have contributed as much to the development of corporate law in recent years as the formal acts of lawmakers. That influence is manifested in actions by courts, legislators and regulators. It is also clear that lawyers in their practice apply the learning from several disciplines solving problems. Some particularly interesting examples of the latter are seen in two provocative articles: Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 Yale L.J. 239 (1984); Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 Yale L.J. 1521(1982).

There is another focus to this book that we have sought to retain: its concern for issues of public policy relating to corporations. All teachers of corporation law understand that this is not a course in corporate mechanics; we are not simply training technicians. Law

students study corporation law, not simply because they intend to practice in that field (some would never dream of doing so) but because all lawyers need to be educated about the phenomenon of the corporation and how the law deals with its impact. All of us constantly raise policy questions with our students: why the law should provide limited liability; why should we delegate enormous powers over other people's money to agents over whom we exercise so little control; why should persons with minimal interests in a corporation be allowed to bring suit in its name; whether our systems of management accountability are adequate; why should insider trading be prohibited; and countless other questions that go to the core of the subject. If anything, we have updated and expanded the materials to assist in this respect.

The second edition reflects the extensive developments that have marked the corporate world during the 1980's. Major changes have occurred in every arena in which corporate law is made: in legislatures, administrative agencies and courts. These changes include important new legislation concerning corporate takeovers and directors' liability, blockbuster cases involving the duty of due care, the duty of loyalty, insider trading, derivative suits and close corporations; and new SEC pronouncements on tender offers and shareholder proposals. It has become increasingly perilous to attempt to capture the field within hard covers. Work on the next supplement to this book will probably begin within weeks after its publication, because we remain dedicated to the task of keeping these materials current. The cutoff date for the materials in the book is May 1, 1988.

The first edition of this book appeared as the American Bar Association was nearing the completion of the Revised Model Business Corporation Act and the American Law Institute was beginning serious deliberation of its Principles of Corporate Governance. The ABA completed the Revised Act in 1984, but the ALI is far from finished. The fate of that project was unclear in 1982, but it is now highly likely that it will achieve a final product, probably in the early 1990's, and that work is bound to influence corporate law makers and lawyers. Both the ABA and the ALI work are featured prominently in this edition, and their further efforts will appear in supplements and ultimately in a third edition.

A corporate law casebook can be written from several perspectives; we have written this book to be helpful primarily to students. We have written many lengthy notes which are designed to provide a fuller understanding of discrete areas, especially where knowledge of the way in which the corporate world operates is needed in order for cases and statutes to make any sense. We have also found that students seek not mere recital of rules, but demand explanations for why things are the way they are and whether they should be that way. Our notes attempt to provide guidance in reaching those explanations. We find ourselves comfortable writing in that environment. While practitioners may also