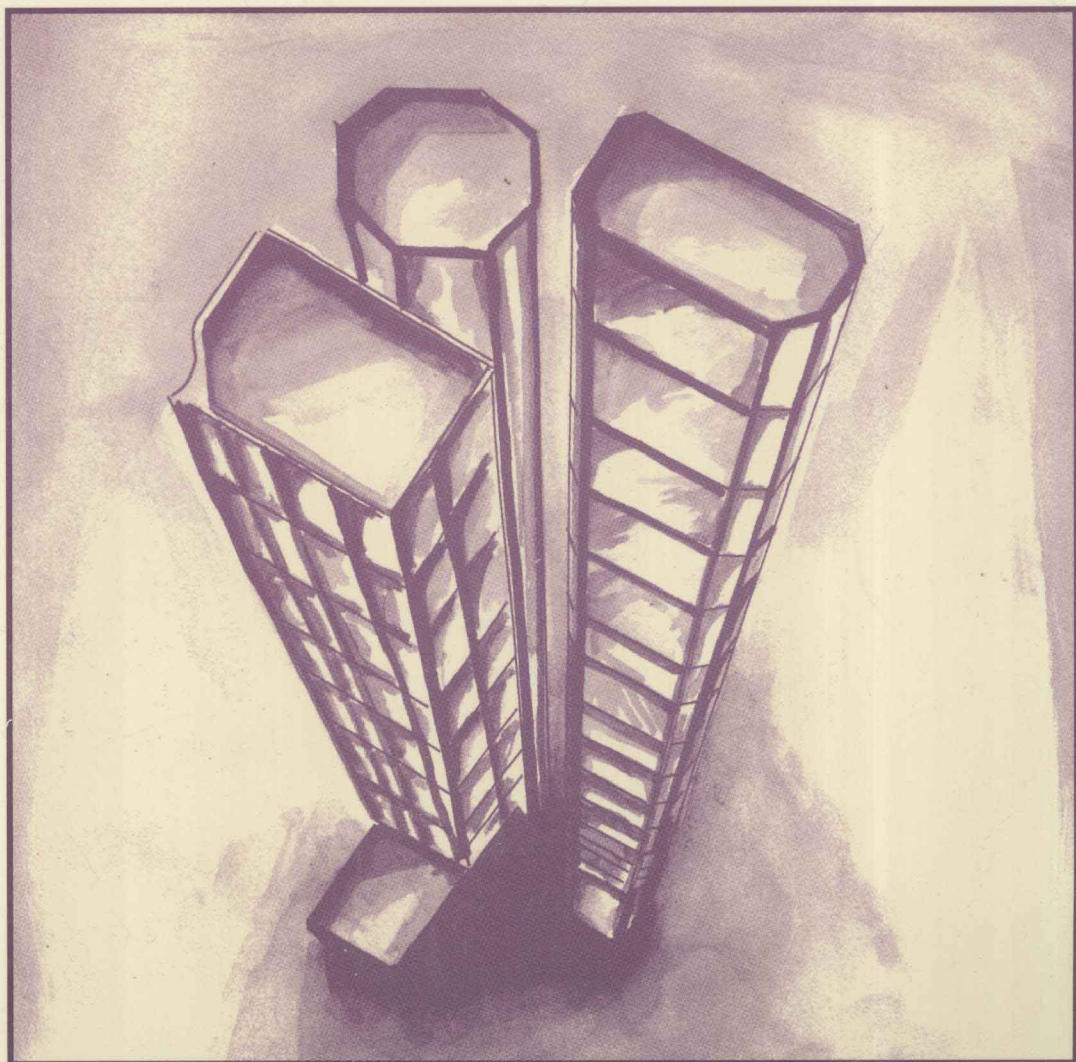


Corporations

Lewis D. Solomon
Alan R. Palmiter



CORPORATIONS

Examples and Explanations *Second Edition*

Lewis D. Solomon

*Professor of Law
George Washington University*

Alan R. Palmiter

*Professor of Law
Wake Forest University*



ASPEN LAW & BUSINESS
Aspen Publishers, Inc.

Copyright © 1994 by Lewis D. Solomon and Alan R. Palmiter

All rights reserved. No part of this book may be reproduced in any form or by any electronic or mechanical means including information storage and retrieval systems without permission in writing from the publisher, except by a reviewer who may quote brief passages in a review.

Library of Congress Catalog Card No. 94-75304

ISBN 0-316-80371-5

Sixth Printing

Second Edition



Published by Aspen Law & Business
Formerly published by Little, Brown & Company

Printed in the United States of America

Preface

For many students corporate law is a cold, uninviting mystery. Notions such as debt/equity ratios, stock markets, bylaws, leveraged buyouts, and cumulative preferred stock cause many to freeze.

In addition to its unfamiliar business setting, corporate law presents a jumble of topics from the first year of law school — some civil procedure, a good dose of contracts and agency, tort concepts in the form of fiduciary rules, a bit of constitutional and property law, and even some criminal law. The methods of analysis are equally varied — pervasive statutory interpretation, heavy case synthesis, moderate regulatory analysis, and goodly policy debates.

Although the corporations casebooks increasingly show sympathy to the student's plight, they often still fail to offer a context: What problems do the statutory rules address? How do the cases fit with the statutes? What are the underlying social and business issues?

This book is meant to help students understand the workings of corporate law and the nature of the legal relationships among the corporate constituents. It covers the areas of the standard corporations and business organizations casebooks but is neither a study outline nor a treatise.

Our purpose is to provide a context for the cases and the statutes and an opportunity for students to probe their own understanding. Textual material offers an analytical framework, and follow-up examples and explanations reinforce and illuminate the text.

Further, the book covers some topics that professors often gloss over in class, such as the ultra vires doctrine, the legal capital regime, the public offering of securities, the common law of insider trading, the disgorgement of short-swing insider profits, merger and appraisal procedures, and federal tender offer regulation.

We have strived to make the book accessible to students without a business background. Students will find that reading the relevant chapter and writing out answers to the questions, before comparing their answers to ours, will go a long way in helping prepare for class and for the exam.

Acknowledgments

We have greatly appreciated the assistance of our students in and out of class. Their questions and comments have inspired much of this book.

We owe special thanks to a cadre of Wake Forest student assistants whose research and editorial suggestions on this second edition were invaluable — in particular, Anne Lee ('94), Brian McGinn ('94), and William Pleasant ('94). We also are indebted to Barbara Rappaport of Little, Brown for her excellent work in moving us through the re-editing process.

Finally, we thank the many professors who have suggested our book to their students, for their many useful comments to us, and for their kind words of encouragement.

Special Notice

To reduce the distraction of citations, the book departs from standard citation form in a number of ways:

1. *Dates.* References to statutory sources and SEC rules are usually undated. All such references are to compilations as of 1993, unless we give a different date.

2. *State statutes.* We abbreviate the citations to corporation statutes:

RMBCA §8.50	Revised Model Business Corporation Act, Section 8.50 (as approved June 1984)
Cal. Corp. §317	California Corporations Code, Section 317
Del. GCL §145	Delaware General Corporation Law, Section 145
N.Y. BCL §721	New York Business Corporation Law, Section 721

3. *State cases.* We cite only to the West regional reporters. An unadorned abbreviation of the state's name means the decision was by the state's highest court. For example, "493 A.2d 946 (Del. 1985)" cites to a decision of the Delaware Supreme Court; "316 A.2d 599 (Del. Ch. 1974)" cites to a decision of the Delaware Chancery Court.

4. *Securities law statutes and rules.* We cite only to the section numbers of the Securities Act of 1933, compiled at 15 U.S.C. §§77a et seq., and the Securities Exchange Act of 1934, compiled at 15 U.S.C. §§78a et seq. Likewise, we cite only to the numbers of the rules promulgated under the 1933 Act, found at 17 C.F.R. §230._____, and under the 1934 Act, found at 17 C.F.R. §240._____.

Contents

<i>Preface</i>	<i>xv</i>
<i>Acknowledgments</i>	<i>xvii</i>
<i>Special Notice</i>	<i>xix</i>

<p>PART ONE <i>Introduction to Corporate Law</i></p>
--

Chapter 1: The Corporation — An Introduction	3
§1.1 Basics of the Corporation	3
§1.2 Sources of Corporate Law	8
§1.3 The Corporation as a Constitutional Entity	10
Chapter 2: Choice of Organizational Form	19
§2.1 The Range of Organizational Choices	19
§2.2 Choosing between a Partnership and a Corporation	21
§2.3 Taxation — A Critical Element in the Choice	24

<p>PART TWO <i>Formation of the Corporation</i></p>

Chapter 3: Incorporation — How and Where	35
§3.1 The Process of Incorporation	35
§3.2 Choosing Where to Incorporate	39
Chapter 4: Corporate Powers — The Rise and Fall of the Ultra Vires Doctrine	45
§4.1 Decline of the Ultra Vires Doctrine	45
§4.2 Modern Ultra Vires Doctrine — A Limited Planning Device	47
§4.3 Distinguishing the Ultra Vires Doctrine from Corporate Duties	47
§4.4 Corporate Largesse and the Ultra Vires Doctrine	48

Chapter 5: The Duties of Promoters	53
§5.1 Promoter's Liability on Preincorporation Contracts	53
§5.2 Liability for Defective Incorporation	60
§5.3 Promoter's Liability for Early Dealings with the Corporation	65
Chapter 6: Piercing the Veil of Limited Liability	69
§6.1 General Rule of Limited Liability	69
§6.2 Traditional Piercing Factors	71
§6.3 Distilling a Principle — Solving the Piercing Conundrum	81
Chapter 7: Statutory Recognition of the Corporate Form	87
§7.1 Statutory Recognition of Corporation	87
§7.2 Equitable Subordination Doctrine	89

<p style="text-align: center;">PART THREE <i>Financial Structure of the Corporation</i></p>

Chapter 8: Capital Structure of the Corporation	95
§8.1 Equity Financing	96
§8.2 Debt Financing	111
§8.3 Choosing a Debt-Equity Mix	114
Chapter 9: Limitations on Corporate Distributions	119
§9.1 Distributions — Transferring Assets to Shareholders	119
§9.2 Limitations on Distributions	121
§9.3 Contractual Limitations on Distributions	129
§9.4 Liability of Directors for Authorizing Illegal Distributions	129
Chapter 10: Federal Regulation of Securities Offerings	139
§10.1 The 1933 Act's Disclosure Mandate	140
§10.2 Exemptions — Tempering the Breadth of §5	141
§10.3 Civil Liability under the 1933 Act	152
§10.4 The Definition of a Security	160

<p style="text-align: center;">PART FOUR <i>The Structure of Corporate Governance</i></p>

Chapter 11: Statutory Model of Corporate Governance	167
§11.1 Basic Elements of the Corporate Governance Structure	168
§11.2 Analyzing the Traditional Model of Corporate Governance	168

Chapter 12: The Corporate Electorate — The Shareholders' Role in Corporate Governance	171
§12.1 The Nature of the Shareholders' Limited Role	171
§12.2 The Mechanics of Shareholders' Meetings	175
Chapter 13: The Center of Corporate Governance — The Board of Directors	181
§13.1 Election of Directors	181
§13.2 Removal of Directors	185
§13.3 Board Decision-Making	186
Chapter 14: The Corporate Bureaucracy — Officers' Authority to Bind the Corporation	195
§14.1 Corporate Authority	195
§14.2 Respondeat Superior — Corporate Liability for Employee Torts	199
<div style="border: 1px solid black; padding: 10px; margin: 20px auto; width: fit-content;"> <p>PART FIVE <i>Management of the Closely Held Corporation</i></p> </div>	
Chapter 15: The Control Dilemma in the Close Corporation — An Introduction	205
§15.1 Special Problems in the Close Corporation	205
§15.2 Planning for the Close Corporation	207
Chapter 16: Control Devices in the Close Corporation	211
§16.1 Supermajority Requirements — Minority Veto Power	211
§16.2 Vote-Pooling Agreements — Shareholder Coalitions	214
§16.3 Voting Trusts — Locking In Shareholders	220
§16.4 Different Classes of Stock — Building Control into the Capital Structure	223
§16.5 Irrevocable Proxies — Voting Power “Coupled with an Interest”	224
§16.6 Transfer Restrictions and Liquidity Rights	231
§16.7 Restraints on Directors' Discretion — Planner Beware!	237
§16.8 Close Corporation Statutes — Certainty and Guidance for the Planner	240
Chapter 17: Dispute Resolution in the Close Corporation	249
§17.1 An Overview	249
§17.2 Judicial Protection of Minority Shareholders	252
§17.3 Deadlocks	258

<p style="text-align: center;">PART SIX <i>Shareholder Action in Public Corporations</i></p>
--

Chapter 18: Shareholders' Role in Publicly Held Corporations	265
§18.1 Shareholder Voting in Public Corporations	265
§18.2 Public Trading of Corporate Securities	269
Chapter 19: Proxy Regulation	275
§19.1 State Proxy Regulation	275
§19.2 Federal Proxy Regulation — An Introduction	277
§19.3 Reach of the SEC Proxy Rules	278
§19.4 Formal Requirements of the SEC Proxy Rules	281
§19.5 Shareholder Initiatives	288
§19.6 Private Action to Challenge Proxy Fraud	297

<p style="text-align: center;">PART SEVEN <i>Fiduciary Duties of Management and Controlling Shareholders</i></p>
--

Chapter 20: Corporate Fiduciary Duties — An Introduction	311
§20.1 The Corporate Fiduciary — A Unique Relationship	312
§20.2 Two Broad Fiduciary Duties — Care and Loyalty	314
§20.3 Fiduciary Duties — Fitting Corporate and Market Realities	316
§20.4 Enforcing Fiduciary Duties	317
Chapter 21: Duty of Care and the Business Judgment Rule	319
§21.1 Standards of Care — General, but Misleading, Guidance	319
§21.2 Business Judgment Rule	321
§21.3 Overcoming the Business Judgment Presumption	323
§21.4 Remedies for Breaching the Duty of Care	332
§21.5 Limitations on Directors' Liability	332
Chapter 22: Duty of Loyalty — Self-Dealing Transactions	343
§22.1 The Danger and Forms of Self-Dealing	344
§22.2 Judicial Suspicion of Self-Dealing Transactions	345
§22.3 The "Fairness" Test	347
§22.4 "Safe Harbors" — Informed Approval by Disinterested Directors or Shareholders	351
§22.5 Remedies for Self-Dealing	353

Chapter 23: Executive Compensation	361
§23.1 Forms of Executive Compensation	361
§23.2 Judicial Review of Executive Compensation	362
§23.3 Directors' Compensation	365
§23.4 Reform Initiatives	365
Chapter 24: Corporate Opportunities and Unfair Competition	369
§24.1 The Corporate Opportunity Doctrine	369
§24.2 Definition of "Corporate Opportunity"	370
§24.3 Corporate Consent and Incapacity	373
§24.4 Competition with the Corporation	374
Chapter 25: Indemnification and Insurance	381
§25.1 Indemnification — Reimbursement by the Corporation	381
§25.2 Insurance	386
Chapter 26: Responsibilities of Controlling Shareholders	395
§26.1 Who Are Controlling Shareholders?	395
§26.2 Dealings between the Corporation and Controlling Shareholders	396
§26.3 Squeeze-out Transactions — Eliminating Minority Interests	399
Chapter 27: Sale of Control	411
§27.1 Sale of Office	411
§27.2 Limitations on Sale of Controlling Stock	411

<p>PART EIGHT <i>Dealings in Securities</i></p>

Chapter 28: Common Law Prohibitions on Insider Trading	423
§28.1 An Introduction to Insider Trading	423
§28.2 State Fiduciary Law on Insider Trading	424
§28.3 Liability to the Corporation for Insider Trading	427
§28.4 Liability for Outsider Trading under State Law	429
Chapter 29: Rule 10b-5	433
§29.1 An Introduction to Rule 10b-5	433
§29.2 Rule 10b-5 — An Overview	435
§29.3 Rule 10b-5 — The Basic Elements	437
§29.4 Limits of Rule 10b-5 — Pruning the Oak	443
§29.5 Rule 10b-5 and Insider Trading	453

Chapter 30: Section 16(b) — Disgorging Short-Swing Profits	465
§30.1 Coverage of §16	465
§30.2 Disgorging Short-Swing Profits under §16(b) — The Mechanical Test	466
§30.3 Special Interpretive Issues	467

<p>PART NINE <i>Shareholder Litigation</i></p>

Chapter 31: Shareholder Litigation	479
§31.1 The Nature of Derivative Litigation	479
§31.2 Distinguishing between Derivative, Direct, and Class Action Suits	482
Chapter 32: Procedural Restrictions on Derivative Litigation	489
§32.1 The Distorted Incentives Created by Derivative Litigation	489
§32.2 Procedural Requirements	490
§32.3 Derivative Litigation in Federal Courts	495
Chapter 33: Dismissal of Derivative Litigation — Finding a Corporate Voice	501
§33.1 The Self-Appointed Derivative Suit Plaintiff	501
§33.2 The Unwieldy Body of Shareholders	502
§33.3 Board of Directors — The Voice of Central Corporate Governance	502
§33.4 Special Litigation Committees	506

<p>PART TEN <i>Organic Changes</i></p>

Chapter 34: Internal Organic Changes — Charter Amendments, Recapitalizations, and Dissolution	517
§34.1 Amendments to Articles of Incorporation	517
§34.2 Dissolution	520
Chapter 35: External Organic Changes — Corporate Combinations	525
§35.1 The Combination Choices — Some Basics	525
§35.2 Mergers and Consolidations	526
§35.3 Sales of Assets	533
§35.4 De Facto Merger and Successor Liability Doctrines	536

Chapter 36: Dissenters' Appraisal Rights	543
§36.1 The Appraisal Remedy — Protection against Majority Tyranny	543
§36.2 The Appraisal Proceeding	545
§36.3 Exclusivity of Appraisal	548

<p>PART ELEVEN <i>Takeover Contests</i></p>

Chapter 37: Takeover Contests — An Introduction	555
§37.1 The Hostile Choices — Proxy Contest or Tender Offer	555
§37.2 A Garden-Variety Takeover Drama	557
§37.3 An Epilogue — Is the Takeover Phenomenon Healthy?	565
Chapter 38: Proxy Contests	569
§38.1 The Insurgent's Uphill Battle in a Proxy Contest	569
§38.2 Federal Regulation of Proxy Contests	570
§38.3 State Fiduciary Regulation of Proxy Contests	571
Chapter 39: Federal Securities Regulation of Tender Offers	579
§39.1 Disclosure of Foothold Position	540
§39.2 Federal Tender Offer Rules	540
§39.3 Standing to Sue for Williams Act Violations	585
Chapter 40: Takeover Defenses	593
§40.1 The Dilemma of Takeover Defenses — The Proper Role of the Target's Board	593
§40.2 State Fiduciary Law — An Evolving Response to the Takeover Dilemma	595
§40.3 The Lurking Question of the Board's Power — A Mild Revival of the Ultra Vires Doctrine	605
§40.4 State Takeover Statutes — Protection for Whom?	611
<i>Index</i>	<i>621</i>

PART ONE

Introduction to Corporate Law

I

The Corporation — An Introduction

What is a “corporation”? There are many answers, some of which you already know from your first year of law school. A corporation is a structuring device for conducting modern business. It is a framework — a legal person — through which a business can enter into contracts, own property, sue in court, and be sued. It is a taxable entity subject to property, sales, income, and other taxes. It can range in size from a one-person business to a multinational conglomerate. It is a capitalist invention for the pooling of capital (from shareholders and lenders), management (from executives), and other factors of production (from suppliers and employees). It is a creature of state law; its formation and existence depend on state enabling statutes.

A “corporation” is an artifice. Nobody (not even your law professor) has ever seen one. A business conducted as a corporation looks much the same as one conducted in a noncorporate form. In the end, a corporation is a construct of the law — a set of legal relationships. It is what the law defines it to be.

In this chapter we consider the principal attributes and constituents of the modern business corporation, the reasons for the corporate form, the purpose and the sources of corporate law, and the status of the corporation as a “person” under the Constitution.

§1.1 Basics of the Corporation

§1.1.1 *Four Basic Attributes*

The paradigmatic corporation has four basic attributes:

Separate existence. The corporation has an independent, perpetual existence. It is an entity distinct from those who contribute capital

(shareholders and lenders) and those who manage the business (directors and officers). The corporation owns the assets of the business and is liable for any business debts.

Centralized management. Management power lies in the board of directors, which often delegates its power to officers. Shareholders elect the directors but cannot control specific board decisions.

Transferability of ownership interests. Shareholders' ownership interests (their shares) are freely transferable.

Limited liability. The corporation is liable for its own debts and obligations but is otherwise a “nonconductor” of liability. The corporation insulates directors, officers, lenders, and shareholders (except to the extent of their investment) from liability.

You should not be surprised to learn that there are exceptions to these tenets. For example, in special circumstances courts may hold shareholders personally liable for corporate debts beyond their investment; lenders may require shareholders to give personal guarantees before they extend credit to the corporation; and, in closely held corporations, shareholders can agree to manage the business and to limit their ability to transfer their stock. Because of this malleability, corporate law places a premium on the lawyer's role as creative planner.

§1.1.2 *Corporate Constituents*

Who is interested in a corporation? We all are. Consider the following range of corporate constituents:

Managers (directors and officers) — business executives who supply their labor (human capital) to run the business.

Shareholders — investors who contribute money in the hope of a return on their investment: discretionary dividends, liquidation rights, and market appreciation. Shareholders can be individual investors or institutions who invest others' money.

Lenders (debtholders) — investors who lend money to the corporation on the promise of interest payments and the repayment of principal. Loans to the corporation can take many forms: secured bank loans, unsecured bonds, short-term notes, suppliers' trade credit.

Employees — those who supply their labor (human capital) to the business, subject to the direction of the corporate managers.

Customers and suppliers — buyers and sellers of goods and services. Some dealings are conducted through long-term contracts and others through market transactions.