

**CORPORATIONS  
LAW AND POLICY  
MATERIALS AND PROBLEMS**  
Sixth Edition

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610 Opperman Drive

P.O. Box 64526

St. Paul, MN 55164-0526

1-800-328-9352

Printed in the United States of America

ISBN-13: 978-0-314-16628-9



TEXT IS PRINTED ON 10% POST  
CONSUMER RECYCLED PAPER



*For Don Schwartz, who inspired us all, with love.*

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# Preface

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This book is an introduction to corporate law and policy. It is not merely about corporate statutes and cases although we include lots of them. This book focuses on important issues of public policy, professional ethics, accounting and economic analysis, and we rely heavily on non-case materials. In short, this book is an introduction to the role of the corporation in society.

The book treats the issues that arise in corporate law through the use of problems. We believe that this organizing principle is more effective in presenting corporation law and policy than a more traditional casebook. Lawyers deal with corporations in whatever their specialized area of practice may be. And because corporate lawyers engage in counseling more than litigation, we believe that our approach is especially suitable for the subject and that it enables students to appreciate where judgment becomes paramount, a skill that all lawyers ultimately should develop. We know that many excellent teachers choose to skip some or all of the problems and we have structured the book to make it easy for them to do so.

The book is divided into eight parts. Part I introduces the basics of corporate law and the themes that are developed throughout the book with increasing depth and sophistication. Chapter 1 uses a simple fact pattern to present 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, questions to which we return throughout the book. Here, we are presenting fundamental economic concepts in order to develop a deeper understanding about the nature of the corporation and the role of law and lawyers.

Chapter 2 addresses the reality that many students lack a basic understanding of corporations and how they function. The chapter identifies some fundamental concepts in corporate law including the duty of care, the business judgment rule and the duty of loyalty. The chapter also illustrates judicial attitudes toward the interaction between the common law and corporate statutes.

Chapter 3 introduces several important concepts arising from the fact that there is no United States corporation statute and that, in our federal system, the choice of the state of incorporation and thus corporate law rests with those who organize the corporation. The materials discuss the internal affairs doctrine which governs the relationship between shareholders and managers as well as the debate over state competition in corporate law. Finally, the chapter provides the first introduction to the regulation of tender offers, focusing on the constitutionality of state anti-takeover statutes.

Chapter 4 discusses the role of the corporation in society, examining the corporation and the Constitution, political expenditures, charitable contributions and the increasingly important corporate social responsibility movement. It also includes important readings on the role of the



lawyer in corporate representation. The materials illustrate the representative nature of the corporate governance system, the centrality of the business judgment rule, the power of managers, and the mechanisms available to shareholders who disagree with managers' actions. Taken as a whole, Part I provides a framework that will allow students to understand better the issues that arise in connection with choosing an organizational form, organizing a corporation, designing a capital structure and allocating power between shareholders and managers—issues that otherwise might seem unrelated.

Part II introduces the student to the issues that arise in connection with the decision to incorporate and in the incorporation process itself. Chapter 5 includes an expanded discussion of limited liability companies and other forms of limited liability business entities. It introduces the basic default rules on formation, limited liability, management and liquidity rights that distinguish different business entities. It also contains a basic description of the tax consequences of the choice of entity.

Chapter 6, in addition to treating the mechanics of the incorporation process, emphasizes the professional ethics issues involved in representing multiple parties in a new business with potentially adverse interests. We believe that a presentation of the ethical problems that lawyers face in corporate practice is essential for students. We introduce some of those problems in this chapter and return to them throughout our later classes.

Part III treats corporate financing. Although some students have a background in business or finance, we direct these materials at those who are coming to the subject for the first time. Chapters 7 and 8 deal with accounting, valuation and corporate finance. Taken together, these chapters show the interplay between a statutory regime, the economics of a business and the needs of the parties in a business venture. Chapter 9 outlines the federal securities law issues relevant to arranging financing for a closely held business. The materials in this chapter are generally treated in much greater detail in a Securities Regulation course but it is important that students have at least an introductory exposure to them here.

Part IV deals with creditor protection. Chapter 10 discusses limited liability and judicial attitudes toward “piercing the corporate veil.” We present a series of cases involving tort creditors, contract creditors and creditors in corporate groups that highlight the seemingly inconsistent results in these cases. Chapter 11 presents materials relating to the rules governing when a corporation is bound by the acts of its officers, agents and employees. It also describes how boards act to bind the corporation and the role of lawyers in giving legal opinions on corporate authority and other matters.

Part V treats the unique problems of the close corporation. We have moved this part from the end of the book back to where it has been in other editions. We have divided the material into two chapters. Chapter 12 deals exclusively with planning questions such as the creation of shareholder voting structures, special management arrangements and liquidity rights for minority shareholders. Chapter 13 discusses issues of oppression and the ability of minority shareholders to seek judicial pro-

tection under various fiduciary and statutory theories. Taken together, the chapters focus on the tension between legal rules and the desire for private ordering and the different approaches courts have taken in resolving conflicts in a close corporation when planning efforts break down.

Part VI explores in greater detail themes relating to corporate governance, corporate structure and the allocation of power between officers, directors and shareholders. Chapter 14 explores these themes in the context of a corporate combination, thus allowing students to become familiar with the basics of mergers and other fundamental transactions which frequently play an important role in the principal cases in succeeding chapters. The chapter also highlights the significance of shareholder voting, particularly for the election of directors, in the structure of corporate governance. It ends with an examination of shareholder inspection rights which have become increasingly important in shareholder voting and litigation.

Chapter 15 presents a detailed discussion of the role of, and rules governing, participation by individual and institutional investors in the governance of publicly held corporations, focusing on the mechanics and collective action problems of public shareholder voting, federal proxy regulation and the shareholder proposal rule. This chapter provides the student with a matrix for the materials in subsequent chapters that deal with fiduciary duties, derivative suit litigation and transactions involving corporate control.

Chapter 16 discusses the corporation's disclosure duties to shareholders which arise under both the federal proxy rules and state law. The chapter explores the elements of such actions, i.e., materiality, reliance, causation, culpability and damages. Chapter 17 addresses the role of outside directors in the public corporation. It summarizes the relevant requirements of the Sarbanes-Oxley Act and the new listing standards of the New York Stock Exchange and NASDAQ. It also discusses the implications for the corporate governance system that arise from Enron and other recent high profile corporate disasters.

Part VII deals with fiduciary duties. Chapter 18 deals with the duty of care and the business judgment rule. It includes the most recent cases discussing directors' duty to monitor and the duty of good faith. This latter duty is in considerable flux and we examine recent cases to explore the relationship between good faith and the traditional fiduciary duties of care and loyalty. The problems in this chapter place the student in the role of an advisor which is the context in which most practicing lawyers confront issues involving the duty of due care.

Chapter 19 addresses the duty of loyalty and includes a problem designed to illuminate the differences between the approaches of the Delaware courts and Model Business Corporation Act with respect to director conflicts of interest. The chapter also presents cases that reflect an evolving standard of director independence. A new Chapter 20 deals exclusively with executive compensation. Recent attention to the subject warrants separate treatment. The chapter examines the nature of executive compensation, the procedures by which such compensation is determined, federal regulation and the evolving judicial treatment of share-

holder challenges to it. The chapter uses the *Disney* litigation to illustrate this last issue.

Chapter 21 consolidates in a single chapter our discussion of the duties of controlling shareholders. It considers those duties as they relate to transactions within corporate groups, cash outs of minority shareholders, and sales of controlling interests. Problems relating to the latter two subjects highlight the critical issues.

Chapter 22 takes a different approach to the topic of shareholder litigation. It introduces students to the possibility of self-serving behavior by plaintiffs' attorneys and suggests that doctrinal developments in this area should be viewed as involving an attempt to mitigate the danger of both management and litigation-related agency costs.

Part VIII deals with shareholder liquidity. Chapter 23 addresses the regulation of insider trading as a matter of both state and federal law. The emphasis in the chapter is on the development of insider trading rules under Rule 10b-5. Chapter 24 covers contests for control through tender offers, proxy contests or both. Rather than focusing on the manner in which such contest are conducted in today's markets, the chapter emphasizes the fundamental governance question of the extent to which shareholders of a target corporation should be free to accept a bid for their shares that the target management opposes. The cases in the chapter treat the evolution of Delaware jurisprudence with respect to that question, including contemporary deal protection cases.

In this edition, we have sought to retain a trademark of the book, namely how issues of public policy relate to corporations. Many teachers of corporation law understand that this is not a course in corporate mechanics and that we are not simply training technicians. Law students study corporate law not simply because they intend to practice in the field (some would never dream of doing so) but because all lawyers need to be educated about the phenomenon of the corporation and the ways in which the law deals with its impact.

We have strived to raise policy questions: why should the law permit limited liability; why should we delegate almost unfettered power over other people's money to managers; to what extent should shareholders play an active role in corporate governance; why should investors with a minimal economic interest in a corporation be allowed to sue in its name; are our systems of management accountability adequate; why should trading by those with inside information be prohibited; and countless other questions that go to the core of the subject.

A corporation law casebook can be written from several perspectives. We have written this book to be helpful primarily to students. We have written many notes 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 sense. We also have found that students seek not mere recitals of rule 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 these explanations. While practitioners and scholars may also find our ap-

proach useful, the reader on whom we have focused our attention is the intelligent novice.

The book is designed to be supplemented by statutory material and legal forms that are available in numerous places. There are several printed collections of the relevant statutes forms and many are also available on different Web sites. The choice of such materials rests with the professor but we believe that it is essential to the use of the book.

We have sought to make the book readable. In editing cases, articles and other materials, we have generally chosen not to signal our edits with ellipses, brackets or other identifying notations. Citations in cases and other materials, as well as footnotes have generally been omitted without so specifying. Numerical footnotes, however, are those of the original source. In a few instances, to aid readability, we have changed the internal order of the materials, again without indicating that we have done so. In the end, we believe that casebooks today are primarily intended as teaching tools rather than research sources. We caution that readers should not quote materials from the book as authoritative but should always consult the original sources. We use the pronoun “she” of “he or she” in most places out of concern for simplicity, not out of bias.

A Teacher’s Manual for this edition is available from the publisher. It contains further details and suggestions as to how an instructor might use the materials and problems in the book.

We owe thanks to many people. The spirit of our late colleague and one of the original authors, Don Schwartz, permeates the entire book. Mitt Regan at Georgetown taught a draft of this edition and made invaluable suggestions as we proceeded. Our prior co-authors have made substantial contributions to what now appears. Colleagues at various law schools, practitioners and judges have been generous with their praise, criticism and suggestions. Our classes acted as crucial guinea pigs in testing an earlier version of this edition. Their comments have assisted us in keeping our focus on our student users and have kept us from making mistakes that otherwise might have gone unnoticed.

Finally, we have had invaluable assistance from student research assistants. Lauren Reynolds, Michele Sacks Fenkel, Shannon German and Ian Wyckoff of Georgetown participated actively in both the research and drafting of several chapters. Without them, our work would have been far more difficult. We are also grateful to Roxanne Birkel at Thomson/West for her considerable help in the production of the book. Without Roxy’s steadfast patience, good humor and keen intelligence under considerable time pressure, it is not an exaggeration to say that this edition could not have been written.

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May 2007

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