

# **BUSINESS ORGANIZATIONS II**

## **Syllabus & Supplementary Materials**

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Room 9107; Office Hours – Tuesday, 4:00-5:00 & Wednesday, 12:00-1:00

### Course Materials

Allen, Kraakman & Subramanian, *Commentaries and Cases on the Law of Business Organization* (Aspen Casebook Series – 4<sup>th</sup> ed. 2012) (“AK&S”)

Allen, Kraakman & Subramanian, 2012-2013 Statutory Supplement

Davis Supplementary Materials (Attached) (“KBD Supp.”)

### Assignment #

## OVERVIEW

### #1. Sources and Structure of Corporate Law

- a. State Corporation Law; Domestic versus Foreign Corporations – AK&S pp. 81-94; KBD Supp. pp. 1-3; Central Metals Problem ¶¶ 1,2; Model Business Corporation Act (“MBCA”) § 15.05; California Corporation Code § 2115
- b. Charter & Bylaws; Exclusive Forum Provisions – AK&S pp. 94-97; KBD Supp. pp. 3-8; Central Metals Problem ¶ 3; Delaware General Corporation Law (“DGCL”) §§ 102, 109; MBCA § 10.20. Also, please look over the Certificate of Incorporation and Bylaws of Twitter, Inc. (KBD Supp. Appendix, following p. 107)

### #2. Levels of Corporate Decision Making

- a. Board of Directors – AK&S pp. 102-111; Badger Labs Problem (KBD Supp. pp. 8-10) ¶¶ 1, 2, 3(a)-(b); DGCL § 141(a)-(c),(f),(g),(i)
- b. Officers – AK&S pp. 111-114; DGCL § 142; Badger Labs Problem ¶ 3(c)

- c. Shareholders – AK&S pp. 153-155; KBD Supp. pp. 10-15; DGCL §§ 109; Badger Labs Problem ¶4

## SHAREHOLDER VOTING & THE PROXY RULES

### #3. Issues under State Law

- a. Shareholder Meetings & Election Contests – KBD Supp. pp. 15-16; AK&S pp. 156-165; 166-168, 188-191; DGCL §§ 109(a), 113, 141(d),(k), 211, 212(b)-(e), 213(a), 214, 216, 220(b), 223, 228(a), 242(b)(1), 275; MBCA §§ 7.02(a), 7.04(a)
- b. Share Voting Rights – AK&S pp. 165-166, 168-187; DGCL §§ 160(c), 212(a), 242(b)(2); MBCA § 10.04

### #4. Federal Proxy Rules

- a. Application of the Securities Exchange Act of 1934 (“1934 Act”) – 1934 Act §§ 12(a),(g)(1), 13(a); KBD Supp. pp. 16-19
- b. Overview and Scope of the Proxy Rules – AK&S pp. 191-194; 1934 Act § 14(a); 1934 Act Rules 14a-1(f),(l), 14a-2(b)(2)
- c. Antifraud Rules; Implied Private Rights; Duty of Candor – AK&S pp. 206-215; KBD Supp. pp. 19-20; 1934 Act Rule 14a-9
- d. Proxy Advisers; Broker Voting – KBD Supp. pp. 20-26; 1934 Act Rule 14a-2(b)(3); Dodd-Frank Act of 2010 (“Dodd-Frank”) § 957
- e. Shareholder Proposals – 1934 Act Rule 14a-8; AK&S pp. 195-196
  - i. Social Responsibility Proposals – AK&S pp. 203-205
  - ii. Corporate Governance Proposals; Challenges to Directors – AK&S pp.194-195, 196-203; KBD Supp. pp 26-31; 1934 Act Rules 14a-1(l)(2)(iv), 14a-2(b)(1), 14a-3, 14a-4(b)(2),(d)(4), 14a-6(a),(b),(g), 14a-7(a),(b),(e), 14a-12; Del §§ 112, 141(b), 216(3), last ¶, 220(b); MBCA §§ 7.28(a), 8.05(b),(e), 10.22

## DUTIES & LIABILITY OF DIRECTORS

- #5. Duty of Care – Business Judgment Rule – AKS pp. 217-220, 227-234, 532-539, 265-268; DGCL § 141(e)
- #6. Duty of Loyalty – Self-Dealing – AKS pp. 276-295; KBD Supp. pp.31-34; DGCL § 144, MBCA §§ 8.60-8.63; ALI Principles of Corporate Governance (“ALI”) § 5.02
- #7. Duty of Loyalty – Corporate Opportunities – AKS pp. 313-316; KBD Supp. pp. 35-40; DGCL § 122(17); ALI § 5.05

#8. Duty of Care – Oversight – AKS pp. 236-265

#9. Indemnification, Insurance and Statutory Immunity – AKS pp. 221-227, 234-236; KBD Supp. pp. 40-41; DGCL §§ 102(b)(7), 145

#10. Good Faith – AKS pp. 310-313, 356-365; DGCL § 102(b)(7)

#### SHAREHOLDER LAWSUITS

#11. Direct vs. Derivative Suits; Policy Debate – AKS pp. 367-379, 414-415; Federal Rule of Civil Procedure 23.1; ALI § 7.01(d)

#12. Pre-Suit Demand – KBD Supp. pp. 41-45; AKS pp. 379-392; MBCA §§ 7.42, 7.43; ALI § 7.03

#13. Special Litigation Committees (“SLCs”) – AKS pp. 392-410; MBCA § 7.44

#14. Settlement – AKS pp. 410-414

#### EXECUTIVE COMPENSATION

#15. Background – AKS pp. 329-343

#16. Judicial Review – AKS pp. 343-356; Sarbanes-Oxley Act of 2002 § 402

#17. Compensation Discussion & Analysis (“CD&A”); Say on Pay – Dodd-Frank §§ 951, 953, 956; Regulation S-K, Item 402; KBD Supp. p. 46

#### TRANSACTIONS IN CONTROL

#18. Duties of Controlling Shareholders – AKS pp. 295-300; ALI § 5.10

#19. Sale of Control Blocks – AKS pp. 417-430

#20. Sale of Office; Looting – KBD Supp. pp. 46-48; AKS pp. 439-443

#21. Variations on the Theme – AKS pp. 432-439; KBD Supp. pp. 48-53

#22. Federal Law Considerations

a. Tender Offers & the Williams Act – AKS pp. 443-445, KBD Supp. pp 53-67, AKS pp. 445-449; 1934 Act §§ 13(d), 14(d),(e); 1934 Act Rules 13d-1(a)-(c), 14d-3, 14d-4(a), 14d-7, 14d-8, 14d-9, 14d-10, 14e-1, 14e-2, 14e-5

b. Hart-Scott-Rodino – AKS pp. 449-451

#### MERGERS & ACQUISITIONS

#23. Background – AKS pp. 453-462

#24. Transaction Structure

- a. Asset Sales – AKS pp. 462-467; DGCL §§ 271, 272; MBCA § 12.02(a)
  - b. Stock Sales; Share Exchanges & Short-From Mergers – AKS pp. 467-468; DGCL § 253; MBCA § 11.03
  - c. Mergers – AKS pp. 469-480; DGCL § 251; KBD Supp. 67-68; MBCA §§ 6.21(f), 10.04, 11.04(f),(g); New York Stock Exchange Listed Company Manual § 312.03
- #25. Protecting Minority Shareholders
- a. Appraisal – AKS pp. 480-487, 300-308; KBD Supp. pp. 68-70; DGCL § 262; MBCA §§ 13.01, 13.02
  - b. De Facto Mergers – AKS pp. 487-491
  - c. Fairness Review – AKS pp. 491-510; KBD Supp. pp. 70-77
  - d. 1934 Act Issues – AKS pp. 630-636; 1934 Act Rules 10b-5, 13e-3

#### CONTESTS FOR CONTROL

- #26. Takeovers & Defenses
- a. Defensive Tactics – AKS pp. 511-532, 275-276; Pennsylvania Business Corporation Law of 1988 § 1715 [KBD Supp. pp. 77-78]
  - b. State Anti-Takeover Statutes – AKS pp. 587-594; KBD Supp. 78-83; AKS pp. 431-432; DGCL § 203
  - c. Recent Developments – AKS pp. 601-605; KBD Supp. pp. 84-87
- #27. The *Revlon* Doctrine & Deal Protection
- a. *Revlon* and Its Progeny – AKS pp. 532-565
  - b. *Lyondell* – AKS pp. 565-574
  - c. Deal Protection – AKS pp. 574-587
  - d. Recent Developments – KBD Supp. pp. 87-92
- #28. Proxy Contests – AKS pp. 594-605; KBD Supp. pp. 92-93

#### INSIDER TRADING

- #29. State Law – AKS pp. 607-618
- #30. Short-Swing Profits – AKS pp. 618-621; 1934 Act § 16(a),(b)
- #31. Policy Debate – AKS pp. 679-684; KBD Supp. pp. 93-94
- #32. Rule 10b-5 – 1934 Act Rule 10b-5

- a. “Classical” Insider Trading – AKS pp. 621-630
- b. Tippees – AKS pp. 636-650; KBD Supp. pp. 95-99
- c. Misappropriation – AKS pp. 650-662, 667-668; KBD Supp. pp. 99-100; 1934 Act Rules 10b5-1, 10b5-2, 14e-3; Regulation FD
- d. Private Recovery; Elements of Liability; – AKS pp. 662-669; KBD Supp. pp. 100-107; AKS pp. 674-679

# **SUPPLEMENTARY MATERIALS**

## **FOREIGN CORPORATIONS**

### **PROBLEM – CENTRAL METALS PROCESSING CORP.**

Central Metals Processing Corp. is a Delaware corporation with its headquarters and factory facilities located in Wisconsin. The majority of its shareholders reside in Wisconsin, Chicago or the Twin Cities.

¶ 1. Does Delaware or Wisconsin law govern the following? (Assume that in each case Delaware imposes fewer restrictions than Wisconsin.)

- a) Voting rights of Central's shareholders.
- b) Fiduciary duty of Central's directors.
- c) Air quality standards applicable to Central's factory.
- d) Employment rights of Central's workers.

¶ 2. Would the answers to any of these issues differ if Central is located in California rather than Wisconsin?

¶ 3. Can Central's bylaws require that suits involving any of the above issues be litigated only in Delaware?

### **MODEL BUSINESS CORPORATION ACT**

#### **Section 15.05. EFFECT OF CERTIFICATE OF AUTHORITY**

(a) A certificate of authority authorizes the foreign corporation to which it is issued to transact business in this state subject, however, to the right of the state to revoke the certificate as provided in this Act.

(b) A foreign corporation with a valid certificate of authority has the same but no greater rights and has the same but no greater privileges as, and except as otherwise provided by this Act is subject to the same duties, restrictions, penalties, and liabilities now or later imposed on, a domestic corporation of like character.

(c) This Act does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state.

*Note*

1. Wisconsin has enacted MBCA § 15.05. In *Beloit Liquidating Trust v. Grade*, 677 N.W.2d 298 (Wis. 2004), the Supreme Court nonetheless held that Wisconsin law governs the issue of whether the directors of a Delaware corporation based in Wisconsin owe a fiduciary duty to corporate creditors.

CALIFORNIA CORPORATION CODE

Section 2115. FOREIGN CORPORATIONS SUBJECT TO CORPORATE LAWS OF STATE;  
TESTS TO DETERMINE SUBJECT CORPORATIONS; LAWS APPLICABLE; TIME OF  
APPLICATION

LEGISLATIVE COMMITTEE COMMENTS—ASSEMBLY 1975

Prior law expressly applies only to corporations which are incorporated in this state subject to a very few exceptions (*e.g.*, provisions relating to indemnification and inspection of records). In general, if a corporation is incorporated in another state it is not required to comply with the General Corporation Law of this state even though all of its shareholders reside in this state and it carries on all of its business within this state. This section requires a foreign corporation with specified minimum contacts in this state to comply with certain provisions of the new law, for the protection of California creditors and shareholders.

This section applies to any foreign corporation (including a foreign parent corporation which does not itself transact intrastate business, but excluding a foreign association) if more than one-half of its business is conducted in California and more than one-half of its outstanding voting securities are held of record by persons residing in this state. Determination of the extent of a foreign corporation's business conducted in California is based on the average of the corporation's property factor, payroll factor and sales factor which are defined in the Revenue and Taxation Code for the purposes of computing the portion of a corporation's income allocable to this state in its franchise tax return. To avoid circumvention of this section, the determination of these factors with respect to any parent corporation must be made on a consolidated basis.

*Notes*

1. Does the U.S. Constitution limit a state's power to impose its laws on the internal affairs of a corporation chartered by a sister state? For example, Article IV, § 1 requires that each state give "Full Faith and Credit" to the acts and judicial proceedings of every other state. As of now, the answer may depend on the state where the issue is litigated. California's courts have consistently upheld section 2115's application to out-of-state corporations and rejected various constitutional challenges. *Kruss v. Booth*, 111 Cal. Rptr. 3d 56, 69-77 (Ct. App. 2010); *Wilson v. Louisiana-Pacific Resources, Inc.*, 187 Cal. Rptr. 852 (Ct. App. 1982). Delaware courts, on the other hand, have relied on traditional choice-of-law principles to hold that

Delaware law, not section 2115, governs the internal affairs of a Delaware corporation. *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005).

2. Subsection (c) of Section 2115, as amended in 2009, provides:

(c) This section does not apply to any corporation (1) with outstanding securities listed on the New York Stock Exchange, the NYSE Amex, the NASDAQ Global Market, or the NASDAQ Capital Market, or (2) if all of its voting shares (other than directors' qualifying shares) are owned directly or indirectly by a corporation or corporations not subject to this section.

BOILERMAKERS LOCAL 154 RETIREMENT FUND v. CHEVRON CORP.

73 A.3d 934

Delaware Court of Chancery, 2013

STRINE, Chancellor.

## I. Introduction

The board of Chevron, the oil and gas major, has adopted a bylaw providing that litigation relating to Chevron's internal affairs should be conducted in Delaware, the state where Chevron is incorporated and whose substantive law Chevron's stockholders know governs the corporation's internal affairs. The board of the logistics company FedEx, which is also incorporated in Delaware and whose internal affairs are also therefore governed by Delaware law, has adopted a similar bylaw providing that the forum for litigation related to FedEx's internal affairs should be the Delaware Court of Chancery. The boards of both companies have been empowered in their certificates of incorporation to adopt bylaws under 8 Del. C. § 109(a).

The plaintiffs, stockholders in Chevron and FedEx, have sued the boards for adopting these "forum selection bylaws." The plaintiffs' complaints are nearly identical and were filed only a few days apart by clients of the same law firm. In Count I, the plaintiffs claim that the bylaws are statutorily invalid because they are beyond the board's authority under the Delaware General Corporation Law ("DGCL"). In Count IV, the plaintiffs allege that the bylaws are contractually invalid, and therefore cannot be enforced like other contractual forum selection clauses under the test adopted by the Supreme Court of the United States in *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972), because they were unilaterally adopted by the Chevron and FedEx boards using their power to make bylaws. . . .

## II. Background and Procedural Posture

### A. The Chevron and FedEx Forum Selection Bylaws

Critical to the resolution of this motion is an understanding of who has the power to adopt, amend, and repeal the bylaws, and what subjects the bylaws may address under the DGCL. 8 Del. C. § 109(a) identifies who has the power to adopt, amend, and repeal the bylaws:



[T]he power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote. . . . Notwithstanding the foregoing, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors. . . . The fact that such power has been so conferred upon the directors . . . shall not divest the stockholders . . . of the power, nor limit their power to adopt, amend or repeal bylaws.

8 Del. C. § 109(b) states the subject matter the bylaws may address:

The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.

Both Chevron's and FedEx's certificates of incorporation conferred on the boards the power to adopt bylaws under 8 Del. C. § 109(a). Thus, all investors who bought stock in the corporations whose forum selection bylaws are at stake knew that (i) the DGCL allows for bylaws to address the subjects identified in 8 Del. C. § 109(b), (ii) the DGCL permits the certificate of incorporation to contain a provision allowing directors to adopt bylaws unilaterally, and (iii) the certificates of incorporation of Chevron and FedEx contained a provision conferring this power on the boards.

Acting consistent with the power conferred to the board in Chevron's certificate of incorporation, the board amended the bylaws and adopted a forum selection bylaw. Generally speaking, a forum selection bylaw is a provision in a corporation's bylaws that designates a forum as the exclusive venue for certain stockholder suits against the corporation, either as an actual or nominal defendant, and its directors and employees. On September 29, 2010, the board of Chevron, a Delaware corporation headquartered in California, adopted a forum selection bylaw that provided:

Unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this [bylaw].

Several months later, on March 14, 2011, the board of FedEx, a Delaware corporation headquartered in Tennessee, adopted a forum selection bylaw identical to Chevron's. Like Chevron, FedEx's board had been authorized by the certificate of incorporation to adopt bylaws without a stockholder vote, and the FedEx board adopted the bylaw unilaterally.

Chevron's board amended its bylaw on March 28, 2012 to provide that suits could be filed in any state or federal court in Delaware with jurisdiction over the subject matter and the

parties. The amended bylaw also provides that the bylaw would not apply unless the court in Delaware had personal jurisdiction over all the parties that were “indispensable” to the action. . .

In their briefing, the boards of Chevron and FedEx state that the forum selection bylaws are in-tended to cover four types of suit, all relating to internal corporate governance:

- *Derivative suits.* The issue of whether a derivative plaintiff is qualified to sue on behalf of the corporation and whether that derivative plaintiff has or is excused from making demand on the board is a matter of corporate governance, because it goes to the very nature of who may speak for the corporation.
- *Fiduciary duty suits.* The law of fiduciary duties regulates the relationships between directors, officers, the corporation, and its stockholders.
- *D.G.C.L. suits.* The Delaware General Corporation Law provides the underpinning framework for all Delaware corporations. That statute goes to the core of how such corporations are governed.
- *Internal affairs suits.* As the U.S. Supreme Court has explained, “internal affairs,” in the context of corporate law, are those “matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders.”

That is, the description of the forum selection bylaws by the Chevron and FedEx boards is consistent with what the plain language of the bylaws suggests: that these bylaws are not intended to regulate *what* suits may be brought against the corporations, only *where* internal governance suits may be brought.

#### B. The Defendant Boards Have Identified Multiforum Litigation over Single Corporate Transactions or Decisions as the Reason Why They Adopted the Bylaws

The Chevron and FedEx boards say that they have adopted forum selection bylaws in response to corporations being subject to litigation over a single transaction or a board decision in more than one forum simultaneously, so-called “multiforum litigation.” The defendants’ opening brief argues that the boards adopted the forum selection bylaws to address what they perceive to be the inefficient costs of defending against the same claim in multiple courts at one time. The brief describes how, for jurisdictional purposes, a corporation is a citizen both of the state where it is incorporated and of the state where it has its principal place of business. Because a corporation need not be, and frequently is not, headquartered in the state where it is incorporated, a corporation may be subject to personal jurisdiction as a defendant in a suit involving corporate governance matters in two states. Therefore, any act that the corporation or its directors undertake is potentially subject to litigation in at least two states. Furthermore, both state and federal courts may have jurisdiction over the claims against the corporation. The result is that any act that the corporation or its directors undertake may be challenged in various forums within those states simultaneously. The boards of Chevron and FedEx argue that multiforum litigation, when it is brought by dispersed stockholders in different forums, directly or derivatively, to challenge a single corporate action, imposes high costs on the corporations and hurts investors by causing needless costs that are ultimately born by stockholders, and that these costs are not justified by rational benefits for stockholders from multiforum filings.

Thus, the boards of Chevron and FedEx claim to have tried to minimize or eliminate the risk of what they view as wasteful duplicative litigation by adopting the forum selection bylaws. Chevron and FedEx are not the only boards to have recently unilaterally adopted these clauses: in the last three years, over 250 publicly traded corporations have adopted such provisions.

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#### IV. Legal Analysis

##### A. The Board-Adopted Forum Selection Bylaws Are Statutorily Valid

###### *1. The Forum Selection Bylaws Regulate a Proper Subject Matter under 8 Del. C. § 109(b)*

Having challenged whether the bylaws are authorized by 8 Del. C. § 109(b), the plaintiffs have to confront the broad subjects that § 109(b) permits bylaws to address. The DGCL provides that bylaws may address any subject, “not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.” . . .

Perhaps recognizing the weakness of any argument that the forum selection bylaws fall outside the plain language of 8 Del. C. § 109(b), the plaintiffs try to argue that judicial gloss put on the language of the statute renders the bylaws facially invalid. The plaintiffs contend that the bylaws do not regulate permissible subject matters under 8 Del. C. § 109(b), because they attempt to regulate an “external” matter, as opposed to, an “internal” matter of corporate governance. The plaintiffs attempt to support this argument with a claim that traditionally there have only been three appropriate subject matters of bylaws: stockholder meetings, the board of directors and its committees, and officerships.

But even if one assumes that judicial statements could limit the plain statutory words in the way the plaintiffs claim (which is dubious), the judicial decisions do not aid the plaintiffs. The plaintiffs take a cramped view of the proper subject matter of by-laws. The bylaws of Delaware corporations have a “procedural, process-oriented nature.” . . . The forum selection bylaws here fit this description. They are process-oriented, because they regulate *where* stockholders may file suit, not *whether* the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation. The bylaws also clearly address cases of the kind that address “the business of the corporation, the conduct of its affairs, and . . . the rights or powers of its stockholders, directors, officers or employees,” because they govern where internal affairs cases governed by state corporate law may be heard. These are the kind of claims most central to the relationship between those who manage the corporation and the corporation’s stockholders.

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###### *2. The Board-Adopted Bylaws Are Not Contractually Invalid As Forum Selection Clauses Because They Were Adopted Unilaterally by the Board*

Despite the contractual nature of the stockholders’ relationship with the corporation under our law, the plaintiffs argue, in Count IV of their complaints, that the forum selection

bylaws by their nature are different and cannot be adopted by the board unilaterally. The plaintiffs' argument is grounded in the contention that a board-adopted forum selection bylaw cannot be a *contractual* forum selection clause because the stockholders do not vote in advance of its adoption to approve it. . . . The plaintiffs argue that this method of adopting a forum selection clause is invalid as a matter of contract law, because it does not require the assent of the stockholders who will be affected by it.

By this artificial bifurcation, the plaintiffs misapprehend fundamental principles of Delaware corporate law. Our corporate law has long rejected the so-called "vested rights" doctrine. . . .

In an unbroken line of decisions dating back several generations, our Supreme Court has made clear that the bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders. Stockholders are on notice that, as to those subjects that are subject of regulation by bylaw under 8 Del. C. § 109(b), the board itself may act unilaterally to adopt bylaws addressing those subjects. Such a change by the board is not extra-contractual simply because the board acts unilaterally; rather it is the kind of change that the over-arching statutory and contractual regime the stockholders buy into explicitly allows the board to make on its own. . . . Accordingly, the conclusion reached by the United States District Court for the Northern District of California in *Galaviz v. Berg*, 763 F. Supp. 2d 1170, 1174 (N.D. Cal. 2011), a case on which the plaintiffs rely heavily – that board-adopted bylaws are not like other contracts because they lack the stockholders' assent – rests on a failure to appreciate the contractual framework established by the DGCL for Delaware corporations and their stockholders.

Even so, the statutory regime provides protections for the stockholders, through the indefeasible right of the stockholders to adopt and amend bylaws themselves. . . . Thus, even though a board may, as is the case here, be granted authority to adopt bylaws, stockholders can check that authority by repealing board-adopted bylaws. And, of course, because the DGCL gives stockholders an annual opportunity to elect directors, stockholders have a potent tool to discipline boards who refuse to accede to a stockholder vote repealing a forum selection clause. . . .

. . . [T]he bylaws will also be subject to scrutiny under the principles for evaluating contractual forum selection clauses established by the Supreme Court of the United States in *The Bremen v. Zapata Off-Shore Co.*, and adopted by our Supreme Court. In *Bremen*, the Court held that forum selection clauses are valid provided that they are "unaffected by fraud, undue influence, or overweening bargaining power," and that the provisions "should be enforced unless enforcement is shown by the resisting party to be 'unreasonable.'" In *Ingres Corp. v. CA, Inc.*, 8 A.3d 1143, 1146 (Del. 2010), our Supreme Court explicitly adopted this ruling, and held not only that forum selection clauses are presumptively enforceable, but also that such clauses are subject to as-applied review under *Bremen* in real-world situations to ensure that they are not used "unreasonabl[y] and unjust[ly]." The forum selection bylaws will therefore be construed like any other contractual forum selection clause and are considered presumptively, but not necessarily, situationally enforceable.

. . . .

B. The Plaintiffs' Parade of Horribles Are Not Facial Challenges to The Bylaws and Do Not Make the Bylaws Inconsistent with Law

. . . [I]f a plaintiff believes that a forum selection clause cannot be equitably enforced in a particular situation, the plaintiff may sue in her preferred forum and respond to the defendant's motion to dismiss for improper venue by arguing that, under *Bremen*, the forum selection clause should not be respected because its application would be unreasonable. The plaintiff may also argue that, under *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971), the forum selection clause should not be enforced because the bylaw was being used for improper purposes inconsistent with the directors' fiduciary duties. . . .

Review under *Bremen* and its progeny is genuine, not toothless. Indeed, the *Bremen* doctrine exists precisely to ensure that facially valid forum selection clauses are not used in an unreasonable manner in particular circumstances. . . .

. . . .

V. Conclusion

For these reasons, the court finds that the challenged bylaws are statutorily valid under 8 Del. C. § 109(b), and are contractually valid and enforceable as forum selection clauses. Judgment is entered for the defendants dismissing Counts I and IV of the plaintiffs' complaints against Chevron and FedEx, with prejudice. IT IS SO ORDERED.

**BADGER LABS**

¶ 1. Golden Gate Capital, a venture capital fund based in San Francisco, has agreed to invest \$50 million in Badger Laboratories Corp., a Madison-based firm incorporated in Delaware and engaged in biochemistry research. Badger was formed two years earlier by Dr. Georgia Szell, its CEO, a former University professor and some of her assistants. The deal calls for Golden Gate to receive 25 percent of Badger's voting stock and two seats on Badger's seven-person board of directors. Cary Kash is president of Golden Gate and has several practical questions about his company's participation in the meetings of Badger's board.

Some of the answers depend upon the content of Badger's charter and bylaws. You may assume that those documents contain the same provisions as those of Twitter, Inc., set forth in the Appendix.

- a. When and where does Badger's board of directors meet?
- b. What does it mean to say that Golden Gate has two board seats? May it designate different representatives to fill those seats on a meeting-by-meeting basis?
- c. Suppose that one of Golden Gate's representatives is unable to attend a particular meeting. May the other representative attend the meeting and cast the absent director's vote by proxy?

d. May the Golden Gate representatives elect to remain in San Francisco but cast their votes at the meeting by mail, fax or telephone?

e. Is there any other way that Golden Gate can cast its two votes without requiring both of its representatives to travel to the meeting?

¶ 2. It is now two years after the original Golden Gate investment in Badger. A dispute has been building between Szell and Kash over the company's direction. Szell prefers to continue Badger's focus on pure research for the immediate future, while Kash, anxious to see a return on Golden Gate's investment, believes the company should begin developing practical applications as soon as possible. The controversy has ripened because of Szell's plan to enter into a contract for new laboratory facilities, equipment and staff that will require an outlay of \$15 million over the next year. Szell has learned that Kash has been talking to some of the other directors about opposing the contract and putting a cap on Badger's annual research budget, which until now has been left to Szell's discretion.

a. Szell knows that Kash and the other Golden Gate representative will be in Tokyo for the next two weeks attending an international conference. The next regular meeting of the Badger board is not for several months, but Szell wonders whether she can schedule a special meeting on short notice, to be held while Kash and his colleague are in Tokyo. Who can call such a meeting and on what notice? Is the attendance of the two Golden Gate directors necessary for a valid meeting?

b. Two of Badger's original directors, Swing and Sway, have been influenced by Kash's concerns and are inclined to take his side. If a board meeting is held while the two Golden Gate representatives are in Tokyo, can Swing and Sway block adoption of Szell's proposals by voting against them? May Swing and Sway boycott the meeting in order to preclude the board from taking action pending Kash's return?

c. Suppose that Szell foresaw Swing's and Sway's possible opposition. When she calls the special meeting, is she required to inform them of her agenda? What happens if Swing and Sway, upon learning of Szell's proposals for the first time at the meeting, choose to walk out?

d. Can Szell avoid a meeting of the board altogether by contacting each director individually and obtaining his or her consent to the proposals. Szell believes that if she can deal with Swing and Sway one on one, she can convince at least one of them to support her, and thereby obtain the approval of at least four – that is, a majority – of the directors. Would these approvals constitute valid board adoption of the proposals?

¶ 3. Are there ways that Szell may bypass the full board of directors and nonetheless obtain valid corporate approval of the \$5 million research contract?

a. Suppose that the board of directors had earlier appointed an Executive Committee, composed of Szell and other directors who were also full-time employees loyal to her. Would such a committee have the authority to approve the contract?

b. Can Szell refer the contract directly to the shareholders for approval?

c. May Szell enter into the contract in her capacity as CEO of the corporation, without requiring board approval?

¶ 4. Kash has heard rumors that Badger plans to donate corporate funds to several organizations that Kash regards as Szell’s “pet” charities and political causes. Kash believes that other large shareholders would join Golden Gate in opposing these expenditures.

a. Can the shareholders adopt a valid bylaw prohibiting the corporation from taking any action that would have violated Section 203 of the Bipartisan Campaign Reform Act of 2002, had that section not been invalidated by the Supreme Court in the *Citizens United* case?

b. What about a bylaw requiring unanimous board approval for any charitable or political contribution in excess of \$10,000?

## SHAREHOLDER-ADOPTED BYLAWS

CA, INC. v. AFSCME EMPLOYEES PENSION PLAN

953 A.2d 227

Supreme Court of Delaware, 2008

JACOBS, Justice.

This proceeding arises from a certification by the United States Securities and Exchange Commission (the “SEC”), to this Court . . . . On June 27, 2008, the SEC asked this Court to address two questions of Delaware law regarding a proposed stockholder bylaw submitted by the AFSCME Employees Pension Plan (“AFSCME”) for inclusion in the proxy materials of CA, Inc. (“CA” or the “Company”) for CA’s 2008 annual stockholders’ meeting.

### I. FACTS

CA is a Delaware corporation whose board of directors consists of twelve persons, all of whom sit for reelection each year. CA’s annual meeting of stockholders is scheduled to be held on September 9, 2008. CA intends to file its definitive proxy materials with the SEC on or about July 24, 2008 in connection with that meeting.

AFSCME, a CA stockholder, is associated with the American Federation of State, County and Municipal Employees. On March 13, 2008, AFSCME submitted a proposed stockholder bylaw (the “Bylaw” or “proposed Bylaw”) for inclusion in the Company’s proxy materials for its 2008 annual meeting of stockholders. The Bylaw, if adopted by CA stockholders, would amend the Company’s bylaws to provide as follows:

RESOLVED, that pursuant to section 109 of the Delaware General Corporation Law and Article IX of the bylaws of CA, Inc., stockholders of CA hereby amend the bylaws to add the following Section 14 to Article II:

The board of directors shall cause the corporation to reimburse a stockholder or group of stockholders (together, the “Nominator”) for reasonable expenses (“Expenses”) incurred in connection with nominating one or more candidates in a contested election of directors to the corporation's board of directors, including, without limitation, printing, mailing, legal, solicitation, travel, advertising and public relations expenses, so long as (a) the election of fewer than 50% of the directors to be elected is contested in the election, (b) one or more candidates nominated by the Nominator are elected to the corporation’s board of directors, (c) stockholders are not permitted to cumulate their votes for directors, and (d) the election occurred, and the Expenses were incurred, after this bylaw’s adoption. The amount paid to a Nominator under this bylaw in respect of a contested election shall not exceed the amount expended by the corporation in connection with such election.

CA’s current bylaws and Certificate of Incorporation have no provision that specifically addresses the reimbursement of proxy expenses.

It is undisputed that the decision whether to reimburse election expenses is presently vested in the discretion of CA’s board of directors, subject to their fiduciary duties and applicable Delaware law.

....

## II. THE CERTIFIED QUESTIONS

The two questions certified to us by the SEC are as follows:

1. Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law?
2. Would the AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?

## III. THE FIRST QUESTION

### A. Preliminary Comments

The first question presented is whether the Bylaw is a proper subject for shareholder action, more precisely, whether the Bylaw may be proposed and enacted by shareholders without the concurrence of the Company’s board of directors.

Pursuant to Section 109(a), CA’s Certificate of Incorporation confers the power to adopt, amend or repeal the bylaws upon the Company's board of directors. Because the statute commands that that conferral “shall not divest the stockholders . . . of . . . nor limit” their power, both the board and the shareholders of CA, independently and concurrently, possess the power to adopt, amend and repeal the bylaws.

[T]he vesting of that concurrent power in both the board and the shareholders raises the issue of whether the stockholders’ power is coextensive with that of the board, and vice versa. . . .



[B]y its terms Section 109(a) vests in the shareholders a power to adopt, amend or repeal bylaws that is legally sacrosanct, *i.e.*, the power cannot be non-consensually eliminated or limited by anyone other than the legislature itself. If viewed in isolation, Section 109(a) could be read to make the board's and the shareholders' power to adopt, amend or repeal bylaws identical and coextensive, but Section 109(a) does not exist in a vacuum. It must be read together with 8 Del. C. § 141(a), which pertinently provides that:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.

No such broad management power is statutorily allocated to the shareholders. Indeed, it is well-established that stockholders of a corporation subject to the DGCL may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation. Therefore, the shareholders' statutory power to adopt, amend or repeal bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a).

[I]t follows that, to decide whether the Bylaw proposed by AFSCME is a proper subject for shareholder action under Delaware law, we must first determine: (1) the scope or reach of the shareholders' power to adopt, alter or repeal the bylaws of a Delaware corporation, and then (2) whether the Bylaw at issue here falls within that permissible scope. Where, as here, the proposed bylaw is one that limits director authority, that is an elusively difficult task. As one noted scholar has put it, "the efforts to distinguish by-laws that permissibly limit director authority from by-laws that impermissibly do so have failed to provide a coherent analytical structure, and the pertinent statutes provide no guidelines for distinction at all." The tools that are available to this Court to answer those questions are other provisions of the DGCL and Delaware judicial decisions that can be brought to bear on this question.

## B. Analysis

### 1.

Two other provisions of the DGCL, 8 Del. C. §§ 109(b) and 102(b)(1), bear importantly on the first question and form the basis of contentions advanced by each side.

AFSCME relies heavily upon the language of Section 109(b), which permits the bylaws of a corporation to contain "any provision . . . relating to the . . . rights or powers of its stockholders [and] directors. . . ." The Bylaw, AFSCME argues, "relates to" the right of the stockholders meaningfully to participate in the process of electing directors, a right that necessarily "includes the right to nominate an opposing slate."

CA argues, in response, that Section 109(b) is not dispositive, because it cannot be read in isolation from, and without regard to, Section 102(b)(1). CA's argument runs as follows: the Bylaw would limit the substantive decision-making authority of CA's board to decide whether or not to expend corporate funds for a particular purpose, here, reimbursing director election expenses. Section 102(b)(1) contemplates that any provision that limits the broad statutory

power of the directors must be contained in the certificate of incorporation. Therefore, the proposed Bylaw can only be in CA's Certificate of Incorporation, as distinguished from its bylaws. Accordingly, the proposed bylaw falls outside the universe of permissible bylaws authorized by Section 109(b).

Implicit in CA's argument is the premise that *any* bylaw that in *any* respect might be viewed as limiting or restricting the power of the board of directors automatically falls outside the scope of permissible bylaws. That simply cannot be. That reasoning, taken to its logical extreme, would result in eliminating altogether the shareholders' statutory right to adopt, amend or repeal bylaws. Bylaws, by their very nature, set down rules and procedures that bind a corporation's board and its shareholders. . . . Therefore, to argue that the Bylaw at issue here limits the board's power to manage the business and affairs of the Company only begins, but cannot end, the analysis needed to decide whether the Bylaw is a proper subject for shareholder action. The question left unanswered is what is the scope of shareholder action that Section 109(b) permits yet does not improperly intrude upon the directors' power to manage corporation's business and affairs under Section 141(a).

. . . To resolve that issue, the Court must resort to different tools, namely, decisions of this Court and of the Court of Chancery that bear on this question. Those tools do not enable us to articulate with doctrinal exactitude a bright line that divides those bylaws that shareholders may unilaterally adopt under Section 109(b) from those which they may not under Section 141(a). They do, however, enable us to decide the issue presented in this specific case.

## 2.

It is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.

Traditionally, the bylaws have been the corporate instrument used to set forth the rules by which the corporate board conducts its business. To this end, the DGCL is replete with specific provisions authorizing the bylaws to establish the procedures through which board and committee action is taken.

Examples of the procedural, process-oriented nature of bylaws are found in both the DGCL and the case law. For example, 8 Del. C. § 141(b) authorizes bylaws that fix the number of directors on the board, the number of directors required for a quorum (with certain limitations), and the vote requirements for board action. 8 Del. C. § 141(f) authorizes bylaws that preclude board action without a meeting. And, almost three decades ago this Court upheld a shareholder-enacted bylaw requiring unanimous board attendance and board approval for any board action, and unanimous ratification of any committee action. Such purely procedural bylaws do not improperly encroach upon the board's managerial authority under Section 141(a).

The process-creating function of bylaws provides a starting point to address the Bylaw at issue. It enables us to frame the issue in terms of whether the Bylaw is one that establishes or regulates a process for substantive director decision-making, or one that mandates the decision itself. Not surprisingly, the parties sharply divide on that question. We conclude that the Bylaw,

even though infelicitously couched as a substantive-sounding mandate to expend corporate funds, has both the intent and the effect of regulating the process for electing directors of CA. Therefore, we determine that the Bylaw is a proper subject for shareholder action . . . .

Because the Bylaw is couched as a command to reimburse (“The board of directors shall cause the corporation to reimburse a stockholder”), it lends itself to CA’s criticism. But the Bylaw’s wording, although relevant, is not dispositive of whether or not it is process-related. . . . A hypothetical example illustrates the point. Suppose that the directors of a corporation live in different states and at a considerable distance from the corporation’s headquarters. Suppose also that the shareholders enact a bylaw that requires all meetings of directors to take place in person at the corporation’s headquarters. Such a bylaw would be clearly process-related, yet it cannot be supposed that the shareholders would lack the power to adopt the bylaw because it would require the corporation to expend its funds to reimburse the directors’ travel expenses. Whether or not a bylaw is process-related must necessarily be determined in light of its context and purpose.

. . . .

The shareholders of a Delaware corporation have the right “to participate in selecting the contestants” for election to the board. The shareholders are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election. The Bylaw would accomplish that by committing the corporation to reimburse the election expenses of shareholders whose candidates are successfully elected. That the implementation of that proposal would require the expenditure of corporate funds will not, in and of itself, make such a bylaw an improper subject matter for shareholder action. Accordingly, we answer the first question certified to us in the affirmative.

That, however, concludes only part of the analysis. The DGCL also requires that the Bylaw be “not inconsistent with law.” Accordingly, we turn to the second certified question, which is whether the proposed Bylaw, if adopted, would cause CA to violate any Delaware law to which it is subject.

#### IV. THE SECOND QUESTION

In answering the first question, we have already determined that the Bylaw does not facially violate any provision of the DGCL or of CA’s Certificate of Incorporation. The question thus becomes whether the Bylaw would violate any common law rule or precept. . . . [I]n response to the second question, we must necessarily consider any possible circumstance under which a board of directors might be required to act. Under at least one such hypothetical, the board of directors would breach their fiduciary duties if they complied with the Bylaw. Accordingly, we conclude that the Bylaw, as drafted, would violate the prohibition, which our decisions have derived from Section 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders.

[Those decisions] involved binding contractual arrangements that the board of directors had voluntarily imposed upon themselves. This case involves a binding bylaw that the

shareholders seek to impose involuntarily on the directors in the specific area of election expense reimbursement. Although this case is distinguishable in that respect, the distinction is one without a difference. The reason is that the internal governance contract – which here takes the form of a bylaw – is one that would also prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement to a dissident slate. That this limitation would be imposed by a majority vote of the shareholders rather than by the directors themselves, does not, in our view, legally matter.

. . . [T]he Bylaw mandates reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude. That such circumstances could arise is not far fetched. Under Delaware law, a board may expend corporate funds to reimburse proxy expenses “[w]here the controversy is concerned with a question of policy as distinguished from personnel o[r] management.” But in a situation where the proxy contest is motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation, the board’s fiduciary duty could compel that reimbursement be denied altogether.

. . . .

Accordingly, we answer the second question certified to us in the affirmative.

#### DISCUSSION NOTES & QUESTIONS FOR THE UNFIREABLE CEO PROBLEM

The “Unfireable CEO” Problem (Casebook pp. 158-159) examines the legal obstacles to translating control at the stockholder level (as represented by Minow’s acquisition of 51 percent of the shares) into control at the board level. Revesz and Minow are considering a variety of strategies, listed below with references to the applicable section of the statutes. As to each, two questions are relevant: Do they have the power to do it? And if so, what do they hope to accomplish?

##### *Revesz Strategies*

- Amend the charter to provide that the power to amend the bylaws shall be vested exclusively in the directors – DGCL §§ 109(a), 242(b)(1); see also the former Illinois statute reprinted on p. 159 of the Casebook
- Amend the charter to provide for cumulative voting – DGCL § 214

##### *Minow Strategies*

- Amending the charter – DGCL § 242(b)(1)
- Amending the bylaws – DGCL § 109(a)
- Increasing or decreasing the number of directors – DGCL § 141(b)
- Filling vacancies on the board – DGCL § 223(a)
- Declassifying the board – DGCL § 141(d)

- Removing on or more directors – DGCL § 141(k)
- Dissolving th company and distributing its assets – DGCL § 275

As to Minow, there is an additional question: As a majority stockholder, does she need to wait until the next annual meeting to in order to take action, or are there ways that she can take control before that? Consider DGCL §§ 211(d), 228(a). How do the charter bylaws of Twitter, Inc. address these issues? How does the Model Act approach to these issues compare with Delaware’s? *See* MBCA §§ 7.02(a), 7.04(a).

## APPLICATION OF THE 1934 ACT

Securities Exchange Act § 12(g)(1) (as amended 2012)

(g) Registration of securities by issuer; exemptions

(1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall –

(A) within 120 days after the last day of its first fiscal year ended on which the issuer has total assets exceeding \$10,000,000 and a class of equity security (other than an exempted security) held of record by either –

(i) 2,000 persons, or

(ii) 500 persons who are not accredited investors (as such term is defined by the Commission), and

(B) in the case of an issuer that is a bank or a bank holding company, as such term is defined in section 1841 of title 12, not later than 120 days after the last day of its first fiscal year ended after the effective date of this subsection, on which the issuer has total assets exceeding \$10,000,000 and a class of equity security (other than an exempted security) held of record by 2,000 or more persons,

register such security by filing with the Commission a registration statement (and such copies thereof as the Commission may require) with respect to such security containing such information and documents as the Commission may specify comparable to that which is required in an application to register a security pursuant to subsection (b) of this section. Each such registration statement shall become effective sixty days after filing with the Commission or within such shorter period as the Commission may direct. Until such registration statement becomes effective it shall not be deemed filed for the purposes of section 78r of this title. Any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. The Commission is authorized to extend the date upon which any issuer or class of issuers is required to register a security pursuant to the provisions of this paragraph.

## CASE STUDY: FACEBOOK, GOLDMAN, SACHS AND THE JOBS ACT

Prior to April 2012, any company with assets above \$10 million became subject to the 1934 Act reporting requirements once the number of its shareholders reached 500 – regardless of whether some of those shareholders were institutions or other sophisticated investors. More precisely, under section 12(g)(1) of the 1934 Act, the triggering event was a class of equity securities held of record by more than 500 persons.

Like many successful Silicon Valley start-ups, the social networking company Facebook had struggled with the challenge of remaining private while compensating its employees with stock and thereby allowing them to participate in the company's success. According to press reports, founder Mark Zuckerberg was dedicated to keeping the company private for as long as possible. But with Facebook's dramatic growth, and the public fascination with its stock, remaining below the 500-shareholder threshold proved especially challenging.

Chief among the strategies employed by all entrepreneurial companies is to structure much of their employee compensation in the form of stock options. While these stock options qualify as equity securities under the 1934 Act, they are treated as a distinct class, separate from the stock itself, for purposes of the section 12(g)(1) test. In other words, a company can have 499 option holders and 499 shareholders and still not exceed the statutory limit. On the other hand, companies that have granted options to 500 or more employees were subject to the 1934 Act requirements even though they had fewer than 500 actual shareholders. Recognizing the importance of option-based compensation for emerging companies, the SEC began exempting stock option grants from the 12(g) limitations in the early 1990s. So long as appropriate steps are taken to prevent the possibility of a trading market in those options, the Commission believed that the purpose of the limitation was satisfied. As formalized in a 2007 rule, the exemption requires the issuer to provide employees with regular financial and other information, and restrict transfer of the options so long as the company remains private.

Facebook had originally relied on stock options for its employees. But once those options are exercised and the employee receives shares in return, the section 12 (g) exemption ceases to apply, and the shares may ultimately be sold to others. Thus, in 2007, Facebook stopped granting options to its new employees and switched to a different form of compensation – “restricted share units” that could not be converted into shares until the company went public or was sold. The company's lawyers were able to obtain a letter from the SEC that, although not options, these units would nonetheless qualify for exemption.

Besides the structure of its compensation, Facebook employed other tactics to stay below the 500-shareholder limit and to address the risk that current holders might sell to others. In acquiring smaller start-ups, the company tried to use cash whenever possible, to avoid issuing additional shares. In 2009, when the Russian firm Digital Sky agreed to invest \$200 million in Facebook, current employees received the opportunity to sell the firm an additional \$100 million of their own shares. In March 2010, Facebook announced a ban on all sales of company stock by employees, then adopted an “insider trading policy” permitting employees to sell only during designated windows.

In late 2010 two developments brought greater public attention to Facebook's efforts to remain private and raised serious doubt about how much longer it could continue to do so. Electronic markets such as SecondMarket and SharesPost had emerged to provide a vehicle for holders of private company stock to sell to wealthy investors and investment firms. Facebook was the most actively traded company on SecondMarket, which in November 2010 auctioned \$40 million of the company's shares. The SEC was said to be looking into these new types of trading venues.

A few weeks later, news leaked of a confidential arrangement in which the investment firm Goldman, Sachs was creating a special purpose vehicle ("SPV") to acquire a large block of Facebook stock, and was contacting numerous prospective investors about the opportunity to participate. Section 12(g) counts only the holders "of record" of the shares – in other words, the person in whose name the stock is registered. As the sole registered owner, the Goldman SPV might be counted as only one shareholder even though it represented the collective interests of hundreds, or even thousands, of participants. The SEC's rules provide, however, that if the issuer knows that the form in which its securities are held "is used primarily to circumvent" section 12(g)'s limitations, the beneficial owners (in this case, the investors in the Goldman SPV) are to be deemed the holders of record.

Whether Goldman's SPV would qualify as a single holder of record was never ultimately put to the test.\* Because of the publicity following the leak, Goldman concluded that it risked violating the securities laws if it continued to offer the securities in the U.S. The investment, ultimately totaling \$1 billion, was therefore confined to Goldman's overseas clients. In its January 2011 announcement of the transaction, Facebook acknowledged that even before the Goldman investment, it had expected to reach the 500-shareholder mark sometime in 2011. The timing was critical. To give companies an opportunity to prepare for the obligations of becoming public, registration and reporting under the 1934 Act is not required until 120 days after the fiscal year in which the threshold is reached. By not closing the Goldman transaction until the beginning of 2011, Facebook was able to delay compliance until April 2012. To the financial markets, this was a clear signal of when Facebook would launch its long awaited IPO.

All the public attention generated by Facebook's struggle to preserve its private-company status helped build support for rethinking the 500-shareholder limitation. The Jumpstart Our Business Startups ("JOBS") Act enacted in April 2012 provided the opportunity. It amended section 12(g)(1) to raise the shareholder limitation to 2,000, so long as the number of those shareholders who fail to qualify as accredited investors remains less than 500. (For this purpose, venture capitalists, institutional investors, company directors and executive officers, and affluent individuals are all treated as accredited investors.†) The JOBS Act also raised the threshold for 1934 Act reporting in two other ways. Excluded from the 2,000- and 500-

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\* In a subsequent report to Congress, the SEC noted some of the obstacles to applying the circumvention test to situations where neither the issuer nor its insiders were involved in establishing the SPV. *Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3)* (Oct. 15, 2012).

† The categories of persons who qualify as accredited investors are defined by Rule 501(a) under the Securities Act of 1933. For individual investors, the test is either a net worth (together with the investor's spouse) in excess of \$1 million or an annual income in excess of \$200,000 (or \$300,000, including the spouse's income) in each of the last two years.

shareholder limitations are the holders of securities (1) received through an employee compensation plan in transactions that are exempt from the 1933 Act's registration requirements or (2) acquired in a "crowdfunding" offering.

## FEDERAL PROXY RULES

### NOTE ON *TSC INDUSTRIES, INC. v. NORTHWAY, INC.*

As the Casebook indicates, the test for materiality under Rule 14a-9 (as well as the other antifraud provisions of the federal securities laws) was established by the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). The case was a challenge to the acquisition of TSC by National Industries, Inc., on the ground that the proxy statement used to solicit shareholder approval of the acquisition was materially misleading. Relying on a statement in the Supreme Court's earlier opinion in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), the Court of Appeals for the Seventh Circuit had held that the appropriate test for materiality was whether reasonable shareholder *might* consider the facts at issue important. Applying that standard, the Seventh Circuit held that the omitted facts were material as a matter of law.

Rejecting this test as unnecessarily low, the Supreme Court expressed concern that "management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information – a result that is hardly conducive to informed decisionmaking." In its place, the Court defined the appropriate standard as whether "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." It elaborated:

It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

426 U.S. at 449.

Prior to the merger that was the basis for the proxy solicitation, National had acquired 34 percent of TSC's stock, an ownership interest that was fully disclosed in the proxy statement, along with the fact that no other person held more than 10 percent. The proxy statement also disclosed the five of TSC's ten directors were National's nominees, and it identified each's affiliation with National. Among the omitted facts that the Seventh Circuit had held to be material as a matter of law were (1) that Stanley Yarmuth, National's president and chief executive officer, was also chairman of the TSC board, and that Charles Simonelli, National's executive vice president, was chairman of the TSC executive committee; and (2) that in filing reports required by the SEC, both TSC and National had indicated that National "may



be deemed to be a 'parent' of TSC." Under the definition of materiality set forth by the Supreme Court, do you believe that these omissions are material?

#### U.S. DEPARTMENT OF LABOR

*29 CFR § 2509.08-2 – Interpretive bulletin relating to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines.*

This interpretive bulletin sets forth the Department of Labor's (the Department) interpretation of sections 402, 403 and 404 of the Employee Retirement Income Security Act of 1974 (ERISA) as those sections apply to voting of proxies on securities held in employee benefit plan investment portfolios and the maintenance of and compliance with statements of investment policy, including proxy voting policy. . . .

##### (1) Proxy Voting

The fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock.<sup>1</sup> As a result, the responsibility for voting or deciding not to vote proxies lies exclusively with the plan trustee except to the extent that either (1) the trustee is subject to the direction of a named fiduciary pursuant to ERISA Sec. 403(a)(1); or (2) the power to manage, acquire or dispose of the relevant assets has been delegated by a named fiduciary to one or more investment managers pursuant to ERISA Sec. 403(a)(2). . . .

If the plan document or investment management agreement provides that the investment manager is not required to vote proxies, but does not expressly preclude the investment manager from voting proxies, the investment manager would have exclusive responsibility for proxy voting decisions. Moreover, an investment manager would not be relieved of its own fiduciary responsibilities by following directions of some other person regarding the voting of proxies, or by delegating such responsibility to another person. If, however, the plan document or the investment management contract expressly precludes the investment manager from voting proxies, the responsibility for voting proxies would lie exclusively with the trustee.

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<sup>1</sup> See letter from the Department of Labor to Helmut Fandl, Chairman of the Retirement Board of Avon Products, Inc., dated February 23, 1988.

SECURITIES AND EXCHANGE COMMISSION  
CONCEPT RELEASE ON THE U.S. PROXY SYSTEM  
Securities Exchange Act Release No. 62,495, July 14, 2010

***V. Relationship Between Voting Power and Economic Interest***

As discussed below, investor and issuer confidence in the legitimacy of shareholder voting may be based on the belief that, except as expressly agreed otherwise, shareholders entitled to vote in the election of directors and other matters have a residual economic (or equity) interest in the company that is commensurate with their voting rights. To the extent that votes are cast by persons lacking such an economic interest in the company, confidence in the proxy system could be undermined. This section examines the possibility of misalignment of voting power in general and three areas in which concerns have been expressed about whether our regulations play a role in the misalignment of voting power from economic interest: The increasingly important role of proxy advisory firms; the impediments in our rules to allowing issuers to set voting record dates that more closely match the date on which voting actually occurs; and hedging and other strategies that allow the voting rights of equity securities to be held or controlled by persons without an equivalent economic interest in the company.

***A. Proxy Advisory Firms***

**1. The Role and Legal Status of Proxy Advisory Firms**

Over the last twenty-five years, institutional investors, including investment advisers, pension plans, employee benefit plans, bank trust departments and funds, have substantially increased their use of proxy advisory firms, reflecting the tremendous growth in institutional investment as well as the fact that, in many cases, institutional investors have fiduciary obligations to vote the shares they hold on behalf of their beneficiaries.<sup>238</sup> Institutional investors typically own securities positions in a large number of issuers.

Every year, at shareholders' meetings, these investors face decisions on how to vote their shares on a significant number of matters, ranging from the election of directors and the approval of stock option plans to shareholder proposals submitted under Exchange Act Rule 14a-8, which often raise significant policy questions and corporate governance issues. At special meetings of shareholders, investors also face voting decisions when a merger or acquisition or a sale of all or substantially all of the assets of the company is presented to them for approval.

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<sup>238</sup> See, e.g., GAO Report to Congress, Corporate Shareholder Meetings – Issues Relating to Firms That Advise Institutional Investors on Proxy Voting (June 2007) (“GAO Report”) at 6-7 (attributing the growth in the use of proxy voting advisers, in part, to the Commission’s recognition of fiduciary obligations associated with voting proxies by registered investment advisers and its adoption of the proxy voting Advisers Act Rule 206(4)-6 (17 CFR 275.206(4)-6), requiring registered investment advisers to “adopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the best interest of clients, which procedures must include how you address material conflicts that may arise between your interests and those of your clients”).

In order to assist them in exercising their voting rights on matters presented to shareholders, institutional investors may retain proxy advisory firms to perform a variety of functions, including the following:

- Analyzing and making voting recommendations on the matters presented for shareholder vote and included in the issuers' proxy statements;
- Executing votes on the institutional investors' proxies or VIFs in accordance with the investors' instructions, which may include voting the shares in accordance with a customized proxy voting policy resulting from consultation between the institutional investor and the proxy advisory firm, the proxy advisory firm's proxy voting policies, or the institution's own voting policy;
- Assisting with the administrative tasks associated with voting and keeping track of the large number of voting decisions;
- Providing research and identifying potential risk factors related to corporate governance; and
- Helping mitigate conflict of interest concerns raised when the institutional investor is casting votes in a matter in which its interest may differ from the interest of its clients.

Firms that are in the business of supplying these services to clients for compensation – in particular, analysis of and recommendations for voting on matters presented for a shareholder vote – are widely known as proxy advisory firms. Institutional clients compensate proxy advisory firms on a fee basis for providing such services, and proxy advisory firms typically represent that their analysis and recommendations are prepared with a view toward maximizing long-term share value or the investment goals of the institutional client.

Issuers may also be consumers of the services provided by some proxy advisory firms. Some proxy advisory firms provide consulting services to issuers on corporate governance or executive compensation matters, such as assistance in developing proposals to be submitted for shareholder approval. Some proxy advisory firms also qualitatively rate or score issuers' corporate governance structures, policies, and practices,<sup>242</sup> and provide consulting services to corporate clients seeking to improve their corporate governance ratings. As a result, some proxy advisory firms provide vote recommendations to institutional investors on matters for which they also provided consulting services to the issuer. Some proxy advisory firms disclose these dual client relationships; others also have opted to attempt to address the conflict through the creation of “fire walls” between the investor and corporate lines of business.

Depending on their activities, proxy advisory firms may be subject to the federal securities laws in at least two notable respects. First, because of the breadth of the definition of “solicitation,”<sup>243</sup> proxy advisory firms may be subject to our proxy rules because they provide

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<sup>242</sup> For example, The RiskMetrics Group (“RiskMetrics”) publishes “governance risk indicators.” Information on these ratings is available at <http://www.riskmetrics.com/GRId-info>. Proxy advisory firms are not the only types of businesses that offer corporate governance ratings or scores.

<sup>243</sup> Exchange Act Rule 14a-1(l)(iii) [17 CFR 240.14a-1(l)(iii)] defines the solicitation of proxies to include “[t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.”

recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy. As a general matter, the furnishing of proxy voting advice constitutes a “solicitation” subject to the information and filing requirements in the proxy rules. In 1979, however, we adopted Exchange Act Rule 14a-2(b)(3) to exempt the furnishing of proxy voting advice by any advisor to any other person with whom the advisor has a business relationship from the informational and filing requirements of the federal proxy rules, provided certain conditions are met. Specifically, the advisor:

- Must render financial advice in the ordinary course of its business;
- Must disclose to the person any significant relationship it has with the issuer or any of its affiliates, or with a shareholder proponent of the matter on which advice is given, in addition to any material interest of the advisor in the matter to which the advice relates;
- May not receive any special commission or remuneration for furnishing the proxy voting advice from anyone other than the recipients of the advice; and
- May not furnish proxy voting advice on behalf of any person soliciting proxies.

Even if exempt from the informational and filing requirements of the federal proxy rules, the furnishing of proxy voting advice remains subject to the prohibition on false and misleading statements in Rule 14a-9.

Second, when proxy advisory firms provide certain services, they meet the definition of investment adviser under the Advisers Act and thus are subject to regulation under that Act. A person is an “investment adviser” if the person, for compensation, engages in the business of providing advice to others as to the value of securities, whether to invest in, purchase, or sell securities, or issues reports or analyses concerning securities. As described above, proxy advisory firms receive compensation for providing voting recommendations and analysis on matters submitted for a vote at shareholder meetings. These matters may include shareholder proposals, elections for boards of directors, or corporate actions such as mergers. We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to maximize the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.

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## 2. Concerns About the Role of Proxy Advisory Firms

The use of proxy advisory firms by institutional investors raises a number of potential issues. For example, to the extent that conflicts of interest on the part of proxy advisory firms are insufficiently disclosed and managed, shareholders could be misled and informed shareholder voting could be impaired. To the extent that proxy advisory firms develop, disseminate, and implement their voting recommendations without adequate accountability for

informational accuracy in the development and application of voting standards, informed shareholder voting may be likewise impaired. Furthermore, some have argued that proxy advisory firms are controlling or significantly influencing shareholder voting without appropriate oversight, and without having an actual economic stake in the issuer. In evaluating any potential regulatory response to such issues, we are interested in learning commentators' views regarding appropriate means of addressing these issues, including the application of the proxy solicitation rules and Advisers Act registration provisions to proxy advisory firms. We are also interested in learning commentators' views as to whether these issues are affected – and if so, how – by the fact that there is one dominant proxy advisory firm in the marketplace, Institutional Shareholder Services (“ISS”),<sup>271</sup> whose long-standing position, according to the Government Accountability Office, “has been cited by industry analysts as a barrier to competition.”<sup>272</sup>

In order to address these issues, which we describe in additional detail below, we would like to receive views about the role that proxy advisory firms play in the proxy voting process, which could, for instance, assist in determining whether additional regulatory requirements might be appropriate, such as the extent to which oversight of proxy advisory firms registered as investment advisers might be improved. Below we outline the two principal areas of concern about the proxy advisory industry that have come to our attention.

#### a. Conflicts of Interest

Perhaps the most frequently raised concern about the proxy advisory industry relates to conflicts of interest. The Government Accountability Office has issued two reports since 2004 examining conflicts of interest in proxy voting by institutional investors.<sup>274</sup> The GAO Report issued in 2007 addressed, among other things, conflicts of interest that may exist for proxy advisory firms, institutional investors' use of the firms' services and the firms' potential influence on proxy vote outcomes, as well as the steps that the Commission has taken to oversee these firms. The GAO Report noted that the most commonly cited conflict of interest for proxy advisory firms is when they provide both proxy voting recommendations to investment advisers and other institutional investors and consulting services to corporations seeking assistance with proposals to be presented to shareholders or with improving their corporate governance ratings.

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<sup>271</sup> See GAO Report, note 238, above, at 13 (stating that, “[a]s the dominant proxy advisory firm, ISS has gained a reputation with institutional investors for providing reliable, comprehensive proxy research and recommendations, making it difficult for competitors to attract clients and compete in the market”). As of June 2007, ISS's client base included an estimate of 1,700 institutional investors, more than the other four major firms combined. *Id.* ISS was acquired by RiskMetrics in January 2007, which in turn was acquired on June 1, 2010 by MSCI, Inc. See “MSCI Completes Acquisition of RiskMetrics,” (June 1, 2010), available at [http://www.riskmetrics.com/news\\_releases/20100601\\_msci](http://www.riskmetrics.com/news_releases/20100601_msci).

<sup>272</sup> GAO Report, note 238, above, at 2.

<sup>274</sup> GAO Report, note 238, above. The GAO issued an earlier report in 2004 that described, among other things, conflicts of interest in the proxy voting system with respect to pension plans and actions taken to manage them by plan fiduciaries. See GAO, Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting (Aug. 10, 2004), available at <http://www.gao.gov/new.items/do4749.pdf>.

In particular, this conflict of interest arises if a proxy advisory firm provides voting recommendations on matters put to a shareholder vote while also offering consulting services to the issuer or a proponent of a shareholder proposal on the very same matter. The issuer in this situation may purchase consulting services from the proxy advisory firm in an effort to garner the firm's support for the issuer when the voting recommendations are made. Similarly, a proponent may engage the proxy advisory firm for advice on voting recommendations in an effort to garner the firm's support for its shareholder proposals. The GAO Report also noted that the firm might recommend a vote in favor of a client's shareholder proposal in order to keep the client's business.

A conflict also arises when a proxy advisory firm provides corporate governance ratings on issuers to institutional clients, while also offering consulting services to corporate clients so that those issuers can improve their corporate governance ranking. The GAO Report also described the potential for conflicts of interest when owners or executives of the proxy advisory firm have significant ownership interests in, or serve on the board of directors of, issuers with matters being put to a shareholder vote on which the proxy advisory firm is offering vote recommendations. In such cases, institutional investors told the GAO that some proxy advisory firms would not offer vote recommendations to avoid the appearance of a conflict of interest.

It is our understanding that at least one proxy advisory firm provides a generic disclosure of such conflicts of interest by stating that the proxy advisory firm "may" have a consulting relationship with the issuer, without affirmatively stating whether the proxy advisory firm has or had a relationship with a specific issuer or the nature of any such relationship. Some have argued that this type of general disclosure is insufficient, even if the proxy advisory firm has confidentiality walls between its corporate consulting and proxy research departments.

#### b. Lack of Accuracy and Transparency in Formulating Voting Recommendations

Some commentators have expressed the concern that voting recommendations by proxy advisory firms may be made based on materially inaccurate or incomplete data, or that the analysis provided to an institutional client may be materially inaccurate or incomplete. To the extent that a voting recommendation is based on flawed data or analysis, issuers have expressed a desire for a process to correct the mistake. We understand, however, that proxy advisory firms may be unwilling, as a matter of policy, to accept any attempted communication from the issuer or to reconsider recommendations in light of such communications. Even if a proxy advisory firm entertains comment from the issuer and amends its recommendation, votes may have already been cast based on the prior recommendation. Accordingly, some issuers have expressed a desire to be involved in reviewing a draft of the proxy advisory firm's report, if only for the limited purpose of ensuring that the voting recommendations are based on accurate issuer data. Some proxy advisory firms have claimed that they are willing to discuss matters with issuers, but that some issuers are unwilling to enter into such discussions.

There also is a concern that proxy advisory firms may base their recommendation on one-size-fits-all governance approach. As a result, a policy that would benefit some issuers, but that is less suitable for other issuers, might not receive a positive recommendation, making it less likely to be approved by shareholders.

Rule 14a-2(b)(3)'s exemption of proxy advisory firms does not mandate that a firm relying on the exemption have specific procedures in place to ensure that its research or analysis is materially accurate or complete prior to recommending a vote. While voting advice by firms relying on the Rule 14a-2(b)(3) exemption remains subject to the antifraud provisions of the proxy rules contained in Rule 14a-9 – and those antifraud provisions should deter the rendering of voting advice that is misleading or inaccurate – it is our understanding that certain participants in the proxy process believe that additional oversight mechanisms could improve the likelihood that voting recommendations are based on materially accurate and complete information. In addition, as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information.

#### DISCUSSION NOTES & QUESTIONS FOR THE TarPERS PROBLEM

Read over the TarPERS problem on pp. 194-195 of the Casebook. There are a variety of steps the Fund might take to express its dissatisfaction with the performance of HLS's management and to pressure for corrective action. They raise a series of issues under both state and federal law.

¶1. The problem indicates that TarPERS wants to “test the waters” by circulating a memorandum to 15 other institutional investors which collectively hold a total of 15 percent of HLS's stock. What problems does circulating that memo pose under the proxy rules? Consider, in particular, rules 14a-2(b)(1) and 14a-6(g).

¶2. Even if TarPERS and the other institutions are ultimately unwilling to offer their own slate of candidates for the board, one alternative is to refuse to vote for the any of the candidates nominated by HLS.

a. Is there a mechanism to, in effect, “just vote no”? *See* rule 14a-4(b)(2)

b. What can TarPERS hope to accomplish from such a strategy?

c. Can TarPERS publicly announce its decision to vote against the HLS slate? Can it encourage other shareholders to do the same, without having to file its own proxy statement? What form may those communications take – a press release, a newspaper ad, an “open letter” to shareholders? *See* rules 14a-1(l)(2)(iv), 14a-2(b)(1). How do the regulatory consequences of these various tactics differ?

d. To counter the TarPERS announcement on a timely basis, can HLS's management issue a press release or “open letter” to its shareholders before it files its definitive proxy statement? *See* rule 14a-12

e. Suppose other institutional investors join TarPERS in withholding their votes, so that the three HLS nominees receive only 40 percent of the proxy votes cast. Have they been duly elected as directors? *See* DGCL § 216(3); MBCA § 7.28(a)

f. Could the minimum vote required for election be increased? How might TarPERS go about that? See DGCL § 216(3) & last ¶; MBCA § 7.28(a); AK&S 196-200

g. Suppose a director candidate fails to get the required vote; what is her or his status? See DGCL § 141(b); MBCA §§ 8.05(b),(e), 10.22. Consider the Wachtell, Lipton proposal discussed at AK&S p. 199

¶3. Suppose that after conferring with the other large institutional investors, TarPERS has decided to nominate three board candidates of its own.

a. TarPERS wants to make its case directly to each HLS shareholder. How does it go about doing so? Can it get a copy of the HLS shareholder list? Can it demand that TarPERS mail the materials on its behalf? Which approach would each party prefer? The answers to these questions illustrate the frequent interplay between state corporate law and federal securities law. See rule 14a-7(a),(b); DGCL § 220(b). How does rule 14a-7(e) relate to the decision in the *Rosenfeld* case?

b. What must TarPERS file with the SEC? See rules 14a-3, 14a-6(a),(b)

c. In addition to its own three candidates, may TarPERS endorse some of the members of the HLS slate to fill the remaining six seats? Why might it wish to do so? See Rule 14a-4(d)(4)

4. Given the expense of waging its own proxy campaign, TarPERS might prefer to use the HLS proxy statement to make the case for its candidates. Of course, HLS will likely refuse to include the opposition candidates unless legally required to do so. This is the basis for the “proxy access” proposals take are the subject of the following case and the SEC rulemaking described on pages 200-203 of the Casebook.

AMERICAN FEDERATION OF STATE, COUNTY & MUNICIPAL EMPLOYEES v. AMERICAN INTERNATIONAL GROUP, INC.

462 F.3d 121

U.S. Court of Appeals for the Second Circuit, 2006

WESLEY, Circuit Judge:

This case raises the question of whether a shareholder proposal requiring a company to include certain shareholder-nominated candidates for the board of directors on the corporate ballot can be excluded from the corporate proxy materials on the basis that the proposal “relates to an election” under Securities Exchange Act Rule 14a-8(i)(8), 17 C.F.R. § 240.14a-8 (“election exclusion” or “Rule 14a-8(i)(8)”). Complicating this question is not only the ambiguity of Rule 14a-8(i)(8) itself but also the fact that the Securities Exchange Commission (the “SEC” or “Commission”) has ascribed two different interpretations to the Rule’s language. . . .



## Background

The American Federation of State, County & Municipal Employees (“AFSCME”) is one of the country’s largest public service employee unions. Through its pension plan, AFSCME holds 26,965 shares of voting common stock of American International Group (“AIG” or “Company”), a multi-national corporation operating in the insurance and financial services sectors. On December 1, 2004, AFSCME submitted to AIG for inclusion in the Company’s 2005 proxy statement a shareholder proposal that, if adopted by a majority of AIG shareholders at the Company’s 2005 annual meeting, would amend the AIG bylaws to require the Company, under certain circumstances, to publish the names of shareholder-nominated candidates for director positions together with any candidates nominated by AIG’s board of directors (“Proposal”). AIG sought the input of the [SEC’s Division of Corporate Finance (the “Division”) regarding whether AIG could exclude the Proposal from its proxy statement under the election exclusion on the basis that it “relates to an election.” The Division issued a no-action letter in which it indicated that it would not recommend an enforcement action against AIG should the Company exclude the Proposal from its proxy statement.<sup>1</sup> Armed with the no-action letter, AIG then proceeded to exclude the Proposal from the Company’s proxy statement. In response, AFSCME brought suit in the United States District Court for the Southern District of New York (Stanton, J.) seeking a court order compelling AIG to include the Proposal in its next proxy statement. The district court denied AFSCME’s motion for a preliminary injunction, concluding that AFSCME’s Proposal “on its face ‘relates to an election.’ Indeed, it relates to nothing else.” [AFSCME has appealed.]

## Discussion

Rule 14a-8(i)(8), also known as “the town meeting rule,” regulates what are referred to as “shareholders proposals,” that is, “recommendation[s] or requirement[s] that the company and/or its board of directors take [some] action, which [the submitting shareholder(s)] intend to present at a meeting of the company’s shareholders,” 17 C.F.R. § 240.14a-8(a). If a shareholder seeking to submit a proposal meets certain eligibility and procedural requirements, the corporation is required to include the proposal in its proxy statement and identify the proposal in its form of proxy, unless the corporation can prove to the SEC that a given proposal may be excluded based on one of thirteen grounds enumerated in the regulations. *Id.* § 240.14a-8(i)(1)-(13). One of these grounds, Rule 14a-8(i)(8), provides that a corporation may exclude a shareholder proposal “[i]f the proposal relates to an election for membership on the company’s board of directors or analogous governing body.” *Id.* § 240.14a-8(i)(8).

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<sup>1</sup> Elaborating upon the nature of the no-action process, the Court has stated:

The no-action process works as follows: Whenever a corporation decides to exclude a shareholder proposal from its proxy materials, it “shall file” a letter with the Division explaining the legal basis for its decision. *See* Rule 14a-8(d)(3). If the Division staff agrees that the proposal is excludable, it may issue a no-action letter, stating that, based on the facts presented by the corporation, the staff will not recommend that the SEC sue the corporation for violating Rule 14a-8. . . . The no-action letter, however, is an informal response, and does not amount to an official statement of the SEC’s views. . . . No-action letters are deemed interpretive because they do not impose or fix legal relationship upon any of the parties.

*N.Y. City Employees’ Ret. Sys. v. SEC*, 45 F.3d 7, 12 (2d Cir. 1995).

We must determine whether, under Rule 14a-8(i)(8), a shareholder proposal “relates to an election” if it seeks to amend the corporate bylaws to establish a procedure by which certain shareholders are entitled to include in the corporate proxy materials their nominees for the board of directors (“proxy access bylaw proposal”). . . . The relevant language here – “relates to an election” – is not particularly helpful. AFSCME reads the election exclusion as creating an obvious distinction between proposals addressing a particular seat in a particular election (which AFSCME concedes are excludable) and those, like AFSCME’s proposal, that simply set the background rules governing elections generally (which AFSCME claims are not excludable). .

When the language of a regulation is ambiguous, we typically look for guidance in any interpretation made by the agency that promulgated the regulation in question. We are aware of two statements published by the SEC that offer informal interpretations of Rule 14a-8(i)(8). The first is a statement appearing in the amicus brief that the SEC filed in this case at our request. The second interpretation is contained in a statement the SEC published in 1976, the last time the SEC revised the election exclusion. Neither of these interpretations has the force of law. But, while agency interpretations that lack the force of law do not warrant deference when they interpret ambiguous *statutes*, they do normally warrant deference when they interpret ambiguous *regulations*.

In its amicus brief, the SEC interprets Rule 14a-8(i)(8) as permitting the exclusion of shareholder proposals that “would result in contested elections.” The SEC explains that “[f]or purposes of Rule 14a-8, a proposal would result in a contested election if it is a means either to campaign for or against a director nominee or to require a company to include shareholder-nominated candidates in the company’s proxy materials.” Under this interpretation, a proxy access bylaw proposal like AFSCME’s would be excludable under Rule 14a-8(i)(8) because it “is a means to require AIG to include shareholder-nominated candidates in the company’s proxy materials.” However, that interpretation is plainly at odds with the interpretation the SEC made in 1976.

In that year, the SEC amended Rule 14a-8(i)(8) in an effort to clarify the purpose of the existing election exclusion. The SEC explained that “with respect to corporate elections, [ ] Rule 14a-8 is not the proper means for conducting campaigns or effecting reforms in elections of that nature [*i.e.*, “corporate, political or other elections to office”], *since other proxy rules, including Rule 14a-11, are applicable thereto.*” . . .

We agree with the SEC that, based on the 1976 Statement, shareholder proposals can be excluded under the election exclusion if they would result in an immediate election contest. . . .

The 1976 Statement clearly reflects the view that the election exclusion is limited to shareholder proposals used to oppose solicitations dealing with an identified board seat in an upcoming election and rejects the somewhat broader interpretation that the election exclusion applies to shareholder proposals that would institute procedures making such election contests more likely. The SEC suggested as much when, four months after its 1976 Statement, it explained that the scope of the election exclusion does not cover shareholder proposals dealing

with matters such as cumulative voting and general director requirements, both of which have the potential to increase the likelihood of election contests.

That the 1976 statement adopted this narrower view of the election exclusion finds further support in the fact that it was also the view that the Division adopted for roughly sixteen years following publication of the SEC's 1976 Statement. It was not until 1990 that the Division first signaled a change of course by deeming excludable proposals that might result in contested elections, even if the proposal only purports to alter general procedures for nominating and electing directors.

Because the interpretation of Rule 14a-8(i)(8) that the SEC advances in its amicus brief – that the election exclusion applies to proxy access bylaw proposals – conflicts with the 1976 Statement, it does not merit the usual deference we would reserve for an agency's interpretation of its own regulations. The SEC has not provided, nor to our knowledge has it or the Division ever provided, reasons for its changed position regarding the excludability of proxy access bylaw proposals. Although the SEC has substantial discretion to adopt new interpretations of its own regulations in light of, for example, changes in the capital markets or even simply because of a shift in the Commission's regulatory approach, it nevertheless has a "duty to explain its departure from prior norms."

....

Accordingly, we deem it appropriate to defer to the 1976 Statement, which represents the SEC's interpretation of the election exclusion the last time the Rule was substantively revised. We therefore interpret the election exclusion as applying to shareholder proposals that relate to a particular election and not to proposals that, like AFSCME's, would establish the procedural rules governing elections generally.

### Conclusion

For the foregoing reasons, we reverse the judgment of the district court and remand the case for entry of judgment in favor of AFSCME.

### *Notes and Questions*

1. Can you think of any reasons why the SEC may have changed its approach to Rule 14a-8's election exclusion in 1990 – and why the court refused to defer to it in favor of the earlier, 1976 interpretation?
2. As the Casebook indicates, following the two AFSCME decisions, Delaware added section 112 to its corporation law.

1934 ACT Rule 14a-8(i)(8) (Amended September 2011)

(i) *Question 9*: If I have complied with the procedural requirements, on what other bases may a company rely to exclude my proposal?

....

(8) *Director elections*: If the proposal:

(i) Would disqualify a nominee who is standing for election;

(ii) Would remove a director from office before his or her term expired;

(iii) Questions the competence, business judgment, or character of one or more nominees or directors;

(iv) Seeks to include a specific individual in the company's proxy materials for election to the board of directors; or

(v) Otherwise could affect the outcome of the upcoming election of directors.

## SELF-DEALING

CDX LIQUIDATING TRUST v. VENROCK ASSOCIATES

640 F.3d 209

U.S. Court of Appeals for the Seventh Circuit, 2011

POSNER, Circuit Judge.

This suit, brought by a trust that holds the common stock of a bankrupt company formerly known as Cadant, charges several former directors with breaches of their duty of loyalty to the corporation, and charges two venture-capital groups, which we'll abbreviate to "Venrock" and "J.P. Morgan," with aiding and abetting the disloyal directors. . . .

Cadant had been created in 1998 to develop what are called "cable modem termination systems," which enable high-speed Internet access to home computers. . . . The founders received common stock in the new corporation at the outset. Others purchased common stock later. Venrock and J.P. Morgan received preferred stock in exchange for an investment in the new company that they made at the beginning of 2000. Eric Copeland, a principal of Venrock, became a member of Cadant's five-member board of directors. He is the director principally accused of disloyalty to Cadant.

In April 2000 the board turned down a tentative offer by ADC Telecommunications to buy Cadant's assets for \$300 million. . . .

In the fall of 2000, Cadant found itself in financial trouble. The defendants attribute this to the deflating – beginning in the spring of 2000 and continuing throughout the year and into the next year – of the dot-com bubble of the late 1990s. [W]hatever the cause the company needed fresh investment. The board considered a proposal from a group of Chicago investors and a joint proposal from Venrock and J.P. Morgan, and eventually decided on an \$11 million loan from Venrock and J.P. Morgan. The terms of the loan were negotiated on Cadant’s behalf by Copeland. The board of directors had grown to seven members, of whom four, including Copeland, were employees of Venrock or J.P. Morgan, though one of them, defendant C.H. Randolph Lyon, resigned from J.P. Morgan before the loan was made, while remaining a director of Cadant.

The loan was a “bridge loan,” which is a short-term loan intended to tide the borrower over while he seeks longer-term financing. The \$11 million bridge loan to Cadant was for only 90 days, at an annual interest rate of 10 percent . . . . Cadant ran through the entire loan, which had been made in January 2001, within a few months. Venrock and J.P. Morgan then made a second bridge loan, in May, this one for \$9 million, again negotiated on Cadant’s behalf by Copeland. The loan agreement provided that in the event that Cadant was liquidated the lenders would be entitled to be paid twice the outstanding principal of the loan plus any accrued but unpaid interest on it; as a result, little if anything would be left for the shareholders. The disinterested directors of Cadant (the directors who had no affiliation with Venrock or J.P. Morgan) who voted for the loan were engineers without financial acumen, and because they didn’t think to retain their own financial advisor they were at the mercy of the financial advice they received from Copeland and the other conflicted directors.

Cadant defaulted on the second bridge loan, and being in deep financial trouble agreed to sell all its assets to a firm called Arris Group in exchange for stock worth, when the sale closed in January 2002, some \$55 million. That amount was just large enough to satisfy the claims of Cadant’s creditors and preferred shareholders (Venrock and J.P. Morgan were both). The sale was approved by Cadant’s board, but also, as required by Delaware law and the company’s articles of incorporation, by a simple majority both of Cadant’s common and preferred shareholders voting together as a single class and of the preferred shareholders voting separately.

. . . .

[While the parties disagree on who bears the burden of proof,] there’s enough proof that the alleged misconduct caused loss to Cadant’s shareholders to make the issue of causation one for the jury no matter which side has the burden of proof. It was after the dot-com bubble burst, and only a few months before Cadant was sold to the Arris Group for \$55 million, that a similar company, River Delta, was sold for \$300 million. Cadant couldn’t hold out for a comparable deal because of the terms of the bridge loans. If the plaintiff’s evidence is credited, Copeland, in cahoots with an employee of J.P. Morgan named Charles Walker (a defendant), used information gleaned from meetings of Cadant’s board to reveal to J.P. Morgan and through it to Venrock that Cadant would accept a smaller bridge loan, and for a shorter term, than Venrock and J.P. Morgan would have expected the board to insist on. Walker himself joined Cadant’s board soon after the first bridge loan was made, as did another J.P. Morgan employee (Stephan

Oppenheimer), who is also a defendant. There is evidence that Copeland, Walker, and Oppenheimer conspired to ensure that Cadant would accept the second bridge loan, which added to the disadvantages to Cadant of the first loan by creating a generous liquidation preference; as mentioned earlier, in the event of a sale or liquidation of Cadant, Venrock and J.P. Morgan would be entitled to be paid twice the amount of their investment in the company, to the prejudice of the common shareholders.

The smaller the loan, the shorter the term, and the bigger the liquidation preference, the worse for those shareholders. The smaller the loan, the less it strengthens the borrower (Cadant) and thus the harder it is for the borrower to hold out for generous offers from prospective buyers. The shorter the term, the shorter the period for which the borrower can hold out for an attractive sale price. The bigger the liquidation preference, the less the stockholders will realize from the sale in the event – which was looming when the bridge loans were made, and which eventually came to pass – that the firm is forced to liquidate. Uncontaminated by disloyal directors, so far as appears, River Delta, in adverse economic conditions similar to those alleged to have beset Cadant, nevertheless was sold for more than five times what Cadant was sold for a few months later. . . .

Even so, the defendants argue, . . . there was no breach of loyalty because their conflict of interest was fully disclosed. The conflict was fully disclosed. But that misses the point.

Section 144(a)(1) of Delaware’s General Corporation Law provides, so far as relates to this case, that if “the material facts as to the director’s . . . relationship or interest and as to the contract or transactions are disclosed or are known to the board of directors . . . , and the board . . . in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors,” then “no contract” between the corporation (call it *A*) and another corporation (*B*) in which a director of *A* is also a director or an officer, or has some other financial interest, “shall be void or voidable solely for this reason,” that is, solely because a director of *A* has an interest in *B*, with which *A* transacted. Copeland was a director of Venrock as well as of Cadant, and Venrock was a lender to Cadant, both as a preferred shareholder (which is a type of lender, not an equity owner) and as a bridge lender. The other defendant directors had a similar conflict of interest. But Copeland (and we may assume the others) fully disclosed to Cadant his (their) relationship with Venrock or J.P. Morgan, the other preferred shareholder-bridge lender, which was acting in partnership with Venrock. This meant that the transactions between it and Venrock and J.P. Morgan, disadvantageous to Cadant though they turned out to be, could not be voided solely because of the conflicts of interest. And if the conflicts thus were sterilized, the directors could not be found to have committed a breach of fiduciary duty just by virtue of the fact that they negotiated those deals.

But that is not the accusation. The accusation is that the directors were disloyal. They persuaded the district judge that disclosure of a conflict of interest excuses a breach of fiduciary duty. It does not. It just excuses the conflict. . . .

To have a conflict and to be motivated by it to breach a duty of loyalty are two different things – the first a factor increasing the likelihood of a wrong, the second the wrong itself. Thus a disloyal act is actionable even when a conflict of interest is not – one difference being that the

conflict is disclosed, the disloyal act is not. A director may tell his fellow directors that he has a conflict of interest but that he will not allow it to influence his actions as director; he will not tell them he plans to screw them. If having been informed of the conflict the disinterested directors decide to continue to trust and rely on the interested ones, it is because they think that despite the conflict of interest those directors will continue to serve the corporation loyally.

*Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A. 2d 114 ( Del. 2006), a derivative suit much like this one, provides an illuminating contrast to this case. A director was interested but his interest was known to the board. Having settled that point, the court went on to consider whether he had breached his fiduciary duty to the corporation, and concluded that he had not. He “did not set the terms of the [challenged] deal; he did not deceive the board; and he did not dominate or control the other directors’ approval of the Transaction. In short, the record does not support the claim that [he] breached his duty of loyalty.” *Id.* at 121. There is enough evidence that Copeland and the other defendant directors did these things to create an issue for a jury to resolve.

REVERSED AND REMANDED, WITH DIRECTIONS

### *Notes and Questions*

1. The Delaware courts have gone back and forth over the degree to which compliance with section 144 protects a transaction from challenge or alters the challenger’s burden of proof. The *Benihana* case, cited by the court, is the Supreme Court of Delaware’s most recent statement on the issue: “After approval by disinterested directors, courts review the interested transaction under the business judgment rule, which ‘is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.’” *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114, 120 (Del. 2006). Is the Seventh Circuit’s decision consistent with this standard?

2. As was the case with Copeland, it is not unusual for representatives of a venture capital fund to sit on the boards of start-up companies the fund finances. In light of the Seventh Circuit’s decision, what if anything could Copeland and the other conflicted directors have done to facilitate the loans to Cadant without exposing themselves to claims that they violated their fiduciary duty?

3. How would this case be decided under the Model Act? *See* MBCA §§ 8.61(b), 8.62

# CORPORATE OPPORTUNITY

BROZ v. CELLULAR INFORMATION SYSTEMS, INC.

673 A.2d 148

Supreme Court of Delaware, 1996

VEASEY, Chief Justice:

In this appeal, we consider the application of the doctrine of corporate opportunity. . . .

We conclude that, although a corporate director may be shielded from liability by offering to the corporation an opportunity which has come to the director independently and individually, the failure of the director to present the opportunity does not necessarily result in the improper usurpation of a corporate opportunity. We further conclude that, if the corporation is a target or potential target of an acquisition by another company which has an interest and ability to entertain the opportunity, the director of the target company does not have a fiduciary duty to present the opportunity to the target company. Accordingly, the judgment of the Court of Chancery is REVERSED.

. . . .

## II. FACTS

[Robert F. Broz (“Broz”) is the President and sole stockholder of RFB Cellular, Inc. (“RFBC”), a Delaware corporation engaged in the business of providing cellular telephone service in the Midwestern United States. Broz was also a member of the board of directors of plaintiff below-appellee, Cellular Information Systems, Inc. (“CIS”). CIS is a publicly held Delaware corporation and a competitor of RFBC.]

[The conduct before the Court involves the purchase by Broz of a cellular telephone service license for the benefit of RFBC. The license in question, known as the Michigan-2 Rural Service Area Cellular License (“Michigan-2”), is issued by the Federal Communications Commission (“FCC”) and entitles its holder to provide cellular telephone service to a portion of northern Michigan.]

Broz has been the President and sole stockholder of RFBC since 1992. RFBC owns and operates an FCC license area, known as the Michigan-4 Rural Service Area Cellular License (“Michigan-4”). The license entitles RFBC to provide cellular telephone service to a portion of rural Michigan. Although Broz’ efforts have been devoted primarily to the business operations of RFBC, he also served as an outside director of CIS at the time of the events at issue in this case. CIS was at all times fully aware of Broz’ relationship with RFBC and the obligations incumbent upon him by virtue of that relationship.

In April of 1994, Mackinac Cellular Corp. (“Mackinac”) sought to divest itself of Michigan-2, the license area immediately adjacent to Michigan-4. To this end, Mackinac



contacted Daniels & Associates (“Daniels”) and arranged for the brokerage firm to seek potential purchasers for Michigan-2. In compiling a list of prospects, Daniels included RFBC as a likely candidate. In May of 1994, David Rhodes, a representative of Daniels, contacted Broz and broached the subject of RFBC’s possible acquisition of Michigan-2. Broz later signed a confidentiality agreement at the request of Mackinac, and received the offering materials pertaining to Michigan-2.

Michigan-2 was not, however, offered to CIS. Apparently, Daniels did not consider CIS to be a viable purchaser for Michigan-2 in light of CIS’ recent financial difficulties. The record shows that, at the time Michigan-2 was offered to Broz, CIS had recently emerged from lengthy and contentious Chapter 11 proceedings. Pursuant to the Chapter 11 Plan of Reorganization, CIS entered into a loan agreement that substantially impaired the company’s ability to undertake new acquisitions or to incur new debt. In fact, CIS would have been unable to purchase Michigan-2 without the approval of its creditors.

The CIS reorganization resulted from the failure of CIS’ rather ambitious plans for expansion. From 1989 onward, CIS had embarked on a series of cellular license acquisitions. In 1992, however, CIS’ financing failed, necessitating the liquidation of the company’s holdings and reduction of the company’s total indebtedness. During the period from early 1992 until the time of CIS’ emergence from bankruptcy in 1994,<sup>\*</sup> CIS divested itself of some fifteen separate cellular license systems. CIS contracted to sell four additional license areas on May 27, 1994, leaving CIS with only five remaining license areas, all of which were outside of the Midwest.

On June 13, 1994, following a meeting of the CIS board, Broz spoke with CIS’ Chief Executive Officer, Richard Treibick (“Treibick”), concerning his interest in acquiring Michigan-2. Treibick communicated to Broz that CIS was not interested in Michigan-2. Treibick further stated that he had been made aware of the Michigan-2 opportunity prior to the conversation with Broz, and that any offer to acquire Michigan-2 was rejected. [I]n August of 1994, Broz contacted another CIS director, Peter Schiff (“Schiff”), to discuss the possible acquisition of Michigan-2 by RFBC. Schiff, like Treibick, indicated that CIS had neither the wherewithal nor the inclination to purchase Michigan-2. In late September of 1994, Broz also contacted Stanley Bloch (“Bloch”), a director and counsel for CIS, to request that Bloch represent RFBC in its dealings with Mackinac. Bloch agreed to represent RFBC, and, like Schiff and Treibick, expressed his belief that CIS was not at all interested in the transaction. Ultimately, all the CIS directors testified at trial that, had Broz inquired at that time, they each would have expressed the opinion that CIS was not interested in Michigan-2.

[PriCellular, Inc. (“PriCellular”), another cellular communications company, had made various overtures to the CIS board concerning an acquisition of CIS.] On June 28, 1994, . . . six CIS directors entered into agreements with PriCellular to sell their shares in CIS at a price of \$2.00 per share [contingent upon the consummation of a PriCellular tender offer for all CIS

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<sup>\*</sup> According to the trial court’s opinion, “Among the service licenses that CIS had when it emerged from bankruptcy were a group in the upper midwest: Duluth, Minn.; Eau Claire, Wis.; Great Falls, Minn.; Wausau, Wis.; Wis. RSA 1; Wis. RSA 6A-2 and Wis. RSA 3.” *Cellular Information Systems, Inc. v. Broz*, 663 A.2d 1180, 1182 (Del. Ch. 1995).

shares at the same price]. On August 2, 1994, PriCellular commenced a tender offer for all outstanding shares of CIS at \$2.00 per share. . . .

[PriCellular originally planned to finance the acquisition with bank loans.] When this financing fell through, PriCellular resorted to a junk bond offering. PriCellular's financing difficulties generated a great deal of concern among the CIS insiders whether the tender offer was, in fact, viable. Financing difficulties ultimately caused PriCellular to delay the closing date of the tender offer from September 16, 1994 until October 14, 1994 and then again until November 9, 1994.

On August 6, September 6 and September 21, 1994, Broz submitted written offers to Mackinac for the purchase of Michigan-2. During this time period, PriCellular also began negotiations with Mackinac to arrange an option for the purchase of Michigan-2. . . .

In late September of 1994, PriCellular reached agreement with Mackinac on an option to purchase Michigan-2. The exercise price of the option agreement was set at \$6.7 million . . . . The agreement further provided that Mackinac was free to sell Michigan-2 to any party who was willing to exceed the exercise price of the Mackinac-PriCellular option contract by at least \$500,000. On November 14, 1994, Broz agreed to pay Mackinac \$7.2 million for the Michigan-2 license, thereby meeting the terms of the option agreement. An asset purchase agreement was thereafter executed by Mackinac and RFBC.

Nine days later, on November 23, 1994, PriCellular completed its financing and closed its tender offer for CIS. . . .

. . . .

#### IV. APPLICATION OF THE CORPORATE OPPORTUNITY DOCTRINE

The corporate opportunity doctrine, as delineated by *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939), and its progeny, holds that a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation. The Court in *Guth* also derived a corollary which states that a director or officer may take a corporate opportunity if: (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity. *Guth*, 5 A.2d at 509.

. . . .

We note at the outset that Broz became aware of the Michigan-2 opportunity in his individual and not his corporate capacity. . . . In fact, it is clear from the record that Mackinac did not consider CIS a viable candidate for the acquisition of Michigan-2. Accordingly,

Mackinac did not offer the property to CIS. In this factual posture, many of the fundamental concerns undergirding the law of corporate opportunity are not present (*e.g.*, misappropriation of the corporation's proprietary information). The burden imposed upon Broz to show adherence to his fiduciary duties to CIS is thus lessened to some extent. Nevertheless, this fact is not dispositive. The determination of whether a particular fiduciary has usurped a corporate opportunity necessitates a careful examination of the circumstances, giving due credence to the factors enunciated in *Guth* and subsequent cases.

We turn now to an analysis of the factors relied on by the trial court. First, we find that CIS was not financially capable of exploiting the Michigan-2 opportunity. . . . The record shows that CIS was in a precarious financial position at the time Mackinac presented the Michigan-2 opportunity to Broz. . . . Further, the loan agreement entered into by CIS and its creditors severely limited the discretion of CIS as to the acquisition of new assets and substantially restricted the ability of CIS to incur new debt.

The Court of Chancery based its contrary finding on the fact that PriCellular had purchased an option to acquire CIS' bank debt. Thus, the court reasoned, PriCellular was in a position to exercise that option and then waive any unfavorable restrictions that would stand in the way of a CIS acquisition of Michigan-2. The trial court, however, disregarded the fact that PriCellular's own financial situation was not particularly stable. PriCellular was unable to finance the acquisition of CIS through conventional bank loans and was forced to use the more risky mechanism of a junk bond offering to raise the required capital. . . . Moreover, . . . the fact that PriCellular had available sources of financing is immaterial to the analysis. At the time that Broz was required to decide whether to accept the Michigan-2 opportunity, PriCellular had not yet acquired CIS, and any plans to do so were wholly speculative. Thus, contrary to the Court of Chancery's finding, Broz was not obligated to consider the contingency of a PriCellular acquisition of CIS and the related contingency of PriCellular thereafter waiving restrictions on the CIS bank debt. . . .

Second, while it may be said with some certainty that the Michigan-2 opportunity was within CIS' line of business, it is not equally clear that CIS had a cognizable interest or expectancy in the license. Under the third factor laid down by this Court in *Guth*, for an opportunity to be deemed to belong to the fiduciary's corporation, the corporation must have an interest or expectancy in that opportunity. As this Court stated in *Johnston v. Greene*, 121 A.2d 919, 924 (Del. 1956), "[f]or the corporation to have an actual or expectant interest in any specific property, there must be some tie between that property and the nature of the corporate business." Despite the fact that the nature of the Michigan-2 opportunity was historically close to the core operations of CIS, changes were in process. At the time the opportunity was presented, CIS was actively engaged in the process of divesting its cellular license holdings. CIS' articulated business plan did not involve any new acquisitions. Further, as indicated by the testimony of the entire CIS board, the Michigan-2 license would not have been of interest to CIS even absent CIS' financial difficulties and CIS' then current desire to liquidate its cellular license holdings. . . .

Finally, the corporate opportunity doctrine is implicated only in cases where the fiduciary's seizure of an opportunity results in a conflict between the fiduciary's duties to the

corporation and the self-interest of the director as actualized by the exploitation of the opportunity. In the instant case, Broz' interest in acquiring and profiting from Michigan-2 created no duties that were inimicable to his obligations to CIS. Broz, at all times relevant to the instant appeal, was the sole party in interest in RFBC, a competitor of CIS. CIS was fully aware of Broz' potentially conflicting duties. . . . Broz sought only to compete with an outside entity, PriCellular, for acquisition of an opportunity which both sought to possess. Broz was not obligated to refrain from competition with PriCellular. . . .

#### A. Presentation to the Board:

In concluding that Broz had usurped a corporate opportunity, the Court of Chancery placed great emphasis on the fact that Broz had not formally presented the matter to the CIS board. . . .

The teaching of *Guth* and its progeny is that the director or officer must analyze the situation *ex ante* to determine whether the opportunity is one rightfully belonging to the corporation. If the director or officer believes, based on one of the factors articulated above, that the corporation is not entitled to the opportunity, then he may take it for himself. Of course, presenting the opportunity to the board creates a kind of "safe harbor" for the director, which removes the specter of a post hoc judicial determination that the director or officer has improperly usurped a corporate opportunity. Thus, presentation avoids the possibility that an error in the fiduciary's assessment of the situation will create future liability for breach of fiduciary duty. It is not the law of Delaware that presentation to the board is a necessary prerequisite to a finding that a corporate opportunity has not been usurped.

. . . .

Therefore, we hold that Broz did not breach his fiduciary duties to CIS. Accordingly, we REVERSE the judgment of the Court of Chancery holding that Broz diverted a corporate opportunity properly belonging to CIS and imposing a constructive trust.

#### *Notes and Questions*

1. Why might the management and shareholders of CIS have wanted Broz, the owner of a competing firm, to be on the company's board? Why might Broz have been willing to serve?

2. *Irving Trust Co. v. Deutsch*, 73 F.2d 121 (2d Cir. 1934), involved a claim that the directors of Acoustic Products Co., a maker of phonographs and radios, usurped a corporate opportunity by buying the stock of De Forest Radio Co., when the latter was in receivership. De Forest owned the patents for technology vital to Acoustic's business. The directors, who included the company's President, argued that Acoustic had neither the funds nor the credit to make the purchase and that, by buying the stock themselves, they could give Acoustic access to the De Forest technology. The court rejected this defense as legally insufficient: "If directors are permitted to justify their conduct on such a theory, there will be a temptation to refrain from exerting their strongest efforts on behalf of the corporation since, if it does not meet the obligations, an opportunity of profit will be open to them personally." *Id.* at 124. How would this line of reasoning have applied in *Broz*?

## NOTE ON *KLINICKI v. LUNDGREN*

Klinicki and Lundgren, two out-of-work airline pilots, formed Berlinair, Inc. as an air transportation service based in Berlin, Germany. Each owned one-third of the shares, with Lundgren's family corporation owning the remaining third. Lundgren's responsibilities included promoting the business, which led him to BFR, a consortium of Berlin travel agents that arranged charter flights for German tourists. The BFR contract was considered a highly lucrative business opportunity, and when Lundgren learned it might be available, he formed Air Berlin Charter Co. ("ABC") to pursue it for himself. Concealing these negotiations from Klinicki, Lundgren succeeded in winning the contract for ABC.

Klinicki charged Lundgren and ABC with taking a corporate opportunity. The key issue in the case was whether Berlinair had the financial ability to pursue the BFR contract on its own. The Supreme Court of Oregon adopted the approach set forth in section 5.05 of the ALI's *Principles of Corporate Governance*. *Klinicki v. Lundgren*, 695 P.2d 906 (Ore. 1985). Under the ALI test, the corporation's financial ability bears only upon whether its rejection of the opportunity is "fair" under section 5.05(a)(3)(A), not on whether a corporate opportunity exists. According to the comments to that section:

Rejection in the context of § 5.05(a)(3) may be based on one or more of a number of factors, such as lack of interest by the corporation in the opportunity, the corporation's financial inability to acquire the opportunity, legal restrictions on the corporation's ability to accept the opportunity, or unwillingness of a third party to deal with the corporation.

However, Lundgren never disclosed the BFR opportunity to the corporation, and thereby failed to give its board or shareholders the choice whether to reject it. Under section 5.05(a)(1), the opportunity must first be offered to the corporation in all cases. Since Lundgren failed to do so, he and ABC could not take the opportunity for themselves, regardless of Berlinair's financial situation.

What might have happened had Lundgren raised the issue with Berlinair's board and sought its approval to take the BFR contract on his own? We do not know the composition of the board, but we do know the composition of Berlinair's shareholders.

## PROBLEM – INDEMNIFICATION & INSURANCE

Recall that in the *Graham* case, directors and officers of Allis-Chalmers Manufacturing Co. were accused of knowingly violating the antitrust laws. Assume that they faced both charges by the U.S. Justice Department and, as in the case, derivative claims by Allis-Chalmers shareholders.

a) May Allis-Chalmers indemnify the officers and directors for the expenses they incur in the Justice Department proceeding, even if they are ultimately found guilty? May the

indemnification include any fines they are required to pay, in addition to their legal fees? Who is to make these decisions? See DGCL § 145(a),(d)

b) May Allis-Chalmers advance funds to the officers and directors to cover their expenses while the case is underway? See DGCL § 145(e)

c) What about the derivative suit? May Allis-Chalmers indemnify the officers and directors for any liability they incur? What if the officers and directors settle before there is a decision on the merits? What is the difference between subsections (a) and (b) of section 145? Suppose the officers and directors believe they will ultimately be vindicated, but the plaintiffs have offered to settle; what do the defendants stand to gain or lose?

d) Section 145(g) allows the corporation to purchase insurance for its directors, officers and other employees, even as to liabilities for which indemnification is impermissible. What is the rationale for this distinction?

## SHAREHOLDER LITIGATION

ARONSON v. LEWIS

473 A.2d 805

Supreme Court of Delaware, 1984

MOORE, Justice:

[W]hen is a stockholder's demand upon a board of directors, to redress an alleged wrong to the corporation, excused as futile prior to the filing of a derivative suit? We granted this interlocutory appeal to the defendants, Meyers Parking System, Inc. (Meyers), a Delaware corporation, and its directors, to review the Court of Chancery's denial of their motion to dismiss this action, pursuant to Chancery Rule 23.1, for the plaintiff's failure to make such a demand or otherwise demonstrate its futility. The Vice Chancellor ruled that plaintiff's allegations raised a "reasonable inference" that the directors' action was unprotected by the business judgment rule. Thus, the board could not have impartially considered and acted upon the demand.

We cannot agree with this formulation of the concept of demand futility. In our view demand can only be excused where facts are alleged with particularity which create a reasonable doubt that the directors' action was entitled to the protections of the business judgment rule. . . .

### I.

. . . The plaintiff, Harry Lewis, is a stockholder of Meyers. The defendants are Meyers and its ten directors, some of whom are also company officers.

In 1979, Prudential Building Maintenance Corp. (Prudential) spun off its shares of Meyers to Prudential's stockholders. Prior thereto Meyers was a wholly owned subsidiary of

Prudential. Meyers provides parking lot facilities and related services throughout the country. Its stock is actively traded over-the-counter.

This suit challenges certain transactions between Meyers and one of its directors, Leo Fink, who owns 47% of its outstanding stock. Plaintiff claims that these transactions were approved only because Fink personally selected each director and officer of Meyers.<sup>2</sup>

Prior to January 1, 1981, Fink had an employment agreement with Prudential which provided that upon retirement he was to become a consultant to that company for ten years. This provision became operable when Fink retired in April 1980. Thereafter, Meyers agreed with Prudential to share Fink's consulting services and reimburse Prudential for 25% of the fees paid Fink. Under this arrangement Meyers paid Prudential \$48,332 in 1980 and \$45,832 in 1981.

On January 1, 1981, the defendants approved an employment agreement between Meyers and Fink for a five year term with provision for automatic renewal each year thereafter, indefinitely. Meyers agreed to pay Fink \$150,000 per year, plus a bonus of 5% of its pre-tax profits over \$2,400,000. Fink could terminate the contract at any time, but Meyers could do so only upon six months' notice. At termination, Fink was to become a consultant to Meyers and be paid \$150,000 per year for the first three years, \$125,000 for the next three years, and \$100,000 thereafter for life. Death benefits were also included. Fink agreed to devote his best efforts and substantially his entire business time to advancing Meyers' interests. The agreement also provided that Fink's compensation was not to be affected by any inability to perform services on Meyers' behalf. Fink was 75 years old when his employment agreement with Meyers was approved by the directors. There is no claim that he was, or is, in poor health.

Additionally, the Meyers board approved and made interest-free loans to Fink totalling \$225,000. These loans were unpaid and outstanding as of August 1982 when the complaint was filed. At oral argument defendants' counsel represented that these loans had been repaid in full.

The complaint charges that these transactions had "no valid business purpose", and were a "waste of corporate assets" because the amounts to be paid are "grossly excessive," that Fink performs "no or little services", and because of his "advanced age" cannot be "expected to perform any such services". . . .

. . . .

#### IV.

##### A.

. . . The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management. The derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it. The nature of the action is two-fold. First, it

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<sup>2</sup> The Court of Chancery stated that Fink had been chief executive officer of Prudential prior to the spin-off and thereafter became chairman of Meyers' board. . . .

is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.

By its very nature the derivative action impinges on the managerial freedom of directors. Hence, the demand requirement of Chancery Rule 23.1 exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits. Thus, by promoting this form of alternate dispute resolution, rather than immediate recourse to litigation, the demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations.

In our view the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability. The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a). . . .

. . . .

The trial court correctly recognized that demand futility is inextricably bound to issues of business judgment, but stated the test to be based on allegations of fact, which, if true, "show that there is a reasonable inference" the business judgment rule is not applicable for purposes of a pre-suit demand.

The problem with this formulation is the concept of reasonable inferences to be drawn against a board of directors based on allegations in a complaint. As is clear from this case, and the conclusory allegations upon which the Vice Chancellor relied, demand futility becomes virtually automatic under such a test. Bearing in mind the presumptions with which director action is cloaked, we believe that the matter must be approached in a more balanced way.

Our view is that in determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Hence, the Court of Chancery must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof. . . . Certainly, if this is an "interested" director transaction, such that the business judgment rule is inapplicable to the board majority approving the transaction, then the inquiry ceases. In that event futility of demand has been established by any objective or subjective standard. This includes situations involving self-dealing directors.

However, the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors, although in rare cases a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists. . . . The Court of Chancery in the exercise of its sound discretion must be satisfied that a plaintiff has alleged facts with particularity which, taken as true, support a



reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment. Only in that context is demand excused.

B.

Having outlined the legal framework within which these issues are to be determined, we consider plaintiff's claims of futility here: Fink's domination and control of the directors, board approval of the Fink-Meyers employment agreement, and board hostility to the plaintiff's derivative action due to the directors' status as defendants.

Plaintiff's claim that Fink dominates and controls the Meyers' board is based on: (1) Fink's 47% ownership of Meyers' outstanding stock, and (2) that he "personally selected" each Meyers director. Plaintiff also alleges that mere approval of the employment agreement illustrates Fink's domination and control of the board. In addition, plaintiff argued on appeal that 47% stock ownership, though less than a majority, constituted control given the large number of shares outstanding, 1,245,745.

Such contentions do not support any claim under Delaware law that these directors lack independence. . . . [I]n the demand context even proof of majority ownership of a company does not strip the directors of the presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation. There must be coupled with the allegation of control such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person. . . .

Thus, it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director. It is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence.

We conclude that in the demand-futile context a plaintiff charging domination and control of one or more directors must allege particularized facts manifesting "a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling". The shorthand shibboleth of "dominated and controlled directors" is insufficient. . . .

Here, plaintiff has not alleged any facts sufficient to support a claim of control. The personal-selection-of-directors allegation stands alone, unsupported. . . . Therefore, we cannot conclude that the complaint factually particularizes any circumstances of control and domination to overcome the presumption of board independence, and thus render the demand futile.

C.

Turning to the board's approval of the Meyers-Fink employment agreement, plaintiff's argument is simple: all of the Meyers directors are named defendants, because they approved the wasteful agreement; if plaintiff prevails on the merits all the directors will be jointly and

severally liable; therefore, the directors' interest in avoiding personal liability automatically and absolutely disqualifies them from passing on a shareholder's demand.

Such allegations are conclusory at best. In Delaware mere directorial approval of a transaction, absent particularized facts supporting a breach of fiduciary duty claim, or otherwise establishing the lack of independence or disinterestedness of a majority of the directors, is insufficient to excuse demand. . . .

In essence, the plaintiff alleged a lack of consideration flowing from Fink to Meyers, since the employment agreement provided that compensation was not contingent on Fink's ability to perform any services. The bare assertion that Fink performed "little or no services" was plaintiff's conclusion based solely on Fink's age and the *existence* of the Fink-Prudential employment agreement. . . .

In sustaining plaintiff's claim of demand futility the trial court relied on *Fidanque v. American Maracaibo Co.*, 92 A.2d 311, 321 (Del. Ch. 1952), which held that a contract providing for payment of consulting fees to a retired president/director was a waste of corporate assets. In *Fidanque*, the court found after trial that the contract and payments were in reality compensation for past services. This was based upon facts not present here: the former president/director was a 70 year old stroke victim, neither the agreement nor the record spelled out his consulting duties at all, the consulting salary equalled the individual's salary when he was president and general manager of the corporation, and the contract was silent as to continued employment in the event that the retired president/director again became incapacitated and unable to perform his duties. Contrasting the facts of *Fidanque* with the complaint here, it is apparent that plaintiff has not alleged facts sufficient to render demand futile on a charge of corporate waste, and thus create a reasonable doubt that the board's action is protected by the business judgment rule.

D.

Plaintiff's final argument is the incantation that demand is excused because the directors otherwise would have to sue themselves, thereby placing the conduct of the litigation in hostile hands and preventing its effective prosecution. This bootstrap argument has been made to and dismissed by other courts. . . . Unless facts are alleged with particularity to overcome the presumptions of independence and a proper exercise of business judgment, in which case the directors could not be expected to sue themselves, a bare claim of this sort raises no legally cognizable issue under Delaware corporate law.

REVERSED AND REMANDED.

## EXECUTIVE COMPENSATION

### EXERCISE ON SAY ON PAY

Suppose you are on the corporate governance staff of a major institutional investor. Review the CD&A sections of the 2013 proxy statements for Apple Inc. (Jan. 27, 2013), McKesson Corp. (June 21, 2013) and Yahoo! Inc. (Apr. 30, 2013). Based on the CD&A information, how would you rank the three companies in terms of whether their executive compensation arrangements deserve an affirmative vote at their 2013 annual meetings?

The web addresses for the three proxy statements are:

*Apple Inc.*

<http://investor.apple.com/secfiling.cfm?filingID=1193125-13-5529&CIK=320193>

*McKesson Corp.*

<http://phx.corporate-ir.net/phoenix.zhtml?c=107291&p=irol-SECText&TEXT=aHRocDovL2FwaS5oZW5rd2l6YXJkLmNvbS9maWxpbnmcueG1sP2lwYWdlPTg5OTUwMTkmRFNFUTowJlNFUTowJlNRREVTQziTRUNUSU9OXoVOVElSRSZzdWJzaWQ9NTc%3d>

*Yahoo! Inc.*

<http://www.shareholder.com/visitors/dynamicdoc/document.cfm?documentid=3109&companyId=YHOO&page=1&pin=&language=EN&resizethree=yes&scale=100&zid=7bb8e1a8>

## TRANSACTIONS IN CONTROL

### NOTE ON *ESSEX UNIVERSAL CORP. v. YATES*

Herbert Yates owned 28.3 percent of the shares of Republic Pictures Corp., a New York corporation, and served as both President and Chairman of its board of directors. He agreed to sell his Republic shares to Essex Universal Corp. for \$8 per share, roughly \$2 above the price at which the stock was then trading on the New York Stock Exchange. To facilitate the transfer of control, the sales contract called for a procedure in which eight of Republic's fourteen directors would resign seriatim, with each resigning director to be replaced by an Essex nominee. Thus, at the end of the sequence, Essex nominees would represent a majority of the board.

When Yates later refused to transfer the shares, and Essex sued for breach of contract, Yates defended on the ground that the contract was void as an illegal sale of corporate office. The trial court granted summary judgment for Yates.

On appeal, the Second Circuit reversed. *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962). The three judges on the panel agreed that under the law of New York, it is illegal to sell a corporate office or management control, but disagreed on the application of that doctrine to situations where, as in the contract before it, the transfer of control is inseparable from the transfer of the shares themselves.

Chief Judge Lumbard structured his analysis by first considering the case where the transfer of control accompanies the sale of a majority of the shares – that is “whether it is legal to give and receive payment for the immediate transfer of management control to one who has achieved majority share control but would not otherwise be able to convert that share control into operating control for some time.” In his view, the New York courts would uphold such an arrangement. He relied in particular on *Barnes v. Brown*, an 1880 decision by the New York Court of Appeals reasoning that:

[The seller] had the right to sell out all his stock and interest in the corporation, . . . and when he ceased to have any interest in the corporation, it was certainly legitimate and right that he should cease to control it . . . . It was simply the mode of transferring the control of the corporation to those who by the policy of the law ought to have it, and I am unable to see how any policy of the law was violated, or in what way, upon the evidence, any wrong was thereby done to anyone.

Judge Lumbard then considered how the doctrine would apply to the transfer of a control block representing less than a majority interest: “Although in the case at bar only 28.3 per cent of the stock was involved, it is commonly known that a person or group owning so large a percentage of the voting stock of a corporation which, like Republic, has at least the 1,500 shareholders normally requisite to listing on the New York Stock Exchange, is almost certain to have share control as a practical matter.” Thus, he concluded:

Because 28.3 per cent of the voting stock of a publicly owned corporation is usually tantamount to majority control, I would place the burden of proof on this issue on Yates as the party attacking the legality of the transaction. . . . If Yates chooses to raise the issue [on remand], it will, on my view, be necessary for him to prove the existence of circumstances which would have prevented Essex from electing a majority of the Republic board of directors in due course. . . . In other words, I would require him to show that there was at the time of the contract some other organized block of stock of sufficient size to outvote the block Essex was buying, or else some circumstance making it likely that enough of the holders of the remaining Republic stock would band together to keep Essex from control.

305 F.2d at 579.

Concurring in the judgment, Judge Friendly was unwilling to go as far as Judge Lumbard’s approach:

I am inclined to think that if I were sitting on the New York Court of Appeals, I would hold a provision like Paragraph 6 violative of public policy save when it was

entirely plain that a new election would be a mere formality – *i.e.*, when the seller owned more than 50% of the stock. . . .

As a judge of this Court, my task is the more modest one of predicting how the judges of the New York Court of Appeals would rule . . . Although *Barnes v. Brown* dealt with the sale of a majority interest, I am unable to find any real indication that the doctrine there announced has been thus limited. . . .

Attractive as [Judge Lumbard’s] proposal is in some respects, I find difficulties with it. . . . When an issue does arise, the “practical certainty” test is difficult to apply. The existence of such certainty will depend not merely on the proportion of the stock held by the seller but on many other factors – whether the other stock is widely or closely held, how much of it is in “street names,” what success the corporation has experienced, how far its dividend policies have satisfied its stockholders, the identity of the purchasers, the presence or absence of cumulative voting, and many others. Often, unless the seller has nearly 50% of the stock, whether he has “working control” can be determined only by an election; groups who thought they had such control have experienced unpleasant surprises in recent years.

*Id.* at 581-82.

Are the subsequent New York decisions, discussed on page 439 of the Casebook, consistent with either of these views?

JONES v. H. F. AHMANSON & CO.

460 P.2d 464

Supreme Court of California, 1969

TRAYNOR, Chief Justice.

June K. Jones, the owner of 25 shares of the capital stock of United Savings and Loan Association of California brings this action on behalf of herself individually and of all similarly situated minority stock-holders of the Association. The defendants are United Financial Corporation of California, fifteen individuals, and four corporations, all of whom are present or former stockholders or officers of the Association. Plaintiff seeks damages and other relief for losses allegedly suffered by the minority stockholders of the Association because of claimed breaches of fiduciary responsibility by defendants in the creation and operation of United Financial, a Delaware holding company that owns 87 percent of the outstanding Association stock.

. . . .

United Savings and Loan Association of California is a California chartered savings and loan association that first issued stock on April 5, 1956. Theretofore it had been owned by its

depositors, who, with borrowing members, elected the board of directors. No one depositor had sufficient voting power to control the Association.

The Association issued 6,568 shares of stock on April 5, 1956. No additional stock has been issued. Of these shares, 987 (14.8 percent) were purchased by depositors pursuant to warrants issued in proportion to the amount of their deposits. Plaintiff was among these purchasers. The shares allocated to unexercised warrants were sold to the then chairman of the board of directors who later resold them to defendants and others. . . .

[T]he book value of the outstanding shares has increased substantially.<sup>2</sup> The shares were not actively traded. This inactivity is attributed to the high book value, the closely held nature of the Association,<sup>3</sup> and the failure of the management to provide investment information and assistance to shareholders, brokers, or the public. Transactions in the stock that did occur were primarily among existing stockholders. Fourteen of the nineteen defendants comprised 95 percent of the market for Association shares prior to 1959.

In 1958 investor interest in shares of savings and loan associations and holding companies increased. Savings and loan stocks that were publicly marketed enjoyed a steady increase in market price thereafter until June 1962, but the stock of United Savings and Loan Association was not among them. Defendants determined to create a mechanism by which they could participate in the profit taking by attracting investor interest in the Association. They did not, however, undertake to render the Association shares more readily marketable. Instead, the United Financial Corporation of California was incorporated in Delaware by [the defendants]. On May 14, 1959, pursuant to a prior agreement, certain Association stockholders who among them owned a majority of the Association stock exchanged their shares for those of United Financial, receiving a “derived block” of 250 United Financial shares for each Association share.

After the exchange, United Financial held 85 percent of the outstanding Association stock. . . . The former majority stockholders of the Association had become the majority shareholders of United Financial and continued to control the Association through the holding company. They did not offer the minority stockholders of the Association an opportunity to exchange their shares.

The first public offering of United Financial stock was made in June 1960. [Shortly after this offering, United Financial offered to purchase the remaining shares of Association stock for \$1,100 per share. At the time, the book value of each of these shares was \$1,411.57. The equivalent “derived blocks” of United Financial shares were then trading for \$3,700 per block, and in addition had received \$927.50 as a return of capital. United Financial held a second public offering in February 1961.]

[In August 1961, United Financial proposed an exchange of its shares for the remaining Association stock. Under this proposal each minority stockholder would have received approximately 51 United Financial shares of a total value of \$2,400 for each Association share. At that time, the value of the “derived blocks” of United Financial shares received by defendants

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<sup>2</sup> Between 1959 and 1966 the book value of each share increased from \$1,131 to \$4,143.70.

<sup>3</sup> H. F. Ahmanson & Co. acquired a majority of the shares in May 1958. . . .

in the initial exchange had risen to approximately \$8,800. When minority shareholders challenged the fairness of the exchange offer before the California Corporations Commissioner, the defendants withdrew it.]

Plaintiff contends that in following this course of conduct defendants breached the fiduciary duty owed by majority or controlling shareholders to minority shareholders. She alleges that they used their control of the Association for their own advantage to the detriment of the minority when they created United Financial, made a public market for its shares that rendered Association stock unmarketable except to United Financial, and then refused either to purchase plaintiff's Association stock at a fair price or exchange the stock on the same basis afforded to the majority. . . .

. . . .

## II

### *Majority Shareholders' Fiduciary Responsibility*

Defendants take the position that as shareholders they owe no fiduciary obligation to other shareholders, absent reliance on inside information, use of corporate assets, or fraud. This view has long been repudiated in California. [Majority shareholders] have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just, and equitable manner. Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's business.

Defendants assert, however, that in the use of their own shares they owed no fiduciary duty to the minority stockholders of the Association. They maintain that they made full disclosure of the circumstances surrounding the formation of United Financial, that the creation of United Financial and its share offers in no way affected the control of the Association, that plaintiff's proportionate interest in the Association was not affected, that the Association was not harmed, and that the market for Association stock was not affected. Therefore, they conclude, they have breached no fiduciary duty to plaintiff and the other minority stockholders.

Defendants would have us retreat from a position demanding equitable treatment of all shareholders by those exercising control over a corporation to a philosophy much criticized by commentators and modified by courts in other jurisdictions as well as our own. . . .

. . . .

Although courts have recognized the potential for abuse or unfair advantage when a controlling shareholder sells his shares at a premium over investment value or in a controlling shareholder's use of control to avoid equitable distribution of corporate assets, no comprehensive rule has emerged in other jurisdictions. Nor have most commentators

approached the problem from a perspective other than that of the advantage gained in the sale of control. . . .

. . . .The case before us, in which no sale or transfer of actual control is directly involved, demonstrates that the injury anticipated by these authors can be inflicted with impunity under the traditional rules and supports our conclusion that the comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material properly governs controlling shareholders in this state.

We turn now to defendants' conduct to ascertain whether this test is met.

### III

#### *Formation of United Financial and Marketing its Shares*

Defendants created United Financial during a period of unusual investor interest in the stock of savings and loan associations. . . . This stock was not readily marketable owing to a high book value, lack of investor information and facilities, and the closely held nature of the Association. . . . Two courses were available to defendants in their effort to exploit the bull market in savings and loan stock. Both were made possible by defendants' status as controlling stockholders. The first was either to cause the Association to effect a stock split and create a market for the Association stock or to create a holding company for Association shares and permit all stockholders to exchange their shares before offering holding company shares to the public. All stockholders would have benefited alike had this been done, but in realizing their gain on the sale of their stock the majority stockholders would of necessity have had to relinquish some of their control shares. . . .

The second course was that taken by defendants. A new corporation was formed whose major asset was to be the control block of Association stock owned by defendants, but from which minority shareholders were to be excluded. The unmarketable Association stock held by the majority was transferred to the newly formed corporation at an exchange rate equivalent to a 250 for 1 stock split. The new corporation thereupon set out to create a market for its own shares. . . . It appears therefrom that the market created by defendants for United Financial shares was a market that would have been available for Association stock had defendants taken the first course of action.

After United Financial shares became available to the public it became a virtual certainty that no equivalent market could or would be created for Association stock. United Financial had become the controlling stockholder and neither it nor the other defendants would benefit from public trading in Association stock in competition with United Financial shares. Investors afforded an opportunity to acquire United Financial shares would not be likely to choose the less marketable and expensive Association stock in preference. Thus defendants chose a course of action in which they used their control of the Association to obtain an advantage not made available to all stockholders. They did so without regard to the resulting detriment to the minority stockholders and in the absence of any compelling business purpose. Such conduct is not consistent with their duty of good faith and inherent fairness to the minority stockholders. Had defendants afforded the minority an opportunity to exchange their stock on the same basis



or offered to purchase them at a price arrived at by independent appraisal, their burden of establishing good faith and inherent fairness would have been much less. At the trial they may present evidence tending to show such good faith or compelling business purpose that would render their action fair under the circumstances. On appeal from the judgment of dismissal after the defendants' demurrer was sustained we decide only that the complaint states a cause of action entitling plaintiff to relief.

....

In so holding we do not suggest that the duties of corporate fiduciaries include in all cases an obligation to make a market for and to facilitate public trading in the stock of the corporation. But when, as here, no market exists, the controlling shareholders may not use their power to control the corporation for the purpose of promoting a marketing scheme that benefits themselves alone to the detriment of the minority. Nor do we suggest that a control block of shares may not be sold or transferred to a holding company. We decide only that the circumstances of any transfer of controlling shares will be subject to judicial scrutiny when it appears that the controlling shareholders may have breached their fiduciary obligation to the corporation or the remaining shareholders.

#### IV

#### *Damages*

Plaintiff contends that she should have been afforded the opportunity to exchange her stock for United Financial shares at the time of and on the same basis as the majority exchange. . . .

Defendants, on the other hand, claim that plaintiff seeks a "free ride" after they have taken all of the risks in creating United Financial and marketing its stock. . . .

Although a controlling shareholder who sells or exchanges his shares is not under an obligation to obtain for the minority the consideration that he receives in all cases, when he does sell or exchange his shares the transaction is subject to close scrutiny. When the majority receives a premium over market value for its shares, the consideration for which that premium is paid will be examined. If it reflects payment for that which is properly a corporate asset all shareholders may demand to share proportionately. . . .

If, after trial of the cause, plaintiff has established facts in conformity with the allegations of the complaint and stipulation, then upon tender of her Association stock to defendants she will be entitled to receive at her election either the appraised value of her shares on the date of the exchange, May 14, 1959, with interest at 7 percent a year from the date of this action or a sum equivalent to the fair market value of a "derived block" of United Financial stock on the date of this action with interest thereon from that date, and the sum of \$927.50 (the return of capital paid to the original United Financial shareholders) with interest thereon from the date United Financial first made such payments to its original shareholders, for each share tendered.

## *Notes and Questions*

1. What, specifically, is the “corporate asset” that, according to the next to last paragraph of the opinion, the defendants appropriated?

## THE WILLIAMS ACT

The Williams Act was enacted in 1968 in response to a surge in the use of hostile cash tender offers as an acquisition tactic. It added sections 13(d) and (e) and 14(d), (e) and (f) to the 1934 Act. Pages 443-445 of the Casebook summarize, from a functional standpoint, the Act’s principal contributions. The excerpt below, taken from the Senate Report, provides a broader look at the Act’s background and objectives. Following it are a chronology that illustrates how the Act, as implemented by SEC rules, operates today and a Case Study that makes for interesting reading.

### FULL DISCLOSURE OF CORPORATE EQUITY OWNERSHIP AND IN CORPORATE TAKEOVER BIDS

Senate Banking & Currency Committee Report No. 550 (1967)

#### A. Introduction

The cash tender offer has become an increasingly favored method of acquiring control of publicly held corporations. The offer normally consists of a bid by an individual or group to buy shares of a company – usually at a price above the current market price. Those accepting the offer are said to tender their stock for purchase. The person making the offer obligates himself to purchase all or a specified portion of the tendered shares if certain specified conditions are met.

The increased use of cash tender offers to acquire control of corporations is evidenced by the fact that in 1966 there were over 100 such offers involving companies with securities listed on national securities exchanges as compared with eight in 1960.

The cash tender offer has advantages over the proxy contest as a means of obtaining control of a corporation. One such advantage is that by using a cash tender offer the person seeking control can operate in almost complete secrecy. At present, the law does not even require that he disclose his identity, the source of his funds, who his associates are, or what he intends to do if he gains control of the corporation. As a practical matter, unless incumbent management explains its position publicly, the investor is severely limited in obtaining all of the facts on which to base a decision whether to accept or reject the tender offer.

The public shareholder must, therefore, with severely limited information, decide what course of action he should take. He has many alternatives. He can tender all of his shares immediately and hope they are all purchased. However, if the offer is for less than all the

outstanding shares, perhaps only a part of them will be taken. In those instances, he will remain a shareholder in the company, under a new management which he has helped to install without knowing whether it will be good or bad for the company.

The shareholder, as another alternative, may wait to see if a better offer develops, but if he tenders late, he runs the risk that none of his shares will be taken. He may also sell his shares in the market or hold them and hope for the best. Without knowledge of who the bidder is and what he plans to do, the shareholder cannot reach an informed decision. He is forced to take a chance. For no matter what he does, he does it without adequate information to enable him to decide rationally what is the best possible course of action. This is precisely the kind of dilemma which our Federal securities laws are designed to prevent.

The competence and integrity of a company's management, and of the persons who seek management positions, are of vital importance to stockholders. Secrecy in this area is inconsistent with the expectations of the people who invest in the securities of publicly held corporations and impairs public confidence in securities as a medium of investment.

#### B. Inadequacy of Present Law

The failure to provide adequate disclosure to investors in connection with a cash takeover bid or other acquisitions which may cause a shift in control is in sharp contrast to the regulatory requirements applicable where one company offers to exchange its shares for those of another, or where a contest for control takes the form of a proxy fight.

Where one company seeks control of another by means of a stock-for-stock exchange, the offer must be registered under the Securities Act of 1933. The shareholder gets a prospectus setting forth all material facts about the offer. He knows who the purchaser is, and what plans have been made for the company. He is thus placed in a position to make an informed decision whether to hold his stock or to exchange it for the stock of the other company.

Where corporate control is sought through a proxy contest, the Securities Exchange Act requires that shareholders be informed of the identity of the participants and their associates, their shareholdings and when they acquired them. When shares are purchased with borrowed funds, the identity of the lender must be disclosed if the funds were obtained otherwise than through a bank loan or margin account. In both the exchange offer and the proxy fight the information is filed with the Securities and Exchange Commission and is subject to statutory requirements and sanctions.

In contrast when a cash tender offer is made, no information need be filed or disclosed to shareholders. Such an offer can be made on the most minimal disclosure; yet the investment decision – whether to retain the security or sell it – is in substance little different from the decision made on an original purchase of a security, or on an offer to exchange one security for another.

## ACQUISITION CHRONOLOGY

### *Open-Market Purchases*

Acquiring Person (“AP”) believes that the shares of Target Co. are undervalued and has been considering the possibility of making an acquisition offer. It may begin by quietly buying Target’s shares in the market, both as a first step to obtaining control and to lock in a future profit in case a rival bidder succeeds in acquiring Target at a premium price. Under section 13(d) of the 1934 Act, added by the Williams Act, AP must disclose its holdings within 10 days once its direct or indirect beneficial ownership exceeds 5 percent of Target’s outstanding shares.

The required filing on Form 13D includes information about AP’s background, the source of its funds and whether its purpose is to acquire control of Target and thereafter engage in a liquidation, asset sale, merger, or other major change. If AP subsequently purchases another 1 percent or more of Target’s stock, or changes its plans, it is required to update its 13D filing.

Given the 10 days before filing is required, AP has substantial time to continue buying after it crosses the 5-percent threshold and therefore could end up with a significantly larger stake in Target before the market becomes aware of what AP is up to. For that reason, leading takeover defense lawyer Martin Lipton has called for shortening the 13(d) “window” to one day, and prohibiting the acquirer from making further purchases until the market has had time to digest the information.

Rather than triggering a 13D disclosure obligation, AP might prefer to instead cap its Target purchases at 4.9 percent until it has a clearer plan whether to seek control and how to go about it.

### *Tender Offer*

If AP ultimately decides to pursue an acquisition, it has two basic choices. It can approach Target’s board with an offer and hope that the board is willing to negotiate. Or it can take its case directly to Target’s shareholders by means of a tender offer. The tender offer might be a partial offer – typically, for only enough shares to give AP majority control and thereby allow it to force a second-step merger to acquire the remaining shares. Or AP may be willing to buy “any and all” shares that Target holders are willing to tender, conditioned upon their tendering at least enough to give AP control. AP might place other conditions on its obligation to purchase the tendered shares, such as a requirement that Target’s board dismantle any takeover defenses it has put in place.

As the Senate Report describes, the principal objective of the Williams Act was to provide target shareholders with meaningful information about the bid and the bidder. Accordingly, if AP decides to go the tender offer route, rule 14d-3 requires it to file a tender offer statement on Schedule TO as soon as practicable after commencement of the offer. (This requirement applies to any tender offer that would result in the bidder beneficially owning more than 5 percent of the target’s stock.) Schedule TO requires comprehensive disclosure about the bidder, the terms of

its bid and its plans for the target. Rule 14d-4 requires that AP also disseminate its offer to Target shareholders as soon as practicable. Bidders will typically both publish the offer in the financial press and seek access to the shareholder list so that they can send the offer directly to shareholders.

In addition to mandating disclosure, the Williams Act also regulates the offer process, with the objective of preserving the target shareholders' freedom of choice. At the heart of this regulatory scheme is the requirement that the offer be open for a minimum of 20 business days. While the Williams Act itself prescribes no minimum offer period, the SEC imposed the 20-business-day requirement under its section 14(e) authority to adopt rules reasonably designed to prevent fraudulent or deceptive practices. Rule 14e-1 also provides that if AP changes the percentage of Target shares that it is seeking, or the consideration it is offering to pay, the offer must remain open for at least ten business days after it gives notice of the change. Thus, if a bidding war for Target develops, and AP is forced to keep increasing the amount it is willing to pay, the duration of its offer may be prolonged well beyond the original 20 business days.

Under rule 14d-7, Target shareholders who tender their shares remain free to withdraw them throughout the entire offer period – an extension of the seven-day period mandated by section 14(d)(5). Thus, if a rival bidder to AP does emerge, Target shareholders can always take back their shares and re-tender them to the highest bidder.

In the case of partial tender offers, what happens if more shares end up being tendered than the bidder has offered to buy? Here too, the SEC has tweaked the original statutory scheme. Section 14(d)(6) requires the bidder to pro rate its purchases, based on the number of shares each shareholder tendered during the first ten days after the offer was announced. The intent is to prevent the bidder from pressuring target shareholders by announcing that it will purchase their shares on a first-come, first-served basis. The SEC decided to lessen the pressure even further, again by using its rulemaking power under section 14(e). Rule 14d-8 extends the “proration period” to the entire duration of the offer. Securities tendered on the final day of the offer must therefore be purchased at the same rate as those tendered at the outset.

Finally, the SEC has extended the principle of section 14(d)(7) that if AP increases the consideration it is offering at any time during the life of the offer, that increased consideration must be paid for all shares Target acquired pursuant to the offer, including any purchased previously. Rule 14d-10 imposes both an “all holders” and a “best price” requirement.\* The former requires the tender offer to be open to all holders of the shares, effectively preventing the kind of discriminatory tender offer upheld by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*, considered in Chapter 12 of the Casebook. The latter mandates that all shares purchased pursuant to the offer receive the highest price paid for any tendered shares. Further, once the tender offer has commenced, AP's right to continue purchasing Target shares in the open market ceases. Rule 14e-5 prohibits the bidder, its affiliates and its advisers from purchasing the target's shares other than by means of the tender offer.

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\* See also rule 13e-4(f)(8) (applying the same all-holders and best-price requirements to self-tender offers by the issuer).

The Williams Act regimen is not limited to the bidder. Rule 14e-2 requires the target to inform its shareholders, within ten days after the tender offer is announced, of its position regarding the offer. It must either recommend acceptance or rejection of the offer; state that it is remaining neutral; or explain the reasons why it is unable to take a position. If the target's board or management does elect to make a recommendation or solicitation to its shareholders, it must satisfy the disclosure requirements of rule 14d-9.

#### CASE STUDY: PLAYING PAC-MAN

*This case study was initially prepared for a course in "Strategy for Lawyers." It involves one of the most colorful chapters in the 1980s takeover era – Bendix Corp.'s failed 1982 attempt to acquire Martin Marietta Corp. For Business Organizations II purposes, the episode illustrates the important consequences of the Williams Act requirement that tender offers be kept open for a minimum period, as well as the interaction between the Act and the state-law rules governing shareholder voting considered earlier. To that end, our classroom discussion will focus on Issue 2 – The Race to Take Control.*

*In navigating this complicated sequence of events, the following timeline may be helpful.*

Spring 1982 – Bendix begins purchasing Martin Marietta and ultimately amasses a 4.5 percent stake at average price of \$27.05 per share

August 25 – Bendix announces its tender offer for 45 percent Martin Marietta at \$43 per share

August 30 – Martin Mareitta announces its counter tender offer for 50.3 percent of Bendix at \$75 per share

September 4 – Expiration of the proration period for Bendix's offer; 58 percent of Martin Marietta shares have been tendered

September 7 – United Technologies Corp. agrees to partner with Martin Marietta and announces its own tender offer for 50 percent of Bendix at \$75 per share

September 7 – Bendix increases its offer price from \$43 to \$48 per share

September 9 – Expiration of the proration period for Martin Marietta's offer; 75 percent of Bendix's shares have been tendered

September 17 – Pursuant to its tender offer, Bendix acquires 58 percent of Martin Marietta at \$48 per share, and increases its offer to include an additional 12 percent

September 22 – Bendix agrees to a merger with Allied Corp., with Bendix shareholders to receive cash and securities with average value of \$81.25 per share

September 23 – Pursuant to its tender offer, Martin Marietta acquires 45 percent of Bendix at \$75 per share, and commits to raising its stake to 51 percent; then agrees to a share exchange with Allied

## *Background*

By the summer of 1982, 44-year old Bendix Corp. CEO William M Agee had already received more than his share of headlines – both for his financial prowess and his personal life. Bright and charismatic, he left his native Idaho to attend Harvard Business School, then quickly climbed the corporate ranks. In 1972, he joined Bendix as its CFO and a member of the newly created office of the chief executive. Historically a manufacturer of components for the automotive industry, Bendix had diversified over the years into a variety of other businesses, including aerospace, auto replacement parts, machine tools and forest products. In 1976, it was named one of the five best managed corporations in America. That same year, when the company's CEO, W. Michael Blumenthal, was appointed as Jimmy Carter's Secretary of the Treasury, Agee got the top job at Bendix. Age 38, he was now CEO of the 70th largest company on the Fortune 500 list.

As Bendix's CEO, Agee combined an engaging personality, a strong analytical mind and an inclusive, low-key management style. Those traits, coupled with some noteworthy corporate acquisitions, quickly gained him public acclaim. *Time* named him as one of "50 faces for America's future" in 1979; a few months later a *New York Times* two-page profile described him as "winning a place among elite American executives."

By 1980 Agee had decided to move Bendix more into high technology, with the benefit of \$770 million in cash he had amassed from a series of well timed divestitures. Assisting Agee in his strategic planning was an attractive 27-year-old woman he had hired directly upon her Harvard Business School graduation, Mary Cunningham. Within fifteen months following her initial hire as Agee's executive assistant, Cunningham received two separate promotions at the vice presidential level. During this same time period Agee's 22-year marriage ended in divorce. The combination of events led to widespread speculation about a romantic relationship between the two, rumors which Agee addressed directly at a well attended employee meeting in September 1980. Under pressure from the Bendix board, Cunningham resigned the next month. With women still a rarity in the upper echelons of corporate management, the story became a national media sensation. Agee and Cunningham ultimately married in June 1982.

In the summer of 1981 Agee believed that stock prices had fallen to the point where he could again pursue his strategy of a major acquisition in the high tech area. He bought substantial blocks of stock in RCA Corp. and Gould, Inc., but his invitations to discuss possible mergers were unequivocally rejected in both cases. In a pointed press release, Thornton Bradshaw, RCA's CEO, announced that Bendix's interest in his company was "not welcomed" and added: "Agee has not demonstrated the ability to manage his own affairs, let alone someone else's."

## *The Battle Begins*

Twice rebuffed, Agee trained his sights on Martin Marietta Corp., principally an aerospace company but also in the cement and aluminum businesses. Based in the Washington D.C. suburbs, Marietta was roughly three-quarters the size of Bendix in terms of assets and revenues,

and ranked 130th on the Fortune 500 list. Bendix began amassing a stake in Marietta in the spring of 1982, and in late July commissioned its investment bankers to undertake a detailed study of the feasibility of an acquisition. Agee's original timetable had contemplated making a decision after Labor Day, to allow time for adequate planning. But a mid-August stock market rally produced a sharp rise in Marietta's stock price, causing Agee to accelerate his plans. On August 25, Bendix announced a tender offer at \$43 per share.

What followed was a dramatic series of ever-increasing commitments by both companies. Martin Marietta not only rejected Bendix's offer, but launched a competing tender offer of its own – for a majority of Bendix stock at \$75 per share. Dubbed the “Pac-Man” strategy after a popular video game of the day, this defense had been employed on two prior occasions but never seen through to completion. Crucial legal issues surrounding the tactic had yet to be resolved. Federal securities law then required a tender offer to be open for 15 business days before the bidder is allowed to purchase the tendered shares.\* By bidding first, Bendix would be in a position to acquire control of Marietta while the latter's hands were still tied. Could Bendix use that control to force Marietta to call off its offer? On the other hand, differences between the laws of the states where Bendix and Marietta were incorporated suggested that Marietta, even though second to acquire the other company's shares, might still win the race to replace its board of directors. All this assumed, however, that the companies would be allowed to vote their respective shares in one another, again an open question. These various issues, and how the parties approached them, are discussed in greater depth below.

Legalities aside, neither Bendix nor the market initially took Martin Marietta's counter-offer very seriously. Bendix's management saw the offer as a ploy to either scare Bendix off or force it to raise its bid. Before the battle Bendix's shares had been trading at about \$50. Because Marietta's \$75 bid extended to only half of Bendix's outstanding shares, Bendix shareholders stood to receive on average, about \$65 per share, well short of the value Bendix management believed the company should command. In response to the Marietta bid, Bendix's stock price rose only to \$57, while Marietta continued to trade within a couple dollars of the Bendix offer – a sign that the market was betting on Bendix.

### *Escalation*

Faced with these credibility problems, Martin Marietta welcomed the emerging interest of a third company into the battle – the much larger United Technologies Corp, a conglomerate built by its strong-willed CEO, Harry J. Gray. Gray and Marietta's CEO, Thomas G. Pownall, had been long-time friends, and Marietta first approached United about coming to its defense as a “white knight,” by acquiring all or part of Marietta on its own. United ultimately decided, however, to make its own tender offer for half of Bendix at \$75 per share, accompanied by a side agreement with Marietta to divide up Bendix's various businesses if either of them prevailed. Bendix reacted by raising its bid for Marietta from \$43 to \$48. Nevertheless, although United's

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\* SEC rules had yet to impose the minimum offer period of 20 business days now required by rule 14e-1(a). However, rule 14d-7, as in effect at the time, permitted tendering shareholders to withdraw their shares at any time up to 15 business days after commencement of the offer, which effectively prohibited the bidder from acquiring the shares until that period expired.



offer was slightly less attractive than Marietta's, it clearly supplied the needed credibility, causing Bendix's stock price to climb \$6 to \$62.50. The battle was now on in full.

For tender offers that are oversubscribed, the law then required that any shares tendered within the first 10 days be eligible for purchase on a pro rata basis.\* This precludes bidders from pressuring shareholders to tender on a first-come-first-served basis. While shareholders retain the right to withdraw their tendered shares for the full 15 business days, the respective percentage of each company's shares tendered during the proration period provides an early gauge of the success of their competing offers. By the time Bendix's proration period expired on September 4, 58 percent of Marietta's shares had been tendered. Five days later (and importantly, following United's entry into the fray), Marietta could claim the tender of 75 percent of Bendix's shares. Thus, the two companies were squarely on course toward a Gordian knot in which each would control the other, though with momentum shifting in favor of Marietta. This shift had required some deft last-minute maneuvering. Weighing strongly in Bendix's favor was the fact that 23 percent of its stock was owned by its own managers through its Salaried Employees Savings and Stock Option Plan ("SESSOP"), an employee benefit plan administered by Citibank. On the eve of the proration deadline, however, Marietta succeeded in persuading Citibank that its fiduciary obligation to obtain the best result for participants overrode the terms of the plan. At the last minute, Citibank tendered all 23 percent.

With both companies' bids now on track for success, Agee and his Martin Marietta counterpart, Pownall, embarked on a delicate game of brinkmanship. Given the total price of \$1.65 billion, the debt and cash outlays needed to complete both tender offers would leave the combined company at serious risk financially. Pownall realized, as the second in line to buy, he would be under considerable pressure to avert this disaster were Bendix to acquire control of his company. And he would have ample legal grounds to do so. Both tender offers contained the customary conditions that gave the offeror multiple outs in the case of adverse new developments. As the date on which Bendix would be free to purchase its shares approached, Marietta therefore sought to send Agee a signal that it would not back down. Its tactic, dubbed "Assured Second-Strike Capability," was to remove virtually all the conditions to its offer. In the view of Marietta's board, this would force Bendix to see its decision to pull the trigger on its own offer as pulling the trigger on Marietta's offer as well.

### *End Game*

Whatever the hope, Agee did not blink. Thursday, September 16 featured a federal court injunction to delay the Bendix offer, its reversal on appeal, and hourly negotiations to resolve the impasse between the investment bankers for both sides. Reportedly, by mid-evening the bankers were only a couple of dollars per share apart on a deal whereby the companies would declare a truce with Marietta buying back its stock from Bendix. But when Agee learned that the Court of Appeals had reversed the injunction, he put an end to further communication between the two camps. At midnight, when it became legally free to do so, Bendix not only purchased all the Marietta shares that had been tendered but announced that it would continue purchasing until its holdings reached 70 percent of the company. That meant, if Marietta were to likewise

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\* The law has since been amended to extend the proration period to the full duration of the offer.

follow through with its offer, the combined company would have \$2.7 million of debt and a net worth of only \$1.1 billion. “He’s a fool,” Marietta’s investment banker is reported to have said upon learning the news, referring to Agee.

Litigation between the parties now took on an even greater role. In its ongoing efforts to prevent Marietta from buying its stock when eligible at midnight on September 22, Bendix drew encouragement from the Delaware Supreme Court’s observation that Marietta now owed a “moral duty” to Bendix as its majority shareholder. Lower courts were unwilling, however, to see this as a sufficient basis to block continuation of Marietta’s bid (although they did hold that the majority-shareholder relationship would preclude Marietta from voting any Bendix shares it purchased). And Marietta’s board, having removed almost all of the conditions to its offer, believed it owed a different duty – to the Bendix shareholders who had tendered their stock in reliance.

Bendix had to focus on a different strategy. If another company were to enter the battle and bid for at least 5 percent of its stock, the law would extend the timetable for the Marietta and United bids by another 10 business days. Agee and his investment bankers had been discussing companies that might be interested in making an investment in Bendix. Among them was Allied Corporation, a former chemical company that CEO Edward I. Hennessey, Jr. had expanded into a wide variety of other businesses on an international scale.\* On September 20, Agee and Hennessey negotiated for Allied to purchase a 20 percent stake in Bendix, but the deal fell apart at the last minute. Agee then flew to Maryland to make one more attempt to persuade Pownall to enter into a friendly deal. When those talks failed to produce an agreement, Agee felt he was out of options. On the afternoon of September 22, racing the clock against the Marietta offer, Agee agreed to sell his company to Allied for \$1.9 billion in cash and securities, equivalent to an average of \$81.25 per share. When the Bendix board met to consider the deal later that day, four of the directors were so shocked by the rapid turn of events that they resigned on the spot. The remaining members approved it.

### *Winners & Losers*

Martin Marietta emerged from the battle battered but independent. Its ultimate fate came down to the wire. Had Bendix been able to resolve its deal with Allied even a few hours earlier, the filing of Allied’s offer would have postponed Marietta’s bid by an additional 10 business days. But the Bendix board meeting went late into the afternoon, too late to file with the SEC that day. Thus, when the withdrawal rights on Marietta’s tender offer expired at midnight, it went ahead with the purchase of a majority interest in Bendix, which it agreed to exchange with Allied for an equally valued portion of the Marietta shares earlier purchased by Bendix. That still left Allied with a 38 percent stake in Marietta, but it agreed to a “standstill” arrangement under which it would take no further steps to acquire control of Marietta for ten years. Over the next two years, through the combination of an initial public offering and the sale

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\* Even by the standards of corporate takeover contests, the battle between Bendix and Marrietta featured more than its share of strong personalities and large egos. Some have speculated that part of Hennessey’s motivation for joining the fray was to outmaneuver Harry Gray of United, who had previously been Hennessey’s boss.

of its aluminum and cement businesses, Marietta was able to buy back the remaining shares from Allied and pay down about two-thirds of its \$1.3 billion post-takeover debt burden.

What about Bill Agee? In negotiating the merger, Ed Hennessey had offered him the Allied presidency. More important to Agee, however, was the position of Chief Operating Officer, which never materialized. In February 1983, Allied announced Agee's resignation. But he did not walk away empty-handed. The Allied deal had increased the value of his own Bendix holdings to almost \$4 million, allowed him to cash in another \$1.4 million in stock options, and entitled him to \$805,000 in annual "golden parachute" payments for five years. In light of this, can Agee and his advisers legitimately claim victory? Ever the deal maker, Agee had mentioned to United's investment banker and others during the contest that he stood ready to sell Bendix for the right price. And in negotiating terms with Allied, he had succeeded in holding out for an additional \$10 per share for Bendix shareholders (including himself) who had elected not to sell to Marietta at \$75. It seems indisputable, however, that had Bendix's intent from the outset been to obtain the best price for its shareholders, a well orchestrated auction would have yielded a better result than the shotgun wedding that occurred.

### *Issues & Miscalculations*

It is more appropriate, therefore, to measure the performance of the Bendix team against its original objective – acquiring Martin Marietta. Viewed from this perspective, there were at least four critical misjudgments in anticipating how events would unfold, including Marietta's counter offer, the legal determinants of the race to take control, Citibank's tender of the SESSOP shares, and Marietta's commitment to pursuing its offer to the finish. Consider each in turn.

#### *1. The Counter Offer*

At the time of the Bendix bid for Martin Marietta, the "Pac Man" defense was still new and untested. Its first use had been three months earlier in a battle between two insurance companies, American General Corp. and NLT Corp., though NLT ultimately succumbed. That same month, Cities Service Co. employed the tactic preemptively, in anticipation of a takeover attempt by Mesa Petroleum Co. That contest eventually led to the acquisition of Cities Service by Occidental Petroleum Co.

Whatever its initial success rate, the "Pac Man" strategy embodies a certain inherent logic: To the extent that an acquisition is motivated by the belief that the bidder and target make a good strategic fit, those benefits should be available whichever of the two ultimately emerges as the acquirer. For Bendix and Martin Marietta in particular, this mutual attraction was not merely conjectural. Marietta was one of the country's prime systems aerospace contractors for the military, and Bendix a leading subcontractor. Both also had cyclical businesses, though in very different industries – automotive and machine tools for Bendix, aluminum and cement for Marietta. Outside observers saw the potential appeal. In a *Newsweek* article on Bendix several months earlier, a stock analyst had predicted Bendix's interest in Marietta. Conversely, the year before, when Marietta sought to develop its own list of possible acquisition targets, its investment bankers identified Bendix, whose automotive division offered the benefit of following a different cycle than Marietta's businesses.

In plotting the bid for Marietta, Bendix's advisers discussed the possibility of a counter offer, but no one appeared to take the threat very seriously. They had several reasons, all of which would prove unfounded. First, they were skeptical that Marietta could line up the necessary financing. (In fact, Marietta was able to secure bank commitments for \$930 million within four days following Bendix's bid.) Also, by making its own offer, Marietta would effectively waive its ability to challenge Bendix's bid on antitrust grounds. Finally, given its head start, Bendix would take control first.

## *2. The Race to Take Control*

The one aspect of Bendix's strategy that has provoked the most criticism, finger-pointing and second-guessing is its assumption that even if Marietta were to counter, Bendix's earlier bid afforded it the advantage of timing. Understanding the issue requires an appreciation of the difference between control of a corporation's shares and control of its board of directors. Because corporate law entrusts business and financial decisions to the board, it is the latter control that is critical. While anyone acquiring a majority of the corporation's shares can ordinarily use that control to replace its board of directors, the procedure for doing so under the law of Delaware, Bendix's state of incorporation, differs markedly from Maryland, Marietta's. Specifically, Maryland allows directors to be replaced only at a meeting of shareholders, which may be called on a minimum of ten days prior notice. Delaware, on the other hand, allows a majority shareholder to replace the board simply by signing a written consent, which can take immediate effect. Thus, even though Bendix had a five day head start in acquiring control at the shareholder level, the ten-day notice period meant that Marietta would have a five-day window to take over the Bendix board. There was some irony to this result. Delaware has often been criticized for the pro-management orientation of its corporate law. Here Delaware's flexibility was actually disadvantaging a company's incumbent management.

There was, however, an additional dimension to Delaware's flexibility: Companies were entitled to negate the availability of this consent procedure in their charters. Had Bendix adhered to its original plan to launch its bid after Labor Day, it might have been able to amend its charter beforehand. But as we saw, the rising stock caused Agee to accelerate his timetable. Bendix was ultimately able to schedule a special stockholders meeting for the morning of September 22 – hours before Marietta would become eligible to purchase its shares – to adopt a package of anti-takeover provisions, including restrictions on the consent procedure. But Bendix had to adjourn the meeting at the last minute when it appeared that Marietta might hold enough proxies to block the amendments.

To be sure, in planning the bid for Marietta, Bendix lawyers appreciated this difference between the two states' procedures for replacing the board of directors. Their willingness to go ahead with the bid in the face of that difference stemmed from their reliance on a different rule, one on which the laws of Delaware and Maryland were substantially the same. When a corporation acquires its own shares, they lose their voting rights. Otherwise, the corporation's management would be able to influence the outcome of decisions entrusted to the shareholders by using corporate funds to acquire and vote outstanding shares as they saw fit. The same logic applies to shares belonging to any subsidiary the corporation controls. Thus, corporation laws routinely prohibit the voting of shares held by any corporation in which the issuing corporation

holds a majority of the shares entitled to vote. Following completion of the Bendix tender offer, Marietta would be deemed a Bendix subsidiary under the terms of those laws. Bendix lawyers therefore reasoned that even if Marietta were to go through with its tender offer, it would not be able to replace Bendix's board, because it would be barred from voting any of the shares it acquired.

Of course, once Marietta was successful in completing its tender offer, Bendix would become a majority-held Marietta subsidiary, so likewise risked losing voting rights on its Marietta holdings. That led Marietta's lawyers to believe that the most likely outcome was, to use their words, a "Mexican stand-off." Though no one could be certain. The underlying legal questions were complex enough to qualify for a law school final exam. First, a corporation fell under either state's statute only when another corporation held a majority of its shares *entitled to vote*. Bendix's lawyers could rely on this phrasing to argue that the sequence of the two acquisitions was determinative. That is, because Marietta would already be a Bendix subsidiary when it acquired its Bendix shares, those shares immediately lost their voting rights, so that even though Marietta might own more than a majority of Bendix's outstanding shares, it would not own a majority of the shares entitled to vote. Under this reasoning, the statutory language would not by its terms apply to bar Bendix from voting.

Predicting the success of such a technical argument was obviously tricky. Was it realistic for a court, confronting two corporations that had just paid out hundreds of millions of dollars to acquire a majority of each other's stock, to disenfranchise one while recognizing full voting rights in the other, based on a few days' difference in when they acquired their shares? Marietta's lawyers would no doubt remind the court that the purpose of the statute was to prohibit corporations from voting their own shares by means of a controlled subsidiary. Courts in other contexts had therefore been willing to read into the statute an implicit requirement that the shares be under the issuer's control. As we have seen, Bendix would not be able to replace Marietta's board and exercise control over its affairs until at least five days after Marietta became its majority shareholder. Could Marietta persuade a court to defer the voting ban during the period in which Bendix could not exercise control? If so, Marietta would have more than enough time to replace the Bendix board through the consent procedure and prevent Bendix's control from ever materializing.

Because of Allied's last minute intervention, none of these issues were definitively resolved. The purpose of the foregoing discussion is simply to portray the uncertainty of the legal landscape created by the competing tender offers. Nonetheless, throughout the fray, Bendix's principal legal strategist, Arthur Fleischer, Jr., author of a leading treatise on takeover tactics, remained steadfast that Bendix, as the initial bidder, would prevail, and that Marietta would be prohibited from voting its shares. Others on the Bendix team were not so confident, and as Marietta continued to press ahead with its counter-bid, Agee complained that the lawyers had not sufficiently "red flagged" the timing issues when Bendix was initially developing its strategy.

In the final analysis, it can fairly be said that Bendix might have won parts of the battle, but clearly lost the war. It was unable to use its status as majority shareholder to dissuade Marietta's banks from following through with their loan commitments, or Marietta's board from

following through with its tender offer, or a court from blocking it. While in the final hours Bendix did obtain a temporary court order prohibiting Marietta from voting any Bendix shares it might acquire through its tender offer, that too was insufficient to discourage Marietta from following through with the acquisition.

### *3. Citibank and the SESSOP Shares*

From the outset, Marietta appreciated that about one quarter of the outstanding Bendix shares were held by the SESSOP, its employee profit-sharing plan. But the Marietta team did not obtain access to the plan documents until the day after its bid. What they learned was discouraging: Bendix employees could withdraw their shares only on the last day of every month – after the Marietta bid was slated to expire. Further, the plan allowed Citibank, as trustee, to sell the shares only to facilitate cash withdrawals by individual participants, which both Bendix management and the Citi officials responsible for overseeing the plan interpreted as prohibiting the plan from participating in the Marietta offer. Agee and his team were confident that the combined effect of these two restrictions would keep the plan shares out of Marietta's hands. Without those shares, Marietta would need almost three quarters of the remaining Bendix shares to be tendered in order to fill its proration pool by the September 9 deadline – a benchmark regarded as critical to preserving the credibility of Marietta's bid.

Complicating the status of the SESSOP shares was the two-tiered structure of Marietta's offer. These structures are by their nature coercive. If the “front end” tender offer of \$75 per share succeeds without the plan shares participating, plan members would be relegated to the package of securities valued at only \$55 that formed the “back-end” merger. The resulting disadvantage to Bendix's plan member-employees led both sides to consult special counsel. The \$20 difference between the front and back ends of Marietta's bid meant that plan participants collectively stood to lose almost \$100 million by not tendering their shares.

While their common concern was fiduciary responsibility under the federal Employee Retirement Income Security Act (“ERISA”), the two sides focused on different dimensions of the issue, and this might have been another fatal oversight on Bendix's part. Its focus was the fiduciary duty of its board of directors, and so it obtained a legal opinion that the board was not required to amend the SESSOP to allow participants to tender their shares. Citi then prepared to distribute the Marietta offer to plan participants with a cover letter from Agee explaining that the terms of the plan precluded them from participating.

Marietta instead focused on Citibank. Did Citi's fiduciary obligations as plan trustee override the terms of the plan? There was, at the time, so little available law on the issue that Marietta's principal outside law firm thought it not worth pursuing. Yet Marietta's in-house lawyers spoke with the Labor Department and received some initial support. Hours before the proration deadline, they were able to secure an opinion from a pension expert at another New York law firm that ERISA required Citi to tender the shares. Those plan members who preferred not to participate – and after all, they were Bendix employees – would remain free to withdraw their shares from the tender offer for another 12 days. Armed with the opinion, Marietta threatened to sue Citi if it failed to tender. Officials from Citi's trust department met

throughout the evening and with the proration deadline less than two hours away, decided to tender.

News of Citi's last-minute change of position shocked the Bendix camp, who had believed they were on the eve of victory. Agee attributed the about-face to the influence of Harry Gray who sat on the boards of Citibank and its parent and its fiduciary committee, while Citi's president sat on United Technologies' board.

This phase of the battle was not entirely over, however. The Bendix board amended the SESSOP to require Citi to withdraw the shares from the tender offer and tender them only if instructed by participants on an individual basis. Agee then wrote the participants to both inform them of this right and discourage them from exercising it. In response, Marietta sued and obtained a court order effectively reversing the board's amendment – the SESSOP shares were to remain in the tender offer pool except to the extent Citi was instructed otherwise by any individual participant.

#### *4. Marietta's Refusal to Give Up*

So far, the discussion has concentrated on specific aspects of the battle where events played out differently from what Bill Agee and his advisers seemed to have predicted. Yet running through the entire episode was a more fundamental theme: Bendix systematically underestimated Marietta's will to aggressively fight back. This began, of course, with the Bendix team's dismissive assessment of the prospect that Marietta would make a counter-bid. Marietta's subsequent effort to send a strong signal of its commitment to remain independent – by removing most of the conditions of its offer – was likewise met with skepticism. Agee continued to remain optimistic about his chance for success even into the final days of the battle, perhaps thinking the force of his personality was sufficient to ultimately win the day. Marietta would become eligible to purchase the Bendix shares at midnight on Wednesday, September 22. On Tuesday morning, Agee hurriedly assembled his advisers for a last-chance trip to Marietta's headquarters in the hope that he could persuade the company's board to reverse its position. He increased his offer for Marietta to \$55 per share, with Pownall to become his second in command and Marietta representatives to receive four seats on the combined company's board. To address the Marietta board's concern that, having removed the conditions, it no longer had legal grounds to withdraw its offer, Bendix agreed to indemnify the directors for any personal liability they might incur. The Marietta board declined, however, to meet with Agee and he flew back to New York empty-handed.

In the view of many observers, Agee never fully appreciated the difference between the two company's cultures. Marietta management saw Agee as a "trader," more oriented to the short-term, in contrast to their own self-image as builders of companies for the long-term. For example, they remained committed, and had focused most of the company's recent capital spending, in its two less glamorous business lines – cement and aluminum. In terms of its aerospace business, Marietta was a weapons system prime contractor, while Bendix produced only subsystems, leading Marietta to frame the battle in terms of the national defense interest: Was Agee qualified to oversee the production of critical missile systems?

Not surprisingly, members of the Bendix camp came to see Marietta's culture and resistance in a less flattering light. In Mary Cunningham's words:

[L]ittle did Agee or anyone else at Bendix take fully into account the military minds of the men at Martin Marietta. Considering themselves merely "an extension of the Defense Department," as Martin Marietta chairman Tom Pownall had once said, they viewed the world in military terms. Their lives were spent in contemplations of missiles, guns and wars, and they thought of business in those terms too. Fight unto the death. Might makes right. But it was only after it was too late that Agee and his comrades realized their misjudgment of the no-holds-barred military mentality. They hadn't taken into account that in business, as in anything else, personalities and cultural norms, not P/E ratios and maximizing shareholder value, sometimes rule the game.

## MERGERS & ACQUISITIONS

DGCL § 251(h) (enacted 2013; amended 2014)

(h) Notwithstanding the requirements of subsection (c) of this section, unless expressly required by its certificate of incorporation, no vote of stockholders of a constituent corporation whose shares are listed on a national securities exchange or held of record by more than 2,000 holders immediately prior to the execution of the agreement of merger by such constituent corporation shall be necessary to authorize a merger if:

(1) The agreement of merger expressly (i) permits or requires such merger to be effected under this subsection and (ii) provides that such merger shall be effected as soon as practicable following the consummation of the offer referred to in paragraph (h)(2) of this section if such merger is effected under this subsection;

(2) A corporation consummates a tender or exchange offer for any and all of the outstanding stock of such constituent corporation on the terms provided in such agreement of merger that, absent this subsection, would be entitled to vote on the adoption or rejection of the agreement of merger; provided, however, that such offer may exclude stock of such constituent corporation that is owned at the commencement of such offer by: (i) such constituent corporation, (ii) the corporation making such offer; (iii) any person that owns, directly or indirectly, all of the outstanding stock of the corporation making such offer; or (iv) any direct or indirect wholly-owned subsidiary of any of the foregoing;

(3) Following the consummation of the offer referred to in paragraph (h)(2) of this section, the stock irrevocably accepted for purchase or exchange pursuant to such offer and received by the depository prior to expiration of such offer, plus the stock otherwise owned by the consummating corporation equals at least such percentage of the stock, and of each class or series thereof, of such constituent corporation that, absent this subsection, would be required to adopt the agreement of merger by this chapter and by the certificate of incorporation of such constituent corporation;



(4) The corporation consummating the offer referred to in paragraph (h)(2) of this section merges with or into such constituent corporation pursuant to such agreement; and

(5) Each outstanding share of each class or series of stock of the constituent corporation that is the subject of and not irrevocably accepted for purchase or exchange in the offer referred to in paragraph (h)(2) of this section is to be converted in such merger into, or into the right to receive, the same amount and kind of cash, property, rights or securities to be paid for shares of such class or series of stock of such constituent corporation irrevocably accepted for purchase or exchange in such offer.

As used in this section only, the term (i) “consummates” (and with correlative meaning, “consummation” and “consummating”) means irrevocably accepts for purchase or exchange stock tendered pursuant to a tender or exchange offer, (ii) “depository” means an agent, including a depository, appointed to facilitate consummation of the offer referred to in paragraph (h)(2) of this section, (iii) “person” means any individual, corporation, partnership, limited liability company, unincorporated association or other entity and (iv) “received” (solely for purposes of paragraph (h)(3) of this section) means physical receipt of a stock certificate in the case of certificated shares and transfer into the depository’s account, or an agent’s message being received by the depository, in the case of uncertificated shares.

If an agreement of merger is adopted without the vote of stockholders of a corporation pursuant to this subsection, the secretary or assistant secretary of the surviving corporation shall certify on the agreement that the agreement has been adopted pursuant to this subsection and that the conditions specified in this subsection (other than the condition listed in paragraph (h)(5) of this section) have been satisfied; provided that such certification on the agreement shall not be required if a certificate of merger is filed in lieu of filing the agreement. The agreement so adopted and certified shall then be filed and shall become effective, in accordance with § 103 of this title. Such filing shall constitute a representation by the person who executes the agreement that the facts stated in the certificate remain true immediately prior to such filing.

#### NOTE ON THE EXCLUSIVITY OF APPRAISAL

In *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712-13 (Del. 1983), the Delaware Supreme Court abandoned the longstanding “Delaware Block” method of valuation in appraisal proceedings – essentially a weighted average based on the company’s earnings, market price and asset value – in favor of “proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court,” including discounted cash flow. By modernizing its approach to valuation, the court sought to make appraisal a more viable remedy for minority shareholders challenging the fairness of a merger. Should appraisal, as a result, become the shareholder’s sole remedy? The implications were significant. The landmark case of *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107 (Del. 1952), had adopted the “entire fairness” standard to address the conflicting loyalties inherent when boards are called upon to consider a merger with a controlling shareholder. In enforcing that doctrine, minority shareholders might bring class actions, pursue equitable remedies, and seek

recovery from defendants other than the corporation – none of which was available in an appraisal proceeding.

On this point the *Weinberger* court sent mixed signals. It allowed claims based on fiduciary grounds to continue in cases that were already pending as well as any future case challenging a merger then underway. But otherwise, appraisal was to be the shareholder's exclusive remedy:

Thereafter, the provisions of 8 Del. C. § 262, as herein construed, respecting the scope of an appraisal and the means for perfecting the same, shall govern the financial remedy available to minority shareholders in a cash-out merger. Thus, we return to the well established principles of *Stauffer v. Standard Brands, Inc.*, Del. Supr., 187 A.2d 78 (1962) and *David J. Greene & Co. v. Schenley Industries, Inc.*, Del. Ch., 281 A.2d 30 (1971), mandating a stockholder's recourse to the basic remedy of an appraisal.

457 A.2d at 715.

At the same time, the court kept the door open to alternative relief in certain circumstances:

While a plaintiff's monetary remedy ordinarily should be confined to the more liberalized appraisal proceeding herein established, we do not intend any limitation on the historic powers of the Chancellor to grant such other relief as the facts of a particular case may dictate. The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved.

*Id.* at 714.

That opening quickly widened. *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A.2d 1099 (Del. 1985), involved the cash-out merger of Philip A. Hunt Chemical Corp. into Olin Corp., which had purchased 63.4% of Hunt's stock sixteen months earlier. In the merger, Hunt's minority shareholders received \$20 per share. Had that merger occurred within one year of the earlier purchase, Olin would have been contractually obligated to pay the same \$25 price it had paid for its initial block. Hunt minority shareholders brought suit, challenging the merger price as grossly inadequate and claiming that Olin had unfairly manipulated the timing of the merger to evade its one-year commitment. The Court of Chancery dismissed the suit. It read *Weinberger* to hold that absent claims of fraud or deception, appraisal was the minority shareholder's exclusive remedy.

On appeal, the Supreme Court reversed, emphasizing *Weinberger's* broader concern for the overall process leading to the merger, which was the basis of the Hunt plaintiffs' claims:

[T]he trial court's narrow interpretation of *Weinberger* would render meaningless our extensive discussion of fair dealing found in that opinion. In *Weinberger* we defined fair dealing as embracing "questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors

and the stockholders were obtained.” While this duty of fairness certainly incorporates the principle that a cash-out merger must be free of fraud or misrepresentation, *Weinberger’s* mandate of fair dealing does not turn solely on issues of deception. . . . Thus, while “in a non-fraudulent transaction . . . price *may* be the preponderant consideration,” it is not necessarily so.

498 A.2d at 1104-05.

Three years later, in *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988), the Delaware Supreme Court upheld the minority shareholder’s right to pursue *both* appraisal and a *Weinberger*-type claim:

[A] statutory appraisal proceeding under section 262 and a rescissory suit for fraud, misrepresentation, self-dealing and other actionable wrongs violative of “entire fairness” to minority shareholders serve different purposes and are designed to provide different, and not interchangeable, remedies.

. . . In a fraud claim, the approach to determining relief may be the same as that employed in determining fair value under 8 Del.C. § 262. However, an appraisal action may not provide a complete remedy for unfair dealing or fraud because a damage award in a fraud action may include “rescissory damages if the [trier of fact] considers them susceptible of proof and a remedy appropriate to all issues of fairness before him.”

542 A.2d at 1186-88.

The cumulative effect of these decisions has been to significantly erode whatever the *Weinberger* court might have originally anticipated as the exclusive role to be played by appraisal in cash-out mergers. In the words of a leading treatise on Delaware law: “A series of Delaware Court of Chancery opinions now hold that a stockholder virtually always may bring a breach of fiduciary duty action challenging a long-form merger in addition to an appraisal action.”\*

KAHN v. M & F WORLDWIDE CORP.

88 A.3d 635

Supreme Court of Delaware, 2014

HOLLAND, Justice:

This is an appeal from a final judgment entered by the Court of Chancery in a proceeding that arises from a 2011 acquisition by MacAndrews & Forbes Holdings, Inc. (“M & F” or “MacAndrews & Forbes”) – a 43% stockholder in M & F Worldwide Corp. (“MFW”) – of the remaining common stock of MFW (the “Merger”). From the outset, M & F’s proposal to take

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\* R. Franklin Balotti & Jesse A. Finkelstein, *Delaware Law of Corporations and Business Organizations* § 9.47.

MFW private was made contingent upon two stockholder-protective procedural conditions. First, M & F required the Merger to be negotiated and approved by a special committee of independent MFW directors (the “Special Committee”). Second, M & F required that the Merger be approved by a majority of stockholders unaffiliated with M & F. The Merger closed in December 2011, after it was approved by a vote of 65.4% of MFW’s minority stockholders.

#### Court of Chancery Decision

The Court of Chancery found that the case presented a “novel question of law,” specifically, “what standard of review should apply to a going private merger conditioned upfront by the controlling stockholder on approval by both a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote.” The Court of Chancery held that business judgment review, rather than entire fairness, should be applied to a very limited category of controller mergers. That category consisted of mergers where the controller voluntarily relinquishes its control—such that the negotiation and approval process replicate those that characterize a third-party merger.

....

#### FACTS

##### MFW and M & F

MFW is a holding company incorporated in Delaware. Before the Merger that is the subject of this dispute, MFW was 43.4% owned by MacAndrews & Forbes, which in turn is entirely owned by Ronald O. Perelman. MFW had four business segments. Three were owned through a holding company, Harland Clarke Holding Corporation (“HCHC”). They were the Harland Clarke Corporation (“Harland”), which printed bank checks; Harland Clarke Financial Solutions, which provided technology products and services to financial services companies; and Scantron Corporation, which manufactured scanning equipment used for educational and other purposes. The fourth segment, which was not part of HCHC, was Mafco Worldwide Corporation, a manufacturer of licorice flavorings.

The MFW board had thirteen members. They were: Ronald Perelman, Barry Schwartz, William Bevins, Bruce Slovin, Charles Dawson, Stephen Taub, John Keane, Theo Folz, Philip Beekman, Martha Byorum, Viet Dinh, Paul Meister, and Carl Webb. Perelman, Schwartz, and Bevins were officers of both MFW and MacAndrews & Forbes. Perelman was the Chairman of MFW and the Chairman and CEO of MacAndrews & Forbes; Schwartz was the President and CEO of MFW and the Vice Chairman and Chief Administrative Officer of MacAndrews & Forbes; and Bevins was a Vice President at MacAndrews & Forbes.

##### The Taking MFW Private Proposal

In May 2011, Perelman began to explore the possibility of taking MFW private. At that time, MFW’s stock price traded in the \$20 to \$24 per share range. MacAndrews & Forbes engaged a bank, Moelis & Company, to advise it. After preparing valuations based on

projections that had been supplied to lenders by MFW in April and May 2011, Moelis valued MFW at between \$10 and \$32 a share.

On June 10, 2011, MFW's shares closed on the New York Stock Exchange at \$16.96. The next business day, June 13, 2011, Schwartz sent a letter proposal ("Proposal") to the MFW board to buy the remaining MFW shares for \$24 in cash. The Proposal stated, in relevant part:

*. . . It is our expectation that the Board of Directors will appoint a special committee of independent directors to consider our proposal and make a recommendation to the Board of Directors. We will not move forward with the transaction unless it is approved by such a special committee. In addition, the transaction will be subject to a non-waivable condition requiring the approval of a majority of the shares of the Company not owned by M & F or its affiliates . . . .*

#### The Special Committee Is Formed

The MFW board met the following day to consider the Proposal. At the meeting, Schwartz presented the offer on behalf of MacAndrews & Forbes. Subsequently, Schwartz and Bevins, as the two directors present who were also directors of MacAndrews & Forbes, recused themselves from the meeting, as did Dawson, the CEO of HCHC, who had previously expressed support for the proposed offer.

The independent directors then invited counsel from Willkie Farr & Gallagher – a law firm that had recently represented a Special Committee of MFW's independent directors in a potential acquisition of a subsidiary of MacAndrews & Forbes – to join the meeting. The independent directors decided to form the Special Committee . . . .

The Special Committee consisted of Byorum, Dinh, Meister (the chair), Slovin, and Webb. The following day, Slovin recused himself because, although the MFW board had determined that he qualified as an independent director under the rules of the New York Stock Exchange, he had "some current relationships that could raise questions about his independence for purposes of serving on the Special Committee."

[The Special Committee engaged Evercore Partners as its financial advisers. Using projections from MacAndrews & Forbes, Evercore valued MFW based on a variety of methods that resulted in a range from \$15 to \$45 per share – valuation based on discounted cash flow produced a range of \$22 to \$38 per share; a "premiums paid" analysis generated a value range of \$22 to \$45.]

[On August 18, 2011, the Special Committee rejected the \$24 a share Proposal, and countered at \$30 per share. The Special Committee characterized the \$30 counteroffer as a negotiating position. The Special Committee recognized that \$30 per share was a very aggressive counteroffer and, not surprisingly, was prepared to accept less.]

[On September 9, 2011, MacAndrews & Forbes rejected the \$30 per share counteroffer. Its representative told the Special Committee Chair that the \$24 per share Proposal was now far less favorable to MacAndrews & Forbes – but more attractive to the minority – than when it was

first made, because of continued declines in MFW’s businesses. Nonetheless, MacAndrews & Forbes agreed later that day to raise its price to \$25 per share, which it said was its “best and final” offer.]

[The next day, at its eighth and final meeting, the Special Committee, although empowered to say “no,” instead unanimously approved and agreed to recommend the Merger at a price of \$25 per share.]

## ANALYSIS

### What Should Be The Review Standard?

Where a transaction involving self-dealing by a controlling stockholder is challenged, the applicable standard of judicial review is “entire fairness,” with the defendants having the burden of persuasion. In other words, the defendants bear the ultimate burden of proving that the transaction with the controlling stockholder was entirely fair to the minority stockholders. In *Kahn v. Lynch Communication Systems, Inc.*, however, this Court held that in “entire fairness” cases, the defendants may shift the burden of persuasion to the plaintiff if either (1) they show that the transaction was approved by a well-functioning committee of independent directors; or (2) they show that the transaction was approved by an informed vote of a majority of the minority stockholders.

This appeal presents a question of first impression: what should be the standard of review for a merger between a controlling stockholder and its subsidiary, where the merger is conditioned *ab initio* upon the approval of **both** an independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders. The question has never been put directly to this Court.

Almost two decades ago, in *Kahn v. Lynch*, we held that the approval by *either* a Special Committee *or* the majority of the noncontrolling stockholders of a merger with a buying controlling stockholder would shift the burden of proof under the entire fairness standard from the defendant to the plaintiff. *Lynch* did not involve a merger conditioned by the controlling stockholder on both procedural protections. The Appellants submit, nonetheless, that statements in *Lynch* and its progeny could be (and were) read to suggest that even if both procedural protections were used, the standard of review would remain entire fairness. However, in *Lynch* and the other cases that Appellants cited, *Southern Peru* and *Kahn v. Tremont*, the controller did not give up its voting power by agreeing to a non-waivable majority-of-the-minority condition.<sup>9</sup> That is the vital distinction between those cases and this one. The question is what the legal consequence of that distinction should be in these circumstances.

[The Court of Chancery held that under these circumstances the business judgment rule should apply. It] rested its holding upon the premise that the common law equitable rule that best protects minority investors is one that encourages controlling stockholders to accord the

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<sup>9</sup> *Kahn v. Lynch Commc’n Sys. (Lynch I)*, 638 A.2d 1110, 1117 (Del. 1994); *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1234 (Del. 2012); *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997).

minority both procedural protections. A transactional structure subject to both conditions differs fundamentally from a merger having only one of those protections, in that:

By giving controlling stockholders the opportunity to have a going private transaction reviewed under the business judgment rule, a strong incentive is created to give minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests. . . . That structure, it is important to note, is critically different than a structure that uses only *one* of the procedural protections. The “or” structure does not replicate the protections of a third-party merger under the DGCL approval process, because it only requires that one, and not both, of the statutory requirements of director and stockholder approval be accomplished by impartial decisionmakers. The “both” structure, by contrast, replicates the arm’s-length merger steps of the DGCL by “requir[ing] two independent approvals, which it is fair to say serve independent integrity-enforcing functions.”

[The Appellants] argue that neither procedural protection is adequate to protect minority stockholders, because “possible ineptitude and timidity of directors” may undermine the special committee protection, and because majority-of-the-minority votes may be unduly influenced by arbitrageurs that have an institutional bias to approve virtually any transaction that offers a market premium, however insubstantial it may be. . . .

With regard to the Special Committee procedural protection, the Appellants’ assertions regarding the MFW directors’ inability to discharge their duties are not supported either by the record or by well-established principles of Delaware law. As the Court of Chancery correctly observed:

Although it is possible that there are independent directors who have little regard for their duties or for being perceived by their company’s stockholders (and the larger network of institutional investors) as being effective at protecting public stockholders, the court thinks they are likely to be exceptional, and certainly our Supreme Court’s jurisprudence does not embrace such a skeptical view.

Regarding the majority-of-the-minority vote procedural protection, as the Court of Chancery noted, “plaintiffs themselves do not argue that minority stockholders will vote against a going private transaction because of fear of retribution.” Instead, as the Court of Chancery summarized, the Appellants’ argued as follows:

[Plaintiffs] just believe that most investors like a premium and will tend to vote for a deal that delivers one and that many long-term investors will sell out when they can obtain most of the premium without waiting for the ultimate vote. But that argument is not one that suggests that the voting decision is not voluntary, it is simply an editorial about the motives of investors and does not contradict the premise that a majority-of-the-minority condition gives minority investors a free and voluntary opportunity to decide what is fair for themselves.

Business Judgment Review Standard Adopted

We hold that business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders. We so conclude for several reasons.

First, entire fairness is the highest standard of review in corporate law. It is applied in the controller merger context as a substitute for the dual statutory protections of disinterested board and stockholder approval, because both protections are potentially undermined by the influence of the controller. However, as this case establishes, that undermining influence does not exist in every controlled merger setting, regardless of the circumstances. The simultaneous deployment of the procedural protections employed here create a countervailing, offsetting influence of equal – if not greater – force. That is, where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm’s-length mergers, which are reviewed under the business judgment standard.

Second, the dual procedural protection merger structure optimally protects the minority stockholders in controller buyouts. As the Court of Chancery explained:

[W]hen these two protections are established up-front, a potent tool to extract good value for the minority is established. From inception, the controlling stockholder knows that it cannot bypass the special committee’s ability to say no. And, the controlling stockholder knows it cannot dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move.

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#### The New Standard Summarized

To summarize our holding, in controller buyouts, the business judgment standard of review will be applied *if and only if*: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.<sup>14</sup>

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<sup>14</sup> The Verified Consolidated Class Action Complaint would have survived a motion to dismiss under this new standard. First, the complaint alleged that Perelman's offer “value[d] the company at just four times” MFW’s profits per share and “five times 2010 pre-tax cash flow,” and that these ratios were “well below” those calculated for recent similar transactions. Second, the complaint alleged that the final Merger price was two dollars per share *lower* than the trading price only about two months earlier. Third, the complaint alleged particularized facts indicating that MFW’s share price was depressed at the times of Perelman’s offer and the Merger announcement due to short-term factors such as MFW’s acquisition of other entities and Standard & Poor’s downgrading of the United States’ creditworthiness. Fourth, the complaint alleged that commentators viewed both Perelman’s initial \$24 per share offer and the final \$25



If a plaintiff that can plead a reasonably conceivable set of facts showing that any or all of those enumerated conditions did not exist, that complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery. If, after discovery, triable issues of fact remain about whether either or both of the dual procedural protections were established, or if established were effective, the case will proceed to a trial in which the court will conduct an entire fairness review.

This approach is consistent with *Weinberger, Lynch* and their progeny. A controller that employs and/or establishes only one of these dual procedural protections would continue to receive burden-shifting within the entire fairness standard of review frame-work. Stated differently, unless *both* procedural protections for the minority stockholders are established *prior to trial*, the ultimate judicial scrutiny of controller buyouts will continue to be the entire fairness standard of review.

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#### Both Procedural Protections Established

Based on a highly extensive record, the Court of Chancery concluded that the procedural protections upon which the Merger was conditioned – approval by an independent and empowered Special Committee and by a uncoerced informed majority of MFW’s minority stockholders – had both been undisputedly established prior to trial. We agree and conclude the Defendants’ motion for summary judgment was properly granted on all of those issues.

#### Business Judgment Review Properly Applied

We have determined that the business judgment rule standard of review applies to this controlling stockholder buyout. Under that standard, the claims against the Defendants must be dismissed unless no rational person could have believed that the merger was favorable to MFW’s minority stockholders. In this case, it cannot be credibly argued (let alone concluded) that no rational person would find the Merger favorable to MFW’s minority stockholders.

#### Conclusion

For the above-stated reasons, the judgment of the Court of Chancery is affirmed.

#### *Notes and Questions*

1. In its opinion, the Court of Chancery had observed: “As our Supreme Court has recognized more than once, the application of fiduciary duty principles must be influenced by current corporate practices.”

In the *Unitrin* case nearly a generation ago, our Supreme Court noted the prevalence of institutional investors in the target company’s stockholder base . . . , stating that

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per share Merger price as being surprisingly low. These allegations about the sufficiency of the price call into question the adequacy of the Special Committee’s negotiations, thereby necessitating discovery on all of the new prerequisites to the application of the business judgment rule.

“[i]nstitutions are more likely than other shareholders to vote at all [and] more likely to vote against manager proposals.” Market developments in the score of years since have made it far easier, not harder, for stockholders to protect themselves. With the development of the internet, there is more public information than ever about various commentators’, analysts’, institutional investors’, journalists’ and others’ views about the wisdom of transactions. Likewise, the internet facilitates campaigns to defeat management recommendations. Not only that, institutional investor holdings have only grown since 1994, making it easier for a blocking position of minority investors to be assembled. Perhaps most important, it is difficult to look at the past generation of experience and conclude that stockholders are reluctant to express positions contrary to those espoused by company management. Stockholders have been effective in using their voting rights to adopt precatory proposals that have resulted in a sharp increase in so-called majority voting policies and a sharp decrease in structural takeover defenses. Stockholders have mounted more proxy fights, and, as important, wielded the threat of a proxy fight or a “withhold vote” campaign to secure changes in both corporate policies and the composition of corporate boards. Stockholders have voted against mergers they did not find favorable, or forced increases in price. Nor has timidity characterized stockholder behavior in companies with large blockholders or even majority stockholders; such companies still face stockholder activism in various forms, and are frequently the subject of lawsuits if stockholders suspect wrongdoing.

2. In its memorandum analyzing the Court of Chancery opinion, the law firm of Sullivan & Cromwell concluded:

By creating a path for business judgment level review, the *MFW* opinion provides a means for effecting minority freeze-out mergers with substantially greater outcome certainty and likely lower transaction friction costs (time, litigation expenses, etc.) for the controllers than previously was possible.

Is the Supreme Court’s opinion consistent with this assessment? Consider, in particular, footnote 14. The Court of Chancery’s decision was on a motion for summary judgment after extensive discovery. What if the defendants had moved for dismissal before discovery?

## CONTESTS FOR CONTROL

### PENNSYLVANIA BUSINESS CORPORATION LAW OF 1988 § 1715

#### § 1715. *Exercise of powers generally*

(a) *General rule.* – In discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of the corporation, consider to the extent they deem appropriate:

(1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and

upon communities in which offices or other establishments of the corporation are located.

(2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.

(3) The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.

(4) All other pertinent factors.

(b) *Consideration of interests and factors.*--The board of directors, committees of the board and individual directors shall not be required, in considering the best interests of the corporation or the effects of any action, to regard any corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor. The consideration of interests and factors in the manner described in this subsection and in subsection (a) shall not constitute a violation of section 1712 (relating to standard of care and justifiable reliance).

AMANDA ACQUISITION CORP. v. UNIVERSAL FOODS CORP.

877 F.2d 496

U.S. Court of Appeals for the Seventh Circuit, 1989

EASTERBROOK, Circuit Judge.

States have enacted three generations of takeover statutes in the last 20 years. Illinois enacted a first-generation statute, which forbade acquisitions of any firm with substantial assets in Illinois unless a public official approved. We concluded that such a statute injures investors, is preempted by the Williams Act, and is unconstitutional under the dormant Commerce Clause. *MITE Corp. v. Dixon*, 633 F.2d 486 (7th Cir. 1980). The Supreme Court affirmed the judgment under the Commerce Clause, *Edgar v. MITE Corp.*, 457 U.S. 624, 643-46 (1982). Three Justices also agreed with our view of the Williams Act, *id.* at 634-40 (White, J., joined by Burger, C.J. & Blackmun, J.), while two disagreed, *id.* at 646-47 (Powell, J.), and 655 (Stevens, J.), and four did not address the subject.

Indiana enacted a second-generation statute, applicable only to firms incorporated there and eliminating governmental veto power. Indiana's law provides that the acquiring firm's shares lose their voting power unless the target's directors approve the acquisition or the shareholders not affiliated with either bidder or management authorize restoration of votes. We concluded that this statute, too, is inimical to investors' interests, preempted by the Williams Act, and unconstitutional under the Commerce Clause. *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250 (7th Cir. 1986). This time the Supreme Court did not agree. It thought the Indiana statute consistent with both Williams Act and Commerce Clause. *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987). Adopting Justice White's view of preemption

for the sake of argument, *id.* at 81, the Court found no inconsistency between state and federal law because Indiana allowed the bidder to acquire the shares without hindrance. Such a law makes the shares less attractive, but it does not regulate the process of bidding. As for the Commerce Clause, the Court took Indiana's law to be regulation of internal corporate affairs, potentially beneficial because it would allow investors to avoid the "coercion" of two-tier bids and other tactics. 481 U.S. at 83, 91-93. Justices White, Blackmun, and Stevens disagreed with the analysis under the Commerce Clause, *id.* at 99-101; only Justice White disagreed with the conclusion about preemption, *id.* at 97-99.

Wisconsin has a third-generation takeover statute. Enacted after *CTS*, it postpones the kinds of transactions that often follow tender offers (and often are the reason for making the offers in the first place). Unless the target's board agrees to the transaction in advance, the bidder must wait three years after buying the shares to merge with the target or acquire more than 5% of its assets. We must decide whether this is consistent with the Williams Act and Commerce Clause.

## I

Amanda Acquisition Corporation is a shell with a single purpose: to acquire Universal Foods Corporation, a diversified firm incorporated in Wisconsin and traded on the New York Stock Exchange. Universal is covered by Wisconsin's anti-takeover law. Amanda is a subsidiary of High Voltage Engineering Corp., a small electronics firm in Massachusetts. Most of High Voltage's equity capital comes from Berisford Capital PLC, a British venture capital firm, and Hyde Park Partners L.P., a partnership affiliated with the principals of Berisford. Chase Manhattan Bank has promised to lend Amanda 50% of the cost of the acquisition, secured by the stock of Universal.

In mid-November 1988 Universal's stock was trading for about \$25 per share. On December 1 Amanda commenced a tender offer at \$30.50, to be effective if at least 75% of the stock should be tendered. This all-cash, all-shares offer has been increased by stages to \$38.00. Amanda's financing is contingent on a prompt merger with Universal if the offer succeeds, so the offer is conditional on a judicial declaration that the law is invalid. . . .

No firm incorporated in Wisconsin and having its headquarters, substantial operations, or 10% of its shares or shareholders there may "engage in a business combination with an interested stockholder . . . for 3 years after the interested stockholder's stock acquisition date unless the board of directors of the [Wisconsin] corporation has approved, before the interested stockholder's stock acquisition date, that business combination or the purchase of stock," Wis. Stat. § 180.726(2). An "interested stockholder" is one owning 10% of the voting stock, directly or through associates (anyone acting in concert with it), § 180.726(1)(j). A "business combination" is a merger with the bidder or any of its affiliates, sale of more than 5% of the assets to bidder or affiliate, liquidation of the target, or a transaction by which the target guarantees the bidder's or affiliates debts or passes tax benefits to the bidder or affiliate, § 180.726(1)(e). The law, in other words, provides for almost hermetic separation of bidder and target for three years after the bidder obtains 10% of the stock – unless the target's board consented before then. No matter how popular the offer, the ban applies: obtaining 85% (even

100%) of the stock held by non-management shareholders won't allow the bidder to engage in a business combination, as it would under Delaware law. Wisconsin firms cannot opt out of the law, as may corporations subject to almost all other state takeover statutes. In Wisconsin it is management's approval in advance, or wait three years. Even when the time is up, the bidder needs the approval of a majority of the remaining investors, without any provision disqualifying shares still held by the managers who resisted the transaction, § 180.726(3)(b). The district court found that this statute "effectively eliminates hostile leveraged buy-outs." As a practical matter, Wisconsin prohibits any offer contingent on a merger between bidder and target, a condition attached to about 90% of contemporary tender offers.

Amanda filed this suit seeking a declaration that this law is preempted by the Williams Act and inconsistent with the Commerce Clause. . . . The district court declined to issue a preliminary injunction. 708 F. Supp. 984 (E.D. Wis. 1989). It concluded that the statute is constitutional and not preempted, and that under Wisconsin law (which the court believed would follow Delaware's) directors are entitled to prevent investors from accepting tender offers of which the directors do not approve. . . .<sup>4</sup> Amanda prevailed on one issue, however: the court held that Universal does not have a private right of action to enforce the margin regulations issued by the Federal Reserve Board, and it therefore declined to consider Universal's argument that Amanda had arranged to borrow more than 50% of the cost of its bid.

## II

### A

If our views of the wisdom of state law mattered, Wisconsin's takeover statute would not survive. Like our colleagues who decided *MITE* and *CTS*, we believe that antitakeover legislation injures shareholders. Managers frequently realize gains for investors via voluntary combinations (mergers). If gains are to be had, but managers balk, tender offers are investors' way to go over managers' heads. If managers are not maximizing the firm's value – perhaps because they have missed the possibility of a synergistic combination, perhaps because they are clinging to divisions that could be better run in other hands, perhaps because they are just not the best persons for the job – a bidder that believes it can realize more of the firm's value will

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<sup>4</sup> . The district court's explanation of its holding is more limited, because it said that the directors might have foreseen three "threats" in this all-cash, all-shares premium offer: a threat that the merger would not occur, leaving some investors locked into a minority position; a threat that the papers filed under the Williams Act "might" contain false information, and a "threat to the corporation itself" in the sense that Amanda might change Universal's business plans. Such "threats" are present in all tender offers. If they are enough to justify defensive tactics, then managers are entitled to "just say no" to tender offers. Nothing in this opinion endorses the district court's rationale concerning these "threats," which is in tension with recent Delaware cases. *City Capital Associates L.P. v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988); *Grand Metropolitan, PLC v. Pillsbury Co.*, 1988 WL 156351, 1988 Del. Ch. LEXIS 158 (Del. Ch. 1988); *MAI Basic Four, Inc. v. Prime Computer, Inc.*, 1988 WL 140221, 1988 Del. Ch. LEXIS 161 (Del. Ch. 1988). In responding to a tender offer directors must exercise "the most scrupulous adherence to ordinary standards of fairness in the interest of promoting the highest values reasonably attainable for the stockholders' benefit." *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1264 (Del. 1989). A policy denying investors the opportunity to accept a substantial premium, based on remote "threats," is not easy to square with the law of Delaware. See also Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 *Business Lawyer* 247, 256-60, 267-73 (1989).

make investors a higher offer. Investors tender; the bidder gets control and changes things. The prospect of monitoring by would-be bidders, and an occasional bid at a premium, induces managers to run corporations more efficiently and replaces them if they will not.

Premium bids reflect the benefits for investors. The price of a firm's stock represents investors' consensus estimate of the value of the shares under current and anticipated conditions. Stock is worth the present value of anticipated future returns – dividends and other distributions. Tender offers succeed when bidders offer more. Only when the bid exceeds the value of the stock (however investors compute value) will it succeed. A statute that precludes investors from receiving or accepting a premium offer makes them worse off. It makes the economy worse off too, because the higher bid reflects the better use to which the bidder can put the target's assets. (If the bidder can't improve the use of the assets, it injures itself by paying a premium.)

Universal, making an argument common among supporters of anti-takeover laws, contends that its investors do not appreciate the worth of its business plans, that its stock is trading for too little, and that if investors tender reflexively they injure themselves. If only they would wait, Universal submits, they would do better under current management. A variant of the argument has it that although smart investors know that the stock is underpriced, many investors are passive and will tender; even the smart investors then must tender to avoid doing worse on the "back end" of the deal. State laws giving management the power to block an offer enable the managers to protect the investors from themselves.

Both versions of this price-is-wrong argument imply: (a) that the stock of firms defeating offers later appreciates in price, topping the bid, thus revealing the wisdom of waiting till the market wises up; and (b) that investors in firms for which no offer is outstanding gain when they adopt devices so that managers may fend off unwanted offers (or states adopt laws with the same consequence). Efforts to verify these implications have failed. The best available data show that if a firm fends off a bid, its profits decline, and its stock price (adjusted for inflation and market-wide changes) never tops the initial bid, even if it is later acquired by another firm. Gregg A. Jarrell, James A. Brickley & Jeffrey M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 *Journal of Economic Perspectives* 49, 55 (1988) (collecting studies); John Pound, *The Information Effects of Takeover Bids and Resistance*, 22 *Journal of Financial Economics* 207 (1988). Stock of firms adopting poison pills falls in price, as does the stock of firms that adopt most kinds of anti-takeover amendments to their articles of incorporation. Jarrell, Brickley & Netter, 2 *Journal of Economic Perspectives* at 58-65 (collecting studies); Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 *Journal of Economic Perspectives* 21, 25-28, 41-45 (1988); Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 *Journal of Financial Economics* 377 (1988); cf. John Pound, *The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence*, 30 *Journal of Law & Economics* 353 (1987). Studies of laws similar to Wisconsin's produce the same conclusion: share prices of firms incorporated in the state drop when the legislation is enacted. Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second Generation State Takeover Legislation*, University of Washington Graduate School of Business Working Paper (Dec. 22, 1988).

Although a takeover-*proof* firm leaves investors at the mercy of incumbent managers (who may be mistaken about the wisdom of their business plan even when they act in the best of faith), a takeover-*resistant* firm may be able to assist its investors. An auction may run up the price, and delay may be essential to an auction. Auctions transfer money from bidders to targets, and diversified investors would not gain from them (their left pocket loses what the right pocket gains); diversified investors would lose from auctions if the lower returns to bidders discourage future bids. But from targets' perspectives, once a bid is on the table an auction may be the best strategy. The full effects of auctions are hard to unravel, sparking scholarly debate. Devices giving managers some ability to orchestrate investors' responses, in order to avoid panic tenders in response to front-end-loaded offers, also could be beneficial . . . .

State anti-takeover laws do not serve these ends well, however. Investors who prefer to give managers the discretion to orchestrate responses to bids may do so through "fair-price" clauses in the articles of incorporation and other consensual devices. Other firms may choose different strategies. A law such as Wisconsin's does not add options to firms that would like to give more discretion to their managers; instead it destroys the possibility of divergent choices. Wisconsin's law applies even when the investors prefer to leave their managers under the gun, to allow the market full sway. . . .

## B

Skepticism about the wisdom of a state's law does not lead to the conclusion that the law is beyond the state's power, however. We have not been elected custodians of investors' wealth. States need not treat investors' welfare as their summum bonum. Perhaps they choose to protect managers' welfare instead, or believe that the current economic literature reaches an incorrect conclusion and that despite appearances takeovers injure investors in the long run. Unless a federal statute or the Constitution bars the way, Wisconsin's choice must be respected.

Amanda relies on the Williams Act of 1968, incorporated into §§ 13(d), (e) and 14(d)-(f) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(d), (e), 78n(d)-(f). The Williams Act regulates the conduct of tender offers. Amanda believes that Congress created an entitlement for investors to receive the benefit of tender offers, and that because Wisconsin's law makes tender offers unattractive to many potential bidders, it is preempted. . . .

The Williams Act regulates the *process* of tender offers: timing, disclosure, proration if tenders exceed what the bidder is willing to buy, best-price rules. It slows things down, allowing investors to evaluate the offer and management's response. Best-price, proration, and short-tender rules ensure that investors who decide at the end of the offer get the same treatment as those who decide immediately, reducing pressure to leap before looking. After complying with the disclosure and delay requirements, the bidder is free to take the shares. . . .

Any bidder complying with federal law is [therefore] free to acquire shares of Wisconsin firms on schedule. Delay in completing a second-stage merger may make the target less attractive, and thus depress the price offered or even lead to an absence of bids; it does not, however, alter any of the procedures governed by federal regulation. . . .

Only if the Williams Act gives investors a right to be the beneficiary of offers could Wisconsin's law run afoul of the federal rule. No such entitlement can be mined out of the Williams Act, however. . . . [T]he Williams Act does not create a right to profit from the business of making tender offers. It is not attractive to put bids on the table for Wisconsin corporations, but because Wisconsin leaves the process alone once a bidder appears, its law may co-exist with the Williams Act.

## C

The Commerce Clause, Art. I, § 8 cl. 3 of the Constitution, grants Congress the power “[t]o regulate Commerce ... among the several States”. . . .

When state law discriminates against interstate commerce expressly – for example, when Wisconsin closes its border to butter from Minnesota – the negative Commerce Clause steps in. The law before us is not of this type: it is neutral between inter-state and intra-state commerce. Amanda therefore presses on us the broader, all-weather, be-reasonable vision of the Constitution. Wisconsin has passed a law that unreasonably injures investors, most of whom live outside of Wisconsin, and therefore it has to be unconstitutional, as Amanda sees things. . . .

Illinois's law, held invalid in *MITE*, regulated sales of stock elsewhere. Illinois tried to tell a Texas owner of stock in a Delaware corporation that he could not sell to a buyer in California. By contrast, Wisconsin's law, like the Indiana statute sustained by *CTS*, regulates the internal affairs of firms incorporated there. Investors may buy or sell stock as they please. . . .

Buyers of stock in Wisconsin firms may exercise full rights as investors, taking immediate control. No interstate transaction is regulated or forbidden. True, Wisconsin's law makes a potential buyer less willing to buy (or depresses the bid), but this is equally true of Indiana's rule. . . . Every rule of corporate law affects investors who live outside the state of incorporation, yet this has never been thought sufficient to authorize a form of cost-benefit inquiry through the medium of the Commerce Clause.

. . . .

. . . The Commerce Clause does not demand that states leave bidders a “meaningful opportunity for success.” Maryland enacted a law that absolutely banned vertical integration in the oil business. No opportunities, “meaningful” or otherwise, remained to firms wanting to own retail outlets. *Exxon Corp. v. Governor of Maryland* held that the law is consistent with the Commerce Clause, even on the assumption that it injures consumers and investors alike. A state with the power to forbid mergers has the power to defer them for three years. Investors can turn to firms incorporated in states committed to the dominance of market forces, or they can turn on legislators who enact unwise laws. The Constitution has room for many economic policies. “[A] law can be both economic folly and constitutional.” *CTS*, 481 U.S. at 96-97 (Scalia, J., concurring). Wisconsin's law may well be folly; we are confident that it is constitutional.

AFFIRMED.



## ACTIVISTS at the DOOR of SOTHEBY'S (I)

Sotheby's is a well-known global art business whose primary activity is acting as agent in high-end art sales. Its shares are listed on the New York Stock Exchange.

In May 2013, Third Point LLC, an activist hedge fund, began acquiring Sotheby's stock. It added to its stake throughout the summer, as did two other prominent activist funds. In August, Third Point made its initial 13D filing, disclosing that it owned 5.7 percent of Sotheby's shares and stating that it intended to pursue a dialogue with the company's board and management, as well as outsiders, that "may relate to potential changes of strategy or leadership." On October 2, 2013, Third Point filed an amended 13D reporting that its holdings had increased to 9.4 percent of the Company. Attached to the 13D was a letter from Daniel Loeb, Third Point's CEO. After outlining his concerns over Sotheby's deteriorating competitive position, Loeb said his "prescription" was to recruit several new directors, including himself, and replace William Ruprecht as the company's CEO. He added that Third Point had already identified and held discussions with several candidates for Ruprecht's job.

The board met the next day to consider the Loeb letter. It learned that Third Point, together with the two other activist funds, now collectively owned about 19 percent of the stock. In response, the board adopted a shareholder rights ("poison pill") plan with a one-year duration. One distinctive feature of the plan was its two-tier trigger – for activist shareholders (specifically, those required to report their holdings on Schedule 13D), the trigger was an ownership threshold of 10 percent of the stock; for all other acquiring persons, the trigger was 20 percent.

Over the months that followed, Sotheby's and Third Point sought to negotiate an acceptable compromise, but failed. At the end of February 2014, Third Point again amended its 13D to state that it had increased its Sotheby's stake to 9.57% and intended to nominate a three-director slate to be elected at the company's annual meeting. As that meeting approached, Third Point requested that the Sotheby's board waive the 10-percent trigger in the poison pill and thereby allow it to increase its stake to up to 20 percent. When the board refused, Third Point brought suit. In *Third Point LLC v. Ruprecht*, 2014 WL 1922029 (Del. Ch. May 2, 2014), the Delaware Chancery Court denied Third Point's motion for a preliminary injunction.

The court held that *Unocal* was the appropriate standard for evaluating both the board's adoption of the poison pill and its refusal to grant the waiver. As to the plan's adoption, the court held that Third Point had no reasonable probability of success under either of *Unocal's* two prongs:

Having determined that the Board probably can demonstrate on a full record that it conducted the requisite investigation, the next relevant inquiry is whether the Board determined that Third Point presented an objectively reasonable and legally cognizable threat to Sotheby's. While the Board has asserted that, at all relevant times, Third Point has presented a multitude of threats to the Company, for purposes of the October 2013 adoption, I need focus only on one: "creeping control." At the time the Board elected to

adopt the Rights Plan in October 2013, it had several hedge funds accumulating its stock simultaneously, and at least as to Third Point, the accumulation was occurring on a relatively rapid basis. The Board also was informed by its advisors that it was not uncommon for activist hedge funds to form a group or “wolfpack,” for the purpose of jointly acquiring large blocks of a target company’s stock. Based on these facts, . . . I cannot conclude that there is a reasonable probability that the Board did not make an objectively reasonable determination that Third Point posed a threat of forming a control block for Sotheby’s with other hedge funds without paying a control premium.

. . . .

I [also] consider it reasonably probable that the Board will be able to meet its burden to demonstrate that the adoption of the Rights Plan in October 2013 was a proportionate response to the control threat posed by Third Point. Plaintiffs here have not litigated the issue of or whether a 10% rights plan comports with Delaware law. Because the entire Board, collectively, owns less than 1% of Sotheby’s stock, a 10% threshold allows activist investors to achieve a substantial ownership position in the Company. This is supported further by the fact that at its current ownership level just below 10%, Third Point is the Company’s largest single stockholder. When the Rights Plan was adopted there also was the objectively reasonable possibility that Third Point was working in connection with one or more other hedge funds in an attempt to create a control block within the Company’s stockholder base. A trigger level much higher than 10% could make it easier for a relatively small group of activist investors to achieve control, without paying a premium, through conscious parallelism. . . .

The gravamen of Plaintiffs’ argument that the Rights Plan is disproportionate pertains mostly to its two-tier structure which permits “passive” investors to buy 20% of the Company shares while “activist” stockholders cannot purchase more than 10%. As an initial matter, I note that while the Rights Plan is “discriminatory” in that sense, it also arguably is a “closer fit” to addressing the Company’s needs to prevent an activist or activists from gaining control than a “garden variety” rights plan that would restrict the ownership levels for every stockholder, even those with no interest in obtaining control or asserting influence. In any event, the importance of the “discriminatory” nature of the challenged Rights Plan appears to be overstated in the circumstances of this case. Because I already have determined that the Board is likely to be able to show that the Rights Plan’s 10% trigger for activist stockholders is reasonable and proportionate, the reason the discriminatory nature of the Rights Plan would be most likely to be found unreasonable or disproportionate is that it allows Schedule 13G filers, who may be more inclined to vote with the Company’s management, to acquire up to 20% of the Company’s shares, and not because a 10% cap on activist stockholders is, itself, unreasonable or disproportionate.

In this case, Third Point is the Company’s largest stockholder meaning that there are no Schedule 13G filers who own more than 10% of Sotheby’s stock. Thus, while the question of whether Schedule 13G filers should be permitted under a rights plan to buy a larger interest in a company than activist stockholders is important in a general sense, I

am not persuaded it can or should serve as a basis to enjoin the Sotheby's annual meeting when, as a practical matter, it is a complete non-issue in terms of the current composition of Sotheby's stockholders.

The court was more critical, however, of whether the board's refusal to waive the 10-percent trigger likewise met the standards of *Unocal*.

This presents a much closer question than the Board's original decision to adopt the Rights Plan in October 2013. Had Third Point asked the Board to waive the Rights Plan in its entirety, rather than just the 10% trigger, based on the record before me, it would have been relatively easy to determine that Third Point posed at least the same threat to the Company that it did when the plan was adopted in the first place. That, however, is not what happened.

Third Point asked only for a waiver of the 10% trigger for Schedule 13D filers so that it could buy up to a 20% interest in the Company. Third Point did not ask, for example, that the Rights Plan be redeemed or that the Company waive the Rights Plan's proscription of concerted action. It is not clear, therefore, that the Board did or should have had the exact same concerns in March 2014 that it did in October 2013 when it adopted the Rights Plan. As a result, I am skeptical that there is a reasonable probability that the Board could establish that when it rejected the request for a waiver, it had an objectively reasonable belief that Third Point continued to pose a "creeping control" risk to the Company, either individually or as part of a "wolf pack."

Nevertheless, despite the change in circumstances, I am persuaded that Sotheby's has made a sufficient showing as to at least one objectively reasonable and legally cognizable threat: negative control. Plaintiffs are correct that the Delaware case law relating to the concept of negative control addresses situations in which a person or entity obtains an explicit veto right through contract or through a level of share ownership or board representation at a level that does not amount to majority control, but nevertheless is sufficient to block certain actions that may require, for example, a supermajority vote. The evidence currently available indicates that Sotheby's may have had legitimate real-world concerns that enabling individuals or entities, such as Loeb and Third Point, to obtain 20% as opposed to 10% ownership interests in the Company could effectively allow those persons to exercise disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power.

. . . If Third Point was given the waiver it requested and achieved 20% ownership it would, by far, be Sotheby's largest single stockholder. That fact, combined with the aggressive and domineering manner in which the evidence suggests Loeb has conducted himself in relation to Sotheby's, provides an adequate basis for legitimate concern that Third Point would be able to exercise influence sufficient to control certain important corporate actions, such as executive recruitment, despite a lack of actual control or an explicit veto power. . . .

. . . Based on the record before me, I find that Plaintiffs have not shown that there is a reasonable probability that the Board will be unable to demonstrate that its refusal to

waive the 10% trigger in the Rights Plan was within the “range of reasonable” responses to the negative control threat posed by Third Point. Therefore, Plaintiffs have not established a likelihood of success on the merits of their claim that the Board breached its fiduciary duties by refusing to allow Third Point in March 2014 to acquire up to 20% of the Company’s stock.

## C&J ENERGY SERVICES

The most recent addition to the *Revlon* line of cases is *C & J Energy Services, Inc. v. City of Miami General Employees’ and Sanitation Employees’ Retirement Trust*, 2014 WL 7243153 (Del. Dec. 19, 2014), in which the Delaware Supreme Court sought to reiterate exactly what *Revlon* required of a board of directors. The case involved a challenge to a merger between C&J Energy Services, Inc. (“C&J”), a Delaware corporation, and a division of its competitor, Nabors Industries Ltd. (“Nabors”).

C&J is an oil field services provider that was founded in 1997 by Joshua Comstock, who remains its Chairman and CEO, as well as a 10-percent stockholder. C&J’s board has seven directors, five of whom are independent, including Adrianna Ma, whose employer, General Atlantic, is a private equity firm that also owned 10 percent of C&J’s stock. In addition to Comstock, the only other management director was Randy McMullen, C&J’s CFO.

In 2013, C&J’s board began to explore strategic acquisitions to grow its business, and authorized Comstock to lead the search. Stephen Trauber, a senior investment banker with Citigroup Global Markets, Inc. (“Citi”), approached Comstock with an unsolicited pitch book suggesting one of Nabors’ two primary divisions, its completions and productions services division (“Nabors CPS”), as a possible target. Trauber arranged a meeting between and Comstock and McMullen and Anthony Petrello, Nabors’ CEO and Chairman. C&J’s board later hired Trauber as its financial adviser.

Discussions between Comstock and Petrello continued over the next several months. Nabors is a Bermuda-domiciled company, and among the possibilities the two sides discussed was structuring the deal so that the surviving company would be domiciled outside of the U.S. and thus pay tax at lower rates – a transaction that is now widely called a “corporate inversion.” C&J could avoid paying U.S. corporate taxes by merging into Nabors and re-domiciling in Bermuda. Citi estimated the tax savings as worth \$200 million in net present value. Both parties agreed that Comstock and C&J’s management team would manage the combined entity. But for the re-domiciling to be effective for tax purposes, Nabors would need to own a majority of the new company.

C&J’s board unanimously approved an offer of \$2.6 billion. Petrello rejected it, arguing that Nabors CPS was worth a minimum of \$3.2 billion. C&J raised its bid to \$2.75 billion, and Comstock and Petrello ultimately agreed to a deal valued at \$2.925 billion.\* The terms of the

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\* Because C&J’s due diligence later revealed that the performance of Nabors CPS had declined from what had been projected, the price was reduced to \$2.86 billion shortly before closing.

transaction called for the creation of a new Bermuda company ultimately named C & J Energy Services, Ltd. (“New C&J”). Following the merger with C&J and transfer of the CPS assets from Nabors, New C&J would be the surviving entity. Former C&J stockholders would receive 47 percent of the new company’s equity and Nabors would own the remaining 53 percent and receive \$938 million in cash. C&J stockholders would have the power to designate four board members of the new company, including Comstock as Chairman. Comstock would also serve as CEO, and McMullen as President and CFO. Petrello assured Comstock that he and the other C&J managers would receive “aggressive” employment agreements.

The plaintiffs filed a class action on behalf of C&J stockholders seeking to enjoin the merger. Finding that there was a “plausible” *Revlon* violation because the C&J board did not affirmatively shop the company either before or after signing the merger agreement, the Court of Chancery enjoined the stockholder vote for 30 days. The Court’s order also required C&J to shop itself in violation of the merger agreement between C & J and Nabors, which prohibited C&J from soliciting other bids.

### *What Does Revlon Require?*

On appeal, the Supreme Court reversed, citing what it saw as the lower court’s misapplication of *Revlon*:

Not only did the Court of Chancery fail to apply the appropriate standard of review, its ruling rested on an erroneous understanding of what *Revlon* requires. *Revlon* involved a decision by a board of directors to chill the emergence of a higher offer from a bidder because the board’s CEO disliked the new bidder, after the target board had agreed to sell the company for cash. *Revlon* made clear that when a board engages in a change of control transaction, it must not take actions inconsistent with achieving the highest immediate value reasonably attainable.

But *Revlon* does not require a board to set aside its own view of what is best for the corporation’s stockholders and run an auction whenever the board approves a change of control transaction. As this Court has made clear, “there is no single blueprint that a board must follow to fulfill its duties,” and a court applying *Revlon*’s enhanced scrutiny must decide “whether the directors made a reasonable decision, not a perfect decision.”

In a series of decisions in the wake of *Revlon*, Chancellor Allen correctly read its holding as permitting a board to pursue the transaction it reasonably views as most valuable to stockholders, so long as the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so. Such a market check does not have to involve an active solicitation, so long as interested bidders have a fair opportunity to present a higher-value alternative, and the board has the flexibility to eschew the original transaction and accept the higher-value deal. The ability of the stockholders themselves to freely accept or reject the board’s preferred course of action is also of great importance in this context.

Here, the Court of Chancery seems to have believed that *Revlon* required C&J's board to conduct a pre-signing active solicitation process in order to satisfy its contextual fiduciary duties. It did so despite finding that C&J's board had no improper motive to sign a deal with Nabors and that the board was well-informed as to C&J's value, and despite the fact that Comstock, one of C&J's largest stockholders, had a strong motive to maximize the value of his shares, and had no reason to do a deal just to secure his (unthreatened) management future. Not only that, but the employer of one of C&J's directors, Ma, was a private equity firm that owned 10% of C&J stock and was therefore unlikely to support a transaction that would compromise the value of its large equity position.

The Court of Chancery imposed a pre-signing solicitation requirement because of its perception that C&J's board did not have "an impeccable knowledge of the value of the company that it is selling." In so ruling, the Court of Chancery seemed to imply that *Revlon* required "impeccable knowledge," and that there was only one reasonable way to comply, *i.e.*, requiring a company to actively shop itself, which ignores the Court of Chancery's own well-reasoned precedent and that of this Court, including our recent decision in *Lyondell*. And the court's perception that the board was not adequately informed was in tension with its other findings, grounded in the record, that C&J's directors were well-informed as to Nabors CPS' value.

....

It is also important to note that there were no material barriers that would have prevented a rival bidder from making a superior offer. As discussed, the C&J board negotiated for a broad "fiduciary out" that enabled the board to terminate the transaction with Nabors if a more favorable deal emerged. This was an unusual protection for a buyer of assets to secure, because sellers (for logical reasons) rarely give buyers such an out. Consistent with his fiduciary duties as a C&J director, Comstock's voting support agreement would fall away upon a decision by the C&J board to exercise its out, leaving him free to vote in favor of a higher priced deal. Therefore, if a competing bidder emerged, it faced only the barrier of a \$65 million termination fee. Further, the transaction was announced on July 25, and was not expected to be consummated until near the end of 2014, a period of time more than sufficient for a serious bidder to express interest and to formulate a binding offer for the C&J board to accept.

In prior cases like *In re Fort Howard Corporation Shareholders Litigation*, 1988 WL 83147 (Del. Ch. Aug. 8, 1988), this sort of passive market check was deemed sufficient to satisfy *Revlon*. But as the years go by, people seem to forget that *Revlon* was largely about a board's resistance to a particular bidder and its subsequent attempts to prevent market forces from surfacing the highest bid. *QVC* was of a similar ilk. But in this case, there was no barrier to the emergence of another bidder and more than adequate time for such a bidder to emerge. The Court of Chancery was right to be "skeptical that another buyer would emerge." As important, the majority of C&J's board is independent, and there is no apparent reason why the board would not be receptive to a transaction that was better for stockholders than the Nabors deal.

....

Given these factors, we conclude that the Court of Chancery failed to apply the correct legal analysis when it imposed the injunction. Because the Court of Chancery could not find that the plaintiffs had met their burden while misapplying *Revlon* and reading it to require an active market check in all circumstances, it certainly could not have found a reasonable probability of success when applying *Revlon* faithfully.

*Do Revlon Duties Even Apply?*

As part of their effort to assure that C&J's former shareholders would retain some control over New C&J notwithstanding Nabors' majority ownership, the C&J board had insisted not only on the board seats and management roles for Comstock and McMullen, but additional governance provisions as well. Among them were:

(i) For a period of five years, a two-thirds vote of the stockholders of the combined entity will be required to amend the bye-laws (unless approved by Comstock and at least three directors not nominated by Nabors); sell the company; issue stock; or repurchase more than 15% of the outstanding shares of the company in a given year;

(ii) In the event of a sale of the company or major assets, all stockholders will receive consideration of the same type and of the same amount calculated on a per share basis. This bye-law [the Bermuda spelling] provision cannot be amended without a unanimous stock-holder vote;

(iii) From the closing date until the earlier of the five year anniversary of the effective date or the date that Nabors owns less than 15% of the combined entity's shares (the "standstill" period), Nabors will be prohibited (without a two-thirds board vote) from acquiring additional shares beyond its ownership stake as of closing . . . ; and

(v) Without a two-thirds vote of the combined entity's board, and during the standstill period, Nabors can only sell its stock to a person or group that is not subject to SEC Rule 13d, *i.e.*, the transferee cannot (i) hold the securities with the "purpose, or with the effect of, changing or influencing the control" or (ii) own more than 20% of the combined entity. . . .

In light of these limitations on Nabors' control, is *Revlon* the appropriate standard for reviewing the merger? On this question, the Supreme Court observed:

Nor does the record indicate that C&J's board was unaware of the implications of structuring the deal so that Nabors would have majority voting control over the surviving entity. As the undisputed facts demonstrate, the C&J board was aware that Nabors would own a majority of the voting stock of New C&J, and indeed that such a shift in control was required to effect the tax-motivated re-domiciling that the board believed would be beneficial to C&J's stockholders. The board took steps to mitigate the effects of that change in control, including by providing that a two-thirds vote will be required to amend the corporate bye-laws, sell the company, or issue stock for a period of five years;

and preventing Nabors from acquiring additional shares or selling its shares for the five year standstill period. Most important, the board negotiated for a bye-law providing that all stockholders will receive *pro rata* consideration in any sale of the company or its assets, a bye-law that cannot be repealed without unanimous stockholder approval.

Although we are reluctant in the context of this expedited appeal to conclude that these provisions were, in themselves, sufficient to take the transaction out of the reach of *Reylon*, they do constitute important efforts by the C&J directors to protect their stockholders and to ensure that the transaction was favorable to them.<sup>98</sup>

### *The Mandatory Injunction*

What about the lower court's requirement that C&J shop itself, even though its merger agreement with Nabors prohibited it from doing so? The Supreme Court was highly critical:

[T]he Court of Chancery also erred by entering a mandatory injunction without applying the correct procedural standard. The court order provides that C&J is "ordered to solicit alternative proposals to purchase the Company. . . ." To issue a mandatory injunction requiring a party to take affirmative action – such as to engage in the go-shop process the Court of Chancery required – the Court of Chancery must either hold a trial and make findings of fact, or base an injunction solely on undisputed facts. Here, the Court of Chancery issued a mandatory injunction on a paper record that surfaced a number of important factual disputes and that was only sufficient to convince the Court of Chancery that the plaintiffs had a plausible merits case. This was error. The plaintiffs here did not seek an expedited trial; they sought a preliminary injunction, and an unusual one at that. The injunction ordered C&J to solicit and negotiate alternative proposals, and stated that doing so would not constitute a breach of the merger agreement, despite the plain language of Section 6.4 of the agreement to the contrary.

Although the equitable authority of our Court of Chancery is broad, it is not uncabined and must be exercised with care and respect for the rights of litigants. The record below did not provide a basis for the Court of Chancery to force Nabors to endure a judicially-ordered infringement of its contractual rights that would, by judicial fiat, not even count as a breach of Nabors' rights. The Court of Chancery made no finding, even on a preliminary basis, that Nabors aided and abetted the C&J's board's alleged breach of fiduciary duties. This was unsurprising, given that the plaintiffs did not even make a fair argument below to support attributing liability to Nabors.

Preliminary injunctions are powerful tools, and their bluntness can be disconcerting to plaintiffs, defendants, and trial judges. But the traditional use of a preliminary injunction in the Court of Chancery is to preserve the status quo – for example, to enjoin a corporate transaction until there is a full trial if the court believes

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<sup>98</sup> We assume for the sake of analysis that *Reylon* was invoked. We recognize that *QVC* suggests that contractual provisions limiting the power of a majority stockholder and securing the minority's ability to share in any future control premium might take a transaction out of *Reylon*'s reach. *See QVC*, 637 A.2d 34, 42 n.12. But given the timing exigencies and the fact that this is an issue of first impression before this Court, we decline to reach the question of whether *Reylon* applies.



that there is a reasonable probability a fiduciary breach has occurred – not to divest third parties of their contractual rights. Even after a trial, a judicial decision holding a party to its contractual obligations while stripping it of bargained-for benefits should only be undertaken on the basis that the party ordered to perform was fairly required to do so, because it had, for example, aided and abetted a breach of fiduciary duty. To blue-pencil an agreement to excise a provision beneficial to a third party like Nabors on the basis of a provisional record and then declare that the third party could not regard the excision as a basis for relieving it of its own contractual duties involves an exercise of judicial power inconsistent with the standards that govern the award of mandatory injunctions under Delaware law.

#### ACTIVISTS at the DOOR of SOTHEBY'S (II)

In *Third Point LLC v. Ruprecht*, discussed above, Third Point had argued that given the upcoming proxy contest, the appropriate standard for evaluating the Sotheby's poison pill was not *Unocal* but *Blasius*. And under that standard, the Sotheby's board must provide a "compelling justification" for acting "for the primary purpose of interfering with the effectiveness of a stockholder vote." Rejecting this argument, the court observed:

In that regard, Plaintiffs have not cited to any case in which this Court or the Supreme Court has invoked *Blasius* to examine a rights plan. There are any number of possible explanations for this dearth of authority, including, but not limited to, that: (1) no Delaware court has ever found that a board of directors adopted a rights plan for the "primary purpose" of interfering with or impeding the exercise of the stockholder franchise; (2) while rights plans can interfere with the franchise, they do not do so in the manner that *Blasius* was concerned with so long as a proxy contest remains a viable option; or (3) to the extent a stockholder rights plan does adversely affect the franchise, that circumstance is adequately dealt with under the *Unocal* standard such that application of *Blasius* has proven unnecessary. Therefore, although *Blasius* might have some theoretical application to the facts of this case, it appears that, based on the relevant precedent, or more precisely, the lack thereof, *Unocal* provides the appropriate framework.

Nonetheless, the court went on to consider the application of the *Blasius* test to the Sotheby's poison pill.

On this truncated record, there is sufficient evidence to support a reasonable inference that the Company has been concerned with the prospect of a proxy fight with an activist stockholder since the Summer of 2013. But the facts here do not support the conclusion that Plaintiffs have a reasonable probability of demonstrating that the Board adopted the Rights Plan in October 2013 for the *primary purpose* of interfering with the franchise of any stockholder, including Third Point, several months later. As stated previously, the Company was facing a rapid increase in hedge fund ownership in its stock that at least one Sotheby's insider believed was "collusive." . . . Because it is reasonably likely that the Board will be able to show that they were motivated to adopt the Rights

Plan in response to this control threat and that “any effect of electoral rights was an incident to that end,” Plaintiffs have not shown that it is reasonably probable that Plaintiffs will be able to establish that interference with the franchise was a major, let alone primary, purpose behind the Board’s decision.

The court cited several other factors that weighed against the conclusion that “the Board’s primary motivation was impeding the voting rights of any Sotheby’s stockholder.” Among them:

First, the record is nearly devoid of facts that would support an inference of entrenchment on the part of the Board. The Board is not staggered, turns over at an above-average rate, and is dominated by outside, independent directors. Moreover, with the possible exception of Ruprecht, there has been no showing that serving on the Sotheby’s Board is material, financially or otherwise, to any director such that they have a disabling personal incentive to quash a proxy contest.

Finally, the court emphasized that the Sotheby’s poison pill lacked the disenfranchising effect required to trigger *Blasius*, because it was neither coercive nor preclusive:

This Rights Plan does not contain any features that would outright force a stockholder to vote in favor of the Board or allow the Board to induce votes in its favor through more subtle means. Said differently, the Rights Plan does not impose any consequences on stockholders for voting their shares as they wish. Thus, the Rights Plan is not “coercive.” Nor is the Rights Plan here preclusive. It is undisputed that Third Point’s proxy contest with the Board is eminently winnable by either side. Therefore, even with a 10% cap on the number of shares it can acquire, there is no credible argument that Third Point’s success in the pending proxy contest is “realistically unattainable.”

## INSIDER TRADING

### NOTE ON INSIDER TRADING & INVESTOR CONFIDENCE

Professor William L. Cary was President John F. Kennedy’s appointee to chair the Securities & Exchange Commission, a post initially held by Kennedy’s own father. In that capacity, Cary authored the seminal opinion, *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), holding that insider trading violated 1934 Act rule 10b-5. At a conference a few years after the *Cady, Roberts* decision, Cary observed:

We sometimes forget that integrity in the capital markets is essential for mass capitalism. I think I can best illustrate this by a discussion in Washington two years ago with the Ambassador from a South American country. He came to ask my advice because he wanted to see more outside capital injected into private firms in his country, and wondered how it could be achieved. I started with the first question, “Are you interested in developing a stock exchange? Are your stock exchange facilities inadequate?” And he said, “No, that really isn’t the question. We have to get back to

fundamentals.” He continued with this crucial statement: “My first concern is whether the public investor there can trust anyone. The trouble with management in my country is that their only loyalty is to their relatives.” This is not uncommon, and it struck me forcefully; it emphasized the importance of confidence, and a high standard of conduct by directors, as an essential ingredient before one can expect the private investor to begin putting his funds into public companies.

I had a similar reaction to this problem when I was in Europe this summer, teaching foreign students. One Norwegian lawyer asked me in surprise after he heard about the developments in this country, “Why become a director if you cannot take advantage of inside information?” And he was quite serious about it.

*Insider Trading in Stocks*, 21 *Business Lawyer* 1009, 1010 (1966).

Even today, how much do we actually know about investor confidence and the willingness to trade in a particular market? In a comprehensive study, two finance professors attempted to measure the country by country effect of insider trading risk on the cost of a company’s equity capital.\* They found that out of 103 countries with stock markets in 1998, 87 had laws governing insider trading (all 22 developed countries, and 65 of 81 emerging markets). Importantly, however, they focused not on the law on the books, but whether it was enforced. Enforcement actions had been brought in only 38 of the countries (18 developed countries and 20 emerging markets). They found that the mere enactment of insider trading regulation had no statistically significant effect on the country’s cost of capital. The initial enforcement of those laws, on the other hand, reduced average annual capital costs by an average of about 6 percent.

While the existence of insider trading laws may not by itself make a difference, perhaps the content of those laws does. Further insight into the relationship between insider trading law and investor confidence is provided by a second study, which focused on the strength of a country’s insider trading law, as measured by factors such as whether it applied to tipping and the types of sanctions available. Examining a cross-section of 33 countries, the study found that those with stricter laws tended to have more dispersed equity ownership, more accurate stock prices and more liquid markets.†

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\* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 *Journal of Finance* 75 (2002).

† Laura Nyantung Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, 7 *American Law & Economics Review* 144 (2005).

UNITED STATES v. NEWMAN

2014 WL 6911278

U.S. Court of Appeals, Second Circuit, Dec. 10, 2014

BARRINGTON D. PARKER, Circuit Judge:

[Defendants-appellants Todd Newman and Anthony Chiasson appeal from judgments of conviction following a six-week jury trial on charges of securities fraud in violation of Exchange Act § 10(b) and rule 10b-5.]

The Government alleged that a cohort of analysts at various hedge funds and investment firms obtained material, nonpublic information from employees of publicly traded technology companies, shared it amongst each other, and subsequently passed this information to the portfolio managers at their respective companies. The Government charged Newman, a portfolio manager at Diamondback Capital Management, LLC (“Diamondback”), and Chiasson, a portfolio manager at Level Global Investors, L.P. (“Level Global”), with willfully participating in this insider trading scheme by trading in securities based on the inside information illicitly obtained by this group of analysts. On appeal, Newman and Chiasson challenge the sufficiency of the evidence as to several elements of the offense, and further argue that the district court erred in failing to instruct the jury that it must find that a tippee knew that the insider disclosed confidential information in exchange for a personal benefit.

BACKGROUND

This case arises from the Government’s ongoing investigation into suspected insider trading activity at hedge funds. . . .

At trial, the Government presented evidence that a group of financial analysts exchanged information they obtained from company insiders, both directly and more often indirectly. Specifically, the Government alleged that these analysts received information from insiders at Dell and NVIDIA disclosing those companies’ earnings numbers before they were publicly released in Dell’s May 2008 and August 2008 earnings announcements and NVIDIA’s May 2008 earnings announcement. These analysts then passed the inside information to their portfolio managers, including Newman and Chiasson, who, in turn, executed trades in Dell and NVIDIA stock, earning approximately \$4 million and \$68 million, respectively, in profits for their respective funds.

Newman and Chiasson were several steps removed from the corporate insiders and there was no evidence that either was aware of the source of the inside information. With respect to the Dell tipping chain, the evidence established that Rob Ray of Dell’s investor relations department tipped information regarding Dell’s consolidated earnings numbers to Sandy Goyal, an analyst at Neuberger Berman. Goyal in turn gave the information to Diamondback analyst Jesse Tortora. Tortora in turn relayed the information to his manager Newman as well as to other analysts including Level Global analyst Spyridon “Sam” Adondakis. Adondakis then

passed along the Dell information to Chiasson, making Newman and Chiasson three and four levels removed from the inside tipper, respectively.

With respect to the NVIDIA tipping chain, the evidence established that Chris Choi of NVIDIA's finance unit tipped inside information to Hyung Lim, a former executive at technology companies Broadcom Corp. and Altera Corp., whom Choi knew from church. Lim passed the information to co-defendant Danny Kuo, an analyst at Whittier Trust. Kuo circulated the information to the group of analyst friends, including Tortora and Adondakis, who in turn gave the information to Newman and Chiasson, making Newman and Chiasson four levels removed from the inside tippers.

Although Ray has yet to be charged administratively, civilly, or criminally, and Choi has yet to be charged criminally, for insider trading or any other wrongdoing, the Government charged that Newman and Chiasson were criminally liable for insider trading because, as sophisticated traders, they must have known that information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose.

At the close of evidence, Newman and Chiasson . . . argued that there was no evidence that the corporate insiders provided inside information in exchange for a personal benefit which is required to establish tipper liability under *Dirks v. S.E.C.*, 463 U.S. 646 (1983). Because a tippee's liability derives from the liability of the tipper, Newman and Chiasson argued that they could not be found guilty of insider trading. Newman and Chiasson also argued that, even if the corporate insiders had received a personal benefit in exchange for the inside information, there was no evidence that they knew about any such benefit. Absent such knowledge, appellants argued, they were not aware of, or participants in, the tippers' fraudulent breaches of fiduciary duties to Dell or NVIDIA, and could not be convicted of insider trading under *Dirks*. In the alternative, appellants requested that the court instruct the jury that it must find that Newman and Chiasson knew that the corporate insiders had disclosed confidential information for personal benefit in order to find them guilty.

[T]he district court did not give Newman and Chiasson's proposed jury instruction. Instead, the district court gave the following instructions on the tippers' intent and the personal benefit requirement:

Now, if you find that Mr. Ray and/or Mr. Choi had a fiduciary or other relationship of trust and confidence with their employers, then you must next consider whether the [G]overnment has proven beyond a reasonable doubt that they intentionally breached that duty of trust and confidence by disclosing material[,] nonpublic information for their own benefit.

On the issue of the appellants' knowledge, the district court instructed the jury:

To meet its burden, the [G]overnment must also prove beyond a reasonable doubt that the defendant you are considering knew that the material, nonpublic information had been disclosed by the insider in breach of a duty of trust and confidence. The mere receipt of material, nonpublic information by a defendant, and even trading on that

information, is not sufficient; he must have known that it was originally disclosed by the insider in violation of a duty of confidentiality.

[The jury returned a verdict of guilty on all counts. The district court sentenced Newman to an aggregate term of 54 months' imprisonment, to be followed by one year of supervised release, imposed a \$500 mandatory special assessment, and ordered Newman to pay a \$1 million fine and to forfeit \$737,724. The district court sentenced Chiasson to an aggregate term of 78 months' imprisonment, to be followed by one year of supervised release, imposed a \$600 mandatory special assessment, and ordered him to pay a \$5 million fine and forfeiture in an amount not to exceed \$2 million. This appeal followed.]

## DISCUSSION

### E. Mens Rea

Liability for securities fraud also requires proof that the defendant acted with scienter, which is defined as “a mental state embracing intent to deceive, manipulate or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). In order to establish a criminal violation of the securities laws, the Government must show that the defendant acted “willfully.” 15 U.S.C. § 78ff(a). We have defined willfulness in this context “as a realization on the defendant’s part that he was doing a wrongful act under the securities laws.” *United States v. Cassese*, 428 F.3d 92, 98 (2d Cir. 2005).

### II. The Requirements of Tippee Liability

The Government concedes that tippee liability requires proof of a personal benefit to the insider. However, the Government argues that it was not required to prove that Newman and Chiasson knew that the insiders at Dell and NVIDIA received a personal benefit in order to be found guilty of insider trading. Instead, the Government contends, consistent with the district court’s instruction, that it merely needed to prove that the “defendants traded on material, nonpublic information they knew insiders had disclosed in breach of a duty of confidentiality.”

In support of this position, the Government cites *Dirks* for the proposition that the Supreme Court only required that the “tippee know that the tipper disclosed information in breach of a duty.” (citing *Dirks*, 463 U.S. at 660) (emphasis added). In addition, the Government relies on dicta in a number of our decisions post-*Dirks*, in which we have described the elements of tippee liability without specifically stating that the Government must prove that the tippee knew that the corporate insider who disclosed confidential information did so for his own personal benefit. . . .

While we have not yet been presented with the question of whether the tippee’s knowledge of a tipper’s breach requires knowledge of the tipper’s personal benefit, the answer follows naturally from *Dirks*. *Dirks* counsels us that the exchange of confidential information for personal benefit is not separate from an insider’s fiduciary breach; it is the fiduciary breach that triggers liability for securities fraud under Rule 10b–5. For purposes of insider trading liability, the insider’s disclosure of confidential information, standing alone, is not a breach. Thus, without establishing that the tippee knows of the personal benefit received by the insider

in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach.

The Government's overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders. By contrast, our prior cases generally involved tippees who directly participated in the tipper's breach (and therefore had knowledge of the tipper's disclosure for personal benefit) or tippees who were explicitly apprised of the tipper's gain by an intermediary tippee.

....

In sum, we hold that to sustain an insider trading conviction against a tippee, the Government must prove each of the following elements beyond a reasonable doubt: that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit. *See United States v. Jiau*, 734 F.3d 147, 152-53 (2d Cir. 2013); *Dirks*, 463 U.S. at 659-64.

....

### III. Insufficiency of the Evidence

The circumstantial evidence in this case was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips. As to the Dell tips, the Government established that Goyal and Ray were not "close" friends, but had known each other for years, having both attended business school and worked at Dell together. Further, Ray, who wanted to become a Wall Street analyst like Goyal, sought career advice and assistance from Goyal. The evidence further showed that Goyal advised Ray on a range of topics, from discussing the qualifying examination in order to become a financial analyst to editing Ray's résumé and sending it to a Wall Street recruiter, and that some of this assistance began before Ray began to provide tips about Dell's earnings. The evidence also established that Lim and Choi were "family friends" that had met through church and occasionally socialized together. The Government argues that these facts were sufficient to prove that the tippers derived some benefit from the tip. We disagree. If this was a "benefit," practically anything would qualify.

We have observed that "[p]ersonal benefit is broadly defined to include not only pecuniary gain, but also, inter alia, any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend." *Jiau*, 734 F.3d at 153. This standard, although permissive, does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature. If that were true, and the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity. To the extent

*Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades "resemble trading by the insider himself followed by a gift of the profits to the recipient," see 643 U.S. at 664, we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. . . .

. . . .

Even assuming that the scant evidence described above was sufficient to permit the inference of a personal benefit, which we conclude it was not, the Government presented absolutely no testimony or any other evidence that Newman and Chiasson knew that they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures, or even that Newman and Chiasson consciously avoided learning of these facts. As discussed above, the Government is required to prove beyond a reasonable doubt that Newman and Chiasson knew that the insiders received a personal benefit in exchange for disclosing confidential information.

#### CONCLUSION

For the foregoing reasons, we vacate the convictions and remand for the district court to dismiss the indictment with prejudice as it pertains to Newman and Chiasson.

#### NOTE ON THE MARK CUBAN CASE

Mark Cuban, who became a billionaire at age 40 when he sold his internet company to Yahoo, is the controversial owner of the Dallas Mavericks basketball team. Cuban also owned 6.3 percent of Mamma.com, a publicly traded company which had decided to raise additional capital through a private placement of new shares (referred to as a "PIPE" transaction). As is typical for PIPE transactions, the privately placed shares would be sold at a discount to Mamma.com's current market price, because the resale of the shares is restricted. Momma.com's CEO called Cuban, told him on a confidential basis about the upcoming PIPE transaction, and offered him the opportunity to purchase some of the shares. Cuban became upset and complained that he objected to PIPE offerings because they diluted existing shareholders.

The CEO followed up with an email inviting Cuban to speak with Merriman, the investment banker handling the PIPE offering. Cuban did so and learned other confidential details about the offering's terms and conditions. Immediately afterward, Cuban called his broker to sell all his Momma.com holdings. When the PIPE transaction was publicly announced, Momma.com's stock price fell 8.5 percent and continued to decline by another 30 percent in the days that followed.



By selling when he did, Cuban avoided over \$750,000 in losses. Did he violate rule 10b-5? Should it matter that when learning the news from the CEO, Cuban told him: “Well, now I’m screwed. I can’t sell.”

The SEC’s attempt to hold Cuban liable for insider trading was initially dismissed by the District Court. It reasoned that the SEC’s complaint alleged only that Cuban had agreed to keep the information confidential, not to refrain from trading on it. To the extent that rule 10b5-2(b)(1) purported to impose liability based solely on the existence of such a confidentiality agreement, the court questioned whether it was within the SEC’s authority under the *O’Hagan* case. *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009).

On appeal, the Fifth Circuit reversed. It held that Cuban’s “I’m screwed” comment could plausibly be interpreted as an agreement not to sell, as a result of which Cuban gained access to the additional confidential information from Merriman. Thus interpreted, the complaint stated a claim under the misappropriation doctrine. *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010).

On remand, the case was tried before a jury, which found for Cuban.

#### HALLIBURTON CO. v. ERICA P. JOHN FUND, INC.

134 S. Ct. 2398

U.S. Supreme Court, 2014

Chief Justice ROBERTS delivered the opinion of the Court.

Investors can recover damages in a private securities fraud action only if they prove that they relied on the defendant’s misrepresentation in deciding to buy or sell a company’s stock. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), we held that investors could satisfy this reliance requirement by invoking a presumption that the price of stock traded in an efficient market reflects all public, material information – including material misstatements. In such a case, we concluded, anyone who buys or sells the stock at the market price may be considered to have relied on those misstatements.

We also held, however, that a defendant could rebut this presumption in a number of ways, including by showing that the alleged misrepresentation did not actually affect the stock’s price – that is, that the misrepresentation had no “price impact.” The questions presented are whether we should overrule or modify *Basic*’s presumption of reliance and, if not, whether defendants should nonetheless be afforded an opportunity in securities class action cases to rebut the presumption at the class certification stage, by showing a lack of price impact.

#### I

Respondent Erica P. John Fund, Inc. (EPJ Fund), is the lead plaintiff in a putative class action against Halliburton and one of its executives (collectively Halliburton) alleging violations of section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5. According to EPJ Fund, between June 3, 1999, and December 7, 2001, Halliburton

made a series of misrepresentations regarding its potential liability in asbestos litigation, its expected revenue from certain construction contracts, and the anticipated benefits of its merger with another company – all in an attempt to inflate the price of its stock. Halliburton subsequently made a number of corrective disclosures, which, EPJ Fund contends, caused the company’s stock price to drop and investors to lose money.

EPJ Fund moved to certify a class comprising all investors who purchased Halliburton common stock during the class period. . . . [Fifth] Circuit precedent required securities fraud plaintiffs to prove “loss causation” – a causal connection between the defendants’ alleged misrepresentations and the plaintiffs’ economic losses – in order to invoke *Basic*’s presumption of reliance and obtain class certification. Because EPJ Fund had not demonstrated such a connection for any of Halliburton’s alleged misrepresentations, the District Court refused to certify the proposed class. The United States Court of Appeals for the Fifth Circuit affirmed the denial of class certification on the same ground. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (2010).

We granted certiorari and vacated the judgment, finding nothing in “*Basic* or its logic” to justify the Fifth Circuit’s requirement that securities fraud plaintiffs prove loss causation at the class certification stage in order to invoke *Basic*’s presumption of reliance. *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. –, 131 S. Ct. 2179, 2185-2186 (2011) (*Halliburton I*). “Loss causation,” we explained, “addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock.” *Ibid*. We remanded the case for the lower courts to consider “any further arguments against class certification” that Halliburton had preserved. *Id.*, at –, 131 S. Ct., at 2187.

On remand, Halliburton argued that class certification was inappropriate because the evidence it had earlier introduced to disprove loss causation also showed that none of its alleged misrepresentations had actually affected its stock price. . . . The District Court declined to consider Halliburton’s argument, holding that the *Basic* presumption applied and certifying the class under Rule 23(b)(3).

The Fifth Circuit affirmed. 718 F.3d 423 (2013). . . .

We once again granted certiorari, this time to resolve a conflict among the Circuits over whether securities fraud defendants may attempt to rebut the *Basic* presumption at the class certification stage with evidence of a lack of price impact. We also accepted Halliburton’s invitation to reconsider the presumption of reliance for securities fraud claims that we adopted in *Basic*.

## II

Halliburton urges us to overrule *Basic*’s presumption of reliance and to instead require every securities fraud plaintiff to prove that he actually relied on the defendant’s misrepresentation in deciding to buy or sell a company’s stock. Before overturning a long-settled precedent, however, we require “special justification,” not just an argument that the precedent was wrongly decided. Halliburton has failed to make that showing.

A

. . . To recover damages for violations of section 10(b) and Rule 10b-5, a plaintiff must prove “(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.” *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 568 U.S. —, 133 S. Ct. 1184, 1192 (2013).

The reliance element “ensures that there is a proper connection between a defendant’s misrepresentation and a plaintiff’s injury.” 568 U.S., at —, 133 S. Ct., at 1192. “The traditional (and most direct) way a plaintiff can demonstrate reliance is by showing that he was aware of a company’s statement and engaged in a relevant transaction – *e.g.*, purchasing common stock – based on that specific misrepresentation.” *Id.*, at —, 133 S. Ct., at 1192.

In *Basic*, however, we recognized that requiring such direct proof of reliance “would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.” 485 U.S., at 245. . . .

. . . .

To address these concerns, *Basic* held that securities fraud plaintiffs can in certain circumstances satisfy the reliance element of a Rule 10b-5 action by invoking a rebuttable presumption of reliance, rather than proving direct reliance on a misrepresentation. The Court based that presumption on what is known as the “fraud-on-the-market” theory, which holds that “the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.” *Id.*, at 246. . . .

Based on this theory, a plaintiff must make the following showings to demonstrate that the presumption of reliance applies in a given case: (1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed. *See id.*, at 248, n. 27.

At the same time, *Basic* emphasized that the presumption of reliance was rebuttable rather than conclusive. Specifically, “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.” 485 U.S., at 248. So for example, if a defendant could show that the alleged misrepresentation did not, for whatever reason, actually affect the market price, or that a plaintiff would have bought or sold the stock even had he been aware that the stock’s price was tainted by fraud, then the presumption of reliance would not apply. *Id.*, at 248-249. In either of those cases, a plaintiff would have to prove that he directly relied on the defendant’s misrepresentation in buying or selling the stock.

## B

....

Halliburton's primary argument for overruling *Basic* is that the decision rested on two premises that can no longer withstand scrutiny. The first premise concerns what is known as the "efficient capital markets hypothesis." *Basic* stated that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." *Id.*, at 246. . . .Halliburton cites studies purporting to show that "public information is often not incorporated immediately (much less rationally) into market prices."

....

The academic debates discussed by Halliburton have not refuted the modest premise underlying the presumption of reliance. Even the foremost critics of the efficient-capital-markets hypothesis acknowledge that public information generally affects stock prices. Halliburton also conceded as much in its reply brief and at oral argument. *See* Reply Brief 13 ("market prices generally respond to new, material information"). Debates about the precise *degree* to which stock prices accurately reflect public information are thus largely beside the point. "That the . . . price [of a stock] may be inaccurate does not detract from the fact that false statements affect it, and cause loss," which is "all that *Basic* requires." *Schleicher v. Wendt*, 618 F.3d 679, 685 (C.A.7 2010) (Easterbrook, C.J.). Even though the efficient capital markets hypothesis may have "garnered substantial criticism since *Basic*," *post*, at 2420 (Thomas, J., concurring in judgment), Halliburton has not identified the kind of fundamental shift in economic theory that could justify overruling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities.

Halliburton also contests a second premise underlying the *Basic* presumption: the notion that investors "invest 'in reliance on the integrity of [the market] price.'" Reply Brief 14 (quoting 485 U.S., at 247; alteration in original). Halliburton identifies a number of classes of investors for whom "price integrity" is supposedly "marginal or irrelevant." The primary example is the value investor, who believes that certain stocks are undervalued or overvalued and attempts to "beat the market" by buying the undervalued stocks and selling the overvalued ones. . . .

But *Basic* never denied the existence of such investors. As we recently explained, *Basic* concluded only that "it is reasonable to presume that *most* investors – knowing that they have little hope of outperforming the market in the long run based solely on their analysis of publicly available information – will rely on the security's market price as an unbiased assessment of the security's value in light of all public information." *Amgen*, 568 U.S., at –, 133 S. Ct., at 1192 (emphasis added).

In any event, there is no reason to suppose that even Halliburton's main counterexample – the value investor – is as indifferent to the integrity of market prices as Halliburton suggests. Such an investor implicitly relies on the fact that a stock's market price will eventually reflect

material information – how else could the market correction on which his profit depends occur?

...

....

### III

Halliburton proposes two alternatives to overruling *Basic* that would alleviate what it regards as the decision’s most serious flaws. The first alternative would require plaintiffs to prove that a defendant’s misrepresentation actually affected the stock price – so-called “price impact” – in order to invoke the *Basic* presumption. It should not be enough, Halliburton contends, for plaintiffs to demonstrate the general efficiency of the market in which the stock traded. Halliburton’s second proposed alternative would allow defendants to rebut the presumption of reliance with evidence of a lack of price impact, not only at the merits stage – which all agree defendants may already do – but also before class certification.

#### A

....

Halliburton argues that since the *Basic* presumption hinges on price impact, plaintiffs should be required to prove it directly in order to invoke the presumption. Proving the presumption’s prerequisites, which are at best an imperfect proxy for price impact, should not suffice.

Far from a modest refinement of the *Basic* presumption, this proposal would radically alter the required showing for the reliance element of the Rule 10b-5 cause of action. What is called the *Basic* presumption actually incorporates two constituent presumptions: First, if a plaintiff shows that the defendant’s misrepresentation was public and material and that the stock traded in a generally efficient market, he is entitled to a presumption that the misrepresentation affected the stock price. Second, if the plaintiff also shows that he purchased the stock at the market price during the relevant period, he is entitled to a further presumption that he purchased the stock in reliance on the defendant’s misrepresentation.

By requiring plaintiffs to prove price impact directly, Halliburton’s proposal would take away the first constituent presumption. Halliburton’s argument for doing so is the same as its primary argument for overruling the *Basic* presumption altogether: Because market efficiency is not a yes-or-no proposition, a public, material misrepresentation might not affect a stock’s price even in a generally efficient market. But as explained, *Basic* never suggested otherwise; that is why it affords defendants an opportunity to rebut the presumption by showing, among other things, that the particular misrepresentation at issue did not affect the stock’s market price. For the same reasons we declined to completely jettison the *Basic* presumption, we decline to effectively jettison half of it by revising the prerequisites for invoking it.

#### B

Even if plaintiffs need not directly prove price impact to invoke the *Basic* presumption, Halliburton contends that defendants should at least be allowed to defeat the presumption at

the class certification stage through evidence that the misrepresentation did not in fact affect the stock price. We agree.

1

[There is no] dispute that defendants may introduce price impact evidence at the class certification stage, so long as it is for the purpose of countering a plaintiff's showing of market efficiency, rather than directly rebutting the presumption. As EPJ Fund acknowledges, "[o]f course . . . defendants can introduce evidence at class certification of lack of price impact as some evidence that the market is not efficient." Brief for Respondent 53.

. . . What defendants may not do, EPJ Fund insists and the Court of Appeals held, is rely on that same evidence prior to class certification for the particular purpose of rebutting the presumption altogether.

. . . .

Such a result is inconsistent with *Basic*'s own logic. Under *Basic*'s fraud-on-the-market theory, market efficiency and the other prerequisites for invoking the presumption constitute an indirect way of showing price impact. . . .

But an indirect proxy should not preclude direct evidence when such evidence is available. As we explained in *Basic*, "[a]ny showing that severs the link between the alleged misrepresentation and . . . the price received (or paid) by the plaintiff . . . will be sufficient to rebut the presumption of reliance" because "the basis for finding that the fraud had been transmitted through market price would be gone." 485 U.S., at 248. . . . Price impact is thus an essential precondition for any Rule 10b-5 class action. While *Basic* allows plaintiffs to establish that precondition indirectly, it does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply.

2

The Court of Appeals relied on our decision in *Amgen* in holding that Halliburton could not introduce evidence of lack of price impact at the class certification stage. The question in *Amgen* was whether plaintiffs could be required to prove (or defendants be permitted to disprove) materiality before class certification. Even though materiality is a prerequisite for invoking the *Basic* presumption, we held that it should be left to the merits stage, because it does not bear on the predominance requirement of Rule 23(b)(3). . . .

EPJ Fund argues that much of the foregoing could be said of price impact as well. Fair enough. But price impact differs from materiality in a crucial respect. Given that the other *Basic* prerequisites must still be proved at the class certification stage, the common issue of materiality can be left to the merits stage without risking the certification of classes in which individual issues will end up overwhelming common ones. And because materiality is a discrete issue that can be resolved in isolation from the other prerequisites, it can be wholly confined to the merits stage.

Price impact is different. The fact that a misrepresentation “was reflected in the market price at the time of [the] transaction” – that it had price impact – is “*Basic*’s fundamental premise.” *Halliburton I*, 563 U.S., at –, 131 S. Ct., at 2186. It thus has everything to do with the issue of predominance at the class certification stage. That is why, if reliance is to be shown through the *Basic* presumption, the publicity and market efficiency prerequisites must be proved before class certification. Without proof of those prerequisites, the fraud-on-the-market theory underlying the presumption completely collapses, rendering class certification inappropriate.

....

Our choice in this case, then, is not between allowing price impact evidence at the class certification stage or relegating it to the merits. Evidence of price impact will be before the court at the certification stage in any event. The choice, rather, is between limiting the price impact inquiry before class certification to indirect evidence, or allowing consideration of direct evidence as well. As explained, we see no reason to artificially limit the inquiry at the certification stage to indirect evidence of price impact. Defendants may seek to defeat the *Basic* presumption at that stage through direct as well as indirect price impact evidence.

\* \* \*

More than 25 years ago, we held that plaintiffs could satisfy the reliance element of the Rule 10b-5 cause of action by invoking a presumption that a public, material misrepresentation will distort the price of stock traded in an efficient market, and that anyone who purchases the stock at the market price may be considered to have done so in reliance on the misrepresentation. We adhere to that decision and decline to modify the prerequisites for invoking the presumption of reliance. But to maintain the consistency of the presumption with the class certification requirements of Federal Rule of Civil Procedure 23, defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.

Because the courts below denied *Halliburton* that opportunity, we vacate the judgment of the Court of Appeals for the Fifth Circuit and remand the case for further proceedings consistent with this opinion.

*It is so ordered.*

Justice THOMAS, with whom Justice SCALIA and Justice ALITO join, concurring in the judgment.

Today we are asked to determine whether *Basic* was correctly decided. The Court suggests that it was, and that *stare decisis* demands that we preserve it. I disagree. Logic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and *stare decisis* cannot prop up the façade that remains. *Basic* should be overruled.

*Notes & Questions*

1. What are the Court's reasons for treating the issue of "price impact" differently from its treatment of materiality in *Amgen*? Do you agree?

2. How is the rule adopted by the Court in *Halliburton* likely to affect the litigation and settlement of class actions?



APPENDIX

TWITTER, INC.

AMENDED AND RESTATED CERTIFICATE OF INCORPORATION

&

AMENDED AND RESTATED BYLAWS

**TWITTER, INC.****AMENDED AND RESTATED CERTIFICATE OF INCORPORATION**

Twitter, Inc. (the “**Corporation**”), a corporation organized and existing under the laws of the State of Delaware, hereby certifies as follows:

A. The original Certificate of Incorporation of the Corporation was filed with the Secretary of State of the State of Delaware on April 19, 2007.

B. This Amended and Restated Certificate of Incorporation was duly adopted in accordance with Sections 242 and 245 of the General Corporation Law of the State of Delaware (the “**DGCL**”), and has been duly approved by the written consent of the stockholders of the Corporation in accordance with Section 228 of the DGCL.

C. The Certificate of Incorporation of the Corporation is hereby amended and restated in its entirety to read as follows:

**ARTICLE I**

The name of the Corporation is Twitter, Inc.

**ARTICLE II**

The address of the Corporation’s registered office in the State of Delaware is 3500 South DuPont Highway, City of Dover, County of Kent, Delaware 19901. The name of its registered agent at such address is Incorporating Services, Ltd.

**ARTICLE III**

The purpose of the Corporation is to engage in any lawful act or activity for which corporations may be organized under the DGCL.

**ARTICLE IV**

A. Classes of Stock. The total number of shares of stock that the Corporation shall have authority to issue is 5,200,000,000, consisting of 5,000,000,000 shares of Common Stock, par value \$0.000005 per share, and 200,000,000 shares of Preferred Stock, par value \$0.000005 per share.

B. Increase or Decrease in Authorized Capital Stock. The Board of Directors is further authorized to increase (but not above the total number of authorized shares of the class) or decrease (but not below the number of shares of any such series then outstanding) the number of shares of any series, the number of which was fixed by it, subsequent to the issuance of shares of such series then outstanding, subject to the powers, preferences and rights, and the qualifications, limitations and restrictions thereof stated in the Certificate of Incorporation or the resolution of the Board of Directors originally fixing the number of shares of such series. If the number of shares of any series is so decreased, then the shares constituting such decrease shall resume the status which they had prior to the adoption of the resolution originally fixing the number of shares of such series.

C. Rights of Preferred Stock. The Board of Directors is authorized, subject to limitations prescribed by law, to provide for the issuance of shares of Preferred Stock in series and to fix by resolution or resolutions the designations, powers, preferences and rights, and the qualifications, limitations or restrictions thereof, of any wholly unissued series of Preferred Stock, including without limitation authority to fix by resolution or resolutions the dividend rights, dividend rate, conversion rights, voting rights, rights and terms of redemption (including sinking fund provisions), redemption price or prices, and liquidation preferences of any such series, and the number of shares constituting any such series and the designation thereof, or any of the foregoing.

D. Rights of Common Stock. Each share of Common Stock shall entitle the holder thereof to one (1) vote on each matter submitted to a vote of holders of Common Stock at a meeting of stockholders.

## ARTICLE V

A. General Powers. The business and affairs of the Corporation shall be managed by or under the direction of the Board of Directors.

B. Number of Directors; Election. Subject to the rights of holders of any series of Preferred Stock with respect to the election of directors, the number of directors that constitutes the entire Board of Directors of the Corporation shall be fixed solely by resolution of the Board of Directors. Subject to the rights of holders of any series of Preferred Stock with respect to the election of directors, each director of the Corporation shall hold office until the expiration of the term for which he or she is elected and until his or her successor has been duly elected and qualified or until his or her earlier resignation, death or removal.

C. Classified Board Structure. Effective upon the acceptance of this Amended and Restated Certificate of Incorporation for filing by the Secretary of State of the State of Delaware (the “**Effective Date**”), and subject to the rights of holders of any series of Preferred Stock with respect to the election of directors, the directors of the Corporation shall be divided into three classes as nearly equal in size as is practicable, hereby designated Class I, Class II and Class III. The Board of Directors may assign members of the Board of Directors already in office to such classes at the time such classification becomes effective. The term of office of the initial Class I directors shall expire at the first regularly-scheduled annual meeting of stockholders following the Effective Date, the term of office of the initial Class II directors shall expire at the second annual meeting of stockholders following the Effective Date and the term of office of the initial Class III directors shall expire at the third annual meeting of stockholders following the Effective Date. At each annual meeting of stockholders, commencing with the first regularly-scheduled annual meeting of stockholders following the Effective Date, each of the successors elected to replace the directors of a Class whose term shall have expired at such annual meeting shall be elected to hold office until the third annual meeting next succeeding his or her election and until his or her respective successor shall have been duly elected and qualified.

Notwithstanding the foregoing provisions of this Article, and subject to the rights of holders of any series of Preferred Stock with respect to the election of directors, each director shall serve until his or her successor is duly elected and qualified or until his or her death, resignation, or removal. Subject to the rights of holders of any series of Preferred Stock with respect to the election of directors, if the number of directors is hereafter changed, any newly created directorships or decrease in directorships shall be so apportioned among the classes as to make all classes as nearly equal in number as is practicable, provided that no decrease in the number of directors constituting the Board of Directors shall shorten the term of any incumbent director.

D. Removal; Vacancies. Subject to the rights of holders of any series of Preferred Stock with respect to the election of directors, any director may be removed from office by the stockholders of the Corporation only for cause. Vacancies occurring on the Board of Directors for any reason and newly created directorships resulting from an increase in the authorized number of directors may be filled only by vote of a majority of the remaining members of the Board of Directors, although less than a quorum, or by a sole remaining director, at any meeting of the Board of Directors. A person so elected by the Board of Directors to fill a vacancy or newly created directorship shall hold office until the next election of the class for which such director shall have been chosen and until his or her successor shall be duly elected and qualified.

## ARTICLE VI

A. Amendment of Bylaws. In furtherance and not in limitation of the powers conferred by statute, the Board of Directors of the Corporation is expressly authorized to adopt, amend or repeal the Bylaws of the Corporation.

B. Written Ballot. Elections of directors need not be by written ballot unless the Bylaws of the Corporation shall so provide.

C. No Stockholder Action by Written Consent. Except as otherwise expressly provided by the terms of any series of Preferred Stock or other class of stock permitting the holders of such series to act by written consent, no action shall be taken by the stockholders of the Corporation except at an annual or special meeting of the stockholders called in accordance with the Bylaws, and no action shall be taken by the stockholders by written consent.

D. Special Meetings. Special meetings of the stockholders may be called only by the (i) Board of Directors pursuant to a resolution adopted by a majority of the Board; (ii) the chairman of the Board of Directors; (iii) the chief executive officer of the Corporation; or (iv) the president of the Corporation (in the absence of a chief executive officer).

E. No Cumulative Voting. No stockholder will be permitted to cumulate votes at any election of directors.

## ARTICLE VII

To the fullest extent permitted by the DGCL, as it presently exists or may hereafter be amended from time to time, a director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director. If

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the DGCL is amended to authorize corporate action further eliminating or limiting the personal liability of directors, then the liability of a director of the Corporation shall be eliminated or limited to the fullest extent permitted by the DGCL, as so amended.

Neither any amendment nor repeal of this Article, nor the adoption of any provision of the Corporation's Certificate of Incorporation inconsistent with this Article, shall eliminate or reduce the effect of this Article in respect of any matter occurring, or any cause of action, suit or proceeding accruing or arising or that, but for this Article, would accrue or arise, prior to such amendment, repeal or adoption of an inconsistent provision.

#### **ARTICLE VIII**

Subject to any provisions in the Bylaws of the Corporation related to indemnification of directors or officers of the Corporation, the Corporation shall indemnify, to the fullest extent permitted by applicable law, any director or officer of the Corporation who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (a "**Proceeding**") by reason of the fact that he or she is or was a director, officer, employee or agent of the Corporation or is or was serving at the request of the Corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, including service with respect to employee benefit plans, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with any such Proceeding.

The Corporation shall have the power to indemnify, to the extent permitted by the DGCL, as it presently exists or may hereafter be amended from time to time, any employee or agent of the Corporation who was or is a party or is threatened to be made a party to any Proceeding by reason of the fact that he or she is or was a director, officer, employee or agent of the Corporation or is or was serving at the request of the Corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, including service with respect to employee benefit plans, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with any such Proceeding.

A right to indemnification or to advancement of expenses arising under a provision of this Amended and Restated Certificate of Incorporation or a bylaw of the Corporation shall not be eliminated or impaired by an amendment to this Amended and Restated Certificate of Incorporation or the Bylaws of the Corporation after the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred.

#### **ARTICLE IX**

If any provision of this Amended and Restated Certificate of Incorporation becomes or is declared on any ground by a court of competent jurisdiction to be illegal, unenforceable or void, portions of such provision, or such provision in its entirety, to the extent necessary, shall be severed

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from this Amended and Restated Certificate of Incorporation, and the court will replace such illegal, void or unenforceable provision of this Amended and Restated Certificate of Incorporation with a valid and enforceable provision that most accurately reflects the Corporation's intent, in order to achieve, to the maximum extent possible, the same economic, business and other purposes of the illegal, void or unenforceable provision. The balance of this Amended and Restated Certificate of Incorporation shall be enforceable in accordance with its terms.

Except as provided in ARTICLE VII and ARTICLE VIII above, the Corporation reserves the right to amend, alter, change or repeal any provision contained in this Amended and Restated Certificate of Incorporation, in the manner now or hereafter prescribed by statute, and all rights conferred upon stockholders herein are granted subject to this reservation; provided, however, that, notwithstanding any other provision of this Amended and Restated Certificate of Incorporation or any provision of law that might otherwise permit a lesser vote or no vote, but in addition to any vote of the holders of any class or series of the stock of this Corporation required by law or by this Amended and Restated Certificate of Incorporation, the affirmative vote of the holders of at least eighty percent (80%) of the voting power of the outstanding shares of stock of the Corporation entitled to vote generally in the election of directors, voting together as a single class, shall be required to amend or repeal, or adopt any provision of this Amended and Restated Certificate of Incorporation inconsistent with, ARTICLE V, ARTICLE VI, ARTICLE VII, ARTICLE VIII or this ARTICLE IX.

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IN WITNESS WHEREOF, Twitter, Inc. has caused this Amended and Restated Certificate of Incorporation to be signed by the Chief Executive Officer of the Corporation on this     day of             2013.

By: \_\_\_\_\_  
Richard Costolo  
Chief Executive Officer

**AMENDED AND RESTATED BYLAWS OF**

**TWITTER, INC.**

(initially adopted on May 17, 2007)

(as amended on October 19, 2013 and effective as of the closing of the corporation's initial public offering)



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## BYLAWS OF TWITTER, INC.

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### ARTICLE I - CORPORATE OFFICES

#### 1.1 REGISTERED OFFICE

The registered office of Twitter, Inc. shall be fixed in the corporation's certificate of incorporation, as the same may be amended from time to time.

#### 1.2 OTHER OFFICES

The corporation's board of directors may at any time establish other offices at any place or places where the corporation is qualified to do business.

### ARTICLE II - MEETINGS OF STOCKHOLDERS

#### 2.1 PLACE OF MEETINGS

Meetings of stockholders shall be held at any place, within or outside the State of Delaware, designated by the board of directors. The board of directors may, in its sole discretion, determine that a meeting of stockholders shall not be held at any place, but may instead be held solely by means of remote communication as authorized by Section 211(a)(2) of the Delaware General Corporation Law (the "DGCL"). In the absence of any such designation or determination, stockholders' meetings shall be held at the corporation's principal executive office.

#### 2.2 ANNUAL MEETING

The annual meeting of stockholders shall be held on such date, at such time, and at such place (if any) within or without the State of Delaware as shall be designated from time to time by the board of directors and stated in the corporation's notice of the meeting. At the annual meeting, directors shall be elected and any other proper business, brought in accordance with Section 2.4 of these bylaws, may be transacted. The board of directors may cancel, postpone or reschedule any previously scheduled annual meeting at any time, before or after the notice for such meeting has been sent to the stockholders.

#### 2.3 SPECIAL MEETING

(i) A special meeting of the stockholders, other than those required by statute, may be called at any time by (A) the board of directors, (B) the chairperson of the board of directors, or (C) the chief executive officer, but a special meeting may not be called by any other person or persons. The board of directors may cancel, postpone or reschedule any previously scheduled special meeting at any time, before or after the notice for such meeting has been sent to the stockholders.

(ii) The notice of a special meeting shall include the purpose for which the meeting is called. Only such business shall be conducted at a special meeting of stockholders as shall have been brought

before the meeting by or at the direction of the board of directors, chairperson of the board of directors or chief executive officer. Nothing contained in this Section 2.3(ii) shall be construed as limiting, fixing or affecting the time when a meeting of stockholders called by action of the board of directors may be held.

## 2.4 ADVANCE NOTICE PROCEDURES

(i) *Advance Notice of Stockholder Business.* At an annual meeting of the stockholders, only such business shall be conducted as shall have been properly brought before the meeting. To be properly brought before an annual meeting, business must be brought: (A) pursuant to the corporation's proxy materials with respect to such meeting, (B) by or at the direction of the board of directors, or (C) by a stockholder of the corporation who (1) is a stockholder of record at the time of the giving of the notice required by this Section 2.4(i) and on the record date for the determination of stockholders entitled to vote at the annual meeting and (2) has timely complied in proper written form with the notice procedures set forth in this Section 2.4(i). In addition, for business to be properly brought before an annual meeting by a stockholder, such business must be a proper matter for stockholder action pursuant to these bylaws and applicable law. For the avoidance of doubt, except for proposals properly made in accordance with Rule 14a-8 under the Securities and Exchange Act of 1934, as amended, or any successor thereto (the "1934 Act"), and the regulations thereunder (or any successor rule and in any case as so amended), clause (C) above shall be the exclusive means for a stockholder to bring business before an annual meeting of stockholders.

(a) To comply with clause (C) of Section 2.4(i) above, a stockholder's notice must set forth all information required under this Section 2.4(i) and must be timely received by the secretary of the corporation. To be timely, a stockholder's notice must be received by the secretary at the principal executive offices of the corporation not later than the 45th day nor earlier than the 75th day before the one-year anniversary of the date on which the corporation first mailed its proxy materials or a notice of availability of proxy materials (whichever is earlier) for the preceding year's annual meeting; *provided, however*, that in the event that no annual meeting was held in the previous year or if the date of the annual meeting is advanced by more than 30 days prior to or delayed by more than 60 days after the one-year anniversary of the date of the previous year's annual meeting, then, for notice by the stockholder to be timely, it must be so received by the secretary not earlier than the close of business on the 120th day prior to such annual meeting and not later than the close of business on the later of (i) the 90th day prior to such annual meeting, or (ii) the tenth day following the day on which Public Announcement (as defined below) of the date of such annual meeting is first made. In no event shall any adjournment, rescheduling or postponement of an annual meeting or the announcement thereof commence a new time period for the giving of a stockholder's notice as described in this Section 2.4(i)(a). "Public Announcement" shall mean disclosure made via a Tweet from a verified account operated by the corporation (e.g. @Twitter), in a press release reported by the Dow Jones News Service, Associated Press or a comparable national news service or in a document publicly filed by the corporation with the Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the 1934 Act.

(b) To be in proper written form, a stockholder's notice to the secretary must set forth as to each matter of business the stockholder intends to bring before the annual meeting: (1) a brief description of the business intended to be brought before the annual meeting and the reasons for conducting such business at the annual meeting, (2) the name and address, as they appear on the corporation's books, of the stockholder proposing such business and any Stockholder Associated Person (as defined below), (3) the class and number of shares of the corporation that are held of record or are beneficially owned by the stockholder or any Stockholder Associated Person and any derivative positions held or beneficially held by the stockholder or any Stockholder Associated Person, (4) whether and the extent to which any hedging or

other transaction or series of transactions has been entered into by or on behalf of such stockholder or any Stockholder Associated Person with respect to any securities of the corporation, and a description of any other agreement, arrangement or understanding (including any short position or any borrowing or lending of shares), the effect or intent of which is to mitigate loss to, or to manage the risk or benefit from share price changes for, or to increase or decrease the voting power of, such stockholder or any Stockholder Associated Person with respect to any securities of the corporation, (5) any material interest of the stockholder or a Stockholder Associated Person in such business, and (6) a statement whether either such stockholder or any Stockholder Associated Person will deliver a proxy statement and form of proxy to holders of at least the percentage of the voting power of the corporation's voting shares required under applicable law to carry the proposal (such information provided and statements made as required by clauses (1) through (6), a "**Business Solicitation Statement**"). In addition, to be in proper written form, a stockholder's notice to the secretary must be supplemented not later than ten days following the record date for the determination of stockholders entitled to notice of the meeting to disclose the information contained in clauses (3) and (4) above as of the record date. For purposes of this Section 2.4, a "**Stockholder Associated Person**" of any stockholder shall mean (i) any person controlling, directly or indirectly, or acting in concert with, such stockholder, (ii) any beneficial owner of shares of stock of the corporation owned of record or beneficially by such stockholder and on whose behalf the proposal or nomination, as the case may be, is being made, or (iii) any person controlling, controlled by or under common control with such person referred to in the preceding clauses (i) and (ii).

(c) Without exception, no business shall be conducted at any annual meeting except in accordance with the provisions set forth in this Section 2.4(i) and, if applicable, Section 2.4(ii). In addition, business proposed to be brought by a stockholder may not be brought before the annual meeting if such stockholder or a Stockholder Associated Person, as applicable, takes action contrary to the representations made in the Business Solicitation Statement applicable to such business or if the Business Solicitation Statement applicable to such business contains an untrue statement of a material fact or omits to state a material fact necessary to make the statements therein not misleading. The chairperson of the annual meeting shall, if the facts warrant, determine and declare at the annual meeting that business was not properly brought before the annual meeting and in accordance with the provisions of this Section 2.4(i), and, if the chairperson should so determine, he or she shall so declare at the annual meeting that any such business not properly brought before the annual meeting shall not be conducted.

(ii) *Advance Notice of Director Nominations at Annual Meetings.* Notwithstanding anything in these bylaws to the contrary, only persons who are nominated in accordance with the procedures set forth in this Section 2.4(ii) shall be eligible for election or re-election as directors at an annual meeting of stockholders. Nominations of persons for election to the board of directors of the corporation shall be made at an annual meeting of stockholders only (A) by or at the direction of the board of directors or (B) by a stockholder of the corporation who (1) was a stockholder of record at the time of the giving of the notice required by this Section 2.4(ii) and on the record date for the determination of stockholders entitled to vote at the annual meeting and (2) has complied with the notice procedures set forth in this Section 2.4(ii). In addition to any other applicable requirements, for a nomination to be made by a stockholder, the stockholder must have given timely notice thereof in proper written form to the secretary of the corporation.

(a) To comply with clause (B) of Section 2.4(ii) above, a nomination to be made by a stockholder must set forth all information required under this Section 2.4(ii) and must be received by the secretary of the corporation at the principal executive offices of the corporation at the time set forth in, and in accordance with, the final three sentences of Section 2.4(i)(a) above; provided additionally, however, that in the event that the number of directors to be elected to the board of directors is increased and there is no Public

Announcement naming all of the nominees for director or specifying the size of the increased board made by the corporation at least ten days before the last day a stockholder may deliver a notice of nomination pursuant to the foregoing provisions, a stockholder's notice required by this Section 2.4(ii) shall also be considered timely, but only with respect to nominees for any new positions created by such increase, if it shall be received by the secretary of the corporation at the principal executive offices of the corporation not later than the close of business on the tenth day following the day on which such Public Announcement is first made by the corporation.

(b) To be in proper written form, such stockholder's notice to the secretary must set forth:

(1) as to each person (a " **nominee** ") whom the stockholder proposes to nominate for election or re-election as a director: (A) the name, age, business address and residence address of the nominee, (B) the principal occupation or employment of the nominee, (C) the class and number of shares of the corporation that are held of record or are beneficially owned by the nominee and any derivative positions held or beneficially held by the nominee, (D) whether and the extent to which any hedging or other transaction or series of transactions has been entered into by or on behalf of the nominee with respect to any securities of the corporation, and a description of any other agreement, arrangement or understanding (including any short position or any borrowing or lending of shares), the effect or intent of which is to mitigate loss to, or to manage the risk or benefit of share price changes for, or to increase or decrease the voting power of the nominee, (E) a description of all arrangements or understandings between or among any of the stockholder, each nominee and/or any other person or persons (naming such person or persons) pursuant to which the nominations are to be made by the stockholder or relating to the nominee's potential service on the board of directors, (F) a written statement executed by the nominee acknowledging that as a director of the corporation, the nominee will owe a fiduciary duty under Delaware law with respect to the corporation and its stockholders, and (G) any other information relating to the nominee that would be required to be disclosed about such nominee if proxies were being solicited for the election of the nominee as a director, or that is otherwise required, in each case pursuant to Regulation 14A under the 1934 Act (including without limitation the nominee's written consent to being named in the proxy statement, if any, as a nominee and to serving as a director if elected); and

(2) as to such stockholder giving notice, (A) the information required to be provided pursuant to clauses (2) through (5) of Section 2.4(i)(b) above, and the supplement referenced in the second sentence of Section 2.4(i)(b) above (except that the references to "business" in such clauses shall instead refer to nominations of directors for purposes of this paragraph), and (B) a statement whether either such stockholder or Stockholder Associated Person will deliver a proxy statement and form of proxy to holders at least the percentage of the corporation's voting shares reasonably believed by such stockholder or Stockholder Associated Person to be necessary to elect such nominee(s) (such information provided and statements made as required by clauses (A) and (B) above, a " **Nominee Solicitation Statement** ").

(c) At the request of the board of directors, any person nominated by a stockholder for election as a director must furnish to the secretary of the corporation (1) that information required to be set forth in the stockholder's notice of nomination of such person as a director as of a date subsequent to the date on which the notice of such person's nomination was given and (2) such other information as may reasonably be required by the corporation to determine the eligibility of such proposed nominee to serve as an independent director of the corporation or that could be material to a reasonable stockholder's understanding of the independence, or lack thereof, of such nominee; in the absence of the furnishing of such information if requested, such stockholder's nomination shall not be considered in proper form pursuant to this Section 2.4(ii).

(d) Without exception, no person shall be eligible for election or re-election as a director of the corporation at an annual meeting of stockholders unless nominated in accordance with the provisions set forth in this Section 2.4(ii). In addition, a nominee shall not be eligible for election or re-election if a stockholder or Stockholder Associated Person, as applicable, takes action contrary to the representations made in the Nominee Solicitation Statement applicable to such nominee or if the Nominee Solicitation Statement applicable to such nominee contains an untrue statement of a material fact or omits to state a material fact necessary to make the statements therein not misleading. The chairperson of the annual meeting shall, if the facts warrant, determine and declare at the annual meeting that a nomination was not made in accordance with the provisions prescribed by these bylaws, and if the chairperson should so determine, he or she shall so declare at the annual meeting, and the defective nomination shall be disregarded.

(iii) *Advance Notice of Director Nominations for Special Meetings* .

(a) For a special meeting of stockholders at which directors are to be elected pursuant to Section 2.3, nominations of persons for election to the board of directors shall be made only (1) by or at the direction of the board of directors or (2) by any stockholder of the corporation who (A) is a stockholder of record at the time of the giving of the notice required by this Section 2.4(iii) and on the record date for the determination of stockholders entitled to vote at the special meeting and (B) delivers a timely written notice of the nomination to the secretary of the corporation that includes the information set forth in Sections 2.4(ii)(b) and (ii)(c) above. To be timely, such notice must be received by the secretary at the principal executive offices of the corporation not later than the close of business on the later of the 90th day prior to such special meeting or the tenth day following the day on which Public Announcement is first made of the date of the special meeting and of the nominees proposed by the board of directors to be elected at such meeting. In no event shall any adjournment, rescheduling or postponement of a special meeting or the announcement thereof commence a new time period for the giving of a stockholder's notice. A person shall not be eligible for election or re-election as a director at a special meeting unless the person is nominated (i) by or at the direction of the board of directors or (ii) by a stockholder in accordance with the notice procedures set forth in this Section 2.4(iii). In addition, a nominee shall not be eligible for election or re-election if a stockholder or Stockholder Associated Person, as applicable, takes action contrary to the representations made in the Nominee Solicitation Statement applicable to such nominee or if the Nominee Solicitation Statement applicable to such nominee contains an untrue statement of a material fact or omits to state a material fact necessary to make the statements therein not misleading.

(b) The chairperson of the special meeting shall, if the facts warrant, determine and declare at the meeting that a nomination or business was not made in accordance with the procedures prescribed by these bylaws, and if the chairperson should so determine, he or she shall so declare at the meeting, and the defective nomination or business shall be disregarded.

(iv) *Other Requirements and Rights* . In addition to the foregoing provisions of this Section 2.4, a stockholder must also comply with all applicable requirements of state law and of the 1934 Act and the rules and regulations thereunder with respect to the matters set forth in this Section 2.4, including, with respect to business such stockholder intends to bring before the annual meeting that involves a proposal that such stockholder requests to be included in the corporation's proxy statement, the requirements of Rule 14a-8 (or any successor provision) under the 1934 Act. Nothing in this Section 2.4 shall be deemed to affect any right of the corporation to omit a proposal from the corporation's proxy statement pursuant to Rule 14a-8 (or any successor provision) under the 1934 Act.

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## 2.5 NOTICE OF STOCKHOLDERS' MEETINGS

Whenever stockholders are required or permitted to take any action at a meeting, a written notice of the meeting shall be given which shall state the place, if any, date and hour of the meeting, the means of remote communications, if any, by which stockholders and proxy holders may be deemed to be present in person and vote at such meeting, the record date for determining the stockholders entitled to vote at the meeting, if such date is different from the record date for determining stockholders entitled to notice of the meeting, and, in the case of a special meeting, the purpose or purposes for which the meeting is called. Except as otherwise provided in the DGCL, the certificate of incorporation or these bylaws, the written notice of any meeting of stockholders shall be given not less than 10 nor more than 60 days before the date of the meeting to each stockholder entitled to vote at such meeting as of the record date for determining the stockholders entitled to notice of the meeting.

## 2.6 QUORUM

The holders of a majority of the voting power of the stock issued and outstanding and entitled to vote, present in person or represented by proxy, shall constitute a quorum for the transaction of business at all meetings of the stockholders, unless otherwise required by law, the certificate of incorporation, these bylaws or the rules of any applicable stock exchange. Where a separate vote by a class or series or classes or series is required, a majority of the voting power of the issued and outstanding shares of such class or series or classes or series, present in person or represented by proxy, shall constitute a quorum entitled to take action with respect to that vote on that matter, except as otherwise required by law, the certificate of incorporation, these bylaws or the rules of any applicable stock exchange.

Whether or not a quorum is present at a meeting of stockholders, the chairperson of the meeting shall have power to adjourn the meeting from time to time, without notice other than announcement at the meeting. At such adjourned meeting at which a quorum is present or represented, any business may be transacted that might have been transacted at the original meeting.

## 2.7 ADJOURNED MEETING; NOTICE

When a meeting is adjourned to another time or place, unless these bylaws otherwise require, notice need not be given of the adjourned meeting if the time, place, if any, thereof, and the means of remote communications, if any, by which stockholders and proxy holders may be deemed to be present in person and vote at such adjourned meeting are announced at the meeting at which the adjournment is taken. At the adjourned meeting, the corporation may transact any business which might have been transacted at the original meeting. If the adjournment is for more than 30 days, a notice of the adjourned meeting shall be given to each stockholder of record entitled to vote at the meeting. If after the adjournment a new record date for stockholders entitled to vote is fixed for the adjourned meeting, the board of directors shall fix a new record date for notice of such adjourned meeting in accordance with Section 213(a) of the DGCL and Section 2.11 of these bylaws, and shall give notice of the adjourned meeting to each stockholder of record entitled to vote at such adjourned meeting as of the record date fixed for notice of such adjourned meeting.



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## 2.8 CONDUCT OF BUSINESS

The chairperson of any meeting of stockholders shall determine the order of business and the procedure at the meeting, including such regulation of the manner of voting and the conduct of business. The chairperson of any meeting of stockholders shall be designated by the board of directors; in the absence of such designation, the chairperson of the board, if any, the chief executive officer (in the absence of the chairperson) or the lead independent director (in the absence of the chairperson of the board and the chief executive officer), or in their absence any other executive officer of the corporation, shall serve as chairperson of the stockholder meeting.

## 2.9 VOTING

The stockholders entitled to vote at any meeting of stockholders shall be determined in accordance with the provisions of Section 2.11 of these bylaws, subject to Section 217 (relating to voting rights of fiduciaries, pledgors and joint owners of stock) and Section 218 (relating to voting trusts and other voting agreements) of the DGCL.

Except as may be otherwise provided in the certificate of incorporation, each stockholder shall be entitled to one vote for each share of capital stock held by such stockholder.

Except as otherwise required by law, the certificate of incorporation, these bylaws or the rules of any applicable stock exchange, in all matters other than the election of directors, the affirmative vote of a majority of the voting power of the shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders. Except as otherwise required by law, the certificate of incorporation, these bylaws or the rules of any applicable stock exchange, directors shall be elected by a plurality of the voting power of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors. Where a separate vote by a class or series or classes or series is required, in all matters other than the election of directors, the affirmative vote of the majority of the voting power of shares of such class or series or classes or series present in person or represented by proxy at the meeting shall be the act of such class or series or classes or series, except as otherwise provided by law, the certificate of incorporation, these bylaws or the rules of any applicable stock exchange.

## 2.10 STOCKHOLDER ACTION BY WRITTEN CONSENT WITHOUT A MEETING

Subject to the rights of the holders of the shares of any series of Preferred Stock or any other class of stock or series thereof that have been expressly granted the right to take action by written consent, any action required or permitted to be taken by the stockholders of the corporation must be effected at a duly called annual or special meeting of stockholders of the corporation and may not be effected by any consent in writing by such stockholders.

## 2.11 RECORD DATES

In order that the corporation may determine the stockholders entitled to notice of any meeting of stockholders or any adjournment thereof, the board of directors may fix a record date, which record date shall not precede the date upon which the resolution fixing the record date is adopted by the board of directors and which record date shall not be more than 60 nor less than 10 days before the date of such meeting. If the board of directors so fixes a date, such date shall also be the record date for determining the stockholders entitled to vote at such meeting unless the board of directors determines, at the time it fixes such record date, that a later date on or before the date of the meeting shall be the date for making such determination.

If no record date is fixed by the board of directors, the record date for determining stockholders entitled to notice of and to vote at a meeting of stockholders shall be at the close of business on the day next preceding the day on which notice is given, or, if notice is waived, at the close of business on the day next preceding the day on which the meeting is held.

A determination of stockholders of record entitled to notice of or to vote at a meeting of stockholders shall apply to any adjournment of the meeting; *provided, however*, that the board of directors may fix a new record date for determination of stockholders entitled to vote at the adjourned meeting, and in such case shall also fix as the record date for stockholders entitled to notice of such adjourned meeting the same or an earlier date as that fixed for determination of stockholders entitled to vote in accordance with the provisions of Section 213 of the DGCL and this Section 2.11 at the adjourned meeting.

In order that the corporation may determine the stockholders entitled to receive payment of any dividend or other distribution or allotment of any rights or the stockholders entitled to exercise any rights in respect of any change, conversion or exchange of stock, or for the purpose of any other lawful action, the board of directors may fix a record date, which record date shall not precede the date upon which the resolution fixing the record date is adopted, and which record date shall be not more than 60 days prior to such action. If no record date is fixed, the record date for determining stockholders for any such purpose shall be at the close of business on the day on which the board of directors adopts the resolution relating thereto.

## 2.12 PROXIES

Each stockholder entitled to vote at a meeting of stockholders may authorize another person or persons to act for such stockholder by proxy authorized by an instrument in writing or by a transmission permitted by law filed in accordance with the procedure established for the meeting, but no such proxy shall be voted or acted upon after three years from its date, unless the proxy provides for a longer period. The revocability of a proxy that states on its face that it is irrevocable shall be governed by the provisions of Section 212 of the DGCL. A written proxy may be in the form of a telegram, cablegram, or other means of electronic transmission which sets forth or is submitted with information from which it can be determined that the telegram, cablegram, or other means of electronic transmission was authorized by the stockholder.

## 2.13 LIST OF STOCKHOLDERS ENTITLED TO VOTE

The officer who has charge of the stock ledger of the corporation shall prepare and make, at least 10 days before every meeting of stockholders, a complete list of the stockholders entitled to vote at the meeting; *provided, however*, if the record date for determining the stockholders entitled to vote is less than 10 days before the meeting date, the list shall reflect the stockholders entitled to vote as of the tenth day before the meeting date, arranged in alphabetical order, and showing the address of each stockholder and the number of shares registered in the name of each stockholder. The corporation shall not be required to include electronic mail addresses or other electronic contact information on such list. Such list shall be open to the examination of any stockholder for any purpose germane to the meeting for a period of at least 10 days prior to the meeting: (i) on a reasonably accessible electronic network, *provided* that the information required to gain access to such list is provided with the notice of the meeting, or (ii) during ordinary business hours, at the corporation's principal place of business. In the event that the corporation determines to make the list available on an electronic network, the corporation may take reasonable steps to ensure that such information

is available only to stockholders of the corporation. If the meeting is to be held at a place, then the list shall be produced and kept at the time and place of the meeting during the whole time thereof, and may be examined by any stockholder who is present. If the meeting is to be held solely by means of remote communication, then the list shall also be open to the examination of any stockholder during the whole time of the meeting on a reasonably accessible electronic network, and the information required to access such list shall be provided with the notice of the meeting. Such list shall presumptively determine the identity of the stockholders entitled to vote at the meeting and the number of shares held by each of them.

## 2.14 INSPECTORS OF ELECTION

Before any meeting of stockholders, the board of directors shall appoint an inspector or inspectors of election to act at the meeting or its adjournment. The number of inspectors shall be either one (1) or three (3). If any person appointed as inspector fails to appear or fails or refuses to act, then the chairperson of the meeting may, and upon the request of any stockholder or a stockholder's proxy shall, appoint a person to fill that vacancy; provided further that, in any case, if no inspector or alternate is able to act at a meeting of stockholders, the chairperson of the meeting shall appoint at least one (1) inspector to act at the meeting.

Each inspector, before entering upon the discharge of his or her duties, shall take and sign an oath to execute faithfully the duties of inspector with strict impartiality and according to the best of his or her ability. Such inspectors shall:

- (i) determine the number of shares outstanding and the voting power of each, the number of shares represented at the meeting, the existence of a quorum, and the authenticity, validity, and effect of proxies;
- (ii) receive votes, ballots or consents;
- (iii) hear and determine all challenges and questions in any way arising in connection with the right to vote;
- (iv) count and tabulate all votes or consents;
- (v) determine when the polls shall close;
- (vi) determine the result; and
- (vii) do any other acts that may be proper to conduct the election or vote with fairness to all stockholders.

The inspectors of election shall perform their duties impartially, in good faith, to the best of their ability and as expeditiously as is practical. If there are three (3) inspectors of election, the decision, act or certificate of a majority is effective in all respects as the decision, act or certificate of all. Any report or certificate made by the inspectors of election is *prima facie* evidence of the facts stated therein.

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## ARTICLE III - DIRECTORS

### 3.1 POWERS

The business and affairs of the corporation shall be managed by or under the direction of the board of directors, except as may be otherwise provided in the DGCL or the certificate of incorporation.

### 3.2 NUMBER OF DIRECTORS

The board of directors shall consist of one or more members, each of whom shall be a natural person. Unless the certificate of incorporation fixes the number of directors, the number of directors shall be determined from time to time by resolution of the board of directors. No reduction of the authorized number of directors shall have the effect of removing any director before that director's term of office expires.

### 3.3 ELECTION, QUALIFICATION AND TERM OF OFFICE OF DIRECTORS

Except as provided in Section 3.4 of these bylaws, each director, including a director elected to fill a vacancy, shall hold office until the expiration of the term for which elected and until such director's successor is elected and qualified or until such director's earlier death, resignation or removal. Directors need not be stockholders unless so required by the certificate of incorporation or these bylaws. The certificate of incorporation or these bylaws may prescribe other qualifications for directors.

In accordance with the provisions of the certificate of incorporation, the directors of the corporation shall be divided into three classes.

### 3.4 RESIGNATION AND VACANCIES

Any director may resign at any time upon notice given in writing or by electronic transmission to the corporation. A resignation is effective when the resignation is delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events. A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable. Unless otherwise provided in the certificate of incorporation or these bylaws, when one or more directors resign from the board of directors, effective at a future date, a majority of the directors then in office, including those who have so resigned, shall have power to fill such vacancy or vacancies, the vote thereon to take effect when such resignation or resignations shall become effective.

Unless otherwise provided in the certificate of incorporation or these bylaws, vacancies and newly created directorships resulting from any increase in the authorized number of directors elected by all of the stockholders having the right to vote as a single class shall be filled only by a majority of the directors then in office, although less than a quorum, or by a sole remaining director. If the directors are divided into classes, a person so elected by the directors then in office to fill a vacancy or newly created directorship shall hold office until the next election of the class for which such director shall have been chosen and until his or her successor shall have been duly elected and qualified.

If at any time, by reason of death or resignation or other cause, the corporation should have no directors in office, then any officer or any stockholder or an executor, administrator, trustee or guardian of a stockholder, or other fiduciary entrusted with like responsibility for the person or estate of a stockholder, may call a special meeting of stockholders in accordance with the provisions of the certificate of incorporation or these bylaws, or may apply to the Delaware Court of Chancery for a decree summarily ordering an election as provided in Section 211 of the DGCL.

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If, at the time of filling any vacancy or any newly created directorship, the directors then in office constitute less than a majority of the whole board of directors (as constituted immediately prior to any such increase), the Court of Chancery may, upon application of any stockholder or stockholders holding at least 10% of the voting power of the voting stock at the time outstanding having the right to vote for such directors, summarily order an election to be held to fill any such vacancies or newly created directorships, or to replace the directors chosen by the directors then in office as aforesaid, which election shall be governed by the provisions of Section 211 of the DGCL as far as applicable.

### 3.5 PLACE OF MEETINGS; MEETINGS BY TELEPHONE

The board of directors may hold meetings, both regular and special, either within or outside the State of Delaware.

Unless otherwise restricted by the certificate of incorporation or these bylaws, members of the board of directors, or any committee designated by the board of directors, may participate in a meeting of the board of directors, or any committee, by means of conference telephone or other communications equipment by means of which all persons participating in the meeting can hear each other, and such participation in a meeting shall constitute presence in person at the meeting.

### 3.6 REGULAR MEETINGS

Regular meetings of the board of directors may be held without notice at such time and at such place as shall from time to time be determined by the board of directors.

### 3.7 SPECIAL MEETINGS; NOTICE

Special meetings of the board of directors for any purpose or purposes may be called at any time by the chairperson of the board of directors, the chief executive officer, the secretary or a majority of the authorized number of directors, at such times and places as he or she or they shall designate.

Notice of the time and place of special meetings shall be:

- (i) delivered personally by hand, by courier or by telephone;
- (ii) sent by United States first-class mail, postage prepaid;
- (iii) sent by facsimile; or
- (iv) sent by electronic mail,

directed to each director at that director's address, telephone number, facsimile number or electronic mail address, as the case may be, as shown on the corporation's records.

If the notice is (i) delivered personally by hand, by courier or by telephone, (ii) sent by facsimile or (iii) sent by electronic mail, it shall be delivered or sent at least 24 hours before the time of the holding of the

meeting. If the notice is sent by United States mail, it shall be deposited in the United States mail at least four days before the time of the holding of the meeting. Any oral notice may be communicated to the director. The notice need not specify the place of the meeting (if the meeting is to be held at the corporation's principal executive office) nor the purpose of the meeting.

### 3.8 QUORUM; VOTING

At all meetings of the board of directors, a majority of the total authorized number of directors shall constitute a quorum for the transaction of business. If a quorum is not present at any meeting of the board of directors, then the directors present thereat may adjourn the meeting from time to time, without notice other than announcement at the meeting, until a quorum is present. A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of directors, if any action taken is approved by at least a majority of the required quorum for that meeting.

The vote of a majority of the directors present at any meeting at which a quorum is present shall be the act of the board of directors, except as may be otherwise specifically provided by statute, the certificate of incorporation or these bylaws.

If the certificate of incorporation provides that one or more directors shall have more or less than one vote per director on any matter, every reference in these bylaws to a majority or other proportion of the directors shall refer to a majority or other proportion of the votes of the directors.

### 3.9 BOARD ACTION BY WRITTEN CONSENT WITHOUT A MEETING

Unless otherwise restricted by the certificate of incorporation or these bylaws, any action required or permitted to be taken at any meeting of the board of directors, or of any committee thereof, may be taken without a meeting if all members of the board of directors or committee, as the case may be, consent thereto in writing or by electronic transmission and the writing or writings or electronic transmission or transmissions are filed with the minutes of proceedings of the board of directors or committee. Such filing shall be in paper form if the minutes are maintained in paper form and shall be in electronic form if the minutes are maintained in electronic form.

### 3.10 FEES AND COMPENSATION OF DIRECTORS

Unless otherwise restricted by the certificate of incorporation or these bylaws, the board of directors shall have the authority to fix the compensation of directors.

### 3.11 REMOVAL OF DIRECTORS

Unless otherwise provided in the certificate of incorporation, any director may be removed from office by the stockholders of the corporation only for cause.

No reduction of the authorized number of directors shall have the effect of removing any director prior to the expiration of such director's term of office.

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## ARTICLE IV - COMMITTEES

### 4.1 COMMITTEES OF DIRECTORS

The board of directors may designate one or more committees, each committee to consist of one or more of the directors of the corporation. The board of directors may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. In the absence or disqualification of a member of a committee, the member or members thereof present at any meeting and not disqualified from voting, whether or not such member or members constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member. Any such committee, to the extent provided in the resolution of the board of directors or in these bylaws, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation, and may authorize the seal of the corporation to be affixed to all papers that may require it; but no such committee shall have the power or authority to (i) approve or adopt, or recommend to the stockholders, any action or matter (other than the election or removal of directors) expressly required by the DGCL to be submitted to stockholders for approval, or (ii) adopt, amend or repeal any bylaw of the corporation.

### 4.2 COMMITTEE MINUTES

Each committee shall keep regular minutes of its meetings and report the same to the board of directors when required.

### 4.3 MEETINGS AND ACTION OF COMMITTEES

Meetings and actions of committees shall be governed by, and held and taken in accordance with, the provisions of:

- (i) Section 3.5 (place of meetings and meetings by telephone);
- (ii) Section 3.6 (regular meetings);
- (iii) Section 3.7 (special meetings and notice);
- (iv) Section 3.8 (quorum; voting);
- (v) Section 7.5 (waiver of notice); and
- (vi) Section 3.9 (action without a meeting)

with such changes in the context of those bylaws as are necessary to substitute the committee and its members for the board of directors and its members. *However* :

- (i) the time of regular meetings of committees may be determined either by resolution of the board of directors or by resolution of the committee;
- (ii) special meetings of committees may also be called by resolution of the board of directors; and
- (iii) notice of special meetings of committees shall also be given to all alternate members, who shall have the right to attend all meetings of the committee. The board of directors or a committee may adopt rules for the government of any committee not inconsistent with the provisions of these bylaws.

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Any provision in the certificate of incorporation providing that one or more directors shall have more or less than one vote per director on any matter shall apply to voting in any committee or subcommittee, unless otherwise provided in the certificate of incorporation or these bylaws.

#### 4.4 SUBCOMMITTEES

Unless otherwise provided in the certificate of incorporation, these bylaws or the resolutions of the board of directors designating the committee, a committee may create one or more subcommittees, each subcommittee to consist of one or more members of the committee, and delegate to a subcommittee any or all of the powers and authority of the committee.

### ARTICLE V - OFFICERS

#### 5.1 OFFICERS

The officers of the corporation shall be a chief executive officer and/or president and a secretary. The corporation may also have, at the discretion of the board of directors, a chairperson of the board of directors, a vice chairperson of the board of directors, a chief executive officer, a chief financial officer or treasurer, one or more vice presidents, one or more assistant vice presidents, one or more assistant treasurers, one or more assistant secretaries, and any such other officers as may be appointed in accordance with the provisions of these bylaws. Any number of offices may be held by the same person.

#### 5.2 APPOINTMENT OF OFFICERS

The board of directors shall appoint the officers of the corporation, except such officers as may be appointed in accordance with the provisions of Sections 5.3 of these bylaws, subject to the rights, if any, of an officer under any contract of employment.

#### 5.3 SUBORDINATE OFFICERS

The board of directors may appoint, or empower the chief executive officer or, in the absence of a chief executive officer, another officer, to appoint, such other officers and agents as the business of the corporation may require. Each of such officers and agents shall hold office for such period, have such authority, and perform such duties as are provided in these bylaws or as the board of directors may from time to time determine.

#### 5.4 REMOVAL AND RESIGNATION OF OFFICERS

Subject to the rights, if any, of an officer under any contract of employment, any officer may be removed, either with or without cause, by an affirmative vote of the majority of the board of directors at any regular or special meeting of the board of directors or, except in the case of an officer chosen by the board of directors, by any officer upon whom such power of removal may be conferred by the board of directors.



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Any officer may resign at any time by giving written notice to the corporation. Any resignation shall take effect at the date of the receipt of that notice or at any later time specified in that notice. Unless otherwise specified in the notice of resignation, the acceptance of the resignation shall not be necessary to make it effective. Any resignation is without prejudice to the rights, if any, of the corporation under any contract to which the officer is a party.

#### 5.5 VACANCIES IN OFFICES

Any vacancy occurring in any office of the corporation shall be filled by the board of directors or as provided in Section 5.3.

#### 5.6 REPRESENTATION OF SHARES OF OTHER CORPORATIONS

The chairperson of the board of directors, the chief executive officer and/or president, any vice president, the treasurer, the secretary or assistant secretary of this corporation, or any other person authorized by the board of directors or the chief executive officer and/or president or a vice president, is authorized to vote, represent, and exercise on behalf of this corporation all rights incident to any and all shares of any other corporation or corporations standing in the name of this corporation. The authority granted herein may be exercised either by such person directly or by any other person authorized to do so by proxy or power of attorney duly executed by such person having the authority.

#### 5.7 AUTHORITY AND DUTIES OF OFFICERS

All officers of the corporation shall respectively have such authority and perform such duties in the management of the business of the corporation as may be designated from time to time by the board of directors or the stockholders and, to the extent not so provided, as generally pertain to their respective offices, subject to the control of the board of directors.

### **ARTICLE VI - STOCK**

#### 6.1 STOCK CERTIFICATES; PARTLY PAID SHARES

The shares of the corporation shall be represented by certificates, provided that the board of directors may provide by resolution or resolutions that some or all of any or all classes or series of its stock shall be uncertificated shares. Any such resolution shall not apply to shares represented by a certificate until such certificate is surrendered to the corporation. Every holder of stock represented by certificates shall be entitled to have a certificate signed by, or in the name of the corporation by the chairperson of the board of directors or vice-chairperson of the board of directors, or the chief executive officer and/or president or a vice-president, and by the treasurer or an assistant treasurer, or the secretary or an assistant secretary of the corporation representing the number of shares registered in certificate form. Any or all of the signatures on the certificate may be a facsimile. In case any officer, transfer agent or registrar who has signed or whose facsimile signature has been placed upon a certificate has ceased to be such officer, transfer agent or registrar before such certificate is issued, it may be issued by the corporation with the same effect as if such person were such officer, transfer agent or registrar at the date of issue. The corporation shall not have power to issue a certificate in bearer form.

The corporation may issue the whole or any part of its shares as partly paid and subject to call for the remainder of the consideration to be paid therefor. Upon the face or back of each stock certificate issued to represent any such partly-paid shares, or upon the books and records of the corporation in the case of uncertificated partly-paid shares, the total amount of the consideration to be paid therefor and the amount paid thereon shall be stated. Upon the declaration of any dividend on fully-paid shares, the corporation shall declare a dividend upon partly-paid shares of the same class, but only upon the basis of the percentage of the consideration actually paid thereon.

## 6.2 SPECIAL DESIGNATION ON CERTIFICATES

If the corporation is authorized to issue more than one class of stock or more than one series of any class, then the powers, the designations, the preferences, and the relative, participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights shall be set forth in full or summarized on the face or back of the certificate that the corporation shall issue to represent such class or series of stock; *provided, however*, that, except as otherwise provided in Section 202 of the DGCL, in lieu of the foregoing requirements there may be set forth on the face or back of the certificate that the corporation shall issue to represent such class or series of stock, a statement that the corporation will furnish without charge to each stockholder who so requests the powers, designations, preferences and relative, participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights. Within a reasonable time after the issuance or transfer of uncertificated stock, the corporation shall send to the registered owner thereof a written notice containing the information required to be set forth or stated on certificates pursuant to this section 6.2 or Sections 151, 156, 202(a) or 218(a) of the DGCL or with respect to this section 6.2 a statement that the corporation will furnish without charge to each stockholder who so requests the powers, designations, preferences and relative, participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights. Except as otherwise expressly provided by law, the rights and obligations of the holders of uncertificated stock and the rights and obligations of the holders of certificates representing stock of the same class and series shall be identical.

## 6.3 LOST CERTIFICATES

Except as provided in this Section 6.3, no new certificates for shares shall be issued to replace a previously issued certificate unless the latter is surrendered to the corporation and cancelled at the same time. The corporation may issue a new certificate of stock or uncertificated shares in the place of any certificate theretofore issued by it, alleged to have been lost, stolen or destroyed, and the corporation may require the owner of the lost, stolen or destroyed certificate, or such owner's legal representative, to give the corporation a bond sufficient to indemnify it against any claim that may be made against it on account of the alleged loss, theft or destruction of any such certificate or the issuance of such new certificate or uncertificated shares.

## 6.4 DIVIDENDS

The board of directors, subject to any restrictions contained in the certificate of incorporation or applicable law, may declare and pay dividends upon the shares of the corporation's capital stock.

The board of directors may set apart out of any of the funds of the corporation available for dividends a reserve or reserves for any proper purpose and may abolish any such reserve. Such purposes shall include but not be limited to equalizing dividends, repairing or maintaining any property of the corporation, and meeting contingencies.

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## 6.5 TRANSFER OF STOCK

Transfers of record of shares of stock of the corporation shall be made only upon its books by the holders thereof, in person or by an attorney duly authorized, and, subject to Section 6.3 of these bylaws, if such stock is certificated, upon the surrender of a certificate or certificates for a like number of shares, properly endorsed or accompanied by proper evidence of succession, assignation or authority to transfer.

## 6.6 STOCK TRANSFER AGREEMENTS

The corporation shall have power to enter into and perform any agreement with any number of stockholders of any one or more classes of stock of the corporation to restrict the transfer of shares of stock of the corporation of any one or more classes owned by such stockholders in any manner not prohibited by the DGCL.

## 6.7 REGISTERED STOCKHOLDERS

The corporation:

(i) shall be entitled to recognize the exclusive right of a person registered on its books as the owner of shares to receive dividends and to vote as such owner;

(ii) shall be entitled to hold liable for calls and assessments the person registered on its books as the owner of shares; and

(iii) shall not be bound to recognize any equitable or other claim to or interest in such share or shares on the part of another person, whether or not it shall have express or other notice thereof, except as otherwise provided by the laws of Delaware.

## ARTICLE VII - MANNER OF GIVING NOTICE AND WAIVER

### 7.1 NOTICE OF STOCKHOLDERS' MEETINGS

Notice of any meeting of stockholders, if mailed, is given when deposited in the United States mail, postage prepaid, directed to the stockholder at such stockholder's address as it appears on the corporation's records. An affidavit of the secretary or an assistant secretary of the corporation or of the transfer agent or other agent of the corporation that the notice has been given shall, in the absence of fraud, be *prima facie* evidence of the facts stated therein.

## 7.2 NOTICE BY ELECTRONIC TRANSMISSION

Without limiting the manner by which notice otherwise may be given effectively to stockholders pursuant to the DGCL, the certificate of incorporation or these bylaws, any notice to stockholders given by the corporation under any provision of the DGCL, the certificate of incorporation or these bylaws shall be effective if given by a form of electronic transmission consented to by the stockholder to whom the notice is given. Any such consent shall be revocable by the stockholder by written notice to the corporation. Any such consent shall be deemed revoked if:

(i) the corporation is unable to deliver by electronic transmission two consecutive notices given by the corporation in accordance with such consent; and

(ii) such inability becomes known to the secretary or an assistant secretary of the corporation or to the transfer agent, or other person responsible for the giving of notice.

However, the inadvertent failure to treat such inability as a revocation shall not invalidate any meeting or other action.

Any notice given pursuant to the preceding paragraph shall be deemed given:

- (i) if by facsimile telecommunication, when directed to a number at which the stockholder has consented to receive notice;
- (ii) if by electronic mail, when directed to an electronic mail address at which the stockholder has consented to receive notice;
- (iii) if by a posting on an electronic network together with separate notice to the stockholder of such specific posting, upon the later of (A) such posting and (B) the giving of such separate notice; and
- (iv) if by any other form of electronic transmission, when directed to the stockholder.

An affidavit of the secretary or an assistant secretary or of the transfer agent or other agent of the corporation that the notice has been given by a form of electronic transmission shall, in the absence of fraud, be *prima facie* evidence of the facts stated therein.

An “**electronic transmission**” means any form of communication, not directly involving the physical transmission of paper, that creates a record that may be retained, retrieved, and reviewed by a recipient thereof, and that may be directly reproduced in paper form by such a recipient through an automated process.

Notice by a form of electronic transmission shall not apply with respect to Sections 164, 296, 311, 312 or 324 of the DGCL.

## 7.3 NOTICE TO STOCKHOLDERS SHARING AN ADDRESS

Except as otherwise prohibited under the DGCL, without limiting the manner by which notice otherwise may be given effectively to stockholders, any notice to stockholders given by the corporation under the provisions of the DGCL, the certificate of incorporation or these bylaws shall be effective if given by a

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single written notice to stockholders who share an address if consented to by the stockholders at that address to whom such notice is given. Any such consent shall be revocable by the stockholder by written notice to the corporation. Any stockholder who fails to object in writing to the corporation, within 60 days of having been given written notice by the corporation of its intention to send the single notice, shall be deemed to have consented to receiving such single written notice.

#### 7.4 NOTICE TO PERSON WITH WHOM COMMUNICATION IS UNLAWFUL

Whenever notice is required to be given, under the DGCL, the certificate of incorporation or these bylaws, to any person with whom communication is unlawful, the giving of such notice to such person shall not be required and there shall be no duty to apply to any governmental authority or agency for a license or permit to give such notice to such person. Any action or meeting which shall be taken or held without notice to any such person with whom communication is unlawful shall have the same force and effect as if such notice had been duly given. In the event that the action taken by the corporation is such as to require the filing of a certificate under the DGCL, the certificate shall state, if such is the fact and if notice is required, that notice was given to all persons entitled to receive notice except such persons with whom communication is unlawful.

#### 7.5 WAIVER OF NOTICE

Whenever notice is required to be given under any provision of the DGCL, the certificate of incorporation or these bylaws, a written waiver, signed by the person entitled to notice, or a waiver by electronic transmission by the person entitled to notice, whether before or after the time of the event for which notice is to be given, shall be deemed equivalent to notice. Attendance of a person at a meeting shall constitute a waiver of notice of such meeting, except when the person attends a meeting for the express purpose of objecting at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted at, nor the purpose of, any regular or special meeting of the stockholders need be specified in any written waiver of notice or any waiver by electronic transmission unless so required by the certificate of incorporation or these bylaws.

### **ARTICLE VIII - FORUM FOR CERTAIN ACTIONS**

Unless the corporation consents in writing to the selection of an alternative forum, the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the corporation to the corporation or the corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the DGCL, or (iv) any action asserting a claim governed by the internal affairs doctrine shall be a state or federal court located within the state of Delaware, in all cases subject to the court's having personal jurisdiction over the indispensable parties named as defendants. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the corporation shall be deemed to have notice of and consented to the provisions of this bylaw.

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## ARTICLE IX - INDEMNIFICATION

### 9.1 INDEMNIFICATION OF DIRECTORS AND OFFICERS IN THIRD PARTY PROCEEDINGS

Subject to the other provisions of this Article IX, the corporation shall indemnify, to the fullest extent permitted by the DGCL, as now or hereinafter in effect, any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (a “**Proceeding**”) (other than an action by or in the right of the corporation) by reason of the fact that such person is or was a director or officer of the corporation, or is or was a director or officer of the corporation serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys’ fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with such Proceeding if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe such person’s conduct was unlawful. The termination of any Proceeding by judgment, order, settlement, conviction, or upon a plea of *nolo contendere* or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which such person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that such person’s conduct was unlawful.

### 9.2 INDEMNIFICATION OF DIRECTORS AND OFFICERS IN ACTIONS BY OR IN THE RIGHT OF THE CORPORATION

Subject to the other provisions of this Article IX, the corporation shall indemnify, to the fullest extent permitted by the DGCL, as now or hereinafter in effect, any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that such person is or was a director or officer of the corporation, or is or was a director or officer of the corporation serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys’ fees) actually and reasonably incurred by such person in connection with the defense or settlement of such action or suit if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation; except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.

### 9.3 SUCCESSFUL DEFENSE

To the extent that a present or former director or officer of the corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding described in Section 9.1 or Section 9.2, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys’ fees) actually and reasonably incurred by such person in connection therewith.

#### 9.4 INDEMNIFICATION OF OTHERS

Subject to the other provisions of this Article IX, the corporation shall have power to indemnify its employees and agents to the extent not prohibited by the DGCL or other applicable law. The board of directors shall have the power to delegate to such person or persons as the board shall in its discretion determine the determination of whether employees or agents shall be indemnified.

#### 9.5 ADVANCE PAYMENT OF EXPENSES

Expenses (including attorneys' fees) actually and reasonably incurred by an officer or director of the corporation in defending any Proceeding shall be paid by the corporation in advance of the final disposition of such Proceeding upon receipt of a written request therefor (together with documentation reasonably evidencing such expenses) and an undertaking by or on behalf of the person to repay such amounts if it shall ultimately be determined that the person is not entitled to be indemnified under this Article IX or the DGCL. Such expenses (including attorneys' fees) incurred by former directors and officers or other employees and agents of the corporation or by persons serving at the request of the corporation as directors, officers, employees or agents of another corporation, partnership, joint venture, trust or other enterprise may be so paid upon such terms and conditions, if any, as the corporation deems appropriate. The right to advancement of expenses shall not apply to any claim for which indemnity is excluded pursuant to these bylaws, but shall apply to any Proceeding referenced in Section 9.6(ii) or 9.6(iii) prior to a determination that the person is not entitled to be indemnified by the corporation.

#### 9.6 LIMITATION ON INDEMNIFICATION

Subject to the requirements in Section 9.3 and the DGCL, the corporation shall not be obligated to indemnify any person pursuant to this Article IX in connection with any Proceeding (or any part of any Proceeding):

(i) for which payment has actually been made to or on behalf of such person under any statute, insurance policy, indemnity provision, vote or otherwise, except with respect to any excess beyond the amount paid;

(ii) for an accounting or disgorgement of profits pursuant to Section 16(b) of the 1934 Act, or similar provisions of federal, state or local statutory law or common law, if such person is held liable therefor (including pursuant to any settlement arrangements);

(iii) for any reimbursement of the corporation by such person of any bonus or other incentive-based or equity-based compensation or of any profits realized by such person from the sale of securities of the corporation, as required in each case under the 1934 Act (including any such reimbursements that arise from an accounting restatement of the corporation pursuant to Section 304 of the Sarbanes-Oxley Act of 2002 (the "**Sarbanes-Oxley Act**"), or the payment to the corporation of profits arising from the purchase and sale by such person of securities in violation of Section 306 of the Sarbanes-Oxley Act), if such person is held liable therefor (including pursuant to any settlement arrangements);

(iv) initiated by such person, including any Proceeding (or any part of any Proceeding) initiated by such person against the corporation or its directors, officers, employees, agents or other indemnitees, unless (a) the board of directors authorized the Proceeding (or the relevant part of the Proceeding) prior to its initiation, (b) the corporation provides the indemnification, in its sole discretion, pursuant to the powers vested in the corporation under applicable law, (c) otherwise required to be made under Section 9.7 or (d) otherwise required by applicable law; or

(v) if prohibited by applicable law; provided, however, that if any provision or provisions of this Article IX shall be held to be invalid, illegal or unenforceable for any reason whatsoever: (1) the validity, legality and enforceability of the remaining provisions of this Article IX (including, without limitation, each portion of any paragraph or clause containing any such provision held to be invalid, illegal or unenforceable, that is not itself held to be invalid, illegal or unenforceable) shall not in any way be affected or impaired thereby; and (2) to the fullest extent possible, the provisions of this Article IX (including, without limitation, each such portion of any paragraph or clause containing any such provision held to be invalid, illegal or unenforceable) shall be construed so as to give effect to the intent manifested by the provision held invalid, illegal or unenforceable.

#### 9.7 DETERMINATION; CLAIM

If a claim for indemnification or advancement of expenses under this Article IX is not paid in full within 90 days after receipt by the corporation of the written request therefor, the claimant shall be entitled to an adjudication by a court of competent jurisdiction of his or her entitlement to such indemnification or advancement of expenses. The corporation shall indemnify such person against any and all expenses that are incurred by such person in connection with any action for indemnification or advancement of expenses from the corporation under this Article IX, to the extent such person is successful in such action, and to the extent not prohibited by law. In any such suit, the corporation shall, to the fullest extent not prohibited by law, have the burden of proving that the claimant is not entitled to the requested indemnification or advancement of expenses.

#### 9.8 NON-EXCLUSIVITY OF RIGHTS

The indemnification and advancement of expenses provided by, or granted pursuant to, this Article IX shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under the certificate of incorporation or any statute, bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in such person's official capacity and as to action in another capacity while holding such office. The corporation is specifically authorized to enter into individual contracts with any or all of its directors, officers, employees or agents respecting indemnification and advancement of expenses, to the fullest extent not prohibited by the DGCL or other applicable law.

#### 9.9 INSURANCE

The corporation may purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power to indemnify such person against such liability under the provisions of the DGCL.



## 9.10 SURVIVAL

The rights to indemnification and advancement of expenses conferred by this Article IX shall continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.

## 9.11 EFFECT OF REPEAL OR MODIFICATION

A right to indemnification or to advancement of expenses arising under a provision of the certificate of incorporation or a bylaw shall not be eliminated or impaired by an amendment to the certificate of incorporation or these bylaws after the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred.

## 9.12 CERTAIN DEFINITIONS

For purposes of this Article IX, references to the “**corporation**” shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors, officers, employees or agents, so that any person who is or was a director, officer, employee or agent of such constituent corporation, or is or was serving at the request of such constituent corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, shall stand in the same position under the provisions of this Article IX with respect to the resulting or surviving corporation as such person would have with respect to such constituent corporation if its separate existence had continued. For purposes of this Article IX, references to “**other enterprises**” shall include employee benefit plans; references to “**finances**” shall include any excise taxes assessed on a person with respect to an employee benefit plan; and references to “**servicing at the request of the corporation**” shall include any service as a director, officer, employee or agent of the corporation which imposes duties on, or involves services by, such director, officer, employee or agent with respect to an employee benefit plan, its participants or beneficiaries; and a person who acted in good faith and in a manner such person reasonably believed to be in the interest of the participants and beneficiaries of an employee benefit plan shall be deemed to have acted in a manner “**not opposed to the best interests of the corporation**” as referred to in this Article IX.

# ARTICLE X - GENERAL MATTERS

## 10.1 EXECUTION OF CORPORATE CONTRACTS AND INSTRUMENTS

Except as otherwise provided by law, the certificate of incorporation or these bylaws, the board of directors may authorize any officer or officers, or agent or agents, to enter into any contract or execute any document or instrument in the name of and on behalf of the corporation; such authority may be general or confined to specific instances. Unless so authorized or ratified by the board of directors or within the agency power of an officer, no officer, agent or employee shall have any power or authority to bind the corporation by any contract or engagement or to pledge its credit or to render it liable for any purpose or for any amount.

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#### 10.2 FISCAL YEAR

The fiscal year of the corporation shall be fixed by resolution of the board of directors and may be changed by the board of directors.

#### 10.3 SEAL

The corporation may adopt a corporate seal, which shall be adopted and which may be altered by the board of directors. The corporation may use the corporate seal by causing it or a facsimile thereof to be impressed or affixed or in any other manner reproduced.

#### 10.4 CONSTRUCTION; DEFINITIONS

Unless the context requires otherwise, the general provisions, rules of construction, and definitions in the DGCL shall govern the construction of these bylaws. Without limiting the generality of this provision, the singular number includes the plural, the plural number includes the singular, and the term “ **person** ” includes both a corporation and a natural person.

### ARTICLE XI - AMENDMENTS

These bylaws may be adopted, amended or repealed by the stockholders entitled to vote; provided, however, that the affirmative vote of the holders of at least eighty percent (80%) of the total voting power of outstanding voting securities, voting together as a single class, shall be required for the stockholders of the Corporation to alter, amend or repeal, or adopt any provision of these bylaws. The board of directors shall also have the power to adopt, amend or repeal bylaws.

A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.

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**TWITTER, INC.**

**CERTIFICATE OF AMENDMENT OF BYLAWS**

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The undersigned hereby certifies that he or she is the duly elected, qualified, and acting Secretary or Assistant Secretary of Twitter, Inc., a Delaware corporation and that the foregoing bylaws, comprising [ ] pages, were amended and restated on [ ] by the corporation's board of directors.

IN WITNESS WHEREOF, the undersigned has hereunto set his or her hand this      day of      , 2013.

\_\_\_\_\_  
Secretary