

Glossary

Terms printed in SMALL CAPITALS are defined elsewhere in the Glossary.

These definitions are intended to be helpful to students using this book. In some cases we omit details or technical qualifications, and in many cases further depth can be found in more technical dictionaries or encyclopedias.

1933 Act or '33 Act See SECURITIES ACT OF 1933.

1934 Act or '34 Act See SECURITIES AND EXCHANGE ACT OF 1934.

¹Accounting A professional discipline devoted to measuring the value and performance of business firms. Of key importance in the law of business organizations, accountants periodically produce FINANCIAL STATEMENTS for firms they serve and, in the case of publicly traded firms, they are produced for inclusion in public filings with the SECURITIES AND EXCHANGE COMMISSION.

²Accounting A judicial remedy under which partners in GENERAL PARTNERSHIPS and some other UNINCORPORATED ENTITIES may resolve disputes among themselves related to the firm's affairs. Because the accounting is a plenary resolution of all disputes among members, it ordinarily entails a valuation of the firm and each member's interest in it.

Accounting Rule A now disfavored and largely defunct rule under which courts once required disputes among partners, of any nature, ordinarily to be resolved only through the judicial remedy of ACCOUNTING. Because the accounting remedy is time-consuming and expensive, it often made the resolution of minor disputes prohibitive. Though the accounting rule itself has been almost universally rejected, all jurisdictions still recognize the accounting as a remedy available to partners, which often may be demanded by individual partners as of right.

Actual Authority AUTHORITY that an AGENT reasonably believes that he or she holds based on MANIFESTATIONS of the PRINCIPAL. It has two chief distinctions from APPARENT AUTHORITY. First, it depends on the *agent's* reasonable belief of the principal's intent, based on the principal's objective manifestations (whereas apparent authority depends on the reasonable belief of the third party with whom the agent deals). Second, actually authorized actions do not in themselves violate the agent's fiduciary duty or otherwise invite legal sanction, whereas actions only apparently authorized ordinarily do breach fiduciary duty.

Adoption An act by which a person takes on liability under a contract that otherwise would not have bound the person. By contrast to RATIFICATION, adoption is not retroactive. That is, the adopted act becomes binding on the adopter as of

the day of the adoption, but legal consequences that would have been binding on the adopter arising before the date of the adoption do not bind the adopter. Strictly speaking, this is because, unlike ratification, adoption is actually the creation of a new contract as of the date of adoption. Ratification is taking on liability under existing contract terms that otherwise would not be binding.

Agency The legal relationship between AGENT and PRINCIPAL.

Agency Cost A loss or disappointment of expectations on the part of a person who employs someone else to perform a task. The disappointment is caused by the tendency of persons and those who perform functions for them to have differing incentives. As a common example, employees working in a restaurant or store may lack incentive to work harder or better than necessary to meet minimum expectations, and will not personally internalize any concern for the firm's performance. Another example commonly discussed in the law of business organizations is that in most larger firms, of a necessity, the investments of some pool of more or less PASSIVE INVESTORS will be under the control of a centralized management, and that management may not fully incorporate the investors' interests. For example, corporate officers may prefer more pay or perquisites, less demanding workloads, or less risky business strategies than would optimize shareholders' interests.

Agent One who acts on behalf of another (known as the agent's principal) in the context of relationship of agency, and subject to the other's control.

ALI See AMERICAN LAW INSTITUTE.

American Law Institute (ALI) A private, not-for-profit entity founded in 1923 by William Howard Taft and other prominent legal figures, and now comprised about 4,000 judges, lawyers, and academics. The ALI exists to study, criticize, and improve American law, particularly its common law. It is best known for producing the RESTATEMENTS OF LAW, which purport to codify common law topics as best they can be synthesized on a national level. In this book we rely at some length on the Restatement (Third) of the Law of Agency. The ALI has produced a number of other works as well, including model codes to govern areas usually governed by state or federal statutory law. In this book we lay some emphasis on one such work, the AMERICAN LAW INSTITUTE PRINCIPLES OF CORPORATE GOVERNANCE.

American Law Institute Principles of Corporate Governance A model code of corporation law, produced in part as an alternative to the widely adopted MODEL BUSINESS CORPORATION ACT, a code produced by the American Bar Association. The *Principles* have never been adopted in whole in any jurisdiction, but individual sections have been influential in specific cases.

Articles of Incorporation The constitutive document of a corporation. In order to create the firm, the articles must be filed with the SECRETARY OF STATE or equivalent state official. They set out the firm's basic governance and capital structure, at a minimum, and can also include other provisions, including special governance rules or limitations on the firm's longevity, purposes, or powers.

Assent Agreement to something, as in agreement to creation of an AGENCY relationship or a GENERAL PARTNERSHIP. MANIFESTATIONS of assent play a significant role in the laws of AGENCY and UNINCORPORATED ENTITIES, where creation of the relationships themselves and the creation of AUTHORITY within them depend on objectively manifested assent. Because manifestations are almost always judged objectively, they are frequently found to have been made in cases that might be contrary to a party's subjective intent. Also for this reason, and because neither agency nor general partnership requires the filing of any government formalities for their creation, those relationships can be created by accident.

Apparent Authority AUTHORITY that a third party with whom an AGENT deals reasonably believes the agent to hold based on MANIFESTATIONS of the PRINCIPAL. It has two chief distinctions from ACTUAL AUTHORITY. First, it depends on the reasonable belief of the third party with whom an agent deals as to the principal's intent, based on the principal's objective manifestations (whereas actual authority depends on the *agent's* reasonable belief). Second, actually authorized actions do not in themselves violate the agent's fiduciary duty or otherwise invite legal sanction, whereas actions only apparently authorized ordinarily do breach fiduciary duty.

Appraisal A remedy for SHAREHOLDERS disappointed with the consideration imposed on them in a change-in-control transaction, such as a MERGER or SHARE EXCHANGE. The appraisal remedy entitles a shareholder to a judicial valuation of the shareholder's shares, and if the result is a value higher than the consideration offered in the transaction, the shareholder is entitled to recover the difference. Jurisdictions vary as to whether appraisal rights are available to shareholders whose firm agrees to a DISPOSITION OF ASSETS. Where they are available, appraisal rights are usually the shareholder's exclusive remedy.

Authority The power of a person to bind another person to contracts or liabilities or otherwise alter their legal relations. AGENTS, including management officials of corporations or other business entities, ordinarily have some power to bind their PRINCIPALS, partners have power to bind their PARTNERSHIPS, and members in MEMBER-MANAGED LIMITED LIABILITY COMPANIES do as well.

Balance Sheet A FINANCIAL STATEMENT that lists all assets, liabilities, and owners' equity interests of a firm at a given time, using the equation $\text{assets} = \text{liabilities} + \text{owners' equity}$.

Blue Sky Law A body of state statutory securities regulations that govern the issuance of securities within a given state. Whether or not a given securities issuance is subject to federal regulatory obligations, it must also comply with the Blue Sky law (or establish an exemption from compliance) in every state in which the securities will be marketed or sold.

Board of Directors A body within a CORPORATION in which is vested the ultimate decision-making authority for the affairs of the company. Board members (known as DIRECTORS) must be elected by holders of voting shares, and corporations must hold at least one general shareholder meeting annually for

the purpose of electing directors. The board elects and oversees the firm's officers, and it sets broad policy for the firm. Certain functions must be performed by the board, including authorization of DIVIDENDS or issuances of new stock, proposals for amendments to the ARTICLES OF INCORPORATION, and proposals for MERGER or other change in control transactions.

Bond A DEBT SECURITY, and more specifically a secured one. The term is often used loosely to refer to both secured and unsecured debt securities, though an unsecured debt security is more properly known as a DEBENTURE.

¹**Book Value** The value of an asset as recorded on a firm's BALANCE SHEET. Because under GENERALLY ACCEPTED ACCOUNTING PRINCIPLES most assets are accounted for at their purchase price (under the so-called HISTORICAL COST rule), and because those rules also require that many assets be DEPRECIATED according to assumed rates of depreciation, an asset's book value at any given time generally will be the price a firm paid for it minus an assumed amount of depreciation.

²**Book Value** The total value of the equity interests of a firm, as shown on its balance sheet as the difference between assets and liabilities.

Break-up Fee A term in an agreement for a change in control transaction requiring the target firm to pay a fixed penalty if the transaction fails to be consummated. Often the penalty must be paid only if the failure is caused by specifically listed events, like the acquirer's failure to secure financing or regulatory approvals. Break-up fees are often said merely to compensate the acquiring firm for its time and expenses in pursuing a failed deal, but they often also serve other strategic purposes. Most importantly they are widely used to discourage competing HOSTILE TAKEOVER efforts by third parties while the deal is pending. Thus, one reason the break-up fee is ordinarily to be paid by the target firm is that if the deal is threatened by a competing TENDER OFFER by some third-party buyer, the obligation to pay the break-up fee would make completion of the tender offer less attractive. *Cf.* REVERSE BREAK-UP FEE.

Broker A person or firm that buys and sells securities on behalf of clients. *Cf.* BROKER-DEALER and DEALER.

Broker-Dealer A person or firm that buys and sells securities both on behalf of clients and on its own account. *Cf.* BROKER and DEALER.

Business Judgment Rule A rule within the law of FIDUCIARY DUTY governing the standard of liability by which some fiduciaries are judged when accused of breaching the DUTY OF CARE. The business judgment rule applies to the conscious business decisions (as opposed to nonfeasance or failures to act) of corporate fiduciaries, including DIRECTORS, OFFICERS, and CONTROLLING SHAREHOLDERS, and is also usually held to apply to the conscious business decisions of managers within UNINCORPORATED ENTITIES. The rule is phrased in varying ways in differing jurisdictions. Generally speaking, though, when a defendant subject to the rule makes a conscious business decision, the decision does not violate the defendant's duty of care so long as it was not self-interested, was reasonably informed, and was rationally related to the best interests of the firm.

There has been academic dispute and some uncertainty in the case law over whether the business judgment rule is a substantive standard of liability or is merely a presumption or a standard of review or some other purely procedural rule. In this book we generally treat the rule as a substantive standard of liability. *Cf.* GROSS NEGLIGENCE.

Business Opportunity Doctrine A rule of FIDUCIARY DUTY requiring that a fiduciary ordinarily may not invest in an opportunity that would be desirable to the beneficiary without first offering the opportunity to the beneficiary. Strictly speaking, the rule is a special application of the DUTY OF LOYALTY.

Buy-Back *See* STOCK BUY-BACK.

C Corporation A corporation taxed under Subchapter C of the Internal Revenue Code, the salient feature of which is that it imposes DOUBLE TAXATION on the corporation and its shareholders.

Call An OPTION that entitles the holder to buy some security or commodity at a specified price on or before a specified date.

Capital Money or other resources invested in a firm for the purpose of producing the firm's product or service.

¹**Capitalization** The sum of wealth invested in a firm, as measured by the total of shareholder's EQUITY (including COMMON STOCK, PREFERRED STOCK, and RETAINED EARNINGS) and long-term debt. (Long-term debt is included because the money borrowed or the resources purchased with it represent a part of the firm's ongoing stock of working resources.) "Capitalization" should not be confused with MARKET CAPITALIZATION.

²**Capitalization** In ACCOUNTING, treating the purchase price of something as creating an asset rather than an expense. "Capitalization" should not be confused with MARKET CAPITALIZATION.

Capital Appreciation An increase in value of any asset. Capital appreciation can be entirely passive, without the investor taking action to make the asset more valuable, simply because supply and demand conditions for it change. Investors can generate capital appreciation much more actively, however, as by working to grow a business and make it profitable. Capital appreciation will ordinarily not be captured in the FINANCIAL STATEMENTS generated in ACCOUNTING, because they ordinarily record the value of assets at their HISTORICAL COST and subject them to assumed DEPRECIATION, and also because they do not reflect the value of a firm's GOODWILL.

Capital Structure The mix of different kinds of investments made in a firm. In general terms, a firm's capital structure will be some combination of DEBT and EQUITY. Since debt is generally more risky from the firm's perspective—because it contractually obligates the firm to repay principal and interest whether or not the firm is earning sufficient revenue to cover it—a firm with more debt vis-à-vis equity is usually said to be more risky than a firm with less.

Caremark Duty *See* DUTY TO MONITOR.

Cash Flow Statement A standard FINANCIAL STATEMENT that summarizes cash receipts and payments for the relevant period. An important purpose of the cash flow statement is to estimate a firm's short-term viability and credit-worthiness, as it reflects the firm's ability to pay its obligations as they come due.

CEO *See* CHIEF EXECUTIVE OFFICER.

Certificate of Incorporation *See* ARTICLES OF INCORPORATION.

CFO *See* CHIEF FINANCIAL OFFICER.

Charter *See* ARTICLES OF INCORPORATION.

Chief Executive Officer (CEO) Generally, the highest-ranking executive within a business. Most large corporations appoint at least one officer with this title, and occasionally firms have two or more such persons, typically identifying them as "co-CEOs."

Chief Financial Officer (CFO) A firm's highest-ranking officer with primarily financial responsibilities. The duties assigned to the CFO are typically broad, and usually include management of the firm's financial planning, financial risk, and financial recordkeeping.

Closely Held Corporation A corporation that is not PUBLICLY TRADED. As with the latter term, closely held corporation has no precise definition and is not a legal term of art. Generally speaking, it implies a firm with a small number of shareholders and no ready market for its shares. A chief feature of close corporations is that because their shares tend to be highly illiquid, and because corporation statutes do not permit unilateral dissolution by shareholders or other tools for forced liquidity, minority shareholders face substantial risk of OPPRESSION.

Common Stock Corporate EQUITY STOCK typically having rights to vote in BOARD OF DIRECTORS elections and other matters on which shareholders are entitled to vote, but enjoying no preference for dividends or payment on dissolution. *Cf.* PREFERRED STOCK.

Conflict of Interest A situation in which one owes a duty to one party that conflicts either with one's own personal interests or with one's countervailing duties to another party. For example, it is a conflict of interest for a corporate FIDUCIARY to cause the corporation to enter into a transaction in which the fiduciary also has a personal pecuniary interest, as for example when the fiduciary agrees to sell his or her own property to the corporation. Likewise, it is a conflict of interest for the fiduciary to act on behalf of the corporation in a transaction in which the fiduciary also owes fiduciary duties to an opposing party in the transaction, as might occur when an officer of one corporation negotiates the purchase of property from another corporation on whose board of directors the officer also sits. Action under conflict of interest is not necessarily a breach of duty, but may subject a fiduciary to risk of liability for breach of the DUTY OF LOYALTY.

Consolidation A MERGER following which both merging firms will cease their independent existence, and will continue as a wholly new firm combining the assets of both. *Cf.* TRUE MERGER.

Controlling Shareholder A person who, usually by virtue of owning either a statistical majority of a corporation's voting shares or a large minority of them along with other indicia of influence, controls the corporation, generally because of the ability to elect its BOARD OF DIRECTORS. The chief legal consequence of being held a controlling shareholder is that persons of that description owe certain fiduciary duties to their corporations.

Corporate Seal A physical device by which documents may be stamped with an official symbol indicating that they are authentic. The seal is often entrusted to the corporate SECRETARY, an officer who by custom holds authority to attest to the authenticity of corporate documents. The significance of the seal largely has been abolished.

Corporation As used in this book, a private, for-profit entity formed under the corporation statute of a given state.

Corporation by Estoppel An equitable doctrine under which courts may recognize the existence of a corporation that has not been properly formed in order to protect the interests of one or more persons who have changed position in reliance on the belief in corporate existence. The doctrine may be applied in a variety of contexts.

Corporation De Facto An equitable doctrine under which courts may recognize the existence of a corporation and protect its shareholders with limited liability even though at the time they incurred liability, the corporation had not come into existence. Courts are likely to apply the doctrine only where the failure to incorporate was inadvertent and the PROMOTERS believed it had properly been formed.

Crown Jewels A TAKEOVER DEFENSE under which a target corporation agrees to sell some valuable asset at a loss to a third party, in the event that a takeover proponent acquires some stated percentage of the firm's stock.

Cumulative Voting A system of shareholder voting meant to assist minority shareholders in securing representation on their boards of directors. In a cumulative voting system, shareholders may apportion the total number of votes they would be entitled to cast for all open board seats to fewer than all races. As a practical example, imagine you own 100 shares of voting stock in a corporation, and that five vacancies on the board are slated for election at the annual shareholders' meeting. Under either cumulative or traditional, non-cumulative voting, you will be entitled to cast a total of 500 votes—one vote per share in each race. But under the two systems you can apportion them differently. Under traditional voting, you could only cast one vote per share for each vacancy—and so, you could cast 100 votes in each race. But under cumulative voting, you could apportion all of the total votes to which you are entitled to one race, casting 500 total votes for one candidate, or 250 votes each for two candidates, or any other combination you choose.

Deadlock A situation in which the voting members of some decision-making body within a business entity are evenly split. Since decision usually requires at

least a simple majority, an evenly divided body cannot make decisions. This can happen in corporations with even-numbered boards of directors or boards in which only an even number of seats are currently filled, and it can happen among shareholders when opposing factions hold equal numbers of shares. (As a practical matter, a shareholder deadlock can only happen in CLOSELY HELD firms.)

Dealer A firm that buys and sells securities on its own account. *Cf.* BROKER and BROKER-DEALER.

Debenture An unsecured DEBT SECURITY. *Cf.* BOND.

Debt An amount the repayment of which is owed or due. The concept typically is used in opposition to EQUITY. *Cf.* DEBT SECURITY.

Debt Security A SECURITY that represents a loan of money from the investor to the ISSUER, which must be repaid, usually with interest, within a specified time period. Unlike an EQUITY security, debt securities do not represent any ownership interest in the firm and generally confer no governance rights on the investor. Variations are many. Two major categories are BONDS, which (with the exception of federal government bonds) ordinarily are secured by collateral, and DEBENTURES, which are not.

De Facto Corporation See CORPORATION DE FACTO.

Delaware Court of Chancery One of the two major trial court systems of the state of Delaware. Because Delaware is one of the few American states to have preserved the distinction between law and equity, it maintains two separate trial court systems. Most corporate law matters in Delaware are within the purview of the Court of Chancery.

¹**Depreciation** A decline in the value of an asset.

²**Depreciation** In ACCOUNTING, an assumed (and often artificial) rate by which the value of an asset will be reduced each year on a firm's FINANCIAL STATEMENTS.

Derivative A contract that derives its value from the value of some other asset. For example, an OPTION is a simple derivative instrument. An option is a contract giving its buyer the right to purchase some asset from the seller of the option, at a specified price, on or before a particular date. The value of the option to both its buyer and seller depends on the value of the underlying security—if the value of the security goes above the specified purchase price during the relevant period, then the option pays off for the buyer but not the seller, and vice versa. Derivative investments are often explained as HEDGING devices, in that they can be used by an investor to offset the risk of some corresponding investment. For example, an airline must purchase large amounts of jet fuel and is exposed to risk because of changing fuel prices. The firm might hedge against that risk by entering into derivative contracts under which the airline will receive a specified payment if the price of jet fuel exceeds a certain amount. To that extent, derivatives often resemble simple insurance contracts. However, derivatives serve other purposes, including sheer speculation.

Director A member of a corporation's BOARD OF DIRECTORS.

Disposition of Assets A change-in-control transaction in which one firm agrees to sell all or substantially all of its assets to another firm or buyer. Jurisdictions vary as to whether shareholders in the selling firm are entitled to voting and appraisal rights (as they would be in other change-in-control transactions having the same substantive consequences, like MERGER or SHARE EXCHANGE).

Dissociation Under many UNINCORPORATED ENTITY statutes, an act causing the separation of one member from the firm, an event that typically ends the member's ability to bind the firm to liabilities and, in GENERAL PARTNERSHIPS, ends the partner's risk of most firm liabilities going forward. Dissociation itself is to be distinguished from DISSOLUTION, which is the formal end of the business as a going entity and requires WINDING DOWN of its affairs and liquidation of its assets. Whether dissociation triggers dissolution depends on the circumstances of the dissociation and also varies by statute. For example, many LIMITED LIABILITY COMPANY statutes contain HOTEL CALIFORNIA provisions, providing that voluntary dissociation does not cause dissolution.

Dissolution In many UNINCORPORATED ENTITY statutes, a special concept specifically distinguished from DISSOCIATION. In those statutes, dissociation is merely an act that separates a member from the firm, and it may or may not trigger dissolution. When events triggering dissolution do occur, the firm must then discontinue operations as a going entity, WIND DOWN its affairs, and liquidate its assets.

Distribution Any distribution of cash or property to a corporation's shareholders. Distributions of retained earnings also are known as DIVIDENDS. Non-cash DIVIDENDS are often known as IN-KIND DIVIDENDS.

Diversification of Risk The spreading of one's investments in relatively small amounts across many different investment opportunities, the risks of which are not closely correlated, rather than investing large amounts in a few opportunities. Where the individual investment's risks are not correlated—that is, they will not all likely fail at the same time, as might be the case if all the investments are in the same industry—then the damage from failure of any one investment is minimized.

Dividend A distribution of cash to a corporation's shareholders representing a sharing of profits. *Cf.* DISTRIBUTION.

Division of Labor The breaking down of some task into sub-tasks, which is generally thought to make the performance of the overall task better or more efficient.

Donahue-Wilkes Duty A fiduciary duty that some jurisdictions impose on shareholders of CLOSELY HELD CORPORATIONS. The duty is owed by each shareholder to all others (by contrast to the traditional corporate fiduciary duties, owed only by OFFICERS, DIRECTORS, and CONTROLLING SHAREHOLDERS, and owed by them only to the corporation itself). The duty was most famously recognized by the courts of Massachusetts in *Donahue v. Rodd Electrotype Co.*

of New England, Inc., 328 N.E.2d 505 (Mass. 1975), and Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976).

Double Taxation The tax imposed on corporations taxed under Subchapter C of the Internal Revenue Code, under which the corporation must first pay income tax on its earnings, like any individual taxpayer. Then, any distribution of profit to shareholders is taxed again to the shareholders who receive it. Each dollar of profit earned by such a corporation is therefore taxed twice, to the extent that it is distributed to shareholders.

Duty of Care One of the two traditional FIDUCIARY DUTIES (the other being the DUTY OF LOYALTY), the duty of care requires a fiduciary to exercise some degree of skill, diligence, and prudence in the performance of tasks on behalf of the beneficiary. Corporate fiduciaries and managers of UNINCORPORATED ENTITIES owe the duty of care, but, insofar as prudence is concerned, their liability under it is usually judged under the deferential BUSINESS JUDGMENT RULE.

Duty of Disclosure A FIDUCIARY DUTY sometimes described as existing independently of the traditional DUTY OF CARE and DUTY OF LOYALTY, the duty of disclosure would require a fiduciary to provide the beneficiary with certain facts under appropriate circumstances. This book takes the view that the duty of disclosure is better thought of not as a freestanding, independent duty, but a reflection of the duties of care and loyalty, depending on the facts. For example, where a fiduciary acts under CONFLICT OF INTEREST, the duty of loyalty will require the fiduciary to disclose to the beneficiary the fact of the conflict and any facts material to the transaction in question. But if there is no conflict of interest, the fiduciary will owe obligations to disclose only where it would violate the duty of care to fail to do so.

Duty of Loyalty One of the two traditional FIDUCIARY DUTIES (the other being the DUTY OF CARE), the duty of loyalty provides that where a fiduciary acts under CONFLICT OF INTEREST the underlying transaction can be challenged and set aside, sometimes under special rules like the BUSINESS OPPORTUNITY DOCTRINE, depending on the circumstances, but often under the more generic INTRINSIC FAIRNESS TEST.

Duty to Monitor A FIDUCIARY DUTY of corporate directors to establish systems of information reporting to detect internal wrongdoing where failure to do so would be so grotesque as to violate their obligation of GOOD FAITH. The duty was recognized in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), and it is frequently known as the *Caremark* duty, though it was significantly elaborated in later Delaware Supreme Court authority. Boards had long had an obligation to investigate risks of wrongdoing wherever “red flags” appeared to indicate they might exist, but *Caremark* added that such a duty could exist in some circumstances even without a red flag. Specifically, if harm befell a company from internal wrongdoing that the board failed to discover through some “utter,” “sustained and systematic failure to exercise oversight,” then it could constitute a breach of the directors’ duties. This stan-

dard received a significant theoretical elaboration in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). *Stone* held that a failure to monitor would be actionable only if it constituted a breach of the obligation of good faith as defined in *In re The Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006). *Disney* held that action in bad faith is conduct intentionally harmful to the company or an intentional dereliction or conscious disregard of one's responsibilities. In addition to holding that a failure to monitor must meet this standard to be actionable, *Stone* established that, in Delaware, good faith is not an independent fiduciary duty separate from the DUTY OF CARE and DUTY OF LOYALTY, but is simply a component of the duty of loyalty.

Edwards-Gingrich Loophole A common strategy for tax-avoidance that seems to explain the otherwise unlikely ubiquity of the S Corporation. Because Medicare and Medicaid taxes are calculated on the total of employee salaries, businesses in which equity owners (like lawyers or other professionals) would ordinarily receive large distributions of salary are formed as S CORPORATIONS that pay the principals minimal salary and distribute the rest of the firm's profits as dividends. The dividends are taxable, but only single-taxed, since the firm is an S Corporation, and the minimization of salary reduces Medicare and Medicaid taxes.

Entire Fairness Test *see* INTRINSIC FAIRNESS TEST.

¹**Equity** The value of one's ownership in a firm or other asset.

²**Equity** An ownership interest in a firm, such as a share of STOCK in a corporation, a partnership interest in a GENERAL PARTNERSHIP, or a membership in a LIMITED LIABILITY COMPANY.

Exchange *see* SECURITIES EXCHANGE.

Exculpatory Clause In corporation law, the phrase usually refers to a provision in the ARTICLES OF INCORPORATION excusing directors for monetary liability for breaches of the DUTY OF CARE. In many jurisdictions they are authorized by statute, as in the widely adopted Delaware General Corporation Law §102(b)(7) and the very similar MODEL BUSINESS CORPORATION ACT §2.02(b)(4). Under such laws directors still face injunctive liability for all fiduciary breaches and full monetary liability for acts in bad faith or in breach of the DUTY OF LOYALTY. Exculpatory clauses also are known as "RAINCOAT PROVISIONS."

Expense The cost of carrying out a firm's ongoing major activities.

Fair Accounting Standards Board (FASB) A private, non-profit entity established by the U.S. accounting profession to develop standards for proper accounting. Specifically, FASB develops and maintains GENERALLY ACCEPTED ACCOUNTING STANDARDS, which the SECURITIES AND EXCHANGE COMMISSION requires be used in preparing FINANCIAL STATEMENTS filed under the federal securities laws.

Fiduciary A person who has both the power and the obligation to act on behalf of another and who therefore owes FIDUCIARY DUTIES. All AGENTS are fiduciaries with respect to their PRINCIPALS.

Fiduciary Duty A legal obligation owed by a FIDUCIARY by reason of that status. Various classes of persons throughout American law may owe fiduciary duties. Within the law of business organizations, fiduciaries include AGENTS, PARTNERS, general partners in LIMITED PARTNERSHIPS, members in MEMBER-MANAGED LIMITED LIABILITY COMPANIES, managers in MANAGER-MANAGED LIMITED LIABILITY COMPANIES, and, in some jurisdictions, shareholders in CLOSELY HELD CORPORATIONS (where the *DONAHUE-WILKES* DUTY or its equivalent is recognized). It is often said that the common law traditionally recognized two main fiduciary duties, the DUTY OF CARE and DUTY OF LOYALTY. In recent decades courts have identified specific applications in particular contexts, including, in the HOSTILE TAKEOVER context, the *UNOCAL* DUTY and the *REVLON* DUTY.

Fiduciary Out Clause A term in an agreement for a change-in-control transaction permitting the target corporation to rescind its recommendation to shareholders to approve the transaction. Usually the change in recommendation is permitted only if the target receives a superior offer or if some other intervening event causes the board to believe the deal is no longer in the firm's best interests. The clause is called a "fiduciary out" clause because it is said to be needed for the target board to comply with its fiduciary obligation to secure the best acquisition price for the firm's shareholders. There is uncertainty, however, whether any limits on the target board's freedom to change recommendation are enforceable in light of the board's fiduciary obligation to shareholders, particularly where the *REVLON* DUTY has attached.

Financial Statement Documents periodically produced by accountants to measure the value and performance of firms. The basic financial statements are the BALANCE SHEET, the INCOME STATEMENT, and the CASH FLOW STATEMENT.

Firm A business entity. In this book we follow the convention of business and economists and use "firm" broadly to mean any business entity, rather than the habit of lawyers to use "firm" to refer only to "law firms."

Front-Loaded Tender Offer A TWO-TIERED TENDER OFFER in which the consideration to be paid shareholders in the initial tender offer phase is more desirable (often much more so) than that to be paid when the remaining minority is merged out in the second, merger phase. The goal is to pressure shareholders into selling in the initial phase, perhaps at a lower price than they might otherwise demand.

General Counsel A company's chief legal officer. In large corporations the general counsel is ordinarily an employee of the corporation and holds the office of vice president or equivalent status. Not uncommonly, smaller corporations engage outside counsel and employ them as general counsel, directing to them oversight of the company's legal affairs.

General Partnership An association of two or more persons to carry on as co-owners a business for profit that has not been formed under a statute conferring some other status. Its chief attributes are that, by default statutory rules,

each member has full, unlimited personal liability for the firm's debts, equal say in management, and an equal share in the firm's profits and losses.

Generally Accepted Accounting Principles (GAAP) A set of rules maintained by the FAIR ACCOUNTING STANDARDS BOARD that govern ACCOUNTING and the preparation of FINANCIAL STATEMENTS.

Golden Parachute A term in an employment contract providing for liquidated damages on the employee's termination. To describe such a term as a "golden" parachute usually connotes that the benefits to be paid are very generous, and generally such terms are reserved for high-ranking officers. Can be used as a TAKEOVER DEFENSE.

Good Faith In general terms, "good faith" is a loosely defined concept used in many areas of law, and connotes action without bad intentions. While the term is frequently used in business entity law, and is frequently said to be an obligation of corporate and other business entity fiduciaries, it is often used without clear definition and in many jurisdictions it has no clear meaning or limits. That said, the concept has a number of significant specific consequences because, among other things, action in bad faith cannot enjoy the protection of the BUSINESS JUDGMENT RULE, a fiduciary's liability for it cannot be INDEMNIFIED, and corporate fiduciaries cannot be shielded for acts in bad faith under EXCULPATORY CLAUSES. Moreover, the courts of one jurisdiction—Delaware—have struggled to clarify the concept. In *In re The Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006), the court held that action in bad faith can constitute either action with the deliberate intent to harm the beneficiary or intentional dereliction or conscious disregard of one's responsibilities. Mere negligent inaction is not enough, even where it might constitute a breach of the DUTY OF CARE. Another decision, *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), clarified that in Delaware, good faith is not an independent fiduciary duty separate from the duty of care and DUTY OF LOYALTY. It is simply a component of the duty of loyalty.

Goodwill The value of a firm as a going entity over and above the liquidation value of its assets; the amount a purchaser of the firm would pay in excess of the value of the firm's assets. Goodwill reflects the firm's expectation of future revenues.

Go-Shop Clause A term in an agreement for a change-in-control transaction permitting the target firm to seek superior offers from third parties during a specified period. The usual rationale is to ensure that target firm shareholders receive an adequate price. *Cf.* NO-SHOP CLAUSE.

Greenmail A coercive strategy under which the greenmailer acquires a significant minority percentage of a company's stock and threatens to take control in order to pressure the company to repurchase the stock at a premium price.

Gross Negligence In Delaware law, the standard of liability under which a corporate fiduciary can be found to have breached the DUTY OF CARE.

Hedge To make one investment that offsets the risk of another. Hedging can be accomplished simply through DIVERSIFICATION. By investing in different

companies in different industries and different circumstances—which reduces the risk that the different investments would rise or fall together—the risk of any one of the investments failing will be offset by the likelihood that most of the rest will succeed. Hedging can also be accomplished with DERIVATIVES. For example, say you buy 10 shares of stock in XYZ, Inc. at \$5 per share. You might be concerned about the risk of the trading price of the stock falling too low. You could hedge against that risk by buying a PUT OPTION from another investor, giving you the right to sell that investor your 10 shares within a given period at a price of \$3. You might still lose money, but the put option avoids loss of your entire investment during the specified period.

Hedge Fund A fund that employs a proprietary strategy for investing pooled capital. Hedge funds generally require very large investments from each participant, and require the investments to be kept in the fund for a specified period. They are designed to avoid most regulation; as part of that strategy their investors must satisfy certain wealth and/or sophistication tests. The name is a historical accident, since today most hedge funds are not primarily concerned with HEDGING against risk (the original hedge funds were focused on hedging risk).

Historical Cost The price at which an asset was acquired. In ACCOUNTING, assets are ordinarily accounted for at their historical cost on FINANCIAL STATEMENTS, and are then DEPRECIATED according to assumed rates. This “historical cost rule” is sometimes artificial, in that it may report a relatively low value for an asset that has in fact appreciated.

Hostile Takeover A change-in-control transaction effected over the opposition of the target company’s board of directors. As a practical matter, a hostile takeover generally takes the form of a TENDER OFFER because, unlike the other possible change-in-control transactions—the MERGER, the SHARE EXCHANGE, or the DISPOSITION OF ASSETS—a tender offer does not require acquiescence of the target firm’s board.

Hotel California Provision A provision in a state LIMITED LIABILITY COMPANY STATUTE providing that voluntary withdrawal does not cause DISSOCIATION or DISSOLUTION. The practical effect is that a member may leave the firm and no longer participate in its affairs, but the member also has no means to force a withdrawal of his or her investment in the firm. The name alludes to the lyrics of the famous song: one can check out, but never leave.

Income Statement A FINANCIAL STATEMENT reporting the revenues, expenses and profits or losses of a business firm for a given period. Unlike the BALANCE SHEET, the income statement is a moving picture of the firm’s financial state over time.

Incorporation The act of causing a corporation to come in to being. In most jurisdictions, incorporation is accomplished simply by delivering the ARTICLES OF INCORPORATION to the SECRETARY OF STATE for filing.

Incorporator A person who causes ARTICLES OF INCORPORATION to be filed on behalf of a corporation.

Indemnification Reimbursement by one person of expenses incurred by another. Agents enjoy certain rights of indemnification as a matter of agency law and corporate officers and directors and the managers of UNINCORPORATED ENTITIES enjoy some mandatory indemnification rights as well.

Indenture *See* TRUST INDENTURE.

Indenture Trustee The party appointed to act as trustee administering the TRUST INDENTURE governing an issuance of DEBT SECURITIES. The trustee must be appointed by the issuer and is required to represent the interests of the investors. The trustee is typically a commercial bank or trust company. The trustee's appointment is ordinarily required in most public debt issuances by the Trust Indenture Act of 1939.

Index Fund A mutual fund with a portfolio designed to match the performance of some stock market index. An "index" is simply some set of stocks or other securities chosen as representative of the market or some part of it, like the familiar Dow Jones Industrial Average or the S&P 500.

Initial Public Offering (IPO) A company's first sale of SECURITIES to the public. An IPO can be of EQUITY or DEBT securities. IPO transactions are heavily regulated and expensive affairs, and generally are administered with the aid of an INVESTMENT BANK acting as UNDERWRITER.

In-Kind Dividend A pro rata distribution of profits to shareholders in the form of anything of value, other than cash. In principle the property distributed could be anything, but often it will consist of the firm's own stock or the securities of some other firm. *Cf.* DISTRIBUTION.

Insolvency Often defined as either the inability to pay debts as they come due or the state in which the firm's assets are worth less than its liabilities. Insolvency is colloquially known as "being in the red" (as opposed to "being in the black," both references to the one-time accounting practice of writing positive values in black and negative ones in red).

Inspector of Election A person appointed to administer voting at corporate shareholder meetings. The inspector need not be an officer of the corporation or otherwise affiliated with it, and can be a third party hired for the purpose. The inspector plays certain key statutory roles, including determining the shares entitled to vote and resolving disputes over the validity of proxies.

Institutional Investor An investor that is a firm rather than an individual, and typically a financially sophisticated firm, like a bank, investment firm, MUTUAL FUND, insurance company, or pension fund.

Interest A payment required of a borrower, over and above repayment of the PRINCIPAL amount, to compensate the lender for use of its funds. Interest on debt sometimes is calculated at a fixed rate, but it need not be. For example, interest is sometimes paid as a percentage of profits, up to some specified total.

Intrinsic Fairness Test The standard of liability under which fiduciaries are ordinarily judged when they have acted under CONFLICT OF INTEREST, and

accordingly are challenged for breach of the DUTY OF LOYALTY. In some circumstances a more specialized test such as the BUSINESS OPPORTUNITY DOCTRINE will apply.

Investment Advisor A person or firm that makes investment recommendations for a fee, whether through direct investment management or publications. Unless exempt, investment advisors are subject to the Investment Advisors Act of 1940, which requires registration with the SECURITIES AND EXCHANGE COMMISSION and compliance with certain other requirements.

Investment Bank A financial firm that assists in funding and executing financial transactions. Among their major functions is acting as UNDERWRITER for PUBLIC OFFERINGS of EQUITY and DEBT SECURITIES. They also act as financial advisors to corporate clients in MERGERS and other major transactions, and many of them serve as BROKERS to institutional clients. Most investment banks also have proprietary trading operations in which the firm trades in securities on its own account, earning its return on its trading profits.

Investment Company A company that (in exchange for its shares) pools the funds of large numbers of investors and invests them collectively. Though there are other categories, the most familiar kind of investment company is the MUTUAL FUND. Investment companies are ordinarily regulated by the SECURITIES AND EXCHANGE COMMISSION under the Investment Company Act of 1940.

Investment Contract One of the many terms contained in the statutory definitions of “security” in both the SECURITIES ACT OF 1933 and the SECURITIES AND EXCHANGE ACT OF 1934, which courts have treated as something of a catch-all. Under the leading construction of the term, it is a scheme pursuant to which “a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . .” SEC v. W. J. Howey Co, 328 U.S. 293, 299 (1946).

IPO *see* INITIAL PUBLIC OFFERING.

Issuer A firm that issues a SECURITY.

Joint Venture An endeavor in which two separate firms cooperate. The term is not a legal term of art and it has no precise meaning, although it is often used to refer to a general partnership formed for a specific, limited-term purpose. Typically, a joint venture is formed either by the contribution of resources by both firms subject to agreement governing rights and management, which creates a GENERAL PARTNERSHIP, or by the creation of a new, freestanding entity jointly owned by the members.

Leverage The degree to which a firm has financed its operations with debt. A firm that has borrowed more to fund itself is said to be more heavily leveraged. Leverage poses strategic issues for both borrowers and investors. On the one hand, borrowing is riskier to the borrower than taking EQUITY investments. In the former, the borrower must repay PRINCIPAL and INTEREST timely or face legal liability, regardless whether the borrower is earning sufficient revenue to cover those obligations.

In the latter, the firm ordinarily has no obligation to distribute profits or make other payments, and so takes no risk of obligations to its owners in times when there are insufficient revenues. But on the other hand, from the borrower's perspective, leverage has advantages. First, payments of interest are tax-deductible to the borrower, whereas distributions of profit to equity investors are not. Second, leverage can make investments highly profitable to the borrower. Say you invest \$100 of your own money in an investment, with a return of \$10. The return on your investment would be 10 percent. But if you can borrow \$90 of the required \$100 at an interest rate of 5 percent (\$4.50), then the \$5.50 you keep represents a return of 55 percent.

Limited Liability Protection for equity owners in a limited liability entity, such as a CORPORATION, a LIMITED LIABILITY COMPANY, a LIMITED LIABILITY PARTNERSHIP, or the like, from personal liability for the firm's own obligations. In practical effect limited liability means that if the firm becomes insolvent or is unable to satisfy claims against it, its creditors cannot then execute their claims against the firm's owners.

Limited Liability Company An entity formed under a state limited liability company statute. Its chief attributes are that members enjoy LIMITED LIABILITY, the firm can enjoy PASS-THROUGH TAXATION, and its governance rules generally can be tailored as the participants desire.

Limited Liability Limited Partnership A LIMITED PARTNERSHIP formed under a statute that permits a LIMITED LIABILITY election, under which even the firm's general partners enjoy limited liability.

Limited Liability Partnership A GENERAL PARTNERSHIP formed under a statute that permits a LIMITED LIABILITY election, under which the partners enjoy complete or (in some states) partial limited liability.

Limited Partnership A firm created under a state limited partnership statute. Its chief attribute is that it consists of two classes of partners, whose roles and liability differ. First, there must be at least one general partner. The default rule is that the general partners hold managerial power for the firm, but, unless the LIMITED LIABILITY LIMITED PARTNERSHIP form is available, also have full UNLIMITED LIABILITY for the partnership's obligations. Second, there can be any number of limited partners. The limited partners enjoy LIMITED LIABILITY, though historically they were required to avoid interference in management to preserve that privilege.

Liquidity The ease with which the value of an asset can be extracted from it and spent. Cash is the most liquid of all assets, as it can always be spent for its full value immediately.

Lock-up Clause A loose term connoting any sort of clause in an agreement for a change-in-control transaction requiring some penalty to dissuade the target firm from abandoning the deal. Lock-up clauses may include a BREAK-UP FEE, a CROWN JEWELS clause, or a STOCK OPTION pursuant to which the disappointed buyer may purchase target-firm stock at a discount.

Manager-Managed Limited Liability Company A LIMITED LIABILITY COMPANY in which the members have elected not to manage the firm themselves,

and rather to appoint managers (who may or may not themselves be members) to manage the firm. The chief consequence is that, unlike the case of a MEMBER-MANAGED LIMITED LIABILITY COMPANY, the members have no fiduciary duties to the firm and lack authority to bind it.

Manifestation In the law of AGENCY and some UNINCORPORATED ENTITIES, an outward indication of one's intent. Usually manifestations may be written, spoken, or non-verbal.

Market In economics, the collection of possible buyers and sellers for some good or service. Markets are thought to have essentially self-regulatory properties, in that when they are healthy and properly functioning, they tend to push price downward and require efficient production of the sellers' output.

Market Capitalization The total dollar value of a firm's outstanding shares. In publicly traded firms, market capitalization can be calculated by multiplying the firm's total outstanding shares by their current trading price.

Market Maker A BROKER-DEALER that holds itself out as available to buy and sell large quantities of a given SECURITY at specified prices. Market makers are essential to the operation of SECURITIES markets, as they provide the liquidity essential to active trading. Market makers earn a return on the activity by maintaining a small difference or "spread" between the price at which they are willing to buy and the price at which they are willing to sell the security.

Master Limited Partnership (MLP) A LIMITED PARTNERSHIP that is publicly traded on a SECURITIES EXCHANGE. As a practical matter, MLPs operate in certain narrow lines of business (mostly involving mineral exploration) because except in those areas federal tax laws treat any publicly traded limited partnership as an entity subject to DOUBLE TAXATION.

Member-Managed Limited Liability Company A LIMITED LIABILITY COMPANY that the members have chosen to manage themselves. The chief consequence is that, unlike the case of a MANAGER-MANAGED LIMITED LIABILITY COMPANY, the members owe fiduciary duties to the firm and they have authority to bind it.

Merger A change-in-control transaction, authorized by statute, in which two firms are combined into one. Merger usually requires approval of both the BOARD OF DIRECTORS and SHAREHOLDERS of the target firm, the approval of the board of directors of the acquiring firm, and often the approval of the shareholders of the acquiring firm as well. The legal consequence of merger is that the firms cease separate legal existence, and that the assets and liabilities of the acquired firm become those of the acquiring firm. *See* CONSOLIDATION; TRUE MERGER.

Model Business Corporation Act A model statute produced by the American Bar Association's Section of Business Law and adopted by a majority of the states. The Act was first promulgated in 1950 and has been revised many times. The last major substantive revision was in 1984, and that code, with its many, rather less ambitious refinements since, generally is still known as the Revised Model Business Corporation Act.

Model Rules of Professional Conduct A model code of professional conduct for lawyers, produced by the American Bar Association and now substantially followed by most states. In this book, all materials concerning ethical conduct in business contexts are keyed to these Model Rules.

Mutual Fund An entity that, in exchange for its shares, pools investors' funds for reinvestment in other securities. Mutual funds are administered by professional investment managers.

No-Shop Clause A term in an agreement for a change-in-control transaction prohibiting the target firm from soliciting other bids for purchase of the company.

Officer An employee of a corporation with relatively high managerial responsibility. Officers commonly include the CHIEF EXECUTIVE OFFICER, PRESIDENT, CHIEF FINANCIAL OFFICER, TREASURER, and SECRETARY, but may include any number of other high-ranking employees with a range of responsibilities.

Oppression Conduct within a closely held firm in which a controlling shareholder or group denies a minority shareholder or group access to financial returns from the company and participation in management. Oppression takes its force from the fact that minority shareholders in closely held firms will by definition have highly illiquid stock. Since corporate shareholders have no default right of unilateral dissolution or other means to force a cashing-out of their investment, they will be dependent on the controlling group for access to any return on that investment.

Option A contract under which one party may buy a SECURITY from the other at a specified price, typically within some specified time period.

Outstanding Shares Shares of STOCK that have been issued by a corporation and that it has not reacquired or redeemed.

Over-the-Counter (OTC) Security A security traded in some manner other than on a formal SECURITIES EXCHANGE. Frequently, OTC securities are traded through networks of DEALERS.

Pac Man Defense A TAKEOVER DEFENSE in which a target firm facing a HOSTILE TAKEOVER attempts to acquire the takeover proponent instead.

Partnership See GENERAL PARTNERSHIP. Note that while the term "partnership" often colloquially stands for "general partnership," several other business entities are also forms of partnership, including the LIMITED PARTNERSHIP, the LIMITED LIABILITY PARTNERSHIP, and the LIMITED LIABILITY LIMITED PARTNERSHIP.

Passive Investor An investor who takes no role in a firm's management. Corporate shareholders are frequently passive, especially in PUBLICLY TRADED companies, though they need not be. LIMITED PARTNERS are at least nominally passive, and members in MANAGER-MANAGED LIMITED LIABILITY COMPANIES are passive.

Piercing the Corporate Veil An equitable doctrine under which a court may permit a corporation's creditors to execute their claims against the personal assets of the company's shareholders or other controlling figures.

Poison Pill Any of a range of TAKEOVER DEFENSES in which the acquisition by a person of some specified number of a firm's shares will trigger some legal consequence making the target firm much more expensive or difficult to buy. For example, a corporation might adopt a plan under which if any person acquires 20 percent of its outstanding stock, the firm would repurchase some substantial number of the remaining outstanding shares either at a high price or in exchange for debt securities paying a high rate of interest. The effect would be to decrease the value of the firm to the acquiring party. Variations are many, and poison pills range from relatively simple plans to extremely complex ones.

Preferred Stock Corporate EQUITY STOCK typically having no voting rights, but enjoying a preference to receive some fixed amount of dividends before any dividends are paid to holders of COMMON STOCK. Preferred stock also often enjoys a preference to receive a fixed payment on dissolution before common stock holders receive any.

Pre-Incorporation Liability Liability incurred by a PROMOTER purporting to act on behalf of a corporation before it has come into existence. Because LIMITED LIABILITY does not attach until a corporation is formed, actions by PROMOTERS are their own actions, though they may purportedly be on behalf of the firm. Moreover, where two or more promoters act on behalf of the same firm (in which case they are often known as co-promoters), they frequently are jointly and severally liable for all obligations incurred by any of them.

President A high-ranking officer who may or may not be a firm's CHIEF EXECUTIVE OFFICER. In some firms one person holds both titles; in other firms there may be a CEO and a president.

¹**Principal** A party to an AGENCY relationship upon whose behalf the other (known as the AGENT) acts, subject to the principal's control.

²**Principal** The base amount that is borrowed by a borrower from a lender, and which must be repaid, not including any INTEREST.

Private Placement An issuance of securities designed to qualify for an exemption from registration under the SECURITIES ACT OF 1933 by reason of the relative wealth, sophistication, and/or access to information of the investors.

Profit For accounting purposes, the difference between a firm's REVENUE and its EXPENSES. Profit can be defined in different ways and in particular it is defined very differently by economists, but in any context, it connotes the firm's overall revenue minus some measure of its costs.

Promoter A person who acts on behalf of a business firm before it has been formally organized.

Prospectus Although for purposes of the federal securities law the term has a highly specialized meaning, in common parlance it generally refers to a formal document describing the attributes of a SECURITY to be issued and its issuer. Unless an issuance of securities is exempt from the SECURITIES ACT OF 1933, the issuer must file a prospectus with the SECURITIES AND EXCHANGE

COMMISSION and make a copy available to those persons to whom the security is marketed or sold.

Proxy The term can have different meanings, and is used differently under different corporation statutes, but it relates to situations in which the owner of a voting corporate security authorizes another person to cast that share's vote. Typically, the term means the document by which a shareholder authorizes another to cast their vote, but it may also refer to the person to whom the authorization is given.

Proxy Regulation Rules under the Securities Exchange Act of 1934 governing PROXY SOLICITATIONS to shareholders in PUBLICLY TRADED firms. Where the proxy rules apply, the person making the solicitation must make a filing in advance with the SECURITIES AND EXCHANGE COMMISSION and must comply with certain disclosure requirements.

Proxy Solicitation This is a term that is the subject of both case law and specific regulations of the SECURITIES AND EXCHANGE COMMISSION, but generally may be used to describe any communication directed to a corporate shareholder requesting the shareholder's PROXY.

Publicly Traded Corporation Like CLOSELY HELD CORPORATION, this term is not a legal term of art and has no precise definition. Generally speaking, a firm is publicly held where it has issued a large number of shares to a large number of passive investors not otherwise involved in the company, and where there is some ready, reasonably liquid market for SECONDARY TRADING in its shares.

Put An OPTION that permits the purchaser to sell a SECURITY or some other underlying asset at a specified price on or before a given date. The purpose of a put option is usually to HEDGE against falling prices in the underlying asset.

Raincoat Provision See EXCULPATORY CLAUSE.

¹**Ratification** An act by which a person or firm makes itself subject to a liability purportedly made on its behalf, but which would not otherwise be binding. Unlike ADOPTION, ratification is retroactive.

²**Ratification** A vote of approval of an already binding liability. For example, a corporate officer might execute a contract with a third party as to which the officer has sufficient authority to bind the firm, but nevertheless submit it to a vote of ratification by the company's BOARD OF DIRECTORS OR SHAREHOLDERS. The purpose of this sort of ratification is generally to alleviate concerns that the person who incurred the liability has violated a FIDUCIARY DUTY.

Registration Statement A filing made by a securities-issuing firm with the SECURITIES AND EXCHANGE COMMISSION under the SECURITIES ACT OF 1933. Although issuers also register classes of securities under the SECURITIES AND EXCHANGE ACT OF 1934, the filing is not usually referred to as a registration statement.

Restatement of Law Any one of a series of codifications of common law doctrine promulgated by the AMERICAN LAW INSTITUTE. In this book we rely at some length on the Restatement (Third) of the Law of Agency.

Retained Earnings PROFIT accumulated by a firm over time and not yet distributed to owners. Retained earnings may be held in the form of cash or other liquid investments, or they may be reinvested in the firm's operations.

Reverse Break-up Fee A term in a change in control agreement similar to a BREAK-UP FEE, except that the penalty is to be paid by the acquiring firm rather than the target.

Reverse Stock Split An act by which a corporation causes the number of its OUTSTANDING SHARES to be proportionally reduced. The split ostensibly affects shareholders equally, so, for example, in a 2-to-1 split, every shareholder's holdings of the company's stock are cut exactly in half. Because the split affects every shareholder equally, it should have no effect on any shareholder's percentage voting rights or the total value of any shareholder's shares. The split does, however, increase the trading price of the stock, since there are fewer shares in number even though the company has the same value. One purpose of a reverse stock split is to raise the price of a stock that is thought to have fallen too low. This may have very practical consequences, since many INSTITUTIONAL INVESTORS have rules against investing in stock whose price is too low, and STOCK EXCHANGE listing requirements may mandate a minimum price. *Cf.* STOCK SPLIT. Another objective may be to force minority shareholders to accept cash in exchange for their shares, if the split ratio is set so as to preclude the minority holders from receiving entire shares.

Revenue The total amount earned by a firm in a given period for its major, ongoing activities, without deducting EXPENSES. *cf.* PROFIT.

Revised Uniform Limited Partnership Act (RULPA) A model code promulgated by the UNIFORM LAW COMMISSION to govern LIMITED PARTNERSHIPS. ULC had issued a prior statute in 1916 that was widely adopted, but since its promulgation in 1976, RULPA has replaced its predecessor in many states. ULC also issued a substantial revision to RULPA in 2001, but it has not been widely followed.

Revised Uniform Partnership Act A model code promulgated by the UNIFORM LAW COMMISSION to govern GENERAL PARTNERSHIPS. The revised Act, first issued in 1992 and substantially revised in 1997, replaced the original UNIFORM PARTNERSHIP ACT of 1914 and has now been adopted in a majority of states.

Revlon Duty A fiduciary duty of outside directors triggered in some cases of HOSTILE TAKEOVER or other change-in-control transaction, first recognized in *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985). Without suggesting that there are definite parameters, it is fair to say that the duty is triggered where break-up of the company or a substantial change in the nature of control of the company is imminent (as for example where a publicly traded company is to be acquired by a party that will become its controlling shareholder). Where the duty is triggered, it requires the outside directors to cease efforts to thwart takeover or otherwise preserve their control over the long-term policy of the firm, and instead seek to auction the company to the highest bidder. *Cf.* UNOCAL DUTY.

S Corporation A corporation taxed under Subchapter S of the Internal Revenue Code. Unlike the C CORPORATION, an S Corporation is subject only to single and not DOUBLE TAXATION.

Seal *see* CORPORATE SEAL.

Secondary Trading Sales of securities not from the issuer to an initial buyer but between a shareholder and subsequent, third-party buyers. For example, most trading on SECURITIES EXCHANGES is secondary trading.

Secretary A corporate officer whose primary duties traditionally included authenticating official company documents and registration and recordkeeping concerning shareholders. Today corporate secretaries also typically undertake significant legal and regulatory compliance duties.

Secretary of State A state government official in most states who oversees an agency typically known as the department of state. The secretary of state plays a role in business organization law, as most business entities must be formed by the filing of documents with the department of state in the state of formation.

Securities Act of 1933 15 U.S.C. §§77a-77aa. A statute adopted in 1933 to require that in all nonexempt issuances of securities, the issuer provide certain minimal information concerning the security to the persons to whom the securities are marketed or sold.

Securities and Exchange Act of 1934 15 U.S.C. §§78a-78pp. A statute adopted in 1934 to create the SECURITIES AND EXCHANGE COMMISSION and provide a panoply of regulations relating primarily to secondary market trading and/or the issuers and holders of securities subject to such trading. *Cf.* SECONDARY TRADING.

Securities and Exchange Commission (SEC) A federal agency created by the SECURITIES AND EXCHANGE ACT OF 1934 and charged with administering that statute, the SECURITIES ACT OF 1933, and several other statutes.

Securities Exchange Although this is a term with a specialized definition which, when satisfied, requires registration with the SECURITIES AND EXCHANGE COMMISSION, it generally is used to refer to a place or system pursuant to which shares are actively traded, or to an organization formed for the purpose of maintaining such a place or system.

Security An instrument representing an investment in a business firm or other endeavor. Colloquially the term connotes at a minimum any corporate STOCK OR DEBT SECURITY, but many other instruments might qualify. Within the federal law of securities regulation under the SECURITIES ACT OF 1933 and the SECURITIES AND EXCHANGE ACT OF 1934, the term is defined very broadly, and can include virtually any scheme pursuant to which a person invests money expecting a return to be generated primarily by the efforts of others.

Share One unit of EQUITY in a business firm. Although a share could include a unit of corporate STOCK, a membership interest in a LIMITED LIABILITY

COMPANY, or an ownership unit in a GENERAL PARTNERSHIP, the term most often is used in the corporate context.

Share Exchange A change-in-control transaction in which, following approval by the target corporation's board and shareholders, all shares in the target corporation are acquired in exchange for consideration paid by the acquiring corporation, which may consist of cash, securities, or some other thing of value. Following the transaction, the target firm continues as the acquiring firm's wholly owned subsidiary.

Shareholder A person who owns a share or shares of corporate STOCK.

Shark Repellant A TAKEOVER DEFENSE.

Short Sale A sale of a SECURITY that the seller does not actually own, but rather has borrowed, with the expectation that the price of the security will go down. If it does, the short seller will then be able to procure shares on the market at the lower price to return them to the party that originally lent the shares. The result is a profit—the difference between the higher price at which the short seller originally sold the borrowed shares and the lower price at which he later buys replacement shares. Of course, there is also the risk that the price will go up in the interim, causing the short seller a loss. Also, the lender of the original shares, which usually will be the short seller's broker or some other institution, usually charges a fee for the service.

Sole Proprietorship A business firm owned entirely by one person, as to which no steps have been taken to incorporate or organize in any other form.

Stock An EQUITY security issued by a corporation.

Stock Buy-Back A repurchase by a corporation of its own OUTSTANDING SHARES from SHAREHOLDERS who currently own them. Because a stock buy-back that is proportional across all shareholders does not affect any shareholder's percentage voting rights, the only practical effect of such a buy-back is to distribute profits to shareholders. And indeed, stock buy-backs are generally treated in the law like DIVIDENDS. For example, as with dividends, a stock buy-back cannot be performed if it would cause the firm to become insolvent.

Stockholder See SHAREHOLDER.

Stock Option See OPTION.

Stock Split An issuance of new stock to existing shareholders in proportion to their current holdings. The effect is simply to increase the number of OUTSTANDING SHARES. It has no effect on the total value of a current shareholder's interest or on their percentage voting power. The usual purpose of a stock split is to reduce the trading price of stock that is thought to have risen too high, to make it seem more affordable. Cf. REVERSE STOCK SPLIT.

Takeover The acquisition of a controlling interest in one firm by another firm or investor. Generally, "takeover" connotes HOSTILE TAKEOVER, and therefore a TENDER OFFER.

Takeover Defense Any maneuver by which a company makes itself less vulnerable to HOSTILE TAKEOVER. *See* CROWN JEWELS; PAC MAN DEFENSE; POISON PILL; WHITE KNIGHT.

Target Company The firm to be acquired in a change-in-control transaction, such as a MERGER, SHARE EXCHANGE, or TENDER OFFER.

Tender Offer Although this term has a specific legal meaning, it generally refers to an offer on the open market to purchase shares of a publicly traded firm, usually at a premium, with the goal of acquiring a controlling percentage of its voting stock. Because the offer is made directly to the shareholders, there is no need for acquiescence by the target firm's board, and for this reason the term tender offer is largely synonymous with HOSTILE TAKEOVER. In that respect it differs from all other change-in-control transactions, which essentially always require cooperation of the target firm's board.

Treasurer A corporate officer, typically acting as or reporting to the CHIEF FINANCIAL OFFICER, who runs a corporation's treasury department. In effect, the treasurer is a financial risk manager, with responsibility to ensure that the corporation has sufficient liquid assets with which to pay its obligations as they come due.

True Merger A MERGER following which one of the merging firms (usually referred to as the "target firm" or "acquired firm") will cease to have independent existence. The other firm (the "acquiring firm") will continue as the survivor. *Cf.* CONSOLIDATION.

Trust Indenture A special subsidiary agreement required in most public issuances of DEBT SECURITIES, under which the issuer appoints a third-party INDENTURE TRUSTEE to act as a fiduciary who represents the interests of the investors. Trust indentures are governed by the Trust Indenture Act of 1939, and generally are required when debt securities are publicly issued.

Two-Tier Taxation *see* DOUBLE TAXATION.

Two-Tier Tender Offer A TENDER OFFER in which acquisition of the target firm's shares will occur in two phases. Strictly speaking, the second phase is ordinarily not a tender offer at all. Rather, the acquirer will secure a majority of the company's voting stock in the first phase, and then in the second phase use that voting majority to approve a merger of the target firm into the acquiring firm. The terms of the merger may require the remaining minority shareholders to accept cash or other consideration in exchange for their shares. *Cf.* FRONT-LOADED TENDER OFFER.

Underwriter Colloquially, a firm, which ordinarily is an investment bank, that manages a PUBLIC OFFERING of some SECURITY on behalf of the issuer, which is the underwriter's client. There is also a much more specialized meaning under the federal securities laws.

Uniform Law Commission (ULC) Formerly known as the National Conference of Commissioners on Uniform State Laws, the ULC is a non-profit

association formed in 1892 to produce model codes to improve and harmonize state law. It is comprised of commissioners formally appointed by each state government.

Uniform Limited Liability Company Act (ULLCA) A model code promulgated by the UNIFORM LAW COMMISSION to govern LIMITED LIABILITY COMPANIES. ULLCA was first adopted in 1995 and substantially revised in 2006. It has not yet been widely adopted, presumably because of its promulgation subsequent to the adoption of LLC-enabling legislation by all 50 states.

Uniform Partnership Act A model code promulgated by the UNIFORM LAW COMMISSION (then known as the National Conference of Commissioners on Uniform State Laws) in 1914, to govern GENERAL PARTNERSHIPS. In its day it was adopted by every state but Louisiana, but it has been superseded by the REVISED UNIFORM PARTNERSHIP ACT of 1997 in a majority of states.

Unincorporated Entity A business entity that is not incorporated under a state corporation statute. Unincorporated entities include GENERAL PARTNERSHIPS, LIMITED PARTNERSHIPS, LIMITED LIABILITY PARTNERSHIPS, LIMITED LIABILITY LIMITED PARTNERSHIPS, and LIMITED LIABILITY COMPANIES.

Unlimited Liability The legal status under which a participant in a firm bears personal responsibility for the firm's debts. In practical effect, if the firm becomes insolvent or is unable to pay claims against it, creditors may then execute their claims against the personal assets of a participant with unlimited liability. Unlimited liability has become comparatively unusual in American law, because it is now so easily avoided without adverse tax consequences or loss of managerial participation by LIMITED LIABILITY participants.

Unocal Duty A FIDUCIARY DUTY of outside directors in cases of threatened HOSTILE TAKEOVER, first recognized in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). In effect, wherever a corporation takes any step meant to thwart hostile takeover, an outside director must be able to demonstrate that it was based on reasonable investigation into threat to corporate policy and effectiveness, and must be reasonably balanced in relation to the threat posed. *Cf. REVLON DUTY.*

Watered Stock Stock for which the agreed-upon consideration is invalid or has not been paid by the purchaser of the stock. If a corporation becomes insolvent or unable to pay claims against it, and its stock is watered, creditors may execute their claims against shareholders who have not paid full and valid consideration, up to the amount of the unpaid consideration.

White Knight A TAKEOVER DEFENSE in which the target firm in a HOSTILE TAKEOVER engages some third-party firm to acquire it, as a buyer preferable to the takeover proponent.

Williams Act A statute adopted in 1969 as an amendment to the SECURITIES AND EXCHANGE ACT OF 1934 and now appearing as provisions of 15 U.S.C. §§78m, 78n. Among other things, the Williams Act requires that when any person seeks to acquire more than 5 percent of a class of securities registered under

the '34 ACT by TENDER OFFER, the person must make certain filings with the SECURITIES AND EXCHANGE COMMISSION, and must make disclosures to target firm shareholders.

Winding Down A process required following DISSOLUTION of a firm, in which its business affairs are ended, its assets liquidated, liabilities resolved, and any residue distributed to the EQUITY owners. The term “winding up” sometimes is used to refer to the same process.