INTRODUCTION

Federal and State Courts

Since we will be reading many cases, some in federal courts and some in state courts, you need to know the distinction between the basic trial courts, the appeals courts, and the supreme courts for final appeals. Trial courts determine the facts of a dispute, but also render a legal decision. Appeals courts review the legal decision in light of other trial court decisions on similar facts, but are not supposed to revisit the facts determined by the trial court.

Statutory and Regulatory Law

There are three types of federal law: constitutional, statutory, and regulatory. Regulatory law arises from the rules and regulations of federal agencies within the authority delegated to them by their authorizing statutes passed by Congress. States also have constitutions but for the most part, their substantive provisions mirror the U.S. Constitution. States have statutory and regulatory law. All judicial decisions build on the relevant constitutional, statutory, or regulatory language, but they are also constrained by the decisions of prior judges in cases with similar fact patterns.

Common Law and Precedent

States also have a fourth type of law called the common law inherited from the English law of property, contracts, and torts. The common law is derived from the decisions of English judges over many years since the Norman conquest in 1066. Thus, the common law causes of action first arose from decisions by judges, and then developed over time as the judges constrained themselves to respect the prior decisions (precedents) of judges in cases with similar fact patterns.

Origins of Corporations and the Delaware Incorporation Statute

Under the U.S. Constitution, corporations are created by states, and all states allow self-incorporation by general incorporation statutes. For many reasons discussed in the course, most major corporations are incorporated under the Delaware statute. So we discuss the provisions of the Delaware statute, such as the bylaws, the board of directors, and shareholder voting.

Fifth and Fourteenth Amendments – Due Process: Ames (1897) and Hope (1944)

These two older cases illustrate how the Due Process Clause in the Fifth and Fourteenth Amendments provides a substantive limitation on federal and state laws and regulations. Both cases dealt with price regulation by a state agency (Ames) or federal agency (Hope). In particular, the price regulations must satisfy a basic rationality test called the “rational basis test” in which the law must be rationally related to a legitimate state interest. Legitimate state interests for the federal government are defined by the powers of Congress under Article II of the US Constitution. Legitimate state interests for state governments are the “police powers” under the Tenth Amendment.

First Amendment – Free Speech: Virginia (1976) and Bellotti (1978)

These two famous cases were decided in the 1970s. In the first case, the U.S. Supreme Court held the advertising is protected under the freedom of speech in the First Amendment of the U.S. Constitution.
That means that state or federal regulation of advertising by corporations requires a higher standard of review called the “strict scrutiny test” in which the law must be narrowly tailored to a compelling state interest. This decision makes it more difficult for state and federal agencies to regulate false and misleading advertising. The Bellotti case then confirms that political speech by corporations is also protected by the First Amendment.


These U.S. Supreme Court cases narrowed the ability of state and federal governments to regulate corporate expenses to advertise on behalf of candidates and political parties during election. They also discuss the history of campaign finance reform. The Citizens United case continues to be very controversial because it has fueled negative campaign advertising by political action committees (PACs).


Finally, we discuss whether corporations are protected by the freedom of religion clause of the First Amendment. This is most relevant for whether corporations can be required to include birth control in the health care plans for their employees. The recent Hobby Lobby case extends this protection to corporations that are closely held by a family with strong religious beliefs.

**PROPERTY LAW**

**Origins of Private Property: Magna Carta (1215)**

This discussion provides a brief history of the development of private property in English Common Law. I explain the development of the three key rights: exclusive possession, inherit and devise (will), and alienate (rent or sell). The first two of these rights are incorporated into the Magna Carta, for the nobility.

**Private Nuisance: Bove (NY, 1932), Boomer (NY, 1970), and Spur (AZ, 1972)**

Private Nuisance is an early common law doctrine to prevent inference by a neighbor in the use and enjoyment of one's private property. The three cases from New York and Arizona illustrate how the doctrine of private nuisance is not suited to resolve conflicting uses between residential and industry uses of neighboring land. As a result these cases illustrate the economic demand for zoning laws. They also illustrate how the Coase Theorem cannot resolve these conflicts because there are transactions costs in the form of either a free-rider or a holdout problem.

**Zoning and the Rational Basis Test: Ambler (1926) and Nectow (1928)**

In the Ambler case, the U.S. Supreme Court upheld the validity of zoning by municipalities (created by states) under the rational basis test. The companion Nectow case illustrated the limits of zoning in that the separation between residential and industrial uses cannot be arbitrary. These cases stimulated the zoning movement in the U.S. which then eventually created problems with exclusive zoning.

**Eminent Domain: Berman (1954) and Kelo (2005)**

State and federal constitutions allow government to take private property for public uses such as roads and government buildings, but the government must pay “just compensation” meaning the fair value of the land. The controversial issue with this power of eminent domain is that cities and towns want to redevelop certain parts with private development such as shopping, restaurants, and new housing. These
two cases illustrate the Constitutional limits on the use of eminent domain for economic redevelopment. The Berman case involves redevelopment in Washington DC in the 1950s and the Kelo case involves redevelopment in New London Connecticut in the 2000s. Both were very controversial and the planned redevelopments never occurred even after the cities took ownership of the land.

**Regulatory Takings: Penn Central (1978) and Lucas (1992)**

There are many examples in which state and federal regulation of land use is so restrictive that it can eliminate virtually all uses of the property for the private owner. The classic examples are historic (Penn Central) and environment (Lucas) preservation. The U.S. Supreme Court has upheld these laws, but there are limits. If the laws prevent all beneficial uses of the land of a private owner, the government may be required to pay the owner just compensation. Of course, the government wants to avoid such payments to the private owners.

**CONTRACT LAW**

**Expectations Damages and Futures Markets: Shepherd (1918)**

In this old case, the U.S. Supreme Court defined the notion of expectation damages for breach of a contract. The goal of expectations damages is to make the non-breaching party equivalent to what they would have been if the other party had not breached and performed on the contract. Expectation damages is the key to the existence of executory contracts for future delivery and payment. For example, expectations damages is crucial for the existence of futures markets.

**Uniform Commercial Code**

The Uniform Commercial Code (UCC) is a state statute defining contracts that nearly all states have adopted. The UCC defines the modern approach to damages for breach of contract. If the seller breaches the contract by refusing to deliver the goods, the buyer should “cover” by purchasing substitute goods and sue for the difference in the cover price and the contract price. If the buyer breaches by refusing to take delivery and pay for the goods, the seller should “resell” the goods to another buyer and sue for the difference in the contract price and the resale price.

**Lost Profits - Manufacturers: Hinckley (IL, 1877) and Lieberman (NY, 1922)**

These two cases discuss the problem when a buyer breaches the contract by announcing that he/she will not take delivery prior to the manufacturer even building the goods. In that case, the non-breaching manufacturer would be relieved of any obligation to actually build the goods, and can sue for the lost profits that he/she would have made from selling the goods at the contract price. The old Hinckley case is one of the earliest cases to allow damages for lost profits on rails for railroads. The Lieberman case involved bodies for a new automobile that consumers did not find attractive.

**Lost Profits - Retailers: Neri (NY, 1972) and Jordan (2007)**

These two cases apply the lost profits damage remedy to retailers. The Neri case involved a boat retailer. The Jordan case is an amusing and interesting application of that principle to the breach of a promotion contract by Worldcom with Michael Jordan, the famous basketball player for the Chicago Bulls.

**Contract Formation and Mergers: Texaco (1987)**
The Texaco case is the leading case in defining whether an announcement of an agreement in principle to execute a merger is a contract or whether the contract only arises after the agreement is formalized into a writing. The answer is that the agreement in principle can be a contract if it includes all of the important terms of the agreement. This decision resulted in Texaco having to declare bankruptcy, and we discuss that case in the section of bankruptcy.

Requirements Contracts: Westinghouse Uranium Cases (1975)

Requirement contracts are long-term contracts which allow the buyer to determine each year how much he wants the seller to deliver. Requirements contracts typically have prices that are linked to inflation in some manner. We then discuss the famous breach by Westinghouse in the supply of uranium rods to the electric utility companies that purchased nuclear power plants from Westinghouse. This case resulted in the largest damage award in the history of contracts, nearly one billion dollars.

CORPORATIONS

Management Duties of Loyalty and Care

The duty of loyalty and care are the two duties of the board of directors and the managers of a corporation. The duty of loyalty requires the managers to avoid conflicts of interest and the duty of care requires the managers to make decisions based on obtaining good information. Both will be important for how the managers can respond to hostile takeover attempts on their corporation.


Corporations which are publicly traded have an obligation to make public statements about material events that affect the prospects of the corporation. For example, they have obligations to make statements when they issue new stock, issue bonds, or agree to mergers. Corporation would violate various provisions of the securities laws if their public statements were false or misleading. The Basic case discusses the criteria for a material event. The Trump case is an example of whether the statements made in a prospectus to issue bonds for building a casino in Atlantic City were false or misleading. This case is a nice illustration of statements about the future success of an investment which is always uncertain.


In this section, we briefly discuss liability for insider trading under Rule 10b-5. Insider trading occurs when a person trades shares of a corporation on the basis of non-public material information that he has obtain by a breach of some fiduciary duty to that corporation or its advisors. This is important topic for anyone to know if they might be investing.

TAKEOVER BATTLES AND DEFENSES

Tender Offers: Williams Act (1968)

This section introduces tender offers in which hostile acquiring corporations can purchase the shares of another target corporation directly from the shareholders. Tender offers must offer the same price to all shareholders and specify a minimum number of shares to be purchase, usually 50% or more of the outstanding shares of the target corporation. Tender offers were permitted by amendments to the Securities laws in 1968 and initiated the period of hostile takeovers and takeover defenses soon after.

Proxy contests arise when there are competing issues before the shareholders. In the Hewlett-Packard case, there was a proxy contest over the shareholder vote for HP to acquire Compaq. This case is a nice illustration about how the management would seek support for the proposed merger by contacting investment funds holding HP shares on behalf of investors.

**Freeze-Out Mergers: UOP (1983)**
A freeze-out merger is a merger in which a parent corporation owning 50% or more of an operating subsidiary creates a new shell subsidiary to merge and acquire the remaining minority shareholders of the operating subsidiary. As a result, the operating subsidiary becomes a wholly-owned subsidiary of the parent corporation. Freeze-out mergers are an important aspect of the early hostile takeover game in the 1980s.

**Unocal Duty: Unocal (1985)**
The Unocal duty is an additional fiduciary duty for the management of a target corporation to its shareholders. The Unocal duty was defined by the Delaware Supreme Court in this case in which a strange takeover defense by Unocal’s management blocked Mesa from making a a hostile tender offer to the Unocal shareholders. In particular, the management cannot maintain a takeover defense in response to any price that would be offered by the acquiring corporation.

**Poison Pills as the Primary Takeover Defense: Interco (1988)**
Poison pills were developed immediately after the Unocal case. A poison pill is an artificial share purchase option that would block a hostile tender offer irrespective of the price offered. Under the Unocal Duty, management must “redeem” a poison pill once the hostile acquiring corporation has made a tender offer at a price corresponding the value of the corporation. The Interco case illustrates the difficulty for courts in deciding at what tender offer price the management would have to redeem the poison pill in order to avoid violating their Unocal duty.

**Revlon Duty: Revlon (1986) and Fruehauf (1986)**
One of the typical takeover defenses is for the target corporation to find a “white knight” corporation to make a competing tender offer for the target corporation. A white knight is a corporation that would maintain the existing management of the target. The two cases illustrate this strategy. The Delaware Supreme Court used the Revlon case to define a new fiduciary duty for the management of a target corporation. The Revlon duty arises when it is clear that the target corporation will be acquired by some other corporation and broken-up by selling its subsidiary corporations. If so, the management of the target corporation must hold an auction among the acquiring corporations to obtain the highest price per share for its shareholders. This implies that the target management cannot favor one acquiring corporation over the other in the auction.

**Time-Warner Decision on Unocal and Revlon: Time-Warner (1990)**
The famous Time-Warner case arose from the strategic plans of media corporations to vertically integrate into the production of programming. Time initiated a friendly merger with Warner, but before the merger could be approved by the Time shareholders, Paramount initiated a hostile tender offer to acquire Time. This case addresses both the Unocal and Revlon duties of the Time management. Although the Delaware Supreme Court held that neither duty was violated, its decision created new confusion in the legal rules for hostile takeovers. This confusion lead to the ITT case.
Tender Offer and Proxy Contest: ITT (1997) and Quickturn (1998)

The ITT case redefined the hostile takeover game and it remains roughly the same since then. The hostile acquiring corporation initiates a contingent tender offer to the shareholders of the target corporation, contingent on redemption of the poison pill. The new feature is that the hostile acquiring corporation mounts a proxy contest to elect a new board of directors at the next shareholder meeting. If elected, the new board would redeem the poison pill and let the tender offer be made. In these two cases, the courts prevent the management of the target corporation from interfering with the proxy contest or the ability of the new board to redeem the poison pill.

PRODUCT LIABILITY IN TORT

Duty of Reasonable Care (Negligence) MacPherson (NY, 1912)

The development of manufacturer liability for consumer injury from the use of its products begins with this famous MacPherson case against Buick decided by the New York Court of Appeals. This case involves a broken wheel spoke that caused an accident. The court used this case to define a general duty for any manufacturer to take reasonable care in manufacturing its products to avoid harm to the users of the product. Negligence occurs when the duty is breached and the users can obtain damages for their injuries. This is a duty in tort law because the users harmed need not have had a contractual relationship with the manufacturer.

Strict Product Liability: Escola (CA, 1944)) and Greenman (CA, 1963)

Strict liability occurs when the manufacturer is liable for the injuries of the user as long as the product was being used as it was intended. The Greenman case applies strict liability for manufacturing defects. This is a major expansion of liability for manufacturers. The economic argument, best stated in the Escola case, is that manufacturers are poorly suited to inspect products for manufacturing defects because many durable goods have become complicated (automobiles) and smaller durable goods are prepackaged.

Negligent Design – Automobiles: Larsen (MI, 1968) and Young (MD, 1974)

The next evolution of product liability law involves the standard of care for the design of products. This development is best illustrated in the design of automobiles, a very controversial issue in the 1960s. The two cases of Larsen (GM Corvair) and Young (Volkswagen Beetle) illustrate design defects in cars that did not cause the accident but increased the injuries of the driver. The automobile industry fought the extension of tort liability for such defects, but these cases were the first to extend the duty of reasonable care (negligence standard) to these type of design defects. The legal argument is that manufacturers can reasonably expect that their cars will be involved in accidents that might injure the driver and passengers.

Duty to Warn: MacDonald (1985) and Vassallo (1998)

The most recent development in product liability is the extension of liability for the failure of the manufacturer to adequately warn about the known or knowable dangers of its products. This duty imposes an obligation on a manufacturer to continually monitor and research the potential dangers of its products, and to then adequately warn its customers. The MacDonald case involved birth control pills and the Vassallo case involved silicon breast implants. This duty is particularly important for medical products that have important benefits but unavoidable side effects. These cases have resulted in class action lawsuits and large damage awards that have forced the manufacturers into bankruptcy. These bankruptcies have created unexpected challenges for bankruptcy judges as discussed in the next section.
Punitive Damages : Exxon (2008)

This last topic explains the debate about punitive damages. In tort cases, the plaintiffs will be awarded compensatory damages for their injuries, but the courts can also award additional punitive damages to punish the breach of duty by the manufacturer and deter future breaches by any manufacturer of any product. These punitive damages provide the source of funds to compensate the lawyers representing the class of plaintiffs. Some economists have argued that the large punitive damage awards have increased the cost of insurance and thus the price of products, and driven some manufacturers into bankruptcy. Others have argued that punitive damages are necessary to create an incentive to investigate and litigate these cases. In the Exxon case about the famous oil spill of the Exxon Valdez, the U.S. Supreme Court provides a nice history of the research on punitive damages and decides the limit punitive damages in the cases of federal maritime law. The appeals lasted nearly twenty years, but resulted in a huge reduction in the punitive damage award against Exxon.

BANKRUPTCY

Reorganization: Greate Bay (2000), Trump (2010), and Texaco (1988)

We first discuss the mechanics of a reorganization from the Bankruptcy Code (1978). The management of the bankrupt corporation propose a plan for a financial and business reorganization, the creditors are then formed into classes and vote on the plan. If a creditor class votes against the plan, the bankruptcy judge can “cramdown” the plan against that class, and confirm the plan for the corporation to exit bankruptcy with a new lower debt service. The Greate Bay and Trump cases illustrate these mechanics in the context of casino bankruptcies in Atlantic City. The Texaco case illustrates the unusual situation in which the bankruptcy arose from one large legal judgment to Pennzoil from the prior case on a merger agreements. The remainder of the cases in this section present other unusual situations for the bankruptcy courts to resolve.

Mass Torts and Bankruptcy: Manville (1988) and Dow-Corning (1999)

The Manville case is the leading case on how to resolve a bankruptcy which arises from a large product liability damage award that exceeds the net value of the corporation. In the Manville case, the judge created a trust fund to compensate the workers and consumers harmed by the use of asbestos in its building products. Manville and its insurance companies were required to fund the trust and the injured parties must take their claims to the trust, not to the new Manville. Trusts became the model to resolve these mass tort bankruptcies and the procedures were also incorporated into the Bankruptcy Code.


Section 365 of the Bankruptcy Code allows the bankrupt corporation to reject leases and contracts that would be unprofitable when it exits bankruptcy. The K-Mart cases illustrates how this power can be used strategically to negotiate lower rents from landlords on the building leases that K-Mart wanted to continue (assume) after it exited bankruptcy. This power dramatically facilitates the business downsizing of the reorganized corporation.


The U.S. Supreme Court interpreted Section 365 to allow the bankrupt corporation to reject collective bargaining agreements with unions, and to lower the wages of workers. As a result, Congress amended the Bankruptcy Code (Section 1113) to impose restrictions on the ability of bankruptcy judges
to approve rejections of collective bargaining agreements. The restrictions impose obligations to negotiate on the wage reductions consistent with the National Labor Relations Act (1935). Despite the restrictions, this power has allowed many corporations to negotiate lower wages outside of bankruptcy by threatening unions that their failure to agree to lower wages will force the corporation into bankruptcy and result in rejection of the collective bargaining agreement. This power has been used by corporations in certain industries facing competition from foreign corporations, such as the steel industry.


After 9/11 in 2001, airline passenger traffic declined sharply forcing most of the airlines into bankruptcy despite a government bailout program. The airlines first negotiated large wage reductions with the unions for the pilots, machinists, and flight attendants. But in several cases, the airlines were still unable to propose a viable reorganization plan because of the large unfunded liabilities to support their pension plans, mostly the defined benefit plans with their unions. The federal law governing pensions, ERISA (1974), provides that a bankruptcy judge can terminate a pension plan if doing so is necessary for a successful reorganization of the corporation. In the cases of US Airways, the pension plans of the three unions were terminated. Once terminated, the funds already set aside to fund the pensions are transferred to a federal agency PBGC and the retirees will receive reduced pension payments from the PBGC. When US Airways exited bankruptcy, it created a new defined contribution for its existing and new employees. Thus, the burden of the reorganization fell primarily on the retired employees. This process has also occurred for corporations in other industries.

**General Motors – Section 363 Sale of Assets: General Motors (2009)**

The Great Recession starting in 2008 resulted in a dramatic reduction in the sales of durable goods, particularly automobiles. Despite a government bailout, GM was depleted of cash by the spring of 2009 and declared bankruptcy. There was no time for a traditional reorganization proceeding which would have taken years. Thus, the Treasury and bankruptcy court worked out an agreement to sell all of the assets to a new corporation called New GM with the Treasury owning a large share of the common stock in the New GM in return for a large infusion of cash. The original GM was now stripped of its valuable assets but retained all of its prior debts. The cash payment for the assets was well below the balance due on all of the debts and other liabilities. This intervention by the Treasury was very controversial at the time. The case also illustrates other aspects of the reorganization plans.