

# **Corporate Finance and Governance**

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**Cases, Materials, and Problems for an  
Advanced Course in Corporations**

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**THIRD EDITION**

**Lawrence E. Mitchell**

JOHN THEODORE FEY RESEARCH PROFESSOR OF LAW  
GEORGE WASHINGTON UNIVERSITY

**Lawrence A. Cunningham**

PROFESSOR OF LAW AND BUSINESS  
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**Jeffrey J. Haas**

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*For Alex*  
L.E.M.

*To the memory of my father*  
L.A.C.

*For Peter (happy 3rd birthday!)*  
J.J.H.

# Contents

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Table of Cases	xix
Preface to the Third Edition	xxv
Acknowledgments	xxix
Introduction and Problem—The Enormous Room	3
Problem	4
Chapter 1 The Corporate Form: Theories and Consequences	7
Section 1. The Ownership Model	8
Trustees of Dartmouth College v. Woodward	8
Questions	10
Dodd, <i>For Whom Are Corporate Managers Trustees?</i>	11
Questions	15
Note on Unocal Corp. v. Mesa Petroleum Co., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. and Paramount Communications, Inc. v. Time Incorporated	15
Question	17
American Law Institute, <i>Principles of Corporate Governance:             Analysis and Recommendations</i>	17
Question	17
Section 2. Economic Theories: The Agency/Contract Model	17
Fama, <i>Agency Problems and the Theory of the Firm</i>	19
Questions	23
Easterbrook & Fischel, <i>The Corporate Contract</i>	24
Question	26
O'Melinn, <i>Neither Contract Nor Concession: The Public Personality             of the Corporation</i>	26
Williamson, <i>Corporate Governance</i>	27
Question	29
Section 3. The Neo-Traditional Response	29
Clark, <i>Agency Costs versus Fiduciary Duties</i>	29
Questions	33
Problems	33
Section 4. Corporate Form and Corporate Governance: The Current Debate	33
Bebchuk, <i>The Debate on Contractual Freedom in Corporate Law</i>	33
Note	35
Dallas, <i>Two Models of Corporate Governance: Beyond Berle and Means</i>	35
O'Melinn, <i>Neither Contract Nor Concession: The Public Personality             of the Corporation</i>	37

Section 5. Close Corporations: A Different Result?	40
Donahue v. Rodd Electrotype Co. of New England	40
Mitchell, <i>Close Corporations Reconsidered</i>	43
Questions	44
<b>Chapter 2 Limited Liability—A Central Problem in Corporate Finance</b>	45
Section 1. The Basic Conflict between Creditors and Stockholders	45
Manning and Hanks, <i>A Concise Textbook on Legal Capital</i>	45
Note	50
Problem—The Term Sheet	51
Section 2. The Origins and Purposes of Limited Liability	51
Mitchell, <i>Close Corporations Reconsidered</i>	51
Halpern, Trebilcock & Turnbull, <i>An Economic Analysis of Limited Liability in Corporate Law</i>	55
Easterbrook & Fischel, <i>Limited Liability and the Corporation</i>	58
Stone, <i>The Place of Enterprise Liability in the Control of Corporate Conduct</i>	60
Problem—The Policy of Limited Liability	62
Section 3. Legal Limitations—Limited Liability and Corporate Structure	63
a. Veil Piercing under Corporate Law	64
(i) Traditional Veil Piercing	64
Problem—Structuring the Corporation	64
Favour Mind Ltd. v. Pacific Shores, Inc.	64
Notes and Questions	69
(ii) Reverse Veil Piercing	73
Notes and Questions	75
b. Lender’s Liability for Corporate Debts	76
Problem—Lender’s Liability for Corporate Debts	76
Krivo Indus. Supply Co. v. Nat’l Distillers & Chem. Corp.	77
Notes and Questions	84
Section 4. Limited Liability and Environmental Claims	85
a. “Owner” and “Operator” under CERCLA	85
U.S. v. Bestfoods	85
Notes and Questions	88
b. Successor Liability under CERCLA	91
North Shore Gas Co. v. Salomon, Inc.	91
Notes and Questions	98
c. Lender Liability for Environmental Claims	98
Monarch Title, Inc. v. City of Florence	98
Notes and Questions	101
<b>Chapter 3 Valuation</b>	105
Section 1. Introduction to Valuation	106
a. The Idea of Capital	106
b. The Idea of Valuation	107
Notes and Questions	109
Section 2. Risk and Return	110
a. Introduction to Risk and Return	111
b. Return as a Function of Present Value	112

(i) Future Value	112
(ii) Present Value	115
(A) Present Value of a Lump Sum	115
(B) Present Value of an Annuity	117
(1) Ordinary Annuity	118
(2) Annuity Due	119
Problems	121
c. Risk as a Function of Probability	121
Section 3. Valuation Methods: Putting Risk and Return to Work	127
a. A Brief Introduction to Basic Accounting Principles	128
Problem—Smith Drugstores, Part I	131
b. Valuation Methods	132
(i) Balance Sheet Based Valuation	132
(A) Book Value	132
(B) Adjusted Book Value	136
(C) Net Asset Value	136
(ii) Income Statement Based Valuation	137
Problem—Smith Drugstores, Part II	141
(iii) Cash Flow Based Valuation	142
(A) Dividend Discount Model	142
(B) Discounted Cash Flow Method	149
c. Capital Budgeting	150
Questions	151
Section 4. Fundamental Valuation in Legal Context	151
a. Valuation in Appraisal Proceedings	152
(i) Valuation Methodology	152
(A) Historical Context	152
Notes and Questions	159
(B) Modern Application	163
Le Beau v. M.G. Bancorporation, Inc.	163
Notes and Questions	171
(ii) Minority and Marketability Discounts	175
Problem—Smith Drugstores, Part III	175
Cavalier Oil Corp. v. Harnett	175
Question	178
Pueblo Bancorporation v. Lindoe, Inc.	178
Notes and Questions	184
(iii) Synergies and Other Benefits of the Merger	187
Cede & Co. v. Technicolor, Inc.	187
Notes and Questions	192
(iv) Exclusivity of Appraisal Rights	194
Cede and Co. v. Technicolor, Inc.	194
Notes and Questions	200
Problem—Providing Appraisal Rights	202
b. Valuation by Agreement	202
Problem—Smith Drugstores, Part IV	203
Allen v. Biltmore Tissue Corp.	203
Note	206
Helms v. Duckworth	207

Notes	210
c. Valuation in Other Legal Contexts	212
Donahue v. Draper	212
Questions	216
Nardini v. Nardini	217
Notes and Questions	220
Section 5. Market-Based Valuation	221
a. Portfolio Theory	222
Problem—Portfolio Theory and Corporate Governance	222
(i) Appetites for Risk	223
(ii) Risk Reduction by Diversification	224
(iii) The Efficient Frontier	226
(iv) Lending and Borrowing	227
(v) Practical Consequences	228
b. Capital Asset Pricing Model	229
Problem—Smith Drugstores, Part V	230
(i) Derivation and Meaning of CAPM	231
(ii) Applications	233
(iii) Assumptions Underlying CAPM	235
(iv) Empirical Testing of CAPM	237
(v) CAPM in Court	239
Cede & Co. v. Technicolor, Inc.	239
Notes and Questions	241
c. Efficient Capital Market Hypothesis	242
(i) “Fraud-on-the-Market” Theory	242
Basic, Inc. v. Levinson	242
Questions	251
Kaufman v. i-Stat Corp.	251
(ii) The Roots and Meaning of the ECMH	258
(iii) Empirical State of Play	262
(iv) Noise Theory	264
Questions	265
d. Behavioral Finance	265
Cunningham, <i>Behavioral Finance and Investor Governance</i>	265
Notes and Questions	271
Note: Post-Modern Finance Theory	274
<b>Chapter 4 Managing Risk (Hedging) with Derivatives</b>	<b>277</b>
Section 1. Types of Derivative Instruments	278
a. Options	278
(i) Overview	278
(ii) Options Used for Hedging: An Example	281
(iii) Options Used for Speculation: An Example	282
(iv) Option Pricing Theory	282
Notes and Questions	284
b. Forwards	285
(i) Overview	285
(ii) Forward Price	285
(iii) Counterparty Credit Risk	286

c. Futures	286
d. Swaps	288
Section 2. The Spectrum from Hedging to Speculation	290
Notes and Questions	291
Long Term Capital Management	291
Cunningham, <i>Outsmarting the Smart Money</i>	291
Section 3. Judicial Analysis of Derivatives	294
a. Contractual Interpretation	294
Eternity Global Master Fund Ltd. v. Morgan Guaranty Trust Co.	294
Note	299
b. Derivatives and Fiduciary Duties	299
Brane v. Roth	299
Notes and Questions	301
c. Derivatives as “Securities”	302
In the Matter of BT Securities Corporation	302
Notes and Questions	308
Jurisdictional Turf Wars	309
Procter & Gamble Co. v. Bankers Trust Co.	311
Caiola v. Citibank, N.A.	320
d. Accounting for Derivatives	326
Enron, Derivatives and Accounting	327
Cunningham, <i>The Sarbanes-Oxley Yawn: Heavy Rhetoric,         Light Reform (And It Might Just Work)</i>	327
<b>Chapter 5 The Rights of Contract Claimants—Part 1:     Holders of Debt Securities</b>	329
Section 1. The Concept and Consequences of Leverage	330
Graham, Dodd & Cottle, <i>Security Analysis</i>	330
Klein & Coffee, <i>Business Organization and Finance</i>	334
Notes and Questions	337
Section 2. The Characteristics of Debt	338
a. Types and General Attributes	338
Klein and Coffee, <i>Business Organization and Finance</i>	338
Questions	341
b. The Changing Nature of Corporate Debt	341
(i) Generally	341
Klein and Coffee, <i>Business Organization and Finance</i>	341
(ii) The Rise (and Fall?) of High-Yield Debt Securities	342
Pitt and Groskaufmanis, <i>A Tale of Two Instruments:             Insider Trading in Non-Equity Securities</i>	342
Note	344
Comment, <i>Junk Bonds: Do They Have a Value?</i>	346
Booth, <i>Junk Bonds, the Relevance of Dividends             and the Limits of Managerial Discretion</i>	347
Notes and Questions	348
Section 3. Valuation of Debt Securities	351
Section 4. The Legal Treatment of Debtholders	352
a. Debtholders as Contract Claimants	353



Simons v. Cogan	353
Questions	357
Pitt and Groskaufmanis, <i>A Tale of Two Instruments:         Insider Trading in Non-Equity Securities</i>	358
Questions	361
b. Interpreting the Debt Contract	361
(i) Key Contractual Terms and Protective Provisions	361
A. The Promise to Pay and Provisions Designed to Support It	361
B. Ranking	362
C. Covenants	363
D. Redemption	365
E. Events of Default	366
Problem—Balancing the Rights of Debtholders and Stockholders in the Bond Indenture	367
(ii) Judicial Interpretation of the Debt Contract	369
Sharon Steel Corp. v. Chase Manhattan Bank, N.A. Note and Questions	369
Rudbart v. North Jersey District Water Supply Commission	377
Note on Zero Coupon Debt Securities	378
Morgan Stanley & Co., Inc. v. Archer Daniels Midland Co.	388
Notes and Questions	389
c. Implied Covenant of Good Faith and Fair Dealing	397
Katz v. Oak Industries Inc.	399
Notes and Questions	406
Problem—Coercing Bondholders	407
DeMott, <i>The Biggest Deal Ever</i>	407
Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.	408
Denouement	422
Notes and Questions	424
Problem—Negotiating and Drafting Event Risk Protection	436
d. The Right to Sue	437
(i) Derivative Suits	437
Hoff v. Sprayregan	437
Notes and Questions	440
Harff v. Kerkorian	440
Notes and Questions	443
<i>American Law Institute Principles of Corporate             Governance: Analysis and Recommendations</i>	446
Questions	448
(ii) Contractual Limitations	448
Problem—Standing to Sue	448
<i>American Bar Foundation Commentaries on             Model Debenture Indenture Provisions</i>	449
Simons v. Cogan	450
Problem—The Extra-Contractual Rights of Bondholders	451
Rabinowitz v. Kaiser-Frazer Corp.	452
Notes and Questions	457

Problem—Collective Action by Bondholders	458
Section 5. Other Participants in Debt Offerings	458
a. Underwriter	458
b. Indenture Trustee	459
(i) Trustee as Competing Creditor	464
Morris v. Cantor	464
Questions	467
(ii) Breach of Fiduciary Duty under State Law	468
Broad v. Rockwell International Corporation	468
(iii) Pre-Default Duties of a Trustee under the TIA	469
Elliott Assoc. v. J. Henry Schroder Bank & Tr. Co.	469
Note	474
(iv) Loyalty to Debtholders	475
Rabinowitz v. Kaiser-Frazer Corp.	475
U.S. Trust Co. of New York v. First Nat'l City Bank	475
Harriet & Henderson Yarns, Inc. v. Castle	478
Notes and Questions	483
Problem—The Duties of the Indenture Trustee	483
c. Rating Agencies	483
Questions	486
Section 6. The Bankruptcy Rights of Debtholders	486
a. Introduction	486
b. Operating in the “Vicinity of Insolvency”	486
Pepper v. Litton	486
Notes and Questions	490
c. The Options Available to a Financially Troubled Corporation	492
d. Why Allow a Failed Business to Reorganize?	499
Roe, <i>Bankruptcy and Debt: A New Model for Corporate Reorganization</i>	499
Baird and Jackson, <i>Corporate Reorganization and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy</i>	501
Roe, <i>Bankruptcy and Debt: A New Model for Corporate Reorganization</i>	502
Notes and Questions	503
e. Fundamental Bankruptcy Concepts	504
(i) Automatic Stay and Adequate Protection	504
Baird and Jackson, <i>Corporate Reorganization and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy</i>	504
(ii) Absolute Priority Rule and “Cram Down”	506
Consolidated Rock Products Co. v. Du Bois	506
Notes and Questions	513
Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting	516
Bank of America Nat’l Trust v. 203 N. LaSalle St. Partnership	521
Notes	528
In re Zenith Electronics Corp.	529
Baird and Jackson, <i>Bargaining after the Fall and the Contours of the Absolute Priority Rule</i>	535

11 U.S.C. §1129 (2005)	537
A Note on the Bankruptcy Abuse Prevention and Consumer Reform Act of 2005	539
(iii) Equitable Subordination	540
Problem—Reorganizing the Troubled Debtor	542
(iv) Fraudulent Conveyance	544
Uniform Fraudulent Transfer Act (1984)	
Selected Provisions	545
Section 7. Legislative Responses to the Plight of Debtholders	546
Problem—Bondholder Protective Legislation	546
Section 8. Advanced Debt Topics	550
a. Application of Fraudulent Conveyance Statutes to Leveraged Acquisitions	550
Problem—The LBO That Failed	550
Pay ‘N Pak Stores, Inc. v. Court Square Capital Ltd.	552
ProtoComm Corp. v. Novell, Inc.	554
Notes and Questions	558
b. Asset-Backed Securitization	567
Major’s Furniture Mart, Inc. v. Castle Credit Corp., Inc.	570
“Ziggy Stardust” Plays the Market	582
Questions	582
<b>Chapter 6 The Rights of Contract Claimants—Part 2: Preferred Stock</b>	585
Section 1. The Characteristics of Preferred Stock	586
Klein and Coffee, <i>Business Organization and Finance</i>	586
Notes and Questions	589
Problem—Drafting and Negotiating the Preferred Stock Contract	589
Optional Problem—Valuing Preferred Stock	590
Section 2. Dividends and Voting	591
Gutmann v. Illinois Central R. Co.	591
Notes and Questions	594
Baron v. Allied Artists Pictures Corporation	596
Notes and Questions	601
Section 3. Repurchases, Redemptions, Conversions and Liquidations	602
Problem—Recapitalizing a Distressed Corporation	602
The <i>De Facto</i> Merger Doctrine	602
In re Sunstates Corp. Shareholders’ Litigation	603
Note	606
Rauch v. RCA Corp.	606
Notes and Questions	609
Elliot Associates, L.P. v. Avatex	613
Notes and Questions	619
Section 4. The Extra-Contractual Rights of Preferred Stockholders	619
Problem—Structuring a Merger	619
Dalton v. American Investment Co.	620
Questions	631
Jedwab v. MGM Grand Hotels, Inc.	632
Questions	644
In re FLS Holdings Inc. Shareholders Litigation	644

Questions	649
Mitchell, <i>The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)</i>	651
<b>Chapter 7 The Rights of Contract Claimants—Part 3: Convertible Securities</b>	661
Section 1. Economics of Convertible Securities	661
Section 2. Justifications for Convertible Securities	667
Klein, <i>The Convertible Bond: A Peculiar Package</i>	668
Questions	670
Problem—Financing with Convertible Bonds	670
Section 3. Obligation of the Corporation to Protect Conversion Rights	671
a. Fiduciary Duties	671
Simons v. Cogan	672
b. Contractual Rights	672
(i) Notice of Redemption	672
Van Gemert v. Boeing Co.	672
Notes and Questions	678
(ii) Antidilution	684
(A) Stock Splits and Reverse Stock Splits	684
Reiss v. Financial Performance Corp.	686
Notes and Questions	688
(B) “Cheap” Stock	692
(C) Distribution of Assets and Evidences of Indebtedness	693
HB Korenvaes Investments, L.P. v. Marriott Corp.	694
Note	711
(iii) Antidestruction	712
Wood v. Coastal States Gas Corp.	712
Notes and Questions	720
Problem—Interpreting the Convertible Debenture Contract	723
(iv) Contractual Example	724
<i>Revised Model Simplified Indenture</i>	724
<b>Chapter 8 The Rights of Ownership Claimants—Part 1: General Concepts</b>	737
Section 1. The Nature of Fiduciary Duty	738
Easterbrook & Fischel, <i>Corporate Control Transactions</i>	738
Mitchell, <i>The Death of Fiduciary Duty in Close Corporations</i>	740
Questions	741
Section 2. The Declaration and Payment of Dividends	741
a. Legal Capital Rules	742
Problem—Legal Restrictions on Dividends	744
1 <i>Revised Model Business Corporation Act Annotated</i>	745
Note	749
b. A Board’s Ability to Declare a Dividend	749
Gabelli & Co. v. Liggett Group, Inc.	749
Questions	753
Baron v. Allied Artists Pictures Corp.	755
Section 3. Dividend Policy	755
Problem—Walton Sporting Goods	756
a. Theories of Dividend Policy	757

Notes and Questions	761
b. Practical Issues in Dividend Policy	763
Notes and Questions	766
c. Dividends of Property and Securities	768
Anadarko Petroleum Co. v. Panhandle Eastern Corporation	770
Notes and Questions	775
Isquith v. Caremark International, Inc.	776
Note on Tracking Stock: The “Internal Spin-Off”	780
Section 4. Redemptions and Repurchases	781
a. Statutory Treatment	782
b. Purpose	782
c. Federal Regulation	783
(i) Open Market Repurchases	784
(ii) Self-Tender Offers	784
(A) Issuer Tender Offers	784
(B) “Going Private” Transactions	785
d. Fiduciary Duties	785
Kahn v. U.S. Sugar Corp.	785
Grobow v. Perot	790
Note and Questions	795
Lowenstein, <i>Management Buyouts</i>	796
Section 5. Preemptive Rights and Dilution	798
Introductory Note and Problem	798
Katzowitz v. Sidler	800
Note and Question	804
Frantz Mfg. Co. v. EAC Industries	805
Notes and Questions	810
Ziegler v. American Maize-Products Co.	811
Section 6. Recapitalizations and Restructurings	813
Problem—Restructuring and the Minority Stockholder	813
Jones v. H. F. Ahmanson & Co.	814
Questions	820
Leader v. Hycor, Inc.	821
Notes and Questions	824
Note: The One Share, One Vote Debate	826
Section 7. Fiduciary Duty and Corporate Democracy	828
Blasius Industries, Inc. v. Atlas Corporation	829
Notes and Questions	836
<b>Chapter 9 The Rights of Ownership Claimants—Part 2:</b>	
<b>Mergers and Acquisitions</b>	839
Section 1. The Duty of Care and the Business Judgment Rule	839
a. A Board’s Decision to Sell the Company	839
Cede & Co. v. Technicolor, Inc.	842
Cinerama, Inc. v. Technicolor, Inc.	845
Notes and Questions	854
b. A Board’s Decision to Purchase a Company	854
Ash v. McCall	854
Note	861

Hewlett v. Hewlett-Packard Co.	861
Notes and Questions	868
Section 2. The Duty of Loyalty	868
a. A Board's Decision to Sell the Company	868
Paramount Communications Inc. v. QVC Network Inc.	871
Notes and Questions	884
b. A Board's Ability to Adopt Defensive Strategies	885
(i) General Standard	886
Problem—Repelling the Hostile Tender Offer	886
Unocal Corp. v. Mesa Petroleum Co.	889
Notes and Questions	896
Problem—Defensive Repurchases	902
Paramount Communications, Inc. v. Time, Inc.	903
Notes and Questions	918
(ii) Poison Pills	920
City Capital Assocs. v. Interco Inc.	920
Notes and Questions	930
Carmody v. Toll Brothers, Inc.	931
Quickturn Design Systems, Inc. v. Shapiro	935
Note	936
(iii) Greenmail	936
Heckmann v. Ahmanson	936
Macey and McChesney, <i>A Theoretical Analysis</i> <i>of Corporate Greenmail</i>	939
Notes and Questions	942
Problem—Legislating Against Greenmail	944
(iv) Deal Protection Measures	944
ACE Limited v. Capital Re Corp.	945
Omnicare, Inc. v. NCS Healthcare, Inc.	949
c. Transactions with Controlling Stockholders	958
Problem—Freezing-Out the Dissenting Stockholder	958
Problem—Freeze-Out by Dissolution	959
Weinberger v. UOP, Inc.	960
Notes and Questions	968
In re Siliconix Inc. Shareholders Litigation	971
Notes and Questions	979
Section 3. Antitakeover Legislation	982
Problem—Enforcing Constituency Legislation	986
Section 4. <i>De Facto</i> Merger Doctrine (Redux)	987
Hariton v. Arco Electronics, Inc.	987
Rath v. Rath Packing Company	988
Notes and Questions	994
Epilogue and Concluding Problem—Reconceptualizing the Corporation	998
Index	1001

# Table of Cases

---

## -No.-

1236 Dev. Corp., In re, 492

## -A-

**Ace Limited v. Capital Re Corp.**, 945

Albright v. Bagandahl, 969

**Allen v. Biltmore Tissue Corp.**, 203, 211

Alpert v. 28 William St. Corp., 201, 969

Alyucan Interstate Corp., In re, 504

Amanda Acquisition Corp. v. Universal Foods Corp., 985

Amer. Fuel Corp. v. Utah Energy Development Co., Inc., 66

Ames Dep't Stores, Inc., In re, 492

**Anadarko Petroleum Corp. v. Panhandle Eastern Corp.**, 356, 672, 720, 770, 775-76, 825

Armstrong v. Marathon Oil Co., 971

Arnold v. Browne, 70

Arnold v. Phillips, 70

Arnold v. Society for Savings Bancorp, Inc., 842, 846, 920

Aronson v. Lewis, 455, 640, 790, 792, 840, 878, 892, 895-96

**Ash v. McCall**, 842, 854

Aspen Advisors LLC v. United Artists Theater Co., 722

Auerbach v. Bennett, 455

## -B-

Balsamides v. Protameen Chem., Inc., 187

Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R., 443

**Bank of America Nat'l Trust v. 203 N. LaSalle St. Partnership**, 521

Barkan v. Amsted Indus., Inc., 645, 850, 852, 877-78, 882

**Baron v. Allied Artists Pictures Corp.**, 596, 751, 755

Baron v. Strawbridge & Clothier, 983

**Basic, Inc. v. Levinson**, 196, 242, 251, 780

Beerly v. Dep't of Treasury, 159

Bennett v. Propp, 893

Beverages Int'l, Ltd., In re, 84

Blake v. Blake Agency, Inc., 185

**Blasius Industries, Inc. v. Atlas Corp.**, 829, 836, 838, 914, 934-35

BNS, Inc. v. Koppers Corp., 985

Borruso v. Communications Telesystems Intl., 187

Boss v. Boss, 42

Bove v. Community Hotel Corp., 610, 654

Bowman v. Armour & Co., 612

**Brane v. Roth**, 299, 309

**Broad v. Rockwell Int'l Corp.**, 427, 468, 683

Brooks v. Weiser, 440

Brown v. Allied Corrugated Box Co., 184, 186

Browning-Ferris Indus. v. Ter Maat, 89

BT Securities Corp., In the Matter of, (CFTC proceeding), 309

**BT Securities Corp., In the Matter of, (SEC proceeding)**, 302

Burden v. U.S., 84

## -C-

**Caiola v. Citibank, N.A.**, 311, 316, 320

Caleb & Co. v. E.I. DuPont de Nemours & Co., 754, 825

Capozzoli v. Stone & Webster Engineering Corp., 574

**Carmody v. Toll Brothers, Inc.**, 931, 935

Cascade Energy and Metals Corp. v. Banks, 71, 74-75

- Case v. Los Angeles Lumber Products Co., Ltd., 508-09, 511-13, 519, 523
- Cavalier Oil Corp. v. Harnett, 175, 182, 191
- Cede & Co. v. Technicolor, Inc., (Del. Ch. 1990), 150, 239
- Cede & Co. v. Technicolor, Inc., (Del. 1993 (Cede II)), 842, 845-47, 849, 851-54
- Cede and Co. v. Technicolor, Inc., (Del. 1998 (Cede I)), 194, 200
- Cheff v. Mathes, 833-34, 893, 895-96, 943
- Cinerama, Inc. v. Technicolor, Inc., Del. 1995 (Cede III)), 845
- City Capital Assocs. v. Interco Inc., (D. Del. 1988), 923
- City Capital Assocs. v. Interco Inc., (Del. Ch. 1988), 871, 916, 919, 920
- Clark v. Pattern Analysis and Recognition Corp., 826
- Clarkeies Mkt. L.L.C., In re, 492
- Cofman v. Acton Corp., 687-90
- Coggins v. New England Patriots Football Club, Inc., 200, 969
- Condec Corp. v. Lunkenheimer Co., 810
- Consolidated Film Industries, Inc. v. Johnson, 611-12
- Consolidated Rock Products v. Du Bois, 506
- Cooperman v. California Unemployment Ins. Appeals Bd., 75
- Corcoran v. Frank B. Hall and Co., Inc., 492
- Credit Lyonnais Bank Nederland, N.V. v. MGM Pathe Communications Co., 490
- Credit Managers Assoc. of So. Cal. v. The Federal Co., 558
- Crum v. Krol, 73, 75
- C-T of Virginia, Inc. v. Barrett, 796
- C-T of Virginia, Inc. f/k/a Craddock-Terry Shoe Corp. v. Partnership, 560
- CTS Corp. v. Dynamics Corp. of Amer., 985
- D-**
- Dabney v. Chase National Bank, 468, 473-74, 477
- Dalton v. Amer. Investment Co., 620, 632, 651
- Danielewicz v. Arnold, 177
- Davison v. Park, Austin & Lipscomb, Inc., 611
- Deutsch v. Blue Chip Stamps, 969
- Donahue v. Draper, 136, 141, 212
- Donahue v. Rodd Electrotype Co. of New England, 40, 783, 823-24
- Dorfman v. Chemical Bank, 440
- Dorothy v. Commonwealth Commercial Co., 577
- Dowling v. Narragansett Capital Corp., 201
- Dukas v. Davis Aircraft Products Co., 378
- E-**
- Edgar v. MITE Corp., 985
- Edick v. Contran Corp., 826
- Eisenberg v. Chicago Milwaukee Corp., 975
- Eisenberg v. Flying Tiger Line, Inc., 177
- Elliot Associates, L.P. v. Avatex, 613
- Elliott Assoc. v. J. Henry Schroder Bank & Tr. Co., 469, 480
- Emerald Partners v. Berlin, 842
- Equity Linked Investors, L.P. v. Adams, 631
- ER Holdings, Inc. v. Norton Co., 838
- Eshleman v. Keenan, 600, 751-52
- Estate of Newcomer v. U.S., 221
- Estate of Newhouse v. Commissioner, 221
- Eternity Global Master Fund Ltd. v. Morgan Guaranty Trust Co., 289, 294
- Evangelista v. Holland, 206
- Evergreen Valley Resort, Inc., In re, 577
- F-**
- Favour Mind Ltd. v. Pacific Shores, Inc., 63, 64, 71
- Federal United Corp. v. Havender, 608, 611, 988
- FGC Holdings Ltd. v. Teltronics Inc., 601
- Fletcher v. Atex, Inc., 73
- FLS Holdings, Inc., Shareholder Litigation, In re, 644
- Foltz v. U.S. News & World Report, Inc., 221
- Francis v. United Jersey Bank, 301
- Franklin v. Compton (In re Bonhman), 577



- Frantz Mfg. Co. v. EAC Industries**, 805
- G-**
- Gabelli & Co. v. Liggett Group, Inc.**, 749, 753-54
- Gabhart v. Gabhart, 969
- Galler v. Galler, 40, 42
- Gardner & Florence Call Cowles Foundation v. Empire, Inc., 417-18, 427
- Garter v. Snyder, 67-68
- Genesco v. Scolaro, 159
- Geren v. Quantum Chemical Corp., 428, 436
- Geyer v. Ingersoll Publications Co., 491
- Giammalvo v. Sunshine Mining Co., 994
- Gibbons v. Schenley Industries, Inc., 187
- Giorgio, In re, 492
- Glassman v. Unocal Exploration Corp., 163, 980
- Glosser Bros., Inc., In re, 272
- Goldman v. Union Bank and Trust, 826
- Graham v. Allis-Chalmers Mfg., 309, 859
- Green v. Hamilton Int'l Corp., 356, 683
- Green v. Santa Fe Industries, Inc., 969
- Grobow v. Perot**, 455, 790, 795
- Gutmann v. Illinois Central R. Co.**, 591, 594
- H-**
- Harcourt Brace Jovanovich, Inc. v. Sun Bank National Ass'n, 734
- Harff v. Kerkorian**, 354-57, 440, 443, 486
- Hariton v. Arco Electronics, Inc.**, 987, 991, 993-94
- Harriet & Henderson Yarns, Inc. v. Castle**, 478, 483
- Harris v. Union Electric Co., 397, 399
- Hartford Fire Ins. Co. v. Federated Dept. Stores, Inc., 427
- Hawkeye Oil Co., In re, 652
- Hazzard v. Chase National Bank, 468, 472, 477
- HB Korenvaes Investments, L.P. v. Marriott Corp., (Del. Ch., June 9, 1993), 426, 649, 700
- HB Korenvaes Investments, L.P. v. Marriott Corp.**, (Del. Ch., July 1, 1993), 694, 721
- Heckmann v. Ahmanson**, 936
- Heine v. The Signal Companies, 943
- Helms v. Duckworth**, 207
- Hewlett v. Hewlett-Packard Co.**, (Del. Ch., Apr. 8, 2002), 861
- Hewlett v. Hewlett-Packard Co., (Del. Ch., Apr. 30, 2002), 868
- Hoff v. Sprayregan**, 437, 440, 442, 444
- Hogan v. Mayor & Alderman of Savannah, 75
- Home Bond Co. v. McChesney, 577
- Hotchkiss v. National City Bank of New York, 425
- Hottenstein v. York Ice Machinery Corp., 611-12
- Howing Co. v. Nationwide Corp., 785
- Hyde Park Partners, L.P. v. Connolly, 985
- I-**
- In Matter of Munford, Inc., 796
- Isquith v. Caremark Int'l, Inc.**, 776
- J-**
- Jedwab v. MGM Grand Hotels, Inc.**, 330, 632, 648, 651-53, 658, 660
- John Hancock Mutual Life Ins. Co. v. Carolina Power & Light Co., 398
- Jones & Loughlin Steel Corp., In re, 201
- Jones v. H.F. Ahmanson & Co.**, 814, 938
- Joseph Kanner Hat Co., Inc., In re, 574
- Joslyn Mfg. Co. v. T.L. James & Co., 91
- Joy v. North, 22
- K-**
- Kahn v. Roberts, 795
- Kaiser Aluminum Corp. v. Matheson, 731
- Kansas City Terminal Ry. v. Central Union Trust Co., 512, 514-15, 519
- Katz v. Bregman, 375, 378
- Katz v. Oak Industries, Inc.**, 359-60, 399, 427, 493-94, 642
- Katzowitz v. Sidler**, 800
- Kauffman v. Dreyfus Fund, Inc., 444
- Kaufman v. i-Stat Corp.**, 251
- KDI Holdings, Inc., In re, 444
- Keller v. Wilson & Co., 611
- Kelley v. EPA, 102
- Kelter Tr. v. Amer. Bankers' Finance Co., 573-75
- Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting**, 516, 526

- Khan v. U.S. Sugar Co.**, 173, 703, 785  
 Kiehl v. Action Manufacturing Co., 75  
 Kingston Square Assocs., In re, 569  
 Kirke La Shelle Co. v. Paul Armstrong Co., 682-83  
 Kirno Hill Corp. v. Holt, 67  
 Klang v. Smith's Food & Drug Centers, Inc., 743-782  
 Klurfeld v. Equity Enterprises, Inc., 769  
 Knapp v. Amer. Gen. Fin., Inc., 84  
 Knox Kreations, In re, 558  
 Krause, In re, 440  
**Krivo Indus. Supply Co. v. Nat'l Distillers & Chem. Corp.**, 77  
 Kusner v. First Pennsylvania Corp., 443-44, 446
- L-  
 Landreth Timber Co. v. Landreth, 352  
 Lawson Mardon Wheaton Inc. v. Smith, 187  
**Leader v. Hycor, Inc.**, 158, 686, 821  
**Le Beau v. M.G. Bancorporation, Inc.**, 150, 163, 172  
 Leeds and Lippincott Co. v. Nevius, 594  
 Lerner v. Lerner, 826  
 Levy v. Bessemer Trust Co., 301  
 Lohnes v. Level 3 Comm., Inc., 721  
 Lorenz v. CSX Corp., 474, 684  
 LTV Securities Litigation, In re, 245-46, 250  
 Lynch v. Vickers Energy Corp., 965
- M-  
**Major's Furniture Mart, Inc. v. Castle Credit Corp.**, 570, 576  
 Mann-Paller Foundation v. Econometric Research, Inc., 754  
 Marks v. Akers, 455  
 Marquis Theatre Corp. v. Condedo Mini Cinema, 492  
 McMahan & Co. v. Warehouse Entertainment, Inc., 434  
 McMullin v. Beran, 976-77  
 Meckel v. Continental Resources Co., 387, 472, 679  
 Meinhard v. Salmon, 421  
 Metlyn Realty Corp. v. Esmark, Inc., 192  
**Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.**, 359-60, 408, 428-29, 436, 655
- Metropolitan Securities v. Occidental Petroleum Corp., 457  
 M.G. Bancorporation v. Le Beau, 192  
 Mills Acquisition Co. v. MacMillan, Inc., 869, 877, 897, 901, 910, 912  
 Minton v. Cavaney, 69  
 Mirkin v. Wasserman, 251  
 Mobile Steel Co., In re, 84  
**Monarch Title, Inc. v. City of Florence**, 98, 101  
 Moody v. Security Pacific Business Credit Inc., 557, 560  
 Moran v. Household Int'l, Inc., 809, 915, 921, 931  
**Morgan Stanley & Co., Inc. v. Archer Daniels Midland Co.**, 388, 389, 399  
**Morris v. Cantor**, 464  
 M.P.M. Enterprises v. Gilbert, 172  
 Mullen v. Academy Life Ins. Co., 201  
 Munford, Inc., Matter of, 796  
 Mutual Savings Life Ins. Co. v. James River Corp., 397
- N-  
**Nardini v. Nardini**, 217  
 Nehorayoff v. Nehorayoff, 220  
 Newcomer, Estate of, v. U.S., 221  
 Nilsson, Robbins v. Louisiana Hydrolec, 70  
 Nixon v. Blackwell, 853-54, 876, 897  
 Nixon Mach. Co., In re, 577  
 Norlin Corp. v. Rooney Pace Inc., 811  
 Norman v. Murray First Thrift & Loan Co., 75  
**North Shore Gas Co. v. Salomon Inc.**, 91  
 Northern Pacific Ry. Co. v. Boyd, 509, 511, 514-15, 519, 536  
 Nunn v. Chem. Waste Mgt., Inc., 76
- O-  
 O'Day Corp., In re, 559-60  
**Omnicare, Inc. v. NCS Healthcare, Inc.**, 949  
 Overseas Private Inv. Corp. v. Industria de Pesco, 84
- P-  
 Pace Photographers, Ltd., In the Matter of, 203, 210, 216

- Paramount Comm. Inc. v. QVC Network Inc.**, 849-50, 852, 871, 884-85, 897, 920
- Paramount Comm., Inc. v. Time Inc.**, 15, 16, 658, 849, 872, 903, 920
- Pay ‘N Pak Stores, Inc. v. Court Square Capital Ltd.**, 552
- Peil v. Speiser, 244, 249
- People v. Service Inst., 577
- Pepper v. Litton**, 486, 490-92, 509, 540
- Petroleum Rights Corp. v. Midland Royalty Corp., 598-600
- Philadelphia National Bank v. B.S.F. Co., 375, 378
- Piemonte v. New Boston Garden Corp., 152, 158-59
- Pittsburgh Terminal Corp. v. Baltimore and Ohio Railroad Co., 679, 735
- Prescott, Ball & Turban v. LTV Corp., 399
- Pritchard v. Mead, 201
- Process-Manz Press Inc., In re, 84
- Proctor & Gamble Co. v. Bankers Trust Co.**, 310, 311, 324
- ProtoComm Corp. v. Novell, Inc.**, 554
- Pruitt v. Rockefeller Center Properties, Inc., 769
- Pueblo Bancorporation v. Lindoe, Inc.**, 178
- Pure Resources, Inc. Shareholders Litigation, In re, 979-80
- Q-**
- Quickturn Design Systems v. Shapiro**, 935
- R-**
- Rabinowitz v. Kaiser-Frazer Corp.**, 952, 975, 483
- Rabkin v. Philip A. Hunt Chemical Corp., 176, 196-67, 846, 968
- Rapid Amer. Corp. v. Harris, 168, 170
- Rath v. Rath Packing Co.**, 813, 988, 995
- Rauch v. RCA Corp.**, 606, 610, 654
- Reiss v. Financial Performance Corp.**, 686, 688
- Revco D.S., Inc., In re, 558, 566
- Reves v. Ernst & Young, 313
- Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 15-16, 485, 651, 843, 868-71, 877-84, 910-13, 917-18, 920, 922, 925-26, 928, 948, 954
- Ricketts v. Pennsylvania R.R. Co., 426
- Robinette v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 177
- Rockwell Developments, LTD v. Newtonbrook Plaza LTD., 57
- Roland Int’l Corp. v. Najjar, 961, 968
- Rothschild Int’l Corp. v. Liggett Group, Inc., 606, 608-09, 638-39, 705
- Roxbury State Bank v. The Clarendon, 558, 565
- RTE Corp. v. Mark IV Indus., 985
- Rudbart v. North Jersey District Water Supply Comm.**, 378
- S-**
- Samuel M. Feinberg Testamentary Trust v. Carter, 943
- Sanders v. Cuba Railroad Co., 594
- Sarrouf v. New England Patriots Football Club, 159
- S.E.C. v. Worldcom, Inc., 528
- Selly v. Flemming Coal Co., 754
- Sharon Steel Corp. v. The Chase Manhattan Bank, N.A.**, 369, 377-89, 394, 396, 399, 609
- Shenandoah Life Ins. Co. v. Valero Energy Corp., 397, 701
- Shidler v. All Amer. Life & Financial Corp., 944, 998
- Sieg Co. v. Kelly, 187
- Siliconix Inc. Shareholder Litigation, In re**, 921, 979
- Simon v. Electrospace Corp., 679
- Simons v. Cogan**, 353, 358, 421, 443, 450, 480, 486, 491-92, 671, 672
- Sinclair Oil v. Levien, 640, 751-52, 772, 889, 892
- Singer v. Magnavox, 789, 961, 968
- Slottow v. Fidelity Federal Bank, 70
- Smith v. Van Gorkom, 110, 301, 637, 789, 793, 795, 834, 839-44, 847, 851, 918
- Solomon v. Armstrong, 776, 897
- Spang Industries, Inc., In re, 136
- Stacey-Rand, Inc. v. J. J. Holman, Inc., 73
- Stahl v. Apple Bancorp, Inc., 837
- Starr v. State Mut. Inv., 440
- State Bank v. Euerle Farms, Inc., 75
- Stepak v. Schey, 201

- Stephenson v. Plastics Corp. of Amer., Inc., 711  
 Stroud v. Grace, 934  
**Sunstates Corp. Shareholders Litigation, In re**, 603
- T-**  
 Taines v. Gene Barry One Hour Photo Process, 186  
 Tanzer v. Int'l General Indus., 961, 968  
 Taylor v. Standard Gas & Electric Co., 84, 509, 540  
 Teschner v. Chicago Title and Trust Co., 823, 826  
 The Business Roundtable v. Securities and Exchange Commission, 827  
 The MONY Group Inc. Shareholder Litigation, In re, 896  
 Toner v. Biltmore Envelope Co., 783  
 Torco Oil Co. v. Innovative Thermal Corp., 72  
 Transvision, Inc., In re, 499  
 Truckweld Equip. Co. v. Olson, 70  
**Trustees of Dartmouth College v. Woodward**, 8, 26, 39
- U-**  
 Unitrin, Inc. v. Amer. General Corp., 900, 934, 954, 957  
**Unocal Corp. v. Mesa Petroleum Co.**, 15, 658, 792, 795, 809-10, 832-34, 836, 838, 843, 869-71, 877-79, 881-82, 889, 896-97, 900-02, 911-15, 917-919, 921, 925-28, 930, 934, 948-49, 954  
 U.S. v. Bestfoods, 73, 85, 89, 91, 93, 98  
 U.S. v. Fleet Factors Corp., 99-101  
 U.S. v. Goldberg, 75  
 U.S. v. Kayser-Roth Corp., Inc., 90-91  
 U.S. v. Tabor Court Realty Corp., 556, 558, 565  
 U.S. Fire Ins. v. Peerless Ins. Co., 72  
 U.S. Trust Co. of New York v. First National City Bank, 468, 474, 475
- V-**  
 Van Gemert v. Boeing Co., 384-85, 394, 672, 679, 683, 735  
 Van Gemert v. The Boeing Co. (Van Gemert II), 678  
 Vecco Construction Industries, In re, 579  
 Virtual Network Services Corp. v. U.S., 84
- W-**  
 Wabash Railway Co. v. Barclay, 12, 591-94, 599  
 Walkovszky v. Carlton, 63  
 Walter S. Cheeseman Realty Co. v. Moore, 184, 186  
 Warner Communications v. Chris-Craft Industries, Inc., 614  
**Weinberger v. UOP, Inc.**, 152, 156, 158-59, 163, 176-77, 190-91, 193-94, 196-97, 200, 230, 240, 272, 624, 638, 640, 844, 846-47, 850-51, 853, 876, 921, 925, 960, 967-69  
 Wheeling-Pittsburgh Steel Corp. v. Intersteel, Inc., 72  
 Wieboldt Stores, Inc. v. Schottenstein, 558-59  
 Wilkes v. Springside Nursing Home, Inc., 783, 824  
 Will of Migel, In re, 356, 442  
 William Passalacqua Builders v. Resnick Developers South, Inc., 67  
 Williams v. Geier, 827  
 Wodogaza v. H & R Terminals, Inc., 75-76  
**Wood v. Coastal States Gas Corp.**, 638-39, 712  
 Woodson v. Rowland, 76  
 Wouk v. Merin, 595
- Y-**  
 Yanow v. Teal Indus., 201, 969  
 Yeager v. Paul Semonion Co., 201  
 Yoder v. Honeywell Inc., 73
- Z-**  
 Zapata Corp. v. Maldonado, 455  
 Zeffiro v. First Penn. Banking & Trust Co., 461  
**Zenith Electronics Corp., In re**, 150, 495, 529  
**Ziegler v. Amer. Maize-Products Co.**, 811  
 Ziegler v. Del. County Daily Times, 72

# Preface to the Third Edition

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The study of corporate finance by lawyers has exploded. At one time the subject was limited principally to an examination of the legal capital rules in a segment of the basic course on corporations. Today, a separate course in corporate finance is part of the business curriculum at most law schools, and the study ranges from the lawyer's traditional world of legal capital to market-based methods of valuation once reserved to the business school curriculum.

There are a number of reasons for this development. One is the increasing complexity and sophistication of the American and world financial markets, with the proliferation of new financial instruments having uncertain legal characteristics. Another is the humble rise of securitization as a means of financing beginning in the 1970s and its evolution into a more than \$6 trillion industry. Yet another is the effect of the takeover boom of the 1980s, not only on the development of financing techniques such as original issue junk bonds but on the rights of security holders in target corporations and the legal understanding of the nature of the corporate form. Of further importance has been the influence of law and economics, first on academic lawyers and, increasingly, on judges and legislators. The result of these factors has been a radical rethinking of the nature of the corporate form, basic principles of corporate governance, the rights of security holders and, correspondingly, the duties of corporate management.

There are a number of reasons for corporate lawyers to study corporate finance. The first, and most practical, is that finance is the essence of any corporate law practice. Private placements, public offerings, debt issuances, securitizations, stock issuances, leveraged transactions, mergers, recapitalizations and the like are all important financing techniques, and the lawyer who lacks at least a rudimentary understanding of the basic business principles involved will be inadequately prepared to draft contracts and financial instruments, let alone counsel her client. The legal consequences of these financing techniques are themselves a part of the cost/benefit analysis that goes into the decision to undertake them, so the lawyer, to have meaningful input into the decisionmaking process, must be equipped to assist in this evaluation. Finally, on a broader professional level, the theory and practice of corporate finance has significant societal consequences, both internal and external to the corporation, and an understanding and appreciation of these consequences is the responsibility of every business lawyer.

This book is centered around two organizing themes. The first is that none of the difficult questions of corporate law (including the scope of corporate law itself) can be resolved without an underlying theory of the corporation. We suspect that judges mostly assume a theory of the corporation in resolving disputes which rarely is explicit in the opinion (or even consciously acknowledged by the judge). The same is often true of corporate scholars, and appears particularly true of legislators. Finance theory also is influenced by, or influences, the theory of the corporate form. We thus begin by pre-

senting a variety of theories of the corporation, both of ancient (in terms of corporate law) and recent vintage, to serve as an organizing theme for the materials that follow.

The second organizing theme of this book is that most difficult corporate law questions revolve around the tension created between principles of fiduciary duty and contract upon which corporate law is based, and that judicial decisionmaking reveals a constant readjustment of these principles within the context of corporate law. The extent to which one predominates in a given case is often a reflection of the judge's theory of the corporation, but again it rarely is acknowledged. A self-conscious analysis of this issue ought to bring greater understanding to corporate law problems and result in more coherent resolutions of those problems.

*What has changed in the Third Edition?*

In addition to updating the materials presented in the *Second Edition*, we have streamlined and reorganized those materials in order to make learning easier. In particular:

- **chapter 1** (The Corporate Form: Theories and Consequences) and **chapter 2** (Limited Liability—A Central Problem in Corporate Finance) have been reduced in length without, in our view, any meaningful reduction in the substance they convey.
- **chapter 3** (Valuation) has been reorganized and enhanced in recognition of the central role that valuation plays in corporate finance. We also added a section on behavioral finance and its impact on investor behavior.
- **chapter 4** (Managing Risk (Hedging) with Derivatives) is a new chapter that includes the derivative materials formerly found in chapter 3. In addition to reorganizing the materials, we provide enhanced coverage of the four building blocks of derivatives—options, forwards, futures and swaps. We also discuss derivatives as tools for both risk reduction and speculation. We finish by examining how the courts are adjudicating disputes involving derivatives.
- **chapter 5** (The Rights of Contract Claimants—Part 1: Holders of Debt Securities) has been completely reorganized. We lead with materials on the use of leverage and the characteristics of debt securities generally that had previously appeared in chapter 7. We then discuss the valuation of debt securities before launching into an extended section addressing the legal treatment of debt securities. We then added a section addressing other participants in debt offerings, to wit, underwriters, indenture trustees and rating agencies. We then provide materials on the bankruptcy rights of debtholders. We finish by focusing on advanced debt topics, including a new subsection on asset-backed securitization.
- **chapter 6** (The Rights of Contract Claimants—Part 2: Preferred Stock) has been significantly reorganized and expanded. Included at the chapter's end is an excerpt from Larry Mitchell's seminal article on preferred stock: "The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)," 51 *Bus. Law.* 443 (1996). This excerpt thoughtfully ties together all of the themes presented earlier in this chapter.
- **chapter 7** (The Rights of Contract Claimants—Part 2: Convertible Securities) is a new chapter that brings all the materials on convertible securities together in one place. The chapter begins with an explanation of the economics of, and justifications for, convertible securities (both convertible debt and convertible pre-

ferred stock). It then provides an extended discussion of, and substantial materials covering, the obligation of an issuer to protect the conversion rights of its convertible securityholders.

- **chapter 8** (The Rights of Ownership Claimants—Part 1: General Concepts) begins with a discussion of the nature of fiduciary duty generally. It then provides extensive coverage of a variety of substantive topics: dividend policy and the legal rules affecting dividends; redemptions and repurchases of common stock; preemptive rights and dilution; and recapitalizations and restructurings. It finishes with materials addressing the intersection between fiduciary duty and corporate democracy.
- **chapter 9** (The Rights of Ownership Claimants—Part 2: Mergers and Acquisitions) is essentially a new chapter dedicated to legal issues arising in mergers and acquisitions. In this context, the duty of care and the business judgment rule are first explored. A board's duty of loyalty is then examined in light of its decision to sell the company, adopt defensive strategies, and enter into transactions with controlling stockholders. The chapter finishes with a discussion of antitakeover legislation and the *de facto* merger doctrine.

Leading the charge on the *Third Edition* is our new co-author, Jeffrey J. Haas. Jeff brings a wealth of both real world and scholarly insights to the book. In addition to updating and reorganizing all of the materials, he was responsible for enhancing the chapters and materials on valuation, derivative instruments, asset-backed securitization, convertible securities and mergers and acquisitions.

At the same time, we wish to thank our former co-author, Lewis D. Solomon, who worked on the first two editions of this book. We wish Lew well with the exciting new projects he is pursuing.

L.E.M.  
L.A.C.  
J.J.H.  
January 1, 2006

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## *Second Edition (1996)*

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## *First Edition (1992)*

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I resist any thing better than my own diversity...

Walt Whitman  
*Song of Myself*