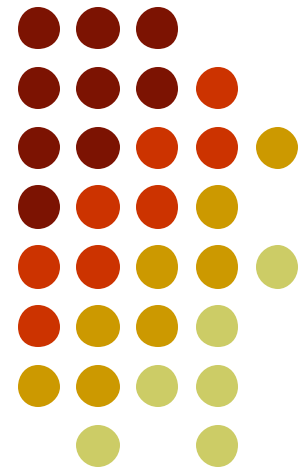


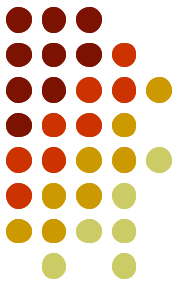
Corporations

Prof. Michael Abramowicz

Public Corporations

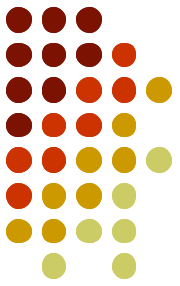


Publicly-Held Corporations Overview of Issues



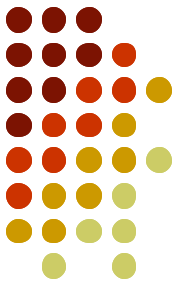
- Introduction to Securities Regulation
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 - Basic Framework of Securities Regulation
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Publicly-Held Corporations Overview of Issues

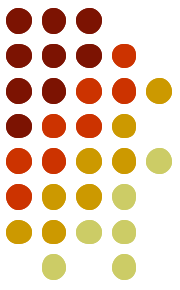


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Framework of Securities Regulation



- History of securities regulation
- Securities Act of 1933
- Securities Act of 1934 and the creation of the SEC

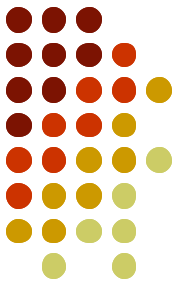


Publicly-Held Corporations Overview of Issues

- Introduction to Securities Regulation
 - Capital Markets
 - Basic Framework of Securities Regulation
- Securities Act of 1933
 - Disclosure
 - How does disclosure 'regulate' securities?
 - Do we need to mandate disclosure, or can we rely on voluntary disclosure?
 - Definition of a security
 - Registration and exemption
- Securities Exchange Act of 1934
 - Securities fraud
 - Insider trading
 - Proxy solicitations
 - Inspection Rights

Disclosure

Securities Act v. Exchange Act



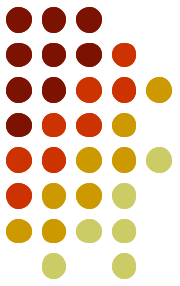
Securities Act:

- Transactional
 - Disclosure by issuers in connection with a primary market transaction.
 - File registration statement with SEC;
 - Provide prospectus to investors.
- Applies to any public sale of securities.

Exchange Act:

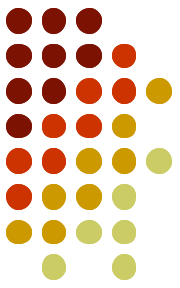
- Periodic
 - Form 10 (once per security class)
 - Form 10-K (annual);
 - Form 10-Q (quarterly);
 - Form 8-K (episodic (w/in 15 days))
- Applies to registered companies only.

Publicly-Held Corporations Overview of Issues



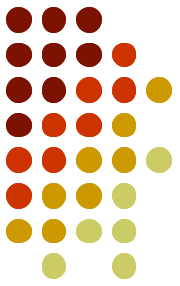
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What is a Security?



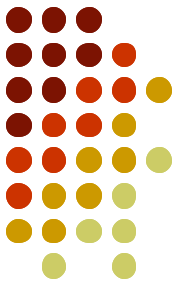
- So what is a security?
 - Securities Act, §2(a)(1): “The term ‘security’ means any **note, stock, treasury stock, bond, debenture**, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, ... investment contract, voting trust certificate, ... any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities... or, in general, any interest or instrument commonly known as a “security”...”
- Wait! It gets worse!
 - First sentence of §2 states that the terms used in the act shall be defined in accordance with the various provisions of §2, “unless the context otherwise requires.”

Robinson v. Glynn



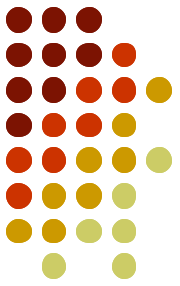
- Facts
- Issues
 - Definition of “security” under the Securities Act of 1933 and the Securities Exchange Act of 1934.
 - “Investment contract?”
 - “Stock?”
- Holding
 - Is Robinson’s interest a security?
 - How broadly should the court rule?

Publicly-Held Corporations Overview of Issues



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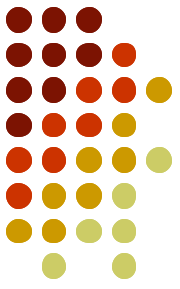
Selling Securities under the Securities Act



- Prior to filing a registration statement with SEC
 - No offering of securities for sale through the mails or by use of interstate commerce.
- From time of filing until the statement becomes effective
 - SEC reviews – examines adequacy of disclosure, not merits.
 - Offers permitted but no sales.
 - Interim period is 20 days after filing unless SEC issues an order halting the process, but price cannot be determined 20 days in advance, so issuer gets advance approval of incomplete statement (w/o price), then adds price and asks to approve statement again, effective immediately. Because it's hard to know price 20 days in advance, very few companies will file a registration statement with a price and then just begin sales 20 days later.
- From time registration statement becomes effective (§ 5 of Act)
 - Selling allowed.
 - Prospectus must be delivered to people offered the securities before the sale.

Securities Act §12 & Private Offerings

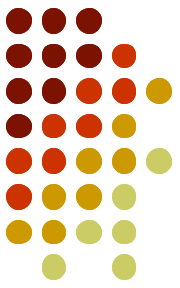
Doran v. Petroleum Management Corp.



- Facts
 - Doran's purchase
 - Other interests
 - Problem with LP
- What does Doran sue for?
- Questions
 - Why does Doran think he can rescind the contract?
 - What's PMC's counter-argument?
- District court
- Appellate court
 - Prima facie case
 - Affirmative defense
 - Factors determining applicability of exemption

Securities Act §12 & Private Offerings

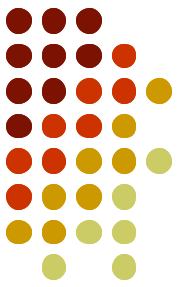
Regulation D



- Regulation D provides a safe harbor for private offerings, elaborating the § 4(2) exemption:
 - If amount raised under \$1M, offer can be directed to an unlimited number of people [Rule 504].
 - If amount raised under \$5M, offer can be made to up to 35 offerees [Rule 505].
 - If amount raised is above \$5M, offer can be made to up to 35 offerees who pass certain tests of financial sophistication [Rule 506].
- In all of these cases, issuer can't advertise publicly, and must file a notice of the sale with the SEC shortly after it issues the securities.

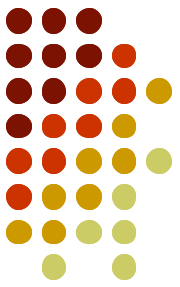
Securities Act §12 & Private Offerings

Regulation D



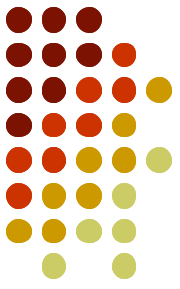
- Generally exempts only the initial sale, so buyers can resell only if they find another exemption.
 - § 4(1) (“transactions by any person other than an issuer, underwriter, or dealer”)
 - But § 2(11) defines “underwriter” as someone who buys a security “with a view to” reselling it
 - A resale by someone who counts as an “underwriter” is sometimes counted by courts as part of the initial offering, thus affecting the numbers for the purpose of Regulation D
 - To avoid this, issuers should make “reasonable inquiry” into the buyer’s plans, informing the buyers of resale restrictions (and placing those restrictions on the stock).
 - Rule 144 also provides a partial safe harbor, where stock acquired in a Regulation D offering is held for two years and then sold in limited volumes.

Civil liabilities: Overview of statutes



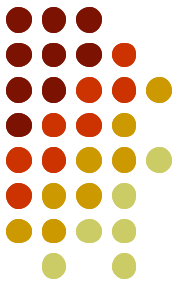
- Express private rights of action:
 - Securities Act §11 – Misrepresentations in the registration statement (does not apply to exempt offering);
 - Securities Act §12(a)(1) – Strict liability for offers & sales (e.g., failure to deliver prospectus, violation of gun-jumping rules) in violation of § 5;
 - Main remedy: rescission (or comparable remedies if plaintiff no longer owns securities)
 - Securities Act §12(a)(2) – Misrepresentations in prospectus/oral sales communication;
- Implied private rights of action:
 - Exchange Act §10(b) & SEC rule 10b-5.
 - Exchange Act §14(a) and proxy rules.

Due diligence: *Escott v. BarChris*



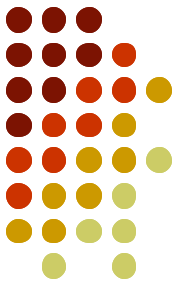
- Facts
 - Who sued and why?
 - Who were the defendants?
- Holding
- Issues
 - Materiality
 - Availability of due diligence defense
 - To issuer
 - To experts
 - To non-experts
- Apply to each of defendants
- Remedy?

Publicly-Held Corporations Overview of Issues



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Exchange Act §10(b)



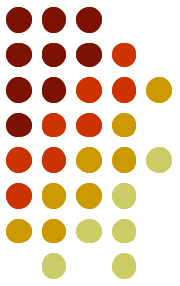
- “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

...

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered... any manipulative or deceptive device or contrivance **in contravention of such rules and regulations as the Commission may prescribe** as necessary or appropriate in the public interest or for the protection of investors.”

- §10(b) applies to both registered & unregistered securities.
- §10(b) is not self executing. SEC promulgated rules to fill this section with specific content. The most well-known of these rules is Rule 10b-5.

Rule 10b-5

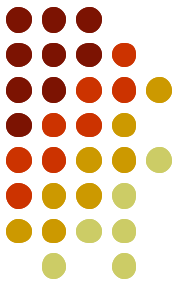


“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

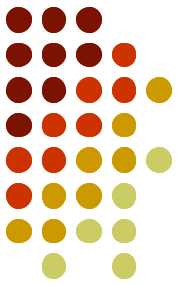
in connection with the purchase or sale of any security.”

Elements of a Rule 10b-5 Violation



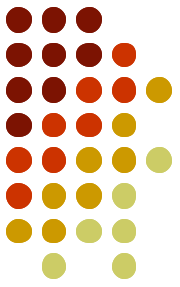
- Jurisdictional Nexus
- Transactional Nexus
- Materiality
- Reliance
- Causation
- Scienter

Basic, Inc. v. Levinson

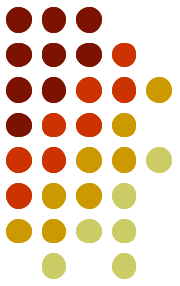


- Facts
 - Secret plans
 - Stock prices over time
- Which former shareholders sued?
- Procedural history
- Issues
 - Materiality
 - Reliance
 - Fraud on the market theory
 - Rebutting the presumption

Publicly-Held Corporations Overview of Issues



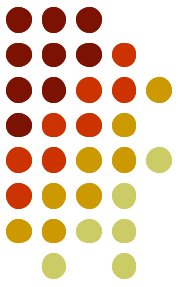
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Is Insider Trading Bad?

- Reasons for prohibition of insider trading
 - Preventing incentives for bad management
 - Fairness
 - Property rights
- Reasons for allowing insider trading
 - Market efficiency
 - Executive compensation

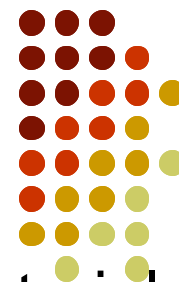
The Common Law: *Goodwin v. Agassiz*



- Facts
 - The geologist's theory
 - On whose behalf were defendants acting?
- Holding
- Reasons
 - Duty
 - Quality of information
 - Trade on securities market

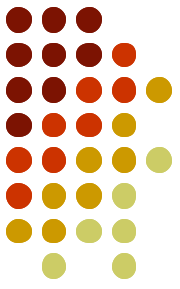
Federal Law on Insider Trading

Rules 10b-5 & 14e-3



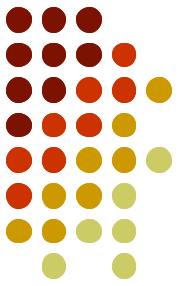
- Insider trading may be considered an omission of a material fact (the inside information) in connection with a purchase or sale of a security – thus violating Rule 10b-5.
 - See Rule 10b5-1(a): “The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.”
 - Rule 14e-3 is also applicable to insider trading; more about it – later.
- Liability for an omission exists only if there is a duty to disclose.
 - State law usually does not create a duty to disclose in exchange transactions (e.g., *Goodwin v. Agassiz*).

SEC v. Texas Gulf Sulphur



- Facts
 - Importance of secrecy
 - Company's claims
 - Timing of trades
 - Whom does the SEC sue?
- Issues
 - Materiality
 - Disclose or abstain
- Individual defendants
 - Darke
 - Coates
 - TGS

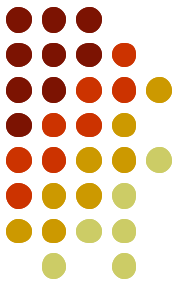
Chiarella v. United States



- Facts
 - Chiarella's access to information
 - What did Chiarella know?
- Holding
 - Traditional theory: Is Chiarella an insider?
 - Misappropriation theory: Not considered

Dirks v. SEC

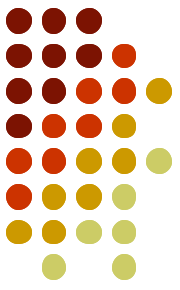
Derivative Liability (Tipping)



- Facts
 - Secrist's and Dirks' attempts to expose fraud
 - Dirks' trading
 - Effect on stock price
- Holding
 - Two elements of a 10b-5 violation
 - SEC's position
 - Requirements for derivative liability
 - Personal benefit
- Additional issues
 - Temporary insiders
 - Information from arms' length transactions

Responses to *Chiarella & Dirks*

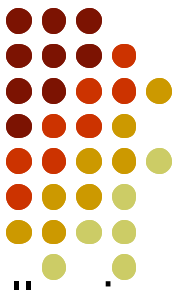
Rule 14e-3



- **Exchange Act, §14(e):** “It shall be unlawful... to make any untrue [statement or omission] or to engage in any fraudulent, deceptive or manipulative acts... **in connection with any tender offer**... The Commission shall [promulgate rules to fill prohibition with content].”
- **Rule 14e-3(a):** When a tender offer has commenced or is about to be commenced, it is a violation of §14(e) for a person other than the offering person to trade in the relevant securities, if that person has material non-public information relating to the tender offer, which the person knows or has reason to know was acquired (directly or indirectly) from:
 - the offering person,
 - the target company, or
 - any officer, director, employee or other person acting on behalf of either the offering person or the target company.

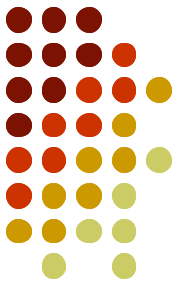
Responses to *Chiarella & Dirks*

Rule 14e-3



- **Rule 14e-3(b):** A “Chinese wall” defense for business associations, allowing exemption where someone didn’t know and there is some procedure for preventing the person from obtaining the information or from trading on it.
Why do we need this special rule?
- **Rule 14e-3(c):** Exception allowing the offering person to purchase the securities (remember *Van Gorkom*).
- **Rule 14e-3(d):** It is a violation of §14(e) for the following persons to communicate material private information to others if it is reasonably foreseeable that this communication will result in a violation of §14(e):
 - The offering person;
 - The target company;
 - Their officers/directors/employees/advisors;
 - Anyone working on their behalf; and
 - Anyone possessing material nonpublic information which she knows or has reason to know was acquired from any of the above.
- This rule creates exceptions for communicating to the target and to necessary people within the offering person.

United States v. O'Hagan



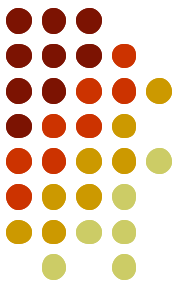
- Facts

- How did O'Hagan get the information?
- Why isn't this a typical traditional theory case?

- Issues

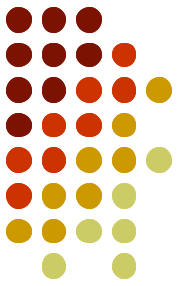
- Misappropriation theory
 - Validity
 - Requirements
- Rule 14e-3

Responses to *Chiarella & Dirks* Misappropriation Theory



- The SEC responded to *Chestman* after *O'Hagan* by adopting rule 10b5-2 in 2000.
- The rule provides a non-exclusive list of three situations in which a person has a duty of trust or confidence for the purpose of the misappropriation theory:
 - Whenever a person agrees to maintain info in confidence;
 - Whenever the person communicating info and the person to whom it is communicated have a history, pattern or practice of sharing confidences, such that the recipient of the info knows or reasonably should know that the person communicating the info expects the recipient to maintain confidentiality; or
 - Whenever the info is obtained from a spouse, parent, child or sibling, unless recipient shows that history, pattern or practice indicates no expectation of confidentiality.

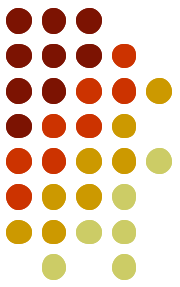
The Insider Trading Checklist



- Rule 10b-5: “Traditional” theory
 - Statutory insider [Exchange Act §16(a) – Directors, Officers, 10% SH]
 - Temporary insider [*Dirks*, FN 14]
 - Derivative liability (tipping).
- Rule 10b-5: Misappropriation theory
 - Duty of confidentiality to the source of the information
 - Rule 10b5-2
- Rule 14e-3: Special rule for tender offers
- Mail and wire fraud
- End result: Insider trading law is somewhere between “law of the jungle” exemplified by *Goodwin* and the level playing field sought by Congress.

The Insider Trading Flowchart

“Traditional” Theory

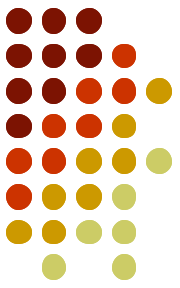


Is Defendant in possession of material non-public information?

- No – **No liability.**
- Yes – Is D a statutory insider or a temporary insider?
 - Yes – Did D trade (recklessly or intentionally) without disclosing [TGS]?
 - Yes – **Subject liable for personal trades under 10b-5.**
 - No – Did D tip others?
 - No – **No liability under “traditional” theory (but check other theories).**
 - Yes – See “tippee” section below.
 - No – Is D a tippee (derivative liability)?
 - No – **No liability under “traditional theory” (but check other theories).**
 - Yes – Did insider tip others recklessly, for personal benefit?
 - No – **No liability for either tipper or tippee (but check other theories).**
 - Yes – Did Tippee know or should reasonably know of tipper’s breach?
 - No – **Tipper liable under 10b-5, tippee is not (but check other theories).**
 - Yes – **Both tipper & tippee are liable under 10b-5.**

The Insider Trading Flowchart

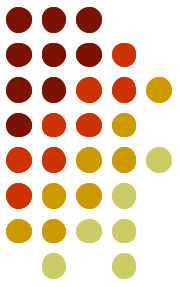
“Misappropriation” Theory



Is Defendant in possession of material non-public information?

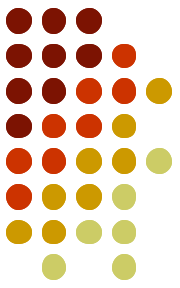
- No – **No liability.**
- Yes – Does D owe a fiduciary duty of confidentiality to possessor of information, and is the information within the scope of this fiduciary duty?
 - No – **No liability under the “misappropriation” theory, unless D received tip from someone who had such a fiduciary duty (in which case, see below).**
 - Yes – Did D trade (recklessly) without disclosing?
 - Yes – **Subject liable for personal trades under 10b-5.**
 - No – Did D tip others?
 - No – **No liability under “misappropriation” theory (check other theories).**
 - Yes – Did insider tip others recklessly, for personal benefit, without disclosing?
 - No – **No liability for either tipper or tippee (check other theories).**
 - Yes – Did Tippee know or should reasonably know of tipper’s breach?
 - No – **Tipper liable under 10b-5, tippee is not (check other theories).**
 - Yes – **Both tipper & tippee are liable under 10b-5.**

Publicly-Held Corporations Overview of Issues



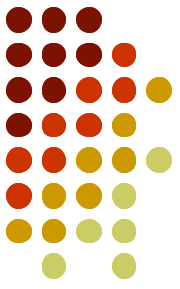
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Role of SH in a Corporation



- SH do not manage the corporation. The BoD does. SH keep the BoD accountable.
- SH have right to vote on certain issues, including:
 - Election of directors (MBCA §§8.03-8.04);
 - Slate voting vs. Cumulative voting (MBCA §7.28: (a) vs. (c)).
 - Slate voting: Everyone gets one vote per slot, and candidates with largest number of votes wins.
 - Cumulative voting: Voters can use their votes more than once per candidate; allows minority shareholders to assure themselves of some representation.
 - Amendments to Aol and bylaws (MBCA §§10.03, 10.20);
 - Fundamental transactions. E.g.,
 - Mergers (MBCA §11.04);
 - Major asset sales (MBCA §12.02).
 - Miscellaneous, such as approval of independent auditors.

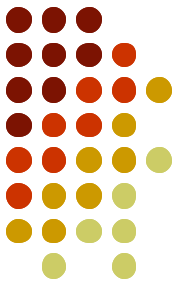
Shareholder Meetings



Shareholder meetings

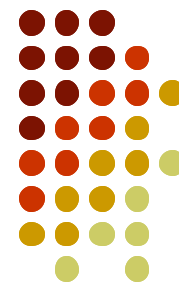
- Annual (Required; MBCA §7.01);
- Special
 - MBCA §7.02: Called by BoD or authorized officer, or by SH owning together a 10% interest (Aol/bylaws may modify this percentage up or down, but it may not exceed 25%).
 - DGCL § 211(d): No right for SH to call meeting unless Aol/bylaws specify such right.

Shareholder Meetings



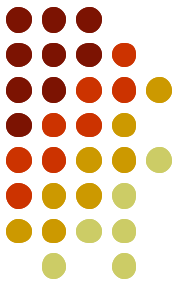
- Procedural rules in SH meetings:
 - Quorum (MBCA §7.25-7.27);
 - Default: A majority of shares entitled to vote (MBCA §7.25(a))
 - Voting;
 - MBCA § 7.25(c): Approved if # of votes cast in favor > # cast against.
 - DGCL § 216: Must be approved by the vote of a majority of shares present.
 - **When is there a difference between these two rules?**
 - Group Voting (MBCA §10.04; DGCL § 242(b)(2));
 - Where share classes or rights would be changed, all holders of outstanding shares of a class may vote as a separate voting group, so that a majority of these shares controls all the votes.
 - Notice (MBCA §7.05);
 - Eligibility (based on the 'record date,' which is usually specified by the bylaws – MBCA §7.07).
- Actions without meetings (i.e., by written consent)
 - MBCA §7.04 – Require unanimity.
 - DGCL § 228(a) – Allowed if consents come from same number of shares as would be needed to take action at a meeting.

Regulation of Proxy Voting

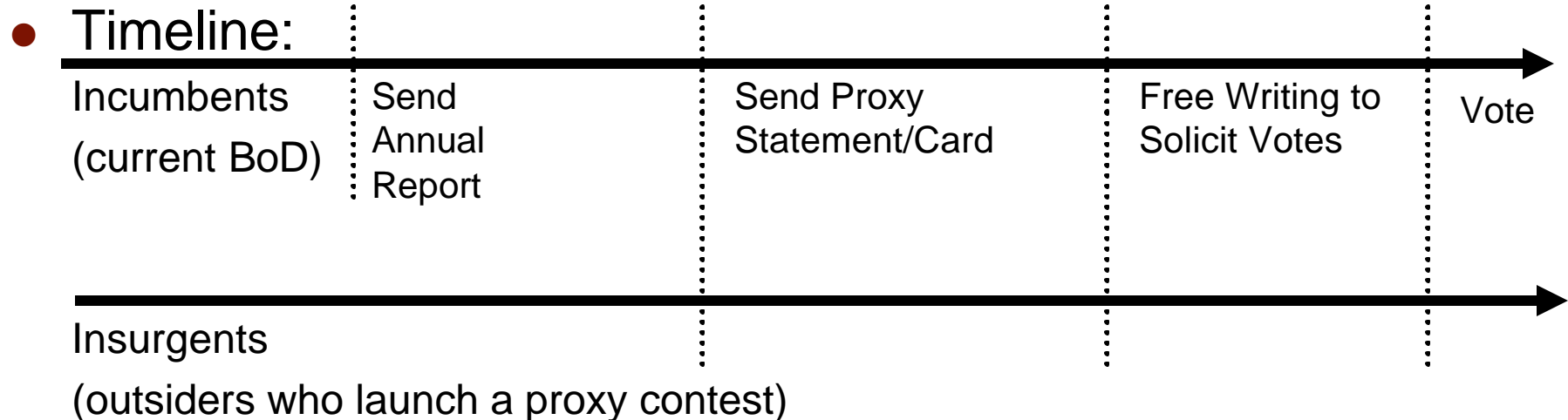


- Exchange Act §14(a): “It shall be unlawful for any person... in contravention of such rules and regulations as the Commission may prescribe... to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12.”
- Like §10(b), §14(a) is not self-enforcing, but relies on SEC rules to provide it with content.
- The section applies only to registered securities.
- **Why do we need to regulate proxy voting?**

Regulation of Proxy Voting

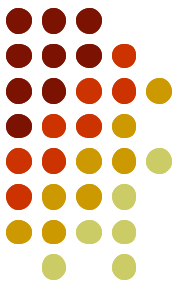


- Rule 14a-3(a): Anyone soliciting a proxy must first provide a written proxy statement (following a prescribed form).
 - Rule 14a-6: Proxy statement must be filed with SEC.
- Rule 14a-3(b): Incumbent directors must provide an annual report before soliciting proxies for the annual meeting.



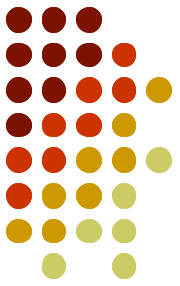
Regulation of Proxy Voting

What is a Solicitation?



- Rule 14a-1(l)(1): The terms "solicit" and "solicitation" include:
 - Any request for a proxy whether or not accompanied by or included in a form of proxy;
 - Any request to execute or not to execute, or to revoke, a proxy; or
 - The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.
- Rules 14a-1(l)(2) & 14a-2 exempt certain activities, including:
 - Public statements as to how a SH plans to vote and her reasons for doing so [14a-1(l)(2)(iv)(A)];
 - Solicitations by a person who doesn't seek (for herself or for others) the power to act as proxy, subject to many exceptions [14a-2(b)(1)];
 - Solicitations (other than by incumbents) to 10 or fewer people [(b)(2)].

Levin v. MGM



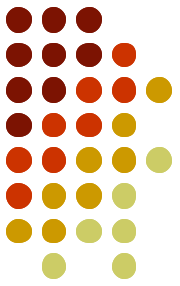
- **Facts**

- **Levin versus O'Brien: What are the disagreements about how the firm is run?**

- **Holding**

- **Were management's expenditures unreasonable?**

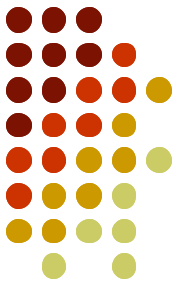
Rosenfeld v. Fairchild Engine & Airplane Corp.



- Facts
 - Incumbents' expenses
 - Insurgents' expenses
- Issues
 - What are “reasonable expenses”?
 - What is a “policy contest”?
 - Why did dissent think some expenses were excessive?

Private Actions for Proxy Rule Violations

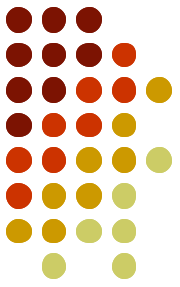
J.I. Case v. Borak



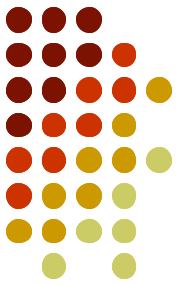
- Facts
 - Merger
 - Alleged falsity
- Issue: Private right of action
 - Court's legal reasoning
 - Practical reason for allowing such a right

Private Actions for Proxy Rule Violations

Mills v. Electric Auto-Lite Co.



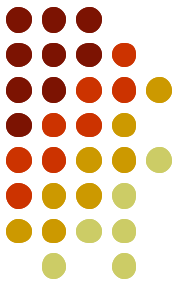
- Facts
 - Relationship between Mergenthaler and Auto-Lite
 - What did the proxy solicitation omit?
- Issue: Causation
 - Relationship to issue of “materiality” issue
 - Must one show that vote was affected?
- Questions
 - Are damages assumed?
 - What if management had enough votes anyway?
 - What forms of relief are possible?



Seinfeld v. Bartz

- Facts
 - Director fees
 - Disclosure on proxy statement
- Issue: Materiality
- Questions
 - What are options?
 - How are options valued?
 - Was enough information provided for market to calculate values of these options?

Lovenheim v. Iroquois Brands (Exclusion for relevance)



- **Facts**

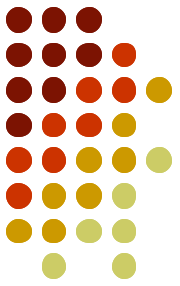
- Lovenheim's beef?
- Lovenheim's request?

- **Issue**

- Can the company exclude the proposal? What does it depend on?
- Rule 14a-8(i)(5)
 - How economically significant was this?
 - Is there sufficient noneconomic significance here?

NYCERS v. Dole Food Co.

Grounds for Exclusion: Improper Under State Law



- **Facts**

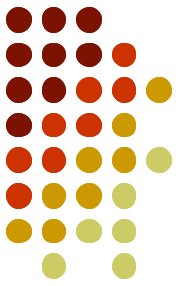
- What was requested?
- Why this phrasing?
- What would happen if BoD refused to go along with recommendation?

- **Issues**

- Rule 14a-8[i](7): Ordinary business operations
- Rule 14a-8[i](5): Five percent threshold
- Rule 14a-8[i](6): Lack of ability to effectuate

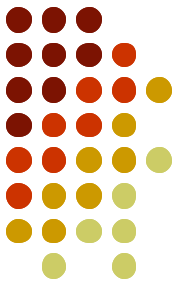
Austin v. ConEd

Grounds for Exclusion: Ordinary Business



- **Facts:**
 - Proposal
 - Pension system
- **Issues**
 - Rule 14a-8[i](7): Ordinary business
 - Rule 14a-8[i](4): Private benefit

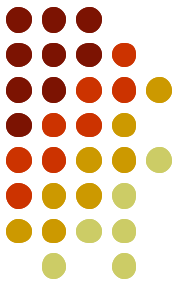
Publicly-Held Corporations Overview of Issues



- Introduction to Securities Regulation
 - Capital Markets
 - Basic Framework of Securities Regulation
- Securities Act of 1933
 - Disclosure
 - Definition of a security
 - Registration and exemption
- Securities Exchange Act of 1934
 - Securities fraud
 - Insider trading
 - Proxy solicitations
 - Inspection Rights

Shareholder Inspection Rights

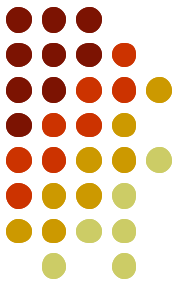
Crane Co. v. Anaconda Co.



- Facts
 - Initial request for shareholder list
 - Later request
- Issues
 - Purpose in obtaining list: proper?
 - Choice of law

Shareholder Inspection Rights

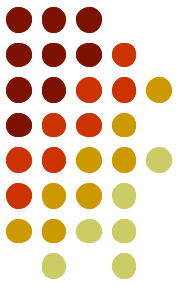
Pillsbury v. Honeywell, Inc.



- Facts
 - Acquisition of stock
 - Pillsbury's concern
- Issues
 - Choice of law
 - Burden of proof
 - Are ideological purposes “proper”?

Shareholder Inspection Rights

Sadler v. NCR Corp.



- Facts
 - AT&T
 - NCR
 - Sadler
- Issues
 - Distinction between NOBO & CEDE lists
 - Required to produce lists?