AGENCY

1. Definitions:

Agent: A person who by mutual assent acts on behalf of another and is subject to the other's control

Agency is the **fiduciary** relationship that results from the **manifestation of consent** by one person to another that the other shall **act on his behalf** and subject to his **control,** and consent by the other so to act The one for whom action is taken is the **principal** The one who acts is the **agent** (e g, real estate broker, attorney) (Rest §1)

Fiduciary: (An agent is a fiduciary): A person having a duty created by undertaking to act primarily for the benefit of another person. Trust, confidence, dependence, special relation.

Legal rights: agents have the ability to perform legal acts for the principal (enter into contractual dealings with others which effect the principal's legal rights and obligations)

General agent - authorized to conduct a series of transactions involving a continuity of services (Rest§3)
Special agent - authorized to conduct a single transaction or series of transactions not involving continuity of services (Rest §3)

2. Key components of agency:

a) On behalf of
b) Control: Additional control above the contract requirements
c) Fiduciary: owing special duties in trust law, acting primarily for the benefit of another

3. Authority of agents/liability of principals to 3rd parties: (did the principal give the agent authority)

A principal is liable to a 3rd party for the acts of an agent (per Rest §140) if the agent had one of the following types of authority

a) **Actual authority** (a k a authority) - a reasonable person in the agent's position would believe that the principal desired that the agent act in this way. Actual authority can be express or implied. Implied authority to carry on incidental acts necessary to accomplish express acts. (Also may be in minutes, articles of incorporation, employment contracts, etc) (Rest §7)

b) **Apparent authority** - the principal makes a manifestation that would lead a reasonable 3rd party to believe the agent had the authority to act the way he did (The principal can withdraw actual authority and the agent can still have apparent authority) (Rest §8)

- Power of position: Apparent authority can be created by appointing a person to a position, thus anyone dealing with the agent in that position can infer authority as to **ordinary habits of locality**, trade or profession.
- The agent can still be liable to the principal for damages.

c) **Inherent authority** - what a reasonable 3rd party would believe is inherently a power of an agent in this type of agency relationship (not derived from actual authority, apparent authority, or estoppel) (Rest §8A)

- Even if the principal forbids the agent from doing the act, he is still liable if 1) the act usually accompanies or is incidental to transactions that the agent is authorized to conduct and 2) the third party reasonable believes the agent is authorized to do the act.

A principal can also be liable to a 3rd party under the following theories

d) **Authority by estoppel**: if agent doesn't have authority but principal caused belief that he did or knew the *3rd* party thought he did, and 3rd party detrimentally relied on "authority" (Rest §8B) This occurs when the principal:

- Intentionally caused such belief, or
- Knowing of such belief and that others might change their positions because of it, he did not take reasonable steps to notify them of the acts.

e) **Ratification:** when a principal is notified of the material facts behind an unauthorized act and takes formal action accepting the deal or the benefits of the deal (Rest §82)

f) **Acquiescence**: failure of a principal to object to an action undertaken by an agent

4. Disclosure and Liability to 3rd parties:

a) *Disclosed principal* - 3rd party knows who principal is, agent cannot be liable if acting with authority. The principal is bound. (Rest §320)

b) *Partially disclosed principal* - 3rd party knows there is a principal, but doesn't know who it is, both the principal and the agent are liable (Rest §321)

c) *Undisclosed principal* – When the agent purports to be acting on his own behalf. The principal is liable and agent can be liable (Rest. §322) (note: if the principal is later disclosed, the majority holds that the agent is discharged from liability as long as the principal can pay; the minority holds that both are still liable)

d) *Implied Warranty of Authority and misrepresentation of authority* - An agent with no authority to act on behalf of the principal and no power to bind a 3rd party is still liable under implied warranty of authority (Rest. §329 and §330)

5. Liability of 3rd parties to principals:

General Rule: If 3rd party enters K w/ agent making him liable to the agent, he is liable to the principal unless the principal was undisclosed and the principal knew the 3rd party would not deal w/ him.

6. Master, servant, independent contractor: §2

a) **A master** is a principal who employs an agent to perform service in his affairs and who controls or has the right to control the physical conduct of the other in the performance of the service.

b) **A servant** is an agent employed by a master to perform service in his affairs whose physical conduct in the performance of the service is controlled or is subject to the right to control by the master.

c) **Independent contractor** (no right to control) is a person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right to control with respect to his physical conduct in the performance of an undertaking. He may or may not be an agent.

7. §228 Servant, within scope of employment

a) The kind he is employed to perform; occurs substantially within the authorized time and space limits; is actuated, at least in part, by purpose to serve the master; if force is intentionally used by the servant against another, the use of force is not unexpectable by the master.

8. Kind of conduct within the scope of employment: §229

a) Conduct must be the same general nature as that authorized, or incidental to the conduct authorized.

b) **Conduct that is incidental**: act is one that is commonly done by such servants; time, place, and purpose of the act; previous relations between the master and the servant; extent to which the business of the master is apportioned between different servants; does the master expect such act to be done; extent of departure from normal method of accomplishing an authorized result; whether or not the act is seriously criminal.

9. Forbidden acts: §230

a) An act forbidden may be within the scope of employment

10. Criminal or tortuous acts: §231

a) An act may be within the scope of employment although consciously criminal or tortuous.

11. Frolic and detour

a) If it is outside the scope of employment then the master is not liable (Fiocco, unless reestablished.

12. Liability of principal to agent:

a) **General <u>Rule:</u>** Must indemnify per their agreement or for authorized acts, but not required to for unauthorized acts or negligent acts (Rest. §§438-40).

13. Liability of agent to principal:

a) **General <u>Rule:</u>** Liable for breach of any duty, and own tortuous acts (see below) (Rest. §401).

14. Termination of agency relationship:

a) **General <u>Rule:</u>** Either party can terminate by manifesting such intent (called a revocation by the principal and a renunciation by the agent) (Rest. §118). The principal may always stop the person from being an agent but there may be contract damages.

   1) Modern: there are many exceptions: Unions: require termination to be for just cause. Arbiter determines what just cause is.
   2) Notification: when an agent is terminated, principle needs to notify those who may rely on the agency relationship.

15. Agent's duties to principal (duties of loyalty):

a) **Contract** – subject to the duty to act in accordance with the agency contract (Rest. §377)

b) **Benefit** - <u>to act solely for the benefit of the principal</u> in all matters connected with the agency relationship (Rest. §387 general principal)

c) **Profit** - to give the principal profits arising from transactions conducted on his behalf (Rest. §388)

d) **Not Adversarial** - to not deal with the principal as an adverse party in a transaction connected with his agency without the principal's knowledge (Rest. §389)

e) **Adversarial** - to deal fairly with and disclose material facts to the principal if notified that dealing with as an adversary (Rest. §390)

16. All servants are agents, but not all agents are servants (a servant is one whose physical conduct is controlled or subject to the right of control.)

17. Using confidential information after the termination of the agency: §386

- **a)** Agent has no duty not to compete with the principal
- **b)** Has a duty to the principal not to use or to disclose to third persons, on his own account or on the account of others, in competition with the principal or to his injury, trade secrets, written lists of names, or other similar confidential matters given to him only for the principal's use or acquired by the agent in violation of duty.
  - The agent is entitled to use general information concerning the method of business of the principal and the names of the customers retained in his memory, if not acquired in violation of his duty as an agent.
- **c)** Has a duty to account for profits made by the sale or use of trade secrets and other confidential information, whether or not in competition with the principal
- **d)** Has a duty to the principal not to take advantage of a still subsisting confidential relation created during the prior agency relation.

18. Causation: the principal can recover from any reasonably foreseeable consequences of the agent's breach of duty.

19. Agents and duty of care: Duties may be found in or defined by:

- a) Contracts, oral or written
- b) Fiduciary duties, which will lead to tort liability for the agents
- c) Duties under the restatement of agency
  1) Duty to principal to act with standard care and skill which is standard in the locality for that kind of work, unless otherwise agreed (rest §379)
  2) Duty to exercise any special skill possessed (§379)
  3) Gratuitous agents have a duty to act with the care and skill required of others who are not agents but are undertaking similar tasks (§379)
  4) Duty no to commit misconduct, tort, crime, breach of the contract (§379)
  5) Duty to disclose relevant information to the principal (§381)
  6) Duty of good conduct in business he is engaged in (§ 380)
  7) Duty to act only as authorized (§383)
  8) Duty not to attempt the impossible or impracticable (§384/5)
  9) Duty to obey the principal (§385)

- d) Duties under the RMBCA §8.42 (If discretionary authority may invoke the BJR)
  1) An officer shall discharge his duties: 1) in good faith; 2) with care an ordinary prudent person in a like position would exercise under similar circumstances; 3) in a manner he reasonable believes to be in the best interests of the corporation. He can rely on officers, employees and professionals (accountants, attorneys) if he reasonable believes they are reliable and competent.

20. Why it might be easier to win against agents

- a) They may be expected to have more specific knowledge regarding what they are working on and sometimes more general knowledge about the business
- b) Statutes do not provide extra protection for agents like they sometimes do for directors.

21. Punitive damages: §217

- a) Punitive damages can be properly awarded against a master or other principal because of an act by an agent if, but only if;
  1) The principal authorized the doing and the manner of the act
  2) The agent was unfit and the principal was reckless in employing him
  3) The agent was employed in a managerial capacity and was acting in the scope of employment; managerial capacity: type of authority the employer has given employee, the amount of discretion the employee has in what is done and haw it is

accomplished.
4) The principal or a managerial agent of the principal ratified or approved the act

b) Punitive under statute requires: malice or with reckless indifference to the federally protected rights of an aggrieved individual
c) Vicarious liability: Similar to strict liability; hold the principal liable even without fault.
d) Managerial employees:
    1) High-level employees in charge of the dept. or division and many lower level employees.
    2) Depends on the size and the type of the organization.
    3) Agency cost: manager may be tempted to maximize his own personal utility rather than the owners of the business.
    4) To avoid agency cost: Give bonuses and incentives to managers for earning money for the owners. Limit the manager's discretion.

22. Lawyers should not enter business with client unless:
    a) terms are fair and reasonable
    b) lawyers interests are fully disclosed
    c) in writing: proof
    d) Client is given the chance of advise from independent counsel.
    e) Client consents in writing.

<u>CASES</u>

<u>NSC v. ARCO (supplement pg. I):</u>
F: Described the different kinds of authority in the context of an agent's authority to enter into an agreement to provide fuel to a new truck stop at a discount.
<u>Fiocco v. Carver</u> <u>(in notes):</u>
F: D's driver sent to deliver truckload of goods but after delivering went to mom's house, carnival, etc. and through his negligence injured a kid riding on his truck.
H: A major departure from the duty will take an agent outside the course of employment and subject him to sole liability. The test is whether the agent's dominant purpose was the departure or the duties of employment.
<u>Kolstad v. ADA:</u>
F: P tried to impute to the principal (American Dental Association) liability for punitive damages arising from employment discrimination of its agent.
H: Principals liable if authorized act, recklessly employed agent, agent was acting within scope of managerial capacity, or principal ratified or approved act (Rest. 217(c)).
<u>Taranowski v. Resop</u> <u>(pg. 19):</u>
F: Agent took bribe to make false representations to his principal to induce him to buy music machine business. **H:** Agent responsible for foreseeable consequences of act + any profit he derived from the agency relationship (e.g., the bribe) (Rest. §388).

PARTNERSHIPS

1. Definitions:

An association of two or more persons to operate, as co-owners, a business for profit (Martin v. Peyton)(RUPA§101(6))

Agent: Each partner is an agent of her copartners and when any partner acts within the scope of the partnership, her acts will bind the other partners

Joint venture: More limited than a partnership, more narrow in purpose and scope, usually formed for a single transaction (but treat like a P-ship under the RUPA)

The RUPA incorporates agency into partnership law

2. Legal nature: RUPA abandons aggregation theory

a) A partnership is an entity distinct from its partners (P-ship can own property, can be sued in its name)
b) No new P-ship just because of membership changes
c) Exception: §306: **Partners joint and severally liable for all debts** unless the P-ship has filed a statement of qualification to become a LLP (More like the aggregate theory)
d) The LLP continues to be the same entity that existed before the filing of the statement.
   1) How to get around limited liability in a LLP: Get a personal guarantee from the individuals involved, not just security from the P-ship.

3. Formation: (see §202 for further requirements)

a) By Association (inadvertent p-ship): the association of two or more persons to operate, as co-owners, a business for profit forms an ownership, regardless of whether they intended to form a partnership, unless they formed the association under a different statute (e.g., formed a corporation) (RUPA §202).
   1) Potential Factors:
      a. Profit sharing
      b. Common property interests
      c. Interests in the management and control (e.g., a passivity may point to a debtor/creditor relationship; activity may point to a partnership relationship)

b) <u>Sharing Profits:</u> a person who receives a share of profits is presumed to be a partner in the business unless the payments are: of debt, for services as an independent contractor or employee, of rent, of an annuity, of interest on a loan, or for the sale of goodwill or property (RUPA §202).

c) <u>By Estoppel</u>: if there is a representation to a 3rd party that someone is a partner and the 3rd party relies on the representation, you are estopped from asserting there is not a partnership with respect to dealings with that 3rd party.

d) **By Contract:** two or more person may enter into a K to form a partnership, but the intent and language of the agreement are not controlling. The court will look at the relationship and conduct of the parties to determine if it is a partnership (Martin v. Peyton).

e) Factors to consider to decide if party is a co-owner

1) Look at instruments: Words that no partnership exist are not controlling
2) Power to initiate and bind: distinguish between position and negative power; did not have the power to initiate but did have veto power.(lack of positive power may convince the court it is not a P-ship: Martin v. Peyton)
3) Loan money not automatically deemed a partner: Secure collateral OK(veto power, inspect books, entitled to any information to safeguard the loan: policy encourages the loan of money.

4. Factors for P-ship vs. debtor/creditor relationship

a) Profit: profit is in the partnership definition; profit sharing is prima facia evidence that the recipient is a partner in the business. Does not matter if profits were never received or made.
b) Losses: If the creditor agreed to share the losses
c) Financial stress of the business, would other creditor institutions have loaned money
d) Absent terms of a loan (payment of principal, interest, time limit)
e) Control: Is the creditor retaining negative or passive powers to protect their loans vs. power to initiate binding transactions.
f) Be careful with joint ventures, may be narrower regarding authority.
g) Policy of the court not to hold creditors out to be partners.

h) Lupien v. Malsbenden: is the lender of money a partner: loan was for 85,000 with no interest, lender was involved in day to day business (positive power) right to participate in control of the business is the essence of co-ownership; look at the total involvement of banker was that of a partner.

5. Liability of a purported partner: §308 (partnership by estoppel)

a) One who holds himself out by words or conduct to be a partner in an actual or apparent partnership, or who expressly or impliedly consents to the representations that he is such partner, is liable to any third person to whom the representations were made who extends credit in good faith reliance on the representations; a person who relies on the representation of partnership can hold the purported partner liable "even if the purported partner is not aware of being held out as a partner to the claimant."

6. Partnership Operations (unless otherwise agreed in contract or agreement): for further characteristics, see §401.

a) **Participation:** Each partner has equal rights in the management and conduct of the business, and in access to books and relevant information (and therefore must be consulted in decision-making (RUPA §401(f)).

b) **Profits:** each partner is entitled to an equal share of profits and is chargeable with a share of the partnership losses in proportion to the partner's share of the profits.(§401(b))

c) **Pay**: A partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership.(§401(h))

d) **Majority rules:** Unless otherwise agreed, decisions with respect to ordinary matters connected with the partnership can be made by a majority vote of the partners; extraordinary decisions/matters usually require unanimity <u>(Summers v. Dooley and RUPA §401(j)).</u>

e) **Becoming a partner:** A person may become a partner only with the unanimous consent of all partners (RUPA §401(i)).

f) **Agency:** Each partner is an agent of the partnership for the purposes of its business (RUPA §301).

7. Distributions, Remuneration, Indemnification, and Contribution:

a) Partners, unless otherwise agreed, shall share equally in profits and losses.
b) Partners, unless otherwise agreed, are not entitled to remuneration for services performed for the partnership.
c) Personal services may be a partner's capital contribution per express or implied agreement.

8. Authority of a Partner:

a) **<u>Agency</u>** Each partner is an agent of the partnership and the other partners, for the purposes of the business (when carrying on in the ordinary course of the business unless the partner had authority to act for the partnership in a particular matter and the person with whom the partner was dealing knew or had received a notification that the partner lacked authority. (RUPA §301)
   1) An act of the partner which is not apparently for carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership binds the partnership only if the act was authorized by the other partners.

b) **<u>Agreements</u>** the authority of partners may be spelled out specifically in filed statements of authority (RUPA § 303)
c) Transferability a party may assign his interest in the partnership, but an assignee will only receive a share of the profits from the partnership He will not receive power to manage or to access books or relevant information (unless unanimous approval to grant)

9. Duties of Partners - Fiduciaries (RUPA §404: general standards of partner's conduct)

a) A partner owes a duty of loyalty and a duty of due care to the partnership and to the other partners:
b) **Duty of loyalty**:
   1) To account to the partnership or hold as trustee for partnership any property, profit, or benefit
   2) Refrain for dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to

the partnership.
   3) Refrain from competing with the partnership before dissolution.
c) **Duty of care**
   1) Refrain from grossly negligent or reckless conduct, intentional misconduct or knowing violation of law in winding up partnership business
d) Partner shall discharge the duties of the partnership with the obligation of good faith and fair dealing.
e) Partner does not violate this act merely because the partner's conduct furthers the partner's own interest (partner is not a trustee)

10. Duty: Meinhard v. Salmon

a) Joint adventurers, like copartners, owe to one another while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workday world for those acting at arm's length are forbidden to those bound by fiduciary ties. Not honesty alone, but the punctilio of an honor the most sensitive in the standard of behavior.
b) The duty is even higher on a managing partner to a silent partner; this imputes an additional agency on managing partners to disclose the new adventure.
c) Opportunity was essentially an extension and enlargement of the subject matter of the existing venture: questions arise if the venture is in a different place or new property, but this was just an extension.

11. Liability of Partners/Partnerships (see sections 305-307):

a) Partners are **<u>jointly and severally liable</u>** for the debts of the partnership (RUPA §306), but partnership assets must be exhausted before a partner's individual assets are reached (RUPA §307) "
   1) A person admitted into a P-ship is not personally liable for any p-ship obligation incurred before the person's admission as a partner. (§306(b))
b) A judgment against a partnership is not a Judgment against a partner (must also be a judgment against the partner) (RUPA §307)
c) **Partners are <u>liable to the partnership and/or other partners for breaches of their duties</u>**

12. Partnership property: §203

a) Property acquired by the partnership is property of the partnership and not the property of the partners individually (thus cannot be transferred by the partner individually)

b) When property is partnership property (§204)
   2) Presumed partnership property if purchased with partnership assets, notwithstanding name on the instrument
   3) Property is deemed partnership property if transferring instrument indicates that property acquired in the name of the partnership or partner's capacity as a partner in the partnership.
   4) Presumed not to be partnership property if the property is acquired in the name of one or more of the partners without an indication in the instrument transferring title to the property of the persons capacity as a partner or of the existence of the partnership and without the use of partnership assets, is presumed to be separate property, even if used for partnership purposes.

5) Usually the partner's intent controls as to whether the property belongs to the partnership or to one or more of the partners in individual capacities.

c) Partner not a co-owner of partnership property: §501

1) A partner is not a co-owner of partnership property and has nor interest which can be transferred either voluntarily or involuntarily. (The property is owned by the entity not the partners).

13. Partner's transferable interest in partnership: §502

a) The only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partners right to receive distributions. (Assignee does not get any right to management.) **The interest is personal property.** (The original partner remains responsible for obligations and management: transferee is not responsible to pay the obligation of the P-ship).

b) Transfer of the partners transferable interest: §503

1) (a) A transfer of a partner's interest in the partnership;
   a. Is permissible
   b. Does not itself cause the partner's disassociation or dissolution
   c. Does not entitle the transferee to participate in management of the partnership business.(people should be able to choose who they are in business with).
2) (b) Transferee has the right to receive;
   a. Distribution that transferee would otherwise be entitled
   b. Receive upon dissolution the net amount otherwise distributable to the transferor.
3) (d) Transferor retains the rights and duties of a partner other than the interest transferred (thus the transferor entitled to participate in management and remains personally liable for all partnership obligations).

c) Partner's transferable interest subject to **charging order: §504**

1) (a) A court having jurisdiction may charge the transferable interest of the judgment debtor to satisfy the judgment
2) (b) A charging order constitutes a lien on the judgment debtor's transferable interest in the partnership. The court may order foreclosure of the interest subject to the charging order at any time. The purchaser will have the rights of a transferee. (if the transferee is not going to be paid fast enough, the court will foreclose to get his money)
3) (c) The interest may be redeemed at any time before foreclosure.

d) Rapoport v. 55 Perry co.

1) G/R: Partner could assign the share of profits in the partnership, but such assignment did not allow the assignee to become an operating partner, taking part in management.
2) G/R: By agreement to become a full partner required unanimous consent of all existing partners.

14. Effect of the partnership agreement; nonwaivable provisions: §103

a) Except as otherwise noted in subdivision (b), relations among the partners and between the partners and the partnership are governed by the partnership agreement. To the extent that the partnership agreement does not provide, this act governs relations among the partners and between the partners and the partnership.

b) **The partnership agreement may not**;
   2) Unreasonably restrict the right to access to books and records
   3) Eliminate the duty of loyalty
   4) Unreasonably reduce duty of care
   5) Eliminate the obligation of good faith and fair dealing
      - 3-5 ensure fundamental core of the fiduciary relationship
   6) Vary power to disassociate as a partner
   9) Vary the law applicable to LLPs

d) **G/R**: RUPA with respect to the rights of the partners are merely default rules, subject to modification by the partners in the partnership agreement
   1) Exception: only rights listed in S103(b) are mandatory and cannot be waived or varied by agreement <u>beyond that authorized</u>.

15. Distributions in kind: §402

a) A partner has no right to receive, and may not be required to accept, a distribution in kind. (Must get cash and the net amount distributable to each partner).

16. Partner's right and duties with respect to information: §403

a) (b) Partner's agents or attorneys have right to access books and records

b) A partner's unlimited personal liability justifies an unqualified right of access to the partnership's books and records.
c) Only reasonable restrictions as to access are authorized, demand can only be denied if reasonable.

17. Capitalization of a partnership:

a) There is no requirement that a partnership be adequately capitalized
b) The partners as co-owners hold property contributed or acquired by the partnership
c) A partner may contribute his personal services as his capital contribution
d) Creditors of an individual can't attach the partnership's property to satisfy those individual debts

18. Dissolution/disassociation:

a) Rules for dissolution:
   1) Outside creditors
   2) Inside creditors
   3) Capital
   4) Profits

b) If the liabilities are greater than the assets then the partners contribute amount as share in losses/profits.

c) **Events causing partner's dissociation: §601**

A partner is dissociated (change in the relation of the partners caused by a partner ceasing to be associated) from a partnership upon the occurrence of any of the following events

1) Partnership having notice of the partner's express will to withdraw as a partner
2) **An event agreed to in the partnership agreement** as causing the partner's dissociation
3) Partner's expulsion pursuant to the partnership agreement
4) Partner's expulsion by the unanimous vote of the other partners if:
   a. It is unlawful to carry on the partnership business with that partner
   b. Transfer of all or substantially all of that partners transferable interest
   c. Others
5) The partner's expulsion by judicial determination because (also wrongful dissolution)
   a. Partner engaged in wrongful conduct that adversely and materially affected the partnership business
   b. Partner willfully and persistently committed a material breach of the partnership agreement
6) The partner's
   a. Becoming a debtor in bankruptcy
   b. Executing an assignment for the benefit of creditors

7) Partner an individual
   a. Partner death, appointment of guardian, and judicial determination of incapacity.

d) **§ 602: (a) every partner has the right to dissociate (withdraw) from the partnership at any time**, rightfully or wrongfully, by express will.

1) (c) Provides that a partner who wrongfully dissociates is liable to the partnership and to the pother partners for damages caused by the dissociation
2) (b) Wrongful dissociation: Dissociation by express provision of the partnership agreement; **Withdrawal of a partner by the partner's express will before the expiration of the partnership term. (will be subject to K damages).**

e) **Effect of the partner's dissociation: §603**

1) Partner no longer has the right to participate in management, duty of loyalty and duty of care terminates, unless partner participates in the winding up of the business
2) Comment: A partner's dissociation will always result in a buyout of the dissociated partner's interest or a dissolution and winding up of the business.

If there is a buyout, go to §701 (but look to 801 first)

f) **Purchase of dissociated partners interest: §701**

1) (a) If not winding up of the partnership business upon partner's dissociation, then partnership shall buy out dissociated partners interest. Buyout price to be determined by (b). §701 (c) provides that the buyout price under (b) be reduced by damages for the wrongful dissociation.
2) Comment: if there is no dissolution, the remaining partners have the right to continue the business and the dissociated partner has a right to be paid the value of his partnership interest.

19. Wind up: if there is a windup go to §801 (if it does not apply go to §701)

a) **Events causing dissolution and winding up of the partnership business: §801**

A partnership is dissolved, and the business must be wound up, only upon the occurrence of any of the following events

1) In a partnership at will has right to force liquidation
2) In a partnership for a definite term or particular undertaking can not be forced to be liquidated prematurely in violation of the partnership agreement
3) An event agreed to in the partnership agreement resulting in winding up
4) Event that makes the business unlawful

5) Judicial determination; I, ii, iii
6) On application by a transferee of a partner's transferable interest, a judicial determination that is equitable to wind up the business
7) Comment: Winding up means; selling partnership assets, paying p/s debts, and distributing the net balance, if any, to the partners in cash according to their interests. The p/s entity continues and the partners are associated in the winding up of the business until winding up is completed, when the winding up is completed the p/s entity terminates.

b) Items to put into the P-ship agreement concerning one partner leaving:
1) Usually interests bought by firm and not individual partners.
2) (b): almost always provide for the interest to be bought instead of just giving the option so a partners estate will get something if he dies.
3) Where $ comes from to buy interest: usually installments over a certain period
   a. Life insurance policy
   b. Retirement policy
4) Non-compete clause: Has to be reasonable in time and area necessary to protect legitimate interests, not harmful to the public and not unduly burdensome.

c) Partnership continues after dissolution: §802
1) (a) Subject to (b), a partnership continues after dissolution only for the purpose of winding up the business. The p/s is terminated when the winding up of its business is completed.
2) (b) Any time after the dissolution of the p/s and before the winding up is completed, all of the partners, including any dissociated partner other than wrongfully dissociating partner, may waive the right to have the p/s's business wound up and the p/s terminated.

d) Right to wind up the p/s business: §803
e) Partner's power to bind the p/s after dissolution: §804
f) Settlement of accounts and contributions among partners: §807

g) Dreifuerst v. Dreifuerst: Brothers with feed mills
1) Holding: a partnership agreement can require an n kind distribution, however, if no such agreement is present then each partner has the right to distribution in cash upon lawful dissolution
2) **Partnership at will**: is a p/s that has no definite term or particular undertaking and can rightfully be dissolved by the express will of any partner.
3) **Winding up**: involves reducing the assets to cash to pay creditors and distribute to the partners the value of their respective interests
4) **Lawful dissolution**: (dissolution not in contravention with the p/s agreement) gives each partner the right to have the business liquidated and his share of the surpluss paid in cash

5) Rinke **exceptions**: Limited cases where the court has held far an in-kind distribution without the express agreement of the partners:
   a. No creditors to be paid from the proceeds
   b. No one rather than the partners would be interested in the assets of the business; and
   c. An in kind distribution was fair to all partners.

g) Page v. page: (laundry service, new air force base, business starts making a profit, one partner wanted all of the profit)
1) Holding: Partner at will is not bound to remain in a partnership regardless of whether the business is profitable or unprofitable
2) A partner may not by use of adverse pressure "freeze out" a copartner and appropriate the business for own use.

3) A partner may not dissolve a p/s to gain the benefits of the business for himself, unless he fully compensates his copartner for his share of the prospective business opportunity. In this regard his fiduciary duties are at least as great as those of a shareholder of a corp.
4) Freeze out: certain people in business push them out by using legal technicalities, can not deprive of any benefits but share equally in the losses.
5) Wrongful dissolution: If the partner acted in bad faith and violated his fiduciary duty by attempting to appropriate to his own use the new prosperity of the p/s without adequate compensation to his copartner.
6) Fiduciaries: Must act in good faith and deal fairly with each other and refrain from injuring the right of another party to receive the benefits of an agreement or relationship.

20. Rightful dissociation vs. wrongful dissociation

a) Drasher v. Sorenson:
b) Potter v. brown
    1) Grounds for dissolution deemed wrongful: fraudulaent or dishonest practice; exclusion of one partner by another from the mangement of the p/s business or possession of p/s property; Going and prosperous business will not be dissolved merely because of friction among partners.
c) Ferrick v. Barry
    1) Wrongful dissolution if atmosphere of non-cooperation, suspicion, and distrust and enterprise organized for equality in proprietorship and management cannot be expected to realize its aims under such circumstances

d) Croisant v. Watrud (Accountant paying money to husband and self, handled p's account when moved to Cal)
    1) G/R: p/s is bound by the partners breach of trust
    2) Fact that money gong to p/s, reasonable belief that extention of previos duties

21. LLP §306(c)

a) An obligation of a p/s incurred while the p/s is a limited liability p/s, whether arising in K. tort, or otherwise, is solely the obligation of the p/s. A partner is not personally liable, directly or indirectly, by way of contribution or other wise, for such a p/s obligation solely y reason of being or so acting as a partner.

22. Dissolution and dissociation nutshell:

<u>Disassociation:</u>

A partner can disassociate at any time Such disassociation is **<u>generally rightful unless</u>** it is

- Breach of express agreement
- Is an expulsion by judicial order (e g , breach of duty) (RUPA §601)

Upon disassociation, can have

- **<u>mandatory buyout</u>** at *fair* value (book value, appraisal, in the agreement), **or**
- winding up (the process of settling the partnership's affairs), liquidation, distribution of assets to the partners, and termination of the partnership entity

<u>Dissolution:</u> A partnership is **<u>dissolved</u>** and it business **<u>must be wound up</u>** when:

- **In a <u>partnership at will.</u>** a partner notifies others of his express will to withdraw from the partnership
- **In a <u>partnership for a definite period or particular undertaking.</u> +**
    - death of a partner + the express will of half of the partners
    - the express will of all partners
    - the expiration of the term or completion of the undertaking
    - an event agreed to in the agreement occurs
    - illegal activities
    - judicial determination (e.g., breach of agreement, incapable of continuing)

Upon dissolution, you have:
- winding up (the process of settling the partnership's affairs), liquidation, distribution of assets to the partners, and termination of the partnership entity.

<u>Martin v. Pevton (pg. 31)</u>
F: P engaged D m negotiations to loan him money for his business At the same time, P offered D a share in the business, but D said "no." The final "loan" arrangement called for D to receive profits as payment and to have decision-making power. **H:** This was a close call but D was held to be a lender, not be a partner

<u>Lupien v. Malsbenden (pg. *35}*</u>
H: Intent is irrelevant in determining whether a partnership was formed. Here, the court determined on the facts of the relationship that it was a partnership. The key was the $85,000 contributed by M that required no interest, was paid back out of profits, and that gave M participation in the control of the business.

<u>Summers v. Doolev (pg. 43)</u>
H: Ordinary matters connected with a partnership are to be decided by a majority vote and the D couldn't be bound to the Ps hiring of a new employee because it was not approved by a majority of the partners (only by the P)

<u>Rapoport v. 55 Perry Co. (pg. 65)</u>
F: P and D entered 50/50 partnership and P tried to transfer 10 percent interest to kids D refused to consent **H:** The consent of all partners is required to admit or change partners. A partner may assign his interest, but this means the assignee is entitled to profits only, and is excluded from management or access to information

<u>Meinhard v. Salmon fog. 72)</u>
F: P was in joint venture with D regarding operation of a hotel When their lease on the hotel ended, D privately
negotiated a much bigger lease in a bigger building, never told P about it, and refused to acknowledge P as a partner
m that venture
D: Partners owe the duty of finest loyalty to each other (fiduciary), including the duty to disclose material
information

Dreifuerst v. Dreifuerst (pg. 79)
F: Brothers had a partnership in two feed mills but no partnership agreement Ps decided they w anted dissolution and winddup but brothers couldn't agree on winding up (Ds wanted a sale, Ps wanted in-kind) **H:** In the absence of an agreement to the contrary, a rightful dissolution is to result in sale of assets and distribution to partners.

Page v. Page (pg. 83)
F: P and D had oral partnership agreement in linen business P wished to terminate, calling it at will D claimed it was for a term and, alternatively, that P was acting in bad faith

H: Partnership may be dissolved by the express will of any partner when no definite term or particular undertaking is specified

Rosenfeld v. Cohen (pg. 87)
H: Partnership at will cannot be dissolved in bad faith (unclean hands)

Drashner v. Sorenson fpg. 94)
F: P and D were partners in a profitable business but sought dissolution (contrary to their partnership agreement) **H:** A partner who wrongfully causes dissolution is not entitled to the goodwill of the partnership m calculating his interest.

CORPORATE FORM

1. Promoters and pre-incorporation transactions:

a) **General Rule** A promoter is personally liable for a K made when the corporation is not yet in existence, unless expressly agreed otherwise or the contracting party knew the corporation was not in existence but agreed to look solely to it anyhow Once the corporation is formed, the corporation is liable as well if it ratifies, adopts, or acquiesces the contract, and the promoter remains liable unless there is a novation by creditor to release the promoter from liability. (Goodman v DDS)
  1) Rational: "strong inference that a person intends to make a contract with an existing person."

b) **Promoters and non-liability:** To ensure that you won't be liable as a promoter
  1) Put it expressly in the contract that the promoter is not liable
  2) Don't enter contracts as a promoter but, instead, wait until the incorporation is complete

c) **Arguments for holding promoters liable:**
  1) Gives the impression he's acting as an agent
  2) Breach of implied warranty
  3) Misrepresents that a corporation was being formed
  4) Misrepresents that a corporation exists

d) **Goodman v. Darden**: The mere signing of a contract with a corp "in formation" does not suffice to show an agreement to look solely to the corp. Look to the party's intent, silence is not acceptance.

e) **Quaker hill:** Exception to the general rule of promoter liability. If the k is made on behalf of the corp, and the other party agrees to look to the corp, and not to the promoters for payment, the promoter incurs no personal liability.

f) **Company stores**: Different jurisdiction; promoters liability determined by looking at the intent of the parties at the time of the K.

2. Corporation liability for promoters K pre-incorporation:

a) Ratification: from date of K (affects SOF)

b) Adoption: Not retroactive, only from the date of adoption (affects SOF), may be express adoption by board, or may be inferred from acts or acquiescence by accepting benefits of the K with knowledge of the terms, but will not relieve promoters of liability absent a novation. The corp and the promoter are jointly liable for breach of the pre-incorporation agreement unless express agreement otherwise or subsequent novation (Illinois controls).

3. De Jure corporation: A corporation which has strictly complied with all of the mandatory provisions for incorporation cannot be attacked by any party (even the state). For de jure status, unless a delayed effective date is specified, the corporate existence begins when the articles are filed (RMBCA § 2.03)

a) RMBCA §2.03 comment: if the articles of incorporation have not been filed, S2.04 generally imposes personal liability on all persons who prematurely act as or on behalf of a corp, knowing the article have not been filed.

b) RMBCA § 2.04: All person purporting to act on behalf of the corp, knowing there was no incorporation under this act, are jointly and severally liable for all liabilities created while so acting.

3. De facto corporations:

a) **General Rule** An organization that has been defectively incorporated or fallen short of full compliance with the incorporation statutes is considered a corporation for purposes of dealing with 3rd parties (and therefore enjoys limited liability) if:

1) An incorporation statute was in place
2) It made a colorable attempt to incorporate (act of executing a certificate of incorporation, a bona fide effort to file it, and dealings with the P in the name of the corp fully satisfy the requisite proof of existence of a de facto corp (Cantor v. Sunshine)
3) There was actual use or enjoyment of corporate privileges
4) Sometime there is a fourth element added, good faith of corp or associates.

b) **Exception** Some jurisdictions may not recognize de facto corporations (Timberhne v Davenport)

1) Timberline: "all persons who assume to actas a corp without the authority of a certificate of incorporation issued by the corp commissioner, shall be jointly and severally liable for all debts and liabilities incured or arising thereof."
2) Cranson: Attorney goofed up and did not file with the state but filed in the filing cabinet.

4. Shareholder liability: Shareholders risk is limited to his investment

a) **RMBCA § 6.22 liability of shareholders**

1) (a) a purchaser from a corporation of its own shares is not liable to the corp or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued (§6.21) or specified in the subscription agreement (6.20)
2) (b) Unless otherwise provided in the articles of incorporation, a shareholder of a corp is not personally liable for the acts or debts of the corp except that he may become personally liable by reason of his own conduct.

5. Estoppel:

General Rule A 3rd party that deals with a de facto corporation as if it were a corporation is estopped from asserting that it is not (Cranson v IBM)

8. Ultra Vires:

a) **Old Rule:** Transactions beyond the purposes or powers of a corporation are unenforceable against it

b) **Modern View** Courts may set aside ultra vires acts where the result would otherwise be inequitable, but there is a very slight chance of ever succeeding under this doctrine (RMBCA §3 04(a)) the validity of the corp action may not be challenged on the ground that the corp lacks or lacked the power to act.

1) Exception: A corp's power to act may be challenged by a shareholder, directly or derivatively or attorney general."

2) Courts are hostile to ultra vires: Ultra vires may not be invoked as a sword in support of a cause of action any more than it can be utilized as a defense. The company may get a SH to bring the suit to get out of the K (Kings hiway).
3) RMBCA §3.01: Unless corp specifies a purpose in the articles, the corp can engage in any lawful business; very hard to find excluding powers

9. Interests other than shareholder interests

a) **G/R: the board's primary responsibility is to the shareholders;**
b) **Corporate social responsibility:** interests other than the maximization of the shareholders wealth
   1) **Dodge v. ford motor company**: Exceptional because enforced a declaration of dividends
      a. Ford owned 58% of ford's stock and controlled the board; the two dodge brothers owned 10% of the stock. Any regular dividends of 1.2 mil and special dividends of 41 mil. In 1916, ford declared it to be settled policy of the company not to pay in the future any special dividends but to put back into the business for the furture all of the earnings of the company. Ford wanted to hire more men to build up homes and lives. Ford has a surplus of 112 mil.
   2) **AP Smith v. Barlow: Give money to Princeton**
      a. Common law allows donation, do not give away everything, give away a reasonable and incidental amount. Share incidentally with charities. Shareholders argued they should have the money to give away to the charities of their choice.
      b. Held: Maintenance of community funds and charitable, philanthropic instrumentalities conducive to public welfare.

   3) **§ 3.02 (13) powers to make donations** for the public welfare or for charitable, scientific, or educational purposes.
      a. (12) Power to pay pension and establish pension plans.. profit sharing plans, share bonus plans, share option plans and benefit incentive plans for any or all of current/former directors, officers, employees and agents.
      b. (14) powers to transaction any lawful business that will aid in govt policy
      c. (15) To make payments or donations, or do any act not inconsistent with law, that furthers the business and affairs of the corp.

   4) **ALI §2.01** (a) A corp should have as its objective the conduct of business activities with a view to enhancing corporate profit and SH gain:
      a. (b)(1) Cannot violate law, board responsible
      b. (b)(2) Ethical considerations (does someone in the corp have a connection with the charity)
      c. (b)(3) May **devote a reasonable amount** of resources to public welfare, humanitarian, educational, and philanthropic purposes.(courts will emphasize reasonable amount).

10. Takeover and tender offers:

a) G/R: Corp directors have a fiduciary duty to act in the best interest of the corp's stockholders

b) Tender offer: Shareholder may be excited about the prospect but the director maybe worried about job security.

c) **ALI §6.02**: Action of directors that has the foreseeable effect of blocking unsolicited tender offers:

   1) (b)(1) The board may take into account all factor relevant to the best interests of the corp and SH, including among other things, questions of legality and whether the offer if successful would threaten the corps essential economic prospectus and

   2) (b)(2) The board may in addition to analysis under (b)(1) have regard for interests or groups (other than SH, employees, customers, community) with respect to which the corp has a legitimate concern if to do so would not significantly disfavor the long term interest of the SH.

d) NY law §717: does not require the SH be primary but considered equal

   1) A director shall be entitled to consider without limitation, current employees, retired, customers and creditors.

e) Delaware case law; boards first duty is to the SH

   1) 2nd duty is to balance the interests of other constituencies

   2) Caveat: Credit Lyonnais bank: "at least where the corp is operating in the vicinity of insolvency a board is not merely the agent of the residual risk bearers, but owes a duty to the corp enterprise." If insolvent then creditors may become primary. If insolvent look for what is best for the entire enterprise including creditors.

CORPORATE STRUCTURE

1. Definition:

An organization for profit incorporated under the applicable statute. Note, the corporation's affairs are governed by the law of the state they incorporate in, even if the state has little or no other contract there (e.g., Delaware).

2. Characteristics:

a) **<u>Transferabilitv</u> -** ownership interests in corporations (stock) are freely transferable, though this may be altered by agreement.

b) **<u>Liability</u>** - shareholders are not personally liable for corporate obligations and are said to have limited liability. Managers also have limited liability, assuming their actions are on the corporation's behalf and with its authority.

c) **<u>Continuity of existance</u>** - the legal existence of a corporation is perpetual, unless the articles of incorporation say otherwise (RMBCA §3.02).

d) **<u>Centralized Management</u>** - a corporation is normally managed by a board of directors, and shareholders, other than electing directors, have no management authority. Officers (e.g., president, vice president, treasurer, secretary) act as agents for the corporation, while directors are not agents.

e) **<u>Entity status</u>** - corporations are entities and, as such, can sue and be sued.

f) **<u>Taxation</u>** - corporations are taxed as entities such that a corporation's income is taxed to the corporation, not the shareholders. Dividends (after tax income distributed to shareholders) are taxed to the shareholders.

g) **<u>Bylaws</u>** - may contain any provision for managing the business that is not inconsistent with the articles of incorporation (RMBCA §2.06).

3. Formation (how a corporation is formed is very statute specific and, though the RMBCA serves as the basis for many state's statutes, Delaware have favorable incorporation laws and a rich case law history on corporate law):

a) **<u>Incorporators:</u>** One or more persons may act as the incorporator(s) by delivering the articles of incorporation to the secretary of state (RMBCA §2.01).

b) **<u>Articles of Incorporation</u>** (RMBCA §2.02):

1) <u>Articles must set forth:</u>
   a. Corporate Name: (§4.01: must contain "corporation, company or limited" or abbreviation
   b. Number of shares the corp. is authorized to issue
   c. Street address of corporations initial registered office and the name of its initial registered agent
      - See RMBCA § 5.01: Registered office and agent: (1) a registered office that may be the same as any of its places of business and (2) a registered agent who

may be an individual who resides in this state and whose business office is identical with the registered office.

d. Name and address of each incorporator.

2) Articles May set forth:

a. Names and addresses of initial directors
b. Provisions not inconsistent with law regarding:
    - Purposes: (§3.01 purposes: (a) veery corp incorporated under this act has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles
    - (b) Management
    - Powers of the corp, its board and shareholders
    - Par value for shares or classes of shares
    - Provisions regarding personal liability of shareholders
c. Elimination or limiting the liability of directors to the corporation or shareholders except:
    - The amount of a financial benefit received but not entitled
    - An intentional infliction of harm on the corp or shareholders
    - A violation of §8.33
    - An intentional violation of criminal law
d. A provision permitting or making obligatory indemnification of a director for liability to any person for action taken

2) RMBCA §2.03, 2.04 (see dejure corporation)

c) **Organizational Meeting:** If initial directors are named in the articles of incorporation, they must meet to complete the organization of the corporation by appointing officers, adopting bylaws, and carrying on any other necessary business. If initial directors are not named, the incorporators must meet and elect directors.

d) **Bylaws:** (secondary to certificate of incorporation)

1) (a) The incorporators or board of directors of a corporation shall adopt bylaws for the corp
2) (b) The bylaws of the corp may contain any provision for managing the business and regulating the affairs of the corp that is not inconsistent with law or the articles of incorporation (§ 2.06)

e) **Purposes:** Every corporation incorporated under the RMBCA has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation (RMBCA §3.01). Note that corporations, if they do define their purpose beyond this, usually do so very broadly. Also note that a corporation's primary purpose is to make money for its shareholders, though this isn't the only purpose (e.g., can make donations under RMBCA §3.02(13)).

f) **Corporate Powers:** Unless the articles provided otherwise, a corporation has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs (see RMBCA §3.02 on pg. 503 for a list of some of the powers).

g) **<u>Internal Power Structure and Operation</u>:** Shareholders elect the board, board elects officers, officers handle the day to day operations.

4. <u>Board of Directors</u>

a) *<u>Powers:</u>* Can exercise any and all corporate powers, subject to any limitations in the articles of incorporation (RMBCA §8.01).

b) *<u>Meetings:</u>* May hold regular or special meetings in or out of the state and may be held through any communication via which all directors can simultaneously hear (RMBCA §8.20)

- Regular meetings don't require notice (RMBCA §8.22) "   Special meetings require at least two days notice, though notice need not detail the purpose for the meeting (RMBCA §8.22)

c) *<u>Action without Meeting:</u>* Unless the articles of incorporation say otherwise, action may be taken by the board without a meeting as long as there is unanimous written approval (RMBCA §8.21).

d) *<u>Committees:</u>* Unless the articles of incorporation or bylaws say otherwise, directors may create committees, as long as they have at least two members (RMBCA §8.25)

e) *<u>Quorum and Voting:</u>* Unless the articles of incorporation say otherwise, a quorum is a majority of directors; the articles or bylaws can set quorum no lower than 1/3 of the directors; articles can require unanimous approval by the directors; approval is a majority of those present (RMBCA §8.24).

f) *<u>Committees:</u>* Unless the articles or bylaws say otherwise, directors may create committees, as long as they have at least two members (§ 8.25)

g) *<u>Removal of Directors:</u>*

1) **<u>Shareholders:</u>** Can remove directors with or without cause, unless the articles of incorporation provide that directors may only be removed for cause (RMBCA §8.08). There are special provisions regarding groups of shareholders, cumulative voting (see pg. 567).
2) **<u>Judiciary:</u>** Can remove if corporation or 10 percent of shares commence action and court finds director engaged in improper conduct (RMBCA §8.09)

5. <u>Officers:</u> who are employees are also agents of the corporation and their duties may be set forth in the articles of incorporation or bylaws.

a) **Required officers**: a corp has the officers described in its bylaws or appointed by the board in accordance with the bylaws

b) **More than one office**: the same individual may simultaneously hold more than one office in a corp (thus could vote more than once)(§ 8.40)

c) **Duties**: Each officer shall perform duties set forth in by laws, duties described by the board (§ 8.41)

d) **Standard of conduct**: BJR (§8.42)

e) **Resignation and removal of officers**: (§8.43)

f) **Contract rights of officers** (§8.44)

6. **Shareholders**: (§§ 7.01, .02,.03,.04,.05,.06,.07)

a) **Annual meeting**: Failure to hold an annual meeting at the time stated in or fixed in accordance with a corp's bylaws does not affect the validity of the corporate action (§7.01)
b) **Record date**: If bylaws do not fix or provide for fixing a record date, the board may fix a future date as the record date (§ 7.07)
c) **Shareholder's list for meeting**: after fixing a record date, a corp shall prepare a alphabetical list of the names of all its shareholders who are entitled notice of a shareholders meeting (§7.20)
d) **Proxy**: Is simply an agent used in corporate law for voting, agency relationship (§7.22)
e) **Quorum and voting requirements**: Unless the articles of incorporation or this act provide other wise, a majority of the voted entitled to be cast on the matter by the voting group constitutes a quorum of that voting group for action in that matter (§7.25)
f) **Greater than quorum and voting requirements**: articles of incorporation may provide for a greater quorum or voting requirement for shareholders than is provided for by this act. An amendment to the articles that adds, changes or deletes a greater quorum or voting requirement must meet the same quorum requirements and be adopted by the same vote and voting groups required to take action under the quorum and voting requirements then in effect or proposed to be adopted whichever is greater (§7.27)

7. Financing a corporation/stock and notes:

a) **Common stock**: Ultimate or residual ownership. The equity interest in the corporation (i.e., the liquid value of what is left over after all other obligations are satisfied).
   1) Voting power, dividends, get paid last at liquidation.
   2) These bear the greatest chance of risk but also the greatest profits.
   3) Typically par value $1

b) **Preferred stock:** First priority for dividends and upon liquidation (after creditors)
   1) Entitled to dividends before common stockholders
   2) No voting rights unless dividends are in arrears for a substantial period of time.

c) **Classes of Stocks:** Can be different classes of stocks with different rights (e.g., non-voting shares) (RMBCA §6.01)
   1) Can only have common stock to qualify as an S-corp.

d) **Corporate debt: Bonds, Debentures and Notes:** Long-term promissory notes whereby the corporation "borrows" money from investors who expect to make a profit off of the loan (i.e., interest)
   1) Interest is deductible for the corp., dividends are not (dividends give rise to double taxation.
   2) These outside creditors get paid back first upon liquidation
   3) Convertibles; option to change the debt into stock

e) Public offerings: Fed. Regulation
   1) Requires only disclosure: as long as the people are told the truth, they have to judge the merit themselves.
   2) Requires corps to register with the SEC before they can sell securities publicly. The primary market is likely to be fraudulent because of the unproven companies and pressure tactics: secondary market is still protected by the requirements of continuous disclosure.
   3) Test as when it's a public offering
      a. Are the buyers in need of protection or can they fend for themselves
      b. Sale to top execs is the only thing that would not qualify
   4) Exceptions to rule:
      a. Intra-state: only to persons within a single state (this is very difficult to comply

5) Investment contracts are securities. Test: (Smith v. Gross: worms)
    a. The investment of money
    b. A common enterprise
    c. With the profits coming solely from the efforts of others.
    d. Problem: Defrauders just have to give the investors something to do. (alternative test: If the other parties efforts are significant.

8. Criminal Liability

The monitoring functions of boards of directors has been significantly emphasized because corporations can be found guilty of a crime by imputing to the corporations the acts and intent of agents acting within the scope of their authority. Determinations of corporate criminal liability have become increasingly common (e.g., antitrust, environmental).

a) **<u>Sentencing guidelines:</u>** under these corporate fines are levied according to the determination of four elements:

1) *Offense level:* the nature of the crime
2) *Base fine:* the base fine for the crime committed
3) *Culpability score:* various aggravating and mitigating factors (e.g., implementing a compliance program)
4) *Fine range:* determined by factoring the base fine with the culpability score

b) **<u>Effective compliance programs:</u>**

1) Standards and procedures for employees
2) Top executives responsible for the standards and procedures for employees
3) Due care in delegating authority
4) Effectively communication of standards
5) Effective monitoring and auditing systems
6) Appropriate disciplinary measures
7) Appropriate responses to detection and steps to prevent additional violations

c) Duty to monitor: Caremark (example of Delaware striking a balance)

1) Board must exercise good faith judgment that the corps information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations.

d) Duty to monitor: Graham vs. Allis Chalmers

1) Board must assure itself that there are policy directives and compliance procedures designed to prevent breaches of the law. Code of ethical conduct for its employees, procedures to ensure that the employees read, understand, and keep current on the code, and procedures to satisfy the due diligence requirements.
2) Incentive: get reduced sentencing if compliance programs are initiated, fed sentencing guidelines are powerful incentives to corps to put compliance programs in place and report prompt violation of the law.

CLOSE CORPORATIONS

1. Definition (must use special form)(§7.31, 7.32, 7.27, 8.24):

a) A close corporation, which bears a striking resemblance to a partnership, is a corporation with:
   1) A small number of shareholders
   2) No ready market for their corporate stock
   3) A substantial number of shareholders participating in management, direction, and operation of the corporation (Donahue v. Rodd).
   4) Transferability of shares is often limited by contract

2. Fiduciary duties because analogous with P/S

a) "Owe a punctilio of honor", all SH in a close corp owe each other substantially the same fiduciary duty that partner owe each other. Must discharge duties in conformity with strict good faith standard. May not act out of avarice, or expediency of self-interest.

b) 2 prong test for breach of strict duty of good faith:
   1) The burden of proof is on the controlling SH to show there was a legitimate business purpose (for freeze out)
   2) Minority: other can show less harmful opportunity

c) If the controlling group purchases shares, That group must give equal opportunity to the minority shares at the same price.
d) Problems arise when: have a duty of good faith in K, and the majority has a fiduciary duty to the minority.
e) Employee at will: Terminate for almost any reason; Courts have been reluctant to hold otherwise just because the person is a SH and is owed a fiduciary.
f) Ingle case: Employee looked like a partner, owner advanced personal funds, guaranteed bank loans, important person on the premises, but refused to grant exception to the employee at will doctrine just because he owned shares. In close corps, G/R is strict standards of good faith and loyalty.
g) Courts look to active role in bargaining and negotiations. However, special situation if have a fiduciary duty to disclose material information like valuation of shares likely to increase. Material information: substantial likelihood that a reasonable investor would put importance on the decision."
   1.

3. Other Characteristics:

a) Becoming increasingly contractual in nature and **RMBCA** §7.32 allows you to set up such a contract and, therefore, your corporation (called a shareholder agreements) in ways that supercede most statutory fallbacks (note, without a separate K or separate state statutes, a close corporation would be obligated to comply with the statutes for corporations
b) Absent contracts or special close corporation statutes, close corporations are often subject to the traditional statutory norms in place for corporations (see the **CORPORATE STRUCTURE** section above)
c) Many states have created statutes specifically for close corporations (corporations

generally must elect such status or opt into being a close corporation)

4. Examples of what you can agree to in Shareholder Agreements under RMBCA §7.32

a) Eliminate the board of directors or restrict its powers
b) Govern authorization of distributions (doesn't have to be based on shares)
c) Transfer to one or more shareholders all authority and corporate power to manage
d) Require dissolution upon the request of a shareholder or upon the occurrence of an event or contingency

5. Duties:

a) Shareholders, including minority shareholders, owe a fiduciary duty of the utmost good faith and loyalty to the other shareholders (substantially the same duties as those owed in a partnership, **see** #9 **in PARNTERSHIP).**

6. Proxies, Voting Agreements, Voting Trusts (these are generally legal as long as they do not affect the rights of creditors)

a) Proxy: A shareholder may appoint a proxy (agent) to vote his shares, and the proxy is revocable unless the proxy appointment form states that it is irrevocable or the proxy is coupled with an interest (RMBCA §7.22 (also has examples - pg. 537)).

b) Voting agreement: Two or more shareholders may enter an agreement providing for the manner in which they will vote (RMBCA §7.31). Note, you may not enter an agreement directing how directors will vote or how you will vote as a director, though you may enter agreements regarding who you will vote for as directors (McOuade v. Stoneham).

1) Exception to limiting directors power with the closely held corp: RMBCA §7.32: shareholder agreements: set forth in bylaws or articles and be approved by all SH. Does not apply if there are public SH at the time of the agreement.

c) Voting trust: Shareholders may confer on a trustee the right to vote or otherwise act for them. The trust is set up by transferring legal title of the shares to the trustee but retaining record title for the shareholder (such that he can still receive dividends). Voting trusts are valid for not more than ten years (you can contract for less) and the legal title reverts back to the shareholder upon expiration of the agreement. (7.30).

d) Purposes*:*

1) Protecting creditors: creditors can become trustees and protect their interests, but may run into problems as the result of a fiduciary relationship that results
2) Management: to ensure professional management (especially if you are worried your beneficiaries aren't suitable for purposes of voting the shares they inherit)
3) Control: shareholders may preserve control if it is a majority that all enters the trust

7. Transferability of shares:

- **a) Equal opportunity doctrine**: Can not freeze out the minority to keep them from selling their shares. Planning can prevent this problem.
- **b)** Reasonable restrictions against the transferability of shares in a close corporation are valid and enforceable.
  1) **<u>First refusals</u>** - Prohibits sale unless the stock has first been offered to the corporation, other shareholders, or both, on the terms offered by a 3rd party. *Generally upheld*
  2) **<u>First options</u>** - Prohibit a transfer of stock unless the shares have first been offered to the corporation, the other shareholders, or both, at a fixed price under the terms of the option. *Generally upheld*
  3) **<u>Consent restraints</u>** - Prohibit a transfer of stock w/out the permission of the corporation. *Controversial and often strictly construed. A restriction will be applied only to those transfers to which it specifically covers; restraints on alienation interpreted strictly.*
  4) **Mandatory** buy-back provisions - the repurchase of the stocks by the corporation is mandatory at a certain price (can be determined in many ways)

- **c) Pricing of the shares** under the first option, repurchase, or buy-sell agreements can be done by:
  1) Book value (assets over liabilities)
  2) By agreement at the time the shares were given (i.e., in a contract or agreement)
  3) Fixed based on capitalized earnings
  4) By agreement subject to periodic revision*
  5) Appraisal at time to be repurchased

7. Dissolution:

- **a) Voluntary dissolution:**
  1) Before corporation really gets started (RMBCA § 14.01)
  2) By an existing corporation (RMBCA § 14.02)
  3) Revoking dissolution (RMBCA § 14.04)

- **b) <u>Judicial dissolution if:</u>**
  1) Deadlocked directors (perpetual, and courts are very reluctant to do this)
  2) Illegal, oppressive, or fraudulent actions by directors
     a. **<u>Oppression</u>** is defined as majority conduct that substantially defeats the objective reasonable expectations of the minority (e.g., freeze out) <u>(Kemp v. Beatley).</u>
  3) Shareholder deadlock (courts, again, are very reluctant to do this) (RMBCA § 14.30)

c) Note **courts** will often give the majority the **option of a mandatory buyout** at fair market value to avoid dissolution (RMBCA §14.34)

1) The Court will determine fair value
2) Minority discounts and lack of marketability discounts are not applicable to a mandatory buyout

8. Provisional directors/receivers/custodians/arbitration/mediation

a) Courts may order, or agreements may call for, the appointment of receivers, custodians, or provisional directors. Agreements may also call for mediation or arbitration.

1) **Receivers:** Manage the affairs as the corporation is winding up
2) **Custodian:** Manage the affairs when the corporation is incapable
3) **Provisional director:** Break deadlocks by acting as an additional director
4) **Mediation:** Someone goes back and forth to try to solve disagreements
5) **Arbitration:** An arbitrator decides who is right and who is wrong. Arbitrator's decisions usually stand and courts are very reluctant to review them. **(RMBCA §7.32)**

INSIDER TRADING

1. Common Law:

Directors and officers owe no duty of disclosure to present or prospective shareholders regarding inside information <u>(Goodwin v. Agassiz).</u> Note though, that as time went on the exceptions to this rule began swallowing it (e.g., fraud, special facts).

2. SEC §10(b) and Rule lOb-5 (pg. 1358): (Scienter or gross negligence)

a) **<u>lOb-5 Generally:</u>**

1) Federal law prohibits insiders and those in trust or fiduciary relationships from using "inside information" to purchase or sell the stock of a corporation. Policy: There is an inherent unfairness of a person taking advantage of information not available to others.

b) **<u>Who can bring suit under lOb-5:</u>**

1) SEC
2) Individuals <u>(Kardon v. National Gypsum)</u>
3) Shareholders in derivative suit (even if the company is not directly harmed, it may be harmed indirectly (e.g., reputation).
4) The duty to disclose arises from a fiduciary relationship: if the party does not have a fiduciary relationship with the P, there is no duty.

c) **<u>lOb-5 Rule regarding insider trading:</u>**

1) If a person 1) has **material**, non-public information and 2) it would be inherently unfair for him to take advantage of that information in a transaction, he must either disclose the information or forego the transaction <u>(In the Matter of Cady. Roberts, & Co.)</u>
2) *Material:* Whether a reasonable man would attach importance in determining his choice of action in the transaction in question. This depends on a balancing of the probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity (SEC v. Texas Gulf).
    a. Look for a change in the behavior of the people after receiving the information
    b. Also the general probability of the information leading to action (experts testify)
3) The party can act when the information is effectively disclosed in a manner to ensure its availability to the investing public.

d) Other rules with 10B-5

1) Cannot be a P under 10B-5 if you are not a purchaser or a seller of a security (the security in question.
2) When people within the organization do not have to abstain from acting on the information before disclosure
    a. Only have to abstain in those exceptional situations that are reasonably certain to have a substantial effect on the market price.
    b. Do not have to disclose analysis of basic facts.
2) Intentional misconduct is required, negligence is not enough (there has to be manipulation or deception)
3) This leaves open the question of whether reckless misconduct is enough.
4) Note the mail fraud statute: very broad if 10B-5 can't reach you.

e) **Rule for fraud:**
   1) It is unlawful to make untrue statements (misrepresentation) or to defraud an individual in a transaction involving securities.

f) **Tipper and tippee:**
   1) Tipper (person who gives information) and tippee (person who receives information) can both be liable, even if the tippee is not an insider.
   2) There is a duty the tippee to disclose: this obligation arises from his role as a participant after the fact in the insiders breach of duty. He has to disclose or abstain.

3. Securities Act of 1933:

a) You **can't** sell unregistered securities. Unregistered securities are defined as investment contracts (.e.g., notes, stocks, bonds, and debentures).

4. Perlman v. Feldman: potential copper, started buying stock, gave misleading announcement

PIERCING THE CORPORATE VEIL/DISREGARDING THE CORPORATE ENTITY

1. **Definition:** When creditors are unable to collect a debt from an insolvent corporation, they may seek payment from individuals who are claiming the protection of the corporate veil (which provides for limited liability).
   a) Policy: Remedy in equity that is heavily permeated with notions of fairness and justice, invoked to prevent fraud or to achieve equity.
   b) G/R: courts are reluctant to pierce

2. **Considerations:**
   a) State statutes
   b) Case law
   c) Choice of law
   d) Generally, courts are reluctant to pierce

3. **ANALYSIS**
   a) Acknowledge other tests, describe 2 part and instrumentality test, use factor analysis and describe discretion of court in weighing factors and determining what would be fair and equitable
   b) Determine factors used in your jurisdiction
   c) Analyze the factors
   d) Acknowledge other jurisdictions use other factors that may be relevant in yours
   e) Determine who can be liable
   f) Establish Causation
   g) Discuss policy reasons and implications

4. **FORMULAS/*TESTS:*** **Formulas states** (provide courts with considerable latitude but little concrete guidance): G/R: Facts and circumstances depending on the individual equities of each case make a meaningful test difficult to formulate.

   a) *Two* prong *test:*
      1) unity of interest and ownership such that separate personalities of corporation and individual no longer exist; and
      2) adherence to the fiction of separate existences who sanction a fraud or injustice

   b) Instrumentality *test/rule* (all three elements must exist):
      1) Control - complete domination over finances, policy, and business practice regarding the transaction so that the corporate entity as to this transaction had at the time no separate mind, will, or existence of its own.
      2) Use of Control to Commit fraud or Wrongdoing, to perpetuate the violation of a statutory or other positive legal duty or a dishonest or unjust act in contravention of the P's legal rights.
      3) The control and breach must have been the proximate cause of the injury.

5. ***FACTORS ANALYSIS:*** **G/R:** Courts employ a balancing analysis to prevent fraud or to achieve equity depending on the circumstance of each case.
   a) Sometime single factors like fraud or inadequate capitalization are enough, but most jurisdictions need a combination of factors.

   b) **Factors test** (courts may consider the following factors, though it is difficult to access how much weight to give each, in deciding whether to pierce the corporate veil. Some courts may pierce based on the existence of just one (rare and, if ever, just for the first two), or because several exist):
      1) Fraud
      2) Undercapitalization
      3) Failure to observe corporate formalities
      4) Non-payment of dividends
      5) Insolvency
      6) Siphoning
      7) Lack of involvement from other officers/directors
      8) No record keeping
      9) Corporation as facade (all from DeWitt Truck Brothers, where it was held undercapitalization alone is not enough)
      10) Commingling
      11) Unauthorized diversions of funds (Miller v. CEC Homes, where the court listed other factors like those above, but primarily analyzed a two prong test analyzing the unity of interest and ownership and the avoidance of fraud or injustice)

   c) **Contract Claimants v. Tort Claimants**
      1) Some argue that it should be harder for contract claimants to pierce the veil because they can protect themselves and tort claimants generally cannot. However, many contract claimants cannot adequately protect themselves either (e.g., consumers).
         a. **Contract**: Claimants enter into the relationship voluntarily and have an opportunity to negotiate the terms reflecting the risk to protect themselves. **Except**: wage earners and consumers cannot negotiate meaningfully over contract terms because of weak bargaining positions and K's of adhesion.
         b. **Tort creditors**: generally cannot protect themselves and may need to be protected by the piercing doctrine. **Inequities**: If the enterprise is undercapitalized vs. the under-insured and negligently injured person.

6. ***KEY FACTORS***
   a) **Undercapitalization** (one of the most critical factors for determining whether to pierce)
      1) G/R: Inequitable for the SH to set up a flimsy corp to escape personal liability. There should be enough assets in the business to account for the degree of risk generally associated with that kind of corp.
      2) G/R: Courts determine that if the deficiency of assets is so great or unreasonable that it is unfair for individuals to take advantage of corp limited liability.

3) Problem: if judges allow piercing because of undercapitilazation alone, they will be faced with a multitude of suits based on UC. Courts need to be careful not to base their decisions on capital alone.
4) Note though, that courts are reluctant to pierce based solely on this factor (slippery slope) and that the notion of undercapitalization is relative (some businesses need very little investment)
5) **Approaches to the Timing of the measurement of capital**.:
   a. At the time of incorporation or inception of the business
   b. Better: Looked at as a continuing problem. Businesses expand and contract, and the need for capital can change dramatically, to arbitrarily freeze the determination of sufficiency of capital.
6) **Assets to be taken into account:**
   a. G/R: Assets that the investors place at the risk of the business should constitute of determining if there is UC. Courts should consider retained earnings, insurance, and even loans to the corp (by SH that are re-characterized as capital) that are available to creditors.
7) **Evidence of UC**: judges are reluctant because they feel unqualified to deal with the business judgement; comes down to a battle of the experts.
   a. Expert testimony regarding whether adequate investment at incorporation
   b. If the business operated for a time before incorporation, its experiences/capital requirements previously
   c. Expert financial analysis and statistics regarding that line of business
   d. Testimony regarding need for and adequacy of insurance
   e. Evidence regarding declining assets or increasing risks

8) Significance of the UC factor:
   a. Depends on if the corp was grossly UC for the purposes of the corp undertaking. If the corp never had any substantial assets and its capital was trifling compared with the business to be done and the risk of loss, this is a very significant factor.

CASES for undercap:

1) Minton v. Cavaney - **Undercapitalization alone was enough** to pierce the corporate veil. The judgment against the corp for a drowned girl was never satisfied by the corp. The court held that the owners of a corp are personally liable when they provide inadequate capital and actively participate in the conduct of corp affairs.
2) Walkovszkv v. Carlton - **Undercapitalization alone was not enough** to pierce the corporate veil. Even though UC was alleged, the court said the complaint did not indicate that the D and his associates were actually doing business in their individual capacity; shuttling their personal funds in and out of the corps without regard to formality and to suit their immediate convenience.
3) DeWitt Truck Brothers v. Fleming - **Undercapitalization alone was not enough** but other factors were taken into account. Other factors must present an element of unfairness or injustice.

2. Misuse of Corporate Assets

a) A party may misuse corporate funds in a number of ways, often by tunneling the corporations assets to himself or to an interested party in a way that is detrimental to creditors. This can be done via salaries, improper loans, improper leases, improper sales, improper gifts, and improper use of corporate assets.

b) ***Examples***

1) Commingling (if the assets cannot be kept separate, then should not be able to claim the protection of the corp).
2) Diversion
3) Treating as your own assets
4) Failure to maintain arm's length transactions
5) Diversion to a 3rd party
6) Siphoning

c) Transfer of assets to interested persons (suspicious transactions)

1) Excessive salaries
2) Use of corp property (charge or free)
3) Distribution of corp assets to interested persons
4) Court considers the disregard for corp formalities (whenever I feel like)

3. Failure to Observe Corporate Formalities

a) When a party fails to observe certain corporate formalities, that may weigh toward piercing the corporate veil, especially if it is shown that there really is no corporate structure, that funds are being commingled, or that assets are being unjustly hidden from creditors. More though, corporations should use their observance of corporate formalities as an argument against piercing. **Use of this factor to pierce is quite questionable**.

b) *Examples of relevant formalities*

1) Holding shareholder/board of directors meetings
2) Corporate record keeping (e g , minutes)
3) Issuance of stock
4) Not commingling funds

b) Non-observance of corporate formalities indicates (in situations when failure to observe is significant) an attempt to hide behind a non-functioning corp and with improper records, creditors are unable to determine assets.

c) **Closely held corp exception**: Failure of a statutory close corp to observe the usual corp formalities or requirements relating to the exercise of its corp powers is not ground for imposing personal liability.

d) Council should advise clients to observe formalities to avoid problems.

4. Fraud

a) Some courts hold that fraud alone is enough to pierce the corporate veil, others consider it a factor, and a few require it.

b) *Kinds of fraud*

1) **Actual fraud** = an affirmative misrepresentation or silence when one has a duty to speak (Bergh, where it was held that promoters have a duty to fully disclose material facts to an individual induced to purchase stock in the corp)
   a. Fraud can be perpetrated by silence when one has the duty to speak
   b. An affirmative misrepresentation or silence when one has the duty to speak
2) **Fraud with deception** = gross undercapitalization, insolvency when incurring debt, diversions of funds, corporations as facades for personal dealings (Carpenter Paper Co)
3) **Constructive fraud** (sham to perpetuate fraud; big in Texas)(broad interprtation) = breach of a legal duty or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, violate confidence, or injure public interests.

7. *WHO CAN BE HELD LIABLE*

a) *Shareholders* - there are strong arguments for making active shareholders liable while shielding passive shareholders from liability (particularly those arguments related to encouraging investment), but it is often difficult to determine active v passive shareholders Some courts hold that only shareholders who participate in the acts that led to the attempt to pierce should be liable. The number of shares one owns is likely irrelevant.
   1) Some juris: Ownership is sufficient to hold the SH liable.
   2) Other juris: distinguish between the active and the passive SH. (Impose liability on the ones who actively participate in the conduct of corporate affairs
   3) Equitable approach: activity usually indicates control (not ownership) rather decision making conduct that contributed to the harm.

b) *Non*-shareholders - Non-shareholder creditors may become so involved in the management of a corporation as to be liable (Krivo Industrial Supply Co) Also, equitable owners may be liable (e g , m Minton. an individual who had applied to the Commission for permission to issue stocks but hadn't issued them yet) Whether non-shareholders can be held liable is up to the jurisdiction
   1) Groups to consider: Creditors with control; employee with control and contract rights to acquire shares, anyone with options or rights to purchase.

c) *Related Corporations (e g , parents, subsidiaries, and siblings)* - Courts will examine many of the same factors described above for piercing the veil with individuals (e.g., commingling, diversion, etc) and **may be more apt to allow piercing against another corporation**, especially when it is dealing with **subsidiaries** in the same line of business

Piercing may be less likely when the two are truly separate entities in different lines of business.

1) **Walkovsky v. Carlton**: Court held where business operated as a single enterprise is divided into a number of corps it is pretty easy to justify piercing the veil because each corp is actually an agent for the larger corp.

8. ***CAUSATION***

a) Factual and legal causation can be particularly difficult with respect to piercing the corporate veil. Some courts will go so far as to ignore meaningful causation requirements (e.g., Bergh) in piercing the corporate veil. The Minton court basically ignored causation and considered the active participation by the individual as sufficient for piercing the veil.

   1) Basically, we are looking for a) control; b) used to commit wrongdoing; c) that causes injury.
   2) Courts can apply the burden in many ways, (e.g., all on P; P must show director and injury and then D must rebut).

9. ***OTHER NOTES***

a) Some courts speak of control and dominance as a factor. However, control and dominance should not constitute reason to pierce and are not in and of themselves evil.

b) Verbal assurances that are not upheld or that an individual never intended to uphold could constitute reason to pierce.

c) Statutes can limit shareholder liability (e.g., freedom from personal liability, even when corporate formalities are ignored).

10. ***POLICY***

a) *For* limited *liability:*
   1) It encourages risk taking and is a benefit if you think risk taking benefits society and the economy
   2) Risks of unlimited liability scare investors away
   3) Diversification of investments would be inhibited by unlimited liability

b) *For unlimited liability:*
   1) More fair to the creditors
   2) Accountability

11. ***REDUCING VULNERABILITY TO PIERCING***

a) *Set up and launch the corporation properly:*
   1) Establish procedures for following corporate formalities
   2) Ensure the corporation is adequately financed and properly structured
   3) Obtain adequate insurance

b) *Continuously advise clients about the ways to ensure piercing doesn 't occur:*
   1) Observation of formalities
   2) Financial responsibility

3) Avoiding misuse of assets/commingling
4) Avoiding inappropriate verbal assurances

c) Education must not only take p[lace at the inception of the corp, but throughout the life of the business.

EQUITABLE SUBORDINATION

1. ***Definition***: This is a mechanism via which creditors (Usually SH) gain priority over other creditors with respect to payment of obligations by a debtor.
   a) Invoked in situations similar to those where the corporate veil is pierced, and counsel for creditors should seek ways to protect their clients from falling victim to this remedy.

2. **TEST**
   a) This doctrine is left to judicial discretion and its invocation is based largely on notions of equity and fairness, though some courts have tried to establish a general test:
      1) The claimant being subordinated must have engaged in inequitable conduct;
      2) Resulting in injury to the creditors or in an unfair advantage to himself; and
      3) Equitable subordination must be consistent with the bankruptcy code

3. Cases
   a) **Pepper v. linton**: court justifies subordination based on the violation of the rules, fair play, and good conscience by the claimant. Linton was the controlling SH and used his power over Dixie to obtain a confessed judgment for his own salary claims in such a way as to get ahead of an outside creditor. The court held that the existence of a planned and fraudulent plan made the need for equitable relief against the fraud compelling. 3 categories recognized by the court as sufficient:
      1) Fraud, illegality, breach of fiduciary duty
      2) Undercapitalization
      3) Claimants use of debtor as a mere instrumentality or alter ego

   b) **Taylor v. standard gas:** Court subordinated a parents claim as a creditor of the subsidiary in bankruptcy court because of the improper management for the benefit of the parent.
   c) **Arnold v. Philips**: Court held that additional monies invested by the owner into the corp was not a loan but rather capital investment. The courts are more lenient if the loan is to save the company.
   d) **Obre v. Alban Tractor**: Court refused to subordinate a SH claim. Ps felt they has shown subordination because Obre was the dominate SH of an undercapitalized corp. Court felt that even if it assumed, without deciding, that the doctrine would be applied on general grounds in a case short of fraud or estoppel, the facts here did not warrant subordination.
   e) **Note**: If SHs advance credit to their own firms when the business is failing, courts may be more sympathetic to upholding the debts against subordination claims because public policy favors efforts by SH to rescue their business.

4. **<u>Considerations sufficient to subordinate claims</u>** (basically, violations of the rules of fair play or good conscience):
   a) Undercapitalization
   b) Breach of fiduciary duties, including fraudulent acts, owed to the corporation, shareholders, or creditors
   c) Use of the corporation as an instrumentality/alter ego

5. **<u>Examples:</u>**
   - <u>Pepper v. Litton:</u> Use of control to put payment of his salary ahead of other creditors was grounds for ES.
   - <u>Taylor v. Standard Gas:</u> Parent's claim ES because improper management of subsidiary

for benefit of parent.

- Arnold v. Phillips: Additional money invested by owner was capital investment, not loan, so ES not an issue.
- Obre v. Alban: Shareholder loan was not capital investment but loan; court refused to ES.

6. Important Points:

a) Courts less likely to ES if shareholders advance credit to their own business when it is failing
b) Claims against creditors can be ES if acted as fiduciary, breached duty, and injured other claimants
c) Claims against creditors can be ES even if not fiduciaries if committed act of moral turpitude causing injury to other claimant
d) To avoid ES if creditor, don't act as fiduciary, don't make improper contributions to corporation

BREACH OF THE FIDUCIARY DUTY OF CARE BY DIRECTORS & AGENTS

1. GENERAL

a) Who may have this duty:

1) Directors
2) Agents (officers, employees, others acting on behalf of the corporation (e.g., attorneys))

b) Kinds of suits:

1) Derivative by shareholders for benefit of corporation
2) By trustees in bankruptcy for benefit of corporation
3) By receivers
4) By creditors

c) Situations when an individual may breach the duty:

1) Corporate distributions and issuance of shares
2) Purchase of assets for excessive consideration
3) Disposition of assets for inadequate consideration
4) Misappropriate of corporate assets
5) Violations of law
6) Improper business practices or decisions
7) Sale of control to looters

d) The analysis:

1) Determine what the **duty** is
2) Establish a **breach**
3) Show that the breach **caused** injury (note, you must show cause in fact, but establishing what "proximate cause" is has been more a function of common sense ;and logic more than anything)

2. DIRECTORS & The Duty of Care

a) **Duty:** A director shall discharge his duties: 1) in **good faith:** 2) with **care an ordinarily prudent person** in a like position would exercise under similar circumstances; 3) in a manner he **reasonably believes to be in the best interests** of the corporation (RMBCA §8.30)(17-16-830)

1) A director is **not acting in good faith** if he has knowledge concerning the matter in question that makes reliance otherwise permitted (officers, accountants, committees, etc) unwarranted.

b) **Possible defenses/arguments against finding breach:**

1) **Business judgment rule** shields from liability if:

a. Not interested
b. Informed with respect to the subject of his business judgment
c. Rationally believes the judgment is in the best interest of the corporation
d. **NOTE:** Another, less-used articulation of this test is the **ordinary prudent person standard,** which operates much like a negligence test via which there would be no breach unless the director's actions were not those of an ordinary and prudent person.

2) **Duty doesn't apply to day to day decisions** but only major management decisions/policies (RMBCA §8.30(a))

3) **Directors** are permitted to **rely on** information, opinions, reports, or statements including financial statements and other financial data, if prepared and presented by:(§8.30(b)).
   a. One or more officers or employees of the corp whom the director reasonably believes to be reliable and competent in the matters presented
   b. Legal counsel, public accountants, or other persons as to matters the director reasonable believes are within the person's professional or expert competence.
   c. A committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence (RMBCA §8.30(b))

4) § 8.30 (e) states that the directors shall consider the interests of the corp's SH but may also consider; The interests of employees, suppliers, creditors, and customers; economy, impact on communities, long-term interests of the company and any other factors relevant to promoting or preserving the public or community interests.

5) Courts should be reluctant to find breach (be: RMBCA comment is **sympathetic** to role of directors)

6) Should follow jurisdictions **require negligence,** or even gross negligence
   a. Delaware: Breach of duty of care standard requires gross negligence rather than ordinary negligence because the courts are unwilling to second guess the director's decisions.
   b. Other juris: Gross negligence, fraud, waste
   c. Minority: breach of duty only requires **negligence**. Courts are reluctant to find directors liable for ordinary negligence: want to encourage part time directorship and the courts are not in a good position to make business judgments.

7) **P usually** has **burden** to show breach of duty and that business judgment rule does not apply to protect the D, or to prove a violation of the duty of care and causation.

8) **Policy** (want to encourage outside directors to serve on boards, don't want too much risk aversion in decision making, courts lack expertise to review business decisions)

9) Not a defense, but can have **insurance** or be **indemnified** by their corporations (this doesn't solve all problems for creditors because insurance may be insufficient, may not cover particular intentional or willful wrongs, and will have ceilings)

c) Arguments for finding breach:

2) **__Language__** of RMBCA is strict and demanding
3) **Reliance** on others may be **__unwarranted:__** Look for any reason that the director should not have relied on another person
4) **__Business judgment rule has not been adopted__** by statute but is left to judicial discretion (see if the jurisdiction is using statute)
5) **__Deter__** wrongdoing, **__Compensate__** injuries
6) Line between negligence and gross negligence may be hard to draw, so jurisdictions requiring gross negligence may not be as difficult as appears
7) **__Interests of those other than shareholders__** (e.g., employees, creditors, customers, communities)
8) Even under the BJR (tough to defeat), you may win if the director's actions are **__so improvident, risky. Unusual, and unnecessary__** as to be contrary to fundamental concepts of business (Litwin v. Alien).

3. __*INATTENTIVE* DIRECTORS *& The Duty of Care*__

a) General: There is no protection from the BJR in these cases: Look at the procedures of the board: did the board pay attention to internal/external auditing, business, ethic policies and on going education of ethic manuals.

b) Elements of attention required:

1) *Acquisition of knowledge:* Must acquire at least a rudimentary understanding of the business: lack of knowledge is no defense.
2) *Monitoring*: not of day-to-day operations, but must generally monitor the corporate affairs and policies.
3) *Attendance at Meetings:* Must regularly attend board meetings and in absence is presumed to concur unless files dissent.
4) *Review of Financial Statements:* Must keep abreast of corporation's financial condition
5) *Response to Improprieties:* Upon discovering illegal activity, must object. If the corporation doesn't correct, must resign.

6) **Duty to make inquiry**: Bates v. dresser: Employees who pay was never more than $12 per month had an automobile, this coupled with a shrinking in the bank’s deposits put a duty to make an inquiry on the bank officer (There could be a different standard for banks b/c of fiduciary attributes)

c) **Levels of** inattention**:**

1) Figureheads - do not function as directors at all
2) *Minimally* functioning *directors*
3) *Active directors* who are occasionally/sometimes inattentive

d) Why may be easier to find directors breached because of inattentiveness:

1) Easier to prove under RMBCA §8.30: easier to show that inattention cause the injury rather than the wrong decision.
2) Business judgment rule not a defense if director not informed

e) **Causasion:** Inattention must be a substantial factor in causing the injury
   1) **ALI §7.**18 Causation: The P has the burden of proof that the board's inattention caused the injury
   2) (b) A violation of the standards of conduct set forth is the legal cause of loss if the P proves that: (I) satisfaction of the applicable standard would have been a **substantial factor in averting the loss**, and (ii) the **likelihood of the injury would have been foreseeable to an ordinary prudent person in a like position to that of the D and in similar circumstances.** It is not a defense to liability in such cases that damage to the corp would not have resulted but for the acts or omissions of other individuals
   3) Gelb apportions liability based on culpability if there are different responsibilities among members of the board, otherwise the ALI does not distinguish between J & S liability and apportioned liability.

f) **Examples**
   1) Smith v. VanGorkom: Directors breached duty of care by not informing themselves
   2) Francis v. United Jersey Bank - D liable as figurehead. Former majority shareholder (actually her executor) held to have breached duty of care for not noticing and trying to prevent sons (officers) from siphoning money from business by disguising as "loans." D knew nothing about business, never attended meetings or reviewed finances, etc., but was aware that sons might do something like this. Had she been attentive, she could have stopped this or tried to stop it.

4. *AGENTS & the duty of care*

a) **Agents:**
   1) Officers (typically set out in bylaws (e.g., president, vice president, secretary, and treasurer))
   2) Employees
   3) Non-officer, non-employees who have taken on such duties (e.g., realtors, attorneys)

b) **2. Duties may be found in or defined by:**
   1) Contracts (oral and written)
   2) Fiduciary duties

c) **Duties under the Restatement of Agency**
   1) Duty to principal to act with **standard care and the** skill which is standard in the locality for that kind of work, unless otherwise agreed (e.g., in contract) (Rest. §379)
   2) Duty to exercise **any special skill possessed** (Rest. §379)
   3) **Gratuitous** agents have a duty to act with the care and skill required of others who are not agents but are undertaking similar tasks (Rest. §379)
   4) Duty **not to commit misconduct, tort, crime, breach of contract** (Rest. §379)
   5) Duty to **disclose relevant information** to the principal (Rest. §381)
   6) Duty **of good conduct** in business he is engaged in (Rest. §380)

7) Duty to act only as **<u>authorized</u>** (Rest. §383)
8) Duty **<u>not to attempt the impossible or impracticable</u>** (Rest. §384)
9) Duty to **<u>obey</u>** the principal (Rest. §385)

d) **Duties under the RMBCA §8.42**

1) An officer shall discharge his duties: 1) in **<u>good faith:</u>** 2) with **<u>care an ordinarily prudent person</u>** in a like position would exercise under similar circumstances; 3) in a manner he **<u>reasonably beliefs to be in the best interests</u>** of the corporation. Can rely on officers, employees and professionals (e.g., accountants, attorneys) if he reasonably believes they are reliable and competent.

e) **Why it might be easier to win against agents:**

1) They may be expected **<u>to have more specific knowledge</u>** regarding what they are working on and sometimes more general knowledge about the business.
2) **<u>Statutes don't provide extra protection</u>** for agents like they sometimes do for directors.

BREACH OF THE FIDUCIARY DUTY OF LOYALTY

1. **Who may have this duty/who are fiduciaries:**
   a) Directors
   b) Officers
   c) Agents
   d) Sometimes shareholders

2. **Kinds of suits:**
   a) Derivative by shareholders for benefit of the corporation
   b) By trustees in bankruptcy for benefit of corporation
   c) By receivers
   d) By creditors

3. **Situations when an individual may breach the duty:**
   a) Contracts between the corporation and fiduciaries or related parties
   b) Dispositions of property by fiduciaries or related parties
   c) Dispositions of property from the corporation to fiduciaries or related parties
   d) Use of property by fiduciaries or related parties
   e) Loans to fiduciaries or related parties
   f) Compensation to fiduciaries or related parties
   g) Usurpation of corporate opportunities by fiduciaries or related parties
   h) Sale of corporate control by fiduciaries or related parties

4. **The analysis:**
   a) Determine if there is **self-dealing (if not.** use business judgment rule, if there is, move on)
   b) Explain the **<u>duty</u>** and the standard it is tested under
   c) Explain the **<u>BOP is on the D</u>** to show disinterested shareholders or directors approved, or that it was fair
   d) If disinterested shareholders or directors approved, **<u>did D disclose</u>** his interest and all material facts
   e) If not disclosed or not fair, determine that it was a **<u>breach</u>**
   f) Show that the breach **<u>caused</u>** injury (note, you must show cause in fact, but establishing what "proximate cause" is has been more a function of common sense and logic than anything)

5. **DIRECTORS*<u> & self-dealing transactions</u>***
   a) **Possible** approaches**:**
      1) Voidable by the corporation on the **<u>basis of the conflict alone</u>** (e.g., common law)
      2) Voidable by the corporation on the **<u>basis of the conflict + fraud or bad faith</u>**
      3) Voidable by the corporation on the **<u>basis of conflicting interest + unfairness</u>** to the corporation (BOP on director)

6. **General approach - RMBCA §8.31 (used by many states though it has been repealed):**
   a) **Transaction** when director has direct (i.e., transaction with him) or indirect interest (i.e., transaction with another entity he has an interest in) **<u>not automatically voidable if:</u>**
      1) Material facts disclosed or known to board or committee of the board and **<u>majority of disinterested board</u> authorized it,**
      2) Material facts disclosed or known to shareholders entitled to vote and **<u>majority of</u>**

<u>disinterested shareholders authorized it: OR</u>

3) **It was **<u>fair</u>** to the corporation (probably also requires proper disclosure)

   a. **NOTE 1:** This applies only to eliminate the rule of automatic voidability in some instances. A transaction may still be voided for other reasons (e.g., waste, unenforceable).
   b. **NOTE** 2: Each jurisdiction is different. Some may hold that the only way it is not voidable is if it's fair. Some may hold that authorization does away with the fairness test. Some may shift the BOP from the director if the transaction was authorized.

7. **Directors & self-dealing loans:**
   a) Jurisdictions **each** have their own rules (e.g., some prohibit all such loans, some limit such loans to specific situations)
   b) Former RMBCA §8.32 (repealed) prohibited unless approved by majority of all disinterested shareholders or the board, upon a finding of benefit to the corporation, approved the loan or a general plan to make loans

8. **Directors & self-dealing compensation:**
   a) Courts generally won't get involved in compensation questions, especially with respect to publicly held corporations
   b) When they do, they generally apply a lenient reasonableness standard

<u>AGENTS & self-dealing transactions</u>

1. **General approach - Rest. §387:**
   a) Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.
   b) Also:
      1) Prohibited from acting as an adverse party in a transaction connected with his agency with principal's knowledge (BOP on agent) (Rest. §389)
      2) Deal fairly and disclose relevant facts if acting as adverse party with principal's knowledge (stringent test) (Rest. §389)
      3) Prohibited from persuading principal to make a hard or improvident bargain (BOP on agent) (Rest. §390)

<u>SHAREHOLDERS & self-dealing transactions</u>

1. **General approach:**
   a) Must demonstrate fairness absent disinterested shareholder approval

EXAMPLES OF OTHER DUTY OF LOYALTY CLAIMS

1. ***CORPORATE*** **OPPORTUNITY** ***DOCTRINE*** - A corporation suffers loss resulting from the improper usurpation of corporate opportunities by fiduciaries.
   a) **Possible approaches:**
      1) **Interest, expectancy, or essential test:** Corporate opportunities are only business opportunities in which the corporation has an interest or expectancy, or which are essential to the organization
      2) **Line of business test:** Corporate opportunities are those in the line of business of the corporation (e.g., Guth v. Loft and the acquisition of a secret formula for soda by officers of a soda company)
      3) **Fairness test:** weighs factors in determining the fairness to the corporation
      4) **Improper use of assets test:** If the fiduciary improperly used corporate assets to acquire the opportunity

2. **CORPORATE OFFICIALS COMPETING WITH THE CORPORATION**
   a) **Fiduciaries who remain with the corporation but compete:**
      1) The jurisdictions differ (e.g., some allow competition, some do not), so check the statutes and the contract between the fiduciary and the corporation.

   b) **Former corporate fiduciaries who compete with the corporation:**
      1) Reasonable contractual restrictions on post-employment competition are recognized as valid in most jurisdictions

   c) **3. Fiduciaries who compete with the corporation in the process of leaving the corporation:**
      1) Check the contract and note that trying to take customers with you will be violations of fiduciary duties (fair dealing, corporate opportunity, competition)

3. *MISUSE OF CORPORATE POSITIONS*
   a) **General approach:**
      1) **Directors/senior executives:** May not use corporate property, non-public information, or corporate position to secure a pecuniary benefit unless: a) value given for use; b) use is compensation; c) use of information & doesn't harm corporation (but not for purchasing securities); or d) authorized by disinterested directors or shareholders.
      2) **Agents:** Unless agree otherwise, pecuniary benefits go to principal (Rest. §388)

MISUSE OF MATERIAL, NON-PUBLIC INFORMATION - States vary as to whether this is a breach of the duty of loyalty, but federal securities laws prohibit insider trading.

USE OF CORPORATE PROPERTY- may be a breach if uses and fails to pay FMV

TRANSACTIONS INVOLVING CONTROL - May be breach in corporate opportunity situations, looting situations, and bad sale situations

NON-FIDUCIARIES WHO PARTICIPATE - Creditors, attorneys, accountants, etc. who participate in a fiduciary's breach of the duty of loyalty may also be liable.