BUSINESS ORGANIZATIONS OUTLINE

§1: INTRODUCTION

A. **Generally:** there are six common types of business organizations:

1. *Unincorporated Business Forms:*
    a. Sole proprietorship: one person owns the business. Many businesses are still conducted this way.
        i. If someone works for the sole proprietor, that person is typically an agent and a servant.
    b. Partnerships: the operation of business by co-owners.
    c. Limited Liability Partnerships: the operation of a business with co-owners, with some being liable for partnership debts, while others are not.
2. *Corporations:*
    a. General Corporations: a corporation is a fictitious legal entity separate from the owners and shareholders which is created by filing with the secretary of the state and the payment of a filing fee.
        i. Corporations can be publicly held, or closely held.
    b. Limited Liability Companies: is a company that is drawn from a mixture of forms of business organizations; that is, they look like corporations but have different rules for tax and liability purposes.

B. **G/R:** Practitioner (i.e. exam) Notes: the general practitioner will have to know how to generally deal with these corporations, and the basic understandings of:

1. Advise clients who are going into business how to:
    a. formulate;
    b. what documents to file, and where to file;
    c. what is the best business organization for the corporation.
2. Advise the client on which factors to consider:
    a. what has to be done;
    b. the structure of management;
    c. the internal operation of the business;
    d. transfers of interest;
    e. responsibility for losses and profits; and
    f. dissolution prossiblities.
    *[Tax law also enters into the equation].
3. For litigation purposes, business organizations are essential because you have to know who is the proper defendant to sue.

§2: AGENCY LAW

I. INTRODUCTION

***SEE* pp. 1-44: Statutory Supplement.

A. Generally: Basic agency and employment relationships underlay virtually all commercial dealings. As such, they define the rights and responsibilities of individuals who work for or on behalf of the business.

1. A corporation, an artificial legal construct that has no physical being of its own, can act only through agents for everything it does.
2. Partnerships similarly involve the law of agency, with each partner being an agent for the partnership.
3. Whenever one person performs services for, or acts on behalf of, someone else, the principles of agency define the relationships and responsibilities of both participants and of person who deal with them.
    a. The most common agency relationship is the employment relationship, but agency law is applicable in many other situations as well.

II. BASIC CONCEPTS

A. **G/R:** Agency: agency is the fiduciary relation, which 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 [Rst. (2) *Agency* §1(1)].

1. Agency can also be defined as a consensual relationship in which one person agrees to act for the benefit of another.
    a. Artificial entities such as corporations, trusts, partnerships, or LLC's can act as principals or agents.
    b. Thus, the law agency is involved whenever a corporation acts, whether it is writing a check, selling a product, or entering into a billion dollar merger.
2. An agency relationship is based on conduct by the principal and agent, the principal manifesting that he is willing to have another act for him and the agency manifesting a willingness to act.
    a. The relationship may be contractual, but it need not be. Persons acting without compensation are still agents.
        i. These agents are unpaid or gratuitous agents.

A(1). **G/R:** Elements of Agency: for the agency relationship to be formed, generally three elements have to be met:

1. *Manifestation:* the principal must manifest that the agent will act for him; consent of the principal [Rst. (2) § 15];
2. *Acceptance:* the agent must accept the undertaking; act on behalf of the principal [Rst. (2) § 15];
3. *Control*: an understanding that the principle is the party in control [Rst. (2) § 14].

B. **G/R:** Principal: a principal is the person or entity whom the agency works or takes action for (i.e. the boss) [Rst. (2) §1(2)].

1. The person for whom the agent is acting is the principal.

C. **G/R:** Agent: the person who is acting (works) for another is the agent (i.e. employee) [Rst. (2) §1(3)].

D. **G/R:** Master: a master is a principle who employs an agent to perform service in his affairs and who controls or has the right to control the physical conduct of another in the performance of services [Rst. (2) § 2(1)].

E. **G/R:** Servant: a servant is an agent employed by a master [Rst. (2) §2(2)].

1. In determining whether one is acting for another the following factors are considered:
    - a. extent of control the master has over the details of work;
    - b. whether the employee is engaged in another business;
    - c. whether the work is usually done under direct supervision;
    - d. the skill required for the particular occupation;
    - e. who supplies the equipment (i.e. tools, place of work, etc…);
    - f. length of time the person is employed;
    - g. the method of payment;
    - h. whether work was part of the regular business of the employer;
    - i. intention of the parties in creating the relationship; and
    - j. whether the principal is or is not a business.
    - *[Rst. (2) §220].
2. Servants are generally employees. For example, a CEO of a large corporation can be a servant.
    - a. In some instances, a party may be an agent, but not a servant. For example, a lawyer in certain situations.

F. **G/R:** Independent Contractor: an independent contractor is someone who contracts with another, but is NOT controlled by him [Rst. (2) §2(3)].

II. FIDUCIARY DUTIES

A. **G/R:** Agency Relationship: the agency relationship is a fiduciary relationship; that is, a relationship or trust and confidence and the expectation of trust that arises from the relationship.

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B. **G/R:** Agent's Fiduciary Duty: The *agent* is a fiduciary with respect to matters within the *scope of his agency* [Rst (2) § 13].

1. *Scope of Agency:* the scope of agency is usually determined by contract between the principal and the agent or by the nature of the instructions given by the principal to the agent. The scope of the agent's fiduciary duty may be shaped by the terms of the contract, but the fiduciary obligation exists even though the contract is silent as to the duties of the agent or purports to abolish this duty
    - a. Duty: This means the agent is accountable to the principle for any profits arising out of the transactions he is to conduct on the principles behalf [Rst. (2) § 388].
    - b. Breach: The agent breaches his fiduciary duty to the principal if he acts either to benefit himself or someone else other than the principle [Rst. (2) § 387].
    - c. This fiduciary duty prevents the agent from acting:
        - i. adversely to the interest of the principle [Rst. (2) § 389];
        - ii. in a way to assist an adverse party to the principle in connection with the agency [Rst. (2) § 391];
        - iii. in a way that competes with his principal concerning the subject matter of the agency [Rst. (2) § 393].
    - d. The agency must act to preserve and protect property entrusted to his care by the principal, and is liable for its loss if he disposes of the property without authority to do so, or it is lost or destroyed because of his neglect or because he intermingles it with his own property [Rst. (2) §§ 402-404A].

i. The agent may be required to account for his actions for for property of the principal entrusted to him.

2. *Caveat:* when parties are dealing at arm's length, one party usually does have a duty to volunteer information to the other.

a. This is NOT the rule, however, if one owes the other a fiduciary duty.

C. **G/R:** <u>Other Duties of the Agent:</u> in addition to the fiduciary duty, an agent must act with reasonable care in carrying out the agency and must meet at least the standard of competence and skill in the locality for work of the character he is obliged to perform.

1. An unpaid agent may have a lesser duty than one who is paid.

D. **G/R:** <u>Principal's Fiduciary Duty:</u> the principal owes a fiduciary duty to the agent. These duties are different from the agent's duties since the basic fiduciary duty only runs from the agent to the principal.

1. The principal must perform its commitments to the agent, act in good faith, cooperate with the agent, and not interfere with or make more difficult the agent's performance of his duties.

a. Implicit in the arrangement may be an obligation by the principal to give the agent work, the opportunity to earn a reasonable compensation, or an opportunity to find additional work.

2. In addition, if the agent incurs expenses or spends his own funds on behalf of the principal, the principal may have a duty to repay or indemnify the agent [Rst. (2) § 432-469].

E. **G/R:** <u>Implied at Law:</u> the law of fiduciary duties is implied at and cannot be abolished through contractual agreements.

1. Distinguish this from an employment contract where the duties and relationship are set forth in the contract, because an employer usually does not owe a fiduciary duty to an employ, especially if the employment at will doctrine applies.

III. <u>THE RIGHT TO CONTROL: INDEPENDENT CONTRACTORS AND SERVANTS</u>

A. **G/R:** <u>Principal's Control:</u> the principal has the right to control the conduct of the agent with respect to matters entrusted to him.

1. The principal can determine what the ultimate goal is, and the agent must strive to meet that goal.

2. The degree of control that a principal has over the acts of the agent, may vary widely within the agency relationship:

a. Distinguish between: principal/agent relationship and principal/independent contractor relationship.

B. **G/R:** <u>Master:</u> a maters 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 [Rst. (2) § 2].

C. **G/R:** <u>Servant:</u> a servant is an agent employed by a master who has the right to control his physical conduct or who does control his physical conduct [Rst. (2) § 2].

D. **G/R:** <u>Independent Contractor:</u> is a person who contracts with another to do something for him but 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 the undertaking [Rst. (2) § 2].

IV. <u>The Responsibility of a Principal for his Agent's Torts</u>

A. <u>Generally:</u> the classification of an agent as a servant or independent contractor is important primarily because different rules apply with respect to the liability of the principal for physical harm caused by the agent's conduct.

B. **G/R:** <u>Principal's Liability:</u>

1. *Servants:* a master is liable for torts committed by a servant within the scope of employment. *See* §2, VIII, Rule D, p. 11.
    a. The principal is liable because of vicarious liability, and the doctrine of respondeat superior.
    b. The main issue will be whether the servant was working within his scope of employment when injured. *See* §2, VIII, Rule D, p. 11.
2. *Independent Contractors:* a principle is not liable for torts committed by an independent contractor in connection with is work because he does not have the right to control, or direct control over the independent contractor.
3. *Liability of Principle to Agent:* the principal has a duty to indemnify the agent for payments authorized by the agent on behalf of the principal if the agent has acted within his actual authority.

C. **G/R:** <u>Power of an Agent to Affect the Principals Legal Rights and Duties:</u> an agent has the power to affect the legal rights and duties of the principal various ways, in addition to tort liability.

1. In other respects, to the extent the agent acts within the scope of his agency his acts are viewed as the acts of the principal and therefore affect the contractual or property rights and duties of the principal accordingly.
2. The agent may also affect the principal's legal rights and duties to some extent even when he is acting in *direct violation* of the principal's instructions, or beyond the scope of the agency relationship, or in some cases even when he is not really an agent at all.

**The issue is the scope of authority!

V. <u>Scope of Authority</u>

A. **G/R:** <u>Authority Generally:</u> if any type of authority exists, the principle is bound by the actions of the agent.

1. *Definition:* liabilities arising out of transactions involving agents, principals, and third parties are addressed by the rules of authority.
2. **g/r:** a principle is liable to a third party for the acts of an agent if the agent has actual, apparent, or inherent authority.
    a. The principle is also liable if the principal in some way indicates that an agent's act was authorized.
3. The issue, usually, is how to hold the principle liable.
4. Authority can be express, or implied "through the course of conduct."

B. **G/R:** <u>Agent's Authority:</u> the power of the agent to affect the principal's rights and duties.

1. *Liability of Agent to Principal:* if an agent acts without actual authority and the principle is bound through apparent authority, the agent is liable to the principal for any resulting damage.

C. **G/R:** <u>Actual Authority:</u> (express authority) arises from the manifestation of a principal *to an agent* that the agent has power to deal with others as a representative of the principle. In other words, an agent has actual authority if a reasonable person in the agent's position would believe that the principal had authorized his to so act [Rst. (2) § 26].

1. An agent who agrees to act in accordance with that manifestation has actual authority to so act, and his actions without more bind the principle.
2. When agent acts within the scope of his authority, he is not liable to third persons on the obligation created.
3. Actual authority may be expressed or implied form the words used, customs, or relations between the parties.
4. A common type of implied actual authority is incidental authority to do acts reasonably necessary to accomplish an authorized transaction.
5. *Hint:* Look at the agent's mindset to determine express/actual authority.

D. **G/R:** <u>Apparent Authority:</u> arises from a manifestation *of a principal to a third party* (directly or indirectly) that another person is authorized to act as an agent for the principle [Rst. (2) § 27]. In other words, an agent has apparent authority in relation to a third party if the words or conduct of the principle would lead a reasonable person in the third party's position to believe the principle had authorized the agent to so act.

1. That other person has apparent authority and an act by him within the scope of that apparent authority binds the principal to a third part who is award of the manifestation by the principal and believes the person is authorized to act on behalf of the principal.
2. Apparent authority arises when a person represents that someone else is his agent when that is not the case, or, more commonly, creates or permits the creation of the *impression* that broad authority exists when it in fact does not.
    a. The theory is that if a third person relies on the representation or appearance of authority, that person may hold the putative (supposed/believed) principle liable for the action of the putative agent.
    b. The principal is bound by the agent's act within the scope of his apparent authority in this situation even though the act was not in fact authorized by the principal.
3. *Difference:* the between apparent authority and actual authority can be most easily envisioned in that actual authority flows directly from the principal to the agent while apparent authority flows from the impression created by (or permitted to exist by) the principal in the mind of a third person.
4. In many instances, the scope of apparent authority is as broad as an agent's actual authority when the statements of authority are made directly or indirectly by the principle to a third party.
5. *Hint:* look at the third party's mind to determine if the manifestation of a principal to an agent exists.

E. **G/R:** <u>Establishing Apparent Authority:</u> in order to establish apparent authority, the third party must establish that:

1. it was reasonable for him to believe that the agent was authorized to act;
2. based on what the principal said or on the impression that principal created.

*If he can do so, the principal is bound even though he never intended to make the person allegedly acting under his authority his agent or to enter into a contract with that third person.

**Liability arises under apparent authority even if the relying party has not changed his position in reliance on the representation.

F. **G/R:** Inherent Authority: arises from the agency *itself and without regard to either actual or apparent authority*. Inherent authority may be viewed as authority arising by implication from the authority actually or apparently granted [Rst. (2) § 8A].

1. In many instances actual authority is coextensive with inherent authority based on the nature of the agency (but not always).
2. Inherent authority protects third parties dealing with agents by holding principles liable. It does not depend on any kind of authority but derives from the agency relationship itself.
3. *Application:* inherent authority can subject a principle to tort or contract liability based on activity of the agent.
3. *Hint: i*nherent authority arises a lot of the time when someone is given a job title which indicates a lot of responsibility, or more responsibility than the title suggests; and the responsibilities that come with either the title or the responsibilities.

G. **G/R:** Incidental Authority: is simply authority to do incidental acts that relate to a transaction that is authorized [Rst. (2) § 35].

H. **G/R:** Implied Authority: the existence of either apparent authority or actual authority may be implied rather than express.

1. The same conduct may often be relied upon to prove the existence of implied actual authority or implied apparent authority.
2. Authority may be implied or inferred from a prior course of conduct by the principal. Such conduct may be the basis for implying that the agent has continuing actual authority to act on the principles behalf.
    a. If known to a third party, the very same conduct may lead to an inference that apparent authority exists.
    b. Apparent authority is destroyed if the third party knows, or has reason to know, that the agent is no longer authorized to act for the principal.

I. **G/R:** Ratification: even if an agent acted without authority, a principal will be held liable if the agent purported to act on the principal's behalf, and the principal:

1. manifested intent to treat the conduct as authorized; or
2. engaged in conduct that showed intent.

*[Rst. (2) § 82].

J. **G/R:** Acquiescence: the failure of a principal to object to an action undertaken by agent can be take as an indication of consent. If the agent performs a series of acts of a similar nature, the failure of the principal to object to them is an indication that he consents to the performance of similar acts in the future under similar conditions [Rst. (2) §43].

VI. DISCLOSED AND UNDISCLOSED PRINCIPALS

A. Generally: this distinction comes into play in the common situation in which an agent is dealing with a third party on behalf of a principal under circumstances in which the third party may not know that the agent is acting for someone else. There are basically three situations in which this comes into play:

1. the disclosed principal;
2. partially disclosed principal; and
3. completely undisclosed principle.

Hint: this arises when you are trying to sue the agent, as opposed to the principal.

B. **G/R:** Disclosed Principals: a principal is disclosed if the third party knows, or has reason to know from the information on hand, the identity of the principal at the time the transaction is entered into.

1. Rule: when a transaction is entered into on behalf of a disclosed principal, the principal becomes a party to that contract.
    a. Equally important, the agent does NOT become a party to such a contract unless there is an agreement to the contrary.
    b. *Application:* if the third party knew that the agent was acting on behalf of a principal and knew the principal's identity, and the principal is bound by the agent through authority or ratification, the agent is not obligated to the third party.
        i. *Caveat:* if the principal is not bound by the agent's act, the agent is liable to the third party.
    b. *Hint:* the agent cannot be liable if: (a) he had authority to act; and (b) the principal is disclosed.

C. **G/R:** Partially Disclosed Principal: a principal whose identity is unknown but the third person is on notice that the agent is in fact acting on behalf of some principal [Rst. (2) §321].

1. Rule: typically, the partially disclosed principal becomes immediately bound to any authorized contracts entered into by the agent.
    a. However, the agent also becomes bound to the third party unless there is an agreement by the third party to look solely to the partially disclosed principal.
2. *Application:* if the third party knows that the agent is acting on behalf of a principal but does not know the principal's identity, the agent is bout to the third party.
3. *Hint:* the agent may be liable if the third party (a) knows the agent is acting on behalf of a principle; and (b) does not know the identity of the third party.

D. **G/R:** Undisclosed Principal: a principal is undisclosed if the third party is not aware that the *agent is acting on behalf* of anyone when in fact the agent is acting on behalf of the principal [Rst. (2) § 322].

1. In effect, the third party is dealing with the agent as though the agent is the sole party in interest.
2. Rule: in this situation the agent is *personally* liable to the third person on any contracts negotiated by him since the third party believes he is dealing directly and solely with the agent as the real party in interest.
3. Rule: an undisclosed principal is also liable on the contract to the third party if the agent was acting within the scope of his actual authority.
4. *Remember:* there generally is no room in the same transaction for concepts of apparent authority and undisclosed principle.
5. *Application:* if the third party believes that the agent is acting on his own accord at the time of the transaction, the agent is bound to the third party.
6. *Hint:* the agent is usually liable if the principle is undisclosed.

VII. TERMINATION OF AGENCY RELATIONSHIPS

A. **G/R:** Termination: the relationship between an agent and principal is a consensual relationship; and that relationship terminates when:

1. The objective of the relationship has been achieved;
2. when the agent dies or becomes incompetent;
3. in a variety of other circumstances; such as, termination when an event occurs, or when the other party had notice of the event, depending on how the relationship was formulated; or
4. when the principal or agent determines to end it.
    a. *caveat:* if the relationship is based on contract, the decision to terminate it may be a breach of contract; nevertheless, the relationship has ended even though contractual liability may still exist.

*[Rst. (2) § 106].

B. **G/R:** Revocation: if the principal manifests an intent to terminate the relationship it is called a revocation [Rst. (2) § 118].

C. **G/R:** Renunciation: if the agent manifests an intent to terminate the relationship it is called a renunciation [Rst. (2) § 118].

D. **G/R:** Termination's Affect on Third Parties: since an inference of apparent authority may be based on the existence of prior actual authority, the termination of the relationship does not of itself eliminate the apparent authority of the agent.

1. Notice may have to be given to the third persons who may have dealt with the agent or otherwise believe that the principal has authorized the agent to act.

*[Rst. (2) § 125].

VII. MANAGERIAL EMPLOYEES

A. **G/R:** Managerial Employees: is a high level employee who is typically in charge of a department or division of a firm and oversees the activities of a number of people, i.e. lower level employees.

1. Under the Restatement of Agency, such an employee is still a servant. However, if there is no one to control the person because the master is a fictitious entity, problems may arise and this creates problems of agency cost.

B. **G/R:** Agency Costs: describes the costs incurred by a principal who entrusts decision making to an agent where the agent reaches decision in light of his own personal preferences and desires rather than those of the principal.

C. **G/R:** Control over Agency Costs: employers attempt to protect against agency costs in three major ways:

1. *Employment Contracts:* which assure tenure and security, among other incentives (like an increase in pay with productivity), to ensure managerial employees will perform in the best interests of the corporation.
2. *Oversight:* the managerial employees must obtain approval from the owners or a more senior manager for all transactions that involve more than a certain amount of money.

3. *Bonds.*

VIII. <u>DAMAGES</u>

A. **G/R:** <u>Classical Rule/Punitive Damages:</u> the common law has long recognized that agency principles limit vicarious liability for punitive damages [*Kolstand v. American Dental Ass'n*].

B. **G/R:** <u>Punitive Damage Awards:</u> Punitive damages can properly be awarded against a master or other principal because of an act of 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 within the *scope of employment*; or
4. the principal or a managerial agent of the principal ratified or approved the act.
*[Rst. (2) § 217C; *Kolstad v. American Dental Ass'n*].

C. **G/R:** <u>Managerial Capacity:</u> in determining if an employee was employed in a managerial capacity the court should review:
1. the type of authority that the employer has given to his employee;
2. the amount of discretion the employee has in what is done; and
3. how it was accomplished.
*[*Kolstad*].

D. **G/R:** <u>Scope of Employment Test:</u> an agent is acting within his scope of employment, even if he commits an intentional tort, if the conduct:
1. is the kind the employee is employed to perform;
2. occurs substantially within the authorized time and space limits; and
3. is actuated, at least in part, by a purpose to serve the employer.
G/R: if these elements are satisfied, an employee may be said to act within the scope of employment even if the employee engages in acts specifically forbidden by the employer and uses forbidden means of accomplishing results.
**[Rst. (2) § 228(1); *Kolstad*].

§2: <u>THE PARTNERSHIP</u>

§2.1: INTRODUCTION

I. <u>PARTNERSHIPS AND THE NEED FOR A WRITTEN AGREEMENT</u>

A. **G/R:** <u>General Partnerships:</u> [as distinguished from limited partnerships]: a partnership is a logical extension of a proprietorship when there is more than one owner. A partnership is the operation of a business by co-owners.
1. It can be formed simply be a handshake, there generally is no need for a written agreement and no public filing of any document other than an assumed name certificate which may be required.
2. Generally, with the respect to local permits and qualifications, the same rules apply to partnerships as to proprietorships.

B. **G/R:** Partnership Definition: a partnership is an association of two or more persons to carry on as co-owners of a business for profit [UPA §6(1); RUPA §101(6)].

C. **G/R:** Need for a Written Agreement: in the formation of a partnership, there generally needs to be a written agreement outlining the party's duties and relationship. There are eight basic reasons why a written agreement is needed:

1. It may avoid further disagreements over what the arrangement really was;
2. A written agreement is readily proved in court while proof of an oral agreement may involve substantial factual controversy;
3. A written agreement may focus attention on potential trouble spots in the relationship which may be unnoticed if the partners proceed on a "handshake" deal;
4. The IRS treatment of partnerships permits partnerships by agreement to allocate the tax burdens among themselves within limits, and a written agreement is clearly desirable where advantage of such provision is taken;
5. UPA and RUPA both contemplate that upon the death or retirement of a partner, the business is either to be disposed of or the interest of the deceased partner is to be purchased by the partnership or by the other partners;
6. A partner may wish to lend rather than contribute specific property to a partnership and written agreement identifies which property is contributed and which is loaned;
7. Where real estate is to be contributed as partnership property or the agreement include a term of more than one year, a written agreement may be necessary to comply with the statute of frauds; and
8. A written partnership agreement is advantageous to the attorney.

§2.2: PROFIT SHARING AND LOSSES

I. PARTNERSHIP PROFIT SHARING, AND LOSS ALLOCATION

A. Generally: absent an agreement, one important non-tax issue in partnership law is how profits and losses of the business are to be shared.

1. *Breakdown:* 20-states (including Wyoming) follow RUPA; 20-states follow UPA; and 10-states have their own rules.
2. Remember: RUPA, and UPA are default provisions and are always subject to modification contractually.

B. **UPA §18:** the rights and duties of the partners in relation to the partnership shall be determined, *subject to any agreement between them*, by the following rules:

1. *Profits:* [§18(a)] Each partner shall…share equally in the profits and surplus remaining after all liabilities, including those to partners are satisfied.
2. *Losses:* [§18(a)] Each partner shall…contribute towards losses…sustained by the partnership *according to his share in the profits.*
3. *Indemnification:* the partnership must indemnify every partner in respect of paryments made and personal liabilities reasonably incurred by him in the ordinary and proper conduct of its business, or the for the preservation of business property.

a. *See* UPA §40(d): the partners shall contribute, as proved by section 18(a) the amount necessary to satisfy all liabilities, and if any partner is insolvent the other partners must shall contribute the additional amount necessary to cover the liabilities.

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

D. **G/R:** Profit Sharing: there are six main ways profits can be divided among a partnership *by agreement*:

1. the partners may share on a flat percentage basis without regard to any other factor;
2. one or more partners may be entitled to a fixed weekly or monthly salary and this payment is treated as a cost and subtracted before the profit is computed for division on some other basis;
3. the partners may share on a percentage basis, with the percentages recomputed each year on the basis of the average amount invested in the business during that year by each partner;
4. the partners may share on a percentage basis, with the percentages recomputed each year on the basis of total income, the sale or billings by each partner, time devoted to the business, or on the basis of some other factor;
5. in large partnerships, each partner may be entitled to a fixed percentage applied against "X" percent of the income; and
6. the agreement may remain silent on the division of profits, with the partners agreeing mutually each year on some amount.

II. PARTNERSHIP DUTIES AND LIABILITIES

A. **UPA §13:** Partnership Bound by Partner's Wrongful Act: where by wrongful act or omission (i.e. tort) of any partner acting within the ordinary course of business loss or injury is caused to any person the partnership is liable therefore to the same extent as the partner committing the act.

B. **UPA §14:** Partnership Bound by Breach of Trust: the partnership is bound to make good the loss:

(a) where one partner acting within his scope of apparent authority misappropriates funds from a third person; and

(b) where the partnership in the course of its business misappropriates funds of a third person.

C. **UPA §15:** Nature of Partner's Liability: all partners are liable:

(a) *jointly and severally* for everything chargeable to the partnership under §§ 13 and 14;

(b) *jointly* for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract.

1. *Note:* joint liability as contemplated by §15(b) requires joinder of all partners as defendants in litigation; this joinder requirement may create serious practical enforcement problems where process cannot readily be served on some partners.

D. **RUPA §305:** Partnership Liable for Partner's Actionable Conduct:

(a) A partnership is liable for loss or injury caused to a person as a result of a wrongful act, omission, or other actionable conduct (i.e. tort) of a partner acting in the ordinary course of the business of the partnership or with authority of the partnership.

(b) If the partnership, or a partner, in the ordinary course of the business of the partnership, misappropriates funds the partnership is liable for the loss.

E. **RUPA §306:** Partner's Liability:

(a) Except as provided in subsection (b), all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.

1. This provision eliminates the requirement that that partners be jointly liable for contract and related claims.

(b) A person admitted as partner into an existing partnership is *not personally liable* for any partnership obligation incurred before the person's admission as partnter

(c) Limited Liability Partnerships, *see* infra section 2.3, Rule A, p.14.

F. **RUPA §307:** Actions By and Against Partnership and Partners:

(a) A partnership may sue and be sued in the name of the partnership.

(b) An action may be brought against eh partnership and, to the extent inconsistent with §306, any or all of the partners in the same action or in separate actions.

(c) A judgment against the partnership is not by itself a judgment against a partner and a judgment against the a partnership may not be satisfied from a partner's assets unless there is also judgment against the partner.

(d) provides that a judgment creditor is first required to exhaust partnership assets before proceeding directly against one or more of the partners.

§2.3: LIMITED LIABILITY PARTNERSHIPS

A. **RUPA §306(c):** an obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is *solely the obligation of the partnership*. A partner is NOT PERSONALLY LAIBLE,

1. directly or indirectly,
2. by way of contribution or otherwise,
3. for such a partnership obligation solely by reason of being or so acting as a partner.
4. This subsection applies notwithstanding anything inconsistent in the partnership agreement that existed immediately before the vote required to become a limited liability partnership under section 1001(b).
   a. RUPA §1001(b): the terms and conditions on which a partnership becomes a LLP must be approved by the vote necessary to amend the partnership agreement except, in the case of a partnership agreement that expressly considers contribution obligations, the vote necessary to amend those provisions.

B. **G/R:** Limited Liability Partnerships (LLPs): an LLP statute is usually called the shield of limited liability. Most state LLP statutes are similar to RUPA §306 (some cover only torts).

1. For most purposes an LLP is a general partnership. It differs from a general partnership only because certain partners are by statute relieved of personal responsibility for certain liabilities.
2. §306(c) provides a *full shield* for general partners and protects them form personal responsibility for all partnership obligations other than caused by their own personal misconduct.
   a. Even under an LLP statute, individual partners who themselves commit acts of malpractice remain personally liable because of their own conduct.

3. The LLP is a very beneficial business form but you must file the appropriate documents with the state to take advantage of it [RUPA §§ 1001-1003].
4. To put the general public notice that a partnership is an LLP (hence, that the partnership does not stand behind its debts as much) you need to file the papers with the state, and put the information on letterhead, envelopes, office signs, etc…

§2.4: MANAGEMENT OF PARTNERSHIPS

A. **RUPA §301:** Partner Agent of Partnership: subject to the effect of a statement of partnership authority under section 303:

(1) Each partner is an agent of the partnership for the purpose of its business.

a. An act of a partner for apparently carrying on in the ordinary course of partnership business binds the partnership *unless*:

i. the partner had *no authority* to act for the partnership in the particular matter; and
ii. and the person with whom the partner was dealing *knew* or had *received notification* that the partner lacked authority.
**Knew:* a person knows of a fact if the person has actual knowledge of it [RUPA § 102(a)].
***Received Notification:* a person receives notification when the notification (1) comes to his personal attention; or (2) is delivered to his place of business.

(2) An act of a partner which is not apparently for carrying on in the ordinary course of the partnership business binds the partnership *only if* the act was authorized by the other partners.

***See also* **UPA § 9(1)-(4).**

B. **RUPA § 401(f):** Partner's Rights and Duties: each partner has equal rights in the *management* and conduct of the partnership business. *See also* UPA § 18(e).

C. **RUPA § 401(j):** Partner's Rights and Duties: a difference arising as to a matter in the ordinary course of a partnership may be decided by a *majority* of all partners. An act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the consent of *all* the partners.

1. In other words, a partner cannot negate the action of another partner unless by majority vote; and an amendment of the partnership agreement must be done by consent of all the partners.
2. *See also* UPA § 18(h).

D. **G/R:** General Partnerships: one or more partners, who are general partners, to do some given business each have the power bind the partnership in any manner legitimate to the business, by operation of law. What either partner does with a third person is binding on the partnership [*National Biscuit Co. v. Stroud*].

1. In cases of an even division of the partners as to whether or not an act within the scope of business should be done, of which the third person had knowledge, it is logical that no restriction can be placed upon the power of the partners to act.

E. **G/R:** Apparent Authority: a partnership is bound by the acts of a partner when he acts within the scope or apparent scope of his authority.

1. In order to determine the apparent scope of authority of a partner an adverse party may look to:

a. past transactions indicating a *custom*;
b. *course of dealing* peculiar to the firm in question; or
c. the partners title, such as "managing partner."

2. **UPA §9:** (1) every partner is an agent of the partnership and any act in the usual scope of business binds the partnership. (2) An act of a partner which is *not* apparently for carrying on the business of the partnership does not bind the other partners unless they authorized the action.
*Demonstrates agency law is a major part or partnership law.
*[*Smith v. Dixon*].

F. **G/R:** Proving Apparent Authority: absent an express limitation of authority known to the third party dealing with the partner, an act of a partner binds the firm if:

1. such an act is for the purpose of apparently carrying on the business of the partnership in the way in which other firms engaged in the same business in the locality usually transact business; or
2. in the way in which the particular partnership usually transacts business.
3. **g/r:** burden of proof: the normal rule is that the party who asserts that the particular act of an agent is within the scope of the agent's authority has the burden of proving the extent of that authority.
*[*Burns v. Gonzalez*].

G. **G/R:** Partners as General Agents: each partner is, by virtue of the partnership relation, authorized to act as the general agent for his co-partners in all matters coming within the scope of the business firm.

1. All the partners are responsible for the act of their partners as agent, even though he acts for some secret purpose of his own, and not for the benefit of the firm [Rst. (2) Agency § 165].
2. Where one partner, by fraudulent promises made in a transaction within the scope of the partnership business, obtains money form a third person and misappropriates it, the other partners are liable.
3. While the agency of a partner extends to all matters connected with the business in which the partnership is engaged, his authority extends no further.
*[*Rouse v. Pollard*].

H. **G/R:** Determining the Scope of Partnership: the scope of any line of business may be gauged by the usual and ordinary course in which such business is carried on by those engaged in it in the locality where the partnership has a seat.

1. The scope may be broadened by the actual, though exceptional, course of conduct of the business of the partnership itself, as carried on with the knowledge, actual or presumed, of the partner sought to be charged.
*[*Rouse v. Pollard*].

I. **G/R:** Joint and Several Liability: liability of partners for the acts of co-partners is based on a principal agent relationship between the partners and the partnership. Partners are jointly and severally liable for the tortious acts of other partners if they have authorized those acts or if the wrongful acts are committed in the ordinary course of the partnership [*Roach v. Mead*; UPA §§ 13, 15].

J. **G/R:** Breach of Trust and Reliance by Third Party Giving Rise to Liability: if a third person reasonably believes that the services he has requested of a member of a partnership is undertaken as part of the partnership business, the partnership should be found liable a breach of trust incident to the employment even though those engaged in the practice of the business would regard it as unusual [*Roach v. Mead*].

1. The reasonableness of the third person's belief is a question of fact.

L. **G/R:** Lawyers as Partners: the lawyer is a fiduciary to his clients and should not enter into business transactions with the client subject to the exceptions set out Model Rules of Professional Conduct §1.8:

1. The terms are fair and reasonable;
2. client knows he can and should seek advice from another attorney; and
3. the client consents in writing.

*Agency law determines the liability of a partner for the negligence of an associate.

§2.5: DUTIES OF PARTNERS TO EACH OTHER

I. FIDUCIARY DUTIES IN PARTNERSHIPS

A. **RUPA §404:** General Standard's of Partner's Conduct:

(a) The *ONLY* fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c).

(b) *Duty of Loyalty:* a partner's duty of loyalty to the partnership and the other partners is limited to the following:

(1) to account for the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business, including the appropriation of a partnership opportunity.

(2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business *as a party having an interest adverse to the partnership*;

(3) to refrain from competing with the partnership in the conduct of the partnership before dissolution.

(c) *Duty of Care*: a partner's duty of care to the partnership and to the other partners is to refrain from engaging in *grossly negligent* or *reckless* conduct, *intentional misconduct*, or knowing violation of the law.

*These duties of loyalty and care may not be waived or eliminated in the partnership agreement.

***See also* **UPA § 21(1):** this is broader than RUPA § 404, and probably incorporates more of a duty of loyalty as established in *Meinhard v. Salmon*.

B. **G/R:** Disclosure: because every partner is an agent to the partnership, there is a DUTY to disclose all material facts to co-partners and failure to do so may be a breach of fiduciary duty [*Meinhard v. Salmon*].

C. **G/R:** Fiduciary Duty: co-partners, owe to one another, while the enterprise continues, the duty of the *finest loyalty*. Not honesty alone, but the PUNCTILIO (highest point) of an honor the most sensitive, is the standard of behavior [*Meinhard v. Salmon*].

1. Put PUNCTILIO in the exam.
2. Many forms of conduct permissible in the general workplace for those acting at arm's length are forbidden to those bound by fiduciary ties.
3. This is a broad fiduciary duty; maybe one of the highest recognized by law.
4. *Meinhard* dealt with joint-ventures, however, it was extended to partnerships, corporations, and most other business organizations.
   a. *Joint Ventures:* involve a more limited business purpose than partnerships, perhaps a partnership for a single transaction. Most partnership rules are applicable to joint ventures, the major difference is the scope of actual authority and apparent authority that each joint venturer possesses to bind the venture.

D. **G/R:** <u>Implied at Law:</u> the fiduciary duty is implied at law, and a party cannot waive the fiduciary duty (with a few exceptions) even through contract.

1. RUPA §404 may go a bit further in allowing a party to contract out of a fiduciary duty; however, a partner cannot completely waive his fiduciary duty.

§2.6: PARTNERSHIP PROPERTY

A. **RUPA § 203:** <u>Partnership Property:</u> property acquired by a partnership is property of the partnership, and not the *partners individually*.

1. *Official Comment:* all property acquired by a partnership, by transfer or otherwise becomes partnership property and belongs to the partnership as an entity, rather than the individual partners.

a. *See also*: **UPA §§ 8(1)** and **25.** However, this section expresses the substantive result of the those provisions.

B. **RUPA § 204:** <u>When Property is Partnership Property:</u>

(a) Property is partnership property if it is acquired in the name of:

(1) the partnership; or

(2) one or more partners with an indication in the instrument transferring title to the property of the person's capacity as a partner.

(c) Property is presumed to be partnership property if purchased with partnership assets, even if not acquired in the name of the partnership or of one or more partners with an indication in the instrument transferring title to the property of the person's capacity as a partner.

C. **G/R:** <u>Charging Order:</u> a charging order may enjoin the members of a partnership from making further disbursements of any kind to the debtor partner, except such payments as may be permissible under a legal exemption right properly asserted by the debtor.

1. In other words, if a partner is unable to pay a debt, the debtor cannot go to the partnership and attach is property but can only get a charging order.

a. A charging order gives the creditor the right to get the profits that are due from the debtor partner which flow out of the partnership; the creditors interest is the debtor partner's profits/surplus.

b. If the charging order proceeds to slowly for the creditor than he can institute a foreclosure proceeding wherein the co-partners will have to share in the debtor partners interest in the partnership.

c. *Foreclosure:* the process by which a secured creditor realizes upon the security.

2. **UPA §28** deals with charging orders.

D. **G/R:** <u>Assignment of a Partner's Interest:</u> a conveyance by a partner of his interest in the partnership, is permissible, and does not of itself dissolve the partnership or disassociate the transferring partner, but merely entitles the assignee to receive in accordance with his contract the profits to which the assigning party would otherwise be entitled [**RUPA § 503**].

1. Thus, an assignee does not become responsible for the partnership obligation and *does not* become a partner, and is not entitled to partake in management of the partnership or inspect the records.

2. A transferee cannot force the dissolution of the partnership.

3. *See also* UPA §§ 27, 32(2).

§2.7: PARTNERSHIP ACCOUNTING

A. Generally: from an accounting standpoint, the business of a partnership is almost universally recognized as being distinct from the financial affairs of the individual partners.

1. The interests of the partners are usually reflected in capital accounts which are adjusted periodically for income, drawings, and contributions or withdrawals of capital.

B. **RUPA § 401(a):** Capital Accounts: (a) Each partner is deemed to have an account that is:

(1) credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership and the partner's share of the partnership profits; and

(2) credited with an amount equal to the capital contributed by the partner less the amount of any distributions to the partner plus the partner's share of the profits less the partner's share of the losses.

*A partner's capital account may be negative from time to time; upon the final settlement of accounts when the partnership is terminated, a partner with a negative account must pay the partnership that amount [RUPA § 807(b)].

A. **G/R:** Formula: the formula for partnership accounting is: (Equity = Assets – Liabilities.)

1. Equity in this equation means *ownership* or *net worth*. The equation simply states that the net worth of a business is equal to its assets minus its liabilities.

B. **G/R:** Balance Sheet: is a fundamental financial statement. A balance sheet restates the formula as (Assets = Liabilities + Equity).

1. A balance sheet records a situation at one instant in time.
2. The bottom line of the balance sheet is not itself a meaningful figure, since transactions may increase or decrease it.
3. The balance sheet is a static concept showing the status of a business at a particular instant in time while the income statement is describes the results of operations over some period of time.

C. **G/R:** Accounting Principles: there are four fundamental premises underlying financial accounting:

1. Financial accounting assumes that the business that is the subject of the financial statements is an entity;
2. All entries have to be in terms of dollars;
    a. whether real estate, tangible or intangible property or assets (i.e. debts), it must be expressed in dollars, either historical cost or fair market value.
    b. a liability in the balance sheet is a recognized debt or obligation to someone else.
3. A balance sheet has to balance; and
    a. the fundamental accounting equation itself states an equality: the two sides of the balance sheet restate that equality in somewhat reorganized form. A balance sheet is therefore an equality and the sum of the left hand side of the balance sheet must precisely equal the sum of the right hand side.
    b. If the balance sheet does not balance, there is a mistake.
4. Every transaction entered into by a business must be recorded in at least two ways if the balance sheet is to continue to balance.

§2.8: PARTNERSHIP DISSOLUTION/DISSOCIATION

I. <u>DISSOCIATION OF A PARTNER</u>

A. **G/R:** under the RUPA the dissociation of a partner does not cause the dissolution of the partnership [RUPA §801].

1. Under the UPA a partnership is dissolved every time a partner leaves [UPA §29].

B. **RUPA §601:** <u>Events Causing Partner's Dissociation:</u> a partner is dissociated from a partnership upon the occurrence of any of the following events:

(1) a partner's express will to withdraw as partner;
(2) an event in the partnership contract causing the partner's dissociation (like retirement);
(3) a partner's expulsion pursuant to the partnership contract;
(4) a partner's expulsion by unanimous vote by the other partner's if:
  (i) it is unlawful to carry on the partnership with that partner;
  (ii) there is a transfer of all the partner's transferable interest in the partnership;
  (iii) if a corporate partner, upon the filing of a certificate of dissolution;
  (iv) if a partnership partner, upon its dissolution;
(5) by judicial determination because:
  (i) the partner engaged in wrongful conduct that adversely and materially affected the partnership;
  (ii) the partner willfully or materially breached the partnership contract;
  (iii) the partner engaged in conduct relating to the partnership business which makes it not reasonable to carry on business with that partner;
(6)(i) the partner's becoming a debtor in bankruptcy;
(7) in the case of a partner who is an individual:
  (i) the partner's death;
  (iii) judicial determination of incompetence/disability.

***See also* **UPA §§ 29-33**

C. **RUPA §603:** <u>Effect of Partner's Dissociation:</u>

(b) Upon a partner's dissociation:
  (1) the partner's right to participate in the management and conduct of the partnership business terminates;
  (2) the partner's duty of loyalty terminates; and
  (3) the partner's duty of loyalty and care continue only with regard to the matters arising and events occurring before the partner's dissociation, *unless agreed otherwise*.

See also* **UPA §38: RUPA § 603 fundamentally changes what occurs after a dissociation, under the UPA every partner dissociation results in the dissolution of the partnership, most of which trigger a right to have the business wound up unless the partnership agreement provides otherwise.

II. <u>DISSOLUTION OF THE PARTNERSHIP</u>

A. **G/R:** Dissolution Defined: the dissolution of a partnership is *the change in the relation* of the partners caused by *any* partner ceasing to be associated in the carrying on (as distinguished from the winding up) of the business [UPA § 29].

1. *UPA:* under the UPA, dissolution refers to the termination of legal relationship among partners (not the winding up and disposition of the partnership business).
2. *RUPA:* in RUPA, the term dissociation is used to refer to the termination of a legal relationship, dissolution refers to the winding up of the business.

B. **RUPA §801:** a partnership is dissolved, and the business must be wound up, only upon the occurrence of one of the following events:

(1) *Partnership at will:* in a partnership at will, any partner who dissociates by his express will may compel dissolution.

(2)-(4) *Partnership for Definite Term:* in a partnership for a definite term, or particular undertaking, if one of the partner's dissociates wrongfully (or a dissociation occurs because of death or dissolution of a partner) a dissolution occurs *only* if HALF (1/2) of the remaining partners agree to dissolve the partnership 90-days after dissociation.

a. Once an event requiring dissolution and winding up occurs, the partnership is to be wound up unless *all the partners* (including the dissociated partner, unless he was a wrongfully dissociating partner) agree.

(5) on application by a partner, a judicial determination that:

(i) the economic purpose of the partnership is likely to be unreasonably frustrated;

(ii) another partner has engaged in conduct which makes it un-practicable to carry on the business in the partnership with that partner; or

(iii) it is not practicable to carry on the partnership business in conformity with the partnership agreement.

C. **G/R:** Partnership at Will: if the partnership agreement (contract) is silent and does not set forth a specified term as to how the long the partnership will continue, a partnership at will has been created and the partnership can terminate at anytime without liability.

D. **G/R:** Partnership for Term: a partnership that is to continue for a specified term or until the occurrence of a specified event is a partnership for term.

1. If a partnership for term has been created, early dissolution by a partner is a breach of the partnership agreement and opens the dissolving party to liability for breach of contract.

E. **G/R:** Winding Up: (winding up is the period which leads to termination of the partnerin the absence of an agreement, the statutory default provisions of RUPA provide that upon the dissociation of a partner:

1. the remaining partners have the option to continue the partnership by buying out the withdrawing partner, *see* § 701 below;
2. allowing the dissolution, and the winding up and liquidation of the partnership.

F. **RUPA § 701:** Purchase of a Dissociated Partner's Interest:

(a) if a partner is dissociated without the dissolution and winding up of the business the partnership can purchase the dissociated partner's interest in the partnership for the amount in (b).

(b) the buyout price of a dissociated partner's interest is the amount of his profits or losses (under §807(b)) the liquidation value of his assets.

G. **G/R:** Continuation Agreements: a contractual agreement which provides for the continuation, and payment of the outgoing interest, if a partner is dissociated. There are several matters that must be determined:

1. The types of dissolution which trigger the clause. These usually include death, disability, retirement, and other things such as bankruptcy or expulsion.
2. Who is to purchase the outgoing interest. Provisions usually provide for one of the following options:
    a. purchase by the other partners;
    b. purchase by an acceptable third person;
    c. purchase by the partnership; or
    d. the outgoing interest may continue to share in the profits on some limited basis.
3. Whether the disposition is optional or mandatory; that is, may the remaining partners elect to terminate, ignoring the provision in the agreement (optional).
4. *Valuation:* the amount the withdrawing partner is going to receive for his interest. There are several options for valuation:
    a. fixed sum, with periodic adjustment (this is probably the best option, and you can use formulas for automatic periodic adjustment which makes it even more attractive);
    b. book value, perhaps with supplemental appraisals;
    c. appraisal;
    d. capitalization of past earnings;
    e. fraction of future earnings over a period of time;
    f. negotiation after the fact;
    g. right of first refusal;
    h. a sum based on the a fraction of the partners income for the previous years.
5. How the partnership will pay for the outgoing interest. If a lump sum is required life insurance is usally the answer.
6. Whether the retiring interest can compete with the partnership interest.
7. Should the retiring interest have access to the books and partnership records.

H. **G/R:** Indissoluble Partnerships: there is not such thing as an indissoluble partnership because there always exists the power, as opposed to the right, of dissolution.

1. The right to dissolution rests in equity, as does the right to relief from the provisions of any legal contract.
2. A court of equity will not assist the partner breaking his contract to procure a dissolution of the partnership because a partner who has not fully and fairly performed the partnership agreement on his part has no standing in a court of equity to enforce any rights under the agreement.
*[*Collins v. Lewis*].

I. **G/R:** Expulsion Agreements: an agreement to provide for the expulsion, or withdrawal, of a partner is common and acceptable.

1. While there is no common law or statutory right to expel a member of the partnership, partners may provide in their agreement for the involuntary dismissal, *with or without cause*, of a partner.
2. The heart of the partnership agreement is the principle that partners can choose who they want wish to associate with.
*[*Gelder Medical Group v. Webber*].

3. **RUPA § 601(1)(3):** a partner is dissociated from a partnership upon the partner's expulsion pursuant to the partnership agreement. *See also* UPA §§ 31(1)(d) and 38(2).

§2.9: INADVERTENT PARTNERSHIPS

A. **G/R:** Partnership Definition: (always start the analysis with this) a partnership means an association of two or more persons to carry on as co-owners a business for profit [RUPA § 101(6)].

B. **RUPA § 202:** Formation of Partnership: (a) the association of two or more persons to carry on as co-owners a business for profit forms a partnership, *whether or not the persons intended to form a partnership*.

(c) In determining whether a partnership is formed, the following rules apply:

(1) joint tenancy, tenancy by the entirety, and joint or common property, even if shared for a profit, *does not* create a partnership;

(2) the sharing of gross returns does not by itself establish a partnership;

(3) a person who *receives a share of the profits of a business* is presumed to be a partner in the business (subject to 6 exceptions such as services of an independent contract, rent, interest or a charge on a loan, the sale of goodwill).

a. The sharing of profits is a rebuttable presumption of a partnership.

*Also remember that persons who are not partners as to each other are not partners as to third persons.

C. **G/R:** Test for Determining if a Partnership is Created: whether an association of two or more persons carried on the business as co-owners to make a profit:

1. *Profits:* profit sharing creates a rebuttable presumption of the existence of a partnership.

2. *Co-Owners:* in determining if someone is acting as co-owner, the main issue is control, and power, in the partnership.

a. If the person cannot initiate any transactions that a partner could, and cannot bind the firm as a partner could, then he is not liable for the debts of the firm and is not a partner.

b. If a partnership in fact exists, recovery can be allowed although the parties may stipulate to the contrary (in other words, it doesn't matter what the parties call themselves, if they share profits and are co-owners they are partners).

*[*Martin v. Peyton*].

D. **G/R:** Contractual Formation of Partnership: a partnership results from contract, whether express or implied.

1. If a partnership contract is denied, it may be proved by the production of some written instrument, by testimony as to some conversation, or by circumstantial evidence.

2. The determination of whether a contract creates a partnership is a matter of law.

3. A partnership is a contractual relationship and the intention to create it is necessary. As to the third parties, a partnership may arise by estoppel.

*[*Martin v. Peyton*].

E. **G/R:** Partnership by Estoppel: a partnership may be created by estoppel; that is, if someone is lending credit to an entity with *reliance* on the fact they are partners. There are two elements which must be satisfied before partnership by estoppel can arise:

1. the person must represent himself as a partner, or in a partnership, in a public manner which;

a. evidence of representation of a partnership may be things such as, whether the letter head holds them out as partners, brochures, copyrights, signatures, etc…

2. causes credit to be given to the actual or apparent partnership in *reliance* on the representation. *[*Smith v. Kelly;* **UPA § 16**].

3. Exception: if a person is held out to the public as a partner, but as between the association of persons, the person is in fact a partnership relationship did not exist, he may not be held liable as a partner [*Smith v. Kelly*].

G. **G/R:** persons who are not partners as to each other, are not partners to a third person.

1. *Caveat:* a person who represents himself, or permits another to represent him to anyone as a partner in an existing partnership, is liable to any such person to whom such a representation was made who has, on the faith of the representation, given credit to the actual or apparent partnership.

2. Partners are jointly and severally liable fore everything chargeable to the partnership. *[*Young v. Jones*].

§3: THE FORMATION OF THE CLOSELY HELD CORPORATION

§3.1: WHERE TO INCORPORATE

A. **G/R:** Closely Held Corporation: typically a closely held corporation is one in which:

1. the number of shareholders is small;
2. there is no outside market for its shares;
3. all or most of the principal shareholders participate in its management; and
4. the free transferability of shares is restricted by agreement.

B. **G/R:** Incorporation State: the selection of the State of incorporation involves considering two factors:

1. a dollars and cents analysis of the relative cost of incorporating, or qualifying as a foreign corporation, under the statures of the States under consideration; and
2. consideration of the advantages and disadvantages of the substantive corporation laws of these states.
3. As a practical matter, the choice often comes down to the jurisdiction where the business is to be conducted, or Delaware, the most popular outside jurisdiction.
4. If the corporation is closely held and its business is to be conducted largely or entirely within a single state, local incorporation is almost always preferred.

§3.2: HOW TO INCORPORATE

A. **RMBCA §2.01:** Incorporators: one or more persons may act as the incorporator(s) of a corporation by *delivering the articles* of incorporation to the secretary of state for filing.

1. There must be an incorporator, but you only need one. The incorporator writes and signs the articles, usually. Practically the lawyer writes the articles, and he could but the incorporator, but probably should not be, and then the incorporator signs and delivers them.

B. **G/R:** Process of Incorporation: the process of incorporation is most states are relatively simple:

1. **RMBCA §§ 1.20-1.27:** the formal requirements for filing of documents.
2. The Articles of incorporation must be filed with the secretary of State, as described in § 1.25.

a. The date of the existence of the corporation begins when the Secretary of State files the document [RMBCA § 2.03].

C. **RMBCA §2.02:** Articles of Incorporation: (a) the articles of incorporation *must* set forth [Mandatory requirements]:

(1) a corporate name that satisfied the requirements of section 4.01;

a. **RMBC §4.01:** a corporate name must include one of the following "magic words"

i. corporation, incorporated, company, limited; or

ii. the abbreviations corp., inc., co., or ltd.

(2) the number of shares the corporation is authorized to issue;

a. a corporation usually issues a smaller number of shares then it authorized so if the business expands there are shares available without amending the articles of incorporation.

i. *Issued Shares:* are there shares in the market;

ii. *Authorized Shares:* is number of shares that can be issued by the corporation as set forth in the articles.

iii. **g/r:** a corporation can't issue what it hasn't authorized; however, there must always be one outstanding share.

iv. As a corporation issues more stock it dilutes the value of the shares of stock because each share is an ownership interest. Each share issued, in total, equals 100% of the business.

(3) the street address of the corporations registered office and the agent of that office;

a. The lawyer should not be the registered office or agent.

(4) the name and address of each in incorporator.

****§2.02(b):** sets forth things that may be added to in the articles of incorporation.

D. **RMBCA §3.01:** Purposes: every corporation has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation.

E. **RMBCA §3.02:** General Powers/Duration: every corporation has *perpetual duration* and succession in corporate name *has the same powers as an individual to all things necessary or convenient to carry out its business and affairs* (including the list of enumerated powers 3.02(1)-(15)).

1. A corporation may list its powers in the articles of incorporation pursuant to §2.02(b)(2)(iii); but does not have to pursuant to §2.02(c).

F. **RMBCA §2.05-2.06:** Requirements after Incorporation: after the articles of incorporation are filed the corporation should also:

1. prepare the corporate bylaws;
2. prepare the notice calling the meeting of the initial board of directors, minutes of this meeting, and waivers of notice if necessary;
3. obtain a corporate seal and minute book for the corporation;
4. obtain blank certificates for the shares of stock, arrange for their printing or typing, and ensure that they are properly issued;
5. open a corporate bank account;

6. prepare employment contracts, voting trusts, shareholder agreements, share transfer restrictions, and other special arrangements, which are to be entered into with respect to the corporation and its shares;
7. obtain taxpayers identification numbers, occupancy certificates, and other governmental permits; and
8. evaluate whether the corporation should file an S corporation election.

G. **RMBCA §5.01:** <u>Registered Office and Agent:</u> every corporation must have a registered office and agent.
1. This is designed to ensure that every corporation has publicly stated a current place where it may be found for purposes of service of process, tax, notices, and the like.

§3.3: DOCTRINE OF ULTRA VIRES

A. **G/R:** <u>Definition:</u> ultra vires means an act performed without any authority to act on the subject; that is, beyond the scope of the powers of incorporation.

B. **G/R:** <u>Classical Rule:</u> an act performed without authority to act on the subject because it is beyond the scope of the power conferred on the corporation in the corporate charter or articles of incorporation are void [*Ashbury Ry. Carriage & Iron Co. v. Riche*].

C. **RMBCA § 3.04:** <u>Ultra Vires:</u> (a) the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked the power to act, except for the exceptions in (b).
(b) A corporations power may be challenged:
(1) in an action brought to enjoin a corporate act;
(2) in an action by (a direct suit) or in the right (a derivative suit) of the corporation against an incumbent or former director/officer/employee of the corporation; or
i. *Direct suit:* a direct suit is one in which the shareholder was harmed directly by the corporation which entitles them to sue the directors/officers directly, there are a lot of class actions under the direct suit on behalf of all the shareholders;
ii. *Derivative suit:* is a suit brought in the name of the corporation by a shareholder to protect the corporation from some harm (like mismangement).
(3) in an action by the attorney general.

D. **G/R:** <u>Charitable Gifts:</u> corporate charitable or educational gifts to be valid must merely be within the reasonable limits with respect to amount and purpose.
1. *Reasonable Test:* in passing on the validity of a corporate gift, the gift is reasonable if it is within the bounds of the IRC's provisions pertaining to charitable gifts by corporations. In other words it has to be reasonable as to both amounts and purpose.
*[*Theodora Holding Corp. v. Henderson*]. *See also* RMBCA §3.02(13).

§3.4: PREMATURE COMMENCEMENT OF BUSINESS

I. <u>PROMOTERS</u>

A. **G/R:** Promoters: a promoter includes a person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer.

1. A promoter is the founder of an enterprise.
2. One of the promoter's duties is to arrange for the formation of the corporation to conduct business.

B. **G/R:** Fiduciary Duty: in the promoter relationship with the enterprise, the promoter owes a significant fiduciary duties to other participants in the venture.

1. Co-promoters may be viewed as partners in a venture to create a business.
2. Thus, promoters owe a fiduciary duty to the corporation and other promoters.
    a. The promoter may also have a duty to ensure that the corporation comes into effect.

C. **G/R:** Scope of Authority and Liability: the promoter, though he acts on behalf of the corporation, may be personally liable on a contract if he is acting outside the scope of his authority.

1. A promoter, though he may assume to act on behalf of the corporation and not himself, will be personally liable on a contract unless the other party agreed to look to some other person or fund for payment.
    a. Promoters, other the one signing the contract, may also be held liable.
2. Exception: if from the terms of the contract, the court can determine that the person entering into the contract is looking only to the corporation for payment, then the promoter is not liable.
*[*Stanley J. How & Assoc. v. Boss*].

D. **G/R:** Contractual Liability promoters are personally liable on their contracts, though made on behalf of the corporation to be formed.

1. Exception: if the contract is made on behalf of the corporation and the other party agrees to only look to the corporation and not the promoters for payment, the promoters incur no personal liability.
2. *Releases:* in the absence of an express agreement to release the promoter from liability, the existence of such release depends on the intent of the parties. As a proponent of an alleged agreement to release the promoter from liability, the promoter has the burden of proving the release agreement.
*[*Quaker Hill v. Parr*].

E. **G/R:** Corporate Liability: a corporation is not liable on a promoters contract unless it expressly or impliedly adopts, or ratifies it.

1. *Adoption:* a corporation adopts the terms of a contract by an express or implied offer, acceptance, and consideration.
    a. A corporation takes an express action through its board of directors, or someone under the authority of the board.
        i. If the president, or board passes a resolution adopting the contract, that is express.
    b. A corporation can take implied action through ratification.
2. *Ratification:* if the board ratifies the actions of the promoter, then it has impliedly agreed to the terms of the contract.

F. **G/R:** Ratification: is the affirmance by a person of a prior act, which did not bind him but was done on his account, which gives the impression that it was originally authorized by him.

1. Affirmance is:

a. a manifestation of election to treat the act as authorized; or
b. conduct by him justifiable only if there was such an election.
*[**Rst. (2) Agency §§ 82, 83**].

II. AGENCY PRINCIPALS WHICH COULD BIND A CORPORATION OR PROMOTERS

A. **Rst. (2) § 329:** Agent who Warrants Authority: a person who purports to make a contract on behalf of another who has full capacity, but no power to bind, is liable to the other party on an implied warranty of authority.

1. *Caveat:* if the person has manifested that he does not make such warranty or the other person knows that the agent is not authorized, he is not liable.
2. *Hint:* this can be used to hold the promoter liable.

B. **Rst. (2) § 330:** Liability for Misrepresentation: a person who tortiously misrepresents to another that he has authority to make a contract on behalf of a principal whom he has no power to bind, is subject to liability to the other in a tort action for loss caused by *reliance* upon such misrepresentation.

1. *Hint:* this can be used to hold the promoter liable.

C. **Rst. (2) § 331:** Agent making no Warranty or Misrepresentation: a person who purports to make a contract on behalf of a principal whom he has no power to bind is not liable to the other party if he sufficiently manifests that he does not warrant his authority and makes no tortious misrepresentation.

1. *Hint:* This can be used to get the promoter off the hook.

GET RST (3) AGENCY RULES, class notes 9-11.

III. DEFECTIVE INCORPORATION

A. **RMBCA § 2.04:** Liability for Preincorporation Transactions: all persons *purporting to act* as or on behalf of a corporation, *knowing* there was no incorporation under this Act [§2.03], are jointly and severally liable.

1. To be held liable for preincorporation transactions under this section 2 elements have to be satisfied:
   a. *Purporting to Act:* all person purporting to act as or on behalf of the corporation means that they have to actively engage in some behavior (e.g. enter a contract, transaction, using the corporate name); AND
   b. *Knowingly:* is a subjective test, that the person knew they were not incorporated.
      i. If the person acted erroneously, but in good faith, they are not personally liable for preincorporation transactions.
   **If both these elements are met the person is jointly and severally liable.
2. The official comment states that this rule does not foreclose the possibility of the courts applying the estoppel doctrine.

B. **G/R:** Estoppel Doctrine: persons who urge defendants to execute contracts in the corporate name knowing that not steps to incorporate have been taken may be estopped to impose personal liability on individual defendants.

1. Estoppel may be based on the inequity that is perceived when persons, unwilling or reluctant to enter into a commitment under their own name, are persuaded to use the name of a nonexistent corporation, and then are sought to be held personally liable under RMBC § 2.04.
*[Official Comment of § 2.04].
2. Estoppel is employed where the person seeking to hold the officer personally liable has contracted or otherwise dealt with the association in such a manner as to recognize and, in effect, admit its existence as a corporate body [*Cranson v. Intern'l Business Machines Corp.*].
3. Directors and corporations may also be estopped. If a director or corporation does business and enters into contracts, but there is a slight mix up on the name of the corporation in the contract (for example), then they are estopped from denying its existence simply to avoid liability.

C. **G/R:** <u>De Jure Corporation:</u> a de jure corporation results when there has been conformity with the mandatory conditions precedents established by statute [i.e. which means the corporation is legally established].

1. *Directive Condition:* is a minor mistake in the corporate filing, or condition precedents (like the wrong address) and does not cause a corporation to lose its de jure status.

D. **G/R:** <u>De Facto Corporation:</u> is a corporation which has been defectively incorporated. There are four elements for a de facto corporation:

1. a valid law under which such a corporation can lawfully organize;
2. an attempt to organize under the law;
3. actual user of the corporate franchise; and
4. good faith in claiming to be and in doing business as a corporation.
    a. Some courts do not require this fourth element.

*This is classical doctrine used to clothe an officer of a defectively incorporated association with the corporate attribute of limited liability.

E. **G/R:** <u>Effect of issuance of certificate of Incorporation:</u> [MBCA § 50]: upon the issuance of the certificate of incorporation, the corporate existence shall begin, and such certificate of incorporation shall be conclusive evidence that all conditions precedents required to be performed by the incorporators have been complied with and that the corporation has been incorporated under this Act [*Robertson v. Levy*].

F. **G/R:** <u>Unauthorized Assumption of Corporate Powers:</u> [MBCA § 139]: All persons who *assume to act* as a corporation without authority so to do shall be jointly and severally liable for all debts and liabilities incurred or arising as a result.

1. **g/r:** the existence of a corporation is conclusive evidence against all who deal with it. Under § 139, if an individual or group of individuals assumes to act as a corporation before the certificate of incorporation has been issued, joint and several liability attaches.
    a. It is irrelevant whether the third person thought he was dealing with a corporation or not under these rules.
2. *Assume to Act:* includes those persons who have an investment in the corporation AND who actively participate in the policy and operational decisions of the organization.
    a. This creates a distinction between active participants and passive investors.
        i. Active participants can be held liable for preincorporation transactions.
        ii. Passive investors cannot be held liable for preincorporation transactions.
    b. This policy distinction is still made a lot because courts like to encourage investment.

*[*Timberline Equip. Co. v. Davenport*].

2. In other words, if you don't use RMBCA §2.04, use *Robertson* and if you have §50 and §139 there is probably liability.

*[*Robertson v. Levy*].

§4: DISREGARD OF THE CORPORATE ENTITY: PIERCING THE CORPORATE VEIL

I. GENERALLY

Analytical Framework: on a piercing question you want to go through these steps:

1. Apply the general premises, that is, corporations are presumed separate entities, burden of proof, and the piercing the veil is the exception, imposed reluctantly, and only used for equity and justice purposes.
2. Then apply one of the three tests: (a) alter ego; (b) instrumentality; or (c) Alaska test. You can get more than one in by using counterarguments because they are listed in decreasing order of strictness;
3. Then apply the 5-main factors the court uses, which it will use in any those tests, such as undercapitalization, etc…
4. Then determine who is liable, the shareholders, a parent corporation, etc…From a thinking standpoint you need to know this first, but don't put it down until last for analytical purposes.

A. **G/R:** Definition: piercing the corporate veil occurs when a plaintiff attempts to hold shareholders personally liable on corporation debts.

B. **G/R:** Escaping Liability: the law permits the incorporation of a business for the very purposes of escaping personal liability [*Bartle v. Home Owners Group*].

1. Generally, the doctrine of piercing the corporate veil is invoked to prevent fraud or achieve equity.
    a. *Fraud:* means more than just lying or misrepresenting facts in the piercing context.
    b. *Equity:* covers a wide range of things, but is typically used by judges when they decide that inequities are clearly present.

C. **G/R:** Burden of Proof: the burden of establishing a basis for piercing the corporate veil rests on the party asserting such a claim [*Dewitt v. Ray Flemming*].

D. **G/R:** each piercing case will necessarily vary according to the circumstances of each case, and ever case where the issue is raised is to be regarded as its own kind to be decided in accordance with the underlying facts [*Dewitt v. Ray Flemming*].

E. **G/R:** Corporate Entity: the corporate is an entity, separate and distinct from its officers and stockholders, and its debts are not that of the individual shareholders.

1. There is a presumption at law, that the corporation and shareholders are distinct.
    a. The presumption is equally applicable whether the corporation has many or only one shareholder.
    b. Only in appropriate cases, and to further the ends of justice, will the corporate veil be pierced and the corporation and its stockholders be treated as identical.

*[*Dewitt v. Ray Flemming*].

2. A party injured by the conduct of a corporation or one of its employees can only look to the assets of the employee or employer corporation for recovery.

a. The shareholders of a corporation (including the parent company) are not responsible.

i. The piercing doctrine is the exception to these general rules.

*[*Radaszewski v. Telecom*].

F. **G/R:** Choice of Law: the law of state of incorporation determines when the corporate form will be disregarded and liability will be imposed on the shareholders [*Fletcher v. Atex*].

1. So if, by chance, you get a piercing question and it deals with a corporation incorporated in Delaware, use the alter ego test.

**START WITH THESE PREMISES BEFORE APPLYING THE TESTS

II. PIERCING THE CORPORATE VEIL TESTS

A. **Instrumentality Test:** [*Radaszewski v. Telecomp. Corp.*]: to pierce the corporate veil a party must show three elements:

1. Control: control is not mere majority or complete stock control; but complete domination, not only of finances, but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will, or existence of its own;

2. Breach of Duty to Commit Fraud: such control must have been used by the defendant to commit fraud or wrong, to perpetuate the violation of a statutory or other positive legal duty, or dishonest and unjust actions in contravention of the plaintiff's legal rights; that is, a breach of corporate duty; and

a. There are three factors which are used to establish this element:

i. *Undercapitalization:* undercapitalization of a subsidiary means taking it and putting it into business without a reasonably sufficient supply of money;

ii. *Improper Purpose:* in a case where a corporation is operating with insufficient funds to meet is obligations an improper purpose on the part of corporation is evidence of fraud; and

iii. making a corporation a supplemental part of an economic unit and operating it without sufficient funds to meet obligations to those who must deal with it is circumstantial evidence tending to show either an improper purpose or reckless disregard of the rights of others.

3. Proximate Cause: the control and beach of duty must proximately cause the injury complained of.

a. Proximate cause may refer not only cause in fact, but also legal cause; that is, whether liability should be imposed as a matter of law. This in some ways parallels proximate cause in tort law.

**In *Telecom* this test was used to pierce a parent corporation for the debts of its subsidiary.

B. **Alter Ego Test:** [*Fletcher v. Atex*; DELAWARE]: to pierce the veil of a parent corporation for the actions of its subsidiary the following elements must be met:

1. Single Economic Entity: the parent and the entity operated as a single economic entity such that it would be inequitable to uphold a legal distinction between them; and

a. there are five factors to consider in determining whether a subsidiary and parent operate as a single economic entity:

i. *undercapitalization:* whether the corporation was adequately funded for the corporate undertaking;
ii. *solvency:* whether the corporation was solvent;
iii. *corporate formalities:* whether dividends were paid, corporate records kept, officers and directors functioned properly, and other formalities observed;
iv. *siphoning funds:* whether the dominant shareholder was siphoning funds; and
v. whether the corporation simply functioned as a façade for the dominant shareholder.

2. Unfairness: there must be an overall element of injustice or unfairness present.

*In *Fletcher* it was a parent subsidiary pierce.

C. **Alaska Test:** for Imposing Liability on a Parent of a Subsidiary: two theories may be used to justify disregard of the corporate status of a subsidiary:

1. A parent corporation may be held liable for the wrongful conduct of its subsidiary when the parent uses a separate corporate form to defeat public convenience, to justify wrong, commit fraud, or defend crime; *or*
2. a parent may be held liable on the alternative theory that the subsidiary is the mere instrumentality of the parent.

*[*McKibben v. Mohawk Oil*].
**This is the broadest of the tests, so if you're a plaintiff's lawyer on the exam, argue for the adoption this test.

**AFTER STARTING WITH THE PREMISES, THEN PUTTING DOWN THE TESTS, MOVE FORWARD, AND (A) LIST ALL THE FACTORS THE COURT COULD CONSIDER, THEN APPLY THEM TO THE FACTS.

III. FACTORS THE COURT CONSIDERS IN PIERCING CASES

A. **G/R:** [this would be good to say on an exam]: in applying the alter ego, or instrumentality doctrines the courts are concerned with reality, and not form, with the how the corporation operated and the individual defendants relationship to that operation; thus the court will consider various factors [*Dewitt v. Ray Flemming*].

B. **Factors Courts Consider in Piercing Cases**:

B(1). Undercapitalization: [probably the most important]: undercapitalization or inadequate capitalization is frequently listed as a factor in piercing cases:

a. *Definition of undercapitalization:* if the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying separate entity privilege.
 i. Illusory or trifling means "gross" or pretty obvious, the court is not going to bicker about the cost of starting of business, so the under funding has to be significant.

a. *Capital:* consists of assets placed by investors at the risk of the business. Capital can include, but is not limited to, money, stock, insurance protection.

b. *Determination:* a determination concerning undercapitalization involves determining if enough assets have been provided for the use of a particular corporation in terms of what may be fair to existing creditors. In determining the adequacy, or lack thereof, of capital the court considers:

i. corporate debts;
ii. prospective liabilities;
iii. the nature of the business; and
iv. the risk of loss.

c. *Policy:* this concept is based on the belief that it is unfair to take advantage of corporate limited liability without providing some reasonably sufficient quantum of assets for corporate creditors.

d. *Time Measurement of Undercapitalization:* there are two views:

1. look only at the time of incorporation;
2. look at it as a continuing problem, and require proper capitalization all the time because it is arbitrary to only look at the time of incorporation.

e. *Proving Undercapitalization:* there are several ways to prove undercapitalization:

1. expert testimony as to what investment is necessary to make a particular business viable;
2. the testimony of expert financial analysts and statisticians as to comparable business capitalization;
3. evidence of insurance, or the lack thereof; and the amounts of the policy;
4. testimony concerning the likelihood of accidents.

f. In some States, e.g. California, undercapitalization is enough to pierce [*Milton v. Cavaney*]; however, most courts prefer a multifactor test with undercapitalization only being one factor.

g. Undercapitalization is an issue more in closely held corporations than in publicly held corporations.

h. **g/r:** insurance can be used to satisfy the capitalization element, so even if the corporation is losing money, or seems undercapitalized look for that fat insurance policy which might be enough to satisfy the element

B(2). <u>Failure to follow Corporate Formalities:</u> courts often focus upon the formalities followed the by the corporation in considering whether to pierce.

1. Some of the factors the court considers is:

a. payment of dividends;
b. holding of meetings of shareholders or directors;
c. corporate record keeping (the absence of corporate records is disfavored by courts);
d. the issuance of stock;
e. commingling of funds.

2. *Distinguish:* when applying this factor you have to distinguish between closely held corporations and publicly, or large close corporations:

1. Small close corporations, or statutory close corporations, will not be held to the level of corporate formality as larger corporations because it would be unfair to require them to hold director's meetings the like if there is only one director, etc…

3. The mere failure upon occasion to follow all of the forms prescribed by law for the conduct of corporate activities will not justify the disregarding of the corporate entity [*Baatz v. Arrow Bar*].

a. Even if the corporation is improperly using its name, that will not be enough to pierce.

B(3). <u>Fraud:</u> while fraud is factor to consider, it is not necessarily an element for piercing. There are several types of fraud, and the presence of any them, will help to establish an inequity or unfairness element.

1. *Plain or Actual Fraud:*
    a. Fraud is a affirmative misrepresentation or silence when one has a duty to speak. This "disclosure" fraud is looked down upon because it may confuse creditors or equity purchasers as to the financial condition of a debtor, as to who actually owns assets that can be reached for the collection of debt, or as to who is really liable as the debtor on a particular obligation.
2. *Fraud without Deception:* there are several factors of fraud that do not involve disclosure:
    a. grossly inadequate capitalization is sometimes referred to as fraud;
    b. insolvency of a debtor corporation at the time the debt was incurred;
    c. diversion of shareholder of corporate funds or assets to their own or other improper uses;
    d. siphoning of funds of the corporation by the dominant shareholder; and
    e. the fact that the corporation is merely a façade for the operations of the dominant stockholders or shareholders; that is, the other directors may not function at all.
3. *Constructive Fraud:* the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure the public interest.

B(4). <u>Whether the case was a tort or contract case</u>**:**
1. It is sometimes argued that it should be harder for contract creditors than for tort creditors to prevail in efforts to hold investors personally liable in piercing cases because of the distinctions between the two.
    a. *Contract Creditors:* have an opportunity to negotiate and protect themselves.
        i. However, not all contract creditors are able to protect themselves, such as wage earners and consumers who are not in a position to negotiate. Same with trade creditors.
    b. *Tort Creditors:* generally cannot protect themselves and need to be protected by the piercing doctrine because they involuntarily encounter and the party does not have the option to protect himself.

B(5). <u>Other factors</u> the court may consider are:
1. the lack of corporate records;
2. payment by the corporation of individual obligations;
3. anything that shows the directors where using the corporation to promote fraud, injustice, or illegalities.
4. **g/r:** when an individual treats a corporation as an instrumentality through which he is conducting his personal business the court may disregard the corporate entity.

***AFTER APPLYING THE PREMISES, THE TESTS, AND THE FACTORS, FIGURE OUT WHO IS LIABLE.

IV. <u>LIABILITY AND PIERCING THE CORPORATE VIEL</u>

A. **G/R:** <u>Shareholder Liability:</u> if a corporate entity is stripped away then all the owners are liable for corporate debts, just as partners would be.
1. *Caveat:* some courts are against imposing personal liability on the purely passive shareholder because (a) it discourages investment, and (b) court like to encourage investment.

2. Thus, you have determine if the shareholder upon whom liability is seeking to be placed is passive or active; however, sometimes this is a difficult distinction to make.

a. Some courts say that even if you can determine between active and passive shareholders, the distinction does not matter and does protect the passive shareholder from liability.

B. **G/R:** Non-Shareholder Liability: a person who is not actually an owner of shares may also be held liable if the veil is pierced. For example, owners of stock options, contractual rights may be vulnerable as defendants. Creditors may be liable also.

C. **G/R:** Intra-Corporate Liability: many piercing cases involve efforts to impose debts liability for the debts of a corporation on another corporation, rather than shareholders, such as, parents, subsidiaries, and siblings.

1. *Parent Corporations:* refers to corporations in control of another corporation;

2. *Subsidiary/Sibling Corporations:* those corporations controlled by the same parent, person or persons.

3. **g/r:** court do not automatically pierce the veil to get to the assets of a parent corporation because the debts are of a subsidiary, or vise versa.

4. **g/r:** the same tests apply for piercing the corporate veil to get to the parent corporation.

a. However, it may be easier to convince the court to pierce the corporate veil when another corporate entity rather than an individual will be held responsible.

b. Remember, however, in cases like *Radaszewski*, and ones in Delaware the court always reminds parties of the general rule that the doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke.

5. When dealing with intra corporate liability, remember there are really two theories:

a. *Traditional Piercing:* hold the parent corporate liable for the subsidiaries debts; and

b. *Enterprise Liability:* get all the brother-sister corporations to create a common pool of funds for liability purposes.

6. **g/r:** courts have generally declined to find alter ego liability based on a parent corporations use of a cash management system.

a. However, if the corporation is co-mingling funds between the parent and subsidiaries that can be evidence of domination by the parent, or that corporate formalities weren't really being followed.

7. It is permissible for a parent corporation, and not domination, if it controls the borrowing of funds of the subsidiaries. It is also permissible for expert employees, or legal staff, to be transferred around from parent to subsidiary without co-mingling occurring.

**AFTER FINDING OUT WHO IS LIABLE, THROW IN SOME POLICY ARGUMENTS: such as:

1. justice, equity, fairness, demand whatever result,

2. you want to promote investment, or don't want to chill it;

3. through out the scares of unlimited liability and the effects it would have;

4. use the presumption of corporate entities separateness, etc…

V. REVERSE PIERCE DOCTRINE

A. **G/R:** Reverse Piercing Doctrine: in a reverse pierce claim, either a corporate insider or a person with a claim against a corporate insider, is attempting to have the insider and the corporate entity treated the same for some purpose.

1. Reverse pierce claims implicate different policies and require different analytical framework for the more routine piercing claims.
2. In a reverse piercing claim there are three important factors to consider:
    a. The degree of identity between the individual and corporation;
    b. the extent to which the corporation is an alter ego; and
    c. whether others, such as creditors and shareholders, would be harmed by the pierce.
3. A reverse pierce should only be allowed in the most carefully limited circumstances because one of the features of a corporation is limited creditor liability to the corporate assets and the corporation could use its shield depending upon which position protects its property best.
*[Carghill v. Hedge].

VI. EQUITABLE SUBORDINATION

A. **G/R:** Equitable Subordination: a doctrine enabling creditors, and in some instances shareholders, to get ahead of others who are making claims as creditors. As a result of equitable subordination, the bottom line may be that a creditor may collect more money on a debt owed by an insolvent corporation than otherwise might be the case [*Pepper v. Littleton*].
1. Usually only arises in the context of bankruptcy proceedings.
2. There is a fiduciary duty owed by the corporation in a bankruptcy proceeding.

B. **G/R:** Test for Equitable Subordination: whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If not, it can be set-aside on equity principles. Three elements have to be satisfied to before the court will set-aside the transaction on equity principles:
1. the claimant must have engaged in some type of inequitable conduct;
2. the misconduct must have resulted in injury to the creditors of the bankrupt claimant or conferred some unfair advantage on the claimant; and
3. the claim must not be inconsistent with the bankruptcy code.
*[*Pepper v. Littleton*].

C. **G/R:** One-Person Corporations: a director and dominant or controlling shareholder or group of shareholders is a fiduciary. Their powers are in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only prove the good faith of the transaction, but also to show its inherent fairness form the viewpoint of the corporation and those interested in it.
1. Salary claims of officers, directors, and stockholders in the bankruptcy of a one man corporation or family corporation have been disallowed or subordinated wher the courts are satisfied that allowance of the claims would be fair or equitable to other creditors.
2. The result may be reached even though the salary claim has been reduced to judgment. It is reached where the claim asserted is void or voidable because the vote of the interested director or stockholder helped bring it into being or where his history of the corporation shows dominancy and exploitation on the part of the claimant.
3. The disallowance of such claims will be in order where they are fictitious or a sham, they do not turn on the existence or non-existence of a debt. They simply involve the order of payment (i.e. creditors should be paid before directors).
*[*Pepper v. Littleton*].

D. **11 U.S.C. §510(c):** of the Bankruptcy act provides that "after notice and a hearing, the Court may under the principles of equitable subordination, subordinate for the purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest."

1. This codified *Pepper v. Littleton*.

§5: DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

A. **Analytical Framework:** if confronted with a business judgment rule and duty of care question on the exam take this approach. To prevail, the plaintiff, usually a shareholder, will have to overcome several obstacles:

1. Can the action be brought as a derivative suit? Or another way?
    a. If the action is to be maintained as a derivative suit all of the requirements of RMBC §§ 7.41, 7.42, and 7.44 have to be met.
        i. If these are satisfied go to #2; if not go to #1b.
    b. If the plaintiff fails in the derivative action, she may be able to bring a class action or injunction action.
2. You have to look at the articles of incorporation and make sure there is not a charter option statute like Delaware's §102(b)(7); which eliminates director liability for negligence, if there is such a statute, and it applies you may be done.
3. If the suit can be maintained; did the director breach his duty of care; that is, did he not act in good faith, use fraud or misappropriate funds?
    a. If yes, you can hold the directors liable.
3. If there is no breach of the duty of care, is the director protected by the business judgment rule; that is, for the plaintiff to win she will have to show that the director:
    a. was grossly negligent; and
    b. not informed.
4. If the requirements of the business judgment are not met; that is, if the plaintiff demonstrated that the directors were grossly negligent and not informed, then:
    1. Under Delaware principles the plaintiff wins *unless* the directors can demonstrate that the entire fairness of the transaction (i.e. no legal cause analysis);
    2. Under the ALI standard, the plaintiff must still prove that the transaction was the legal cause of the harm complained of.

B. **W.S. § 17-16-830:** General Standards for Directors:

(a) Duty of Care: A director *shall* discharge his duties as a director, including his duties as a member of a committee:
    (i) in good faith;
    (ii) with the care *an ordinary prudent business person* in a *like position* would exercise *under similar circumstances*; and
    (iii) in a manner he reasonably believes to be in or at least not opposed to the best interests of the corporation.

(b) In discharging his duties as director is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, if prepared and presented by:

(i) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in matters presented;
(ii) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the persons professional or expert competence; or
(iii) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.

(c) A director is *not acting in good faith* if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) <u>Business Judgment Rule:</u> A director is *not liable* for any action taken as director, or any failure to take any action, if he performed the duties of his office in compliance with this section..

(e) For purposes of subsection (a) a director, in determining what he reasonably believes to be in or not opposed to the best interests of the corporation, *shall* consider the interests of the corporation's shareholders and, in his discretion, may consider any of the following:
(i) the interests of the corporation's employees, suppliers, creditors and customers;
(ii) the economy of the state and nation;
(iii) the impact of any action upon the communities in or near which the corporation's facilities or operations are located;
(iv) the long term interests of the corporation and its shareholders; and
(v) any other factors relevant to promoting or preserving public or community interests.

I. <u>DUTY OF CARE</u>

A. **G/R:** <u>Duties of Corporate Directors:</u> corporate directors are trustees and in the performance of their duties stand in a fiduciary relationship to the company.

1. The directors are bound by all the rules of fairness, morality, and honest in purpose, which the law imposes under fiduciary obligations and responsibilities, and are held to the extreme measure of candor, unselfishness, and good faith.
2. Any adverse interest of the director will be subjected to rigid scrutiny.
3. The director may not profit at the expense of his corporation and in conflict with its rights; he may not personal gain divert unto himself the opportunities which in equity and fairness belong to the corporation.
4. The director is required to used his independent judgment and in the discharge of his duties must act in honesty and good faith with some degree of skill, prudence and diligence.
5. Directors should know of and give direction to the general affairs of the institution and its business policy and have general knowledge of the manner in which it is conducted, the character of investments, and the employment of resources.
   a. No custom or practice can make a directorship a mere position of honor void of responsibility, or cause a name to become a substitute for care and attention.

*[*Litwin v. Allen*].

B. **G/R:** <u>Liability of Corporate Directors:</u> directors are liable for negligence in the performance of their duties; however, not being insurers, directors are *not* liable for errors in judgment or for mistakes while acting with reasonable skill and prudence.

1. A director is required to conduct the business of a corporation with the same degree of fidelity and care as an ordinary prudent man would exercise in the management of his own affairs of like magnitude and importance.
2. Factors to consider in determining if the director has acted reasonable are:
    a. the facts and circumstances of the particular case;
    b. the kind of corporation involved;
    c. the corporation's size and financial resources;
    d. the magnitude of the transaction; and
    e. the immediacy of the problem presented.
3. *Caveat:* a director is not liable for loss or damage other than what was proximately caused by his own acts or omissions in breach of his duty.
4. *Bank Directors:* a director of a bank is held to a stricter accountability than the director of an ordinary business corporation because he is entrusted with funds of depositors, and stockholders look to him for protection from the imposition of personal liability.
    a. *See also* **12 U.S.C. § 1821(k)** which codifies the fact that bank directors are held to a higher duty of care than regular directors. However, this is meant to be the minimum liability of directors, and if a State has a higher standard of care, that can apply in lieu of the federal standard [p. 683].

*[*Litwin v. Allen*].

C. **G/R:** <u>Test for Liability of a Director:</u> a director of a corporation is liable in negligence for loss or damage that is proximately causes by his breach of fiduciary duty under the facts as they exists at the time of the transaction or occurrence, not aided or enlightened by actions which took place afterwards [*Litwin v. Allen*].

D. **G/R:** <u>Implied Agreement of Shareholders:</u> it is fundamental corporation law that the majority of the corporation's stockholders shall control the policy of the corporation, and regulate and govern the law exercise of its franchise business.
1. Everyone purchasing or subscribing for stock in a corporation *impliedly agrees* that he will be bound by the acts and proceedings done or sanctioned by the majority of the shareholders or by the agents of the corporation duly chosen by such majority.
    a. The scope of the powers are conferred by the charter, and courts of equity will not undertake to control the policy or business methods of the corporation, although it may be seen that wiser policy might be adopted and the business more successful if other methods were pursued.

*[*Shlensky v. Wrigley*].

E. **G/R:** <u>Court's Function:</u> it is not a function of the courts to resolve for corporations question of policy and business management. The directors are chose to pass on such questions and their judgment is final and enjoys the presumption that was formed in good faith and was designed to promote the best interests of the corporate they serve.
1. <u>Exception:</u> if the director's judgment is tainted with fraud their judgment is not final and the courts can set aside the directors decision.
    a. Court's in equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilt of fraud or misappropriation of the corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so

would amount to such an abuse of discretion as would constitute fraud or breach of good which they are bound to exercise toward stockholders.

*[*Shlensky v. Wrigley*].

II. BUSINESS JUDGMENT RULE

A. **ALI Principles of Corporate Governance §4.01:**

(a) *Duty of Care:* a director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he reasonably believes to be in the best interest of the corporation, and with the care that an ordinary prudent person would reasonable be expected to exercise in a like position and under similar circumstances.

(1) The duty in (a) includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need to be informed.

(2) In performing any of his functions the director is entitled to rely on materials and persons such as directors, officers, employees, experts, and committees of the board.

(b) …the board may delegate any function to persons; a director may rely on such committees and person in fulfilling the duty under this section with respect to any delegated function…

(c) *Business Judgment Rule:* a director or officer who makes a business judgment in good faith fulfills the duty under this section if the director or officer:

(i) is not interested in the subject of the business judgment;

(ii) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and

(iii) rationally believes that the business judgment is in the best interests of the corporation.

(d) *Burden of Proof:* A person challenging the conduct of a director of officer has the burden of proving breach of a duty of care, including the inapplicability of the business judgment rule and in a damage action the burden of proving that the breach was the *legal cause* of the damage suffered by the corporation.

(i) The legal cause of loss exists where the plaintiff proves that:

(1) satisfaction of the applicable standard would have been a substantial factor in averting loss; and

(2) the likelihood of injury would have been foreseeable to an ordinary prudent person in like position to that of the defendant in similar circumstances.

(A) It is not a defense to liability in such cases that damage to the corporation would not have resulted *but for* the acts or omissions of other individuals.

*Unless the plaintiff demonstrates that §4.01(c)[the business judgment rule] does not apply, then §4.01(a) does not apply.

**The burden is on the plaintiff to prove:

a. That the business judgment rule does not apply; that is, the director is only liable if:

i. conflict of interest;

ii. not informed that the director reasonably believes [objective and subjective test]; and

iii. did not rationally believe that the business judgment was in the best interest of the corporation.

b. Then the plaintiff still must prove that the transaction was the legal cause of harm.

B. **G/R:** Business Judgment Rule: [*Process Due Care Test*] under the business judgment rule, as applied by the courts, as long as a director acts in good faith and with *due care* in the process sense, the director will not be found liable even though the decision itself was not that of the ordinarily prudent person. The process due care test will be met if the director takes appropriate steps to become INFORMED.

1. *Due Care Test:* under corporate law the standard of due case met if two tests are satisfied:
   a. due care must be used in ascertaining relevant facts and law before making a decision; and
   b. the decision must be made after reasonable deliberation.
   *Thus, the due care standard in corporate law is applied to the decision making process and *not* to its result.
2. If the court finds the judgment grossly unsound or a gross abuse of discretion, one which would have been reached by no person of sound ordinary business judgment, or an egregious abuse of discretion [like in *Litwin v. Allen*] the directors will not meet the standards of the business judgment rule.
3. Absent bad faith, or some other corrupt motive, directors normally are not liable to the corporation for mistakes of judgment.
*[*Charles Hanson*; *In Re Caremark Litigation*].

C. **G/R:** Business Judgment Rule: [DELAWARE]: the business judgment rule presumes that directors act on an informed basis, in good faith, and in an honest belief that the actions are for the good of the company.

1. The plaintiff shareholder has the burden of rebutting this presumption.
2. *Duty of Care:* the duty of care owed by directors, absent bad faith or fraud, is to INFORM themselves properly.
   a. Directors have to informed to protect outside directors and investors.
   b. For the business judgment rule to stand, the directors must *be informed*, if they are not, that is the easiest way to win a case and get around the business judgment rule.
   c. A director is informed if (or conversely the plaintiff needs to show that the director did not do the following):
      i. they consulted with outside experts on the issue;
      ii. they did not act in haste;
      iii. they conversed with the insider directors; and
      iv. gave a reasonably sufficient consideration to the issue at hand (in *Van Gorkom* they only conversed for two hours before the transaction).
3. Delaware director liability is predicated on gross negligence; that is, if the board of directors is grossly negligent in failing to inform themselves properly, they can be held liable (many States use this standard).
4. Thus, the issue in most cases involving the business judgment rule is: whether the directors made an *informed judgment* from the *material information* that was reasonably available at the time of the transaction.
5. Thus, to be liable under the business judgment rule the director must be (a) grossly negligent; and (b) inadequately informed.
   1. A director is usually grossly negligent when they are not informed, but if they are informed and still grossly negligent, they may still be held liable.
*[*Smith v. Van Gorkom*; *Aronson v. Lewis*].

D. **G/R:** Factors in Determining if the Business Judgment Rule Applies: there are three main factors that apply in determining if the business judgment rule applies:

1. The business judgment rule protections can only be claimed by a *disinterested director* whose conduct otherwise meets the tests of the business judgment.

a. A disinterested director is one who is not on both sides of the transaction and does not expect to gain any personal benefit from the transaction in the sense of self-dealing, as apposed to a benefit which devolves on the corporation or all its stockholders generally.

2. To invoke the business judgment's rules protections, directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Once informed, the directors have a duty to action with reasonable care in the discharge of their duties.

a. *Irrationality of Decision:* if the director's cannot attribute their business decision to a rational business rule or purpose, then they are not afforded the protection of the business judgment rule.

i. Delaware courts will not review the substance of a decision, but if it is attacked as being irrational, then the court will make an enquiry into it and that is the outer limits of the business judgment rule.

3. Director liability is predicated on the standards of gross negligence and the business judgment rule operates only the context of director action.

*[*Aronson v. Lewis*].

E. **G/R:** Causation: [DELAWARE] once the requirements and the requirements of the business judgment rule are *not* met the directors may only avoid liability if they can establish the entire fairness of the transaction. Tort principles of causation have not place in a business judgment rule standard of review analysis [*Cede & Co., Cinerama v. Technicolor*].

F. **G/R:** Monitoring, Oversight, and Supervision: the business judgment rule applies to director's making a judgment, so if there is no judgment, the rule does not apply. A judgment, however, can be positive or negative, so when the board considers something acts, or fails to act, then the business judgment rule can apply.

1. However, in the *non-decision making context* directors have been found liable for the obvious and prolonged failure to exercise oversight or supervision.

2. **g/r:** directors are under a *continuing obligation* to keep informed about the activities of the corporation; while directors are not required to audit corporate books they should maintain familiarity with the financial status of the corporation by a regular review of financial statements because a director is not an ornament but an essential component of corporate governance.

a. The *continuing obligation* to keep informed includes reading and understanding financial statements, making reasonable attempts at detection and prevention of illegal conduct of other directors and officer, and protect against the misappropriation of money entrusted in the corporation.

b. The director will only be liable if his negligence was the proximate cause of the loss. Causation can be inferred where it is reasonable to conclude that the failure to act would produce a particular result and that result followed.

*[*Francis v. United Jersey Bank*].

3. If the director is put on notice that an employee or officer is misappropriating corporate funds, and they do not try and reasonably stop the misappropriation, then the director will be liable [*Bates v. Dresser*].

4. For directors to meet their oversight duties they must have compliance programs; that is, standards which are set forth and are disseminated throughout the corporation so employees are on notice of the law [*In Re Caremark Litigation*]. *See* infra §5, III, Rule C, p. 48.

III. <u>LIMITING DIRECTOR LIABILITY</u>

A. **Del. Gen. Corp. Law §102(b)(7):** [p. 455, 457 statutory supplement; many other states have similar charter option provisions]:

(b) In addition to matters required to be set forth in certificate of incorporation, the certificate of incorporation may also contain:

(7) a provision *eliminating* or *limiting* the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director:

(i) for breach of the duty of loyality;
(ii) for acts or omissions not in good faith, intentional misconduct, or knowing violation of the law;
(iii) under section 174 of Delaware Law (improper dividends, stock purchases, or redemeptions); or
(iv) any transaction from which the director derived an improper personal benefit.

B. **G/R:** <u>Charter Option Provisions:</u> [many states, around 30, have charter option provision like Delaware, here are some general observations]:

1. §102(b)(7) gets a director right off the hook for negligence because it allows the corporation to eliminate or limit *personal liability* of a director to the corporation and its shareholders for breach of fiduciary duty, subject to some unwaivable provisions.

a. In Delaware, this really means gross negligence, so there is no director liability for gross negligence if the statute has been adopted.

2. However, to be effective, IT MUST BE IN THE CHARTER.

3. §102(b)(7) only protects directors from monetary damages, so stockholders can still bring injunction suits. However, as a practical matter that is very difficult to accomplish, especially if a merger is involved, because stockholders have to act quickly.

4. The required disclosure by stockholders implicates the duty of care (not loyalty) and thus director's can be shielded from liability for non-disclosure. However, the court will still engage in a motive inquiry and determine if the directors *purposefully* [§102(b)(7)(iii)] breach their duty of care; that is, had a conflict of interest or impressible motives rather than just gross negligence which is excused by §102 [*Zirn v. VLI Corp.*].

C. **G/R:** <u>Reducing Director Liability through Compliance Programs:</u> the federal sentencing guidelines, which apply to individual and corporate crimes, and impose large fines on corporations can be reduced through compliance programs.

1. Under the federal sentencing guidelines, if the corporation has implemented a program of education through written and/or oral programs to give notice to its employees of all the crimes that the are not supposed to commit then the judge imposing the fine will *drastically* reduce the fine. Thus, if you have a system of education, and compliance programs, then the directors reduce their liability, and even a failure to implement the compliance programs may be a beach of their duty of care.

IV. <u>DERIVATIVE SUITS AND THE DEMAND TO SUE</u>

A. **G/R:** <u>Derivative Suits:</u> are suits by shareholders to enforce corporate rights, and any recovery obtained goes to the corporation. The right of a stockholder to bring an action to litigate corporate rights is solely for the purpose of preventing injustice where it is apparent that material corporate rights would not otherwise be protected [*Zapta Corp v. Maldonado*].

1. The derivative suit developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it. The nature of the action is two-fold:

a. it is the equivalent of a suit by shareholders to compel the corporation to sue; and

b. it is a suit by the corporation, asserted by the shareholders, on its behalf, against those liable to it.

*[*Aronson v. Lewis*].

2. <u>Definition:</u> a derivative proceeding means a civil suit in the right of a domestic or foreign corporation [RMBCA §7.40].

3. Derivative suits against directors are the most common ways that shareholders can hold corporate director's liable for mismanagement. There is three elements a stockholder can demonstrate to maintain a derivative action against directors, the shareholders must demonstrate that the director's action was:

1. fraudulent;
2. illegal; or
3. the result of a conflict of interest in their decision making.

*The court will not interfere unless the directors conduct borders on one of these elements.

**[*Shlensky v. Wrigly*].

B. **RMBC §7.41:** <u>Standing:</u> a shareholder may *not* commence or maintain a derivative proceeding *unless* the shareholder:

(1) was a shareholder of the corporation at the time of the act or omission complained of; and

(2) fairly and adequately represents the interests of the corporation.

C. **RMBC §7.42:** <u>Demand:</u> no shareholder may commence a derivative proceeding until:

(1) a written demand has been made upon the corporation to take suitable action; and

(2) 90-days have expired from the date the demand was made unless

a. the shareholder was notified that the demand was rejected; or

b. irreparable injury will result to the corporation.

D. **RMBC §7.44:** <u>Dismissal:</u>

(a) A derivative proceeding *shall be* dismissed by the court on a motion by the corporation if [a majority vote of independent directors, a majority vote of a committee consisting of two or more independent directors, or a court appointed panel] has determined in *good faith* after conducting a reasonable inquiry upon which its conclusions are based that the *maintenance of the derivative proceeding is not in the best interests of the corporation*.

(d) If the derivative proceeding is commenced after a determination has been made rejecting a demand by a shareholder, the complaint shall allege with particularity facts establishing either:

(1) that the majority of the board of directors did not consist of independent directors at the time the determination was made; or

(2) that the requirements of (a) have not been met.

(e) If a majority of the board of directors does not consist of independent directors at the time the determination is made, the corporation shall have the burden of proving that the requirements of (a). If a majority of the board of directors consists of independent directors at the time the determination was made, the plaintiff shall have burden of proving that the requirements of (a) have not been met.

D(1). <u>Process:</u> the RMBC process for maintaining or dismissing a derivative action is this:

1. The plaintiff must have been a shareholder the time of the act or omission complained of [§7.41];

2. The plaintiff then must send a written a demand to the corporation to take action (i.e. bring the suit, or allow it to be brought) [§7.42].

a. The plaintiff then waits 90-days and if is not notified by the corporation that it is going to take action she can bring the suit.

i. Then go to 3a.

b. If she receives notice rejecting the demand before 90-days she can bring the suit.

ii. Then go to 3b.

c. If the plaintiff can prove irreparable harm to the corporation (using a standard like that for preliminary injunctions) she can bring the suti.

3. If the plaintiff brings the action it can be dismissed if [§7.44]:

a. the corporation files a motion saying that it [through independent directors or an committee of independent directors] has in good faith determined the action should not be brought because it is not in the best interests of the corporation.

b. If the action is brought after a rejection for the demand then:

i. the plaintiff must plead with particularized facts that:

(A) a majority of the board was not independent; or

(B) maintaining the action would be in the best interest of the corporation.

ii. If the plaintiff succeeds in proving that a majority of the board is not independent then:

(A) the burden of proof is on the corporation to show that not maintaining the action is in the best interests of the corporation (i.e. a second chance to have the case dismissed).

iii. If the plaintiff does not succeed in proving that the directors were independent then she has the burden of proving that maintaining the action would be in the best interests of the corporation.

E. **G/R:** <u>Right to Sue the Corporation:</u> when the interests of the corporation are at stake, it the responsibility of the directors of the corporation, in the first instance, to determine whether an action should be brought on the corporation's behalf.

1. The decision of the corporate directors whether or not to assert a cause of action held by the corporation rests within the sound business judgment of the management.

2. *Business Judgment:* whether or not a corporation shall seek to enforce in the courts a cause of action for damages, is like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders.

a. Courts seldom interfere to control such discretion within the corporation, except where directors are guilty of misconduct equivalent to the breach of trust, or where they stand in a dual relation which presents an unprejudiced exercise of judgment.

3. Absent allegations of fraud, collusion, self-interest, dishonestly, or other misconduct of a breach of trust (fiduciary), and absent allegations that the business judgment exercised was grossly unsound, the court should not at the instigation of one shareholder interfere with the judgment of corporate officers.

4. *Committees:* A special litigation committee, of disinterested directors appointed by the board, may in its sound business judgment determine whether a derivative suit may be maintained against the corporation.

1. *Policy:* on the one hand the corporation usually does not maintain the action against itself; however, on the other hand it may be just as unfair to allow only a couple of stockholders to bring an action which may be opposed by a large number of stockholders.

*[*Gall v. Exxon Corp*].

F. **G/R:** <u>Demand Requirements Under Delaware Law:</u> under Delaware law, the role of the court in reviewing the board's determination varies depending on whether the plaintiff is a demand required or demand excused situation:

1. Delaware courts always start their analysis with a premise to the effect: under general Delaware law:

a. corporations exist because of legislative grace and possess only the authority granted by the legislature;

b. directors rather than shareholders manage the business affairs of the corporation, this power to manage encompasses decisions whether to initiate or refrain from entering into litigation [*see* §141(a), p. 466 statutory supplement];

c. the existence of this powers carries with it significant fiduciary duties and is the sound business judgment of the directors; and

d. stockholders are not powerless to challenge director action which results in harm to the corporation because they can bring derivative actions.

F(1). <u>Demand Excused:</u> [*Demand Futility Test*] demand is excused only if the plaintiff pleads with particularized facts that:

1. Create a reasonable doubt that a majority of directors *at the time demand would be made* are independent or disinterested; or alternatively

2. the challenged transaction was the product of a valid exercise of business judgment by the approving board.

a. the inquiry into the exercise of business judgment looks at the substantive nature of the transaction and the board's approval thereof;

b. the alleged wrong is substantively reviewed against the background of the particular facts alleged in the complaint.

*[*Aronson v. Lewis*].

3. In a case where the plaintiff's demand is excused under either of the *Aronson's* requirements, the plaintiff has standing to bring the derivative suit.

4. If the corporation seeks to reassert its right to control the litigation, the corporation will:

a. form a special litigation committee determine if the litigation is in the best interests of the corporation.

i. If the corporation files a motion to dismiss the litigation based upon the recommendation of the special committee, Delaware law requires the corporation to bear the burden of:

(A) the independence of the committee;
(B) the reasonableness of its investigation; and
(C) the reasonableness of the bases of its decision reflected in the motion.
*[*Zapta Corp. v. Maldonado*].

F(2). Demand Requirement: demand is required in any case in which the demand would not be futile and the demand requirement imposes a duty on the plaintiff to exhaust his intra-corporate remedies first.

1. When demand is not futile, and hence is required, the *Zapata* principles do not apply.
2. The board, or special litigation committee of independent directs, then decises whether the corporation should take the action the shareholder requests or respond in some other way.
3. As with all board decisions, the board's decision to the shareholders demand is then reviewed under the traditional business judgment rule.
4. As a result, the the shareholder in filing suit bears the normal burden of creating by particularized pleases a reasonable doubt that the board's response to the demand was wrongful. The plaintiff must allege with particularity:
    a. a lack of good faith, care, independence or disinterestedness by the directors in responding to the demand.

*[*Aronson v. Lewis*].

G. **G/R:** Demand Requirements under ALI: the ALI also has a demand requirement test which is similar to the RMBCA and Delaware models. *See* **ALI Principles of Corporate Governance: §§7.10-7.17** (pp. 1158-1164 statutory supplement).

§6: DUTY OF LOYALTY AND CONFLICT OF INTEREST

A. **W.S. § 17-16-831:** Director Conflict of Interest:

(a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A conflict of interest transaction is not voidable by the corporation solely because the director's interest if any one of the following are true:

(i) the *material facts* of the transaction and the director's interest were DISCLOSED or known to the board of directors (or a committee of the board) *and* the board of directors (or committee) authorized, approved, or ratified the transaction;

--a conflict of interest transaction is authorized, approved, or ratified if it receives the affirmative vote of a majority of the directors on the board (or committee) who have no direct or indirect interest in the transaction, but it cannot be authorized, approved or ratified by a single director [17-16-831(c)].

(ii) the *material facts* of the transactions and the director's interest were DISCLOSED or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction; or

--a conflict of interest transaction is authorized, approved, or ratified if it receives the vote of a majority of the shares entitled to be counted. Shares owned by or voted under control of a director (or entity) who has a direct or indirect interest in the transaction may not be counted in a vote of shareholders to determine whether to authorize, approve, or ratify the transaction [17-16-831(d)].

(iii) the transaction was fair to the corporation.

(b) A director of the corporation has an *indirect interest* in a transaction if:
(i) another entity in which he has a material financial interest or in which he is a general partner is a party to the transaction; or
(ii) another entity of which he is a director, officer or trustee is a party to the transaction and the transaction is or should be considered by the board of directors of the corporation.

**If the transaction is one which falls under §17-16-831(a)(i) or (a)(ii) the court will still review the transaction under the intrinsic fairness test to ensure that it was fair to the corporation and shareholders.

I. <u>SELF-DEALING</u>

A. **G/R:** <u>Self Dealing:</u> occurs when a director, by virtue of his position in the corporation, causes the corporation to act in such a way that the director receives something from the corporation to the exclusion of, and detriment to, the minority of shareholders in the corporation.

A. **G/R:** <u>Duty of Loyalty:</u> the fiduciary relationship between directors and the corporation imposes fundamental limitations on the extent to which a director may benefit from dealings with the corporation which he serves.

1. Thus, the voting for and taking of compensation may be deemed constructively fraudulent in the absence of shareholder ratification, statutory, or bylaw authorization.
*[*Marciano v. Nakash*].
2. *Duty of Loyalty:* corporate officers and directors bear a duty of loyalty to the corporations they serve. Corporate fiduciaries must discharge their duties in good faith with a view towards furthering the interests of the corporation.
    1. Directors or officers must DISCLOSE and not withhold relevant information concerning any potential conflict of interest with the corporation, and they must refrain from using their position, influence, or knowledge of the affairs of the corporation to gain personal advantage. *[*Northeast Harbor Golf Club v. Harris*].
3. *Remember:* these rules apply equally to large publicly held corporations and closely held corporations.

B. **G/R:** <u>Rule of Per Se Voidability:</u> [Classical Rule]: the common law rule was that transactions approved by interested directors and officers were constructively fraudulent, absent shareholder ratification, and the transaction was automatically voidable.

1. This rule has been superceded by statutory law in most states because of the policy reasons that not all insider dealings are inherently wrongful, and can be regulated by statutory safeguards.

C. **G/R:** <u>Intrinsic Fairness Test:</u> [Modern Test][DELAWARE LAW, §144(a)(1)-(3), pp. 470-471 supplement; these tests are almost identical to WS § 17-16-831, and the tests can be used in analyzing a problem under section 831]: the court will apply §144 (or §17-16-831), which provides several situations where interested transactions can be vailidated, coupled with the intrinsic fairness test.

1. **Intrinsic Fairness Test:** a self dealing transaction will be upheld if it is ultimately deemed to be intrinsically fair the corporation; that is, if there is evidence of the earmarks of an arms length deal, then the transaction was probably fair to the corporation.

a. *Burden of Proof:* if the intrinsic fairness test is applied, then the burden is on the corporation, subject to careful judicial scrutiny, to prove that its transactions were objectively fair [*Sinclair Oil v. Levin*].

i. *remember:* that if there is no self dealing, the court will apply the business judgment rule and the burden is on the plaintiff to prove that there was no rational basis for the decision.

2. The Courts apply the intrinsic fairness test, in addition to the three tests enumerated in the statutes because all the tests in the statute do is abrogate the common law rule of per se voidability.

D. **G/R:** <u>Corporate Salaries:</u> the issue of self-dealings often arises with respect to corporate salaries because they are usually set by the board, and sometimes provided for in the bylaws. There are several rules the court will apply in reviewing the setting of corporate salaries:

1. Courts are generally reluctant to interfere with the internal management of a corporation because they are ill equipped to solve or grapple with entangled economic problems of the corporation, which is not even in the province of the judicial branch.

a. Courts are concerned that corporations be honestly and fairly operated by directors, with observance of the formal requirements of the law; but what is a reasonable compensation for its officers is primarily the stockholders responsibility.

b. *Caveat:* directors who are fiduciaries cannot commit waste, or misuse or abuse trust property.

2. <u>Corporate Waste:</u> for a plaintiff to prevail in a claim against directors establishing their own salaries they will have to demonstrate that the salaries were so unreasonable that they constituted corporate waste; that is, that no person with reasonable judgment could have paid that amount to the corporate executive.

a. **Corporate Waste Test:** if a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority of stockholders have no power to give away corporate property at the expense or protest of the minority.

i. The rule prescribed by a bylaw cannot, against the protest of a shareholder, be used to justify payments of sums of salaries so large that as in substance and effect it amounts to spoliation or waste of corporate assets.

ii. *remember:* the executive salary may be unreasonable, but that does not necessarily mean it amount to corporate waste. The waste standard is much higher, and the courts are more deferential to the directors.

*[*Heller v. Boylan*].

3. To establish, or prove, that corporate salaries amount to waste or spoliation the plaintiff can use the following evidence:

a. what other executives similarly situated received;

b. the ability of the executive;

c. whether the IRS allowed the corporation to deduct the amount of the salary alleged to be unreasonable;

d. whether the salary bears a reasonable relation to the success of the business;

e. whether increases in salary are geared towards increases in the value of services rendered; and

f. the amount of the challenged salary compared to other salaries paid by the employer.
*[*Wilderman v. Wilderman*].

E. **ALI §1.42:** Waste of Corporate Assets: [p. 1119 supp.]: a transaction constitutes a "waste of corporate assets" if:

1. It involves an expenditure of corporate funds for which no consideration is received in exchange and for which there is not rational business purpose; or
2. if consideration is received in exchange, the consideration the corporation receives is so inadequate in value that no person of ordinary sound business judgment would deem it worth that which the corporation has paid.

F. **G/R:** Self Dealing Between Parents and Subsidiaries: when the situation involves parents and subsidiaries, with the parent controlling the transaction and fixing the terms, the test of *intrinsic fairness* is applied, with its resulting shifting of the burden of proof (as opposed to the business judgment rule).

1. A parent owes a fiduciary duty to its subsidiary when there are parent-subsidiary dealings.
    a. However, this alone will not invoke the intrinsic fairness test; this standard will only be applied when the fiduciary duty is accompanied by self-dealing—the situation where the parent is on both sides of the transaction.
2. *Self Dealing:* self dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to the minority of stockholders of the subsidiary.
3. **Intrinsic Fairness Test:** the standard of intrinsic fairness involves both a high degree of fairness and a shift in the burden of proof. Under this standard the burden is on the parent company to prove, subject to care judicial scrutiny, that its transactions with the subsidiary were objectively fair.

*[*Sinclair Oil Co. v. Levin*].

II. CORPORATE OPPORTUNITY DOCTRINE

A. **ALI §505(b):** Definition of Corporate Opportunity: [p. 1140 supp.]: corporate opportunity means:

(1) any opportunity to engage in a business activity of which a director becomes aware, either:
    (A) in connection with the performance of functions as a director, or under circumstances that should reasonably lead the director to believe that the person offering the opportunity *expects it* to be offered to the corporation; or
    (B) through the use of corporate information or property, if the resulting opportunity is one that the director should reasonably be expected to believe would be of interest to the corporation.

B. **ALI §505(c):** Burden of Proof: a party who challenges the taking of corporate opportunity has the burden of proof.

1. Exception: if the party challenging the action proves that the corporation or shareholders *did not* reject the corporate opportunity in advance following a disclosure by the director; then the burden is on the director to show that rejection and taking of corporate opportunity were fair to the corporation.

C. **G/R:** Corporate Opportunity Doctrine: [*Northeast Harbor Golf Club v. Harris*] corporate directors always owe a fiduciary duty to the corporation, and there are several tests that are applied to determine if a director has breached that duty by taking a corporate opportunity because of his position:

C(1). **ALI Test, §5.05(a):** [MAINE]: a director or senior executive *may not* take advantage of a corporate opportunity *unless:*

(1) the director first offers the corporate opportunity to the corporation and makes *disclosure* concerning the conflict of interest and the corporate opportunity;
(2) the corporate opportunity is rejected by the corporation; and
(3) either:
(A) the rejection of the opportunity was fair to the corporation;
(B) the opportunity is rejected in advance, following disclosure, by *disinterested directors* in a manner that satisfies the business judgment rule; or
(C) the rejection is authorized in advance or ratified, following disclosure, by *disinterested shareholders* and the rejection is not equivalent to the waste of corporate assets.

** Under the ALI Test:

1. *Full disclosure* is an ABSOLUTE condition precedent to the validity of any forthcoming rejection as will as to the availability to the director of the defense of fairness.
2. A good faith, but defective disclosure may be ratified after the fact only by an affirmative vote of the disinterested directors or shareholders.
3. The ALI test defines corporate opportunity broadly. It includes opportunities closely related to the business in which the corporation is engaged and also encompasses any opportunities that accrue to the fiduciary as a result of his position with the corporation.

C(2). **Line of Business Test:** [DELAWARE]: if there is presented to a corporate officer or director a business opportunity which:

1. the corporation is financially able to undertake;
2. is from its nature in the line of the corporation's business;
3. is of practical advantage to corporation and is an opportunity in which the corporation has an interest or reasonable expectancy; *AND*
4. by embracing the opportunity the director's self interest will be brought into conflict with the interest of the corporation; *THEN*
5. the law will not permit him to seize the opportunity for himself.

*<u>Issue:</u> the real issue under this test is whether the opportunity was so closely associated with the existing business activities so as to bring the transaction within that class of cases where the acquisition of property would throw the corporate officer purchasing it *into competition with* his company.
**This is a highly factually inquiry because it often hard to establish when a discussion which the director may take advantage of is business or not (like the golf-playing example.

C(3). **Fairness Test:** [MASSACHUSETTS] the corporate opportunity doctrine rests on the unfairness in the particular circumstances of a director, whose relation to the corporation is fiduciary, taking unfair advantage of an opportunity for his personal profit when the interest of the corporation justly calls its protection.

1. This requires application of ethical standards of what is fair and equitable in a particular set of facts and is a highly factual inquiry.

C(4). **Hybrid Line of Business/Fairness Test:** [MINNESOTA]: this is a two prong-test:

1. First, the court determines whether a particular opportunity was within the corporations' line of business; then
2. scrutinizes the equitable considerations existing prior to, at the time of, and following the director's acquisition.

D. **G/R:** Duties to other Constituencies: the principle duties owed by corporate officers and directors run to holders of common stock; however, limited duties exist with respect to preferred shareholders, holders of convertible securities, and creditors.

§7: TRANSACTIONS IN SHARES: RULE 10b-5, INSIDER TRADING AND SECURITIY FRAUD

§7.1: STATE LAW

I. MERGER'S UNDER THE RMBCA

A. **RMBCA § 11.01**: Definitions:

(b) *merger:* means a business combination pursuant to §11.02.
(d) *other entity:* means any association or legal entity other than a domestic or foreign (out of state), organized to conduct business including general partnerships, limited liability partnerships, limited liability companies, joint ventures, joint stock companies, and business trusts.
(e) *survivor:* means the corporation or other entity into which one or more other corporations or other entities are merged. A survivor of a merger may preexist the merger or be created by the merger.

B. **RMBC §11.02:** Merger:

(a) one or more domestic corporations may merge with a domestic or foreign corporation or other entity pursuant to a *plan of merger*.
(c) the plan of merger must include:
- (1) the name of the margining corporation and the name of the surviving corporation;
- (2) the terms and conditions of the merger;
- (3) *the manner and basis of converting shares of each merging corporation and interests of each merging other entity* into shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing;
- (4) the articles of incorporation of any corporation…;
- (5) any other provisions required by the laws under which any party to the merger is organized…

(e) the plan of merger may also include a provision that the plan may be amended prior to filing the articles of merger…

B(1). Official Comment: this section imposes virtually no restrictions or limitations on the terms or conditions of a merger, except those in §11.02(e).

1. Owners of shares or interests in a party to the merger that merges into the survivor may receive:
   - a. shares or other securities of the survivor (stock for stock merger);
   - b. cash (cash merger); or
   - c. shares or other securities of a party other than the survivor, interests, obligations, rights to acquire shares or securities, or other property.

2. Although chapter 11 imposes virtually no limits on the terms and conditions of the merger, section 11.02(c) requires that the terms and conditions be set forth in a plan of merger. A plan of merger *must* set forth:

a. the articles of incorporation of any corporation; and

b. the organizational documents of any other entity to be created by the merger.

C. **RMBCA §11.04:** Action on a Plan of Merger or Share Exchange:

(a) a plan of merger or share exchange must be adopted by the board of directors.

(b) …directors must submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest it should not make such a recommendation…

(e) …approval of the plan of merger requires the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be case on the plan exists…

C(1). Official Comment: under §11.04 a plan of merger must be adopted by the board.

1. Then the board of directors, after adopting the plan of merger, must submit the plan of merger to the shareholders for approval. When submitting the plan of merger the directors must make a recommendation to the shareholders that the plan be approved, unless there is a conflict of interest (this exception is intended to be used sparingly).

2. Then the merger can be approved by the shareholders if a quorum consisting of a majority of the votes entitled to be case on the plan exists (a majority of the shareholders vote for the merger).

a. *Proxies:* this can be done through a proxy, which is an "agency form" that gives the directors the authority to cast the shareholders votes.

3. If a shareholder does not like the options the can institute a dissent proceeding pursuant to **RMBCA §13.**

a. A lot of people would rather bring a dissent action under federal law (and say they were mistreated) rather than dissent from the original proxy because it provides a better remedy.

§7.2: FEDERAL LAW

I. PROXY REGULATION [Securities and Exchange Act of 1934: Regulation 14A, p. 1560 supplement].

A. **Rule 14a-9:** False or Misleading Statements:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement…written or oral, containing any statement which, at the time and in light of the circumstances under which it is made, is false or misleading with respect *to any material fact*, or which *omits* to state a material fact necessary in order to make the statements therein not false or misleading…

A(1). Comments: §14(a) [regulation of proxies] of the Securities and Exchange Act was intended to promote the free exercise of the voting rights to stockholders' by ensuring that proxies would be solicited with explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.

1. There is an implied cause of action for individuals for violations of Rule 14a-9.

B. **G/R:** <u>Elements to State a Cause of Action under Rule 14a-9:</u> three elements must be satisfied to bring an action under Rule 14a-9:

1. a misstatement or omission in the proxy statement;
2. that is *material*; and
3. the *causal* relational between the violation and injury is sufficiently established, which means that the proxy solicitation itself was an *essential link* in the accomplishment of the transaction.

*The plaintiff need not demonstrate that the alleged defect in the proxy statement actually had a decisive effect on voting, he only needs to establish the foregoing elements.

**[*TSC Industries v. Northway*].

B(1). <u>Materiality:</u> the question of whether a statement that is false or misleading to a material fact is an objective one.

1. **Test for Materiality:** a misstatement or omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.
    - a. In other words, there must be have been a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor has having *significantly altered the total mix of information made available.*
    - b. This standard is fully consistent with the general description of materiality as a requirement that the defect have a significant propensity to affect the voting process.
    - c. The does contemplate a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of a reasonable shareholder.

*[*TSC Industries v. Northway*].

C(2). <u>Causation:</u> to maintain an action under Rule 14a-9 causation has to be established. Causation exists when the proxy solicitation is an *essential link in the accomplishment of the transaction.*

1. *Essential Link:* if you can demonstrate materiality, that is the essential link and the plaintiff does not have to prove reliance for each individual shareholder.
    - a. The causation of damages by a material proxy misstatement can be established by showing that minority proxies necessary and sufficient to authorized the corporate acts had been given in accordance with the tenor of the solicitation. The proxy solicitation establishes such a causal relationship when the proxy solicitation is an essential link in the accomplishment of the transaction.
        - i. *Shame Facts:* are facts which had they been disclosed would have "shamed" the management into abandoning the proposed transaction. The defendant corporation can argue these because they did not want the bad publicity and only mislead the shareholders to reach the end result—getting the transaction approved.
        - ii. *Sue Facts:* a sue fact is a fact which is material to a sue decision. A sue fact decision is a decision by a shareholder whether or not to institute a representative or derivative suit alleging a state law cause of action. The plaintiff can argue these to establish the causal link.

*[*Virginia Bankshares v. Sandberg*].

C(3). <u>Degree of Culpability:</u> the Supreme Court has not yet decided on the degree of culpability of the directors in order to hold them liable. However, you should argue for negligence because the shareholders should know what is going to affect the market, and directors owe a fiduciary duty.

1. Negligence, in a proxy statement, is probably enough to win. Reckless or intentional misleading statements is probably enough in all cases involving proxies to hold the director liable.

D. **G/R:** Opinions and Fact: under §14(a) a statement which is phrased as an opinion is a fact when the parties are so situated that the buyer may reasonably rely upon the expression of the seller's opinion, it is no excuse to give a false opinion [*Virginia Bankshares v. Sandberg*].

E. **G/R:** Statement of Belief: under §14(a) a plaintiff is permitted to prove a specific statement of reason knowingly false or misleadingly incomplete, even when it is stated in conclusory terms.

1. A statement of belief may be open to objection only when statements of reason misstate the speakers reasons, however, solely as a misstatement of the psychological fact of the speaker's belief in what he says.
2. Proof of mere disbelief by the directors in the proxy statement or belief undisclosed does not suffice for liability under §14(a).
3. Thus, a conclusory statement which purports to be an opinion is a material fact because the director's have a fiduciary duty, and the shareholders will take into account the director's opinion or fact.
    a. Sometimes there can be enough in the proxy statement to neutralize the misleading statement, the court looks at the misstatement in the context of the entire proxy statement.

*[*Virginia Bankshares v. Sandberg*].

F. **G/R:** Purpose of a Proxy Statement: the purpose of a proxy statement is to inform, not challenge the reader's critical wits. Only when an inconsistency in the proxy statement would exhaust the misleading conclusion's capacity to influence the reasonable shareholder would a §14(a) action fail on the element of materiality [*Virginia Bankshares v. Sandberg*].

II. SECURITIES AND EXCHANGE ACT OF 1934: RULE 10B-5 [pp.1524 supp.]

A. **S.E.A.: Section 10:** it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality, of interstate commerce or of the mails, or of any facility of any national securities exchange…

(b) to use or employ, in connection with the *purchase or sale of any security* registered or unregistered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

B. **Rule 10B-5:** Employment of Manipulative and Deceptive Devices: it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange:

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

B(1). <u>Comments:</u> rule 10B-5 deals with all fraud, not just in proxy statements, but all fraud in the sale or purchase of securities. It is applicable to large public corporations as well as close corporations.

C. **G/R:** <u>Elements to State a Cause of Action under Rule 10B-5:</u> there is an implied cause of action for individuals under Rule 10B-5 if they demonstrate the following elements:

1. there was a device, scheme, artifice to defraud, or misstatement or omission of a material fact [Rule 10B-5(a)(b)];
    a. the materiality test is the same as in the *TSC Industries* case: a misstatement or omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding to buy or sell a security.
2. with scienter, that is, a mental state embracing the intent to deceive, manipulate, or defraud [*Ernst & Ernst v. Hochfelder*];
3. that can be fairly viewed as manipulative or deceptive within the meaning of the statute [*Santa Fe Industries v. Green*];
    a. manipulative generally refers to practices that are intended to mislead investors by artificially affecting market activity.
4. to an actual purchaser or seller of securities [*Blue Chips Stamps v. Manor Drug Stores*].

C(1). <u>Implied Cause of Action:</u> there is an implied cause action in Rule 10b-5, for private litigants, in federal court [*Kardon v. National Gypsum Co.*].

1. An implied cause of action means that a private person who is injured can bright a suit against the person who perpetrated the injury.
2. Rule 10b-5 is the provision routinely relied upon in all cases involving claims of securities fraud, deception, or trading in securities on the bases of undisclosed information in both publicly held and closely held corporations.

C(2). <u>Birnbaum Rule:</u> private plaintiffs in Rule 10b-5 suits are limited to actual purchasers or sellers of securities [*Blue Chips Stamps v. Manor Drug Stores*].

1. The *Birnbaum* rule permits exclusion prior trial those plaintiffs who were not themselves purchasers or sellers of the stock in question.
2. The fact of purchase of stock and the fact of sale of stock are generally matters which are verifiable by documentation, and do not depend upon oral recollection, so that failure to qualify under the *Birnbaum* rule is a matter that can normally be established by the defendant either on a motion to dismiss or for summary judgment.

C(3). <u>Scienter:</u> scienter (a mental state embracing the intent to deceive, manipulate, or defraud) is a required element of a Rule 10b-5 cause of action [*Ernst & Ernst v. Hochfelder*].

1. Section 10b-5 makes unlawful the use or employment of any manipulative or deceptive device or contrivance in contravention of Commission rules.
2. *Degree of Culpability:* the intent requirement (scienter) means that there has be some degree of culpability.
    a. Negligence is not enough to maintain a 10B-5 action;
    b. Reckless conduct might by actionable;
    c. Intentional conduct is actionable.

C(4). Actionable Conduct: a breach of the director's fiduciary duty is not actionable under Rule 10b-5 unless the conduct alleged can be fairly viewed as manipulative or deceptive within the meaning of the statute [*Santa Fe Industries v. Green*].

1. Manipulation is a term of art when used in connection with securities markets. The term refers generally to practices, such as wash sales, matched orders, or rigged prices that are intended to mislead investors by artificially affecting market activity.
2. The fundamental purpose of the securities act is to implement a philosophy of full disclosure. Once full and fair disclosure has occurred, the fairness of the terms of the transaction are at most a tangential concern of the statute.

D. **G/R:** Statute of Limitations: the statute of limitations in Rule 10b-5 cause of action is that suits must be brought within one year after the discovery of facts constituting the cause of action and within three years after such cause of action accrued [*Lampf Pelva v. Gilbertson*].

1. The courts should look to the statute form, which the federal cause of action was implied to determine whether a uniform period of limitations is imposed in similar suits.

E. **G/R:** Aiding and Abetting: claims based on aiding and abetting are not authorized under Rule 10b-5 [*Central Bank v. First Interstate Bank of Denver*].

1. The absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement or omission on which a purchaser or seller of securities relies may be liable as a primary violator under Rule 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.

F. **G/R:** Right of Contribution: there is an implied right of contribution among defendants in a Rule 10b-5 case [*Musick, Peeler & Garret v. Employers Ins. of Wausau*].

§7.3: INSIDER TRADING

A. **G/R:** Obligations of Insiders: the anti-fraud provisions are phrased in the terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors, and controlling shareholders. These three groups, however, do not exhaust the classes of persons upon whom there is an obligation. Analytically, the obligation rests on two principle elements:

1. the existence of a relationship giving access, directly or indirectly, to information intended to be available for a corporate purpose and not for the personal benefit of anyone; and
2. the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

*Thus, the court's task is to identify those persons who are in a special relationship with a company and privy of internal affairs, and thereby suffer correlative duties in trading its securities.
** [*In the Matter of Cady, Roberts, & Co.*].

B. **G/R:** Rule 10B-5: was promulgated to prevent inequitable and unfair practices and to ensure fairness in securities transactions generally, whether conducted face-to-face, or on exchanges.

1. The Rule is based in policy on the justification that in the securities marketplace all investors trading on impersonal exchanges have relatively equal access to material information.

2. The essence of the Rule is that anyone, trading for his own account in the securities of a corporation has access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, may not take advantage of such information knowing it is unavailable to those with whom he is dealing—the investing public.
3. Insiders, as directors or management officers, are by the Rule precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not strictly be termed an insider within the meaning of the Act.
*[*SEC v. Texas Gulf*].

C. **G/R: Disclosure or Abstain: [this is the main insider trading rule]: anyone in possession of *material* [*TSC Indust* test to determine materiality] inside information must:
1. disclose the material information to the investing public; or
2. must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed because
a. he was unable to disclose the material information in order to protect corporate confidence, or
b. he chooses not to disclose the material information.
*[*SEC v. Texas Gulf*].

D. **G/R:** Disclosure Requirements: the courts and the SEC have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to the people with whom they deal, and if known would affect their business judgment.
1. The obligation to disclose or abstain derives from an affirmative duty traditionally been imposed on corporate insiders.
2. The duty to disclose or abstain arises from:
a. the existence of a relationship affording access to inside information intended to be available only for corporate purposes; and
b. the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.
3. **g/r:** one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to disclose.
a. The duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or similar relation of trust and confidence between them.
b. The SEC has recognized a relation of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their positions within the corporation.
c. This relationship gives rise to a duty to disclose because of the necessity of preventing a corporate insider from taking unfair advantage of the uninformed minority of shareholders.
4. **g/r:** federal courts have found violations of §10(b) where corporate insiders used undisclosed information for their own benefit.
a. The cases have emphasized in accordance with the common law rule, that the party charged with failing to disclose market information must be under a duty to disclose it.
*[*Chiarella v. US*].

E. **G/R:** No Duty to Disclose: a purchaser of stock who *has no duty to a prospective seller because he is neither an insider or fiduciary* has no obligation to reveal material facts [*Chiarella v. US*].

F. **G/R:** Timing of Disclosure: the timing of disclosure is a matter for the business judgment of corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and the SEC.

1. Where a corporate purpose is served by withholding the news of a material fact the person who owe a fiduciary duty to the corporation must no deal personally in the corporation's securities or give outsiders confidential information not generally available to all the corporation's stockholders during the period of non-disclosure.

*[*SEC v. Texas Gulf*].

G. **G/R:** Tippees: tippees of corporate insiders are liable under §10(b) because they have a duty not to profit form the use of inside information that they know is confidential or know, or should know, came from a corporate insider.

1. The tippees obligation has been viewed as arising from his role as a participant after the fact in the insiders' breach of fiduciary duty.

*[*Chiarella v. US*].

H. **G/R:** Permissible Insider Investments: an insider can invest in his own company, although he is more familiar with the company's operations than outsiders.

1. *Duty:* an insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if the extraordinary situation is disclosed.

2. An insider is not obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions.

*[*SEC v. Texas Gulf*].

I. **G/R:** Silence as a Manipulative or Deceptive Device: §10(b) does not state whether silence may constitute a manipulative or deceptive device. §10(b) was designed as a catchall clause to prevent fraudulent practices; therefore, when the allegation of fraud is based on nondisclosure there cannot be fraud unless there is a duty to speak. If there is no duty to speak, the duty to disclose under §10(b) does not arise from the mere possession of nonpublic market information [*Chiarella v. US*].

J. **G/R:** Policy and Objectives: the policy of Rule 10B-5 is the implementation of the congressional purpose that all investors should have equal access to the rewards of participation in securities transactions.

1. It was the intent of congress that all members of the investing public should be subject to identical market risks.

2. The only regulatory objection is that access to *material information* be enjoyed equally, but this objective requires nothing more than basic disclosure of fact so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of insiders.

§7.4: TRANSACTIONS IN CONTROLLING SHARES

A. Generally: these situations will arise where a shareholder owning a majority interest (or controlling interest) of the shares sells that control in a transaction from which the other shareholders are excluded (the controlling shareholder receiving a premium price per share on the sock over book or market value) or where all sell, but the owner of the control shares receives more than the other shareholders because they are selling “control” and that is valuable.

B. **G/R:** the general rule is that a shareholder may sell his stock to whomever he wants at the best price he can get.

1. Recognizing that those who invest the capital necessary to acquire a dominant position in the ownership of a corporation have the right of controlling that corporation, it has long been settled law, a controlling stockholder is free to sell, and purchaser is free to buy, that controlling interest at a premium price, absent looting of corporate assets, conversion of corporate opportunity, fraud, or other acts of bad faith.
*[*Zetlin v. Hanson Holdings*].

C. **G/R:** Classical Rule: a controlling shareholder owed no duty to minority shareholders or to the controlled corporation in the sale of his stock.

D. **G/R:** Duty of Controlling Shareholder: [Modern Rule]: in any transaction where the control of the corporation is material, the controlling majority shareholder must exercise good faith and fairness from the viewpoint of the corporation and those interested therein.

1. *Duty of Fair Dealing and Good Faith:* that duty of good faith and fairness encompasses obligations of the controlling shareholder in possession of facts such as to awaken suspicion and put a prudent man on his guard that a potential buyer of his shares may loot the corporation of its assets to pay for the shares purchased.
2. The corporate seller has a duty to conduct a reasonable and adequate investigation of the buyer.
3. Thus, in a situation where the purchaser buys all the controlling stock, a controlling shareholder may be liable to the minority when the purchaser later loots the corporation if the seller knew, or should have known, the purchaser intended to loot the corporation.
*[*Debaun v. First W. Bank and Trust Co.*].

E. **G/R:** Tests for Holding a Controlling Shareholder Liable for Breach of Duty:

E(1). **Delaware Test:** a person who transfers corporate control to another is not a surety for his buyer. However, when the circumstances would alert a reasonably prudent person to a risks that his buyer is dishonest or in some material respect not truthful, a duty devolves upon the seller to make such inquiry, as a reasonably prudent person would make, and generally to exercise case so that others who will be affected by his actions should not be injured by wrongful conduct.

E(2) **ALI § 5.16:** a controlling shareholder has the same right to dispose of voting equity securities as any other shareholder, including the right to dispose of those securities for a price that is not made proportionally available to other shareholders. The shareholder violates his duty of fair dealing to the other shareholders if:

(a) the controlling shareholder does not make disclosure concerning the transaction to other shareholders with whom the controlling shareholder deals in connection with the transaction; or
(b) it is apparent from the circumstances that the purchaser is likely to violate the duty of fair dealing in such a way to obtain a significant financial benefit fro the purchaser or associate.

F. **G/R:** Factors the Selling Shareholder should Consider: there are several factors that should alert a seller of likely looting or misconduct:

1. the buyer can only pay for the stock with corporate assets;
2. the buyer has a bad credit report;
3. inspection of public records indicate that there judgments for bad faith actions;
4. the buyer is financially weak, and is using corporate securities to fund the purchase;
5. the economics of the deal, whether the buyer can make payments on the loans;
6. knowledge of any other acts of bad faith; and
7. paying a premium is one possible indication of the buyer's intention to loot.

§8: FINANCIAL MATTERS AND THE CLOSELY HELD CORPORATION

§8.1: Debt and Equity Capital

A. Generally: every firm needs capital in order to conduct its operations. Capital may be obtained from a variety of different sources:

1. borrowing funds from private sources;
2. by capital contributions for the owners of the firm;
3. capital contributions from outside investors who thereafter become owners of the firm; or
4. by retaining business earnings rather than distributing them to owners.

B. Distinction between Equity and Debt: one basic distinction in the raising of capital is whether the funds provided come from equity or debt.

1. *Equity:* is synonymous with ownership; it is composed of contributions by the original entrepreneurs in the firm, by other investors, from the retained earnings of the business enterprise.
2. *Debt:* is associated with the concepts that it must at some point be repaid back and is not dependent upon the earnings of the business.

**WE are dealing with the raising of equity capital through the sale of securities.

§8.2: Types of Equity Securities

A. Class of Shares: a "class of shares" means all authorized shares of a corporation that have identical rights.

1. Shares mean the units into which the proprietary interests in a corporation are divided [RMBCA § 1.04(21).

B. Common Shares: if a corporation issues only was class of shares, they are referred to as common shares (although a corporation can issue preferred and common shares at the same time). There are two fundamental characteristics of common shares:

1. they are entitled to vote for the election of directors and on other matters coming before the shareholders; and
2. they are entitled to the net assets of the corporation (after making allowance for debts), when distributions are made in the form of dividends or liquidating dividends.
[*See* RMBCA §§ 6.01(b); 6.03(c)].
3. Common shares are usually viewed as representing the residual ownership interest of the corporation (i.e. the common share owners have the remainder of the power is distributed).

4. Owners of common shares also have the right to:
   a. inspect the books and records [§16.02];
   b. sue on behalf of the corporation to remedy a wrong committed against it [§§ 7.40-7.47]; and
   c. a right to financial information [§ 16.20].
5. Most closely held corporations will only use common shares and not preferred shares.

C. Dividends: is the distribution from current or retained earnings. The RMBCA only sets out a definition for distribution and rules for distributions generally [§§ 1.40(6); 6.40].

1. The decision to make a distribution, or cancel a distribution, and for how the distribution will be is within the business judgment of the directors.

D. Preferred Shares: preferred means that the share entitle the holder to some preference or priority in payment against the holders of common shares. This priority may be either in the payment of dividends or in the making of distributions in liquidation of a corporation, or very commonly, in both.

1. A priority or preference simply means that the holders of preferred shares are entitled to a specified distribution before anything can be paid on the common shares.
2. The precise scope of the rights of a preferred shareholder is traditionally established by the detailed provisions in the articles of incorporation creating that class of shares, which is usually referred to as the preferred shareholders contract and may not be amended without the consent of some statutorily defined fraction of the preferred shareholders themselves.
3. Preferred shares are usually non-voting shares; however there are several rights and privileges given to publicly traded preferred shares such as:
   a. cumulative dividend rights;
   b. liquidation preferences;
   c. redemption rights;
   d. conversion rights; and
   e. other protective provisons.

E. **RMBCA § 6.01:** governs the authorization of shares for a corporation and allows almost anything to be done.

§8.3: ISSUANCE OF SHARES

A. **RMBCA § 6.03:** Issued and Outstanding Shares:

(a) A corporation may issue the number of shares of each class or series authorized by the articles of incorporation. Shares that are issued are *outstanding shares* until they are reacquired, redeemed, converted, or cancelled.

(b) The reacquisition, redemption, or conversion of outstanding shares is subject to the limitations of subsection (c) and RMBCA § 6.40.

(c) At all times that share of the corporation are outstanding, one or more shares that together have unlimited voting rights and one more shares that together are entitled to receive the net assets of the corporation upon dissolution must be outstanding.

B. Par Value: par value is an authorized arbitrary number without economic significance that, in older statutes, determines the amount of permanent capital and capital surplus in the original capitalization of the corporation.

1. In about 20-states, the articles of incorporation must state the par value of the shares of each class, or state that the shares issued are without par value. The RMBC, and the remaining states, have eliminated or made optional the concept and the current trend is toward the elimination of this concept as a historical anomaly.
2. *Nominal Par Value:* today the practice is to use nominal par value; that is, one cent, ten cents, or one dollar per share when the shares are issued for several dollars or more per share. This is used more often than issuing shares with no par value because it helps to avoid watered stock liability and is important for tax purposes.

§8.4: DEBT FINANCING

A. Generally: evidence of indebtedness usually referred to as securities are bonds and debentures. Both involve unconditional promises to pay a stated sum in the future, and pay interest periodically until then.

1. *Debenture:* is an unsecured corporate obligation.
2. *Bond*: is a corporate obligation secured by a lien or mortgage on corporate property.
    a. A registered bond is one that has been registered in the name of a specific individual and from which the coupons have been removed; interest is paid directly to the owner. Virtually all bonds issued today are in registered form and freely transferable.

*The word bond is used to describe both bonds and debentures.

3. From an economic standpoint, debt financing is considerably more important than equity financing.

B. Leverage: debt owed to third persons creates leverage. Leverage is favorable to the borrower when the borrower is able to earn more on the borrowed capital than the cost of borrowing. The entire excess is allocable to the equity accounts of the corporation, thereby increasing the rate of return on the equity invested in the corporation.

1. Debt financing is attractive during periods of high inflation because the loans will ultimately be repaid with inflated dollars; of course, the competition for these loans in such circumstances may cause high interest charges which will offset, wholly or partially, this advantage of debt financing.

C. Tax Treatment of Debt:

1. *C Corporations:* A C corporation is a separate taxpayer that must pay taxes on is income according to a Tax Rate schedule set forth in the IRC that is different from the schedules applicable to individuals.
    a. A corporation that has not elected to be an S corporation, is a C corporation. Because the S corporation election is available only for corporations with fewer than 75 shareholders, large publicly held corporations have no choice but to be C corporations; however, closely held corporations can elect to be C corporations also.
    b. A C corporation involves double taxation in this sense: the corporation is first taxed directly on its income calculated using the corporate rate schedule, if it then makes distributions to its shareholders, the amount of those distributions is subject to a second tax at the shareholder level to the extent the corporation has earnings and profits.

i. Corporate earnings of C corporations are subject to the double tax only to the extent earnings are distributed to the shareholders.

2. *S Corporations:* an alternative the C corporation tax treatment is the S corporation election. The effect of this election is that the corporation has many of the tax characteristics of a conduit entity, with corporate income or loss being directly allocated to the shareholders. The election of an S corporation, which can be made by filing a relatively simple form, is only available in limited circumstances:

a. the corporation must have no more than 75 shareholders;
b. the shareholders must be individuals;
c. no shareholder may be a nonresident alien; and
d. the corporation must have only one class of stock.

i. Thus, although RMBC §6.01 allows the creating of stocks, or classes of stocks, having both voting and proprietary rights many close corporations will not have variations on the proprietary rights because they would lose their status as an S corporation.

§8.5: PUBLIC OFFERINGS

A. <u>Generally:</u> whenever a corporation makes a public offering of shares, consideration must be given to the possible application of the state (blue sky laws) and federal (Securities Act of 1993; Securities Exchange Act of 1934) securities laws.

1. If an offering is made to only a few persons, on or more exemptions will often be available, though, that cannot be absolutely guaranteed simply by the size of the offering; if the offering is made in a public manner or to numerous persons, there is a presumption that compliance with both state and federal law will be necessary unless an exemption is clearly available.

B. <u>Disadvantages and Advantages of Public Offerings:</u> there are several advantages and disadvantages to a public offering:

1. *Advantages:* (a) a successful public offer may create a market for the shares of the corporation;(b) the entrepreneur may later use this market to liquidate a portion of his investment; (c) very large amounts of capital may be raised through a public offering.

2. *Disadvantages:* (a) the cost of a public offering for an "unseasoned" company (one that has not previously made a public offering) is so substantial that a public offering of at least $10-million is necessary to justify the expense; (b) there are substantial disclosure obligations with respect to previous transactions that the entrepreneur may prefer not be made public; and (c) a public company takes on disclosure and other legal obligations that add to the cost of the operation and limit the amount of information about future developments that might be kept confidential.

C. **Securities Act of 1933:** [§§ 6(a), 7; p. 1274-1275 supp.]: full compliance with the Act requires filing a registration statement with the SEC. A registration statement consists of two parts:

1. (a) *Prospectus:* a prospectus is a document that is to be distributed to potential and actual investors; and (b) additional information that must be submitted to the SEC and is publicly available but need not be included in the prospectus.

2. A registered public sale of securities will usually involve the use of professional securities underwriters and securities firms to distribute the securities to the investing public.

a. An underwriter is a person or organization that acquires shares for resale or who arranges the direct sale of shares by the issuer. Investment bankers, and securities firms, regularly underwrite new securities issues on a commercial basis.

3. §5 of the Securities Act is the important section which prohibits selling securities not in compliance with the Act.

D. **G/R:** Security Definition: [Securities Act (SA) §2(1), p. 1267 supp.]: a security is defined as any note, stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of depository for a security, fractional undivided interest in oil and gas, …among other things.

1. A franchise agreement is *not* a security.

E. **G/R:** Liabilities: [SA §12]: any person who offers or sells a security in violation of §5, or offers or sells a security by means of a prospectus or oral communication which includes an untrue statement or omission of a material fact shall be liable to the person purchasing the security from him (for damages or rescission of the contract).

F. **G/R:** Exceptions to the Security Act:

1. *Intrastate Exception:* [SA §3(a)(11)]: the security act does not apply to any security which is part of an issue offered and sold only to persons resident within a single state of the same state as the issuer.

a. Although this exception sounds good, it is really not and is not used much because if a corporation uses an means of interstate communication (i.e. phones, mail, etc…) it does not apply.

2. *Private Offering Exception:* [SA §4(2)]: the provisions of section 5 do not apply to transactions by an issuer not involving a public offering.

G. **G/R:** Public Offering Test: to be a public offering within the meaning of the Act, the offering need not be open to the whole word; however, the court considers several elements in determining whether an offering was public:

1. whether there appears in the circumstances of the offering of securities the need for protection of the Act to be given to the purchasers;
2. whether the offerees need access to material information in making their investment decision; and
3. the number of offerees (although the Supreme Court in *Ralston Purina* did not emphasize it as much); as general matter if the number of offerees is large it is public offering.

a. As a rule of thumb, more than 25 offerees may be considered a public offering.

b. In addition, if the amount of the offering is large (the bigger the dollar amount) the more it looks public.

H. **G/R:** Private Offering Exception: [SA §4(2)]: the exemption from the registration requirements of the Securities Act exempts transactions by an issuer not involving any public offering from the registration requirements of section 5 of the act.

1. The design of the statute is to protect investors by promoting full disclosure of information through necessarily informed decisions; in other words, if the offerees do not have access to the kind of information that registration would disclose, the issuer is not entitled to the exception.
2. The applicability of the private offering exception turns on whether the particular class of persons needed protection from the Act.
3. An offering to those who are shown to fend for themselves is a *transaction not involving any public offering.*
*[*SEC v. Ralston Purina*].

I. **G/R:** Howey Test: an investment contract is a security, the conditions for an investment contract are:
1. an investment of money;
2. in a common enterprise; and
    a. a common enterprise is one in which the fortunes of the investor are interwoven and dependant upon the efforts and success of those seeking the investment of third parties.
3. with profits to come solely from the efforts of others.
    a. the word solely in this element means whether the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.

*[*Smith v. Gross*].

J. **G/R:** Factors to Consider in Determining the Existence of an Investment Contract:
1. the defendant persuaded the plaintiff to invest by representing that the efforts required of them would be very minimal; and
2. that if the plaintiff's diligently exerted themselves, they would still not gain the promised profits because those profits could be achieved only if the defendant's secured additional investors at inflated prices.
*[*Smith v. Gross*].

§8.6: DISTRIBUTIONS BY A CLOSELY HELD CORPORATION

A. **RMBC § 1.40(6)**: Distribution: means a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect to of any of its shares. A distribution may be in the form of a dividend, purchase, redemption, or other acquisitions of shares.
1. Thus, a distribution includes virtually all transfers of money, indebtedness or other property to shareholders in respect of the corporation's shares.

B. **RMBC § 6.40:** Distributions to Shareholders:
(a) A board of directors may authorize and the corporation may make distributions to its shareholder subject to restriction by the articles of incorporation and the limitation in subsection (c).
(b) If the board does not fix the record date [for distributions]…it is the date the board of director's authorizes the distribution.
(c) *NO* distribution may be made if, after giving it effect:
    (1) *Equity Insolvency Test:* the corporation would not be able to pay its debts as they become due in the usual course of business; or

(2) *Balance Sheet Test:* the corporation's total assets would be less than the sum of its total liabilities…plus the amount that would needed…to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

(d) The board of directors may base a determination that a distribution is not prohibited under subection (c) either on financial statements…fair valuation or other [reasonable methods].

C. **G/R:** <u>Payment of Dividends:</u> if an adequate corporate surplus is available for the payment of dividends, directors may not withhold the declaration of dividends in bad faith.

1. The mere existence of adequate corporate surplus is not sufficient for the court to invoke action to compel such a dividend because the payment of dividends are within the business judgment of directors. There must be bad faith before the court will compel dividends to be paid.

2. <u>Test for Bad Faith:</u> the essential test of bad faith is to determine whether the policy of the directors is dictated by their personal interests rather than corporate welfare. Director's are fiduciaries to the stockholders.

3 <u>Factors Indicating Bad Faith:</u> there are several factors that are evidence of bad faith on the part of directors when withholding dividends:

a. intense hostility of the controlling shareholders against the minority;

b. exclusion of the minority from employment by the corporation;

c. high salaries, bonuses, or corporate loans made to the officers in control;

d. the fact that the majority group may be subject to high personal income taxes if substantial dividends are paid; and

e. the existence of a desire by the controlling directors to acquire the minority stock interests as cheaply as possible.

*[*Gottfried v. Gottfried*].

D. **G/R:** <u>Business Judgment:</u> a business corporation is organized and carried on primarily for the profit of its stockholders.

1. The powers of the directors to the shareholders are to be employed for that end.

2. *Business Judgment:* there is committed to the discretion of directors, which must be exercised in good faith, the infinite details of business, including the amount of dividends to be paid.

*[*Ford v. Dodge*].

E. **G/R:** <u>Director Compensation:</u> the authority to compensate corporate officers is normally vested in the board of directors and the compensating of corporate officers is a matter of contract, within the business judgment of the directors.

1. Courts are hesitant to inquire into the reasonableness of director compensation when a disinterested board fixes it; however, the standard is stricter when the recipient himself fixes the compensation.

a. *Burden of Proof:* if a disinterested board approves the salary the plaintiff has the burden of demonstrating it was unreasonable.

2. *Shift in Burden:* where the recipient's vote as a director is necessary to fixing the amount of his compensation then the burden of proof to demonstrate that it was reasonable is on the director defendant.

a. This is because fiduciary position which the director's hold towards their corporation and stockholder.

3. *Factors in Assessing Reasonableness:* there are several things to consider in assessing the reasonableness of a director's salary:

a. what other executives similarly situated received;

b. the ability of the executive;

c. whether the IRS allowed the corporation to deduct the amount of the salary alleged to be unreasonable;

d. whether the salary bears a reasonable relation to the success of the business;

e. whether increases in salary are geared towards increases in the value of services rendered; and

f. the amount of the challenged salary compared to other salaries paid by the employer.

*[*Wilderman v. Wilderman*].

F. **G/R:** <u>Closely Held Corporations:</u> a closely held corporation is an integration of ownership and management in which the stockholders occupy most of the management positions; or a corporation that has few stockholders and there is little market for corporate stock.

1. There are three factors that typify a closely held corporation:

a. a small number of stockholders;

b. not a ready market for corporate stock; and

c. the substantial majority of the stockholders participate in the management, direction, and operations of the corporation.

*Thus, the closely held corporation bears a striking resemblance to a partnership.

2. *Fiduciary Duties in Close Corporations:* just as in a partnership, the relation among the stockholders of a close corporation must be one of trust, confidence, and absolute loyalty if the enterprise is to succeed. This applies equally to larger close corporations and small ones.

*[*Donahue v. Rodd*].

G. **G/R:** <u>Dividend Distributions:</u> Courts do not prefer to interfere with the sound financial management of the corporation by its directors, but declare as a general rule that the declaration of dividends rests within the sound discretion of the directors, refusing to interfere with their determination unless a plain abuse of discretion is made to appear [*Donahue v. Rodd*].

F. **G/R:** <u>Dissolution of Close Corporations:</u> the stockholder of a close corporation, or incorporated partnership, may achieve dissolution and recovery of his share of the enterprise assets only by compliance with the rigorous terms of the applicable chapter of the general laws.

1. To secure a dissolution of the ordinary close corporation (subject to the general laws) the stockholder, in the absence of corporate deadlock, must own at least 50% of the shares or have the advantage of a favorable provision in the articles of incorporation.

a. The minority shareholder, by definition lacking 50% of the corporate shares, can never authorize the corporation to file a petition for dissolution under the general laws by his own vote. He will seldom have at his disposal the requisite favorable provision in the articles of incorporation.

b. Thus, because the majority has the power freeze out the minority, they are held to a good faith and inherent fairness standard.

2. *Good Faith and Inherent Fairness Standard:* stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise as partners owe to one

another. Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with the strict good faith standard.

a. The directors may not act of avarice, expediency, or self-interest in derogation of their duty of loyalty to the other stockholders of the corporation.

b. The director's paramount duty is to the corporation and their personal pecuniary interests are subordinate to that duty.

c. Stockholders participating in management owe a fiduciary duty more exacting than the traditional good faith and inherent fairness standard because of the trust and confidence reposed in them by their other shareholders; thus, as in *Meinhard v. Salmon* there is a strict duty of loyalty to all stockholders in close corporations.

*[*Donahue v. Rodd*].

G. **G/R:** <u>Equal Opportunity Doctrine:</u> a domestic corporation, unless forbidden by statute, has the power to purchase its own shares (not in Delaware).

1. *Test:* when a corporation reacquiring its own stock and is a close corporation, the purchase is subject to the additional requirement that stockholders who, as directors, or controlling shareholders, cause the corporation to enter into a stock purchase agreement must have acted with the utmost faith and loyalty to the other stockholders.

a. To meet this test, if the stockholder whose shares were purchased was a member of the controlling group, the controlling shareholder must cause the corporation to offer each stockholder an equal opportunity to sell a ratable number of his shares at an *identical price.*

i. The controlling group may not, consistent with the strict duty of loyalty to the minority, utilize its control of the corporation to obtain special advantages and disproportionate benefit from its share of the ownership.

ii. Consistent with the strict fiduciary duty, the controlling group may not utilize its control of the corporation to establish an exclusive market in previously unmarketable shares from which the minority stockholders are excluded.

*[*Donahue v. Rodd*].

§9: <u>MANAGEMENT AND CONTROL OF THE CLOSELY HELD CORPORATION</u>

§9.1: MODERN AND TRADITIONAL ROLES OF SHAREHOLDERS AND DIRECTORS

I. <u>MODERN ROLES OF DIRECTORS AND SHAREHOLDERS</u>

A. **RMBCA § 7.32:** <u>Shareholder Agreements:</u>

(a) An agreement among the shareholders of a corporation that complies with this section is effective among the shareholders and the corporation even though it *is inconsistent with one or more other provisions of this Act*, in that it:

(1) eliminates the board of directors, or restricts the discretion or powers of the board;

(2) governs the authorization or making of distributions whether or not *in proportion to ownership of shares*, SUBJECT to the limitations of §6.02;

(3) establishes who shall be directors or officers of the corporation, and their terms of office or manner or selection or removal;

(4) governs, in general or in regard to specific matters, the exercise or division of *voting power* by or between the shareholders and directors…including the use of weighted voting rights or director proxies;
(5) establishes the terms and conditions of any agreement for the transfer or use of property…
(6) transfers to one of more shareholders or other persons all or party of the *authority to exercise the corporate powers*…including the resolution of any issue about which there exists a deadlock among directors or shareholders;
(7) requires *dissolution* of the corporation at the request of one or more of the shareholders or upon the occurrence of an event or contingency;
(8) otherwise governs the exercise of the corporate powers…and is not contrary to public policy (catchall provision, the outer-limits).

(b) An agreement authorized by this section shall be:
(1) by UNANIMOUS shareholder approval regardless of entitlement to vote.
(2) subject to amendment only by *all* persons who are shareholders at the time of the amendment; and
(3) valid for 10-years, unless the agreement provides otherwise.

(c) The existence of an agreement authorized by this section shall be noted *conspicuously* [see §1.40(3)] on the front or back of each certificate…The failure to not the existence of the agreement on the certificate…*shall not* affect the validity of the agreement…Any purchaser of shares who, at the time of the purchase, did not have knowledge of the existence of an agreement shall be entitled to rescission of the purchase…

(d) An agreement authorized by this section shall cease to be effective [when the corporation goes public (i.e. this section only applies to *close corporations*)].

B. **RMBCA § 8.01:** <u>Requirement for and Duties of the Board of Directors</u>
(a) *Except* as provided in section 7.32, each corporation must have a board of directors.
(b) *All corporate powers shall be exercised by or under the authority of,* and the business and affairs of the corporation managed by or under, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement under §7.32.
**However, a board of directors cannot increase or decrease its own size [RMBCA § 8.03(b), (c)].

C. **RMBCA §8.08:** <u>Removal of Directors by Shareholders</u>:
(a) The shareholders may remove one or more directors *with* or *without cause*, unless the articles of incorporation provided that directors may only be removed for cause.
(c) …a director may be removed only if the number of votes case to remove him exceeds the number of votes cast not to remove him (i.e. majority).
*If the corporation only wants directors to be removed *for cause* it has to set it up in the articles of incorporation.
***See Also* **RMBCA §8.09:** which allows directors to be removed by judicial proceeding if a shareholder, holding at least 10% of the outstanding shares petitions, and the court finds the director engaged in fraudulent or dishonest conduct, grossly abused his discretion with respect to the corporation or removal is in the best interest of the corporation.

D. **RMBCA §8.25:** Committees

(a) …a board may create one or more committees and appoint…members…to serve on the committee.

(d) To the extent specified by the board of directors…each committee may exercise the powers of the board of directors under section 8.01.

(e) A committee may not:

(1) authorize or approve distributions,…

(2) approve or propose to shareholders action that this Act requires be approved by shareholders;

(3) fill vacancies on the board of directors…

(4) adopt, amend, or repeal bylaws.

E. **G/R:** Long-term Management Contracts: the corporation can enter into long term management contracts with a person who is not a director, so long as the corporation, or board, maintains oversight.

F. **G/R:** Choice of Law: the generally accepted choice of law rule with respect to a corporations internal affairs, such as the relationship between shareholders and directors, is the law of the State where the corporation is incorporated will govern.

G. **G/R:** Priorities of Corporate Governance: when examining a problem dealing with corporate governance, in decreasing order of priority, the court will look at:

1. The state constitution (for example, some state constitutions require cumulative voting);
2. State statutes (the RMBCA is in force in a lot of States, but some, like Delaware, New York, California have their own statutes);
   a. *Caveat:* if the State has adopted §7.32, you can trump a statute by use of §7.32.
3. Articles of Incorporation;
4. Bylaws;
5. Resolutions dually adopted.

II. TRADITIONAL ROLES OF DIRECTORS

A. **G/R:** Classical Role of Directors: directors are the exclusive executive representatives of the corporation, charged with the administration of its internal affairs and the management of and uses of its assets.

1. Directors manage the business of the corporation and an agreement among shareholders whereby it is attempted to divest the directors of their power is illegal as against public policy [not any more, see §7.32].
2. Traditionally, the shareholder's elect the board of directors, they appoint the officers, and the shareholders only vote to elect the directors.

*[*McQuade v. Stoneham*].

B. **G/R:** Statutory Norm: the board of directors is under the power of the shareholders.

1. In large, publicly held corporations, that is still the norm. In smaller close corporations §7.32 governs, if adopted.
2. *Agency:* directors are not agents of the shareholders because they are not subject to control of the principle. Directors are fiduciaries, so they owe a duty, and they cannot agree to eviscerate this duty, but they are *not* agents.

1. Officers, however, are agents in the corporation because they are subject to control of the board.

C. **G/R:** Inherent Stockholder Power: stockholders who are empowered to elect directors, by existing provisions in the articles and bylaws, have the *inherent* power to remove the director for cause after service of specific charges, adequate notice, and full opportunity of meeting the acquisitions [*Matter of Auer v. Dressel*] [*But see* RMBCA § 8.08, can remove with or without cause].

1. There is nothing invalid about a shareholder proposal to amend the articles and bylaws so that they can elect successor directors who have been removed.
2. Thus, shareholders have the inherent powers to make *recommendations* to the board.
   a. This is important, and still good law, because allowing shareholders to express themselves and putting the directors of notice of shareholder prerogatives could affect another election.
      i. This becomes the basis for the proposition that shareholders can vote on advisor matters; that is, this *Matter of Auer* stands for the proposition that shareholders can wage campaigns over what the company does and advise the board on what the corporation should do.
   b. This is particularly important today, because the SEC allows shareholders to conduct proxy votes on advisory matters, which gives shareholders the power to voice their concerns. Practically, the usually lose, however, there are three important reasons for it:
      i. public relations;
      ii. puts a certain amount of pressure on the corporation, even if the shareholders lose; and
      iii. institutional shareholders can pool a lot of votes and actually win.
3. **g/r:** shareholders have the power to make recommendations on advisory matters. *[*Matter of Auer v. Dressel*].

§9.2: SHAREHOLDER VOTING AND SHAREHOLDER AGREEMENTS

I. Shareholder Voting

A. Beneficial and Record Owners:

1. *Beneficial owner:* the person who is the actual owner of the shares, the person *actually* entitled to dividends, vote, and liquidation rights.
2. *Record Owner:* the person whose name the shares are registered in.
   a. Generally, the corporation may treat the record owner of the shares for purposes such as voting, the payment of dividends or distributions, and determining to whom shares have been transferred.
3. **g/r:** where the record owner and the beneficial owner are different persons, the beneficial owner can compel the record owner (by court process if necessary) to execute a proxy appointment in the name of the beneficial owner so that the owner may vote the shares as he desires.
   a. The beneficial owner also has the power to compel the record owner to turn over any distributions made by the corporation and, ultimately to register the shares in the name of the beneficial owner when required to do so.
4. Traditional practice is to issues certificates representing shares in the name of the record owner [RMBCA §6.25(b)(2)].

5. Shareholder voting and entitlement to distributions are determined from the records of the corporation; it is not necessary for shareholder to exhibit the share certificate in order to vote or receive a distribution.

B. **G/R:** <u>Voting Date:</u> the mechanics for establishing a date on which shareholders are entitled to vote will be determined as set forth in **RMBCA §§ 7.07; 7.20.**

D. **RMBCA §1.40(26):** <u>Voting Group:</u> mean all shares of one or more classes or series that under the articles of incorporation or this Act are entitled to vote and be counted together collectively on a matter at a meeting of shareholders.

C. **RMBCA § 7.21:** <u>Voting Entitlement of Shares:</u>

(a) …unless the articles of incorporation provide otherwise, each outstanding share, regardless of class, is entitled to one vote on each matter voted on at a shareholder's meeting. Only shares are entitled to vote.

**Many articles of incorporation "provide otherwise" creating multiple or factional votes per share, and providing that some classes of shares have multiple or fractional votes per share, while other shares are non-voting shares, etc…(*see* official comment p. 614).

D. **RMBCA § 7.25:** <u>Quorum and Voting Requirements for Voting Groups:</u>

(a) ….a majority of the of the votes entitled to be cast on the matter by the voting group constitutes a quorum of that voting for action on that matter.

(c) If a quorum exists, action on a matter (other than voting for directors) by a voting group is *approved* if the votes case within the voting group favoring the action exceed the votes case opposing the action….

*In other words, action by shareholders at a meeting requires the existence of a quorum (one more than half) *and* approval by the requisite number of votes at a meeting at which a quorum was present.

E. **RMBCA §7.30:** <u>Voting Trusts:</u>

(a) One or more shareholders may create a voting trust, conferring on a trustee the right to vote or otherwise act for them, by signing an agreement setting forth the provisions of the trust *and* by transferring their shares to the trustee…When a voting trust agreement is signed, the trustee shall prepare a list of the names…of the beneficial interests in the trust…and deliver copies of the list and agreement *to the corporation's principal office*.

(b) a voting trust becomes effective on the date the first shares subject to the trust are registered in the trustee's name…but is not valid for more than 10-years.

**The filing of a copy the voting trust agreement with the corporation is essential for the validity of the voting trust.

E(1). <u>Voting Trusts:</u> when a shareholder creates a voting trust, they sign an agreement which transfers the stock to a voting trustee, like transferring legal title. In effect, the voting trust separates legal title from equitable title by transfers the shareholder's shares of stock to a trustee who then retains the right to vote the shares.

1. The shareholder still retains his dividend and liquidation rights, he just transfers his voting rights.

2. Under most statutes, absent Delaware, voting trusts are limited to ten years. During this period the voting trustees are the record owner of the shares, and the shareholder gets the voting certificate which says he is the beneficial owner.

E(2). **G/R:** a [voting] trustee may not exercise powers granted to him in a way that is detrimental to the beneficiary of the trust; nor may one who is a trustee for different classes favor one class at the expense of the other.

1. Such an exercise of power is a breach of the trust and the fiduciary duty the trustee owes to the beneficial owner; even if the exercise of power is within the scope of powers granted to the trustees in general terms.
2. It is well settled that the depositories of the power to vote stock are trustees in the equitable sense, and a voting trust is a trust in the accepted equitable view.

*[*Brown v. McLananhan*].

E(3). <u>Voting Trust Test:</u> when determining if a voting trust has been created, there are three elements which evidence the existence of a voting trust:

1. the voting rights of the stock are separated from the other attributes of ownership (i.e. dividends and liquidation rights);
2. the voting rights are intended to be irrevocable for a definite period of time; AND
3. the principal purpose of the grant of voting rights is to acquire control of the corporation.

*[*Lehrman v. Cohen*].

E(4). <u>When Voting Trusts Are Used:</u> (a) if creditors insist that controlling shares be placed in a voting trust as a condition to the extension of credit; (b) if regulatory agencies insist that voting control of a regulated corporation be placed in a voting trust as a condition for permitting private parties to acquire the regulated corporation; (c) if the parent corporation of a regulated corporation when the corporation is a relatively small portion of the parent's business; (d) in some bankruptcy proceedings; and (e) is some family suits.

F. **RMBCA § 7.31:** <u>Voting Agreements:</u> [Pooling Agreements]

(a) Two or more shareholders may provide for the manner in which the will vote their shares by signing an agreement for that purpose. A voting agreement created under this section is *NOT* subject of the [voting trusts provisions] of §7.30.

(b) A voting agreement under this section is specifically enforceable.

F(1). **G/R:** <u>Voting Agreements:</u> in a voting agreement, shareholders exchange promises to vote their shares in some specific way, or as some part of the group shall direct. These agreements are generally held to be specifically enforceable, absent fraud or illegal motive.

1. A shareholder may exercise wide discretion of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profits, or determined by whims or caprice so long as he violates no duty owed to his fellow shareholders.
2. Ownership of voting stock imposes no legal duty to vote at all.
3. A group of shareholders may vote their respective shares so as to obtain advantages of concerted action. They may lawfully contract with each other to vote in the future in such ways as they, or a majority of their group from time to time determine.
4. Reasonable provisions for cases of failure of the group to reach a determination because of an even division in their ranks is not objectionable (i.e. got to an arbitrator, or something of like).

*[*Ringling Bros v. Ringling*].
5. *Ringling Bros* demonstrates that voting agreements are legal, however if want the document enforced the parties need to put something in the agreement on how to enforce the agreement because the court will *not* imply a voting proxy to satisfy the agreement.

G. **RMBCA § 7.28:** Voting for Directors; Cumulative Voting:
(a) Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to it vote in the election at a meeting at which a quorum is present.
(b) Shareholders *do not have the right* to cumulate their votes for directors, unless the articles of incorporation so provide.*
(c) A statement included in the articles of incorporation that "all a designated voting group" of shareholders are entitled to cumulate their votes for directors (or words of similar import) means that the shareholders designated are entitled to multiply the number of votes they are entitled to cast by the number of directors for whom the are entitled to vote and cast the product for a single candidate or distribute the product among two or more candidates.
(d) [requires notice to be given for cumulative voting on other matters].

*This is an *Opt-in Cumulative Voting statute*; which requires that you have to put this in the articles of incorporation or there is no cumulative voting allowed for directors.
**Remember, shareholders always *vote their shares*, so on the TEST *do not* say three shareholders voted, if thy have 100 shares each, say 300 shares were voted (if they are only voting on one director).

G(1). Cumulative and Straight Voting:
1. *Straight Voting:* each shareholder gets as many votes, as she has shares, for each director.
2. *Cumulative Voting:* each shareholder gets as many votes, as she has shares, times the number of directors being elected.
a. Ex: A=12 shares; B=82 shares; Directors to be elected = 5.
i. *straight voting:* A gets 18 votes for each of the five directors; B gets 82 votes for each director (thus, B will get all five of his directors elected).
ii. *cumulative voting:* A gets 90 votes (18 x 5); B gets 410 votes (82 x 5) (thus, A will get at least one director if she cases all her votes for director #1 because B cannot divided 410 votes among five directors in a way to give each director more 90 votes.
b. The reason for cumulative voting is that it increases minority participation; on the other hand it can be confusing.
c. Cumulative or straight voting can apply to any action which requires a vote, and which method is used depends of the articles of incorporation.

G(2). Limitations on Cumulative Voting: a corporation can limit the impact of cumulative voting by staggering the terms of directors pursuant to **RMBCA § 8.06.**

H. **G/R:** Proxy Voting: [RMBCA § 7.22]: a proxy is usually revocable because a proxy creates an agency relationship with the real owner; and agency relationships are revocable. A shareholder can usually revoke a proxy be sending a later proxy, dated later, which makes the original proxy automatically revocable.

1. **RMBC §7.22(d):** *Irrevocable Proxies:* an appointment of a proxy is revocable UNLESS the appointment form….conspicuously [see §1.40(3)] that it is irrevocable and the appointment is coupled with an interest.

I. **G/R:** Delegation: directors may not delegate their duty to manage the corporate enterprise; however there is no conflict with the principle that where the delegation of duty is made not by directors but by stockholder action under the articles of corporation it is legal [*Lehrman v. Cohen*]. *But see* RMBCA § 8.25(d) (allows board of directors to delegate authority to a committee).

J. Limiting Takeovers: if a corporation staggers its directors terms pursuant to §8.06, and puts in the articles of incorporation pursuant to §8.08 that a director can only be removed for cause, this limits the ability of over companies to takeover the corporation.

II. SHAREHOLDER AGREEMENTS AND RESTRICTIONS ON THE TRANSFER OF SECURITIES

A. **RMBCA § 6.27:** Restriction on Transfer of Shares and other Securities:

(a) The articles of incorporation, bylaws, or *agreement* among shareholders, or an agreement between shareholders and a corporation *may* impose restrictions on the transfer or registration of transfer of shares of the corporation. A restriction does not affect shares issued before the restriction was adopted *unless* the holders of the shares are parties to the restriction agreement or voted in favor of the restriction.

(b) A restriction on the transfer or registration of transfer of shares is valid and enforceable against the holder or a transferee of the holder if the restriction is authorized by this section and its existence is noted *conspicuously* on the front or back *of the certificate* or is contained in the information statement required by §6.26(b). Unless so noted, a restriction is not enforceable against a person without knowledge of the restriction.

(c) A restriction on the transfer or registration of transfer of shares is authorized:

- (1) to maintain the corporation's *status* when it is dependent on the number or identity of its shareholders;
  - a. "status" refers to a (a) a corporation's election as a close corporation status under a close corporation statute; (b) election of an "S" corporation status for tax purposes; or (c) entitlement to a program or eligibility privilege by governmental agencies or national securities exchange.
- (2) to preserve exemptions under federal or state securities law; or
- (3) for any other *reasonable purpose*.
  - a. Other reasonable purposes presumably include provisions in closely held corporations designed to enable the owners to remain close, i.e. to select the persons with whom they will be associated in business and to permit withdrawing participants to liquidate their investments on some reasonable basis.

(d) A restriction on the transfer or registration of transfer shares may:

- (1) obligate the shareholder *first offer* the corporation or other persons…an opportunity to acquire the restricted shares [i.e. right of first refusal];
- (2) obligate the corporation or other persons…to acquire the restricted shares;
- (3) require the corporation, the holders of any class of its shares, or another person to approve the transfer of the restricted shares, if the requirement is not *manifestly unreasonable*.

A(1). **RMBCA §1.40(3):** Conspicuously: means so written that a reasonable person against whom the writing is to operate should have noticed it. For example, printing in italics or boldface or contrasting color, or typing in capitals or underlined, is conspicuous.

A(2). **G/R:** Restraints on Alienation of Stock: a corporation may impose restrictions on the disposition of its stock if the restrictions do not unreasonably restrain or prohibit transferability [*Ling & Co. v. Trinity Savings and Loan*].

1. Share transfer restrictions constitute contractual obligations that limit the power of owners to freely transfer their shares.
2. The traditional view was that share transfer restrictions constitute a restraint on alienation (like in property) and therefore are strictly construed. However this view be fading for a more receptive approach to restrictions on the transferability of shares.

B. **Drafting a Shareholder Agreement:** [buy/sell agreements] in drafting a shareholder agreement there are eight major things that need to be taken into consideration.

B(1). Objectives: the drafter must assess the objectives of the agreement and provide for:

1. the death, retirement, or withdrawal of a shareholder;
    a. When the buy/sell agreement is made when the corporation is formed then you can provide for mechanisms of shareholder control if a one shareholder leaves; or on the disposition of his shares (e.g. so his wife does not get them); to keep control of the corporation because if one shareholder dies, the others administratix could appoint a new director; and to keep the status as an S corporation, if the corporation is an S corporation.

B(2). Triggers: triggering events which cause the agreement to go into effect; like the death of shareholder, retirement, withdrawal, disability, if the persons ceases to be employed by the corporation, etc…

B(3). Buyers: provide for who will purchase the shares, either the (a) shareholders; (b) the corporation; (c) the presumption is to let the corporation buy it first, that is a redemption because the corporation buys the shares back.

B(4). Mandatory or Optional: provide for if the buyout will be mandatory or optional.

1. Mandatory is the most common method because there is really not much point to making it optional.
2. RMBC §6.04(c): the corporation cannot distribute shares if the corporation is insolvent in both the equity insolvency and bankruptcy test.
    a. Then the agreement can provide that it is mandatory for the shareholders to purchase the stock if the corporation cannot.
3. Other methods are: (a) giving shareholders an option to purchase the shares, but the agreement must provide a formula or fixed price for the cost of the shares; (b) give the corporation a right of first refusal.

B(5). Price: the price of the shares is usually determined in one of four ways:

1. use book value of the shares as of the date of death or the end of the preceding accounting period;
2. use a fixed price set out in the agreement, arrived at between the shareholders;
3. appraisal after death; or

4. use a self adjusting formula (and there are a lot formulas that can be used).

B(6). Method or Terms of Payment: the terms affect the price; the agreement can provide for immediate payment in a lump sum, or periodic payments over a period of time, and the like.

B(7). Funding: how will the corporation fund the buyout. If it is upon death, life insurance can fund the payments; however, the agreement must provide for funding on the event of withdrawal.

B(8). Covenants Not to Compete: if someone withdraws from the corporation, the agreement may provide for a covenant not to compete, although disfavored by courts, will be upheld if they are reasonable in time, space, length and purpose.

§9.3: DEADLOCKS AND DISSOLUTION

A. **RMBCA §8.05(e):** Terms of Directors Generally: despite the expiration of a director's term, he continues to serve until his successor is elected and qualifies or until there is a decrease in the number of directors.

1. This solves the problem in cases such as *Kelly v. Gearing* about when, and who becomes a director after the expiration of the director's term and a new director cannot be appointed because of deadlock.

B. **RMBCA §14.30:** Grounds for Judicial Dissolution: the court may dissolve a corporation:

(2) in a proceeding by a *shareholder* if it is established that:

(i) the directors are *deadlocked* in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock.

(ii) the directors or those in control of the corporation have acted, are acting, or will act, in a manner that is *fraudulent, oppressive*, or *illegal*.

a. "Fraudulent" is a material withholding, lying, or misrepresentation or deception. Fraud at least means non-disclosure and it could mean more like embezzlement.

b. "Illegal" means breaking the law, which probably covers embezzlement.

c. "Oppressive" means harsh, burdensome, wrongful conduct, a lack of probity, a lack of fair dealing in the affairs the company to prejudice some of its members, or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.

i. Oppressive conduct is the most common violation for which a buyout (or judicial dissolution) is found to be an appropriate remedy.

ii. Courts take an especially broad view of the application of oppressive conduct to a closely held corporation where oppression may more easily be found.

iii. An ordered buyout of stock at its fair value is an especially appropriate remedy where the oppressive acts of the majority are an attempt to "squeeze out" the minority who do not have a ready market for the corporations shares, and are at the mercy of the majority.

iv. **Test for oppressive conduct:** oppressive conduct is described as an expansive term that is used to cover a multitude of situations dealing with improper conduct and a narrow definition would be inappropriate. Courts may determine, according to the facts of the particular case, whether actions complained of serve to *frustrate the legitimate expectations of minority shareholders*, or whether the acts are of such severity as to warrant the requested relief.

(A) This is an objective reasonable person test for oppression.

v. *Factor Indication Oppression:* if a minority shareholder has to prove oppression she can put in evidence demonstrating:

(A) oral testimony about her expectations, the agreement, and employment ;
(B) an company documents indicating the oppressive behavior is against corporate policy (i.e. bylaws, resolutions, etc…);
(C) conspiracy to deprive of an interest in the corporation;
(D) willful breach of fiduciary duty; and
(E) that the oppressed shareholder would be denied a future voice in the corporation.

*[*Davis v. Sheerin*].

(iii) the shareholders are *deadlocked in voting power* and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whos terms have expired; or

(iv) the corporate assets are being misapplied or wasted.

B(1). **RMBCA § 14.32:** the court can appoint a custodian or receiver in a judicial proceeding brought to dissolve the corporation.

1. *Reciever:* winds the business down, and tries to solve the problems that arise in dissolution.
2. *Custodian:* is someone who is put in charge to try and salvage the business so it does not have to be dissolved. The court will appoint a custodian as a more lenient remedy then dissolving the corporation.

B(2). <u>Test for Determining if Dissolution is Appropriate</u>**:** RMBCA §14.30 is discretionary, the court *may* order dissolution, or it may not, even if the plaintiff proves everything, so the court also applies this test:

1. *Test:* the prime inquiry, as to the necessity of dissolution, is whether judicially imposed death on the corporation will be beneficial to stockholders and not injurious to the public.
*[*In Re Random & Neidorff*].

C. **RMBCA §14.34:** <u>Election to Purchase In Lieu of Dissolution:</u> [a buyout provision to which is less harsh than judicially imposed dissolution]:

(a) Instead of dissolution, the corporation, or one or more its shareholders, may elect to purchase all of the shares owned by the petitioning shareholder a the *FAIR VALUE* of the shares. An election pursuant to this section is irrevocable and can only be commenced if three prerequisites are met:

1. a proceeding to dissolve the corporation must have been commenced under §14.32(ii);
2. the corporation must be a closely held corporation; that is, it cannot have shares of any class listed on a national securities exchange or regularly traded over the counter; and
3. the election may only be made by the corporation or by shareholders other than the shareholder who is seeking to dissolve the corporation under section 14.30(ii).

(c) If within 60-days of filing the election, the parties reach an agreement as to the fair market value and terms of purchase, the court shall enter an order directing the purchase of the petitioner's shares.
(d) If the parties are unable to reach an agreement the as to the fair value of the shares the court shall determine the fair value of the shares as of the day of filing suit under section 14.32(ii).
(e) Upon determination of the fair value of the shares the court shall enter an order directing the purchase upon terms and conditions the court deems appropriate.

§9.4: ACTION BY DIRECTORS: MEETINGS

A. **RMCA §§ 8.20, 8.22, 8.23:** Meetings, Notice, and Waiver:
1. *Meetings:* The board of directors may hold regular or special meetings in or out of the State, in which all directors may participate [RMBCA §8.20].
a. The board of directors may permit any or all directors to participate in a meeting; *or* conduct the meeting through the use of any means of communication by which all the directors participating may simultaneously **hear** each other during the meeting (i.e. phone conference calls, etc…).
2. *Notice:* Regular meetings by the board of directors may be held without notice. Special meetings by the board of directors must be preceded by at least two days notice of the date, time, and place of the meeting [RMBCA §8.22].
3. *Waiver:* a director may waive any notice required by the Act, but the waiver must be in writing, signed by the director entitled to notice, and filed with the minutes.
a. A directors attendance at a meeting or participation in a meeting waives any required notice to him of the meeting, unless the director at the beginning of the meeting objects to the holding of the meeting.
*[RMBCA §8.23].

B. **G/R:** Classical Rule: the governing body of a corporation, are agents of the corporation only as a board and not individually; hence, the governing body of a corporation has no authority to act *except when assembled at a board meeting*.
1. Separate action of the persons composing the governing board, taken individually by members of the board, is not an action of the constituted body of the board that has corporate powers.
2. *Classical Minority Rule:* directors may bind their corporation, acting separately, if this is their usual practice in transacting the corporate business.
*[*Baldwin v. Canfield*].

C. **RMBCA §8.21:** Action without a Meeting:
(a) Unless the articles of incorporation provide otherwise or bylaws provide otherwise, action required by or permitted by this Act to be taken at a board of directors may **be taken without a meeting** if the action is taken by all members of the board. The action may be evidenced by one or more *written consents describing the action taken*, signed by **each director** [i.e. UNANIMOUS] and included in the minutes or filed with the corporate records reflecting the action taken.
(b) Action taken under this section is effective, *when the last director signs the consent*, unless the consent specifies a different effective date.
(c) A consent signed under this section has the *effect of a **meeting vote*** and may be described as such in any document.

C(1). **G/R:** Action without a Meeting: it would be unjust to require a claimant against a corporation to prove his case by formal corporate records.

1. *Close Corporations:* it is well known that corporations, which include few stockholders, do not often act with as much formality as larger corporations.
2. A statement that is unequivocally made, with a majority of the board's conduct which is sufficient for ratification of the proposal, is considered ratified by the board, even if taken without a formal meeting, and binding on the corporation.

*[*Mickshaw v. Coca Cola Bottling Corp.*].

**This case represents the more modern trend of requiring less formality for close corporations; however, under the RMBCA §8.21 the ratification would have had to been written, signed, and unanimous.

D. **RMBCA § 8.24:** Quorum and Voting:

(a) Unless the articles of incorporation or bylaws require a greater number…a quorum of the board of directors consists of:

(1) a majority of the fixed number of directors if the corporation has a fixed board size; or

(2) a majority of the number of directors prescribed, or if no number is prescribed the number in the office immediately before the meeting begins, if the corporation has a variable-range size board.

(b) The articles of incorporation or bylaws may authorize a quorum of the board of directors to consist of *no fewer than one-third* (1/3) *of the fixed or prescribed* number of directors determined under (a).

(c) If a quorum is present when a vote is taken, the affirmative vote of a majority of directors present is **the act of the board of directors** *unless* the articles of incorporation or bylaws require the vote of a greater number of directors.

E. **G/R:** Disclosure: if a director acts, without authority, or approval of the board, and does not **disclose** that action to the board of directors, the board/corporation is not bound by his actions, and is usually self-dealing or breach of fiduciary duty which can cause the invalidation of the act [*Cooke v. Lynn Sand & Stone Co.*].

1. In *Cooke*, it was even the vice president who drafted the contract, for the president, but since they did not disclosure the contract to the board, it was a breach of fiduciary duty because when an insider makes a contract with the corporation, the board MUST approve it, and the insiders power to contract with third parties does not give him the power to contract with the corporation for himself, to the *detriment of the corporation*.

F. **G/R:** Liability: directors may be subject to personal liability for failing to exercise due care in making decisions; and alternatively, for failing to make decisions or paying attention to corporate affairs [WYO. STAT. 17-16-830]. Directors may also be liable for violating a duty of loyalty to the corporation; such as, self-dealing transactions and usurpation of corporate opportunities.

1. *Caveat:* this liability is limited by the *business judgment rule* and possibly by specific exonerating provisions in the articles of incorporation.

§9.5: AUTHORITY OF OFFICERS

I. OFFICERS AND THEIR DUTIES

A. **RMBCA § 8.40:** Officers:

(a) A corporation has the officers described in its bylaws or designated by the board of directors in accordance with the bylaws.

(b) The board of directors may elect individuals to fill one or more officers of the corporation [traditional way of appointing officers]. A *duly authorized officer* may appoint one or more officers if authorized by the bylaws or the board of directors.

(c) The bylaws or the board of directors shall delegate to one of the officers [secretary] responsibility for preparing minutes of the directors and shareholders' meetings and for maintaining and authenticating *records* of the corporation.

--**§1.40(20):** *Secretary*: means the corporate officer to whom the board of directors has delegated responsibility under section 8.40(c) for custody of the minutes of the meetings of the board of directors and of the shareholders for authenticating records of the corporation.

--**§16.01(a) and (e)**: (a) a corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors, and a record of all actions taken by the board of directors or shareholders…(e) A corporation shall keep a copy of the following on record at its principle office (1) articles of incorporation; (2) bylaws; (3) resolutions adopted by the board; (4) minutes of all shareholder meetings; (5) all written communications to shareholders generally; (6) list of names and business addresses of corporate directors and officers; and (6) its most recent annual report from the secretary of State.

(d) Some individual may simultaneously hold more than one office in a corporation.

B. **RMBCA §8.41:** Duties of Officers: each officer has the authority and shall perform the *duties set forth in the bylaws*,…the duties prescribed by the board of directors or by direction of an officer authorized by the board of directors to prescribe the duties of the officers.

C. **RMBCA §8.42:** Standards of Conduct for Officers:

(a) An officer, when performing in such capacity, shall act:

(1) in good faith;

(2) with the care that a person in a like position would reasonably exercise under similar circumstances; and

(3) in a manner the officer reasonably believes to be in the best interest of the corporation.

(c) An officer **shall not be liable** to the corporation or its shareholders for *any decision* to take or not to take action…if the duties of the officer are performed in compliance with this section.

C(1). **G/R:** Official Comment: the principles of *agency*, generally govern the conduct of corporate employees, an officer is expected to observe the duties of obedience and loyalty and to act with the care that a person in a like position would reasonably exercise under similar circumstances.

1. **Rst. (2) Agency §379(1):** Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard of care and with the skill which is standard *in the locality for the kind of work which he is employed to perform* and, in addition, to exercise any special skill that he has.

D. **Generally:** Difference between Corporate Governance in Close and Public Corporations:

1. *Close Corporations:* close corporations, particularly ones enacted under §7.32, can get away with a lot of informality, and many things can be done by officers informally, or by written consent agreements.

2. *Publicly Held Corps:* in publicly held corporations, strict compliance with the corporate formalities are required, with any informal action, because shareholders, and the public, *rely* on the corporation to use corporate formalities.

E. **G/R:** Traditional Roles: there are three traditional roles of officers, however, they are not required by the RMBCA [§ 8.40(a)], those roles are:

E(1): President: the president shall be the principal executive officer of the corporation and, subject to the control of the board of directors, shall in general supervise and control all of the business affairs of the corporation.

1. The president shall preside at all shareholder meetings and meetings of the board of directors.
2. He may sign instruments for the corporation (certificates for shares, deeds, mortgages, bonds, contracts, or other instruments which the board of directors has authorized to be executed);
3. He shall perform all others duties incident to the office of the president, and other duties prescribed by the board.

E(2). Secretary: the secretary shall:

1. keep the minutes of the proceedings of the shareholders and the board of directors in one or books;
2. see that all notices are duly given in accordance with the provisions of the bylaws or as required by law;
3. be a custodian of the corporate records and of any seal of the corporation and affix the seal to documents;
4. authenticate records of the corporation;
5. sign with the president or vice president; certificates of shares;
6. have general charge of stock transfer books; and
7. in general perform duties incident to the office, or prescribed by the president or board.

E(3). Treasurer: the treasurer shall:

1. have charge and custody of and be responsible for all funds and securities of the corporation;
2. receive and give receipts for moneys due and payable to the corporation form any source and deposit corporate money in banks or other depositories as selected by the board of directors; and
3. in general perform all duties incident to the office of treasurer, and such other duties as assigned by the board or president.

Remember: these duties will be described in the bylaws, and bylaws grant very little express authorityto the officers; therefore, the principles of agency will come into play and you'll have to analyze through apparent authority.

F. **G/R:** President's Power: the president of a corporation has no power, merely because he is president, to bind the corporation.

1. The management and affairs of a corporation is ordinarily in the hands of the board of directors, and president has only such power as has been given him by the bylaws and the board of directors, and such other power as may arise from his having assumed and exercised the power in the past with the **apparent** consent and acquiescence of the corporation.
2. The president has only the power to do what the corporation gives him power to do; to determine this, look at:

a. Bylaws;
b. company practices;
c. articles of incorporation;
d. board resolutions;
e. ratification, duty of conduct through contracts (express or implied);
f. actual authority (express or implied);
i. the employment contracts of the directors;
g. statutes; and
h. case law in the jurisdiction.

*[*Black v. Harrison Home Co*.].

II. <u>BINDING THE CORPORATION FOR OFFICER ACTION</u>

A. **G/R:** <u>Binding the Corporation:</u> the president cannot act or contract for the corporation any more than ay other one director. The president of a corporation has no power to buy, sell, or contract for the corporation, nor to control its property, funds or management.

1. The board of directors may expressly authorize the president to contract; or his authority to contract may arise from his having assumed and exercised that power in the past; or
2. the corporation may ratify his contract or accept the benefits of it, and thereby be bound.
3. A corporation will be bound, so far as third persons are concerned by the acts of its agent which are within **the apparent scope of his authority**, and that the authority of an officer to make certain contracts on behalf of the corporation may arise as to third persons from:
    a. his having assumed and exercised the authority in the past with the acquiescence of the corporation, and
    b. that a corporation may ratify and render binding a contract entered into by one of its officers in excess of his authority.

*[*Black v. Harrison Home Co*.].

B. **G/R:** <u>Agency Law:</u> agency is potentially applicable whenever the president, or other officer, is acting in behalf of the corporation, there are two highly pertinent provisions:

C. **Rst. (2) Agency § 329:** <u>Agent Who Warrants Authority:</u> A person who purports to make a contract, conveyance or representation on behalf of another (i.e. the corporation) who has full capacity, but whom he has no power to bind, is subject to liability to the other party on an *implied warranty of authority*.

1. *Unless:* he manifested that he does not have the authority; or the other person knows he does not have the authority.

D. **Rst. (2) Agency § 330:** <u>Liability for Misrepresentation of Authority:</u> a person who tortiously misrepresents to another that the has authority to make a contract, conveyance, or representation on behalf of a principal (i.e. corporation) whom he has no power to bind, is subject to liability to the other in an action of tort for loss caused by reliance upon such misrepresentation.

H. **G/R:** <u>Authority and Agency Law:</u> generally, questions concerning the authority of officers are normally specially issues of agency law, and as in agency law, the major relevant concepts are those of actual and apparent authority.

1. When an agent is an executive of a corporation, the application of both these concepts often rests on the *executive's formal position*.

H(1). **ALI Principles of Corporate Governance 84-86:** the president of a corporation only has the authority to bind his company by acts arising in the *usual and regular course of business* but not for contracts of an **extraordinary** nature.

1. *Things Outside Apparent Authority of President:* some matters, such as the declaration of dividends are required by statute to be decided by the board. Typically statutes also enumerate certain matters that the board cannot delegate to a committee. It is not within the *apparent authority* of executives to take action with respect to these matters.
2. **Test for Extraordinary:** decisions that would make a significant change in the structure of the business enterprise, or the structure of control over the enterprise, are extraordinary corporate actions, and therefore are normally outside the apparent authority of executives.
    a. *Elements of Determining What Constitutes an Extraordinary Action* (which would normally be outside the apparent authority of executives):
        i. the economic magnitude of the action in relation to corporate assets and earnings;
        ii. the extent of the risk involved;
        iii. the time span of the action's effect; and
        iv. the cost of reversing the action.
    b. Examples:
        i. the creation of a long term retirement plan or other significant debt;
        ii. the reacquisition of significant amounts of equity;
        iii. significant capital investments;
        iv. business combinations including those effected for cash;
        v. the disposition of significant businesses;
        vi. entry into important new lines of business;
        vii. significant acquisitions of stock in other corporations; and
        viii. actions that would foreseeably expose the corporation to significant litigation or significant new regulatory problems.

H(2). **G/R:** <u>Life Contracts:</u> the president of a corporation only has authority to bind his company by acts arising in the usual and regular course of business but not for contracts of an "extraordinary" nature. The substance of the rule lies in the content of the term extraordinary.

1. It is generally settled that the president as part of his regular course of business has authority to hire and discharge employees and fix their compensation.
    a. In so doing, he may agree to hire them for a specific number of years if the term selected is deemed reasonable.
2. Contracts for life, or on a "permanent" basis, are generally regarded as extraordinary and beyond the authority of any corporate executive if the only consideration for the promise is the employee's promise to work for that period.
3. Accordingly, the Courts have erected a veritable array of obstacles to their enforcement:
    a. they have construed them as terminal at will;
    b. too indefinite to enforce;
    c. *ultra vires*;
    d. lacking in mutuality or consideration;
    e. abandoned by subsequent action,

f. the supporting evidence deemed insufficient to go to the jury; and
g. **made without proper authority**.
i. Authority is a question of fact for the jury.
*[*Lee v. Jenkins Bros*.].

I. **G/R:** Estopping a Corporation from Denying the Existence of a Contract: the secretary of the corporation generally has a duty to keep the corporate records and to make the proper entries of the actions and resolutions of the directors.

1. Statements made by an officer or agent in the course of a transaction in which the corporation is engaged and which are within the scope of his authority are binding on the corporation.
2. **G/R:** if a party enters into a transaction with the corporation, and the secretary presents a resolution saying that the corporate officers have the power to enter into the contract (rather than go through the corporate minute/record books) with the *corporate affixation*, it as good as a bona fide resolution.
   a. **estoppel:** this will estop the corporation from denying that the officers lacked the authority to enter into the corporation.
3. This is the rule because the secretary has the authority to bind the corporation because it is within the secretaries apparent authority to certify a resolution that was adopted, and then the corporation is estopped from denying that an officer did not have the authority to enter into the transaction.

*[*In the Matter of Drive In Dev. Corp*.].

§10: OTHER UNINCORPORATED BUSINESS FORMS

I. GENERALLY

A. **G/R:** Types of Unincorporated Ventures: there are nine main types of unincorporated business ventures, however, this list is not exhaustive:

1. The proprietorship (for single-owner business) or the general partnership (for multi-owner business);
2. the general partnership which elects to be a limited liability partnership (LLP);
3. the limited partnership with one or more individuals as general partners;
4. the limited partnership with a coporation or other other limited liability entity as a general partner;
5. the limited partnership which elects to be a limited liability limited partnership;
6. a member mananaged limited liability partnership;
7. a manager managed limited liability company;
8. a corporation for tax purposes may be a “C” or “S” corporation; and
9. a professional corporation, if the owners are engaged in a profession which is prohibited from incorporating under the general business corporation statute.

§10.1: LIMITED PARTNERSHIP

A. **Generally:** the limited partnership as a form of business is exclusively a creature of statute; and in the absence of a statute, or the failure to comply with mandatory provisions of an applicable statute, all partners are general partners no matter what their private understanding is or how they are designated in the partnership agreement.

1. The typical modern limited partnership is a federal income tax driven business in which there are scores or hundreds of limited partners and one or two general partners that are usually corporations or other limited partnerships rather than individuals.
2. The modern limited partnership seems closer, economically, to a close corporation than a general partnership.

B. **G/R:** <u>Difference:</u> a limited partnership differs from a general partnership in that there are two classes of partners: (a) one or more general partners; and (b) one or more limited partners, who are not personally liable for the debts of the partnership and who are not expected to participate in the partnership's day to day affairs.
1. In effect, limited partners, are passive investors, who stand to lose what the y have invested in the enterprise but no more.
2. Partners who are not specifically identified as limited partners, are general partners, and are unlimitedly liable for the debts of the business.

C. **ULPA:** limited partnerships, in States which have adopted them (Wyoming has NOT), are governed by ULPA.
1. **ULPA §1105:** in any case not governed by the ULPA, the provisions of [R]UPA govern.
    a. This means that limited partnerships, are not a default entity, if the provisions of ULPA are not followed, the entity is a partnership.

D. **G/R:** <u>Holding a Limited Partner, in a Limited Partnership Liable:</u> there are two theories for holding a limited partner liable:
1. <u>Filing Defect:</u> if everything is not filed correctly, in order, and registered with the Secretary of State, a LP does not because it is not a default entity. Under ULPA all the entity is required to do to become a LP is to follow the provisions of the Act, and file with the state.
2. <u>Control:</u> A limited partner shall not become liable as a general partner, *UNLESS* in addition to the exercise of rights and powers as a limited partner, he takes **part in the control of the of the business.** However, if the limited partner participates in the control of the business, he is only liable to person who transact business with the limited partnership, reasonably believing, based on the limited partner's conduct, that the limited partner is a general partner. [ULPA §303(a)].
    a. **ULPA §303(b)(6):** gives a list of things a limited partner can do, and still have limited liability, in participating in "control" of the partnership.
    b. **UPLA §304(b):** describes the situations in which a person erroneously believing that he is a limited partner, may be held liable as a general partner.

E. **G/R:** to form a limited partnership, an entity has to use the term "limited partnership" without abbreviation and the name of a limited partner cannot be used [ULPA §102(a),(b)].

F. **G/R:** <u>Fiduciary Duty:</u> general partners owe a fiduciary duty to limited partners [*In Re USACAFES*, LP Litigation].

§10.2: <u>LIMITED LIABILITY COMPANIES</u>

I. <u>GENERALLY</u>

A. **Definition**: the LLC is an unincorporated business organization that contains dissolution, management, and transferability provisions similar to those of a general partnership but that can be easily altered to resemble the limited partnership approach or to approach the corporate model.

1. A related unincorporated business entity, the limited liability partnership (LLP) essentially operates as a general partnership for business purposes, while offering the partners either partial or total liability protection.

B. **Generally:** the LLC offers a domestic entity that tax advantages of the of a partnership with limited liability protection for all members, an advantage commonly associated with corporations. The LLC is a hybrid of the corporate and partnership forms. The LLC is best understood in terms of four general characteristics:

1. Limited liability;
2. partnership tax features;
3. the ability to choose between centralized and direct member management (almost complete internal flexibility); and
4. creditor protection provisions.

C. **G/R:** Scope of Liability: all LLC statutes provide that members, like corporate shareholders, are not liable as such for the debts of the LLC.

1. LLC statutes do not protect members from liability for:
    a. agreed contributions and excessive distributions;
    b. for members own wrongs (torts); or
    c. for the debts the members contractually assume or guarantee.

D. **G/R:** Two-Member Requirement: Many LLC statutes either explicitly require the LLC to have two members or require that at least two people from the LLC at the time of the creation, and do not permit the LLC to have only one member.

E. **G/R:** Piercing the Veil: an LLC, like a corporation, may have its veil pierced. Therefore, on equitable grounds, the courts may impose liability on members of the LLC that have complied with statutory formalities. [*Hamilton v. AAHLC*].

1. The court, like in corporation cases, will use a multi-factor test focusing on undercapitalization, following corporate formalities, co-mingling of funds; *alter-ego* test, and a mixture of funds.

F. **G/R:** Comparison with Corporation: an LLC is superficially similar to a corporation:

1. It is a separate legal entity that is formed by filing articles of organization with the Secretary of the State;
2. It may be formed for any lawful purpose, subject to exceptions for certain kinds of businesses such as banking and insurance;
3. An LLC has regulations and an operating agreement (instead of bylaws);
4. The owners are called members (rather than shareholders);
5. LLC's have managers (rather than directors) and the mangers are chosen similar to a way in which shareholders choose directors of a corporation.
6. **Remember:** an LLC can closely resemble a corporation incorporated under §7.32.

G. **G/R:** Comparison with Partnership: LLC's are also similar to partnerships:

1. An LLC may elect to assume a management structure that is virtually identical to that of a general partnership (with the sole exception of avoidance of unlimited liability).
2. The operating agreements in many LLCs more closely approximates a partnership agreement than corporate bylaws.
3. Membership interests in an LLC are also similar to partnership characteristics:
    a. under some statutes, transferees of membership interests may be admitted only with unanimous consent of the members;
    b. death, bankruptcy, or retirement of a member may constitute a dissolution (or disassociation) of the LLC unless a majority in interest of the remaining members votes to continue the LLC.
4. *Member-Managed LLC's*: statutes defining member managed LLC's follow the partnership model:
    a. They provide that each member is an agent of the LLC for the purpose of its business; that each member has the right to posses LLC property for business purposes and so forth.
    b. These statutes may also provide for partnership type duties of care and loyalty.

H. **G/R:** Comparison with a Limited Partnership: the LLC differs from a limited partnership in that all participants must actively take part in control of the business without restriction and fear of personal liability for business obligations.

1. The source of limited liability provided by an LLC is analogous to that provided by limited partnership statutes for limited partners.
    a. A limited partnership files a certificate with the secretary of State, and the limited partners thereby obtain the shield of limited liability. Similarly, the LLC files articles of organization with a designated state official, and the members of the LLC thereby obtain the shield of limited liability.

II. WYOMING'S LIMITED LIABILITY COMPANY ACT: W.S. §§17-15-102 THROUGH 17-15-144

A. **17-15-103:** Purpose: (a) Limited liability companies may be organized under this Act for any lawful purpose, except for the purpose of banking or acting as an insurer.

B. **17-15-104:** Powers: (a) Each LLC organized and existing under this Act may:

(i) Sue and be sued, complain and defend, in its name;
(ii) ….deal in or with real property;
(iii) Sell, convey…transfer and otherwise dispose of all or any part of its property or its property assets;
(iv) Lend money to otherwise assist its members, managers or employees;
(v) Purchase, …own, hold, vote, use, employ, …and otherwise use and deal in and with shares or other interests in or obligations of other LLC's, corporations, or partnerships
(vi) make contracts and incur liabilities…;
(vii) lend,…invest…its funds and hold real property and personal property …
(viii) conduct its business, carry on its operations and have and exercise the powers granted by this act in any state….
(ix) elect or appoint managers….
(x) make or alter operating agreements, not inconsistent with the articles of organization…

(xi) indemnify a member or manager of the LLC against expenses actually and reasonably incurred by him or it in connection with the defense of an action, suit or proceeding, civil or criminal, in which he is made a party by reason of being a manager….
(xii) cease its activities and surrender its certificate of organization;
(xiii) have and exercise **all powers necessary or convenient** to effect any or all of the purposes for which the LLC is organized.

C. **§17-15-105:** Name: [Magic Words]: (a) the words "limited liability company" or its abbreviations "LLC" *shall be included in the name of every limited liability company formed*.

(b) Omission of the words "limited liability company" or "LLC" in the use of the name of the LLC *shall* render any person who participates in the omission, or knowingly acquiesces in it, *liable for indebtedness, damage or liability*, **occasioned by the omission.**

--"occasioned by the omission" means that there is a causation element required before one can be held liable under the act.

D. **§17-15-106:** Any person may form a limited liability company which shall have two or more members.

E. **Wyoming LLC case:** the Court basically held that the articles of organization are important. The Court said when you contribute to an LLC you get:

1. profit sharing and losses;
2. management;
3. transferability; and
4. the articles of organization are important in deciding what rights the individual has.