Business Associations Outline

INTRODUCTION & OVERVIEW OF BUSINESS FORMS

Sole Proprietorship: Business owned & run directly by one person.

- Disadvantages: Unlimited liability (owner is liable for all debts of the business & they can go after his personal assets as well as the business assets).
  - If your business tanks & you owe debt to Starbucks they can come after you personally. But if your uncle lent you the money to start the business w/ no strings, they can't go after him unless he retained some control in how you ran it.
- Advantages: Easy to start up + flexibility in running business + all profits go to owner.
  - Pass through taxation (owner does not have to pay separate business income tax)
  - Control & cash flow rights rest in same person. You use your money to open it, you make all the decisions & bear all gains & losses.

Partnerships: Involves joint ownership by 2 or more individuals.

- Disadvantages: Potential for conflict in making decisions & allocating profits & losses.
  - Personal liability: Partners are personally liable for all obligations of the partnership & each partner is responsible for the acts of all other partners.
- Advantages: Easy to form (no filing required, no formal partnership agreement required).
  - Default Rules: There are default rules to govern management, allocation of profits
  - Flexibility: Can change the default rules in a partnership agreement.
  - Tax: No tax at partnership level.

Corporations: Treated like fictitious legal persons (apart from their owners).

- Disadvantages: More formality: establish by making filing w/ secretary of state & pay fee
  - More rigid structure & rules for internal management found in state corporation statutes.
  - Double Taxation: Dividends taxed twice (as corporate profit & personal income)
  - Separation of Ownership and Control
- Advantages: Limited Liability: Shareholders can't lose more than what they invested in the corporation. Creditors can't go after shareholders' personal assets.
  - Freely Transferable Interests/Unlimited Duration: Shareholders can freely sell their shares; company goes on despite change in ownership.

Final Exam

-All essay

-3 questions

-Partnerships: Only UPA not RUPA.

-Corporate: Delaware only & SEC rules.

-Don't need to know Restatement Numbers for Agency

AGENCY LAW

- **Overview: Legal Consequences of Establishing an Agency Relationship**
    - Agent's actions may create liability for principal:
        - **(i)** Agent can bind principal to a 3rd party in contract.
        - **(ii)** Principal may be liable for agent's torts (if agent is driving your van & runs over someone you may be liable as his principal).
    - Agent owes a fiduciary duty to the principal.

I. Formation of Agency Relationship (Who Is An Agent?)

Rest 2d §1 Agency: Agency is the fiduciary relationship that results when the following 3 prongs are satisfied:

(1) Manifestation of consent by the principal that the agent shall **act on his behalf**; &

• Example: P says to A "I want you to be my stage assistant."

(2) Subject to the control of the principal; &

• Example: P says to A "You will do as I say."

• Easy to establish control prong. It does not mean the principal has to be telling the agent what to do at every point. Principal does not have to be exercising continuous control over the actions of its agent, they just have to set up the ultimate principles & objectives of the relationship.

(3) Manifestation of consent by the agent that he will do that.

• Example: A says to P "I will be your assistant."

- **Do not need intent to enter into a principal agency relationship,** so people enter into these types of relationships all the time without knowing it. Possibility exists everywhere.
- **Do not need a formal written contract** to enter into a principal agency relationship.
- **Do not need consideration** to establish principal agent relationship. For example, if I ask you to return something for me or go buy me tea you're my agent even if I don't pay you.

- **Buyer Supplier Argument & Prong 1** (*See Cargill)*: A buyer supplier relationship is usually not a principal agency relationship, but it can turn into one.
    - **Rest 2 §14K:** One who contracts to acquire property from a third person & convey it to another is the agent of the other **only if** it is agreed that he is to act **primarily for the benefit of the other** & not for himself.
    - 3 factors that can turn buyer supplier relationship into agency relationship:
        - **(1)** Is the supplier receiving a fixed price?
        - **(2)** Is supplier holding title to the items before passing them to the buyer?
            - If supplier is holding title then he is independent & is not an agent b/c he is bearing risk.
        - **(3)** Does the supplier have any other business?
            - If yes, then you are an independent business & not an agent.

- **Lender Borrower Argument & Prong 2 Control:** Generally lenders (creditors) & borrowers are not in a principal agency relationship even if the creditor puts certain conditions on the borrower. But, under **Rest 2d §14O**, **a creditor can become a principal if they start exercising de facto control over the conduct of the borrower**. Court lists 9 factors to determine if there is de facto control & lender becomes principal:
  - **(1)** Borrower can't enter into mortgages, purchase stock, or pay dividend's w/o lenders approval--**normal for lenders to do this.**
  - **(2)** Lender has right of entry onto borrower's premises to carry on periodic checks & audits--**normal for lenders to do this.**
  - **(3)** Lender has power to discontinue financing of borrowers operations--**normal for lenders to do this.**
  - **(4)** Lender can make recommendations to borrower--**normal for lender to do.**
  - **(5)** Lender sends correspondence & criticism regarding borrowers finances, officer salaries, & inventory--**normal for lenders to do this.**
  - **(6)** Lender determines that borrower needs strong paternal guidance--**this is normal too, it is just an opinion.**
  - **(7)** Lender has right of first refusal over borrower's products--**this just means you are a big important customer, it does not mean you have control over the company. But it does give you a lot of leverage.**
  - **(8)** Financing all of the borrower's purchases & operating expenses--**not normal for mere lenders, this shows you have a lot of control over them & that there is a strong commercial relationship between the two of you.**
  - **(9)** Lender gives borrower drafts & forms w/ it's name printed on them--**not normal for mere lenders, this shows you have a lot of control over them.**

- **Example "on behalf of" (i.e. prong 1):** P owns mall. A rents a store in the mall under a lease which gives P the right to approve or disapprove A's operational plans for the store. Is A Ps agent?
  - A is not acting on behalf of mall owner P so there's no agency relationship.
  - What if A also agrees to collect the rent from the mall's other tenants & remit it to P in exchange for a monthly service fee. Is A P's agent?
    - Yes b/c A is now collecting rent on behalf of P so "on behalf of" prong is easily satisfied here. A is going to be P's agent for collecting the rent but not necessarily for running the store. Can be agent of someone for some purposes but not others.

Cases

- ***Gorton v. Doty:*** HS football game & players riding in private car. Teacher Doty tells Coach Garst to take her car as long as he drives. There is an accident. P sues car owner (teacher) under agency theory. Was Coach an agent of principal Teacher (car owner)? Court holds yes. 3 prongs:

  (1) Manifestation of consent by teacher to coach to act on his behalf:
  - Teacher to coach: "Garst I want you to drive the team in my car."
  - But counter argue that teacher did not ask coach to "act on his behalf" here so that part of the prong is not satisfied.

  (2) Agent is subject to control of teacher:
  - Teacher: "Only Garst can drive my car." But dissent thinks saying 'only you can drive my car' is not enough to show control by teacher over coach.

  (3) Manifestation of consent by principal
  - Coach says: "I will be your driver." Taking the car is enough to show he consented.

• Policy rationale for holding the teacher liable is that we don't want people to take the risk off of themselves by putting it on to others AND we want people to be insured so it's incentive to car owners to get insurance to cover things like this. How can the teacher try to avoid liability in the future?

- Don't say that only you can drive my car, just say no kids can drive the car.
- Establish that she is just lending him the car & he is just borrowing the car.
- Try to enter into an agreement with the coach to allocate the risk.
- Get insurance that covers other drivers.

- ***Jenson Farms v. Cargill:*** Warren buys grain from farmers & sells it. Most of it is sold to Cargill. Cargill gives Warren a loan & starts to gain control over Warren's business. Specifically, Cargill gets a **right of first refusal** (meaning first dibs on Warren's grain) and a **revolving line of credit.** As Cargill gives more & more money it starts exercising more control over Warren. Eventually Cargill starts buying 90% of Warren's grain. Cargill starts to get very worried b/c Warren is not running the business well & is in debt. Cargill sends people to check up on Warren, gives him recommendations, sends letters, etc. Warren ignores all this & goes broke. Farmers now try to sue Cargill even though the farmers & Cargill never had a contract together. Farmers argue that although they did not transact w/ Cargill directly, they contracted with Warren, and Warren was Cargill's agent. Cargill argues that Warren was not their agent & they never had an agency relationship b/c they did not consent to one & had no agency contract. Court holds there was an agency relationship, it doesn't matter that they didn't have a contract b/c neither intent nor contract is require to create an agency relationship. Three Prongs:

(1) Manifestation of consent by principal that agent will act on his behalf:

• Cargill: "Warren I want you to buy grain from farmers for me." Cargill told Warren to buy grain for Cargill, so prong 1 is satisfied.

• But Cargill will counter argue it was just acting as a buyer & Warren was just their supplier. **Buyer supplier argument** (3 factors that can turn buyer supplier into agency + Rest 2). Court says they are **not buyer & supplier** b/c Warren was not an independent business, it depended too much on Cargill to be independent.

(2) Subject to control:

• Cargill: "I'll tell you how to run your grain business." They had people there telling Warren what to do with daily checkups.

• Cargill will counter argue we didn't have control over them, we just gave them money & they did what they wanted. We are just a lender & lenders put conditions on borrowers all the time, so its normal. **Lender Borrower Argument**. Court holds they were not mere lender borrower b/c they exercised de facto control over Warren (re: 9 factors).

--But just assuming de facto control is not enough, still need consent by agent & manifestation of consent by principal. So here we can argue Warren was never really acting on behalf of Cargill, Warren was just acting on its own behalf.

(3) Consent by Warren to be the agent of Cargill:

•Warren: "Will do. Show me the money." We just assume that by taking the grain from the farmers & by selling the grain to Cargill, Warren consented to that relationship.

• Policy reasoning is that it makes sense to put pressure on Cargill to make sure its intermediaries are straight shooters otherwise Cargill would not care, this gives them incentive to care b/c they are in the best position to exert control.

II. Liability of the Principal for the Agent's Actions-CONTRACT Liability

- Two types of liability:

(1) Liability for **contracts** entered into by the agent.

(2) Liability for the **torts** committed by the agent.

- Any contract that an agent enters into with a third party, if the agent had authority to enter into it, then the principal is going to be liable to the third party. There are many types of authority & more than one type of authority can be present in a given fact pattern. **But you only need to establish one type of authority to make the principal liable**.

- **Overview: Types of Contract Liability Based on Authority**
  - **(1)** Actual Authority
    - -Express
    - -Implied + by virtue of custom
  - **(2)** Apparent Authority
  - **(3)** Inherent Authority
  - **(4)** Ratification
  - **(5)** Estoppel

A. Actual Authority

Rest 2d §26: Two steps to create actual authority:

(1) Some type of **communication from the principal to the agent** to do an act; **AND**

• Communication can be **written or spoken words** OR **conduct of the principal**

(2) In interpreting that communication, it is **reasonable** for the agent to believe he was authorized to do certain actions.

- **Two Types of Actual Authority:**

(1) Actual Express Authority- When principal tells the agent to go do X.

- The principal (P) tells the agent (A) to do X, and A does X. P is bound.
- Example: Board of directors of Muppet Labs authorizes Fozzie Bear,VP of Marketing, to sign an endorsement contract w/ Ricky Martin, as part of its new ad campaign. Muppet Labs is bound by the endorsement contract signed by Fozzie.
- If I P tell you A to go buy me coffee, & if you don't pay the stand, they can come after me to pay up b/c I gave you actual authority to make the purchase.

(2) Actual Implied Authority- If the principal tells the agent to take certain action & in order to fulfill that action, the agent may have to take other actions.

- P can't always think of everything that it would authorize A to do. **If, in order to carry out P's explicit instructions, A takes some other steps necessary to carry out those instructions, P is bound.**
- If Fozzie has to go to Miami to meet w/ Ricky to negotiate the contract, then he can charge his plane ticket to Muppet Labs & Muppet Labs is liable b/c he had implied authority.
- **Actual Implied Authority by Virtue of Custom:** If it's customary for a certain type of agent to have certain powers, then the agent has actual (implied) authority to exercise such powers **unless the principal expressly directs otherwise**.
  - • **Example**: Unless Muppet Labs indicates otherwise, Fozzie will (reasonably) believe he has the authority to do the things that Marketing

VPs typically do. If such VP's usually have power to sign endorsement deals for the company then Fozzie may have actual authority to enter into such agreements even if the board doesn't tell him to. But if the board tells him explicitly that he can't sign endorsement deals then he does not have the authority to sign them, even if all other VP's do have that power.

- Takeaway: **Actual Authority** depends on the **<u>beliefs of the AGENT</u>** does he reasonably believe he is authorized to do this.

B. Apparent Authority

Rest 2d §27: Two steps to create apparent authority:

(1) Some **communication or manifestation** from the **principal to the third party**; **<u>AND</u>**

(i) Communication can be **written or spoken words** OR **conduct of the principal** OR **some business custom.**

(ii) A business card can create apparent authority.

(iii) Agents mere assertion of his authority is not enough b/c not coming from P.

(2) In interpreting that communication, it is **reasonable** for the third party to believe that the principal consents to having this act done (i.e. that the agent represents the principal).

• Ask, how did the third party learn about the agent's alleged authority? It must come from the principal.

- **Apparent Authority by Virtue of Custom**: Even if P has expressly forbidden A from doing customary acts, (implied) apparent authority by virtue of custom may exist if:

(1) Third party knows that P has placed A in a certain position; and

(2) It is customary for A's in that position to have authority to enter into that type of agreement.

• If ML gave business card to Fossie that says VP of marketing & such VP's usually have the power to sign endorsement deals, then when Ricky sees the card he's going to believe Fossie has authority.

- Takeaway: **Apparent Authority** depends on the **<u>beliefs of the THIRD PARTY,</u>** does he reasonably believe that the agent he is transacting with has authority to bind the principal.

- **Actual vs. Apparent Authority**

• Actual Express & Implied Authority depend on communication between P & A.

  - So you must look at **what the agent believes.**

• Apparent Authority depends on communication between Principal & third party.

  - So you must look at **what 3rd party believes.**

Examples

- If ML called Ricky & said we're sending Fossie & want you to negotiate an endorsement agreement w/ him, that would create apparent authority for Fossie to bind ML.

- If ML gives Fossie a business card & says you are VP of marketing, that creates actual or implied authority by custom on Fossie b/c actual authority focuses on belief of the agent.

- Fossie is VP of marketing & VPs have power by custom to sign endorsement deals on behalf of company. But when they named him VP they told him he can't sign agreements w/o our authority.
  - If he does go & sign an agreement, did Fossie have actual authority?
    --NO b/c it was not reasonable for Fossie to think that b/c he was told explicitly he could not do that.
  - Is there apparent authority?
    --Yes, b/c Ricky could have reasonably believed, given the business card saying he is VP of marketing, that Fossie had power to bind muppet labs.

- Pam owns Whiteacre. Alan is her real estate broker. Ted is an outsider who claims Alan entered into a contract on Pam's behalf to sell Whiteacre to Ted. Ted seeks to establish authority by submitting as evidence a letter from Pam to Alan in which Pam directed Alan to sell Whiteacre. What type of authority is Ted trying to establish?
  - Third party is trying to show actual express authority b/c it is going to the agent.

- Ted seeks to establish authority by submitting as evidence a letter sent by Pam to Ted in which Pam said she had ordered Alan to sell Wacre. What type of authority is Ted trying to establish?
  - Apparent authority b/c given the letter Pam sent to Ted, Ted can reasonably believe that Alan has the power to sell the property.

- Suppose Alan told Ted that he is Pam's agent. Does Alan have apparent authority?
  - It depends on what else Alan has given Ted. If it's just a random person who walks up to you & says it then it may not be reasonable for you to believe that he has authority to sell it. But if he has business card or something then it may be reasonable for Ted to believe it
  - But if Pam tells Alan: "Alan I want you to sell this house & I want you to tell Ted that you are my agent" then that would create apparent authority (b/c remember the manifestation from the principle to the third party does not have to be direct, it can be done through agents—tricky example). **You can't have apparent authority without any action from the principal.**

- Suppose Pam had been present when Alan tells Ted he is Pam's agent. She was silent. Does Alan have apparent authority?
  - Yes b/c this silence can be a manifestation. It is reasonable for Ted to interpret Pam's silence as her saying yes.

- Suppose Ricky wants his assistant to negotiate a contract for him w/ ML. Ricky faxes a letter to the assistant & a copy to ML stating that the assistant is authorized to contract on his behalf.
  - The letter to the assistant creates Actual Express Authority.
  - The letter to ML creates Apparent Authority b/c ML received this document saying the assistant is authorized, so this was the manifestation from the principal.

- Now, suppose at the bottom of his letter to the assistant, he scrawls, "But call me first."
  - Ricky still has created AA through the fax. Ricky has not given actual express authority but there is still apparent authority b/c ML never saw the handwritten note.
  - Ricky has *not* granted the assistant Actual Express Authority to sign.

- Paul owns an apartment building & hired Ann to manage it.
  a) Paul tells Ann to hire company to cut the grass. Ann does it. Is Paul bound by the K?
     Ans: Yes, Ann had express actual authority.
  b) Without express instructions, Ann hires a janitor to clean the building. Is Paul bound by the employment contract with the janitor?
     Ans: Yes, Paul told her to run the building and to do that it is reasonable to hire the janitor, so Ann has actual implied authority.

c) Suppose Paul specifically instructed Ann not to hire a janitor, but that local custom gives apartment managers the power to hire janitors. Would Paul be bound by the contract?

Ans: Anne no longer has actual express or implied authority to hire a janitor. But the janitor can argue there is apparent authority b/c it is customary for managers to have this hiring power so it's reasonable for the janitor to assume the manager had the power to hire him. Apparent authority is enough to bind the principal and create contract liability.

Cases

- ***Mill Street Church v. Hogan*:** Principal is MS Church & agent is Bill. MS commissions Bill to do painting & Bill hires his brother Sam (third party) to help, Sam breaks his arm & sues MS. If Bill had authority to hire Sam then Sam can go after MS. Court holds he had authority:
  - Bill had actual express authority to paint the church.
  - Bill had actual implied authority to hire help if help is reasonably necessary to do the paint job. Yes, it was necessary to have 2 people to do this job.
  - Also apparent authority b/c in the past Bill had hired Sam & it was okay, so Sam could reasonably believe that Bill had authority. Plus MS never told Bill he could not hire Sam.
  - If MS had told Bill he can't hire Sam and Bill hired him anyway w/o telling him that, then Sam might still have apparent authority b/c Sam did not know & it was reasonable for him to think Bill has authority.

- ***370 Leasing v. Ampex*:** Joyce is friends w/ Kays who works for Ampex (boss is Mueller). Joyce negotiates w/ Ampex to buy computers. Ampex sends Joyce a document about the transaction but Ampex never signs it. Joyce tells them the only person he wants to deal w/ is Kays & Ampex agrees. Mueller sends interoffice memo saying Kays is the only person who will deal w/ it. Kays sends a letter to Joyce about delivery details. They don't deliver & Joyce sues to enforce it. Did Kays (A) have authority to bind Ampex (P)?
  - Kays did not have Actual Express Authority b/c only contract managers had authority to sign sales agreements in this company.
  - Kays probably didn't have Actual Implied Authority b/c he was mere salesperson & knows his own companies policies don't allow salespeople to sign agreements.
  - **Kays did have Apparent Authority**
    - What were Ampex's manifestations to Joyce?
      - Kays was employed as salesman & it was reasonable for third party buyer to assume salesman could enter into K w/ him.
      - Ampex did nothing to dispel that inference. So the manifestation from the P that reaches the third party in this case is Ampex naming Kays a salesperson. They never relate to Joyce that a salesperson can't enter into sales agreements. Even the letter they sent to Joyce made Joyce believe he can deal with Kays exclusively.
      - They never told Joyce about their company policy so it really doesn't work against Joyce.
      - NOTE: Ampex can counter argue that they were extending Joyce a lot of credit & it was unreasonable for him to assume mere salesperson can extend so much credit, therefore, from that it should also be unreasonable to presume that salesman has authority to enter into sales contracts.

C. Inherent Authority

- **When Agents Go Rogue**: Going rogue means the agent is not following the principal's instructions. This can be even more problematic when the principal is undisclosed b/c if the third party does not know a principal exists, how can there be a manifestation to create apparent authority. **Rest 2 §4: Three Types of Principals:**

(1) Disclosed: At time of transaction, 3rd party knows **(i)** she is dealing w/ an agent acting for a principal and knows **(ii)** the principal's identity.

(2) Partially Disclosed/Unidentified: At the time of transaction, 3rd party knows **(i)** she is dealing with an agent but **(ii)** does not know the principal's identity.

- Like dealing with Remax when buying a house, you know that Remax does not own the house you are buying.

(3) Undisclosed: At time of transaction, 3rd party has no notice she is dealing with an agent acting for a principal. 3rd party just thinks he is dealing w/ a principal.

- If the agent is acting beyond his actual authority, then in this situation it can be hard for the third party to argue there is apparent authority b/c they have never gotten a manifestation from the principal b/c they don't know there is a principal out there.

- **Rest 2 §195: Liability of Undisclosed Principle-**An undisclosed principal who entrusts an agent w/ the management of his business is subject to liability to third parties w/whom the agent enters into transactions **(1) usual in such business and (2) on the principal's account**, <u>although contrary to the directions of the principal</u>.

- **Rest 2 §8A: Inherent Authority-** Inherent agency power is derived not from actual authority, apparent authority or estoppel, but **solely from the agency relation and exists for the protection** of persons harmed by or dealing with a servant or other agent.
  - **B/c of the position the principal has put the agent in, we say the power is inherent to the position.**
  - Example: If undisclosed P names a manager then we can say the manager had inherent authority to bind the P in ways that managers usually can.

- ***Watteau v. Fenwick*****:** Principal bought bar from Humble (A) but Humble stayed on as manager & his name was on door. They told him he can't buy items for bar. Third party did not know about existence of P & sold stuff to Humble on credit thinking Humble was still the owner. He sues P to recover money. **Court holds Humble had inherent authority to bind undisclosed P.**
  - Humble did not have actual authority b/c P told him not to do it.
  - Humble did not have apparent authority either. Although he was the owner before & had done it before, the third party had no manifestation from the actual principal. Third party could not trace it back to the principal b/c he thought Humble was the principal. But court holds P is liable b/c Humble was the manager & usually mangers have the authority to buy bar supplies, so he had inherent authority, & as a undisclosed P you're responsible
    - Counter argue Humble was not acting on principal's account b/c he was buying the stuff to pocket the profit himself. **See Q#5 on Kermit Handout.**

D. Ratification

Rest 2 §82: Ratification-Ratification is when the agent acts completely outside of his authority, but if the P ratifies the K then we act as if it was authorized by the P from the start. It can be:

(1) Express ratification by P (P expressly assents to it); or

(2) Implied ratification by conduct where P accepts or retains the benefits from the K; or
(3) Principal learns about the K & fails to repudiate it OR stays silent. This is ratification.

- Ratification is not valid if the P is ignorant of material facts involved in the original transaction, and is unaware of his ignorance.

- Ratification is an all or nothing thing. Have to ratify the entire agreement or nothing, can't just ratify pieces of it.

- **Ratification & 3rd Party-**Ratification will not be effective where it would be unfair to bind the third-party to the contract, such as if:
  - **(1)** Prior to ratification, third party manifested intent to withdraw; or
    - Example, when 3rd party learns the K was entered into by the agent w/o authority, the third party says that is too sketchy & I want out of this.

  - **(2)** There is some material change in circumstances (between transaction & ratification) that would make it inequitable to bind the third party.

Examples
(1) Pam is a writer. Her husband Alex enters into a K w/ ABC Book Publishers under which Pam's next book is to go to ABC. Pam gets a check from ABC, representing the advance on the K, which she cashes. She spends it on a new computer for her office. Some months later Pam tries to sell her new book to diff publisher. ABC claims the book. Pam says Alex had no authority to act as her agent. ABC argues?

ANS: Husband had no actual or apparent authority but ABC can argue that by her actions in depositing the check & spending it she ratified the contract entered into by her husband.

•To repudiate the K, Pam could've sent the check back & told ABC they dont have a deal.

(2) Pam thought the check was for royalties on one of her previous books, which ABC had published. She neither knew nor had reason to know that it was an advance on her next book. What can Pam argue?

ANS: She can argue she didn't know the check was for a new K, so by accepting the check she was not validating it b/c she did not know the material circumstances.

(3) Alan, a Pam fan, goes to a landscaping company & pretending to be Pam's butler, asks the company to cut Pam's grass. Pam arrives home just after the men finished up. Pam thanks them & goes inside. Company sues her for refusing to pay. Pam argues that Alan had no authority to enter into this K. Company claims she ratified the K by accepting & retaining its benefits. What can Pam argue?

ANS: She can argue that she can't decline the benefit & repudiate the K b/c the grass is already cut. So under agency law it seems like the landscaping company is out of luck.

- Q: Can the landscaping company argue they had apparent authority?
  - **ANS**: No b/c the company would want some evidence that he is really Pam's butler.

(4) Paula is an investor who has opened an account at a local brokerage. She instructs Al, her broker, only to purchase treasury bonds. Al disregards instructions & buys stock in risky stocks. Paula does not learn about this until her first monthly statement arrives. She decides to wait & see. When her next monthly statement arrives she notices that the stock's price has tanked. She calls Al & demands that he close the account & reimburse her. She claims he had no authority to buy stock. Al claims Paula ratified the purchase by waiting. Who is right?

ANS: Al can argue that by waiting she ratified the purchase of the stock (ratified by silence).

(5) Paula owns Whiteacre. Alan, having no authority to do so, enters into a sale contract w/ Ted by which Ted is to purchase Whiteacre. The next day Whiteacre burns to the ground. Paula then expressly affirms the contract. Ted says she's too late. Who wins?

> **ANS:** Ted wins It would be inequitable to enforce the K against the 3rd party so we are not going to let the principal ratify this agreement. **BUT if the agent had actual or apparent authority then the third party would be bound by the contract**.

E. Estoppel

Rest 2 §8B: Agency by Estoppel

A person who is not otherwise liable as a party to a transaction purported to be done on his account, is nevertheless subject to liability to persons who have **changed their positions (payment of money, expenditure of labor, suffering a loss or subjection to legal liability)**, **if**

> **(a)** He **intentionally or carelessly caused such belief**, or
>
> **(b)** Knowing of such belief, **did not take reasonable steps** to notify them of the facts.

- To win on a case of agency by estoppel, the plaintiff must prove:
  - **(1) Acts, words, or omissions by the P**, either intentional or negligent, **created an appearance of authority in the purported A**; and
  - **(2)** Plaintiff **reasonably & in good faith acted in reliance** on such appearance of authority; and
  - **(3)** Plaintiff **actually changed her position** in reliance on it

- ***Hoddeson v. Koos Bros:*** Mrs. H goes into store to buy furniture, salesman takes her order & money & does not give her a receipt. Furniture never comes, store claims they have no record of her purchase & salesman was an impostor. He was not our agent & we shouldn't be bound by his actions. None of the types of authority work here b/c store never made any manifestation that he was their agent. Court decides case based on estoppel. It is the duty of the storekeeper not to let impostor salesmen hang around & talk to people. Owner can't claim impostor had no authority if his dereliction of duty enables someone who isn't his agent to act as such. To win on estoppel, Mrs. H must prove:
  - **(1)** She was reasonable & prudent (reasonable to believe this guy was an agent & she acted in a prudent way). Store can try to counter argue that she never got a receipt so she was unreasonable in not getting one.
  - **(2)** She actually had a change in position (like she actually lost money).
  - **(3)** Store failed to supervise the floor & allowed this to go on, etc.

  • If she & impostor had merely entered into K for purchase of furniture, and she hadn't paid him any money, then she would have no actual loss (no change in position), so she cant claim estoppel

- **Summary: When is the *3rd party bound* to the principal in contract?**

  --When there is actual express authority, actual implied authority, apparent authority, & sometimes inherent agency powers (the exception to this is when the agent does fraud & conceals the name of the principal, b/c in that scenario, the 3rd party would not have entered the K if he really know who the principal was).

  --Ratification also usually works unless one of the exceptions discussed earlier applies.

  --For estoppel, usually it is the third party who is trying to enforce the agreement, not get out of it.

F. Agent's Own Liability to Third Parties

When is the agent a party to the contract?

(1) If all parties intend agent to also be a party to the K, then the agent is bound; **OR**

(2) When an agent acting w/ actual, apparent or inherent authority makes a K on behalf of

(1) Disclosed Principal: Agent is **NOT** a party to K unless otherwise agreed.

(2) Unidentified/ partially disclosed principal: Agent **IS** a party to the K unless otherwise agreed.

(3) Undisclosed principal: Agent **IS** a party.

• This puts the weight on the agent to disclose who his principal is b/c otherwise, w/ an undisclosed P, the third party can sue the agent for nonperformance of the contract.

- **Rogue Agents** (agents that have no authority to transact on behalf of the principal)
  - If A lacks actual authority but P is bound by contract, **P may recover damages from A.**
  - If A lacks authority, but represents otherwise & lies to the third party, A is subject to liability to the third party in cases where the principal refuses to ratify the contract and there is no other authority to bind the principal.
    - Harm incurred & the amount by which he would have benefited had authority existed.

- ***Atlantic Salmon v. Curran:*** D represents himself as an agent of Boston International Seafood (which does not exist) & buys fish from plaintiff. D actually owns another corporation called Marketing Design (MD) which plaintiff did not know about. Plaintiff sues D personally to recover money for the fish. D claims he was just an agent & should not be personally liable b/c he was not a party to the contract. MD was a partially disclosed principal b/c their name was on the checks so plaintiff saw the name. That means plaintiff knew there was a principal roaming around somewhere, he just didn't know principal's real identity. Court found the agent personally liable b/c there was a partially disclosed principle. **Agent has a duty (when he has a partially disclosed principle) to disclose to the third party the identity of the principal.** The fact that plaintiff could have figured this out themselves does not matter, the **burden is on the agent**.

- **Insert PP1 & PP2.**

III. Liability of the Principal for the Agent's Actions-TORT Liability

When can a third party sue the principal for the torts committed by his agent?

• **Rest 2 §219(1): Principal's Liability in Tort-**A master is subject to liability for the torts of **his servants** committed **while acting in the scope of their employment**.

That means P is liable when:

(1) The agent is a **servant**, **<u>AND</u>**

(2) Commits the tort while acting in the **scope of the agents employment.**

(A) Who is a Servant?

- **Rest 2 §2(2):Definition of Servant-** A servant is an **agent** employed by a master to perform services in his affairs whose **physical conduct in the performance of the service is controlled OR subject to the right of control** by the master.
  - ➔Right to control manner & means of the agent's performance at work.

- **Rest 2 §2(3):Definition of Independent Contractor (IC)-**An IC is a person who contracts w/ another to do something for him but **who is not controlled** by the other **nor subject to the other's right to control w/ respect to his physical conduct** in the performance of the undertaking.
  - ➔That means an IC is a person who contracts w/ another to do something for him but is not controlled by the other nor subject to his right to control.
  - ➔**IC is NOT a servant but he may or may not be an agent.**

- Depending on what type of A the agent is classified as, P's liability changes. If agent is:
  - **(1) Servant- P is liable** as long as A is acting within the scope of his employment.
    - • P has total control over A's manner & means & A is his servant.

  - **(2) Agent Type Independent Contractor- P is NOT liable except in special cases** b/c P only has limited control. A has power to act on P's behalf & is like an agent. The special cases exist b/c we want to give P incentive to hire someone good so that nobody gets hurt. See below for rule.
  - • Principal is not liable for torts committed by an IC (who is an agent but not a servant) or IC's employees **UNLESS:**
    - **(1)** Principal retains the **right to have some control** over the aspect of the work in which the tort occurs; or
    - **(2)** Principal hires an **incompetent IC**; or
    - **(3)** The activity contracted for is a nuisance per se, meaning it is an **inherently dangerous** or ultra-hazardous activity.

  - **(3) Non-Agent Type Independent Contractor-P is NOT liable at all in agency**
    - • A has no power to act on P's behalf. A is not P's agent.
    - • P is not held liable for most IC's b/c P does **not supervise the details of the IC's work, has no control over IC,** & therefore is not in a good position to prevent negligent performance.

- **Indicators of Master Servant Relationship:** Factors that courts look at when trying to determine if the agent is a servant (they are just factors, not all have to be met):
  - **(1) Is the agent paid per job or with a salary/wage?**
    - -A salary makes you more like a servant than paid per job.
  - **(2) Is the work being done by the A a regular part of the P's regular business?**
    - -If yes, then you are more likely a servant. Example: a baker in a bakery is a servant but a plumber in a bakery is probably not a servant.

(3) The beliefs of P & A about their relationship.

(4) Whether the Principal is in business herself?

-If you hire a plumber to go to your house you are still not a master, but if Sears hires a plumber then we are more likely to think Sears is a master. So if the P is a business then they are more like a master.

(5) Who provides the supplies?

(6) The location of the work?

(7) Terms of the relationship?

-How long is the relationship.

(8) Extent of P's control over work details?

(9) Whether A has distinct business (i.e. whether the agent is in business herself)?

-If yes, then she is not a servant.

(10) Practice of supervision-locality/trade?

(11) Skill required of the A?

-The more skills they have the more we think they are not a servant (i.e. doctor, lawyer, engineer are not servants).

***BUT** these Restatement factors regarding control are easily manipulable by clever attorneys. Therefore, **a better approach to determine control is to follow the money:**

(1) What is the financial structure of the operation; &

(2) Who bears the most economic risk (who makes the most money if business does well & who loses the most money if business tanks). That is who has control

Examples & Cases

- P employs A as a broker to sell Blackacre. A, while driving T, a prospective customer, to inspect the premises, negligently injures him. P is not liable to T. Broker was clearly the principals' agent but he is NOT a servant of the principal b/c the principal is not telling him how to sell the house.

- The salesman of the real estate broker, while driving T, a prospective customer, to view a house, negligently injures him. The broker, but not the broker's principal, is subject to liability to T. The broker's principal is the owner of the house & is not going to be subject to liability b/c the salesman is not the servant of the house owner.

- You have a coffee stand & want to sell cookies. 3 possible ways you can do it:

  (1) Hire a baker to come bake cookies for you. Baker is your **agent & servant** b/c you tell him how to do it.
  (2) Ask a baker friend to bake cookies for you & buy them from him. He would be your **agent but not your servant** b/c you're not telling him how to bake the cookies.
  (3) Go to supermarket & buy cookies from there & sell them at your stand. Here the supermarket is a **non-agent independent contractor**, not a servant.

- ***Humble*:** Customer Love's car rolls off a gas station & crashes into Martins house down the street. Humble, the oil company, says he is not liable to Love or Martin b/c the gas station was owned by an independent contractor Schneider & he is not responsible for IC's negligence. Court holds Humble is liable b/c there was a master servant relationship between Humble & Schneider b/c Humble retained so much control over the station. Schneider had to do what Humble told him.

- ***Hoover:*** Sun Oil owned the gas station, the operator of the station was Barone & his employee Smilyk set plaintiffs car on fire as he was putting gas in it. Sun Oil says Barone was an independent contractor so they are not responsible. Smilyk was clearly a servant & liable. But to determine if Barone was a servant of Sun Oil such that Sun Oil should be liable as P, court looks at certain factors to see how much control they had over him. Barone gets most of his supplies from Sun Oil & they give him lots of training but he sets his own hours & doesn't report to them.

- **Comparison of the 2 Cases**: In ***Hoover*** Sun Oil had no control over the hours of operation, they had some control of the products, the station owner did not have to take their advice, owner was allowed to sell competing products as long as he sold their products too. Owner owned all the products in the store so if the customers didn't buy the products, it was his loss, therefore he had more control over day to day operations & bore more of the economic risk of running the station. Duration of the agreement was not so drastic b/c both parties could terminate the agreement on 30 days notice. That is important b/c each party has control over it (but in ***Humble,*** oil company could kick him out at will so it was a lot of power in their hands to terminate unilaterally). Restatement factors are easily manipulable, so instead we should follow the money to determine who retains control, whoever bears more economic risk is usually in control.

(B) What is in Scope of Agents Employment?

- **Rest 2 §228(1): Scope of Employment - Authorized Conduct**
  Conduct is within scope of employment if and only if:
  - It is of a kind you are employed to perform;
    - To argue if conduct was authorized or not, ask whether it was or was not the *kind of act* the agent was employed to perform?
      Argue that b/c **Rest 2 §229(1)** says conduct must be of the same general nature as that authorized, or incidental to the conduct authorized.
  - It is substantially within authorized time/space limits;
  - It is done at least in part to serve the master;
  - If force is used, it is not unexpected by the master (i.e. intentional torts).

- **Rest 2 §229(2): Scope of Employment - Unauthorized Conduct**
  Unauthorized conduct may be within the scope of employment **if it is similar or incidental to conduct that is authorized.** Factors to determine this include:
  - The act commonly done by such servants;
  - Time, place, and purpose of act;
  - Previous relations between master and servant;
  - Would the master expect such an act;
  - Similar in quality to authorized acts;
  - Instrument of harm is furnished by the master;
  - Extent of departure from normal authorized methods.

  - **Rest 2 §229(2) Illustration**
    - P operates a small store employing 2 clerks & a delivery boy. One of the clerks, during the absence of P & delivery boy, to oblige a customer, although his ordinary employment does not include such service, delivers a package to a point close to the store, using a bicycle supplied for the delivery boy's use. **It may be found that the conduct of the clerk was within the scope of employment.**

- Same as above, except that P has no delivery boy, makes no deliveries, and A uses his own bicycle. **The act was not within the scope of employment b/c this looks more like a personal favor done by the agent for the customer.** P was not involved here so he's not going to be liable.

- **Note on Intentional Torts**- Sometimes a servant's intentional torts are also within the scope of their employment. For example:
  (1) Intentional torts involving the use of force result in liability **if that use of force is not something unexpected by the master. Rest 2 §228(1)(d).**
  - **Example:** When Master bar owner hires a bouncer (servant), the intentional torts of the bouncer are foreseeable & they are not something a master would never expect.

  (2) Consciously criminal or tortious acts are not per se excluded from scope of employment. **Rest 2 §231.**
  - **Example:** See *Conoco.* Just b/c no master would ever authorize his servant to commit a discriminatory tort does not mean the servants discriminatory torts are always considered outside the scope of his employment.

- **Rest 2 §219: Principal's Liability in Tort**
  A master is subject to liability for the torts of his servants committed while acting in the scope of their employment. A master is **not subject to liability** for the torts of his servants **acting <u>outside</u> the scope** of their employment **UNLESS:**
  - Master intended the conduct or consequences;
  - Master was negligent or reckless;
  - Servant's conduct violated a non-delegable duty of the master;
  - Servant purported to act on behalf of principal & there was reliance upon apparent authority OR the servant was aided in accomplishing the tort by the existence of the agency relationship.

- ***Conoco*:** Conoco sells gas to gas stations. Stations have racist employees & victims try to sue Conoco as principal. Some stations were Conoco branded & others were Conoco owned.
  (1) Is station employee that committed the tort a servant of Conoco?
  (i) For **Conoco Branded** stations, **employee was not a servant** b/c the K between Conoco & gas station explicitly said Conoco is not involved in day to day operations & not involved in hiring & firing. **BUT the contract between them is not dispositive**, even though it says they are not master/servant, if in substance they really are like master & servant, that would be important & might make them liable. = No agency relationship for Conoco branded so not liable.
  (ii) For **Conoco Owned** stations, **employee is a servant**, b/c the stations are owned by Conoco & the employees are servants of the gas station. Conoco did the hiring/firing & had complete control over their stations.

  (2) Was employee acting within scope of employment when she committed the tort?
  --It does not seem like the employees racist remarks are the type of thing she was hired/authorized to do, but that is not the end of it b/c even unauthorized conduct can be within the scope of employment. Ask: was employees action authorized,

of kind employed to perform (§228(1), 229(1))? Court refers to §229(2) - unauthorized conduct:

- **Time, place & purpose of act:** She made remarks while working at the station as a cashier completing transactions. It was in the gas station during working hours.
- **Similar to authorized acts:** As a clerk she is authorized to engage with customers & get money from them.
- **Whether commonly performed by servants:** Used intercom to make the remarks.
- **Extent of departure from normal methods**: It was a big departure from normal methods of communication.
- **Whether Conoco could reasonably expect this**: No they could not reasonably expect her to do this.
    - So the last 3 factors are weak in terms of holding Conoco liable. But these are just factors, not a checklist, so you don't need to meet all of them.

--Victim argues it was in scope of employment b/c she was on duty as cashier when she began yelling racial epithets, it was done while she was selling gas & conducting sales which is what clerks do, & she used the intercom. Conoco argues it was not within scope of her employment & she was acting from her own racial bias.
--Court rejects the idea that just b/c employee behaved in an unacceptable manner, she was obviously outside the scope of her employment. Her **position** as clerk & her **authorization** from Conoco to **conduct sales allowed her** to **interact w/ victim** & **put her in the position to commit** the discriminatory tort. She used her authority to conduct credit card transactions & used the station intercom to commit the tort. Court says it can go one way or the other, based on these facts, as to whether her actions were within the scope of employment or not

(C) Agent Liability For It's Own Torts

Rest 2 §343 **Agent's Liability:** Agent is always liable to a third party for the agent's own torts:

- An agent who does a tort is **not relieved** from liability by the fact that he acted at the command of the principal or on account of the principal.
- Example: You as an agent can't say, I was biking to make a delivery for my boss & someone got hurt but it's not my fault b/c I was doing it for my boss. Its always your fault

SUMMARY: Principal Tort Liability Flowchart (when is P liable for A's Torts)

(a) Was the tort committed by an agent?

-If NO, the principal is not liable.
-If YES, then ask:

(1) Is the **agent a servant?**

-If YES, then ask:

(i) Was the servant's conduct the type of conduct that is **within the scope & authorized?**
-If YES, then principle is liable.
-If NO, then principle is not liable.

(ii) Was servant's conduct **within the scope but unauthorized?**
-If YES, then principle is liable.
-If NO, then principle is not liable.

(iii) Did he have a **non-innocent master?**
-If YES, then principle is liable.
-If NO, then principle is not liable.

-If NO, then ask:

(i) Was this person an **agent type independent contractor?**
-If NO, then P is not liable.
-If YES, then P is liable if:
(1) P retained some (right to) control over the aspect of the work in which the tort occurred; **OR**
(2) He is an incompetent IC (i.e. P hired an incompetent IC); **OR**
(3) The activity contracted for is a nuisance per se (i.e., an inherently dangerous or ultra-hazardous).

(ii) Was this person a **non-agent type independent contractor?**
-If YES, then P is NOT liable for his torts.

IV. Fiduciary Duties of Agent's To Principals

Overview:Two Types of Duties that the Agent Owes to the Principal:

(A) Duties Relating to Performance
- **(1)** Duty of Care
- **(2)** Duty to Follow Instructions
- **(3)** Duty to Provide Information

(B) Duty of Loyalty

Rest 2 §387 states general fiduciary duty.

Rest 2 §388-396 state agent's specific duties of loyalty:
- **(1)** Material Benefit Arising out of Position
  - **(a)** Usurping business opportunities (*Singer*)
- **(2)** Acting as or on Behalf of an Adverse Party
- **(3)** Competing Against Principal
- **(4)** Use of Principal's Property/Information

(A) Duties Relating to Performance

(1) Duty of Care & Skill Rest 2 §379(1): A paid agent has a duty to the principal to act with the **standard of care & skill which is the standard of that locality**.

(i) This means agent must perform it w/ standard of care & skill as other people doing the same type of job he does in his area.

(ii) P&A can contract around it & set a lower bar or higher bar for the performance of the agent.

(2) Duty to Act as Authorized & Follow Instructions [Rest 2 §383, 385]:
- Agent has a duty to take action only within the scope of the A's actual authority.
- Agent has a duty to comply with all lawful instructions received from the P.

• If an agent's actions go beyond the scope of his actual authority & cause loss to the principal, then the agent is liable to the principal (P can sue him).

(3) Duty to Provide Information **[Rest 2 §381]:** Unless otherwise agreed, an agent has a duty to use reasonable efforts to give his P information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have & which can be communicated w/o violating a superior duty to a third person.

(i) This means when A learns of a fact that he thinks P would like to know, he should tell P about that fact.

• **Example:** You are about to sell a house for $100K but you learn that someone else is willing to pay $120K, you as an agent have a duty to inform your principal about that.

(ii) P & A can contract around this duty to eliminate it.

(B) Duty of Loyalty

(1) General Fiduciary Duty of Loyalty **[Rest 2 §387]:** Unless otherwise agreed, an agent has a duty to his P to act solely for the benefit of the P in all matters connected with his agency. Agent has to subordinate his own interests to the interests of the P.

• If this duty of loyalty is violated by the agent, the Principal can get:

(a) Monetary Relief to recover his loss (or get A to disgorge his benefit).

(b) Non-Monetary relief like an injunction to stop the agent.

(c) Can fire the agent.

(2) Duty to Account for Material Benefit (i.e. profit) Arising Out of Employment **[Rest 2 §388]:** Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the P has a duty to give such profit to the P.

• **P & A can contract around this** so that A does not have to give P profits.

• **Example**: If you're a bartender you're supposed to give the tips to the P under this section, the reason bartenders don't give principal's tips is b/c they agreed otherwise beforehand.

(3) Duty to Not Usurp Business Opportunities: All agents have a duty to the P not to take personal advantage of an opportunity & not to give the opportunity to a third person.

(i) This subsection is applicable when either **(1)** the nature of the opportunity or **(2)** the circumstances under which the agent learned about it, require that the agent offer the opportunity to the principal.

• **Example**: If you work for hybrid car company & they send you to a conference & you meet electric battery makers, you can't go off & form your own hybrid electric car company b/c that new business opportunity belongs to your P not you. A new business opportunity belongs to the P it doesn't belong to the A.

(4) Duty to Not Act as (or on behalf of) an Adverse Party w/o Ps Consent [Rest 2 §389 391]: An agent can't deal w/ the principal as an adverse party AND can't represent a party that is adverse to the P unless the P gives consent. **Burden is on the agent to fully inform the P**, it has to be informed consent. **Restating the Rule:** Unless otherwise agreed, an agent has a duty not to

(a) Deal with his principal as an adverse party; OR

(b) Act on behalf of (i.e. represent) an adverse party

•in a transaction connected w/ his agency w/o the principal's knowledge.

(5) Acting as Adverse Party with Principal's Consent [Rest 2 §390]: Once an agent does have P's consent, and acts on his own account in a transaction in which he is employed, the agent has a duty to:

(a) deal fairly with his P; and

(b) disclose to his P all facts which the agent knows or should know **would reasonably affect the principal's judgment.**

• Unless the P has manifested that he knows such facts or that he does not care to know them.

(6) Acting for Adverse Party with Principal's Consent [Rest 2 §392]: Once an agent does have the consent of two principal's, and acts for both of them in a transaction between them, the agent has a duty to:

(a) act with fairness to each; and

(b) disclose to each all facts which he knows or should know would reasonably affect the judgment of each in permitting such dual agency.

• Unless a P has manifested that he knows such facts or does not care to know them.

(7) No Competition as to Subject Matter of Agency [Rest 2 §393]: Unless otherwise agreed, an A has a duty not to compete w/ his P concerning the subject matter of his agency.

➔Note: Applies only during agency, not afterwards.

(8) No Acting for someone with conflicting interests [Rest 2 §394]: Unless otherwise agreed, an agent has a duty not to act OR to agree to act, during the period of his agency, for people whose interests conflict with those of his P in matters in which the agent is employed. (Example: brokers who represent buyers and sellers of homes).

(9) Using or Disclosing Confidential Information [Rest 2 §395]: Unless otherwise agreed, an agent has a duty to the P not to use or to communicate information

(a) confidentially given to him by the P; or

(b) acquired by him during his agency; or

(c) in violation of his duties as agent,

• in competition with OR to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, UNLESS the information is a matter of general knowledge.

➔Basically this means, **you can't use confidential information, either for yourself or for someone else, to make a profit or to harm your principal.**

(C) Getting Principal's Consent

An agent does not breach a fiduciary duty if the **principal consents to his conduct** AND**:**

(1) In obtaining consent, **agent** acts in **good faith** and **discloses** all **material facts** that would reasonably affect the principal's judgment; **and**

(2) Consent concerns either a **specific act** or transaction, or acts or transactions of a **specified typ**e that could reasonably be expected to occur in the ordinary course of the agency relationship.

➔Basically this means, if you get P's consent, you have to get their specific consent for the act in question.

- ***GA v. Singer*:** GA makes car parts & hires Singer to bring in business b/c he had experience in industry. They pay him base salary + percentage of sales (as incentive to bring more business). He has to work for GA full time & can't engage in other work. When he determined that GA could not fill certain orders he would form side deals w/ others who could (competitors of GA) & give them the job & keep the profits. GA sues him for breach of duty of loyalty & wants the profit he made off these side deals. Court holds he should have told GA about these orders to see what they wanted to do about trying to fill them. He kept quiet & went to competition, so he must disgorge.
  - **Material Benefit Arising out of Position**-Yes he took these business opportunities for himself. But Singer can counter argue that these other people were contacting him b/c he was famous in the industry already, they were not contacting him b/c he worked for GA.
  - **Acting as or on Behalf of an Adverse Party**-Yes he was aiding competitors & also acting on behalf of the people who had orders to fill.
  - **Competing or aiding competitors-** Yes.
  - **Use of Principal's Property/Information**-Yes b/c he would not have known about these big orders if he didn't work for GA.
  - Singer can argue GA is overcompensated if he has to hand over his profits b/c GA never could have filled these orders anyway & they never could have gotten all these clients w/o Singer. Court says no, **by setting up disgorgement as a harsh default rule, we are putting the weight on the agent to disclose AND we are forcing the parties to discuss & bargain about this before hand by giving them incentive to.**

V. Termination of Agency Relationship

Duties After Termination of Agency [Rest 2 §396]: After termination of agency, an agent:

(i) Has **NO** duty not to compete with the principal

(ii) Has a duty not to use or to disclose to 3rd persons in competition with the P trade secrets, written lists of names, or other similar confidential info given to him only for the principal's use or acquired by the agent in violation of his duty.

(iii) Has a duty to account for profits made by the sale or use of trade secrets and other confidential info, whether or not in competition with the principal.

➔**Basically this means, agent can compete with his former P, BUT he still has a duty not to disclose or use trade secrets or other confidential information.** If he does any of these things he has to give the profits he makes back to the P.

- **Preparing to Compete[Rest 2 §393 comment e]:**
  - Even before the termination of the agency, the agent is entitled to make arrangements to compete, except he can't use confidential info peculiar to his employer's business and acquired therein.
  - An agent who plans to compete is free to make arrangements for setting up a new business (e.g., incorporating new firm, arranging for space).
  - An agent is not free, while still employed, to commence doing business as a competitor or to solicit customers away from the principal.

  ➔Basically this means, you can make arrangements to compete while still employed by your P (can rent an office, etc)but you can't use confidential information.

- **Termination of <u>Actual</u> Authority:** Actual authority is terminated when:
  - **(1)** Agent or principal dies; **OR**
    - If the **principal is an individual** then the **agent has to have notice** that P died for actual authority to end, or else they can bind the P's estate.
  - **(2)** If the principal loses capacity; **OR**
    - If P is individual, A must have notice.
  - **(3)** They agree to end the authority.

- **Termination of <u>Apparent</u> Authority:** Just b/c actual authority has terminated does not mean apparent authority has also terminated. Apparent authority is going to end when it is **no longer reasonable for the third party to believe the agent has authority.**

Why do we Care About Agency Law?

- <u>Sole Proprietorships</u>: Sole owners interactions with employees, independent contractors, etc, are all governed by agency law.
- <u>Partnerships</u>: Rights & liabilities of partners with respect to each other & to third persons are largely determined by agency principles.
- <u>Corporations</u>
  - Not "real" people, so they have to act through agents.
  - Board of directors & officers may be seen as agents of shareholders.

PARTNERSHIPS

- Personal Liability: Partners are personally liable for the debts & obligations of the P'ship, just like in a sole proprietorship. P'ships are governed by Uniform Partnership Act (UPA).

I. Definition & Formation of Partnerships

(A) What is a Partnership?

- **UPA§6(1):** A partnership is an **association** **of two or more persons** to carry on **as co-owners** of a business for profit.
  - **(i) Association:** implies there is a consensual agreement
    - No formal requirements. No need to file paperwork. Just need agreement (can be verbal, even a handshake is enough) to do business as co-owners.
    - Intent to form a partnership is NOT required to actually form a partnership
  - **(ii) Co-owners** requires having (must have co-ownership for a partnership):
    - **(1) Shared profits** of the business; **AND**
    - **(2) Shared control** of the business.
      - Beware **silent partner**: all you need is the ***power*** **to be able to exercise control** even if you don't ever actually exercise it.

- If a partnership is found to exist, several default rules governing relationships between partners & the partnership and the outside world will apply by default:
  - **(1)** Each partner can bind the partnership in contracts & the partnership is also liable for a partner's torts.
  - **(2)** Partnership obligations are personal obligations of the partners.
  - **(3)** Fiduciary duties owed to partners (partners owe each other fiduciary duties).
  - **(4)** Entitled to shared control 50/50.
  - **(5)** Entitled to shared profits (and loses) 50/50.

- **Most of these rules are just default & you can contract around them easily.** But you can't contract around rules that have to do with third parties.

(B) How Do You Know if You Are In a Partnership?

UPA §7: Ask the following questions to determine if you are in a partnership or not:

-Is it an **association** to carry on as **co-owners** of a business for profit (need profit + control)?

(1) Is there a sharing of profits?-A **person receiving a share of the profits** is **prima facie evidence** under **UPA §7(4)** that he is a partner. BUT this does not apply if:

(i) If those profits were received as **payment for an employees wages**. An employee profit sharing program is just a compensation scheme for the employee & does prove that there was a partnership b/c of shared profits. *Fenwick.*

(ii) If those profits were received as **payment of the interest on a loan (or as repayment of a loan).** So repayment of a loan (debtor making a payment) to someone from your business profits does not make that person your partner. *Peyton*

(iii) The sharing of mere **gross returns** does NOT establish a partnership.

- Gross returns = sales + expenses. It is all the money that results from selling products & includes your expenses too.
- Profits = sales - expenses. This is your net income that you get to take home in the end, it is pure profit.
- Sharing the gross returns is not enough to establish a partnership b/c you do not have that much invested in the business profits, all you care about are making more sales.

(2) Is there a sharing of control?-Merely calling something a P'ship is not enough, we must understand the structure of the relationship to see if both people really had shared control. To determine control & if overall P'ship, consider factors like those in *Fenwick:*

(1) Intention of parties- did parties intend to enter into a partnership.

(2) Right to share in profits- need shared profit for partnership.

(a) Return- does each person get an equal profit on returns or does one get more than the other.

(b) Obligation to share in losses- who bears the bigger risk if the business fails?

(3) Ownership and control of property & business- who owns the property and runs & manages the business.

(4) Community of power in administration- managerial vs. clerical duties

(5) Conduct of the parties toward 3rd parties- did they represent themselves as partners to the rest of the world.

(6) Rights of parties on dissolution

(a) What does each person get if business dissolves? Whoever gets the profits form the sale of the business is the one in control.

(b) Can either party sever the agreement?

- **Note on Creditors & Control:** Generally, creditors & borrowers are not partners. But when creditors put too many restrictions & assert too much control over their borrowers, they can inadvertently turn into partners. Key is to **protect yourself without controlling them**. *See Peyton.*

(A) Acceptable Lender Protections

- Must ask lender for permission regarding change in ownership/ leadership of business
- Inspection rights
- Express limit on specific risky actions
- Counseling on discrete matters and/or recommend consultants-Can recommend things as long as company is not mandated to take it (but saying something like Hall can't be fired will be okay).

(B) Danger Zone

- Constant Advising (don't ask to be consulted on all business decisions).

- Veto Power over all business decisions (too much interference)
- Call option to join the company.
- Resignations/Designating Management

- ***Fenwick*****:** Fenwick owned salon & hired Chesire as cashier. Cashier asked for raise & they enter into a written agreement where if she made Fenwick more money she would get a raise (tie wages to performance of the business). Was this a P'ship agreement or an agreement about employee compensation? Court holds this was NOT a partnership b/c this was just employee compensation plan & Chesire had no real control over the business. Profit sharing is not enough, you need shared control too.

  (a) Return: Under agreement, Chesire was paid salary + 20% of profits. Fenwick got higher salary + 80% of profits.
    - Unequal return on profits not enough to show no partnership.
    - Mere profit sharing plan not enough to show partnership, need control.

  (b) Risk: Fenwick bore all the risk b/c he contributed all capital and owned & ran the business. Chesire bore no risk so it makes her look like an employee b/c if company tanks the only thing she loses is her job. But counter argument is that she took a risk by staying in this company & being underpaid, she could have gone somewhere else to work & gotten a higher salary, so she decided to stay b/c of this agreement.

  (c) Control: She had no control over company. Fenwick kept running the company in the same way that he had always done & he had all the managerial control.

  (d) Duties: Fenwick was doing managerial work & she was doing clerical work.

  (e) Duration: Either party could sever (can say I'm out of here) w/ ten days notice. If Fenwick sold the business he would get all the profits from the sale & she would get nothing.
    - Note: How to draft a valid P'ship agreement where it looks like both Fenwick & Chesire have control, but really Fenwick remains dominant? **Ans:** Give Fenwick more votes.

- ***Martin v Payton:*** Hall is a partner in KNK & got a $500K loan from his friend Peyton. In exchange, Peyton gets 40% of KNK's profits until the loan is payed back & he gets an option to join the firm. Until the loan is payed back, management of the firm was in the hands of Hall & a $1 million life insurance policy was taken out on his life & assigned as further collateral to Payton. Payton was also to be advised as to the conduct of the business, consulted on important matters, & could veto any business decision he thinks is too risky. Court holds this is normal b/c lenders should have this power in order to safeguard their loan. Therefore, Payton was just a lender, not a partner, & he is not personally liable for the partnerships losses. Court says profit sharing here did not show partnership b/c it was more like a loan (profit sharing as a way to repay a loan) + Peyton did not share control & control is required for co-ownership. **But this was a very close case & could have gone the other way.** To argue that Peyton did have control & was not just a mere lender, try to argue:
    - **Peyton kept in loop as to conduct of business- NORMAL** for creditors.
    - **Peyton consulted on certain matters- QUESTIONABLE** for creditors. This could be sketchy if the consulting means he is going to make KNK do whatever he wants. But just consulting & asking for advice is okay.
    - **Veto power over business believed too speculative- QUESTIONABLE** for creditors. Veto power to kill certain deals may be too much control (but it would have been worse if Peyton had the power to tell KNK they need to engage in this & this transaction).
    - **Limit on money that KNK firm could loan to its partners; KNK partners' assigned rights to profits to Peyton- ACCEPTABLE** for creditors. Banks do this all the time, they put restrictions on dividends (can't pay dividends to your shareholders as long as the loan is still outstanding).
    - **Hall to be designated manager - QUESTIONABLE** for creditors. This is sketchy b/c Hall was Peyton's friend & Peyton has no right to decide who gets to be manager. But

Peyton can counter argue that Hall was already in the company & he was most comfortable with him b/c he was the one who approached him with the idea to invest in the first place. Also just b/c he wants Hall to run the show does not mean Hall is a robot & is going to do everything Peyton tells him to.

- **Option to become partner of KNK at any time - QUESTIONABLE** for creditor. This is dodgy & not normal. Banks cannot do this. If they give you a loan, they can't take options to get 50% of the company. But still this is not too crazy b/c you can get bonds that are convertible into stocks.
- **Resignation of KNK partners held by Hall (written out & unsigned); Hall &Peyton could agree to accept resignation - QUESTIONABLE** for creditors. This is very sketchy, banks usually don't have this power.

• Matters b/c when company goes bankrupt it sells assets & start to pay off creditors. Creditors collect based on priority & non-partner creditors collect before partner creditors. So if Peyton is deemed a partner he is sent to the back of the line, if he is not deemed a partner he goes to the front of the line. Also, if he is deemed a partner he is personally liable for P'ship debts.

• **Distinguish *Peyton* from *Cargill*:** Cases are similar in the sense that you have someone who lent money to another & now some third party is suing them saying you are more than a lender so I want you to pay me what this person owed me. Differences are:
(i) *Peyton* is partnership case & *Cargill* was agency case.
(ii) In *Cargill* they were not sharing profits.
(iii) No principal agency relationship between Peyton & KNK b/c KNK was not acting on behalf of Peyton (Peyton got no benefit from KNK's activities). *Cargill* did get a benefit (they got grain), so they benefitted financially from the relationship with Warren.

II. Fiduciary Obligations of Partners

(A) When is Partnership Liable to <u>Third Parties</u> in Contract & Tort?

Summary Takeaway: Partnership is liable for a partners contracts & torts if the partner was:

(1) Carrying on the regular business of the partnership; **OR**

•But for contracts, if a partner has no authority for an act & the third party knows that he has no authority, then the partner cannot bind the partnership, even if what he does is in the regular course of partnership business.

(2) If not regular business of P'ship, he had authorization from the other partners to do it.

Partner's Liability for Partnership Obligations [UPA §15]: All partners are liable:

(a) Jointly & Severally for all torts.

• Joint & Several Liability means you can sue any partner & recover from the partner you sue. You do not have to sue them all.

(b) Jointly for all other debts & obligations of the partnership (i.e. **contracts**). But any partner may enter into a separate obligation to perform a partnership contract.

• Joint Liability means all the partners are liable for the debt as if it was their own debt. The third party has to sue all the partners under joint liability.

<u>Rules</u>

(1) Partner as Agent – Ordinary Course CONTRACT [UPA §9(1)]: Every **partner is an agent** of the partnership for the purpose of its business. That means the **act of every partner can bind the P'ship in contract in matters that relate to the business** of the partnership UNLESS:

(a) the partner has no authority for that act he wants to do; **AND**

(b) the third party has knowledge that he has no authority.

➔This means, **if you put restrictions on a partner in the partnership then you better give the third party notice** of that or else the partner can bind you w/ apparent authority.

(2) Partner as Agent – Extraordinary course CONTRACT [UPA §9(2)]: An act of a partner that does not carry on the regular business of the partnership does not bind the partnership unless he has been authorized by the other partners.

(3) Partnership Liability for Partners TORTS [UPA §13]: When a partner commits a tort (either a wrongful act or omission), the partnership is going to be liable for that partners tort if:

(a) The partner was doing the ordinary business of the partnership; **OR**

(b) Partner was authorized by co-partners to do what he was doing when tort happened.

(B) When Are Partners Liable to Each Other (i.e. what duty do partners owe each other)?

- Regarding partners duties under the UPA, we rely mostly on **agency law** b/c **UPA §9** says that every partner is an agent of the partnership for partnership business.

(1) Duty of Care [UPA /Rest 2 Agency §379]: Same duty as in agency. Partner has duty to act with standard care & skill which is standard in the locality for that kind of work.

• Courts say you satisfy this duty if your actions don't constitute **gross negligence** or **willful misconduct.** The standard is fairly low for partnerships b/c all the partners are there & can monitor each other easily.

(2) Information Duties

- **UPA §19:** Partners have access to & **may inspect the partnership books any time.**
- **UPA §20**: Partners shall give, **on demand,** true & full information of all things affecting the partnership to any partner.
- **Rest 2 Agency §381**: Information which is relevant to the affairs entrusted to him & which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.

(3) Duty of Loyalty [UPA/Rest 2 Agency]: Same duty as in agency, which includes:

(1) Material Benefits Arising out of Position

(2) No Acting as/on behalf of an Adverse Party

(3) Duty not to Compete w/ partnership before dissolution

•**Note:** Partner can prepare to compete while still working in partnership as long as he is not secretive about it & doesn't place the partnership at a disadvantage where they can no longer compete against him. *Meehan.*

(4) Use of Property/Confidential Information

+

- **UPA §21 Partnership Opportunities**: Partners must account for (& hold as trustee) any profits/benefits from transactions connected w/ the partnership OR from use of partnership property. (This means partnership opportunities (i.e. business opportunities) belong to the partnership, so an individual partner cannot take it for himself).

- **Factors To Consider In Defining The Scope of the Partnership (i.e, is something a Partnership Opportunity or not):**
  - **(a)** Geographic location
  - **(b)** Type of business
  - **(c)** Partner status (i.e., managing partners are held to a higher standard b/c they are going to be in best position to identify opportunities since everyone has to deal w/ them & go through them).
  - **(d)** Does the opportunity arise during or near the end of the partnership?
  - **(e)** Are they general partners OR are they just specific joint venturers on this one venture? (*Meinhard* was a specific joint venture).

Modifying These Duties by Contract/Agreement – UPA

- **Duty of Care:** Partners **CAN** modify this by contract, there is a lot of flexibility.
- **Duty of Information:** Partners can probably **NOT** modify this (i.e. UPA has no provision to modify §20, so it has a mandatory flavor to it).
- **Duty of Loyalty:** Partners **CAN** modify this the same way as in agency law.
  - Agency Law: Principal may consent **(1)** after full disclosure of material facts & **(2)** to specific acts or types of act reasonably expected to occur.
  - **UPA §21** (partnership opportunities) is less flexible; there is **NO** provision to modify it. But they can put a clause in the partnership agreement that specifically talks about how they will deal with future partnership opportunities.
  - But note that partners can always ratify/consent to an action after the fact (assuming there is full disclosure).

- ***Meinhard v. Salmon***: Salmon leased property (for 20 years) to renovate it & borrowed money from Meinhard for renovations. In exchange, Meinhard was to get part of the profits. Each would bear losses equally but Salmon had sole power to manage & re-lease the property. When the 20 year lease was ending, the owner offered Salmon a new long term lease & Salmon agreed w/o telling Meinhard anything about it. Meinhard sues Salmon saying we were partners & I want in on this new lease b/c it was a partnership opportunity. Court deems them co-adventurers & says they owed each other duty finest loyalty. Salmon breached this duty by not telling Meinard anything & not giving him a chance to compete. **What Salmon did wrong was to not give notice to his partner about the new lease**. It was an extension of the same lease they were both involved in so Salmon should have told him. Cardozo & Andrews both agree a partner can't take a P'ship opportunity for himself, but they disagree over how to define a partnership opportunity. Cardozo says this was a P'ship opportunity & b/c duty of loyalty is so important, Salmon had to give his partner notice. Andrews dissent says this was just a joint enterprise limited in size & scope to the first 20 year lease. It was not a general real estate partnership agreement that was to expand greatly in the future, it was just an agreement about this one property & that defines the scope of their partnership, so any opportunity that does not fit during that 20 year timeline does not qualify as a partnership opportunity. New lease was not part of the old partnership, it was a separate thing.

- ***Meehan v. Shaughnessy:*** Meehan & Boyle were partners at law firm & decided to leave & open their own firm. While still working at old firm, they began making preparations to leave, including: prepared list of clients, prepared letters to send to those clients, obtained a lease & financing, tried to poach other attorneys to come with them. Rumors started & other partners confront them about it, but they deny it. Court holds they breached fiduciary duty to P'ship b/c:
    - They were secretive & lied to their partners about their plans to leave. Although a partner has no duty to inform other partners that he plans to leave, the conduct here was not okay b/c they lied to the other partners when the partners asked them about it. Can't lie about something if partners straight up ask you.
    - They waited too long to hand in list of clients that they were going to take with them, which the firm asked for. It took them a few weeks to hand in this list.
    - During this time they were contacting the clients & encouraging them to make the move. Contacting clients may or may not be okay depending on what you tell the client & if the partnership agreement says anything about it (if banned, can't do it).
    - Overall, they did not give their partnership the opportunity to compete with them, and that is what they did wrong.
    - Leasing office space & trying to convince other partners to leave was okay.
    - **Note**: Mere associate (i.e. employee) has no duty to advise the partnership that he is planning to leave, even if a partner asks him about it point blank.

  Takeaway: You can always prepare to compete against your current partners or existing principle, it is just about the way you do it. You can't be sneaky & can't put your partners at a disadvantage against you.

- **Hypo:** Mark & Norma are lawyers & have practiced as partners for 5 years. One day Peter comes to the offices & asks to see Mark & tells him that he has a brother who was injured in a car accident & needs a lawyer. Peter says he has heard Mark is a good lawyer. Mark quickly concludes that Peter's brother has a strong case & is likely to recover a large judgment. Mark concludes at that moment that its time to end his partnership w/ Norma & begin practicing on his own. If he does so, what are his obligations to Norma w/ respect to representation of Peters bro?

    ANS: Peter is an opportunity, he is not a client yet. If he was a *partnership opportunity* then Mark cannot take Peter unless Norma consents & agrees. If he was not a partnership opportunity, then Mark can take him.

III. Management Rights in the Partnership

- Repeat here the duties of partner as agent (discussed above in Section II-fiduciary obligations of partners & liability to third parties).

- **Partner Rights [UPA §18]:****

  (e) All partners **have equal rights** in the management & conduct of the P'ship business.

    • Rule is **one partner one vote**, regardless of how much money each partner put in for the partnership. This is the default rule if you don't contract around it.

  (g) No person can become a member of a partnership unless **all partners consent** to it.

  (h) Resolving differences in ordinary matters vs. extraordinary matters:

    (1) Any differences regarding **ordinary matters** connected to the partnership business can be decided by a **majority vote**.

    (2) An act outside the ordinary course of the partnerships day to day business (i.e, **extraordinary matters** like expanding the business, expanding geographically or selling a major partnership asset), which is not covered by the partnership agreement, can only happen if **all partners consent** to it.

- **P'ship Management Hypo:** Kermit, Fozzie & Gonzo form a P'ship. Their capital contributions are: Kermit 55%; Fozzie 25%; Gonzo 20%. Under their agreement, profit tracks capital.Who wins in the following disagreements?
  (1) Kermit votes to hire a secretary; Fozzie& Gonzo vote no.
    - **ANS:** Agreement is silent as to voting rights so each partner gets one vote, Fozzie & Gonzo win. (This is ordinary course of business, so majority vote is enough & 2 beats 1)

  (2) Fozzie & Gonzo vote to admit new partner; Kermit votes no.
    - **ANS:** All partners must agree before admitting a new partner, so Kermit wins & new partner does not come in.

  (3) Fozzie & Gonzo vote to increase their draw, contrary to P'ship agreement; Kermit votes no.
    - **ANS:** Draw means they are trying to increase the amount of money they can get. Since this is contrary to the partnership agreement, all the partners must consent so you need unanimity & Kermit wins.

- ***National Biscuit Company (NBC) v. Stroud:*** Stroud & Freeman are general partners in a partnership to sell groceries. Stroud told NBC that he would no longer be responsible for bread purchased by Freeman, so NBC began dealing w/ Freeman. Freeman defaults & NBC goes after Stroud. Court holds the entire partnership is bound by Freeman's action of buying bread b/c buying bread is carrying on in the usual course of business for this type of partnership. Stroud could not restrict the power of his co-partner Freeman to buy bread for the partnership.
  ➔To remove Freeman's authority to do something that is in ordinary course of business Stroud needs a majority vote, he could not remove Freeman's authority by himself.
  ➔ Stroud argues he told NBC not to deliver bread even though Freeman keep asking for it. Ask:
  (1) Was the partners act in the ordinary course of business?
  -Yes buying bread was in the ordinary course of grocery business.
  (2) Was the partner expressly prohibited from the act and did the third party have notice?
  -Stroud sent notice to the third party but the other partner Freeman was never expressly prohibited from ordering the bread. To take that authority away (to make him expressly prohibited from buying bread) they would have to beat him out by partnership majority vote, so more than 50% of partners would have to take that power away from him and it was not possible to do that here b/c they were only 2 partners.

    - Suppose Freeman cancelled orders from NBC & ordered bread from Sara Lee. Stroud disagrees w/ this course of action & notifies Sara Lee. What happens?
      - **ANS:** If Sarah Lee knew Stroud was a partner who specifically disagreed then Sara Lee had notice b/c this is a K with a new company. Different from our case b/c here we can say that for changing suppliers, he was expressly prohibited.

Muppets Hypo:
(1) Kermit & Gonzo are partners in law firm. Kermit tells Gonzo he's lost confidence& wants to prohibit him from taking new clients, signing letters, etc w/o Kermit's approval. Can Kermit impose this limitatin?
- **ANS:** If they are 50/50 partners he can't impose this limitation b/c such a limitation is outside the normal course of business. This is the type of stuff that partners have a right to do on a regular basis so barring them from doing it is extraordinary. He would need the agreement of a majority of the partners to pass it.

(2) Kermit writes to all the firm clients & advises them that he will not be liable for malpractice done by Gonzo. Will that do him any good?
- **ANS:** No. The only way he can avoid liability is to dissolve the partnership & send notice to the clients.

(3) Kermit, Fozzie & Gonzo are the partners. Could Kermit & Fozzie impose such limitation on Gonzo?

- **ANS:** No they can't b/c you need unanimity to make a limitation like this, which is not in the ordinary course of the partnership, and gonzo is never going to agree with this, so their only avenue is to dissolve the partnership.

- ***Day v. Sidley Austin:*** Day was a partner at Sidley but he was not a member of the Executive Committee (EC). Sidley decided to merge w/ another firm & after the merger changes happened that Day didn't like. Day sues claiming fraud & breach of fiduciary duty. Court denies both. Per the P'ship agreement, all salary & expenses decisions were to be made by EC. Also voting was by percentage, it was not just one partner one vote. All of his possible claims (contract, tort, & duty):

  (1) Contract Claim: Did the way they executed the merger violate the partnership agreement?

  -NO. The agreement said EC has the power to do this.

  (2) Tort Claim: Even before the merger, Day only had his one single vote, so he suffered no change in terms of his control rights over the partnership after the merger.

  (3) Breach of Duties:

  - **Duty of care:** Did the partners of the EC violate duty of care in planning & executing the merger agreement?
    -No b/c this was good for the partnership, they consulted with the rest of them, etc
  - **Duty of loyalty:** Did EC violate duty of loyalty to other partners by beginning negotiations w/o consulting other partners & not revealing all changes that would occur post-merger?
    -No. Duty of loyalty only applies in narrow situations & this is not one of them. It applies when someone is trying to make money off of someone else.
  - **Duty to disclose:** Was there a duty to disclose "information regarding change in the internal structure of the firm"?
    -No. Partners had agreed the EC would deal w/ these issues so they did not continuously have to disclose all potential changes to everyone.

Takeaway: Partners are free to make an agreement that suits them that gets around UPA. **P'ship agreement can allow majority approval for matters that require unanimity under the UPA.**

IV. Financial/Economic Rights in the Partnership

Two types of Economic Rights: **(1)** Property Rights & **(2)** Equity Rights.

(A) Property Rights of a Partner

UPA §24: The 3 property rights of a partner are:

(1) His rights in **specific partnership property**,

• **UPA §25(1):** All partners are co-owners of partnership property (they hold it as *tenants in partnership*). This gives them the right to use the partnership property for partnership purposes (but not otherwise).

• **Property rights are NOT assignable** (partner can't assign his right to that half of the plot of land to someone else).

(2) His **interest in the partnership**, and

• **UPA §26:** A partner's interest in the partnership is **his share of the profits & surplus.**

• **This right IS assignable.** A partner can assign his share of the profits to someone else. So if a partner sells his shares in the partnership to someone else or gives them to a creditor, that 3rd party can go & collect the profits.

(3) His right to **participate in the management**.

- **UPA §27(1):** Partner has the right to participate in the management of the P'ship.
  - **This right is NOT assignable.** Just b/c you assign your interest in the partnership to a third party, that third party can NOT interfere with the management or administration of the partnership business. He can't ask for information or ask to inspect the partnership books. The only thing he is entitled to get is the profits which you were entitled to.
  - Remember, to become a full fledged partner & get all of these rights, you need unanimous consent of all the other partners.

- ***Putnam v. Shoaf:*** Putnam was in a partnership w/ Charlton for the Frog Jin Company. Putnam sold her interest in the partnership to Shoaf. Later Frog Jin sued its old bookkeeper for embezzling & got a large judgement. Does Putnam retain a right in getting the proceeds? Court holds no, Putnam's intent was to convey her interest in the partnership & she did so. Putnam never had a right to the claim against the bookkeeper in the first place, that right belonged to the partnership, so Putnam could not assign it.
  - The fact that the claim was not listed as an item of partnership property is irrelevant.
  - She had no right to convey (or retain) interest in specific partnership property (known/ unknown) since these are held by the partnership.
    - Putnam never directly had an interest in the claim against the bookkeeper.
  - All she could convey was her interest in 'share of the profits'(& losses) of the partnership

(B) Equity Rights

- This is about how you split the money. Default rule is that partners:
  - Share profits equally, regardless of their capital contribution.
  - Losses are shared in the same way as the profits.

- **Rules for Order of Distribution**: After a partnership dissolves & the assets are sold off, the money gets distributed in the following order:
  - **(1)** Pay off non-partner creditors.
  - **(2)** Pay what you owe to partners other than capital & profit (like loans/partner creditors & wages);
  - **(3)** Pay partners back their capital (which is what they initially contributed)
  - **(4)** Pay partners profits.
  - If there isn't enough money left to pay for the first 3 categories, then partners have to contribute their own money to cover them.

- **Distribution Hypo:** Kermit makes a capital contribution of $100. Fozzie is the working partner who is going to earn a salary of $40 & he makes no capital contribution. They agree to share profits 50/50. They buy $30 of cookies from Gonzo on credit:

  (a) If they end the partnership & sell the stand for $300, how do we distribute the $300:

  ANS: (1) First amounts owed to non-partner creditors: G = $30; **(2)** Next, partner wages: F = $40; **(3)** Partner capital contribution: K= $100; **(4)** Partner profit: K= $65 & F = $65

  (b) If they sold the stand for $150.

  ANS: (1) Amounts owed to non-partner creditors: G = $30; **(2)** Partner wages: F = $40; **(3)** Partner capital contribution: K= $80 b/c that is all that's left. Kermit is still owed $20 for his capital contribution. So that $20 is the loss & the partners have to split the loss equally (b/c they share profits equally) so each partner has to put up $10 (K=$10 F=$10).

- ***Kovacik v. Reed:*** Kovacik contributed all the money (capital contribution of $10K) & Reed contributed $0, but Reed was to do all the work. They agreed to share the profits & nobody was going to get a salary. They do not discuss sharing losses (which means the default rule applies & they share losses the same way as profits, so here 50/50). Partnership dissolves & there is an outstanding loss. Kovacik wants to split that loss w/ Reed b/c they were equal partners.
  (1) What does the statutory formula say?
  - After selling all assets for $1320, they first pay off creditors, then partner wages (if Reed were getting paid a salary he would get paid at this point). Then they have to pay partner capital contributions which is Kovacik's $10,000. Kovacik gets the $1320, but the rest of his $10K is considered a loss, so both partners would split that loss ($8640) equally meaning Kovacik would put in $4340 & Reed would put in $4340. **See PP 3.**

  (2) What does the CA Supreme Court Say?
  - CA supreme court says no. **Reed put human capital & he was not getting paid a salary for his work. So human capital contributed by him was equal to the money capital put in by Kovacik.** But if Reed were getting paid a salary, result wouldn't come out this way.
  - Under this CA approach, each partner contributed $10,000 in capital ($10K by Kovacik & $10K by Reed) = total capital that must be repaid is $20,000. There is a profit of $1320 from sale of assets. That $1320 goes toward repayment of the capital contribution, so from that Kovacik & Reed (as capital contributors) each get $660. **See PP4**
    - Then the remaining capital has to be repaid, which is 20,000-$1320 =$18680. Since they are sharing equally in the losses as partners, they split that up, $18680/2 = $9340. So Kovacik & Reed each have to put in $9340, as partners, to cover it.

    - **Overview of the Reality:** Under the *Kovacik* rule, the services-only partner does not share in loss of the amount initially invested by the capital-only partner.
      (a) Under the statutory approach:
      (1) Reed loses 4 months of labor + $4340.
      (2) Kovacik loses $4340.
      (b) Under the Kovacik CA Approach:
      (1) Reed loses 4 months of labor
      (2) Kovacik loses $8680.

- By creating such a tough default rule that is very costly to one of the parties, the court is trying to penalize the parties into (forcing them to) talk about it beforehand.

- **What does Kovacik Rule Mean?**
  Kovacik rule is basically saying that when there is a service only partner who does not contribute any capital & does not earn a salary, then we are going to equate his human capital (the work he puts in) w/ the capital contribution of the partner who actually puts up money capital. So if you have a Kovacik type situation, argue that if the *Kovacik rule* is used for the calculations, then then service only partner made a capital contribution too.

- **Courts DO NOT apply the *Kovacik* rule where:**
  - The service partner (Reed) was compensated for his work (i.e. got salary); **OR**
  - The service partner (Reed) made a capital contribution, even if that contribution was nominal (even if he put in $5 & did all the work, the default rule would apply & he would be liable for losses).

V. Dissolution of Partnership

- Dissolution is the process through which a partnership is terminated, so it's a process not just a final event.

(A) Steps & Terminology

- **<u>Dissolution</u>**: Process that begins w/ winding-up & ends in the termination of the P'ship.
- **<u>Winding-up</u>**: Liquidating the partnerships assets or the business in an orderly manner:
  - Settling the partnership's debts/obligations.
  - Dividing between the partners the balance (remaining assets/money).
- **<u>Termination</u>**: The partnership ceases to exist.

(B) Three Ways to Dissolve a Partnership

(1) By the will of a partner or partners.
(2) By the occurrence of certain events (they can agree on these events beforehand)
(3) Dissolution by Decree of the court (based on the application of a partner)

- A partner always has the ***power*** to dissolve, but he does not necessarily always have the ***right*** to dissolve. If a partner does not have the **right** to dissolve and he does dissolve, that is considered a **wrongful dissolution.**

(C) What Happens if you Wrongfully Dissolve?

UPA §38 says if a partner (bad partner) wrongfully dissolves, the following consequences apply:

(1) Ex-partners (i.e., good partners) can sue you for damages for your breach of the partnership agreement.

(2) Ex-partners can also choose to either:

(a) Liquidate the partnership property/assets & distribute the proceeds to all of the partners, including to the bad partner (minus any cost he owes in damages); **OR**

(b) Continue the business & pay the bad partner the value of his interest in the partnership (i.e. buy him out) & indemnify him against present and future partnership liabilities.

• When calculating how much his interest is worth, the value of the **goodwill** of the business is NOT considered.

• Goodwill is the value of the business above just its economic value & physical assets. It includes reputation, clients, etc. A partner that wrongfully dissolves loses that extra goodwill value when he gets paid off.

(D) How to Make a Dissolution Rightful (i.e., how not to wrongfully dissolve)

A dissolution is not wrongful if:

(1) The partnership was only for a definite term, either express or implied, & that term has passed (i.e. for a year) OR it was for a **particular undertaking** (i.e., to build a bridge) & the undertaking has been completed.

(i) When a **partner advances a loan** to p'ship w/ the understanding that it's going to be paid back from profits, then p'ship is considered for the 'term' reasonably required to repay the loan (so partner giving loan makes it a term p'ship). *Owen*

(ii) But just talking about making profits (and expecting to make profits) is not enough to be considered an implied term partnership (i.e., there is no implication that the P'ship is for the term it takes us to make that profit or is for the undertaking of making a profit). *Page. v. Page.*

(2) It was an "at will" partnership. If there is no term or undertaking in the partnership agreement, then the partnership is considered at will & **any partner can always dissolve an "at will" partnership.**

(3) All of the partners unanimously agree to dissolve the partnership. So dissolution by the express will of ALL the partners, either before or after the termination of any specified term or undertaking, is okay.

(4) Partnership is dissolved by operation of law. UPA §31 says if any of the following events happens, then the partnership is dissolved by operation of law:

(a) The partnership business is illegal.
(b) A partner dies.
(c) A partner or the partnership goes bankrupt.

(5) Partner gets a decree of the court dissolving the partnership. Court grants decree of dissolution when (courts are more likely to grand when the good guy wants out of it):

(1) A partner is a lunatic, is incapable, or has been guilty of conduct prejudicially affecting business.
(2) Partner willfully or persistently commits a breach of the P'ship agreement, or so conducts himself in partnership matters that it is not reasonably practicable to carry on partnership business with him.
(3) Business can only be carried on at a loss.
(4) Other circumstances making dissolution equitable

- **NOTE:** Even if dissolution is not wrongful, fiduciary duties still apply. That means even if your dissolution is technically not wrongful, if you violate a fiduciary duty that makes it wrongful. See ***Page v. Page***
  --If the dissolution is wrongful ONLY b/c you breached a fiduciary duty in dissolving, then the consequences of Section 38 don't apply. But you include the value of the missed new business opportunity when you calculate the non-breaching partners share in the partnership.

Takeaway: If you want to dissolve (first always try to argue is was not a wrongful termination):

- Argue that partnership is at will (i.e. there is no term or particular undertaking)
- If that fails, argue that any express or implied term has been met.
- If that fails, argue that the court should dissolve it.
- If that fails, you can still dissolve since you have the power. But you don't have the *right* so you need to worry about the consequences that come w/ wrongful dissolution.

Wrongful Dissolution Flowchart (don't really need this chart, just make sure it makes sense)

(1) Do all partners unanimously consent to the dissolution?

-If YES, then dissolution is not wrongful b/c partners can unanimously agree to dissolve at any time (whether partnership is for term or at will).

-If NO, then ask:

(a) Was the partnership dissolved by operation of law? Dissolution by operation of law happens if: partnership business is illegal, a partner dies, a partner or the partnership goes bankrupt.

-If YES, then dissolution is not wrongful.

-If NO, then ask:

(i) Was the partnership for an express or implied term?

-If NO, then P'ship was at will & any partner can dissolve

-If YES, then ask, has the term been met?

(a) If YES, then partner has the right to dissolve.

(b) If NO, then ask:

(ii) Was dissolution ordered by court decree (courts grant decrees when a partner is a lunatic, or willfully commits breach of the P'ship agreement, or when business can only be carried on at loss).

-If YES, then dissolution is not wrongful.

-If NO, then dissolution is wrongful b/c partner had no right to dissolve, so he must suffer the consequences.

- ***Owen v. Cohen*:**O&C have oral agreement to start bowling alley business as a partnership. They don't expressly state any default period of time for the duration of their undertaking. O gives $7000 loan to the partnership w/ understanding that he will be paid back as soon as they make profits (this was clearly a loan, not a capital contribution). O&C each get a $50 salary & each is supposed to work/manage the business. O&C don't get along & disagree on everything. C mistreats O & C does not want to do any work, wants to open a gambling room & steals money. O tries to buy him out but C doesn't let him. So O files suit asking for court decree of dissolution (if he just dissolved on his own that would be wrongful). Court grants dissolution & says C breached P'ship agreement & conducted himself in way that did not make it practicable to carry on business w/ him. Court says after assets are sold off, O's $7K is to be repaid first, then they can split whatever profit is left.

- ***Collins v. Lewis*:** L&C enter into partnership for cafeteria business. L was to do all planning, managing, & supervision of construction + get a salary. C just put up all the money. C was to be repaid back his money in 1 year, then they would split remaining profits. The lease on the cafeteria was for 30 years (so this makes it look like a term p'ship). Things start going wrong w/ construction delays, spiraling costs, etc. C gets upset & tells L he is running the business into the ground & threatens to withhold funds if the business stays unprofitable. L says I know what I'm doing, these things take time & you're not letting me manage it properly. C sues for court decree of dissolution claiming the business can never be profitable. Court does not grant a dissolution.
  (i) Court says this is term partnership so C could not dissolve it on his own.
  •Term b/c 30 year lease + b/c when a partner gives a loan expecting to be repaid from the profits, then it is considered a term partnership for the amount of time reasonably necessary to pay back the loan.

(ii) Court says C is the bad guy here. Even though L was supposed to pay C back within a year & didn't, L still didn't breach the P'ship agreement since L was forced to buy stuff on his own credit b/c C started withholding funds.
(iii) Court can't grant dissolution b/c this business could be profitable if L was allowed to manage it the way he wanted to.
(iv) So C is stuck w/ L if he wants to keep the business going, he has to learn to work with him or try to buy him out.

- **Comparing *Owens & Collins***
  - Cases look a lot alike
    - Partnership is not at will
    - Bad blood between the partners + one partner got fed up & wanted out
  - Court let Owen out; Collins is stuck. Why?
    - *Owen:* Bad guy is lazy Cohen but Owen is the one seeking dissolution.
    - *Collins:* Bad guy is Collins &Collins is the one seeking dissolution
    - Because there was wrongdoing in one & not in the other. The good guy wanted out in the first but not in the second.

- ***Page v. Page*:** P&D are brothers who had oral partnership agreement for linen business. Both contributed money & initially business was not good. One of their major creditors is a corporation owned by P that supplied their goods. Business got better & P sued to dissolve & terminate the partnership b/c he wanted to take it over for himself & since he was a major creditor already he would win at the auction selling off partnership assets after dissolution. Issue is whether this was a p'ship at will (P can dissolve) or term p'ship (P can't dissolve). Lower court says it was for an **implied term** (that term is as long as it takes for them to make a profit & it is based on the past history of partnerships they had). Higher court says no, there was no implied term here, they were just talking about being in business & wanting to make a profit. **It should not be this easy (by just saying we expect to make money) to create a term partnership**.
  (i) This is different from *Owen* b/c in *Owen* there was a loan to be repaid, it was not just about making profits generally, and that is what created the implied term. That is the metric that was used there. There was no similar implied term here, so it's an at will p'ship & any partner can dissolve at any time.
  (ii) But P is not off the hook & free to dissolve b/c he still has to meet his fiduciary duties (loyalty & good faith). If he acts in bad faith & violates his duty by attempting to take a partnership opportunity for himself, then his dissolution is wrongful.

- ***Pav Saver (PS) v. Vasso*:** Dale owns PS & Meersman owns Vasso. These two corporations enter into a partnership where PS contributes the patents/trademarks & Vasso contributes financing. Economy tanks, PS wants to dissolve P'ship & sends Vasso letter telling him. Vasso does not like it, he barricades himself in the office, kicks out PS & tries to continue the business by himself. Court says he was right. **Issues:**
  - **Was the termination/dissolution wrongful, thus bringing UPA§38 into play?--YES**
    Section 11 of their p'ship agreement said p'ship was not to be terminated unless they had mutual approval of both parties & if one side does terminate they have to pay the other 4X liquidated damages. **2 Possible Interpretations of Section 11** (one allows PS to dissolve rightfully & other doesn't):
    Approach 1: Wrongful for either party to ever dissolve unilaterally. If a party does then UPA§38 comes into play & in determining damages under UPA§38, it is the amount specified in Section 11. **Court takes this approach.**
    Approach 2: Any party can dissolve & terminate partnership at any time (not a wrongful termination) subject to the damages provision (i.e., as long as it pays the damages). This approach overrides UPA§38 & says party has to pay whatever Section 11 says they have to pay & their termination is not wrongful.

• Court adopts Approach 1 & says unilateral termination is wrongful under their p'ship agreement & the rest is just about damages terminating party has to pay. Since it's a wrongful dissolution, that means UPA§38 applies, which says the non-dissolving party is entitled to damages & he may continue the business. He just has to pay off the other dissolving partner.

- **Was Vasso entitled to continue business using the PS patents?--YES**
  Section 3(b)(2) of P'ship agreement says all patents must be returned to PA at expiration of the partnership. Weird b/c we don't know what expiration means. It seems like patents should be returned to PS under this, but court says no. **Vasso, as non-dissolving partner, is allowed to continue the business & in order to continue the business he needs the patents so he gets to keep them & does not have to return them.** B/c he has the rights to continue the business, he is going to have the right to keep the patents. This was a big jump for the court to make.

  Ascertaining Value of Interest/Damages
  - It is okay to exclude the value of PS patents & trademarks when calculating the value of PS's interest (i.e., how much you have to pay them to buy them out) b/c they are part of goodwill & dissolving partners are not entitled to value of goodwill. But another court might have said this was wrong b/c value of patents is not part of goodwill, it's just a regular p'ship asset so it should be included in the interest value calculation.
  - What is the implication of the agreement as to liquidated damages?
    - Used to determine damage payment owed to PS, not to replace UPA38
  - Dissent says parties specified what their damages should be in the agreement so that should govern & they said the patents would go back to PS. Plus UPA38 says you can try to continue the business, it doesn't say that business has to be profitable, so just b/c you need patents to continue does not mean you are automatically entitled to them.

- **SEE Bar Exam Partnership Hypo (#1).**

CORPORATIONS

I. Characteristics & Formation

(A) Characteristic of Corporations

Three Types of Corporations

(1) Closely Held Corporations: Very small w/ only a few people running it (coffee cart)
- Shares contain restrictions on transfer.

(2) Private Corporations: A bit larger but they still have limited number of shareholders (i.e. facebook before it went public).
- Federal law restricts share transferability.

(3) Public Corporations: Large w/ many shareholders who are not involved in managing
- Shares are freely tradable on stock market + must comply w/ disclosure rules.

Sources of Corporate Law

- State law
  - State law, of the state of incorporation, governs the corporation internally.
  - Model Business Corporations Act (MBCA)
  - Delaware Law (DGCL)
- Federal law (primarily "public" corporations)
  - Disclosure + Insider trading + Shareholder voting (proxy) + Tender offers
  - Stock exchange rules (e.g. NYSE)

Critical Attributes of Corporations

1. Legal personality
2. Limited liability
3. Liquidity
4. Separation of ownership and control
5. Flexible capital structure
6. Tax Treatment

(1) Legal Personality: Corporations have a legal personality that is separate from the identity of the owners. Separate legal existence from its owners & managers:
- Enters into contracts + owns assets
- **Note: Corporations can even enter into a partnership together.**

(2) Limited Liability: LL means you don't lose more than what you put in the company. Shareholders are not personally liable for the debts of the corporation. This makes people feel comfortable investing in companies in which they don't have control.
- Unless otherwise provided in the articles of incorporation, a **shareholder** of a corporation is **not personally liable** for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.
- Shareholder losses are limited to amount they invested
- Closely held corporations: Personal guarantees + Control/Insurance
- Piercing the veil doctrine/enterprise liability (involuntary v. voluntary creditors)

(3) Liquidity: Ownership interests in corporations (the shares) are freely transferrable (can sell your shares to someone else), so investors can get out easily if they want to. Also corporations are of infinite life, they don't die (doesn't matter who dies like the CEO or shareholders):

• Closely held corporations may: (1) restrict transfer, and/or (2) have an illiquid market.

(4) Separation of Ownership & Control: All corporate powers shall be exercised under the authority of the board of directors, & board manages the business & affairs of the corporation.

- **Shareholders** – **Elect the board of directors.** Also, shareholders own shares of common stock & that entitles them to some cash flow & control rights:
    - **Cash Flow Rights:** They own the residual or equity interest in the corporation, which means they can get dividends & they can get assets in case of liquidation (after debts are paid off).
    - **Control Rights:** They can elect directors & vote on certain matters at shareholders' meetings. But that's it, they have no other control rights. They cannot otherwise tell the company what to do.

- **Board of Directors** – Choose the CEO & other officers. Board has the power & duty to manage corporate affairs & make important decisions.
    - Shareholders cannot tell them what to do.
    - Individual directors/board members are NOT agents of the corporation, so they can't bind the corporation in contract. Only the board itself can act as a "super-agent" and bind the corporation.
    - Directors meet periodically as a board to review & approve significant investment & operational decisions presented by management.
    - Decisions of Board are protected by Business Judgment Rule, but still subject to fiduciary duties.

- **Executive officers/directors** – Run company day to day. Three types of directors:
    - **Insiders** (members of management team)
    - **Significant relationship with management**
    - **Outsiders/independent directors**
        - Traditionally, CEO nominates independent directors that are proposed to shareholders to vote on.One of the duties of the board to is to manage the officers so this can be problematic w/ inside directors b/c we are asking them to monitor themselves.
        - **Agency Problems in Corporations:** In large corporations, board members usually own less than 1% of the stock but they have all the control & make all the decisions. Concern is that they may have their own objectives which they pursue at the expense of shareholder interests. If they make bad decisions they don't have that much to lose.
        - **Closely Held Corporations**: Possible to oppress the minority here b/c it's hard to sell shares & get out.

(5) Flexible Capital Structure: Corporation has assets & future profits that are going to roll in. Investor's claims on these assets & future earnings are packaged in the form of securities (stocks & bonds). Capital structure is comprised of BOTH the **debt securities** & **equity securities:**

(1) Debt securities are: bonds (public debt) + bank debt.

(i) Bond is when company borrows money from the public. Investors give the company money & company gives investor a bond saying we will pay you a fixed money value monthly & pay back your original sum in thirty years. Bonds are transferrable. Bonds allow the company to raise lots of money from investors

(ii) Debt security holders have 2 rights:

(1) Receive stream of payments in the form of interest over period of years

(2) Return of principal at maturity.

- No right to elect directors or vote; <u>contract</u> may give certain rights.

(2) Equity securities are: common stock + preferred stock.

(i) Equity Security holders (i.e., shareholders) get to:

- Equal right to participate in distributions of the firm's earnings (dividends)
- In liquidation, share equally in firm's assets remaining after all prior claims are satisfied.
- Limited right to participate in decision making by electing directors & voting on major corporate decisions.

- If the value of the firm assets goes down the debt holders don't lose anything b/c they are still entitled to their interest payment. Equity holders suffer when things go bad.

Authorized vs. Outstanding Shares

- **Authorized shares:** They are the number of shares that the articles of incorporation has authorized the corporation to issue.
- **Outstanding shares:** The number of shares the corporation has sold to the public and has not repurchased.
- **Authorized but unissued shares**: Authorized but unissued shares are those that are authorized to be issued but have not been issued yet.
- **Treasury shares:** Shares issued and repurchased by the firm.

- **Preferred Stock:** Preferred stock has a fixed dividend value that must be paid each year. The value does not go up or down depending on how the company does. But common stock holders do not have to get paid a mandatory dividend, it is up to the discretion of the board.Preferred stock holders get paid after the debt holders (so that means the bank gets paid first), but before the common stock holders.

(6) Tax Treatment: Double taxation for corporations. If corporation makes a profit of $60, they have to pay a tax on that profit. And then whatever is left of that, if they decide to give dividends, then the shareholders have to pay a tax on the dividends too.

(B) Formation of Corporations

- Pick a state & file your articles of incorporation w/ the secretary of state. Corporation is born. Have a meeting to finalize the steps & adopt the bylaws.
  - You do not have to incorporate in the state you do your business in.

Articles of Incorporation MUST Include:

- Corporate name for the corporation
- Classes and number of shares the corporation is authorized to issue
- Name & address of the corporation's initial registered office & agent
- Name & address of incorporators (or initial directors)
- Purpose of corporation (in Del.)

- Articles can be amended by a **vote of majority of the shares** (more than 50%), UNLESS a higher number is specified in the articles of incorporation. Articles also say who has power to amend the bylaws.

Articles of Incorporation May Include:

- provisions not inconsistent with law regarding how to manage the corporation
- imposition of personal liability on shareholders for debts of the corporation
- eliminating or limiting the liability of a director to the corporation or its shareholders
- provision permitting or mandating indemnification of a director for liability
- duration of corporation (otherwise forever)

Bylaws

Bylaws state the number of directors, the committees, the officers & how they are selected, how to call meetings of the board, how to call meetings of the shareholders, etc.

- Number and qualification of directors
- Committees of the board, responsibility
- Quorum, notice requirements for shareholder & board meetings
- Titles, duties of officers
- Articles of incorporation determine whether the power to amend the bylaws is vested in either the board or the shareholders (or in both).

(C) Promoter Liability (to 3rd parties) in Forming Corporations

A promoter is a person who takes the preliminary steps in organizing a corporation:

- Issues a **prospectus** describing operations of the proposed corporation to let prospective investors (**subscribers**) make the decision to buy. Procures stock subscriptions & secures a corporate charter. Makes **contracts** (purchase/lease property for corporate facilities).
- The promoter acts as an agent of the business prior to its incorporation.
- **Promoter is personally liable on contracts made prior to incorporation**, unless the 3rd party agrees to hold the corporation, rather than the promoter, liable (i.e. novation).
  - Just indicating that promoter is signing for "a corporation to be formed" is not enough. Must include clause in the contract where 3rd party says promoter is released from liability. Releasing him from liability is a separate act.

- Once the corporation is formed, it may assume liability on the contract (by adopting the contract) & release the promoter but promoter is still liable to 3rd party. Once the articles are filed & corporations is formed, the corporation becomes a party to the K, but this does not happen automatically. **Corporation must adopt the K**. Adoption can be either:
  (a) Express OR **(b)** Implicit (e.g., ratification by acceptance of benefits).
- But even if the corporation adopts the K, that does not mean the promoter is released from liability b/c the only person that can release the promoter is the 3rd party.

- If the articles are not filed (& corporation is not formed), is a promoter liable on the K?
  - Yes. Absent an agreement to the contrary, the promoter remains liable on the K if the corporation never comes into existence. Tricky in defective incorporation.

Defective Incorporation

Sometimes people think they have already formed the corporation but in reality they haven't b/c there was a mistake w/ their application. By this point, promoter has already secured investors, so they might be deemed partners (to the extent that they are sharing control & profits) & be liable. Two doctrines try to tackle this mistaken unformed corporation problem:

(1) De Facto Corporation - Treat them as corporations & give shareholders limited liability if the organizers try in **good faith** to incorporate & have acted as a corporation all along. This protects investors so that later they won't be held liable as partners. **Requires good faith.** Works against tort creditors as well.

- Treat as a corporation & give shareholders limited liability if organizers:
  - In good faith tried to incorporate
  - Had a legal right to do so
  - Has acted as a corporation.
- Some states don't apply this doctrine to protect a person who was *aware* that the incorporation effort was defective at the time.

(2) Corporation by Estoppel -Applies against third party contract creditors if that creditor thought it was dealing w/ a corporation all along. **This does not work against tort creditors, it only works with contract creditors**.

- Grant shareholders limited liability against only <u>contract</u> creditors if person dealing with the firm (does not apply to tort creditors):
  - Thought it was dealing with a corporation all along
  - Would earn a windfall if now allowed to argue that the firm was not a corporation.
- Shareholders may be protected even in the absence of good faith effort to incorporate on their part **(does NOT require good faith).**

• ***Southern Gulf****:* Promoter of corporation was trying to enforce a K—made on behalf of a corporation before it's incorporation—against a 3rd party that wanted to escape the K. 3rd party was bound to the K & could not get out b/c it was estopped from denying the promoters corporate existence.

  • Usually, it will be 3rd party trying to sue promoter & initial shareholders on a K entered into on behalf of company prior to incorporation. **However, it is a two way street** (case shows us that).

II. Liability to Third Parties (limited liability + piercing corporate veil)

(A) Limited Liability

- Limited liability rule says that, unless otherwise provided in the articles of incorporation, a **shareholder** of a corporation is **not personally liable** for the **acts or debts of the corporation** except that he **may become personally liable by reason of his own acts or conduct**. **MBCA 6.22(b).** It means:
  - Shareholder losses are limited to the amount the shareholder invested
  - It is the corporation that incurs the debt or commits the tort (legal person)
  - Personally liable means the shareholder becomes direct liability through piercing of the corporate veil.

- Limited liability is the default rule & you can try to contract around it (i.e., "unless otherwise provided in articles...").

Piercing Corporate Veil Test***

For the shareholders of a corporation to become personally liable for the corporations obligations (i.e. for the court to be able to pierce the corporate veil), the Plaintiff must show BOTH:

(1) Unity of Interest- There is such a unity of interest & ownership that the individuality, or separateness, of the person & corporation has ceased. This is where the shareholder treats the corporation like a toy & the corporation is really just an extension of the individual; **AND**

(2) Promote Fraud or Injustice- The facts are such that an adherence to the fiction of the separate existence would sanction a fraud or promote injustice. Meaning, if we don't pierce the veil & make them liable, then there is some fraud or injustice being promoted.

'Unity of Interest' Prong Factors

- **Failure to Follow Corporate Formalities:** Corporations that never hold meetings, don't have minutes, etc., are not following corporate formalities.
- **Commingling of funds & assets (using corporate assets as your own):** If you have a corporation and you only have one bank account that you use for corporate & personal use.
- **Business is a Closely Held Corporation**: Court is more likely to pierce the veil in closely held corporations that are small. You never see veil piercing in publicly held corps like GE.
- **Deceive Creditors or Make Misrepresentations:**
- **If Defendant is a Corporate Shareholder:** Corporations can own stock in other corporations and corporations have many subsidiaries. Courts are more willing to pierce the veil when the shareholder of a corporation is another corporation.

'Promote Fraud or Injustice' Prong Factors

- **Undercapitalization**: This is when you don't leave enough assets in the company to satisfy the debts and liabilities of the corporation (having less money than what you would expect the liabilities of the company to be).
- **Insiders Deceive Creditors/Misrepresentations:** If you lie to creditors & suppliers.

- **Plaintiff is an Involuntary Creditor:** Voluntary creditors are suppliers & lenders, involuntary creditors are tort victims. Courts are less willing to pierce corporate veil for voluntary creditors b/c they can defend themselves by doing due diligence. But involuntary creditors like tort victims can't protect themselves in this same way so courts are more willing to pierce the veil for them & make shareholders liable.

Note on Voluntary vs. Involuntary Creditors

- Voluntary (suppliers, lenders): Can bargain for safeguards (guarantees, higher prices) as long as these are not deceived.
    - Corporate formalities matter (e.g., due diligence); undercapitalization shouldn't (especially if discoverable).
- Involuntary (tort victims): can't protect themselves beforehand; do not assume risk of dealing with limited liability entity.
    - Adequacy of capitalization should matter more.

- **A mere unsatisfied judgement is NOT enough to satisfy fraud/injustice prong.** If your only argument is that if the court doesn't pierce you are not going to be able to collect on your judgement, then that is not enough to meet this prong. It must be something more, something that is really a big wrong, like: Unjust enrichment, deliberate attempt to use the corporations to escape his creditors, etc. ***SEE Sealand***

(B) Liability of Corporate Groups

- Corporations usually add a lot of subsidiaries in order to **insulate themselves** (i.e to protect GE when GE Capital tanks) and **to insulate each subsidiary from the mistakes of the other subsidiaries** (i.e to protect GE Healthcare from when GE Capital goes under); and also to **keep assets separate for different types of enterprises**.

--Limited Liability creates barriers between these GE subsidiary companies (if you lend money to GE Healthcare you can't ask their subsidiary GE Aviation to pay for them & you can't ask the parent GE general to pay either). Limited liability also protects all of the shareholders.

(1) Factors for Parent/Subsidiary Piercing

Look at all these factors to see if you should pierce the veil from parent to subsidiary (i.e. pierce from GE general to GE Aviation). **The key is, how independent is the subsidiary from the parent.** Look at who is running the show (are the same people running GE general the ones running GE Aviation?). How financially independent is the subsidiary from the parent? Does the subsidiary send all of the money to the parent? That would be bad b/c that would leave the subsidiary without adequate capital & funds. **Factors for Parent-Subsidiary Piercing**:

- common directors, officers, business departments
- file consolidated financial statements & tax returns
- parent finances the subsidiary
- parent caused the incorporation of the subsidiary
- subsidiary operates with grossly inadequate capital (undercapitalization)
- parent pays the salaries & expenses of the subsidiary

- all subsidiary business is given to it by the parent
- parent uses the subsidiary's property as its own
- daily operations are not kept separate
- subsidiary does not observe basic corporate formalities

(2) Enterprise Liability Doctrine--Horizontal Piercing

GE is at the top & owns lots of subsidiary companies, so you can argue that all these separate entities are not really separate & are acting as a common group. **Horizontal piercing of enterprise liability doctrine says if all these subsidiaries are being operated as one business enterprise then you can disregard & ignore the walls between the companies.** So ask, has the group of corporations been operated as a single business enterprise? **Factors to look at:**

- common business name; address; phone number
- same officers; same shareholders; common employees
- services rendered by employees of one corporation on behalf of another; payment of wages by one corporation to another corporation's employees;
- common record keeping & accounting; unclear allocation of profits/losses btwn corp's
- undocumented transfers between corporations

- ***Walkovsky v. Carlton:*** P was injured when he was run down by a taxi owned by D. D is stockholder of 10 corporations & each only has 2 cabs in it w/ the minimum insurance. P can't satisfy the judgement by just suing this one cab, so he has 2 other things he can do:
  (1) Pierce Corporate Veil: Go after Carlton, the shareholder of the whole cab company, **personally** under piercing corporate veil theory. To pierce veil, P must show:
    (a) Unity of interest- This prong fails b/c no evidence that he is doing business in his individual capacity or shuffling personal funds in & out of the corporation.
    (b) Promote Fraud/Injustice-Fails b/c there is no fraud here, just carrying the minimum insurance on your cars is not fraud, if insurance law allows you to do that, it's okay.
      • **Court does NOT pierce the corporate veil.**
      • **Dissent** says he was intentionally undercapitalizing for purpose of avoiding liability. He did not keep any money in the business & it's not like he wasn't making money. As soon as money came in he took it our for this purpose. So for dissent, being undercapitalized on purpose is enough for fraud/injustice prong

  (2) Enterprise Liability: Argue that all of these small cabs were really just one big company with multiple cabs (they are not independent entities), so under enterprise liability, I should be able to go after the assets of the whole cab company. Carlton did not respect the separate identities of the corporations; these were all just one single business entity (and held out as that)
    - Assignment of drivers from one company to the other.
    - Use of mixed bank accounts +Ordering of supplies, etc
      - **Court holds it does look like one big cab company.**

- **Questions**
  - Can you incorporate your business for the express purpose of avoiding personal liability? **Yes**
  - Can you split a single business enterprise into multiple corporations so as to limit the liability exposure of each part of the business? **Yes**
  - How can Carlton avoid personal liability for his business?
    -Follow corporate formalities, have meetings, leave money in the company, have insurance.
  - How can he avoid enterprise liability?

Ans: Avoiding enterprise liability is more difficult, you need separate books & bank accounts for each corporation, plus careful accounting for supplies, for borrowing of drivers, etc. Try to keep the businesses completely separate w/ separate drivers, separate cars, funds, garages, etc. But this will probably make the business more expensive.

- ***Sea-Land v. Pepper Source**:* SL transports stuff for PS & PS owes them money. Marchese is the owner of PS & he owns a few other companies fully & one partially. PS has no assets left so SL wants to pierce the veil & recover from Marchese personally. (SL does not try for enterprise liability b/c his other companies were other types of businesses so it would be hard to argue that all of these companies are the same business entity). Piercing the Veil Analysis:
  (1) Unity of Interest: Court says this is met b/c he had the same office & phone line for all the companies & himself, held no corporate meetings, used same bank account for business & personal, used corporate funds for personal expenses.
    - There is also no difference as to the company he owned partially (Tie-net) b/c he treated it like the others. If he's not deterred by the fact that he did not hold all the stock in TieNet why should his creditors be.

  (2) Fraud or Injustice: This prong is harder b/c P's only argument is "if you don't pierce the veil I'm not going to get my judgement paid" & that is **not enough to further an injustice or be fraud.** Need something more than this, something bad that Marchese did to you. On remand, lower court saw that he used personal funds to avoid taxes (tax fraud) & lied to SL promising he would pay their bill knowing that he was not going to. That became enough to satisfy this prong.

(C) Being a Creditor vs. Being a Shareholder + REVERSE PIERCING

Suppose SL is able to pierce the veil & get to Marcheses personal assets. Marcheses only asset is Jamal stock (his other company). Assume Jamal owes $90K debt to bank. SL takes the stock & sells it to satisfy the judgment. SL is owed $90K & bank is owed $90K. How much does SL get?

ANS: Nothing, b/c Jamal owes $90K to the bank already & the creditors come before the stockholders (SL is now considered a Jamal stockholder). So by piercing the veil, all SL has done is get access to Marcheses assets.

What does SL get as the holder of Jamal stock?

- Lets say that Jamal is sold for 100K. How much does SL get?
  = 10K (b/c 90K goes to bank)
- Jamal is sold for 140K. How much does SL get? = 50K (b/c 90K goes to bank)
- Jamal is sold for 180K. How much does SL get? = 90K (b/c 90K goes to bank)
  - So to be in a better position SL should try to become a creditor not a shareholder.

What if SL was able to become a creditor of Jamal?

- Lets say that Jamal is sold for 80K. How much does SL get?
  = If bank & SL are both owed 90K each, then they would each get half of the 80K, so 40K to bank & 40K to SL.
- Jamal is sold for 100K. How much does SL get? = 50K (other 50K goes to bank)
- Jamal is sold for 140K. How much does SL get? = 70K (other 70K goes to bank)
- Jamal is sold for 180K. How much does SL get? = 90K (other 90K goes to bank)

How can SL become a creditor instead of a shareholder?

Option 1: Argue enterprise liability. Under enterprise liability, you can say that Jamal & PS are just one business entity and the assets of the two are pooled; therefore, any debt of PS is also a debt of Jamal. Then SL becomes a creditor of PS, not a shareholder.

Option 2: Reverse Pierce. If SL can't argue enterprise liability b/c of the facts (like in this case), then they can try to do <u>**reverse piercing**</u> **(pierce down)** & say that the debts of Marchese are also the debts of Jamal (so you can use Jamal's assets to pay off Marchese's debt). In this scenario Marchese is like GE General & Jamal is like GE Healthcare?

> **Note:** If Marchese had used Jamal as a proper business corporation & had only used PS as his toy corporation, then SL could not pierce the veil of Jamal.

- **SEE Muppets & Piercing Veil Problem Handout (#2).**

III. Fiduciary Duties to Shareholders

Directors/Officers (i.e. the Board of Directors)

- **(i)** What they do?
- **(ii)** To whom they owe duties?
- **(iii)** What is the content of these duties?
  - Duty of Care + Duty of Loyalty

(A) What Does Board Do? (shareholder primacy & the purpose of the corporation)

- **Board Functions DGCL §141(a):** Duty of the board is to manage & control the business & affairs of every corporation.
  - Select, evaluate, replace senior management (hire/fire).
  - Oversee strategy, management of corporate resources.
  - Review, approve major plans and actions.
  - Set capital structure & dividend policy (board has discretion on dividends).

- **Board Composition DGCL §141(b)**: Board has to have 1 or more members who are natural persons. Board members don't have to be shareholders unless the certificate of incorporation requires it. Number of directors shall be fixed in the bylaws, unless the certificate of incorporation fixes the number. The certificate of incorporation or bylaws may prescribe other qualifications for directors.

- **Board Committees DGCL §141(c)(2):**Board can designate a committee (of 1 or more directors) & delegate duties to that committee (i.e., auditing committee).

- Goldilocks problem is about how much control to give the board. We want a board of experts running the corporation, but giving them too much authority on behalf of shareholders raises accountability issues b/c they're playing w/ shareholder's money. But we don't want to let shareholders micromanage the board either. **Solution:**
  - Give board of directors a **goal**. The goal is to **maximize shareholder's wealth (i.e. profits). Shareholder Primacy Theory.**
  - Give board ample **discretion** in choosing how to attain that end.
    - Limited/Periodic voting by shareholders
    - Business Judgment Rule (no judicial meddling or second guessing)
  - Limit the boards discretion w/ **fiduciary duties** (if board breaches these duties, shareholders can sue them).
    - Duty of Care + Duty of Loyalty

• ***Dodge v. Ford Motors:*** Investors initially contribute $5 million. Ford owns 58% of stock & is in control. Dodge bro's own 10% & are not members of the board. Ford issues regular & special dividends b/c business was good, but one year they don't issue a special dividend b/c they want to reinvest money in a new plant. Dodge is not happy b/c he wanted the special dividend so he sues to get special dividend & enjoin construction of the new plant. Court grants the special dividend but refuses to touch the plant issue.

(1) Issue 1 Dividends: General Rule is that **courts leave dividends to the discretion of the directors (business judgment rule). Absent fraud, illegality, conflicts, negligence, or waste, they approve whatever a board decides.**

• Court ignores the rule & says the decision not to issue dividends here was arbitrary & wrong so Ford has to issue them. Court is afraid Ford is running a charity not a business (b/c he raises pay & quality) & the primary purpose of any corporation is to maximize shareholder profits & the powers of the directors are to to be used for that end. Ford lost b/c he got up on stand & said I want to help people & spread the wealth, he should have said "I love profit." As long as your goal is to make money you get a lot of discretion.

• Board can NOT run the corporation for the **merely incidental** benefit of making a profit, **making a profit has to be their number one goal.**

• Ford could have argued his plan would benefit shareholders by raising profit b/c: lowering price of cars means more people will buy them, raising salaries will result in more happy, efficient & loyal employees.

(2) Issue 2 New Plant: Court says the decision to build the plant should be left to the discretion of the board b/c judges are not business experts.

(B) BJR Shield & Protection for Business Decisions (+ Duty of Care)

- **Business Judgement Rule**: Courts are very deferential to business decisions made by the board. The BJR is a **rebuttable presumption** that directors in performing their functions are honest & well-meaning, & decisions are informed & rationally undertaken. BJR protects directors from liability for decisions that are merely dumb. It is very hard to overcome the BJR presumption and the **board RARELY loses in these cases**.

- To overcome the BJR, the person challenging the board's decision must show (has <u>BoP</u>) that the board did one of the following, or else the court defers to the board:

  (1) Lacked good faith.
  - fraud or illegality
  - bad faith
  - conflict of interest

  (2) Lacked a rational business purpose (waste). *Kamin v. Amex*

  (3) Failed to get informed in decision-making (<u>gross negligence</u>). *Van Gorkem*
  - Informed means having all material info that is *reasonably available.* Reasonably available standard requires: outside valuation study & for board to actually read the terms of a pending agreement.
  - **DGCL§141(e)** provides a defense for directors who rely in **good faith** on the information & reports from company officers. But they can't rely blindly, they have to ask some questions.

  (4) Failed to oversee the corporation's activities (inattention). *Francis*

- If the board does do any of these 4 things, then they have **breached their <u>duty of care</u>**.
  - **DGCL§102(b7):** Corporations can exculpate directors for breach of duty of care

- **Duty to Creditors**: Normally directors owe a fiduciary duty to the corporation & to the shareholders, but they **owe NO duty to creditors** (duties to creditors are just contractual & they are what is in the loan agreement). **Two Exceptions** to this rule:

  (1) When the corporation is in a line of business in which the corporation takes money from clients & holds that money in trust for the clients, then we are going to find a fiduciary duty running toward those clients (applies in *Francis*)

  (2) When corporation is in zone of insolvency (Section V of outline-Creditor Protectn)

- **Overview Director's Duty of Care**
  - Actions taken by the Board of Directors:
    - Most covered by BJR: *Kamin v. Amex*
    - Unless not acting in shareholders interest: *Dodge v. Ford*
    - Or process by which decision is made is flawed: *Van Gorkom*
  - Inaction of a Director: *Francis*
    - Not covered by BJR b/c no action taken + affirmative oversight duties
    - Owe no duty of care to ***creditors*** unless an exception applies.

Type 2: Lacked a rational business purpose (waste)

• ***Kamin v. Amex* (lack of rational business purpose):** Shareholders sue board of Amex asking for a declaration that issuing of certain special dividends (of DLJ stock purchased by Amex) is a waste of assets & should not be issued. Court sides with board & says courts do not get involved in business judgements about how to deal w/ bad investments. Shareholders are mad at Amex for making this stupid investment but can't sue them for that b/c BJR bars it. Instead they sue claiming that how Amex dealt w/ the bad investment was wrong & wasteful, instead of declaring special dividend they should have just sold it & gotten a big tax benefit. Board knew that issuing dividend would mean they lost the tax benefit, but they decided to do it anyway b/c the alternative of selling at a loss would be a big hit on their financial statement & make their stock price tank.

(i) Kamin-Standard of Review: Court says question of whether or not dividend is to be declared or distribution of some kind should be made is **exclusively a matter of business judgment** for the Board & court will not second guess it unless:

- Powers have been illegally or <u>unconscientiously</u> executed; or unless fraudulent or collusive & <u>destructive of the rights of stockholders;</u>
- It appears that directors have not been acting in <u>good faith</u>
  - **Merely alleging that another course of action would have been more advantageous than what the Board did is not enough.**

(ii) Acting in good faith?-Possible argument that board might not be acting in good faith b/c directors are compensated based on how good the companies financial statement looks, so that's why board was so keen on doing it this way. Court says no, that is way too speculative.
(iii) Informed Decision?-When board made its decision they were fully informed about it (tax benefits) & that is key. If board failed to inform itself about the tax consequences then shareholders could argue they were grossly negligent in decision making & BJR shouldn't apply. Directors very rarely lose on this ground (lightning struck in *Van Gorkom).*

Type 3: Failed to get informed in decision-making (gross negligence)

• ***Van Gorkom* (failure to get informed in decision making-gross negligence):** This case is about M&A (LBO). Van Gorkom is CEO of Trans Union & decides to sell company b/c tax credits were expiring. Idea is brought up at a board meeting, they do informal feasibility study & decide $55/share would be good price to sell at. Company stock was trading at $38/share on the market. Van Gorkom negotiates leveraged buyout at $55/share w/ Pritzker. Pritzker wants to close deal fast & asks for conditions like not allowing them to solicit other buyers & not allowing them to provide info to others. On Sept 20 Van Gorkom presents it to senior management & they don't like it at all. Board of Directors approves the merger after a 2 hour meeting on Sept 20. Board & Van Gorkom sign the agreement w/o reading it. Amendments are made in October & they all approve w/o reading them. Shareholders sue claiming the Board was grossly negligent b/c it failed to become informed before entering into agreement to sell at $55/share. Shareholders have the burden of proof on this.

- **The determination of whether a business judgment is an informed one turns on whether the directors <u>have informed themselves</u> prior to making a business decision, <u>of all material information reasonably available</u> to them.** No protection by BJR for an ***uninformed*** decision.

(i) Following makes it look like board was not informed:

- Had no idea what meeting was for (no idea it was for a merger) + Met just for 2 hours
- Did not read agreement
    - No auction. This was the protection Pritzker asked for, it was to not let the board conduct an auction for the company & seek other purchasers.
    - Lock up. Pritzker agreed to enter into merger agreement if company sold him 1 million shares at $38/share, regardless of who ends up buying company (whether Pritzker buys it or anyone else buys is), & that is the lockup. By doing this, Pritzker is increasing the price of the company for any other buyer.
- Did not think hard about price
    - No outside advice re: valuation of the company
    - No hardball questioning of Van Gorkom as to how he came up w/ that $55 price

(ii) What are Board's Arguments for it's decision?

(1) Price was above market: Pritzker was willing to pay a $17 premium over the market price of $38 so it seemed like a good deal.

- Court says no. Board did not really know what the company was worth b/c they didn't do valuation (i.e. fairness opinion) study w/ outside experts to assess company value & see if $55 was a good price (just looking at historic stock price of a company is NOT enough). Board also did not try to figure out how much control of this company was worth to Pritzker, maybe they could have gotten a better price out of him. Board didn't even know how Van Gorkem came up w/the $55 figure.
- **Lesson:** Board should <u>always</u> bring in outside bank to do a **fairness opinion** about the worth of the company. (And they should allow for the auction).

(2) Van Gorkom said it was a good deal: And he's the CEO so we listened to him.

- Court says no. Although board takes what officers tell them in good faith (DGCL§141 (e)), you still have to do due diligence & ask questions & at least ask why $55 was a good price. This doesn't protect board here b/c:
    - Van Gorkom was uninformed himself
    - BoD had a duty of inquiry: can't rely blindly, must ask something.

(3) Amended Agreement: They amended the original agreement to fix the shady parts of it.

- **Court says no.** Amendments don't help b/c board didn't read the amendments & amendments did not allow the company to accept competing bids from others.

(4) Nobody else bid on it during the auction period anyway so Pritzker's deal was the best.

- Court says no. The auction process was completely screwed up already b/c Pritzker had so much control with the lock up, it became too expensive for any other competitor. So it wasn't a fair market test.

Evaluating the Standard: The "reasonably available" standard requires an in-depth study:

- Valuation study. Make sure to get one done it's important.
- Discussion in course of the negotiations. CEO usually does not go out & bargain without the board knowing about it.
- Review of actual contract, terms. Need to read the agreement.

How to Protect Directors from Liability (recap)

(1) Business Judgment Rule

(2) Exculpation: **DGCL 102(b)(7)** -After *Van Gorkem* directors started freaking out & liability insurance for directors became too expensive, so new laws were passed to protect them from liability. Corporations can put provision in certificate of incorporation saying **shareholders can't sue board members for breach of duty of care** (i.e., corporations can **exculpate** directors when they breach duty of care). Under the current law, only duty of care can be exculpated, not others (can't exculpate breach of duty of loyalty, acting in bad faith, intentional misconduct, or improper personal benefit).

(3) Indemnification DGCL§145- This is another way directors are protected. Indemnification is when the company indemnifies the director or board member for losses or any amounts the director may owe after being sued:

- If the director wins in the suit he **must** be indemnified.

- If the director gets sued & is not successful on the merits, ***and he was sued by the shareholders or by the corporation itself***, then the company can **NOT** indemnify the director unless the court permits it.

- If the suit is by a third party & the director loses, then the company **ma**y (but does not have to) indemnify the director even if he loses.

  > "If suit is by 3rd party, then may indemnify if acted in **good faith** & in a manner **reasonably believed to be in** or not opposed to the **best interests of the corporation**, & had **no reasonable cause** to **believe** conduct was **unlawful**."

(4) Directors & Officers Insurance: DGCL §145(g)-The company can buy insurance on behalf of the directors, and to cover expenses it may have in indemnification. The key is that you can buy insurance to cover any amount of money the director would owe if he breached a duty, even if you could never indemnify for that type of breach.

- **Example:** When the company sues the director & company wins, the director is liable to the company. The company can't indemnify the director & the director would have to pay both the legal fees & judgement owed. But, under this, the company can buy insurance to cover the directors judgement, even though they couldn't indemnify him.

Type 4: Failure to Oversee the Corporations Activities/Inattention

Directors have a duty to be informed (affirmative oversight duties), which includes:

- Have rudimentary understanding of firm's business (to exercise ordinary prudent care)
- Monitor & keep informed of corporation's affairs
- Read/understand financial statements (at least every quarter)
- Don't rely on subordinates when you have notice that they are acting inappropriately
- If you see shady stuff inquire further & object; if necessary resign.

• ***Francis v. United Bank:*** Lillian became head of reinsurance brokerage company after husband died (owned 48%). She was a director only in name b/c she had no idea what company was about or what was going on. Her sons Charles & Will were the one's running it, stole from it & caused bankruptcy. United Bank is the bankruptcy trustee suing Lillian on behalf of the **creditors** (not the shareholders).

(1) Issue 1: Did Lillian Owe Duty to Companies Clients (plaintiffs)?

• Normally directors owe no duties to creditors, but an exception applies here b/c the corporation was in a line of business where it took money from clients & held it in trust for them, so fiduciary duty runs towards those clients.

(2) Issue 2: Did she breach her duty?

• **Can't protect herself with business judgement rule** b/c she made absolutely no decisions & technically BJR does not apply b/c BJR protects decisions. You can make a decision not to act & that would be a decision protected by the BJR, but that didn't happen here. BUT, even if BJR doesn't apply, she is still not automatically liable b/c **P has burden of proof** to show she breached duty of care.

(3) Issue 3: What was her duty?

• Type 4, duty to oversee corporation & pay attention. Directors must be informed about the company; have to understand the firm's business; have a sense of what companies financial statements say; they can't rely on subordinates when they know subordinates are being bad; if you see shady stuff happening you have a duty to inquire & object and if after your objections the management keeps doing something you think is wrong, **you have to resign.**

(4) Issue 4: Was Her Breach a Proximate Cause of Client's Loss?

• Director must object & protest to the bad conduct. If her objections don't work she has to sue the wrongdoers, or take other action to stop them, or resign. She can't just say they didn't listen to me so I lack causation b/c I myself didn't cause the client's loss, **she has an affirmative duty to do something more.**

(C) Duty of Loyalty

- Overall, there are 4 types of troublesome transactions that might seem tainted
  - **(1) Conflict of Interest (self-dealing) *(Bayer)***- When the director is a party to a transaction with the company.
  - **(2) Corporate Opportunities *(Broz)*-** When a director takes advantage of an opportunity that belongs to the corporation
  - **(3) Competing with the Corporation-** Not going to discuss this further.
  - **(4) Transactions Detrimental to Minority Shareholders-**(See Outline Section VI)

Conflict of Interest (self-dealing)

(1) When Do Conflicts of Interest Happen?

(a) Direct Interested Transaction-When a director of a corporation himself enters into a contract with his corporation (i.e to sell the corporation land, to give corporation a loan).

(b) Indirect Interested Transaction-Two types:

Type 1: When a director of a corporation has a material financial interest in the transaction (but he doesn't enter into the K w/ the corporation himself).

-Example: CEO of ML has an interest in FrogCorp & a transaction or contract takes place between ML & FrogCorp.

Type 2: When a party that is somehow related to the Director of a corporation enters into a contract with the corporation.

-Example: ML enters into a K with CEO's wife.

➔**Plaintiff** who is trying to challenge the transaction has the **burden** to prove there is a COI.

(2) What Can Cure a Transaction That Involves a Conflict of Interest? **See PP 5&6**

(1) Fairness *(Bayer)***-** If there is no ratification by board or shareholders, then we ask was the transaction fair to the corporation. If it was fair, then it cures the taint. **Burden of proof is on the D** to show that it was fair. Hallmarks of a fair transaction are:

(a) Must replicate **arm's length** transaction by falling into range of reasonableness

• Courts carefully scrutinize terms, particularly price, to see if interested director advanced her interest at the expense of the corporation.

(b) Transaction must be **valuable to the corporation**, as judged by its needs & scope of business.

(c) Examine **role of interested director** in transaction's initiation, negotiation & approval.

(2) Ratification (*Wheelabrator)*- A tainted transaction is cleansed if it is ratified by disinterested members of the board OR ratified by the shareholders.

(a) Ratification By Board DGCL 144(a)(1): A contract or transaction with a conflict can stand if it is approved/authorized by a **majority of disinterested directors**, assuming they have **full disclosure** of all **material facts**.

(i) DGCL §141(b): In order to be able to vote on this at all, you need a **quorum** to start the meeting. A quorum happens if a **<u>majority</u> of all of the directors show up** (this **includes both interested & disinterested directors)**. This means you can count interested directors when you try to figure out if quorum requirement has been met or not (**DGCL 144(b)).**

• To **<u>authorize</u>** the transaction, you need a majority of those directors that are present to vote yes. BUT to **<u>cleanse</u>** the conflict, you need a **majority of *disinterested* directors that exist generally** (NOT the majority of disinterested directors that show up at the meeting-that is not enough) **to vote yes.*****

• So note that you can have a scenario where you authorize a transaction under DGCL 141(b) <u>but you do NOT cleanse</u> the conflict of interest inherent in that transaction b/c enough disinterested board members did not vote yes. Then, in that case you D have to argue the transaction was fair (see above).

• Disinterested directors are those that have **no direct or indirect financial interest in that transaction** (if that company you are a director of enters into a K w/ another company where you are a director, you are considered an interested director).

• Note the bylaws of a corporation can require a higher number of directors to constitute a quorum, but if bylaws don't mention it then default is just more than 50%.

(b) Ratification By Shareholders DGCL §144(a)(2): A **fully informed** (full disclosure) vote by the **majority of <u>disinterested</u> shareholders** ratifying (approving) a transaction with a conflict of interest does NOT automatically cleanse the conflict, it just means the **burden is on the P** & under the **BJR**, P has to show the transaction was grossly negligent/wasteful & violated duty of loyalty

(i) Recall that if there is no ratification vote that happens at all by board or shareholders (or if not enough *disinterested* shareholders ratify it in the scenario here), then the **burden is on the D** (interested director) to show that the transaction was fair to the corporation (see above-Fairness).

(ii) If the fully informed majority of disinterested shareholders approves the transaction, BUT the transaction involved a **controlling shareholder**, then the **burden is still on the P but the standard is <u>entire fairness</u>**, not the BJR. That means P has to argue the transaction was unfair to the corporation & that is easier for a P to do rather than argue it was grossly negligent & violated the BJR. So court is just more cautious & not as deferential when a controlling shareholder is involved.

• ***Bayer* (transaction fair to corporation):** Company does radio ad campaign w/ CEO's wife & gets sued **(1)Issue 1Breach of Loyalty**: P says they hired her only to advance her career & b/c they were scared of CEO. Court holds no breach of loyalty, directors acted lawfully b/c transaction was fair to corporation. P met his burden to show there was a conflict of interest & it was not ratified/cleansed by vote of board or shareholders so Board has burden to prove it was a fair transaction to get off . Factors of fair transaction:

(a) arm's length-they hired an ad agency to handle the transaction so it was professionally done by experts. Her contract was on a standard form, her compensation was reasonable.
(b) valuable to corporation-the program worked to increase sales, there is no evidence that another singer would have done better, the cost was not unreasonably high.
(c) interested director's role in trnsxn-there is no evidence that husband pushed for radio ads.

(2) Issue 2 Breach of Care: P claims they spent too much money on stupid radio ad & never did this type of advertising before. Court holds no breach of duty of care b/c under BJR this was a valid business decision board can make, they had to spend money on new ads to try & target rich people

• **Bayer Based Ratification Example**

5 directors: Dreyfus (married to singer Tennyson), Alice, Bob, Charlie & Ed. Only Dreyfus, Alice, & Ed show up. Alice & Ed vote in favor of K w/Tennyson. Dreyfus abstains b/c he's married to her. **Quorum?**

  - Yes there is a quorum b/c 3 of 5 are present. Fact that Dreyfus is interested doesnt matter for quorum, he still counts. Quorum is what you need to start the meeting.
- Has there been valid authorization/approval of the K with Ms. Tennyson?
  - Yes b/c all you need is a vote of the majority of total directors present in the meeting (of the 3 people that come, 2 vote for it so that is a majority).
- Has the conflict been cleansed?
  - No. There are 4 disinterested members on the board generally &you only have a vote from 2 of them, so conflict has not been cleansed b/c 2 is not a majority. So a shareholder can try to attack the K in court by saying there was no cleansing by disinterested board.
- All 5 directors present in person or by phone. Dreyfus, Alice, Bob, & Ed vote for transaction. Charlie abstains. Has transaction been approved?
  - Yes there is a quorum b/c all 5 board members are present. 4 voted for it, and 4 is a majority so the K has been duly approved.
- Has conflict been cleansed?
  - Yes b/c Alice Bob & Ed are 3 of the 4 disinterested directors & all 3 voted for it.

• ***Wheelabrator:*** Waste Management buys 22% of WTI (wheelabrator) stock & puts 4 of its people on their board. Later a merger agreement was negotiated where Waste would acquire 33% more of WTI stock (making them a 55% shareholder & giving them control of the company). Conflict of interest (director conflict) here is that people from Waste Management took part in the vote. P has 3 complaints:
(1) Proxy Disclosure was Inadequate: Company put the merger to a vote of shareholders & gave them proxy statement w/ all the info. P says it was missing info b/c it said board has carefully thought about this, when in reality board only met for 3 hours.

-Court said 3 hours by itself is not enough to create inference that it was wrong, must look at what they did in 3 hours & what they did here was good.

(2)Directors Violated Duty of Care: Board was grossly negligent in entering this agreement b/c they didn't pay attention to it & flaked off.

-Court says b/c majority of disinterested shareholders approved the merger, there is no violation. **If the proxy statements have full disclosure & majority of disinterested shareholders approve it, then any duty of care claim is extinguished** (even if they goofed off in meeting & wrote in the proxy statement that they did absolutely nothing).

(3) Directors Violated Duty of Loyalty: No breach of duty of loyalty. b/c majority of disinterested shareholders approved it See ratification by shareholders section above.

• **Bayer Based Example: *Shareholder* Ratification**

- Directors: Dreyfus, Alice, Bob, Charlie & Ed. 1 million outstanding shares; each director owns 5K shares. Board decides to put issue to shareholder vote
- Vote: 506,000 yes
  494,000 no
  - All five directors voted their shares "yes"
- Has shareholder ratification cleansed conflict?
  - YES, take away Dreyfuse's 5000 shares (b/c he is interested shareholder), his shares don't count for the cleaning vote. For ratification you need a majority of disinterested shareholders: you only have 995,000 disinterested shares & to get a majority you need 497,592 yes votes. You have (506,000-5000) = 501,000 disinterested yes votes, so you have more than you need and you're good.

• **Hypo:** DreamTeam, Inc. is a studio owned in equal parts by Mouse, Duck & Flintstone.The 3 also make up the board. DTI has signed a contract w/ director Stone for a movie. In the movie, Stone will star Flintstone. For directing, Stone will receive $25M. For playing the villain, Flintstone will get $5M.
Question 1: Stone contract was approved by a 2–1 vote among directors, with Mouse objecting. Mouse now brings a derivative suit to enjoin the contract.

- Agreement btwn DTI & Stone. The K was duly authorized b/c there was a quorum (3 went) and of those present, 2 of 3 (which is more than 50%) voted in favor. There is no conflict of interest b/c Stone is not a member of the board of DTI & he is not a shareholder (if the K btwn Stone & DTI said I stone agree to direct only if Flinstone is an actor then that would be a conflict of interest). Since there is no conflict of interest, Mouse had to try to argue there was a duty of care violation and the board was grossly negligent in approving this transaction.

Question 2: Flintstone contract was approved by a 2–1 vote among the directors, w/ Mouse objecting. Mouse similarly sues to enjoin the contract.

- The contract was duly approved by the board here too (fact that Flinstone went to meeting & voted does not matter). Yes, there is a conflict of interest b/c Flinstone is a member of the board & this vote does not cleanse that conflict, b/c you need a vote of majority of disinterested directors, Mouse&Duck, & they voted 1-1 so no majority. So board would have to prove K was fair to corp.

Question 3: Stone will use the movie to push her fringe-left political philosophy. Mouse shares this philosophy; Duck does not, but does not care as long as the movie makes money; Flintstone objects to the philosophy. Can Flintstone block the use of a DTI movie for political ends?

- The key is that the movie makes money. If the movie loses money (and their only purpose is to push their ideology) then it would be a no no, that goes back to shareholder primacy b/c goal of the board is to maximize profits for shareholders. If the movie makes money he can't block it. If it was incredibly obvious that the movie would lose money, then the court might find them liable.

Question 4: Suppose Mouse had been absent when Flintstone contract was considered by board. The contract was approved by a vote of 2–0, both Duck and Flintstone voting in the affirmative. Mouse objects (a) that the action was invalid for lack of a quorum and (b) that the contract should be enjoined as unfair and unauthorized. What result?

- Mouse does not have a case b/c there was proper quorum. Fact that Flinstone is an interested director does not mean he won't count for quorum. And again the K was authorized by majority of directors present at the meeting.

Duty of Loyalty Analysis Flowchart

(1) First ask if there is a conflict of interest (COI).

➔**Plaintiff has the burden to show there is a COI.**

--If NO COI, then there is no duty of loyalty issue & the regular BJR applies to the transaction with the burden on the Plaintiff.

--If YES COI, then ask:

(2) Was the transaction approved/ratified by disinterested board members OR by shareholders?

(a) If YES, then ask was it approved by:

(i) Disinterested Board Members/Directors under 144(a)(1); **OR**

-In which case the standard is the BJR & burden is on the P.

(ii) Disinterested Shareholders under 144(a)(2)

-In which case the standard is the BJR & burden is on the P, **UNLESS** there's controlling shareholder, which means burden is still on P, but the standard is *fairness,* not BJR

(b) If NO (ratification), then ask:

(3) Was the transaction fair to the corporation?

➔Now ***burden shifts to D*** to show it's fair.

-If NO (fair), then the transaction is voidable.

-If YES, then *Bayer* says it's good enough & acceptable b/c it's protected by the business judgement rule.

Corporate Opportunities (similar to agency & partnerships)

- Next duty of loyalty issue is Corporate Opportunities. Corporate Opportunity doctrine says a **director or fiduciary of the corporation cannot appropriate the business prospects that the firm is itself capable of & interested in pursuing.**

I. Overview of COD Analysis

(1) Determine if something is a corporate opportunity

--If it is not, then the fiduciary (i.e. officer or director) can take the opportunity.

--If it is a corporate opportunity, then he has to disclose to the corporation that it exists & that he's interested in taking it. Usually done through a formal letter. After disclosure corporation can choose to take it or not.

(2) Is the opportunity rejected by the corporation after disclosure?

--If not rejected, then constructive trust.

--If yes rejected, then ask was it properly rejected under either

(a) Rejection by disinterested directors under 144(a)(1); or

(b) Rejected by disinterested shareholders under 144(a)(2)

--If yes, properly rejected under either one, then the fiduciary can take the opportunity.

(3) If a director or officer takes the opportunity without disclosure to the corporation, then the corporation gets to disgorge the opportunity.

II. What is a Corporate Opportunity?

4 possible approaches: Interest/Expectancy; Line of Business; Source of opportunity; Delaware

(1) Interest or Expectancy Test:

- Interest: Any project over which the corporation has an existing legal right is a corporate opportunity.
- Expectancy: Expectancy is a little broader & says that any project which is likely to happen given the corporations current rights (while not already secured through contract) is a corporate opportunity (i.e. corporation that has a lease and expects it to be renewed).
- References <u>current</u> activities of the corporation: usually this relationship is already in existence between the corporation & other party (or they are in the process of getting some deal which they don't have yet).

(2) Line of Business Test

- Corporate opportunity if it is an activity about which the corporation has knowledge, practical experience & ability to pursue; and is adaptable to the corporations business & meets the corporations needs/plans to expand.
- Given its assets, knowledge, expertise, & talents, firm could reasonably be expected to adapt itself to pursue that opportunity now or in the reasonable future.
- Sweeps in <u>prospective</u> areas of growth.

(3) Source of the Opportunity Approach

- Focuses on how the director or executive became aware of the opportunity. If he learned about it during the course of his performance of duties for the corporation then we're likely to see it as a corporate opportunity.
- In connection w/ performance of functions, under circumstances that should reasonably lead him to believe that person offering opportunity expects it to be offered to the corporation.

(4) Delaware Corporate Opportunity Definition (Delaware Factors) *Broz*

- Corporation is financially able to take the opportunity
- Opportunity is in corporation's line of business
- Corporation has an interest or expectancy
- Embracing the opportunity would create conflict between director's self-interest & corporation

III. Common Defenses

(1) People argue as a defense that the opportunity came from a source that was attracted to agent's personal skill, reputation & expertise, and not those of the corporation. (*Singer*)

(2) Or people argue the corporation was unable to pursue the opportunity itself b/c of.

- Legal constraints
- Financial constraints
- Day to Day Business constraints (e.g., right personnel)
- Refusals by 3rd party deal with corporation

IV. Corporate Rejection of the Opportunity

If after full disclosure the firm rejects an opportunity, the fiduciary can exploit it. How can corporation reject an opportunity:

(1) Via board/shareholder ratification vote. **DGCL 144.**
(2) Informal approval may be okay (*Broz*).
(3) In the case of a senior executive, approval by a disinterested superior may be okay (if CEO tells you to take it, you can do that).
(4) Implied refusal (some courts): If you disclose & company doesn't respond to you, that is an implied refusal & you can take it.
(5) Contracting Out of Corporate Opportunity Doctrine DGCL §122(17):
Corporations can contract out of the COD, meaning the corporation can say in its articles or bylaws that they are going to reject any opportunity that comes in the future (so if a director faces a corporate opportunity he should be free to take it).

Does Lack of Formal Board Approval Matter?

- Formal board approval or lack thereof for a corporate opportunity is not required, it just **creates a safe harbor** if you do it. Otherwise informal is okay.
- Meeting individually/informally with board members
  - Does not count as formal
  - But is evidence of good faith

- ***Broz:*** Broz wears 2 hats: he has his own company RFBC & is also director on board of CIS. Same line of business, cell phones. Mak is selling license for Michigan 2 & Broz learns about it b/c broker approaches him w/ the offer, in his capacity as RFBC owner, not as CIS board member. Broker did not contact CIS b/c CIS is financially unstable & selling off its own licenses. Broz buys license after consulting CIS directors (board, general counsel, CEO) who said they

were not interested. CIS sues Broz b/c in meantime CIS was acquired by PriCell & PriCell wanted this license. Delaware factors for Corporate Opportunity:
(1) CIS Corporation was not financially able to take it, it was close to insolvency.
(2) It is in their same line of business.
(3) Didn't have interest or expectancy b/c they were not actively pursuing this M2 license
(4) In taking opportunity Broz was acting in good faith b/c he violated no duty to the company, he fully disclosed everything. Court says it's okay that he did not formally approach the board b/c he consulted so many of them individually. Plus he became aware of the opportunity through his ownership of his own company, not through his position on the CIS board. So this was never a corporate opportunity in the first place.

• **Hypo:** George: Marketing VP for Zapco, a manufacturer of video game software for *arcades, nintendos*. One of George's duties is to test competitor models. Testing games at an arcade George meets 2 computer software engineers who have developed a *voice recognition program for personal computers*. The two engineers set up a new corporation & hire George as marketing consultant (shares, commission). Zapco sues George for violating the COD.

- Assuming Zapco is in Delaware, has George violated the corporate opportunity doctrine?
  - Can argue that the two types of software are different things, they are separate enough. Can also say he met them at a public arcade, but then again he was doing his job there. Its important to know if Zapco was looking to integrate this kind of technology into its video games or not.

- What if the engineers had approached George at Zapco's booth at a computer trade fair?
  - He was in the course of Zapco business & people thought they were approaching Zapco, not him personally.

- Would it be relevant to the outcome that the two engineers refused to work with Zapco, because they refused to work with a mere game company?
  - It would show that Zapco was not able to pursue the opportunity at all, so it would cut against being a corporate opportunity b/c they refuse to deal w/ zapco.

- After meeting with the engineers, but before signing the contract w/ Wordco, George approached Zapco's CEO and told him about this project. CEO said Zapco had no interest in the project & no objection to George working for Wordco as long as it didnt interfere w/ his Zapco duties. Result?
  - This would cut against Zapco and it shows good faith on George's his part.

- Suppose transaction was a corporate opportunity. In good faith, he takes it for himself. He then mentions to the firm's lawyer that he is working on this project on the side. The lawyer sees that this is a corporate opportunity, which should have been offered to the company. Based on the lawyer's advice, George tells the board about the opportunity, offers it to the corporation, & asks board to ratify his taking the opportunity. Board does so. Is George insulated from liability?
  - Yes, as long as he fully informed the board about all of the material facts in dealing with the opportunity, then he is insulated from liability. Also, note that he took the opportunity in good faith. Even if he had taken it in bad faith, if the board ratifies it later he is still insulated from liability.

(D) Duty of Good Faith (to Monitor/Oversight)

- In *Francis*, court said board has a minimal duty to be informed about what is going on in the corporation, as part of the duty of care.

- In *Caremark,* court further said board has a duty to put a system in place (to monitor) to channel information to the board, board can't bury its head in the sand & has to make effort to get information (must use a law compliance program w/ policy manual, training of employees, compliance audits, sanctions for violation + provisions for self-reporting of violations). This was also part of the duty of care. But problem is that corporations can exculpate directors from violations of duty of care under **DGCL 02(b)(7).** So how can court enforce legal compliance programs? Two ways:

(i) Create a new duty (the duty of good faith); or

(ii) Move the duty of oversight from belonging under duty of care to duty of loyalty b/c you can't exculpate duty of loyalty. Court adopts this approach

Rule: Directors have a duty to implement a law compliance system. They will be liable if:

(1) They fail to install any kind of reporting or control system; or

(2) They install the system but do not pay attention to it (consciously fail to oversee or monitor it).

- In either case, imposition of liability requires a showing that the **directors knew they were not discharging their fiduciary obligations**. Its more than negligence & is like recklessness (they were reckless in not installing or not monitoring).
- The fact that they don't install one or don't monitor **shows bad faith** & acting in bad faith violates the duty of loyalty (don't say it violates duty of good faith b/c there is no such thing). Can't exculpate from duty of loyalty, like you can for duty of care violations.
    - **Duty of loyalty is not limited to cases involving a conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.**

- ***Stone v. Ritter:*** Bank is sued by government for failure to file suspicious activity reports. Plaintiffs sue bank board/directors for not having system in place that monitored employee filing of these SARs. Bank had 102(b)(7) provision in its charter. First court confirms *Caremark,* directors do have a duty to implement a law compliance system, so you will be liable if you fail to install one or if you install one then don't pay attention to it. But P has to show directors knew they were not discharging their fiduciary obligations. Court says bank is not liable, they had a system in place to train employees & people monitored it.

Caremark Reconceptualized

- Stone has shifted the focus in a Caremark inquiry from board information to board intent.
    - Not installing *Caremark* monitoring shows bad faith
- Redefines *Caremark* claims from duty of care to loyalty.
    - acting in bad faith is to breach the duty of loyalty
- This removes Caremark claims from §102(b)(7) so corporations cannot insulate directors.

IV. Mergers & Acquisitions (when one company buys another)

- This lecture on M&A came before *Van Gorkem* b/c case was about M&A. I took this info out of that section b/c it was too confusing in the context of duties.

I. Why do companies do M&A?

- Market expansion: companies are worth more together than each one separately.
- Vertical integration + Empire Building: instead of buying supplies you just acquire your supplier & that saves you money.
- Diversification of cash flows: some businesses do well & others don't so you want to diversify to make sure you don't tank if one of your businesses tanks.
- Using overpriced stock: if you know that your stock is overvalued & is going to go down in the future, you can acquire another company using your stock as cash, so you use your overvalued stock before it comes crashing down.

II. How Mergers Happen (Being Green Inc & Muppet Labs Inc merger hypo)

BG wants to acquire ML. First BG has to create a subsidiary that is going to do the acquisition, so it creates KerFoz Inc. Then they talk to the board of ML to bargain & enter into a merger agreement. Once the merger agreement is approved by the ML board, the ML shareholders get to vote on it. Merger agreement can have two types of compensation for the shareholders of ML:

(1) Stock (shareholders of ML get shares of BG stock); or

(2) Cash (instead of getting shares of BG, shareholders of ML get cash & are bought out).

III. How do companies pay for mergers?

- **Tender Offer:** A tender offer is an offer to buy shares of stock from shareholders, who are invited to tender their shares to the offeror for purchase at a specified price within some specified period of time. Often the completion of the transaction is made contingent on the offeror receiving some specified number of shares, sufficient, for example, to give it control of the target corporation.

- How do you finance a tender offer (i.e., how do you convince a bank to give you this much cash to buy the shares in another company if you don't have cash on hand)?
    - Leverage (mostly debt and a little cash): This means you secure the loan using the assets of the company you are trying to buy. So you are using the assets of something you don't own yet (i.e., borrowing using the target companies assets, which is what a leveraged buy out is). **Leveraged Buy Out's (LBO's)**
        - Acquisition of all the target's outstanding shares
        - Using borrowed funds
        - Secured by the assets of the acquired company
        - Usually shifts target's capital structure toward debt (i.e., more leverage)
        - People do leveraged transactions b/c it helps finance the purchase itself & also has greater risk. Greater risk creates more return & more discipline.

- **Why More Debt:** An LBO just means buying anything using bank financing (it does not necessarily have to be two companies merging together, it can just be one person going in & buying something). Since LBO's are secured by the assets of the company being acquired, if the target at first did not have that much debt (leverage in this context means you have a lot of debt), after the buyout they do b/c now they have their old debt & their new debt acquired in the process of the buyout, therefore the equity of the company has been reduced greatly. When the company has so little equity, the value to the shareholder is zero. Leveraged bought company must be disciplined b/c it can be wiped out easily (if you screw up & have a lot of debt & no equity, can easily get thrown into bankruptcy).

- **Management Buy Out (MBO):** An MBO is an LBO in which the purchaser is the company's own management. Instead of the purchaser being an outsider, it is actually a member of the management. So the manager borrows money against the firms assets & decides to buy the company for himself.

IV. How Leverage Affects Returns Hypothetical

House is for sale for $150,000 & you expect it to have a resale value in one year of $180,000. What is the rate of return if you purchase it with $150K in cash & resell it in one year at $180K?

    - Calculate the return by looking at the profit you make. 180K-150K = $30,000. You invested $150K. So 30K divided by 150K (30/150) gives a 20% return.
- What is the rate of return if you finance the transaction as follows:
    - Put 10% down-payment of $15,000 from your own money.
    - Borrow $135,000 at 10% interest.
    - If in a year you sell the house for $180,000. What is the rate of return?
        - First you pay back the bank
        - (10% of $135K (which is 13,500) +$135K =$148,500 to bank.
        - Next, do $180,000-$148,500 = $31,500 left over.
          Invested $15K of your own money, so do $31,500-$15,000 = $16,500 which is your pure profit.
          Rate of return is 16,500/15,000 =110%
          This is the same thing as a leveraged buy out (just using the example of buying a house instead of a business).
- But if you buy it for $150K then the value of the house goes down, you're cooked.

V. Why do companies pay a control premium? (or why pay $55 for a stock trading at $38?)

- Stock consists of two rights: Economic and Voting
    - A single share of stock gives the owner little control over the company
    - Market price of that share of stock reflects just the estimated present value of future stream of dividends
    - Someone buying a controlling block of stock gets the ability to elect the entire board of directors. Purchaser can change corporate management & policies to make firm more valuable.

V. Protection of Creditors

(A) What is the Tension About?

- **Interests of Shareholder vs. Interests of Creditors**
  - Shareholders only care about firm profitability.
  - Creditors only care about firm solvency.
    Since shareholders control the firm, and this affects an asset the creditors own, creditors have their own agency problem.

- **Hypo 1: Shareholders vs. Creditors: Excessive Risk–Near Insolvency** **See PP7.**
  Creditor lends ML $50. ML now has $50 in assets & has to pay the $50 back to the creditor in a year. ML has two alternative investing opportunities:
    (1) Put the money in the bank & get 1% return (so get $1 at end of year = $51); or
    (2) Buy ACME for $50. In a year, there is a 50% chance ACME will be worth $0 and a 50% chance it will be worth $80.

    (i) Buying ACME on its own is a bad investment b/c it's very risky: Multiply 80 x 50% (1/2) = 40. Multiply 0 x 50% = 0. Then 40 + 0 = 40. So logically the best alternative is to put the money in the bank. But if the shareholders are running the company (and/or are close to bankruptcy), then they have more incentive to invest in ACME b/c if they don't invest in it they don't make a profit of off that $50 (b/c putting it in bank will only get them $1).
    (ii) But if ACME turns out to be good company then its worth $80 the next year, so shareholders can give $50 back to the bank & keep $30 for themselves as profit
    (iii) If ACME tanks, then ML shareholders don't get anything & the creditor does not get anything either. Therefore, ML shareholders have incentive to gamble the money b/c under the status quo they won't get anything anyway, so they have little risk. Its the creditor who loses if ACME tanks b/c its loan doesn't get paid.
      - **The closer a company is to bankruptcy the more they are likely to make risky investments to save themselves.**

- **Hypo 2: Decision Making in Good Times** **See PP8**
  ML has $100 in assets & has to pay $50 to a creditor in 1 year. 2 investing opportunities:
    (1) Put all the money ($100) in the bank.
    (2) Put $50 in the bank. Use $50 to acquire ACME.
      - 50% chance ACME will be worth $0 & 50% chance it will be worth $80 a year from now.
  - What alternative do bondholders prefer? What do shareholders prefer?
      - Shareholders prefer to put the money in the bank in this situation, when the company is doing well.

- **Hypo 3: Shareholders vs. Creditors-Excessive Dividends**
  ML has $50 in assets & has to pay $50 to a creditor in a year. Board of directors decides to declare dividend of $40, to be divided pro-rata among shareholders. As a result, shareholders end up w/ $40, creditors get only $10. So creditors worry about this type of situation.

(B) How Do We Resolve the Problem & Protect Creditors?

Shareholders & Creditors have these different conflicting interests. The board does not owe a general fiduciary duty to its creditors, so creditors must find other ways to protect themselves. There are 2 ways to protect creditors:

(1) Through Contract

(a) Monitoring Provisions

(i) Creditor gets observation/inspection rights (contractual).

(ii) Limiting the number of creditors the company can borrow from.

(b) Bonding: include protective covenants in loan agreement restricting company.

Types of Protective Covenants:

- **Negative covenant:** Things the company can't do:
  - Pay dividends beyond specified amount
  - Issue more senior debt
  - Issue new debt that is more than $X
  - Buy another company or sell certain assets
- **Positive covenant:** Things the company must do:
  - Use proceeds from sale of assets to pay down debt
  - Payoff debt in the event of a merger or spinoff
  - Maintain good condition of assets
  - Provide audited financial information

(2) Through Corporate Law

(a) Through Fiduciary Duties

(b) Capitalization Requirements

(c) Restrictions on Distributions

Through Fiduciary Duties

- There is no direct fiduciary duty owed by directors to creditors. But when corporation is **close to insolvency,** the board members are no longer only the agents of the shareholders, their duty shifts from protecting interest of shareholders to protecting the interest of the **corporate enterprise**.

- **Zone of Insolvency:** Board's duties shift when company enters insolvency. How do we define insolvency?

  (1) Equity Insolvency: company can't pay bills as they become due; **and/or**

  (2) Balance Sheet Insolvency: companies assets are less than its liabilities (Assets<Liabilities)

- ***Credit Lyonnais:*** PCC borrows money from bank to buy MGM (lbo). But it ends up being a bad deal & PCC is losing money. Bank gets worried PCC won't be able to pay them back. PCC signs corporate governance agreement w/ the bank where CEO of PCC agrees to step down & allow someone from the bank to step in & run it (to protect the assets & make sure enough is left to pay the loan). But old CEO didn't abide by the deal, he was still trying to make decisions, call board meetings & shuffle assets. Power struggle between him & bank. CEO argues that the people appointed by the bank to serve on the board breached their fiduciary duty to the companies shareholders b/c they need to run the company while keeping the interests & profits of shareholders in mind (and make the decision that will maximize profits for shareholders). Court says no & holds that the CEO violated the agreement but bank did not violate it. When corporation is close to insolvency, boards duty shifts from protecting interest of shareholders to protecting interest of the **<u>corporate enterprise</u>** (to make sure there is $ left in the corporation).

Through Capitalization Requirements

- **Legal Capital & Trust Fund Doctrine:** Another way to protect creditors is by using **capitalization requirements** which means telling the corporation that it has to keep a minimum level of assets inside the corporation (called **capital stock**). It's like a pledge or trust fund for payment of the debts contracted by the corporation.
    - Capital stock = Stated capital
        - Number of shares multiplied by par value. **Par Value** is the minimum price the corporation can sell one share at.

- **Erosion of Par Value:** But the idea of par value has eroded over the years b/c it's burdensome to corporations & many states don't even use it anymore. Instead we just use restrictions on distributions (see below) to protect creditors.
    - Par value became an arbitrary figure having no relation whatsoever to the price at which shares were issued or to their price on stock market. Just became symbolic.

Through Restrictions on Distributions

- Creditors are often concerned about distribution of corporate assets to shareholders b/c it leaves less money in firm to satisfy the creditors claims; therefore, we try to limit how much corporations can distribute. 2 ways a corporation distributes assets to shareholders:
    (i) Dividends to Shareholders
    (ii) Share Repurchase-buying shares on the open market (buying shares back from the shareholders).

- **Capital Impairment Surplus Test:** Statutes restrict what amount corporations can distribute to shareholders & often they say **distributions can only be made out of <u>surplus</u>**. If distribution exceeds surplus then it impairs the firm's capital & is voidable.

(I) What is a Balance Sheet? See PP 9

A balance sheet is a snapshot of a companies financial condition. On one side list all the assets company has & on other side list the total liabilities.

- **Current Assets:** assets that can be converted into cash in less than a year. They include cash, inventory & accounts receivable (money owed to company).
- **Long Term Assets:** land, property, equipment, intangibles like patents etc.
    - To be balanced, the total assets should equal liabilities plus shareholders equity.
        - **Assets = Liabilities + Shareholders' Equity**

(II) What is Surplus?

- **Surplus Defined DGCL §154:** Surplus is net assets minus stated capital.
  - **Surplus** = Net assets – Stated Capital
    - **Net assets** = Total assets – Total liabilities
      - Similar to shareholders equity
    - **Stated capital (paid in capital)** = par value of all issued shares

- Surplus can be broken down into two kinds:

  (1) Capital surplus (*aka* additional paid in capital): Amount paid for the stock in excess of its par value. If a share of stock has $5 par value & you the corporation sell it for $7 then $5 goes to the *stated capital* & the extra $2 is the *capital surplus*
  (2) Earned Surplus: Accumulated retained earnings/net profits (and losses) not paid to the shareholders. When the company has been making money & not distributing it to shareholders, that goes to shareholders equity as well. Some states only allow you to make distributions from earned surplus.

Example 1 -- Company issues 1,000 shares, $1 par value, at a price of $10 (see PP 10)
New company. Par value is $1/share. Company sold 1000 shares for $10/share, meaning they made $10K
- **Shareholders Equity:** Assets - Liabilities (10,000-0) = 10,000. At this point shareholders equity is $10,000 b/c the company has no liabilities.
- **Stated Capital:** Par value of all shares that were issued. (1000 x $1) = $1000
- **Capital Surplus** (aka additional paid in capital): Net assets-Stated capital ($10,000-$1000) = $9000

Example 2 -- Company borrows $10,000 from bank & buys a $15,000 machine (see PP 11)
Company already had $10,000 in cash. So now it has $5000 in cash left & machine worth 15000.
- **Shareholders equity** = Assets - Liabilities (20,000-10,000) = $10,000
- **Stated Capital** = same as Example 1 = $1000
- **Capital Surplus** = same as Example 1 = Net assets - Stated capital = $10,000 -$1000 = $9000
  - Net assets = ($20,000-$10,000) = $10,000

Example 3 -- Company sells machine for $20,000 (see PP 12)
Company sells machine for $20,000. Remember the company had $5000 in cash & the machine, so now it has $25,000 in total assets. Liabilities are the same b/c it still owes $10,000 to bank.
- **Shareholders Equity** = Total assets - Total Liabilities = (25,000-10,000) = $15,000
- **Stated Capital** = same as above = $1000
- **TOTAL Surplus =** Net Assets - Stated Capital = $15,000 - $1000 = $14,000
  - **<u>Earned</u> Surplus:** This is the gain that the company had from selling the machine. They bought it for $15,000 & sold it for $20,000, so they have an earned surplus of = $5000.
  - ~~Capital Surplus = Total surplus - Earned surplus = $14,000 - $5000 = $9000~~

Example 4 -- Company sells machine for $10,000 (instead of $20,000) (see PP 13)
Company had $5K in cash plus the machine. So total assets now $5000+$10,000 from the sale = $15,000
- **Shareholders equity** = Total assets - Total Liabilities = ($15,000-$10,000) = $5000
- **Stated Capital** = same as above = $1000
- **Capital Surplus** = Net assets - Stated capital = $5000-$1000 = $4000

NOTE: Not sure if they way I calculated it when earned surplus comes into play, like in example 3, is accurate, but this is the only way I can get it to make sense & the formula works for this too.
- **TOTAL Surplus =** Net Assets - Stated Capital = $5,000 - $1000 = $4,000
  - ~~Earned Surplus:No earned surplus here b/c company did not make money off sale= 0~~
  - **Capital Surplus** = ~~Total surplus - Earned surplus~~ = $4,000 - $0= $4000

(III) Dividends to Shareholders

- **Dividends DGCL §170(a):** Directors of corporations may declare & pay dividends on shares of its stock either:
  - **(1) Out of its surplus;** or
  - **(2) Nimble Dividends:** In case there is no surplus, you can declare a dividend to the extent that you made profits this year OR this year + last year.

- **Liability for Illegal Dividends DGCL §174(a):** If board issues a dividend that violates the rule, then the directors are liable to the corporation or to creditors. As a board member (director) you have to object on the record and vote against it, if you do that you are not going to be liable. But if you don't object then you will be liable.

- **Reevaluation Issue:** In calculating the surplus, the corporation is not tied to the values on the balance sheet b/c the balance sheet lists the historical price at which you purchased things for. You can use the **fair market value** of the items to calculate surplus. Example, if you purchased a building for $5000, and it's current FMV is $10,000, you can use the $10,000 number when you compute your total assets.
  - But board must be careful to use acceptable data & standards such that a reasonable business person will believe it will lead you to the true present value of an item (bring in experts to do it).

Example 1 -- What size dividend can company pay to its shareholders? PP14
Step 1: Calculate net assets (total assets - total liabilities) = 145K-105K = $40,000
Step 2: Stated capital is par value of shares sold (50,000 shares x .50 par value) = $25,000
Step 3: Surplus is net asset - state capital = $40,000 - $25,000= $15,000. Max dividend it can pay

Example 2 -- What size dividend can company pay? PP15
Step 1: Net assets are $330K-$225K= $105,000
Step 2: Stated capital (1000 x $100) = $100,000
Step 3: Surplus is net assets - stated capital = 105K-100K = $5000. Max dividend company can pay.

Example 3 -- Reevaluation Issue PP16
Step 1: Net assets are $33,000 - $38,000 = -$5000
Step 2: = $15,000 (given in problem)
Step 3: Surplus = Net assets - Stated capital = -$5000 - $15,000 = -$20,000. Since its a negative number, the company cannot declare a dividend here. But, if they reevaluate the price of one of their assets to its current FMV, that changes their total assets & may allow dividend. In Example 4 below, the price of their building is calculated using it's FMV (so building goes from $9K to $30K & raises their total asset value).

Example 4 -- Reevaluation Issue PP17
Step 1: Net Assets $54K-$38K = $16K
Step 2: Stated Capital (given) = $15K
Step 3: Surplus is $16K-$15K = $1000. So now they can pay $1000 in dividends.

Example 5 -- Year 1 PP18
Net assets: = $120,000 - $110,000 = $10,000
Stated Capital = $25,000
Surplus: Net assets - stated capital (10,000-25,000) = $-15,000. Since its a negative the company can't pay dividends out of assets in this case.

Example 6 -- Year 2 Nimble Dividend PP19

Lets say in the next year, the company makes a profit of $10,000. In this case, the surplus is still negative after you do all the calculations below, BUT you can issue a dividend here out of the net profits (net profits = $10,000), this is the nimble dividend.

Net assets: (130,000-110,000) = $20,000
Stated Capital = $25,000
Surplus: Net assets - stated capital (20,000-25,000) = -$5000

Example 7 -- Year 2 With reevaluation of Building Price PP20

In balance sheet items are listed at their historical price but we can use FMV for calculation. So if building was purchased for $5000 & it's FMV today is $30,000, then use $30,000. On the balance sheet the figure remains $5K, but in doing surplus calculation use $30K estimate.

Net assets: $155,000 [b/c building is worth $30,000 not $5000] - $110,000 = $45,000
Stated Capital = $25,000
Surplus: Net assets - stated capital = $45K-$25K = $20,000.

(IV) Share Repurchases

- **Repurchases DGCL § 160(a):** Every corporation may repurchase its own shares unless the capital of the corporation is impaired OR such a repurchase would cause any impairment in the capital of the corporation.
    - Impairment of capital means the company will have negative surplus after making the repurchase.

- Reevaluation & Director Liability for Illegal Distributions apply in the same way to share repurchases (as they did to dividends above).

- **Status of Repurchased stock**
    -Unissued shares are the ones not issued by the company yet.
    -Issued shares are those that have been issued by the company.
    -Outstanding shares are those that are issued and owned by the public.
    -Treasury Shares: When the company buys some of those shares from the stockholders then we call them treasury shares.

- ***Klang v. Smith F&D:*** CEO Smith held 62% of shares in SFD & wants to sell to Yucaipa. Enter into merger agreement where SFD would give Youcaipa 3 million newly issued shares of SFD stock. SFD would do a recapitalization where it would acquire lots of new debt & offer to repurchase 50% of its outstanding shares from shareholders for $36 per share. P shareholder sues saying the stock repurchase impaired SFD's capital & board violated fiduciary duties by failing to disclose material facts before obtaining stockholder approval. P's issue is that the company did not have enough surplus to declare this distribution b/c after the repurchase the balance sheet shows negative shareholder's equity (asset - liabilities) = a negative number (meaning no surplus). Court says no, D brought in experts to reevaluate it's assets at their FMV to reassess the surplus calculation & under that it was okay. When reevaluating assets the board must, in good faith, be careful to use acceptable data & standards which reasonably reflect present value.

VI. Balance Sheets & Loans (not very important)

- This lecture on balance sheets/loans came after *Francis* b/c case was about loans. I took it out of that section b/c it was too confusing in the context of duties & put it here.

- When a director wants money from the company, he can do one of two things:
    (1) Pay himself a salary or (2) Take a loan.

Hypothetical: Salary v. Loan **SEE PP 21-24**

Assets
Cash = $40
Accounts receivable = $100
Land = $200 — Total assets = $340

Liabilities
Accounts payable = $50
Notes payable = $150 — Total Liability = $200

Shareholders' Equity
Capital = $100
Surplus = $40 — Total Shareholder's Equity: (asset - liability) (340-200) = $140
Total liabilities & shareholder's equity (200+140) = $340

- If you take $20 from the company as salary, you take that out of the cash assets & that makes both the assets & shareholders equity go down. So shareholders equity goes down.

- If you take $20 out as a loan, that decreases the cash but it increases the accounts receivable (by $20) b/c company is still owed that money under the loan. So under this, the **total assets remain the same & shareholders equity also remains the same**, so it is less noticeable than just taking the money out as salary. So if you're bleeding corporation dry like *Francis* boys, you'll do it like this so it won't show up on the financial statement.

V. Shareholder Lawsuits

- When the corporation is harmed by a third party, the shareholder is going to suffer a harm as well b/c the value of his shares goes down, but that is an indirect harm. The direct harm is to the corporation itself & the corporation is the one that has to sue.
    - Decision to sue is another business decision the board has to make.

- Two Types of suits shareholders can attempt: Direct & Derivative.

(A) Direct Actions

- Direct Actions are those that the shareholder can bring directly (alleging a direct loss to shareholder). These causes of action belong to the shareholder in his individual capacity & he brings the suit in his own name.
    - Example: If shareholder has been directly injured by someone.

- **Bases for direct claims** (things that the shareholder is already legally entitled to):
    (1) Force payment of declared dividend
    (2) Compel inspection of corporations books & records
    (3) Securities fraud (if someone in the company lies & you buy or sell stock b/c of that lie & lose money yourself)
    (4) Protect voting rights

(B) Derivative Actions

- A derivative suit happens when the shareholder goes to court & says I want to compel the corporation to bring a lawsuit against someone (it's a suit in equity against corporation to compel it to sue a third party).
    - A suit alleging a loss to the shareholder caused by a loss to the corporation.
    - Brought by a shareholder on corporation's behalf
    - Cause of action belongs to corporation since it arises out of an injury done to the corporate entity.

- **Bases for derivative suits:**
    - **(1)** Breach of duty of care
    - **(2)** Breach of duty of loyalty
    - **(3)** Waste of corporate assets

- **Is a Claim Derivative or Direct-**Must first figure this out. It's a 2 prong test:
    - **(1)** Who suffered the alleged harm?
    - **(2)** Who would receive the benefit of any recovery or other remedy?

- **Examples**

(1) ML entered into endorsement K w/ Ricky Martin. Ricky breached the K, but ML has not sued him for that breach. May a shareholder of ML sue Ricky directly?

> **ANS**: No, his K was with the corporation so it would be a derivative claim.

(2) ML's treasurer embezzles all of corporation's money & absconds. Shareholders' stock is now worthless. May a shareholder of ML sue treasurer directly?

> **ANS**: No shareholder can't bring the action directly, it must be derivative. The action belongs to the corporation b/c the assets were stolen from the corporation.

(3) Board of ML agrees to sell 80% of its assets to an unaffiliated purchaser. Although a vote is required by state law for the sale of "substantially all" assets, no shareholder vote is scheduled. Board disputes P's claim that the sale amounts to a disposition of substantially all of ML's assets.

> **ANS:** Shareholder can bring this directly b/c it violates his right as a shareholder. The action taken by the board is infringing on a right that already belongs to the shareholder, the right to vote in this type of transaction.

- **Three Hurdles to Jump Over In Order to Bring a Derivative Action**
    - **(1) Plaintiff Qualification [Del. Court Rule 23.1]**
    - **(2) Demand Requirement** *(Grimes v. Donald)*
    - **(3) Special Litigation Committees** *(Zapata)*

(1) Plaintiff Qualifications

(a) Plaintiff must have been a **shareholder at the time of the alleged wrong & maintained that status** throughout the litigation (must keep your shareholder status throughout the litigation); **AND**

(b) Plaintiff must fairly and adequately represent the interests of the shareholders.

- Directors have no standing in Delaware to bring a derivative claim.

(2) Demand Requirement

- Shareholders must first approach the board & **demand that the board pursue the legal action UNLESS it's futile**, in which case demand is excused. Demand is usually:
  - **(i)** In the form of a letter from the shareholder to the board. It must be sufficiently specific enough to apprise board of nature of the cause of action & its merits (identify wrongdoers, describe factual basis & harm caused, etc).

- **When is demand excused (meaning when is it futile)?** To excuse demand, Plaintiff has to allege particular facts using the "tools at hand" to create a reasonable doubt that if he did make a demand to the board, the **board would not be capable of making an independent decision** about whether or not to pursue the claim. The way to do this is to:
  - **(i)** show that the **majority of board (or a director) is not independent** for purposes of responding to the demand. Director/Board is not independent if:
    - **(1)** He has material interest in challenged transaction; **OR**
    - **(2)** Is controlled/dominated by the wrongdoer (the person that has the material or financial interest); **OR**
    - **(3)** Challenge the transaction by saying it was not a valid exercise of business judgment (was grossly negligent, etc.) so BJR shouldn't apply.
      - But a director may be independent even if he:
        - Approved the challenged transaction;
        - Was named as a defendant in the derivative action;
        - Was nominated by the alleged wrongdoer.

  - **(ii)** Tools at hand means the shareholder can use public sources, media, corporate books & records & government filings (can't use discovery, only tools at hand).

- **Effect of Making Demand:** Once a P makes a demand on the board, **he can no longer come back afterward & argue that demand was excused** so he should be able to bring the suit himself. **By making a demand, the P is conceding that a demand was required** & if the board decides not to pursue the action, the P can no longer challenge the board's independence.
  - • **Takeaway:** As a plaintiff, **don't make a demand to the board first.** Just file your lawsuit & tell court you are not going to make a demand b/c it is excused (futile). If you lose on futility question, then you make your demand to the board.

- **Was Board's Refusal of Your Demand Wrongful?**: The <u>business judgement rule</u> applies here & the P has to argue **particularized allegations** to the court as to why the court should not defer to the Board's business judgement in refusing his demand (P has to show that rejecting the demand was not the product of a valid business judgment).
  - --If court determines the board's refusal was wrongful, P can bring the suit.
  - --If court determines the board's refusal was NOT wrongful, P can't bring the suit

- ***Grimes v. Donald:*** Board has employment agreement w/ CEO Donald where he gets a very nice termination package if fired w/o cause. He can also declare a constructive termination w/o cause if he thinks Board is unreasonably interfering w/ him. P shareholder sues claiming board breached its fiduciary duty b/c package was too excessive & board was abdicating it's duties b/c Board would be afraid to disagree w/ him for fear h'ed leave & take all this w/ him:

(1) Abdication Claim: This is a direct claim b/c shareholders have the right to elect the board of directors (& board makes all final management decisions). On the merits, court says it was ok b/c board can still force its will on him, it will just be more expensive to do

(2) Excessive Compensation Claim: This is a derivative claim b/c the harm, paying too much for too little, was suffered by the corporation not by the shareholders.

-For this claim, P made a demand to the board, and a demand was required, but the board refused his demand. Now P is trying to argue that demand is excused here so he should be able to bring the suit himself.Court says once you make a demand to the board you cant come afterward & say demand was excused (b/c you are conceding that demand was required in the first place).

-Court says board's refusal of his demand was not wrongful under BJR so P can't bring the suit.

• **Hypo:** Agricorp owns & operates many large farms. It has 5 directors, including Adams, who is Chairman of the Board & CEO. Adams learns of an opportunity to purchase a large farm in Indiana.
Q1: Adams & two of the other directors decide to buy the Indiana farm for themselves. Assume that this constitutes self-dealing in violation of duty of loyalty. A shareholder wants to sue. Direct or derivative?

ANS: Derivative b/c the harm is to the corporation. Duty of loyalty has been violated (specifically corporate opportunity) & that ran to the corporation.

Q2: Assuming the lawsuit is derivative in nature, is demand required or excused under Delaware law?

ANS: It's excused if they can show demand is futile. You argue it is futile b/c the 3 directors took a corporate opportunity away for themselves & those 3 directors constitute a majority of the board, so a majority of the board is interested & can't be independent in reviewing this demand b/c they are the wrongdoers.

Q3: Suppose only Adams is going to buy the land. She discloses the opportunity to the other directors. The other directors vote to have the corporation reject the opportunity&approve Adams personal purchase of the land. A derivative suit is to be brought. Is demand required or excused under Delaware law?

ANS: A majority of the board is no longer explicitly interested in the transaction; so the only way to argue that demand is futile is to say that the process by which board rejected the opportunity was grossly negligent so the BJR will not apply to this transaction. Or you can say the other board members were controlled by Adams so they were not really independent.

(3) Special Litigation Committee (SLC)

- Some corporations may create an SLC, which is an independent committee of disinterested directors, to evaluate the claims in the demand & determine if the corporation should pursue or dismiss the cause of action. The interested/tainted directors can appoint this committee. How much deference should courts give to SLC's recommendation to dismiss the demand? Two approaches:

(1) Other States Approach- Court defers to the SLC's decision under the BJR as long as the committee was independent & the investigation was adequate (done in good faith).

➔Burden is on the plaintiff to try & argue that the SLC's decision violates the BJR.

(2) Delaware Approach- Court reexamines the substance of the SLC's decision. It is a 2 step inquiry (step 1 is like the other state approach, it's step 2 that's extra):

Step 1: First inquire into:

--Composition of committee: was it really independent & did they do it in good faith?

--Bases supporting their recommendation: how did they reach this decision (experts, document review, etc)?

➔Burden is on corporation to prove independence, good faith & a reasonable investigation.

Step 2: If the SLC survives the first step, then the court can go on & apply its own business judgment to review the substance of the recommendation (court can use its own judgement to agree or disagree).

- ***Zapata***: Maldonado is stockholder of Zapata & initiates derivative action for breach of fiduciary duty. He does not make a demand on Board first b/c demand would be futile since all directors were named as defendants & participated in the bad acts. So board creates an independent SLC composed of 2 new disinterested directors who were not yet hired when the bad acts happened. SLC recommends the suit should be dropped.

Derivative Litigation Flowchart

(1) Is it a Direct or Derivative Claim?

-If Direct, P shareholder can bring it himself.

-If Derivative, then ask:

(2) Is demand excused (futile)?

-If YES excused, P can bring suit himself.

-If NOT excused, P must make a demand on the board first to bring the suit.

***But note, in reality, P should never first make a demand before filing suit b/c by doing that he concedes that demand was required, so he should just file it & try to argue demand is excused to the court. If court says demand was not excused here, then P can go to the board and make his demand. He ends up in the same place anyway.

***Also note, this is where a tainted board can appoint an SLC to review the demand so that the board can have control over the litigation & uphold that demand is required & not excused.

(3) Did the Board Refuse P's demand?

--If NO, then that means the Board will file the suit that the P wants them to file.

--If YES, then ask:

(4) Was Board's refusal of the demand wrongful?

-If YES, then P can bring the suit.

-If NO, then P can not bring the suit.

****Standard:** Reasonable doubt as to whether BJR applied to the board's decision to refuse the demand.

- **See ML Shareholder Suit Problems Handout (#3).**

VI. Fiduciary Duties of Shareholders

The general rule is that **shareholders acting as shareholders owe one another no fiduciary duty.** Two Exceptions to this rule:

(A) Controlling shareholders-controlling shareholders owe fiduciary duties to minority

(i) Siphoning Assets (*Sinclair)*-stealing from minority shareholders by forcing corporations to enter into contracts that are good for controlling shareholders.

(ii) Freeze-out/Squeeze-out Mergers: When majority can force out the minority.

(B) Close Corporations- in a close corporation shareholders may owe each other duties.

(A) Controlling Shareholders

- Controlling shareholders have lots of control over the corporation so they can exert their influence & make corporation do things that benefit them at the expense of other minority shareholders.

- Examples of some contexts in which this might come up include:
  - Wholly Owned Subsidiary: when parent owns 100% of the subsidiary.
  - Majority Controlled Subsidiary: when the parent owns more than 50 % of the stock in another corporation. In this scenario, the parent always wins. It is impossible for a third party to gain control of the corporation.
  - Minority Controlled Subsidiary: where the parent owns less than 50% of the stock in the subsidiary but they still control the subsidiary corporation. The question is whether the parent has control here or not.

- If a controlling shareholder dominates or controls a corporation then he owes a fiduciary duty to the minority shareholders & the duty applies when the controlling shareholder receives a benefit at the minority shareholders' expense. See Flowchart for steps.

Fiduciary Duties of Controlling Shareholders Flowchart--How To Do It

(1) Does the shareholder <u>control or dominate</u> the corporation?

--If NO (shareholder doesn't dominate), then there is no problem & no fiduciary duty attaches to that shareholder.

--If YES, then that controlling shareholder owes a fiduciary duty to the minority shareholders. To see if this duty is activated, ask:

(2) Did the controlling shareholder <u>receive a benefit to the exclusion and at the expense of</u> the minority?

--If NO, then the standard is the **BJR** & burden is on the **<u>P</u>** (like usual).

--If YES, then that means there is a conflict of interest & a duty of loyalty issue (like an interested transaction), and the standard changes to **intrinsic fairness** (no longer BJR) and the burden is now on the **<u>defendant</u>.**

(i) BUT, if the transaction (that gave the controlling shareholder the benefit), was approved by an *informed majority of the minority shareholders*, then the **burden shifts** to the **<u>plaintiff</u>,** but the standard is still intrinsic fairness.

- Note: Issuing a regular dividend does not give a controlling shareholder a benefit to the exclusion of the minority b/c dividends go out to everyone. But if controlling shareholder owns majority of preferred stock & causes only a dividend for preferred stock then he is getting a benefit to the exclusion of the minority b/c minority shareholder get no dividend

- ***Sinclair Oil:*** Sinclair Oil (SO) is a controlling shareholder in Sinven (a Venezuelan subsidiary of Sinclair Oil) b/c SO owns majority of Sinven's shares & entire board of Sinven was nominated by SO. Minority shareholders of Sinven bring derivative action against SO claiming:
  (1) Excessive Dividends: SO caused Sinven to issue large but legal dividends but minority wanted to reinvest that money instead (SO was just bleeding Sinven dry).
    - Did SO receive a benefit to the exclusion & at the expense of other Sinven shareholders?
      -No b/c the dividends go out to everyone.
    - What is the standard or review? Who has burden of proof?
      -BJR & burden is on the plaintiff.

  (2) Corporate Opportunity & Expansion: Opportunities to drill in Alaska could have been taken by Sinven but SO didn't give it to them. Court says no, under the Delaware corporate opportunity test, these were not corporate opportunities that belonged to Sinven b/c Sinven only worked in Venezuela. Therefore, SO did not get a benefit at the expense of minority shareholders.
    - Standard is BJR & burden on plaintiff.

  (3) Breach of Contract: Sinclair International, another subsidiary, breached a K w/ Sinven & SO did not allow Sinven to sue Sinclair International for breach of K.
    - Court says this is unfair dealing b/c SO got a benefit to the exclusion of the Sinven shareholders.
    - It triggers the entire fairness standard & burden shifts to the D (SO) to prove that their decision to prevent Sinven from suing was fair to Sinven.
      - If SO's decision (to not allow Sinven to sue for breach of K) had been approved by a majority of disinterested shareholders (a "majority of the minority"), then that would shift the burden to the plaintiff Sinven (standard is still fairness).

• **Hypo:** XYZ Corp is an oil company mainly doing business in Texas. XYZ owns 90% of the common stock of ABC Corp, a subsidiary oil company w/ operations in Louisiana. XYZ also owns 100% of ABC's preferred stock. ABC's board of directors, taking their orders from XYZ, cause ABC to pay dividends only on the preferred stock. What is the standard?

•This is self dealing b/c the preferred stock only got dividends, not the minority. So the majority is getting a benefit that the minority is not getting, so the burden shifts to the board of ABC and they have to show that this preferred stock dividend was fair.

• **Hypo:** XYZ Corp is an oil company mainly doing business in Texas. XYZ owns 90% of the common stock of ABC, a subsidiary oil company w/ operations in Louisiana. XYZ is presented w/ opportunity to develop oil field in Alaska. XYZ causes liquidation of ABC & uses its share of proceeds to develop Alaska project.

• In the liquidation, everyone gets their share of the money, so xyz is not getting something to the benefit of the minority. And as for the corporate opportunity it doesn't belong to ABC b/c they are in louisiana, not alaska. XYZ is off the hook here.

• **Freeze Out/Squeeze Out Mergers (Not on exam):** This is when the majority proposes a merger between the majority & minority & minority members receive some type of cash pay out. It's called a merger b/c they are forcing the minority out & concern is that the majority sets the price & that might be unfair to the minority. **JUST ANALYZE THIS USING THE REGULAR SINCLAIR RULE.**

(B) Close Corporations

- Close corporations are run by a small group of people & conflicts in the group can lead to deadlock or oppression of minority b/c there is no ready market to dispose of shares.

  Locked in: close corporations often restrict share transfers
  - Even if no formal restrictions, there is no secondary market, so can't get out if there is a deadlock in decision-making.

  Frozen out: minority may have no control over corporations activities or decisions & may be denied compensation if denied employment, so they can be easily oppressed.

- **Oppression Example:** Kermit, Fozzie &Gonzo are the founders & sole shareholders of KFG, Inc. The 3 are the only members of board & hold the titles of President, VP & Secretary. KFG pays no dividend, but they get salaries. Kermit & Fozzie have a fight w/Gonzo. They decide to remove him from the board, remove him from office, take out his salary & continue to pay no dividend. Assuming each owns 1/3 of the shares, can they legally get rid of Gonzo off the board?

  ANS: Yes, They can vote him out b/c they are a majority.

  Q2: How can they make sure Gonzo is no longer an officer of the corporation?

  ANS: They can fire him (the board can fire him). But if this were a partnership they could not get rid of him that easily b/c partners owe each other fiduciary duties & have equal rights in management. In partnership, Gonzo could go to court & have the partnership dissolved, but shareholders can't do that in a corporation.

- **How to Protect Minority from Oppression in Close Corporations?**

  (1) Liberal Dissolution Statutes

  (a) Some states allow for judicial dissolution where the corporation petitions the court to issue a dissolution.

  (b) Delaware does not allow judicial dissolution of corporations. The only way to dissolve a corporation (close or large) in Delaware is through the 2 normal methods that apply to dissolution of all types of corporations.

  (1) Voluntary (DGCL §275): Board approves a resolution that corporation should be dissolved, there is meeting of shareholders, they approve it, & certificate of dissolution is filed; or

  (2) If all **shareholders agree unanimously,** then don't need board approval.

  (2) Imposition of Expansive Fiduciary Duties in Close Corporations

  Another way to protect minority shareholders in close corporations is to expand their fiduciary duties. Usually, shareholders in a corporation don't owe each other fiduciary duties, but in **close corporations**, court says **shareholders are like partners in a partnership** & owe each other a duty of good faith (legitimate business purpose test/Wilkes test).

  Wilkes Test- shareholders in a close corporation owe each other a duty of good faith. If a minority shareholder alleges a breach in court then the:

  (1) Controlling shareholder must show a **<u>legitimate business objective</u>** for the action that the minority complains of;

(2) If that objective is demonstrated by the majority, then the minority must show that the controlling group could have accomplished its objective in a <u>manner that was less harmful to the minority's interests</u>

(3) If the minority can show that alternative, then the court gets to <u>balance</u> the legitimate business purpose against the practicability of the proposed alternative & decide what is best.

- ***Wilkes v. Springside Nursing Home*****:** Wilkes, Riche, Quinn & Pipkin set up close corporation (Springside) to run a nursing home business. They pay salaries but not dividends. Wilkes relationship w/ the rest goes bad & the other 3 convene a board meeting & vote to kick him off the board & cut his salary. They offer to buy him out at low price & he has no alternatives b/c nobody else is going to buy his shares. So he sues for breach of fiduciary duty & wins. Court says there was no legitimate business purpose for firing Wilkes, they only fired him b/c of personal animosity. Court doesn't even go to the second step b/c D fails test on prong 1.

What Would Be a Legitimate Business Purpose?
Suppose Wilkes had been negligent in failing to perform his duties (no due care). Suppose the board found another person to perform his duties at a lower salary. After due deliberation, board fired Wilkes and hired the other person.

- Here, the majority can argue their legitimate business purpose was to get a more efficient officer & to reduce expenses.
- Wilkes can come back and argue the rest of them are all getting the same salary still. So it is unclear if the boards action is okay here.

Alternatives Theories
--These are all alternative theories that you have to argue on an exam.

- Could Wilke sue Riche, Quinn & Connor for breach of their fiduciary duties as *directors*?
    - You would have to show they breached their duties & acted in a way that was harmful to the *corporation*. Wilkes could say they harmed the corporation by approving salaries for themselves that are too high, and that is a conflict of interest & brings up a duty of loyalty issue. BUT this might have to be derivative action b/c it belongs to the corporation, however here demand would be excused b/c ¾ directors are involved.

- Could Wilkes sue his oppressors using the rationale in *Sinclair Oil*?
    - Wilkes would have to first prove that they are controlling shareholders, so he would have to sue all 3 together & say they are acting in unison & are the equivalent of a controlling shareholder. Next, he would have to show they are getting some benefit to the detriment of the minority, namely the high salaries to themselves.

- What if the nursing home had been a partnership?
    - Couldn't get rid of him if it was a partnership.

Recap-Delaware Approach for Fiduciary Duties of Shareholders to each other:
Do not say shareholders owe each other fiduciary duties in Delaware b/c there are no fiduciary duties among shareholders in Delaware.

- Rejects special close corporation fiduciary duties.
- All they have is the **Sinclair standard,** where controlling shareholders owe a fiduciary duty to the minority in certain circumstances. Delaware does it this way b/c they want people to contract around it beforehand.

VII. Role of Shareholders in Management

(A) Control & Governance in Close Corporations

There are 2 methods to form a contractual agreement to manage a close corporation:

(1) Voting Trust- shareholders give their shares to a trust & trust becomes the record owner of the shares and votes in the way the trustee tells it to; or

(2) Shareholder Agreements [DGCL §218(c)]**:** Two types

(a) Relating to Election of the Board of Directors-these are agreements where shareholders promise to do certain acts as shareholders (wearing shareholder hat)

(b) Relating to Limitations on Board's Discretion-agreements where shareholders promise to do certain acts as directors (wearing director hat).

• Sometimes these agreements will be held invalid as **violating public policy** b/c directors cannot bind themselves to act in any specific way. -Directors must exercise independent business judgment on behalf of **all** shareholders. **McQuade Rule** says you can bind yourself when you're wearing your shareholder hat, but you can't bind yourself when you are wearing your director hat. When you are a shareholder you can bind yourself as to what you do as a shareholder, but you can't bind yourself as to what you do as a board member. So as a shareholder you can agree to elect each other as directors.

Exception to McQuade Rule: If all shareholders are directors (i.e., if there are no other shareholders) then the McQuade rule does not apply & you can do whatever you want & bind yourself however you want b/c nobody else will be harmed. McQuade rule is there to protect shareholders that are not a party to the agreement.

• ***McQuade:*** Stoneham was the president & had 1306 shares. McGraw had 70 shares & was VP. McQuad had 70 shares & was treasurer. They enter into a **shareholder agreement** where they promise to (1) vote for each other as members of board & (2) make sure the others were officers &(3) get paid specific salary. But Stoneham controls the board & has power to elect directors b/c he is the majority shareholder. Board voted to kick off McQuad& he sued claiming they violated the agreement. Is agreement valid (provision)?

(1) Elect each other as directors—Valid b/c they are acting as shareholders here. They can agree as shareholders to vote in favor of someone as a director.
(2) Appoint each other to specified officer positions—Invalid b/c they are no longer acting as shareholders, they are acting as directors. Directors have a duty to run the corporation on behalf of all the shareholders, so this provisions goes against public policy. You can't commit yourself to take actions against the interest of shareholders when you are a director.

(3) Paid specified salaries—Invalid b/c the board decides salaries of the officers & shareholders cannot agree to vote in a certain way as directors. So you can't commit yourself to act in any way as a director (&appointing officers & determining their salaries are decisions made by the board).

Hypo: Suppose you were advising them at time of incorporation. They want to make sure that they can remain officers of the corporation. What would you advise them to do to get around the *McQuade* rule?

- Put a provision in the articles of incorporation or bylaws that says officers can only be removed by **unanimous vote of the board**.
- **This protects you b/c your shareholder agreement puts you on the board, and since officers can only be removed by unanimous vote of board, that gives you veto power on the boards action. Just make sure the bylaws can't be amended without your consent.**

• ***Clark v. Dodge:*** Clark (brains guy) owned 25% of stock & Dodge (money guy) owned 75% of stock in their medicine making company. They enter into a shareholder agreement w/ certain provisions & issue is whether the agreement is valid. Dodge argues that under the McQuade rule it is not valid. Specifically, looking at the details of the agreement, Clark discloses his secret formula to Dodges's son. Then Dodge votes, **as shareholder & director,** to assure that:

(1) C would be a director—Valid b/c shareholders can agree to vote for anybody as director.
(2) C would be General Manager as long as his performance was faithful, efficient & competent—Under McQuade this would not be valid b/c this is something the board is in charge of (Dodge is making this promise while wearing his director hat).
(3) C receives 25% of profits (salary/dividends)—Same as above, this is a decision to be made by the board. Invalid under McQuade.
(4) No other employee is paid too much—Same as above, this is a decision to be made by the board. So these last three would be unenforceable under McQuade.

--But Court says the agreement is okay & McQuade Rule does NOT apply for two reasons:

(1) No one is being harmed. There are no minority shareholders that are not part of the agreement so no one is being harmed.

- So this is the **EXCEPTION to the McQuade Rule**: If all shareholders agree, then the McQuade rule does not apply b/c that rule is there to protect shareholders that are not a party to the agreement.

(2) Second reason is that some of the promises were consistent with what directors would do anyway. For example, the promise to keep him on as an officer if he is competent.

VIII. Shareholder Voting

(A) Who Is Entitled To Vote?

- **DGCL §213(a):** Owner of a share on **record date** is entitled to notice & vote**.**
  - Record date can't be earlier than 60 days before the meeting, no later than 10 days. MUST be a shareholder on the record date in order to be able to vote.
  - **DGCL §212(a):** Generally, each share is entitled to one vote **(1 share = 1 vote)** unless certificate of incorporation specifies otherwise.

(B) When Do Shareholders Vote?

- Annual Shareholder meetings: **DGCL §211(b)**
  - Elect directors, routine matters, consider shareholder proposals
- Special Shareholder meetings: **DGCL §211(d)**
  - By request of the board, or someone entitled under articles/bylaws
  - Mergers, major asset sales

(C) How Do Shareholders Participate?

- Shareholders may appear and vote **either in person or by proxy** **DGCL §212(b)**
  - Shareholder appoints a proxy (agent) to vote his/her shares at the meeting
  - Appointment effected by means of a proxy (card)

(D) How Do Shareholders Vote?

(a) Quorum Requirement: In order for shareholders to take action, there must be a quorum at the meeting.

- A quorum is the presence of the majority of shares entitled to vote. **DGCL§216(1)**
- But certificate of incorporation or bylaws can reduce that number as long as it does not go below 1/3.
- Quorum requirements can be a problem for largely held companies b/c it's hard to get all those people out there for the meeting. We solve the problem by allowing shareholders to appear by proxy (tell someone else to vote for you).

(b) Required Vote **DGCL §216(2)**: Most matters require a majority of shares present at the meeting (or represented by proxy) at which there is a quorum. BUT some actions have different voting requirements, for example:

(1) Electing Directors (§216(3)): Requires plurality of shares present

(2) Bylaw Amendments (§109(a)) & Precatory Shareholder Resolutions: Requires Majority of shares present.

(3) Ratifying Conflict Transactions (§144(a)(2)): Requires majority of disinterested shares present.

(4) Mergers & Sale of all or substantially all of assets & Amending Certificate of Incorporation: Requires Majority of shares entitled to vote (i.e., outstanding).

(E) What Do Shareholders Vote On?

Shareholders get to vote on the following 4 types of things:

(1) Election of Directors

- In general, directors are elected at annual meeting. It requires a **plurality of votes cast**, meaning if there is one open seat & 3 people are running then the top vote getter wins even if he didn't get 50% of the votes. **DGCL§216(3).**

- **Three types of voting systems**

  (1) Default Voting System-Each share gets one vote. For example, a corporation has 10 shares. Kermit owns 6 & Fozzie owns 3. There are 3 seats available on the board so each voting member has to vote for 3 people per ballot (6 people are running for the positions, including Kermit & Fozzie). So Kermit votes for 3 people and he gets to submit his ballot 6 times b/c he owns 6 shares. Fozzie gets to submit his ballot 4 times b/c he has 4 shares. If Kermit votes the same way on all 6 ballots he will win b/c he has more shares. Under this system Fozzie loses out b/c he has less shares so he gets no people on the board.

(2) Cumulative Voting **DGCL §214**-In this system you **multiply the number of shares you own by the number of positions open on the board,** and then you can allocate those to any candidate you want.

- Corporations may adopt cumulative voting in certificate or bylaws.
- Shareholders may split their votes on any number of candidates; or use all votes on a single candidate.
- The candidates with the most number of votes are elected.
- **Example:** There are 3 open seats. Kermit has 6 shares (6x3=18) so he gets 18 voting dollars & he can allocate them however he wants. Under this system, Fozzie can get someone on the board if he gives all of his votes to one candidate.
- Cumulative system protects minorities b/c it gives them some votes that actually count.

(3) Classified or Staggered Boards **DGCL §141(d)**- Here you only elect part of the board each year, you don't re-elect every board member position each year.

- This is what the Tesla board looked like. People do it so that it becomes harder for other companies to take them over.

- **Which Directors Can You Vote For?**

(1) Incumbents-They are the members that are already on the board. To get elected again, they must nominate themselves (or company uses a nominating committee) & the corporation sends out a proxy card w/ their names on it for shareholders to fill out and vote.

- The corporation does not have to include on this proxy statement the names of the other people (who are not on the board) that will be running for board positions. But the bylaws of some corporations may contain proxy access provisions which do allow the shareholders to nominate candidates for the board on the board's proxy card (i.e., allow you to put these new potential candidates on their proxy statements). **DGCL §112.**
- This proxy statement is done using corporate funds so the incumbent directors are not paying for it out of their own pocket, they get reimbursed whether they win or lose.

(2) Insurgents- These are the shareholders who are not on the board but want to run for board positions in opposition to the existing board. Insurgents can be either a group of shareholders who just want to vote no one some proposal or they can be electoral contests where a competing slate of directors runs agains the group of incumbent directors.

- Insurgents must pay out of their own pocket to send out their proxy solicitations & materials to the shareholders (insurgent himself pays for printing, mailing, etc). If he wins he can ask board to pass a resolution reimbursing him for proxy costs, but if he loses he probably won't get paid reimbursement b/c the board is not going to approve it (see Froessel Rule).

- **Froessel Rule**: Reimbursement of costs incurred during proxy fight by:
  (a) Incumbent management-Management can use corporate funds for expenses in proxy fight as long as
    (1) the amount is reasonable &
    (2) proxy fight deals with a policy question (easy to show).
  (b) Insurgents-Insurgents can use corporate funds to reimburse themselves for proxy fight costs **IF the shareholders approve it.** But problem is that the board has to pass a resolution saying lets reimburse the insurgents, so for an insurgent to get his cost reimbursed he has to win b/c if he loses the board he has been smearing through this election is not going to vote to reimburse him.

- ***Rosenfeld*****:** There is a battle between the incumbent board and the insurgents who want to take over the board. The insurgents win the battle and take control of the board. After the insurgents win, they reimburse themselves for the cost of their proxy fight (after stockholders approved it); and they reimburse the old board too. Court says it's okay, they are allowed to do this.

- **AOL Example:** Starboard owned 5% of AOL & sent letter to AOL board about being unhappy w/ companies performance. Talks began between the two but Starboard got frustrated & sent a letter saying we have found 5 people that have agreed to run for the AOL board and if we don't reach an agreement we are going to try to get these new people elected. AOL got scared & did what they wanted. So the mere threat by a someone who owns only 5% is enough to scare them & make them listen b/c that 5% owner can convince other shareholders to vote their way too.

(2) Fundamental Corporate Changes

There are 3 fundamental decisions in a firm's life:

(1) mergers,
(2) sale of all or substantially all assets,
(3) dissolution

- These actions must be initiated by the board & then presented to shareholders for approval, usually at a special meeting.
- Approval requires majority of shares entitled to vote (i.e., outstanding shares).

(3) Amending Articles and/or Bylaws

(a) Modifying Certificate of Incorporation **DGCL §242(b)(1)**-The directors shall adopt a resolution and holders of a majority of the outstanding stock must vote in favor of the amendment.

(b) Modifying Bylaws **DGCL §109(a)**-The power to adopt, amend, or repeal bylaws shall be in the stockholders entitled to vote (plus, directors if provided in the certificate).

(4) Shareholder Proposals- This is when shareholders want the company to do something.

(I) Types of Proposals

(1) Social Proposals**-**Usually get rejected. Examples include human rights policy, nondiscrimination, energy & recycling issues, pesticides & toxic chemicals, etc.

(2) Governance Proposals-these are about how the company is run & they are more likely to get passed than social proposals. Examples include takeover defenses, CEO compensation, proposal to adopt cumulative voting, etc.

(II) The Rule

- **SEC 14a-8** is the rule that allows qualifying shareholders to put a proposal before their fellow shareholders for a vote. The proposal is included on the companies proxy statement so you do not have to pay for it yourself, the company bears the expense.

(III) What Can Companies Do With These Proposals (i.e. company response to proposals)

(1) Adopt the proposal as submitted; or

(2) Negotiate with the proponent to water down the result; or

(3) Include the proposal in their proxy statement AND include their own opposing statement encouraging shareholders not to vote for it; or

(4) Try to exclude the proposal on procedural or substantive grounds.

- They must have a **specific reason to exclude that is valid under Rule 14a-8**

(IV) Process For Excluding a Proposal

(1) First management must file a notice of intent to exclude with the SEC & send a copy to the shareholder.

(2) SEC reviews your notice & there can be 3 possible outcomes:

(a) SEC tells you yes you can exclude it (they issue you a “no action letter”).

(b) SEC tells you no you should include the proposal.

(c) SEC says the proposal is not includable right now but it can easily be cured (so the shareholder can revise it & try again)

(V) Eligibility Requirements the Proposal Must Meet

The proposal must meet the following requirements or else the company can exclude it:

(1) Shareholder must have owned at least 1% of company stock or $2,000 worth of company stock (whichever is less) for at least one year prior to submission of proposal. **Rule 14a-8(b)(1).**

(2) Proposal plus supporting statement cannot exceed 500 words. **Rule 14a-8(d)**

(3) Only one proposal per corporation per year per shareholder. **Rule 14a-8(c)**

(VI) Company Can Exclude the Proposal If It Is Any of the Following:

(1) Repeat Proposal Rule 14a-8(i)(12)-Proposal can be excluded if it or a substantially similar one was submitted:

- Once during the preceding 5 years & got less than 3% of the vote

- Twice in the preceding 5 years & got less than 6% of the vote the last time it was submitted
- Three times in the preceding 5 years & got less than 10% of the vote the last time it was submitted.

(2) Not A Proper Action for Shareholders to Initiate Under the Laws of the Companies State. **Rule 14a-8(i)(1).**

• Must look to state law.

• If shareholders are not allowed to initiate it they can still make the proposal if they use precatory language (i.e. say I think the board should consider merging w/ microsoft. But if you say "the board should merge w/ microsoft" that is not ok)

• ***CA Inc. v. AFSCME*****:** Shareholder wants to propose new bylaw to be voted on at next meeting which would make the corporation reimburse insurgent stockholders for expenses incurred in a proxy fight. Currently, the corporations bylaws do not contain any provisions about proxy expense reimbursement so the board gets to choose whether to reimburse or not. Board tries to exclude proposal on 2 grounds:

(i) This is not a proper subject for shareholder action.

--Both board & shareholders have the power to amend their bylaws under DGCL §109, but DGCL §141(a) says the board has, in general, the power to conduct & manage the business. So this will cause tension if the proposed shareholder amendment interferes w/ the board's prerogative to manage the corporation. Court resolves the tension by saying this proposed amendment is just procedural and the shareholders definitely have a strong interest in how directors are elected. Shareholders are not trying to tell the board what to do here, they are just saying this is how the board should be elected. So this is a proper subject for shareholder action under Delaware law.

(ii) If the proposal passes it may cause the company to violate state (Delaware) law if implemented.

--Yes it might cause the company to violate Delaware law, as it is currently drafted, b/c the proposal binds the board to reimburse these nominators as long as they meet certain criteria. Board gets no say on whether they should be reimbursed or not & that can end up forcing the board to violate delaware law b/c board may violate some of its fiduciary duties (where reimbursing these nominators hurts the company like if they are running only to steal company secrets). So P should amend the proposal to leave some discretion to the board (i.e., a fiduciary out where the board has to reimburse unless they think reimbursement would violate a fiduciary duty).

(3) Proposal is not relevant to firm's operations Rule 14a-8(i)(5)-If the proposal relates to operations which account for less than 5% of the company's total assets at the end of its most recent fiscal year, and for less than 5% of its net earnings & gross sales for its most recent fiscal year, and is **not otherwise significantly related to the company's business**, then company can exclude it.

- ***Lovenheim*:** Lovenheim is Iroquois shareholder & tries to submit a proposal about animal cruelty & the companies foie gras supplier. Company wants to exclude the proposal from proxy materials saying it is not relevant to the companies operations under Rule 14(a)8(i)(5). Foie was only a small part of their business (they were losing money on it) & made up less than 5% of company assets & less than 5% of sales. P says even though it makes up less then 5%, it is still significantly related to the companies business. Court agrees saying certain causes can be significantly related to the business (although not economic, it has ethical & social significance).
    - Note: P did not offer a proposal prohibiting the company from selling pâté b/c that would be excluded under Rule 14-a8(i)(1), not proper for the shareholder. Selling pate is the boards decision not the shareholders.

(4) Ordinary Business Rule 14a-8(i)(7)-If proposal deals w/ ordinary business decisions (fire someone, give people healthcare, etc) shareholders can't make it b/c shareholders don't manage ordinary business & we don't want them to micromanage.

(5) Relates to Electing Directors Rule14a-8(i)(8)-You can't have proposals that try to elect or disqualify or fire someone from the board OR try to affect the outcome of a board election. Also can't have proposals that question the competence or character of directors.

- But if the proposal is more procedural, like suggesting the company should institute cumulative voting instead of default system, that type of proposal is okay.

(6) Implementing proposal would violate the law.
(7) Implementing would violate proxy rules (proposal is false, misleading, vague).
(8) Proposal involves personal grievance or special personal interest.
(9) Company lacks power or authority to implement.
(10) Conflicts with company's proposal
(11) Proposal already substantially implemented
(12) Duplication with an included proposal
(13) Specific amount of dividends

FEDERAL SECURITIES ACTS (Insider Trading & Securities Fraud)

I. History of Federal Securities Acts.

- **1934 Securities Exchange Act (SEA)**: This deals w/ what corporations do on an ongoing basis regarding their secondary market (meaning what happens to securities after the company sells them to investors).
  - Focus on mandatory disclosures: 10Qs, 10Ks
  - Fraud prevention: Rule 10b-5 & Section 16

- There are 3 ways to become a company subject to the 1934 Securities Exchange Act:
  (1) If you sell shares in a registered public offering; or
  (2) Even if you don't make a registered offering, if you have (a) more than 500 shareholders AND (b) total assets exceeding $10 million, then you become a public company automatically and have to start filing disclosure documents with the SEC; or
  (3) If you list your stock on a national stock exchange like the NYSE.

- When a company becomes public, it becomes subject to a number of SEA requirements:
  - Section 13: Reporting Requirements
  - Section 14: Proxy \ Tender Offer Rules
  - Section 16: Short Swing Profit Rules

- **What Needs to be Disclosed**
  - Principal forms required for public issuers:
    - 8-K - reports certain material developments or extraordinary events
    - 10-K - annual report; 10-Q - quarterly report
  - Only need to disclose the items that are required in the form. No need to disclose <u>all</u> material information
    - But if you say something, don't lie about it.
  - Anti-fraud Liability: SEA Section 10, Rule 10b-5

- Fraud Can Happen in Two Scenarios
  (1) In the documents/disclosure forms that we mandate the company to file, the company may lie or make a mistake.
  (2) When a company just lies when communicating with investors.

- Companies commit fraud b/c they want to raise price of shares, insiders can benefit from this price increase by selling their stock or b/c they get bonuses if the stocks are at higher prices. People who stand to gain most from fraud are the insiders themselves
  - Society thinks fraud is bad b/c if people cant trust the markets then markets will disappear b/c people won't invest if they know only insiders have an advantage. We wan't people to have an advantage only if it's available to everyone, for example, by doing research on a company before investing.

- Section 10(b) of 1934 Exchange Act gives the SEC the power to create rules against fraud committed in the securities markets. Rule 10(b)5 is the anti-fraud rule.

II. Rule 10b-5

To bring an action under Rule 10b-5, you need all of the following things:

(1) Jurisdictional Nexus-"Instrumentalities of interstate commerce" **AND**

(2) Transactional Nexus-"In connection with the purchase or sale" **AND**

(3) Elements

- **(a)** Misrepresentation or Omission
- **(b)** Material Fact
- **(c)** Scienter
- **(d)** Reliance
- **(e)** Loss Causation
- **(f)** Damages

(1) Jurisdictional Nexus

"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**."

- This means that to make a federal crime out of it you need to get JD.
- Instrumentalities of interstate commerce is very broad, they only have to touch the transaction **at any point in time**. If I tell you I'm going to mail you a stock certificate that is enough, or if I give u a check that's enough b/c I'm using federal banking system
- Using the phone, the mail, email, wire transfer, a bank, or any national security exchange like the NYSE is enough for this.

(2) Transactional Nexus

"In connection with the purchase or sale of <u>**any**</u> security."

(i) To be a **plaintiff** in a Rule 10(b)(5) action you must be either:

(1) **Seller or purchaser of a security** (u must have bought or sold the stock); **OR**

- But if microsoft puts out a press release saying they are good & I'm a microsoft shareholder and was thinking about selling my stock before the press release and after the press release I decide not to sell it. Then it comes out that microsoft lied. I can't sue microsoft b/c I never bought or sold my stock even though I would have sold if they hadn't issued the press release.

(2) **the SEC**

(ii) Being a **defendant** in a Rule 10(b)(5) action is a little broader. The D can be any person (person can be a natural person or a legal business entity) **whose fraudulent activity is "in connection with" the purchase or sale of a security by plaintiff.**

- "In connection with" is very broadly defined & the defendant doesn't have to be a buyer or seller of securities.
- Example: If the CEO lies to analysts & people buy the stock based on those lies the buyer cannot sue who he bought the stock from, but he can sue the CEO even though he did not buy the stock from the CEO. Buyer can also sue the company under theory of respondeat superior b/c CEO is an agent of the company.

➔ Rule 10b-5 applies whether or not the security is registered or listed on an exchange (so it applies to small private companies that sell stock).
➔Rule 10b-5 applies to both issuer transactions (initial offerings) & secondary market transactions (i.e. stocks sold on stock exchanges).

(3) Elements

(a) Misrepresentation or Omission-This requires deception.

(1) Misrepresentation- This is a misrepresentation of a material fact.

(2) Omission- Omission is a failure to disclose material inside information when there is a preexisting **duty to disclose**.

(3*) Also includes tipping material inside information.

*****Note**: <u>Full disclosure</u> negates any deception (so if you disclose you are off the hook).

(b) Materiality- There has to be an important lie involved. An omitted fact is **material** if there is a **substantial likelihood that a *reasonable* shareholder would consider that fact important in deciding how to vote**. To determine whether something is material or not look to:

(1) The significance of the event. Look at the misstatement relative to the size of the company to determine if it is material (if your sales are $5 million & you say they're $6 million, that is a big lie. But if your sales are $250 million & you say they're $251 million that is not so bad).

(2) The probability of the event happening (example, how likely is it that a merger will happen).

(c) Scienter- This is about what state of mind you need for liability under Rule 10(b)(5).

•Negligence is not enough (need more).

•**Recklessness is enough** to meet the scienter requirement.

-Example: If CEO is on notice that something is wrong he has to check, he can't just say who cares b/c that is reckless.

• Intentional or willful conduct designed to deceive or defraud investors is enough.

(d) Reliance-P has to show that the misrepresentation caused him to enter into the transaction.

(1) If **affirmative misrepresentation** then:

(i) In **face to face transactions** investor must show <u>individual reliance</u> (establishing reliance is easy in face to face transactions b/c people bargain & exchange information).

(ii) In **open market transactions** (like buying stock through your fidelity account online) we <u>**presume reliance**</u>,meaning we **presume you have relied on any misrepresentations out there b/c those misrepresentations are already reflected in the market price.** This is called the "fraud on the market theory" & it says the stock price already reflects all publicly available material information so investors will rely on it when they transact in the stock at the market price, even if they are unaware of the false information.

- But it is a <u>**rebuttable**</u> **presumption** & D can try to rebut it b/y proving that the market price is not reflective of the information out there.

(2) If **omission with duty to disclose**, then:

- In BOTH face to face transactions & open market transactions, reliance is presumed.
- Remember that omissions are not actionable unless the person first owes a duty to you.

(e) Loss Causation-P has the burden of proving that defendant's alleged act or omission (fraud) caused the loss for which the P seeks to recover damages (P must establish link between D's misrepresentation & P's loss).

(i) For omission, P would say D's omission caused his loss b/c if P knew about that thing (that omission) he **never would have paid the high price** that he actually paid for it.

(ii) If the plaintiff sells before the misrepresentation is revealed, plaintiff is not harmed.

- Example 1: The drop in a stock's price is due to the misrepresentation that the plaintiff is complaining about in his allegations.
- Example 2: My company has land in TX & I tell you we can find oil there b/c we have 10 holes (in reality we had 6 but I exaggerated to 10) & you invest in my company. I start digging holes & in the meanwhile the price of oil tumbles b/c they find oil on the moon. The company finds no oil in those holes & you lose your investment. There is no loss causation here b/c the biggest hit to the company was b/c of the external factor (oil on moon), not b/c of your misrepresentation, so no causation.

(f) Damages-Two rules for damages:

(1) SEA §28(a) says no punitive damages for Rule 10(b)(5) actions.

(2) Recovery is usually for out of pocket damages (the difference between the transaction price & real price of the stock at the time of the transaction).

- ***Dupuy v. Dupuy:*** Brothers M & C form corporation to do hotel venture together. M got sick & had to sell his shares to C & claims C defrauded him during the sale by inducing him to sell his shares at much lower price than what they were really worth. They had convo over phone. C did both misrepresentation (lie) & omission. Lie was about status of project & omission was about one of their assets getting recently appraised for high price. Elements:
  (1) JD Nexus-met b/c talked over phone. Works even though both people were in the same state.
  (2) Transxn Nexus-met b/c they talked about the hotel & project, so he lied while selling the stock
  (3) Misrepresentation or Omission-yes, made both.
  (4) Materiality-they were material misrepresentations, it was important to this small corporation that one of its assets was highly valued.
  (5) Scienter-yes, he knew all these things.
  (6) Reliance-he thought his brother was telling him the truth.
  (7) Causation- he could have sold the stock for more money if he knew the truth.

- **See Securities Acts & General Review Questions (#4).**

III. Insider Trading & Rule 10b-5

- Insider Trading is buying or selling securities w/ inside information. Inside information is information about the firm that is not publicly available. But using non-public info is not always insider trading, for it to qualify as insider trading, the non-public info must be:

  (1) Material; **AND**

  (2) There must be a duty to disclose somewhere.

- **Overview: Types of Transactions That Are Illegal Insider Trading-**Federal securities prohibitions on insider trading based on Rule 10b-5:

    (1) Classical insider trading/core insiders (*TGS, Chiarella*)-A fiduciary trades in shares of his or her own firm, based on information gained as a fiduciary. For example, someone works at microsoft, they know microsoft is going to announce something good so they buy microsoft stock before the announcement is made.

    (2) Tipper & tippee liability (*Dirks)*-I work for microsoft & learn about something microsoft is going to do, so I tell my wife to go & buy microsoft stock before microsoft makes the official announcement.

    (3) Tender Offer Rule 14(e) (*O'Hagan*)**-**Trading on info about a tender offer.

    (4) Misappropriation Theory (*O'Hagan*)-A fiduciary trades using information that was misappropriated. For example, I work at microsoft & learn something about apple & I go buy/sell apple stock based on that information. That is not covered under the classical theory b/c I owe no duty to apple. So instead misappropriation theory covers it.

    (5) Section 16 Statutory Insider Trading (*Reliance*) (not based on 10(b)(5))

(1) Classical Insider Trading/Core Insiders

Classical insider trading is when a fiduciary (i.e. an officer or employee of the company) trades in shares of his own firm, based on information gained as a fiduciary.

- **Rule:** If insiders have material non-public information, they must either:

    (1) disclose the info to the public before trading; **OR**
    (2) abstain from trading.

        -But if you are an insider & your company says we are not going to disclose, you have to abstain from trading.

- But there is no general freestanding duty to disclose info to public if they are not trading on it, it is up to the business judgement of the board to decide when they want to reveal things to the public.

- Rationale for the rule has changed over time (see cases):
  (1) ***TG v. SEC:*** We expect all investors trading on impersonal exchanges in securities markets have **equal access to material information**. Anyone who has access to non public info may not take advantage of the info knowing it is unavailable to public.
  (2) ***Chiarella/Dirks***: To be liable, must owe a fiduciary duty to the corporation whose stock you are trading OR owe a duty to the people you are selling/buying stock from.

- ***TG v. SEC*****:** TG does exploratory drilling & hole looks promising. Company orders everyone to keep the info secret b/c they want to buy the land. Insiders start buying stock in TG b/c they knew once info about the drill comes out stock price will rise. Rumors spread & company issues press release on April 12 saying nothing big has been found. On April 16 they issue another statement saying tons of stuff had been found. SEC sues insiders for insider trading.
  (1) Info must be material for 10b-5 to apply. Was the first hole find info material?
  Materiality: Is there a substantial likelihood that a reasonable investor would consider the omitted fact important in deciding whether to buy or sell securities at a given price (what is the likelihood of finding stuff times the magnitude of the find)? Court holds knowledge of the first hole & the promise it showed was material b/c insiders thought it was **important enough to go buy the stock AND company bought the land.**
  (2) Assuming it is material, did company have duty to disclose when it dug first hole?
  No duty to disclose material info generally. Only have to disclose if SEC requires it OR if they want to trade based on that info. Management decides when they want to disclose info to public
  (3) Why was this company itself sued for violating Rule 10(b)(5)?
  Company itself did not buy or sell securities, but they were "acting in connection w/ the purchase or sale" by issuing a misleading press release. "In connection w/" is satisfied & makes the company a D if the press release would cause reasonable investors to rely on it & purchase or sell the company stock. This is a straight up fraud claim. Court holds the press release was not misleading b/c people took it to mean very different things so not liable.

- ***Chiarella:*** D works at printing press that prints pamphlets & sees on pamphlet that one company is going to do tender offer to buy another company. Once tender offer goes public, stock price of company to be taken over is going to go up. Knowing that D bought stock in target company. Is he liable for insider trading? Court holds no b/c he owed no duty to the target company (it doesn't matter that as an agent he owed duty of confidentiality to the company that is doing the takeover b/c he didn't trade in that company stock). Under Chiarella, for you to be liable for insider trading you need to owe a duty to the corporation whose stock you are trading OR owe a duty to the people you are selling/buying stock from.
  Duty to disclose/abstain after *Chiarella*
  - 10b-5 liability for insider trading premised on a duty to disclose arising from a relationship of trust & confidence between parties to the transaction:
    - No duty to disclose where the person who has traded on inside information was not the corporation's agent, was not a fiduciary, or was not a person in whom the sellers of the securities had placed their trust &confidence.
    - Today misappropriation theory would say he was liable b/c of the duty he owed to the company that was doing the takeover.

(2) Tipper & Tippee liability

When insider has access to inside info & tells someone else about it & they profit from it.

- **When is a tippee liable?**
  - A tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic info only when the **insider has breached his fiduciary duty to the shareholders** by disclosing the information to the tippee **AND the tippee knows or should know that there has been a breach** (i.e., under some circumstances, tippee may become an "insider" for disclose/abstain rule).

  When does tipper breach duty (for purposes of tippee liability)?
  - <u>**Tipper**</u> breaches a fiduciary duty **only if the purpose of the disclosure is to obtain, directly or indirectly, a personal benefit.** Merely giving tip not enough

- **Takeaway Rule**: For a tippee to be liable for insider trading you need:
(1) Breach by the fiduciary insider who is disclosing information (the tipper); **AND**
(2) Tippee knows or should have known the insider breached (meaning the tippee knew or should have known the tipper was getting some personal benefit by disclosing).
    - Must look at the motivation of the tipper in making the tip & if the tipper made the tip to gain some personal benefit then he breached his duty in making the tip. Then the tippee will inherit the duty to abstain or disclose.

- **2 Scenarios Where There is No Personal Benefit (i.e., no tippee liability)**
    (1) Helping fraud to come to light
    (2) Being careless is also not enough. Example: CEO is talking to someone in an elevator & reveals material non public info & some guy overhears it & trades based on it, that is not covered by this b/c CEO did not get any personal benefit.

- **Who is an Insider?**
    - Agents & fiduciaries
    - Tippees (even though they're not insiders, they can be subject to insider trading prohibitions)
    - Constructive Insiders: You don't have to be an officer, employee, or agent to be an insider for purposes of insider trading. *Dirks* also establishes a category of **constructive insiders** who can violate the classical insider trading prohibitions. When does someone become a constructive insider?
        - When they **(1)** obtain material nonpublic information from the issuer with **(2)** an expectation on the part of the corporation that the outsider will keep the disclosed information confidential and **(3)** the relationship at least implies such a duty.

- ***Dirks:*** Dirks finds out info about a insurance company from a former insider Secrist who tells him the company is doing fraud. Dirks investigates & tells people about it, people sell their stock in the company knowing it's going to tank soon. Company tanks & stock prices fall. SEC says Dirks violated rules by repeating fraud allegations to others. Court says no, he is not liable. Ex employee Secrist did owe a duty to the company b/c he was a former insider but Dirks owed no duty to the company & did not inherit Secrists' duty b/c Secrist did not breach his duties in disclosing the info to Dirks b/c Secrist's motivation was to expose the fraud, it was not for personal gain (personal gain can be very broad).

Some Variations
(1) Suppose Secrist sold EFA stock short in hopes that Dirks would get the truth out causing the stock price to tumble. Dirks is unaware of Secrist's short sales & could not reasonably find about them. Would Dirks be liable? Would Secrist?
- Dirks is not liable b/c he didn't know.
- **What is Short Selling Stocks?:** You know apple stock is going to go down in value, so you find an apple shareholder & ask to borrow his shares for 3 months. You sell his shares, and then later when the price goes down you buy them back at that lower price & give them to the shareholder.

(2) What if Dirks is aware of Secrist's short sales when receiving the tip from Secrist? Would Dirks be liable? How about the third party clients of Dirks who also trade?

--Yes Dirks would be liable if he knew Secrist's intentions b/c that means he has inherited the abstain or disclose duty that Secrist had. So now you analyze Dirks the same way you would analyze an insider. If Dirks tells his clients about this he is liable b/c he gets a personal benefit in getting a better reputation in the industry and any commissions.
--Clients would not be liable if they don't know about this, but if Dirks told them the truth about this string of breaches then they would be liable b/c they too would inherit Secrists original duty.

- **Rule 10b5-1(c) – Affirmative Defense-** Purchase or sale is not "on the basis of" material nonpublic info if the person making the purchase or sale demonstrates that before becoming aware of the information, the person had:
  - Entered into a binding contract to purchase or sell the security,
  - Instructed another person to purchase or sell the security for the instructing person's account, or
  - Adopted a written plan for trading securities.
    Example: You work for microsoft and were planning to sell your stock b/c you want to buy a house. But you learn material non public info before you sell it. If you had this plan to sell beforehand, you can go ahead and sell even if you have this material non-public info. But it has to be a rock solid plan that was in place & you couldn't change it. See below for requirements of plan.

  Rule 10b5-1(c)- The contract, instruction, or plan:
  - Specified the amount, price & date on which securities were to be purchased/sold;
  - Included a written formula for determining the amount, price & date; or
  - Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales.
  - Also, any other person who did exercise such influence must not have been aware of the material nonpublic information when doing so.

- **Summary So Far**
  - ***TGS*:** insiders possessing material non-public info must disclose or abstain.
  - ***Chiarella*:** no duty to disclose where person who trades on the information is not issuer's agent, fiduciary, or is not a person in whom the counterparty had placed trust/confidence.
  - ***Dirks*:** Tippees may inherit disclose/abstain duties from "insider" tippers.
  - ***Dirks*:** constructive or temporary insiders---you don't have to be an agent or fiduciary of the issuer, you can be a temporary insider (lawyer, accountant, printer, etc) and have the same duties that agents have toward the corporation.

(3) Tender Offers-Rule 14(e)

- Under *Dirks*, the guy in Chiarella is still not liable b/c he was a constructive insider of Company A but he traded the stock of company B & had no relationship with company. That is why this tender offer rule was passed, and under this Chiarella would be liable.

- **Rule 14e-3 Tender Offers**: If you have material non public info about a tender offer & that info originated from an insider then you cannot trade.
  - Illegal to trade in securities of a company that will be the target of a tender offer using information obtained, directly or indirectly, from (i.e., using material nonpublic info):
    - (1) The bidder
    - (2) The target
    - (3) Anyone connected to the bidder or the target
  - **No breach of fiduciary duty to anyone is required**
    - **Mere possession** of material, nonpublic information about a pending tender offer **is enough & leads to duty to disclose or abstain.**

- Problem w/ rule 14e3 is that it is limited to tender offers. If you short sell apple stock b/c you know it's going to go down after the company you work at, microsoft, announces something good, then under Dirks you are not liable for insider trading b/c you owe no duty to apple. And under 14e3 you are not liable either b/c its not a tender offer. So that was still a hole that was left. The misappropriation theory fills that hole.
  - • But if you short sell apple stock knowing all this, then you can be liable under **agency theory** to Microsoft. You are an agent of microsoft & microsoft is your principal. Principal gave you confidential info that you were supposed to keep secret (microsoft can sue you & get the profit you made from apple b/c you violated your fiduciary duty to your principal).

(4) Misappropriation Theory

A fiduciary trades using info that was misappropriated. Trader breaches fiduciary duty, not to shareholders of the company which securities he's trading, but to the **source of the information.**

- Using confidential information acquired during agency for agent's own benefit
- This is the "deception" needed for 10b-5.
- **"In Connection with" Prong:** The fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the info to purchase or sell securities.

• ***O'Hagan:*** O'Hagan was partner in law firm that represented GM in tender offer to buy Pillsbury. Tender offer was not public info & O'Hagan bought Pillsbury stock knowing price would go up once tender offer was made. He is not liable under classical theory b/c he owed no duty to Pillsbury. He is liable under 14e3 b/c he traded stock in the target company based on material non public info. SEC also argues misappropriation theory b/c it wants to add consistency to Rule 10-b5 (i.e., wants to say the breach of duty is not to the corporation of the security in which person is trading, breach is to the source of info)

(1) How is breach "connected to the purchase or sale":

-Breach occurs when he buys the stock in the target company & makes profit (the breach does not occur when you learn about the material non-public info).

- Trader breaches fiduciary duty, not to shareholders of the company which securities he is trading, but to the **source of the information.**
  - Using confidential information acquired during agency for agent's own benefit.
  - This is the "deception" needed for 10b-5.

(2) If the duty breach is to the source of information rather than trading counterpart, how is the fraud "in connection with" the purchase/sale of stock?

- The fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the info to purchase or sell securities. The securities transaction & the breach of duty thus coincide (i.e., the way misappropriator expects to make profits from the misappropriation is through a securities transaction).
- O'hagan owed duties to his client &when he bought the other target companies stock using material non public, confidential info, **he breached that duty that he owed to his client (the duty of every agent to keep confidential info & not profit from it).** The advantage that this guy had is b/c he stole the info from his principal, he didn't just do more research. But if O'hagan had disclosed this to GM (his client) & they said go ahead (which they never will) then he is **not liable** & there is no misappropriation theory.

Rationale for Rule

- Misappropriation theory consistent w/ Exchange Act's goal to "insure honest securities markets & promote investor confidence." The misappropriators advantage comes from deception & other investors can't overcome that w/ research or skill.

Rule 10b5-2 expands the trust relationships that can give rise to misappropriation of info:

- You can just be a friend or family member of someone, you don't have to be their lawyer or agent--you just can't trade on that information.
- All relationships of trust qualify, if the person trusts you & tells you, you need to shut up and not use it.
- Duty of trust/confidence arises (for purpose of misappropriation theory) in addition to others circumstances when:
  - Person agrees to maintain info in confidence
  - Persons have a history/practice of sharing confidences, such that the recipient reasonably should know that person communicating info expects him to maintain confidentiality; or
  - Info is obtained from a close family member, unless recipient shows that history/ practice indicates no expectation of confidentiality.

- **Sporkin Hypo:** Analysts would hang out in courtroom during securities trials & try to figure out how the judge would rule, this is not insider trading & is okay. But if your husband is the lawyer in the trial & you overhear him talking about it on the phone to his partner, you can't trade based on that info b/c that is the misappropriation theory, you have a trust relationship.

IV. Section 16(b) Statutory Insider Trading Liability (Short Swing Profits)

- Nobody was expecting Rule 10b-5 to be used for insider trading, originally it was §16(b) of the 1934 SEA that was supposed to cover insider trading.

- §16 is very narrow b/c it only applies to public companies & it only applies to equity securities (i.e. stocks). But Rule 10b5 applies to all issuers & securities, meaning it applies to bonds & applies to corporations with only 2 shareholders even.

Rule: Section 16(b) says that any profit realized by a:

(1) Beneficial owner (either a 10% or more owner in the company **OR** a director or officer of the company)
(2) Who made an **offsetting transaction** to buy/sell or sell/buy
(3) Within a **6 month** period
(4) And made a **profit** in those transactions,
then those profits go to the corporation (disgorged to corporation) & you can't keep them.

Recovery

- Any recovery (disgorgement) goes to company.
- Only the corporation itself (or a derivative suit brought by the corporations shareholders) can bring an action under Section 16, the SEC can't.

Offsetting Transaction-Sales & Purchases

- § 16(b) applies whether the sale follows the purchase or vice versa
    - If the trader sells 10 shares of stock and later buys back 10 shares of stock in the same company at a cheaper price, she is still liable.
    - **It is strict liability** (no scienter, no defenses).
- Sale & purchase must occur within 6 months.

Beneficial Owner

Insiders: §16 applies only to **(a)** officers, directors, or **(b)** shareholders w/ more than 10% stock

- Smaller group of insiders than under Rule 10b-5.
- No tippees, misappropriators, constructive insiders.

(a) Sales & purchases by directors, officers, etc.

- Sales & purchases by directors & officers are covered if they were a director/officer at time of <u>**either**</u> the purchase **or** the sale.
- If you are a director at the time of initial transaction but not a director at the time of the second transaction, happening within 6 months, then you ARE liable under this rule.
- But if you are not a director at the time of the initial transaction, but you are a director at the time of the second transaction (within a 6 month period), then you are NOT liable.

(b) Sales and purchases by 10% owners

- 16(b) excludes any transaction where such beneficial owner was not a beneficial owner **both** at the time of the purchase & sale, or the sale & purchase, of the security involved. Meaning, it excludes any transaction when the 10% owner was not a 10% owner at the time of the first transaction. So have to be a 10% owner at the time of both transactions.
    - Is the purchase that makes you a 10% percent owner subject to Section 16 (i.e., matchable)? = **NO**
    - Is the sale that brings you below 10% threshold subject to Section 16 (i.e., matchable)? = **YES**
        - If so, can you just sell down to 9.99% (subject to Section 16) and then sell the remaining 9.99% without being subject to Section 16? **= YES**

-**Must match the buys & sales** (if you buy 2 shares & sell 4, you are only responsible for the 2).

- ***Reliance Electric*****:** Emerson bought 13% shares in Dodge in failed takeover attempt in June. In the meantime Dodge merged w/ Reliance Electric so Emerson wanted to get rid of it's shares w/o violating Section 16. Emerson wanted to avoid liability so it first sold 37,000 shares (sold off 3%) in August bringing it's ownership to 9%, then it later sold the 9% in September. Court says second sale in September is not subject to liability under 16b (not a matchable transaction) b/c by that time they were no longer a 10% owner. But the first 3% sale in August is subject to liability under Section 16 b/c when they made that sale they were a 10% owner.
    - -Is the first transaction in June where he bought the first 13% subject to16(b) liability?
        - -No b/c before they bought the 13% they were not a 10% owner in the company.
        - -But if Emerson bought 11% on June 16, and bought 2% more on June 18 then the transaction on June 18 is subject to Section 16 b/c by that point he was a 10% owner.

- **Problem 1:** Bill is CEO of (SCLI), a chain of law schools in California. SCLI stock is registered under the 1934 Act, and 1,000,000 shares are outstanding. **On January 1, Bill purchased 200,000 shares of SCLI common stock for $10 per share**. Determine his liability, if any, under §16(b) if:
    - **(a) On May 1 Bill sells all 200,000 shares at $50 per share. PP 25**

        --Since he is CEO, he is subject to 16(b) & the answer is $8 million.
        (200,000)x($50) – (200,000)x($10) = $10,000,000 – $2,000,000 = $8,000,000

        --But if he was a random guy off the street & didn't own 10% of the company then this transaction would not be subject to 16b.

    - **(b) On May 1 Bill sells 110,000 shares at $50 per share. Then on May 2, he sells 90,000 shares at $50 per share. PP 26**

        --Answer is still $8 million.
        Sale 1: (110,000)x($50) + Sale 2: (90,000)x($50) = $10 million
        He bought all 200,000 shares (200,000 x $10) for $2 million
        $10 million - $2 million = $8 million

    - **(c) On May 1 Bill sells 110,000 shares at $50 per share. He resigns as CEO. The next day, on May 2, Bill who is no longer CEO sells 90,000 shares at $50 per share. Is the last transaction subject to Section 16(b)? PP 27**

        --Yes it is b/c he purchased then while he was an officer or director of the company. If it were the opposite, meaning if he was not a director at time of first transaction and then he becomes an officer by the time of the second transaction, then his first transaction would NOT be subject to Section 16(b) b/c he was not a director at the time.

- **Problem 2:** Bill, the CEO of SCLI, buys 100,000 shares on March 1 at $10 per share; 700,000 shares on April 1 at $90/share & sells all his shares on May 1 at $30/share. **PP28**

(a) Did he make any money in the transactions?

--No.

(Sale proceeds) - (purchase costs) =

($30 x 800,000) - [($10)(100,000) + ($90)(700,000)] =

$24,000,000 - ($1,000,000 + $63,000,000) = $40,000,000

(b) Is he liable under §16(b)?

--Bill is liable under §16(b) on the 100,000 shares that he bought at $10 per share in March b/c he later sold those 100,000 shares at a higher price in May. So even though overall he lost money, he still has to disgorge those profits. **So we must match the 100,000 shares purchased in March with the same 100,000 shares sold in May at a higher price. That is how much he owes the corporation.**

- ($30 x 100,000) - ($10 x 100,000) = $2,000,000