BA Outline

Sunday, December 04, 2011
11:08 AM

I. Agency Law
  A. Agency
    a. General Definition
      1. Agency is a fiduciary relationship that is created when there is:
        a) Mutual assent that
          ◇ Can be shown through course of dealing
        b) A will act on Pr's behalf and
        c) Subject to Pr's control
          ◇ For tort liability, the level of control must be day-to-day control
          ◇ For contract liability, the level of control is only "control over ends"
          ◇ Factors indicating control:
            ► Direct control - e.g. reporting or other duties required of A
            ► Operational control - e.g. uniforms or setting hours
          ◇ The more risk undertaken means the more control exerted because tend to be more worried and more active
    b. Key Considerations
      □ Form will NOT trump substance! No matter what the K terms are, will look to what the actual course of dealings were.
      □ Just because jointly own or share profits no mean pship exist. It is best to evaluate based upon intent of the parties. Did the intend to be co-owners, agreement language, conduct toward T, treatment of return and risk
      □ The more protections a creditor puts into place the more likely they will be found to be a Pr
    ❗ c. Cargill
      □ Warren was Cargill's agent for purchasing wheat, grain, and seeds. Warren stored grain for farmers (T). Cargill was Warren's creditor and financed Warren's business and bought of most of Warren's product (chief customer). Warren bought grain from farmers but couldn't pay, the farmers wanted to hold Cargill liable under agency theory of liability. Cargill tried to claim that they were merely creditors and a purchaser. Here, **course of dealing** went to show there was mutual assent that Warren became an agent because Cargill had many factors that indicated they controlled Warren. They had a right of first refusal on commodities, they inspected books, they made constant recommendations, they offered strong paternal guidance, Cargill also had the power to discontinue Warren's financing but kept them afloat.
        ◆ Note that here the farmers could sue Warren and Cargill. Typically can't sue agents but Warren was a party to the K between the farmers, so could sue them.
    d. Statutes
      (a) Rest. 2d
        ◆ 1, 12-15, 117-199
      (b) Rest. 3d
        ◆ 1.01, 1.02, 1.03, 1.04, 3.06
  B. **Contract** Liability to Third Parties
    a. Principal Liability for Agent's Acts
      (a) Statutes
        ◆ Restatement 2d
          ◇ 4, 7, 8, 8A, 12, 13, 26, 27, 33, 140, 161
        ◆ Restatement 3d
          ◇ 2.01-2.06, 4.01-4.08

(b) Types of Authority

a) Overview of Types

1. Actual
   i. Implied
   ii. Express
2. Apparent
3. Inherent

b) Actual Authority

1. Express
   - ▶ Authority that the P intend to give the A; what the P told the A he could do.
2. Implied
   - ▶ Agent reasonably believes that the Principal intended him to have the authority
   - ▶ Factors for Implied Authority Analysis:
     - ▸ Past conduct
     - ▸ Nature of the task (e.g. more likely if not a 1-man job)
     - ▸ Present conduct (e.g. if P pay the person hired)
   - ▶ Third party belief is not relevant here

c) Apparent

- ◇ Authority a third party reasonably believes the Agent to have will create Principal liability
- ◇ Factors for Analysis
  - ▶ Principal acts in a way that would create a reasonable belief in a T that the A has the authority to act
  - ▶ Present conduct analysis may mean that creates belief if fail to act (i.e. fail to inform A no have authority)
  - ▶ Nature of task analysis - if it is something that is *usual or proper* for an A to be doing that might create a reasonable belief

d) Inherent

- ◇ Rule
  i. Principal is liable for A's acts that are **usual or necessary** in the course of the agency relationship when the Pr is **disclosed or partially disclosed.**
- ◇ A's Liability - if A doesn't disclose the Pr then the A will be liable on the K too.

e) Cases

- ❗ ◇ Mill Street - example of actual authority (implied)
  - ▶ Church handyman hires someone to help him with painting the steeple. The church did not expressly give him the authority to hire the handyman but apparent authority was found by implied. The prior conduct was such that he could hire on people, church's present conduct show that he had the authority because they paid the hired person, and the nature of the task was such that a second person was needed. The church had told him to hire someone else but they had not expressly limited his hiring power to that individual, and in the past he had the flexibility to hire different people.
- ❗ ◇ Three-seventy Leasing - example of apparent authority
  - ▶ The principal was trying to get out of a K that had been signed by one of its field reps. They claimed that there was no actual authority because field reps were expressly told they did not have the authority to enter into Ks. Further, there was no implied authority because in the past they had not been allowed to do it,

etc. However, the ct still held Pr liable because the buyer reasonably believed the field rep could bind the company. The pr was involved in the negotiations and didn't say anything about lack of ability, the field rep was called a sales agent, all of this was present conduct that went to show reasonable belief.

- ◇ Watteau - example of inherent authority
  - ► Beerhouse. The agent only had the authority to buy alcohol and water. He bought all kinds of other stuff. The pr was a secret one (not disclosed to the T) but the ct still held him liable on the K because purchasing food, etc was usual and necessary in an agency relationship.

(c) Ratification (for K Liability)

a) Overview
- ◇ Even when there is no authority/agency, a Pr can subsequently become liable on a K if he ratifies the K. Ratification can be express or implied.
- ◇ T can/must elect to sue either the Pr **OR** A (unless A was a party to the k or A committed tort/fraud)
- ◇ Look for this when there is no authority

b) Rule - Ratification occurs when A enters into a K purportedly on Pr's behalf without actual or apparent authority, and Pr subsequently adopts the K. In such situations both Pr and T are bound by K.

c) Clark Summary
1. Despite a lack of authority, agency,
2. A was purportedly acting on Pr's behalf, and
3. Pr subsequently ratified/ affirmed the K. (ACCEPTANCE OF K's results or benefits with intent to ratify). This can be shown by either:
   - i. Express ratification
   - ii. Implied Ratification Test
     - (a) Acceptance of Result or Benefits of A's act
     - (b) With **intent** to ratify and **knowledge** of all **material** circumstances

d) Analysis Tips for implied ratification
- ◇ Look to see if Pr chose to accept benefits
- ◇ Look to see if Pr had knowledge of terms (reasonable alternative?)
  - ► Knowledge is required but cannot be willfully blind
- ◇ There cannot be a material change in circumstances
- ◇ Principal CANNOT adopt a wait and see approach

e) Botticello - no ratification. H was not purportedly acting on W's behalf (W not mentioned in the K) and W did not have full knowledge of the material terms.

(d) Estoppel

a) Overview
- ◇ Generally, in order for apparent authority to exist there must be some type of affirmative conduct by the Pr
- ◇ But Agency by estoppel is a very rare exception to this rule. Pr may still be liable though he didn't do anything.

b) Agency by Estoppel Rule
- i. The Pr may be estopped to deny authority/agency where the T was induced to make a detrimental change in position by the Pr's tortious dereliction of duty (i.e. intentional or careless conduct).
  - ► It's a unique circumstance where they have failed to surveillance or supervise and failed to detect an impostor

c) Hoddeson - women buy furniture from someone she believed to be a sales agent at the furniture store. Furniture store was liable because failed to sufficiently supervise and detect the impostor.

i. Agent's Liability on Contract
   (a) General Rule
      - General rule is that agents are not liable for Ks they execute on behalf of their Pr.
      - Even if A make a mistake and exceed authority, likely not liable.
      - There are three narrow exceptions to this rule where A can be held liable on the K
      - See chart below on whether Pr can sue A
   (b) Exceptions
      1. Undisclosed Principals.
         ◇ Unless otherwise agreed, a person purporting to make a K with another for a partially disclosed or undisclosed Pr is a party to the K. Pr also liable here.
      2. Fraud or Misrepresentation
      3. A expressly a party to K.
         ◇ Need convincing/compelling evidence of this.
   (c) Statutes
      a) Rest. 2d
      b) Rest. 3d
   (d) Atlantic Salmon - K liability of the A in a situation where there is a partially disclosed Pr. Unless otherwise agreed, the person purporting to make K with another for a partially disclosed is also a party to the K. The T is not required to search the records to determine that the person is someone's agent (contructive notice insuff). The A must give him actual knowledge, or info a reasonable man would take as knowledge. He had a fake company under which he entered into a K and claimed to be that company's Agent. Tried to claim that he was acting as an A of another company (that did exist). This would be the undisclosed Pr. A still liable.

C. **Tort** Liability to Third Parties
   a. Principal Liability for Agent's Acts
      (a) Overview
         - For a Pr to be liable for an agent's acts you must first find that 1) there was an <u>agency relationship</u> and 2) that it was <u>within the scope of employment</u>.
         - General Rule: only certain kinds of Pr (i.e. employers) are vicariously liable for the torts committed by agents with the scope of the Agency Relationship.
         - Master/Servant or Employment Relationship
            ◇ Pr liable for torts of employees within the scope of employment
            ◇ There will be more control here. The right to control the **physical conduct** of another. It is day-to-day control.
         - Independent Contractor Relationship
            ◇ Pr not liable for torts of i.c., ONLY liable for Ks
      (b) Employees v. Independent Contractors
         a) Statutes
            i) Rest. 2d
               ► § 219-220
            ii) Rest. 3d
               ► 7.03
         b) Difference
            ◇ Employees are agents whereas independent contractors are not. Thus, can be liable if find as ee but not if i.c.
            ◇ Will hinge on the extent of control that the Pr exerts over the tortfeasor
            ◇ Test for Agency Relationship
               1. Mutual assent that
                  - Can be shown through course of dealing
               2. A will act on Pr's behalf and

3. Subject to Pr's **DAY TO DAY** control
    - For tort liability, the level of control must be day-to-day control
    - For contract liability, the level of control is only "control over ends"
    - Factors indicating control:
        - Direct control - e.g. reporting or other duties required of A
        - Operational control - e.g. uniforms or setting hours

c) Direct Indices of Control versus Indirect Indices of Control
- Difference
    - Direct indices of control are what the A is required to do
    - Indirect indices of control are things that suggest the Pr has a right to control (things that up the risk the Pr is undertaking)
- Direct Indicators - Look at express terms of the K, including whether or not the rship is labeled "i.c.".
    - Principal's control of A's day to day operations
    - As obligation to make reports to Pr
    - A works under Pr's direct supervision
    - Pr's payment of Operating Costs
- Indirect Indicators - Risk generally indicates control. The more risk of loss the Pr assumes in operating the bus, the more control we expect him to be able to exercise over his As

d) Analysis Tips
- When a T wants to sue the Pr, first identify if it is a K or tort claim.
- If it is a K claim then analyze under normal agency factor. But if it is a tort claim analyze under the master-servant factors with heightened day-to-day control.
- Look for Direct Indices of Control and Indirect Indices of Control (
- Financial control is not direct control (e.g. operational) but it is a proxy for control. And it is important to cts in determining the analysis, the extent of financial control will often be the tiebreaker in close cases.
- Don't forget to talk about it being within the scope of employment for tort liability - this gets at foreseeability.

e) Examples
- Not Agency Relationship
    - Buyer-Supplier
    - Debtor-Creditor
- Hybrid
    - Franchise Arrangements
    - Oil Co Dealer Arrangements
- Agency Relationship
    - Express, e.g. employee

f) Cases
- Humble - the oil-dealer arrangement. There was day-to-day level of control (control hours of operation, only able to sell its products, required to wear its uniform). But there was evidence of no control - the gas station hired its own employees, and was responsible for training, these people believed the gas station manager was their boss NOT the oil-dealer. The control exerted was because of their financial arrangement. But the ct find agency because of the level of control.
    - Find agency relationship
- Hoover - another oil-dealer arrangement. There was no day-to-day control (gas station set its own hours, had the option of selling other

products). There were weekly visits and recc, they wore oil co uniforms, oil furnish all equip. Ct say because no day-to-day control therey were indpendent contractors

- ► No find agency rship
- ► Clark says that reduced the likelihood of finding agency rship by allowing gas station to set own hours, make its advice only recc, let gas station take on risk by having title to the products and equip. NO matter that had a term provision and the gas station likely would defer.

◇ Bushey - Looks at whether it was within the scope of employment. Held Pr (Govt) liable for A (sailor) torts. Drunk cost guard sailor flooded the drydock after a night out. The ct held that it was commonplace for sailors to get druck so the sailor's conduct was not so unforeseeable as to make it unfair to charge the govt for responsibility.

(c) Franchises: Actual v. Apparent Authority

a) Overview

◇ Less likely to find control here sufficient to find agency relationship

◇ Cts will focus the analysis on whether the operator bears the risk, and not give as much weight to other evidence of direct control by the corporation/franchisor.

◇ Financial control is an impt factor for cts in deciding whether to find agency rship even though not truly control (e.g. operational control)

◇ Make sure that you analyze these cases for both actual and apparent authority (i.e. do the analysis regarding whether there was mutual assent, A would act on Pr's behalf and subject to Pr's control. And then do analysis on whether Pr's conduct made it reasonable for a T party to believe that A had the authority to act).

b) Cases

❗ ◇ Murphy - slip and fall case against Holiday Inn Franchisor. Goes to show that K terms are not determinative. Nature and extent of control that they have agreed upon (i.e. mutual assent) is the critical analysis. There was a sign that said it was owned by a separate company. They did not control the day-to-day operations. Just analyze on a case by case basis.

❗ ◇ Miller - McDonald's case where bite into burger and crack tooth on a sapphire. Goes to show that it is a case by case analysis and that it is typically improper to get this dismissed on s.j. Also goes to show that apparent authority can create liability of a Pr.

◇ Conoco - group of a.a. and latino discrim against at two types of Conoco estab, some conoco owned and some conoco branded. P was going after Conoco seeking fundamnetal change is policy. The ct held the conoco owned was liable but not the Conoco branded stations. Reason is that the branded ones were franchises that limited control to selling gass, much of what happened (racial discrim) was outside the agreement.

(a) Agent Liability for its own Torts

□ Statutes

- ◆ Rest. 2d § 343
- ◆ Rest. 3d § 7.01-7.02

□ Agent is liable for tortious conduct

□ See chart summary below on whether Pr can sue A

D. Chart on Liability/Indemnification

	Actual	Apparent (T reasonably believes)	Inherent (usual or necessary)	Ratification	Estoppel
Can Pr sue A?	No	Yes, but only if there is no actual authority	Yes, but only if there is no actual	No	Yes

			authority		
Can T sue A?	No	No - unless A is a party to the K or A commits tort/fraud	Yes if Pr is undisclosed or partially disclosed	T can/must elect to sue Pr or A (unless A is party to K or A commits tort/fraud)	Yes
Can T sue Pr	Yes 1. Pr intend or 2. A reasonably believe that 3. A had authority to act Factors: • Past conduct • Present conduct • Nature of Task	Yes *Pr's conduct* creates a reasonable belief in T that A had the authority to act Factors: • Past conduct • Present conduct • Nature of risk	Yes 1. Pr is undisclosed or partially disclosed 2. A acts are usual or necessary in the course of such bus (agency rship)	Yes 1. Despite lack of agency/ authority 2. A purportedly acts on Pr behalf and 3. Pr subsequently ratifies or affirms the K • Ratification can be express or implied • Requires 1. **Acceptance** of result with **intent** to ratify and with **knowledge** of all **material circ**	Yes, last resort Pr derelict duty owed to invited customer Lack of surveillance and supervision

Remember:

- □ Agency Test: 1. Mutual Assent, 2. that A will act on Pr's behalf, and 3. subject to Pr's control.
- □ Tort Hurdle if suing Pr: 1) there was an agency relationship and 2) was within the scope of employment

E. Fiduciary Duties of Agents to Principals

a. Overview

- □ Fiduciary duties found in Restatement of Agency are default rules - **these duties can be relaxed or expanded by the actual employment K.**
- □ Duty of Care and Skill
  - ◆ An A is under a duty to act with the care and skill that is std for the kind of work he had been hired to perform, and also to exercise any special skills he may have.
- □ Duty of Loyalty
  - ◆ Law imposes this duty. Unless otherwise agreed, an A is subject to act **solely** for the benefit of the Pr in all matters connected with his agency.
  - ◆ Duty prohibits the agent from
    - ◇ Taking secret profits
    - ◇ Usurping business opportunities
    - ◇ Stealing Pr's property and trade secrets
    - ◇ Using Prs property to benefit A
    - ◇ Competing with Pr in subject matter of agency
- □ Remedy is to disgorge profits
- □ Distinguish that mere preparation to compete is not a violation
- □ Once agency ends, the duties end. But parties can alter this by K. And trade secrets have an ongoing obligation.

b. Statutes

1) R.2d § 376-396
2) R.3d § 8.01-8.12

c. Duty of Loyalty

(a) Use of Pr's Property for Personal Benefit

a) Rule

i) An agent has a duty not to use Pr's property for his own purposes or those of a third party. **R.3d § 8.05.**

ii) Agent has a duty not to acquire a material benefit from a T in connection with transactions conducted or other actions taken on behalf of the Pr or otherwise through the A's use of the agent's position. **R.3d § 8.02**

- ► Cannot take a business opp that presents itself because of your agency relationship.

iii) Generally, after the relationship ends you do not have a duty to the Pr. But the Exception is Trade Secrets.

b) Trade Secrets - A duty extends even beyond the end of the agency rship to not use this information for personal benefit where:

1. There is some sort of innovation or special effort of the Pr, and
2. Pr tries to keep it confidential

c) Remedy

- ◇ Disgorgement - this is designed to punish the wrongdoer, so it doesn't even matter if the Pr would not normally have a right to the money (e.g. what the A was doing was illegal…Pr still gets the money).
- ◇ Expectation Damages - this is what you would get if it was just a Breach of K. So Pr could get less here. But only if find that the activity was not a breach of fiduciary duty and more about breach of K.

d) Distinguish: Personal Experience

- ◇ There is a difference btwn gaining an opp from the Pr, versus gaining experience. The latter is not something that belongs to the Pr and you can use for your own personal benefit.

(b) Duty to Disclose/ Competing against Pr

a) Rule

i) A's have a duty to disclose opportunities that present themselves because of their role with the Pr.

- ► Something may not be an opp of the Pr, but where the A is an interested party he must disclose it and let the Pr decide.

ii) A's may not compete against their Pr.

- ► Even if not competing, would still need to disclose opp.

(c) Analysis

- ◆ Need to first find that the A is Competing
  - ▪ Without competition then there is no duty to disclose
- ◆ Look to the K terms of the A-Pr relationship.
  - ▪ Fiduciary duties cannot be contracted away but the K can help to define to what extent the role creates/ no create a duty
  - ▪ If there are K terms then this may be additional source for liability. But the remedy here would be expectation damages NOT disgorgement.

(d) Cases

! a) Reading

- ▪ Soldier taking bribes to stand on a ship to get it through the canal unsearched. The bribery money had to be disgorged back to his Pr (the govt). The opportunity presented itself by virtue of his agency relationship with the Pr. So it didn't matter that the money was not something that the Pr could have gotten on its own (i.e. bribery is illegal so it was not something that the A was competing with the Pr on to do because neither could do it). Instead, any money

! b) General Automotive v. Singer

- ▪ this about duty of loyalty where the A is an interested party. The arguments over whether or not he was directly competing against the Pr - either because he was just the middleman and so no duty to give this opportunity to him or because this was an area where they were not

equipped to handle (even if wanted to compete, they couldn't) - became less relevant…he had a duty to disclose because he was an interested party. The ct says that the interested party doesn't get to decide whether this is an area of competition or not. Key pointers here was that when deciding whether this was a bus opp or not you would look to factors such as whether in the line of business, the ability to take the opp, proximity in time and space to the business, etc. Also key here is that there was a contractual term that said he was required to devote his efforts to the business.

c) Town & Country
- Stealing clients from home cleaning business. He was allowed to compete because no longer an agent. But the clients were considered trade secrets because had lots of effort into finding them (specially screened at great expense) so violated f.d.

d. Duty of Care and Skill

(a) Rule

i. Agents (in pship or corp) must use due care and skill when evaluating and making business decisions. And act with good faith and fair dealing in discharging duties to bus (pship and other partners or corp and shareholders).
- Generally mere negligence will not violate duty. But Partner must NOT engage in:
  - ► Gross negligence, reckless conduct, intentional misconduct, or a knowing violation of the law.

(b) Special Case of Attorneys Leaving Firm

a) Improper Actions
- Communicating with clients before giving notice to firm that they are leaving
- Taking client files
- Lying
- Not letting clients know they have a choice about whether to stay with the firm or move with the departing attorney

b) Acceptable Actions
- Looking for and obtaining office space
- Setting up merger or affiliation with another firm
- Negotiating with partners (different from associates)
- Reminding clients they have the right to choose their attorney

c) Grey Areas
- Contacting clients after notice to the firm, but before leaving
- Talking to associates about accompanying the attorney

(c) R.3d § 8.08-8.12

F. Principal's Duties to Agents

a. Statutes

1) R.2d § 438-440
2) R.3d § 8.13-8.15

II. Partnership

A. Overview

a. Definition

□ A pship is an association of two or more **persons** to carry on as co-owners a business for profit. [**UPA § 6**]. *It is the default relationship that arise when 2+ persons go into business together without specifying a business form.*
- ◆ **Persons**: Pships can comprise different corporations or other business entities. § 2 of UPA says persons are individuals, phships, corps, etc.

b. Distinguish

□ Joint Ventures - formed only for a single transaction (or series of trans) and so

typically more ltd in duration
- □ Fixed Duration Ks - not typically pship because pships are like marriages, enter into them with unlimited duration

B. Default Rules in Pships
   a. Overview
      - □ The Pship Agreement is the law of the pship, but in the absence of any governing agreement the Pship will be governed by default rules of the state's pship statute (UPA or RUPA).
      - □ UPA serves two functions
         1. Provide outside parameters that cannot be altered by agreement, and
         2. Provide a set of default rules or gap-filler that are applicable where the pship agreement is silent.
   b. Outside Parameters (CANNOT ALTER)
      a) T Liability - Although pship K can provide for indemnity among Ptrs, T may always sue any Ptr for pship debts. **§ 15.**
      b) Agency - each Ptr is an agent of the Pship and have apparent and actual authority to act in the usual course of business. **[§ 9(1) & § 18(b)]**
      c) Unusual Acts - An act of a Ptr which is not apparently for the carrying on of business of pship in usual way does not bind Pship unless authorized by other Ptrs. [§ 9(2)].
      d) Truth - Ptrs must render **on demand** true and full information of all issues affecting the pship. **§ 20.**
         - Inspection - the right to inspect books and pship records cannot be eliminated.
      e) Fiduciaries - Each ptr owes a f.d. to the pship and to other ptrs individually; hold as trustee any profits derived by him without consent of other ptrs. **§ 21.**
      f) Assignment of Ptrs Interest - A Ptr may assign his financial interest in pship to a T. The assignee does not become a Ptr, but merely becomes entitled to whatever financial rights the former ptr had. No get mngmt or inspection rights, BUT if pship dissolution occur then assignee can receive assignor's interest and get an acctg up to the date last agreed upon by all ptrs (including his assignor). **§ 27(1).**
   c. Gap Fillers (ONLY APPLY WHEN PSHIP AGREEMENT SILENT)
      a) Profits and Losses - All profits shall be divided equally among the Ptrs. All losses shall be divided in same ratio as the profits. **§ 18(a).**
      b) Indemnity - The pship must indemnify every Ptr for payments/personal liabilities reasonably incurred by him in ordinary and proper conduct of its bus, or for the preservation of its bus or property. **§ 18(b).**
      c) Management - All Ptrs have equal rights in mngmt and conduct of the pship business. **§ 18e.**
      d) New Ptrs - No person can become a member of the pship without the consent of all ptrs. **§ 18g.**
      e) Acting against pship agreement - Ordinary matters may be decided by majority of ptrs. But no act in contravention of any agreement btwn the ptr may be done without the consent of all ptrs. **§ 18h.**
         - **18h** - Default is that any partner has authority to bind pship in ordinary course of business
   d. Voting/ Management
      - □ Partners jointly share the management, but equal votes or control is not necessary
         - The default is that equal management and control, equal voting rights
         - Can change to give someone greater voting rights based upon capital contributions, etc
      - □ Ordinary business versus Non-Ordinary
         - **18h** - Default is that any partner has authority to bind pship in ordinary course of business. <Repeat of above>
         - **25(2)(b)** - Rights with respect to pship property not assignable, requires unanimous approval to convey all or substl intr.

        - Non-Ordinary (e.g. sale of the pship's entire assets, addition of new partner) require unanimous approval
        - BUT **10(1)(3)** - re T rights. The conveyance of property held in pship name valid if bfp4v because ptr has authority to do (just because in pship name, all ptrs not reqd to sign). Can seek indemnity

e. Inspection
    - This is a right to inspect the books of the pship that cannot be eliminated

f. Loss Sharing (Risk)
    - **18a** - Default is that liable for losses to the same extent as profit sharing. <Repeat of above>
    - Partners are liable for all debts of the pship. Cannot alter T rights, but can K for indemnity provisions between partners.
    - Except so far as necessary to wind up, dissolution **terminates all authority** of any ptr to act for pship. **§ 33.**
    - Dissolution of pship no discharge existing liability of partner. But the ptr can be discharged from existing liab upon dissolution by agreement btwn the creditor and the continuing pship/ptrs; and such agreement may be inferred from course of dealing btwn creditor and continuing pship. **§ 36.**
    - Liability of persons Continuing the Business **§ 41**
        - If bus continued without liquidation of pship affairs (because admit new or retire/die and assign) the creditors of first/dissolved pship are also creditors of new bus. § 41(1).
        - Same if bus continued when wrongfully dissolve. § 41(5).
        - New partner not liable for old pship's debts beyond his stake in pship (i.e. liab will be satisfied out of pship property only). **§ 41(7).**
        - Creditors of dissolved pship have prior right (as opposed to exiting ptr's creditors) to any claim of exiting ptr's interests. § 41(8).
        - Nothing in this section modified any right of creditors to set aside assignment grounds of fraud. § 41(9).
        - Continuing use of pship name or name of decease ptr by itself no make dead ptr liable for pship debts. § 41(10).
    - ~~Disassociating and New Partners~~
        - ~~Disassociated ptrs are not responsible for pship liabilities that arise after disassociation (only ones prior to it). No seem fair because he already deducted this from his payment BUT that's just because can't alter T rights. The disassociated ptr would be able to seek indemnification from pship/ptrs though.~~
        - ~~New ptrs are ONLY personally liable for new debts that incurred once person joins the firm.~~

g. Profit Sharing (Return)
    - Default is that get equal profit sharing
    - Can change to make it consistent with management/ownership or with capital contribution
    - Sharing profits is p.f. evidence that pship exists, except where the profts are for:
        - Rent
        - Debt service
        - Wages
        - Annuity
    - It's a rebuttable presumption. Just because jointly own or share profits doesn't mean a pship exists.

h. Continuation/ Dissolution
    - Right to Wind Up - unless otherwise agreed, ptrs who didn't wrongfully dissolve has right to wind up pship affairs. **§ 37**
    - **Dissolution of Term Pship**

- Rightful partners get all rights and a breach of K claim against wrongful partner for any damages caused by breach. **§ 38(2)**
- Remaining partners must opt to unanimously continue the pship **OR** they can seek to dissolve. **§ 38(2).**
- Wrongful partner gets the value of his interest in pship at dissolution less any damages caused by breach if they opt to dissolve. § 38(2).
- IF they opt to continue then wrongful partner get value of interst in pship less any damages caused by his breach, not including good will. **§ 38(2)(c).**
  - But if there was any money or land he provided then he will not get that back until the end of the pship term. But he can get the repayments as scheduled per their agreement.

□ Dissolution versus Disassociation
- Under the old rule any time ptr left this was dissolution. The remaining partners had to vote on whether to continue.
- ~~RUPA has disassociation - ptr withdraw either voluntarily or involuntarily.~~

□ ~~If the pship is at-will then the disassociating ptr gets the value of his interest at the time of disassociation~~

□ ~~If pship is for term then not entitled to be paid for his share until end of term or completion of undertaking~~

□ ~~General Rule re Valuation~~
- ~~The disassociating partner receives~~
  - ~~Value of its pship interest (measured as the greater of either going concern value of the liquidation value of the pship)~~
  - ~~MINUS the disassociated partners' share of any liabilities~~
  - ~~PLUS any damages for wrongful disassociation~~
  - ~~PLUS interest paid from date of disassociation to date of payment~~
  - ~~Payable within 120 days provided pship is at will or at end of term or undertaking, unless payment would not create a hardship for the pship.~~

i. Transferability of Interests

□ Two type of Interest
1. Management Rights
2. Economic Rights

□ Default is that mngment interests are not freely transferrable, requires unanimous consent

□ Exception to this is that economic rights (e.g. profit sharing interests) are freely transferrable.
- Examples of how get:
  - Voluntary transfer by transferor partner,
  - Involuntary transfer by transferor partner which may occur due to enforcement of jdgmt against him or her, or
  - Death of transferor partner
- Transferee dependent on transferor to enforce fiduciary protections and to vote in trasnsferor's interest.

j. Rules that cannot be limited

□ Unreasonably restrict access to book and record of pship

□ Eliminate duty of loyalty, unreasonably reduce duty of care, or eliminate the obligation of good faith and fair dealing

□ Vary power of a partner to disassociate, vary the right of a court to expel partner under specific circ, or vary reqmt to wind up pship bus in certain circ

□ Restrict rights of third parties under the RUPA

C. Partnership Formation

a. Defining a Partnership

□ UPA § 6, 7, 9, 13-18 (some repeat from above)
- UPA § 7 - Partnership is two or more partners who carry on as co-owners a

business for profit
- 19 - access to pship books (can be though of as implicit, can't have secret profits so must have some acctg, but also stated expressly)
- 20 - duty to render true and full info
- 21 - ptnr hold as trustee for pship any profits derived from pship business or use of property
- 22 - ptnr who has been wrongfully exldued from pship bus and prop has right to acctg (so can get what they are owed

b. Factors for Finding Pship
- None of these things are determinative (e.g. what the parties call themselves) it is a totality of circ type analysis
  - Intention of the Ptrs
  - Proft Sharing (return) - prima facie evidence that pship exists. But can rebut.
  - Sharing of Loss (risk)
  - Ownership of Property (control)
  - Management of Property (control)
  - Duration
  - Language in Agreement
  - Conduct/ holding out to other parties
  - Rights of parties on dissolution/ termination

c. Distinguishing from Other Legal Relationships

(a) Employee
- Fenwick - beauty shop receptionist. The ct said she was an employee. There was evidence that she was a partner in the sense that there was a K that called her a partner, she got a share of the profits. But she had none of the risk of the business, she was not held out as a partner.

(b) Debtor-Creditor
- Martin - Situation where T were trying to define rship as pship so that could hold the parties individually liable. This was a loan arrangement, it's terms were unusual because he had built in a lot of management protections into the agreement. But there was a date of repayment (so for a set duration). Also the risk was limited to the amount he loaned the bus. They didn't hold themselves out as partners to others. Intentions also were that not partners - agreement refer to selves as creditor-debtor. Ct said that it was not a pship.

(c) Limited Duration Partnerships/ Joint Ventures
- Rule
  - Opp that arise because of ltd duration pship (i.e. for a term) mean that need to disclose the opp and give the other party an opp to compete. The reason is that ptrs have a duty of loyalty and due care.
  - Analysis will require that you identify:
    1. Term of the pship (to see if still owe duty)
    2. Control - where a partner has a great degree of control he has a greater duty to disclose
    3. Subject Matter of the Opportunity (i.e. is it an opportunity)
       - Opportunity Analysis
         1. Nexxus to business
         2. Geography
         3. How opportunity came to the partner
- Meinhard - this was the hotel in a part of town that was getting redeveloped. It was only for a limited term so not required to go into business with the party BUT still find breach duty because failed to disclose the opp. Reason is that find pship.
- Southex Exhibitions - home expo shows. Parties entered into an agreement about producing home shows. The agreement was for a set period of time and

one of the parties was hesitant to take on risk. Ct felt that it was not a pship. This became an issue because had this been a pship then there might have been an obligation to disclose/disgorge the opp of continued home shows.

(d) Analysis Tips

- Typical Lender Protections that okay
  - Permision re change in ownership/ldrship
  - Inspection rights
  - Express limits on specific risky actions
    - Better way would be just a reqmt on what the corp has to have on hand
  - Counseling on discrete matters and/or recommend consultants
- Danger Zone where starts to look like pship
  - Constant advising
  - Veto power over bus decisions
  - Call option
  - Resignations/designating mngmt
  - Assurances to other creditors

d. Partnership by Estoppel

(a) Overview

- This is instances where someone is not a ptr in the pship, but still might be responsible for debts of the pship.
- Distinguish Apparent Authority
  - There the true ptr is being held liable for the actions of a purported ptr (under apparent authority liability of agency)
  - This involves the liability of the fake ptr
- Rule
  1. Actual Reliance - party claiming pship needs to actually rely on manifestation (not enough to claim would have relied)
  2. Reliance must be reasonable
  3. Some manifestation of the alleged partner is required - must act or fail to act in some way which holds out that he is a partner. It doesn't need to be made directly to the T.

(b) Young

D. Management Rights and Partnership Liability

a. Overview

- Each Ptr is agent of pship for purpose of its business. § 9.
  - Each Ptr has actual and apparent authority to bind Pship to obligations.
    - Actual - carrying on in the usual way of business.
    - Apparent - Ptr must have held out that had authority and T had reasonable belief that ptr had authority. [But if lack actual, then ptr must indemnify].
- Extraordinary Acts.
  - If an act is extraordinary then actual authority can be granted only by a **unanimous** vote of the Ptrs (unless pship agreement provides otherwise).
  - Examples of extraordinary acts
    - Assigning pship property in trust for creditors or on the assignee's promise to pay for depts of pship
    - Disposing of good will of bus
    - Dowing any other act which would make it impossible to carry on ordinary business of pship
    - Confessing a jdgmt
    - Submitting a pship claim or liability to arbitration

1) UPA § 9, 10, 13-18, 24-27, 40

b. Agency and Partnership Liability

- A pship is liable to T for wrongful acts of a Ptr committed within the scope of the pship business or otherwise committed with authority. § 13.
- Torts versus Contract
  - Liability is **jointly and several** for torts and breaches of trust fraud.
  - Liability is **joint** for contract. § 15b. But if the other ptr is insolvent then the other ptrs can be liable for entire debt (but can seek contribution from insolvent ptr). § 40d.
- Indemnification - pship must indemnify every ptr in respect of payment made and personal liabilities reasonably incurred in ordinary and proper conduct of bus or for preservation of pship obligations. § 18b.
- Also see above for info re liability of incoming/disassociated ptrs.

c. Deadlocks - Restricting/Authorizing Actual Authority

(a) Jdx Split re 18h interpretation

1. National Biscuit Approach (Majority to Restrict)
   - Under this interp of § 18h a majority vote is needed in order to restrict a Ptr's authority to act in ordinary matters, so in a deadlock the ptr would have actual authority to bind the pship.
2. Summers Approach (Majority to Act)
   - Under this interp of § 18h a majority vote is needed in order to act in ordinary matters, so in a deadlock the ptrs would NOT have actual authority to bind the pship.

d. Contract Limits on Management Rights

(a) Overview

- Under UPA § 18e all Ptrs have equal right in mngmt and conduct of pship unless agree otherwise. Even though mngmt rights may be equal though Ptrs may be entiteld to larger percentage of profits if agree to that.

(b) Loss Sharing

- Default is that share to the same extent as profits percentage (no matter what cap contrib were). But can agree otherwise.
- EXCEPTION to this general rule is that where one ptr contributes capital and the other ptr contributes skill then neither party is liable to the other with regard to losses sustained.
  - See Kovacik

(c) Conveyance of RP

- Under § 10 any Ptr may convey title to property that is held in pship name. Both § 10(1) and (2) include caveat that can invalidate the conveyance if the ptr signing did not have actual authority (i.e. not in usual way of business). But this can only be done if the buyer didn't know the Ptr exceeded his authority (i.e. the buyer is a bfp4v).

(d) Ptrs' Property Rights in Pship

- Under § 24, a ptr's property rights consist of 1) his rights in specific pship prop, 2) his interst in the pship, and 3) his right to participate in mngmt.
- Rules
  - Interest in Specific Pship Prop - each Ptr has equal right to use pship prop for pship purposes. However, a ptr owns no personal specific interest in pship's assets or proerty - it is the pship that owns the property not the individual. § 25.
  - Possession - equal right to possess for pship purposes, but not right to possess for any other purpose without consent of other ptrs. § 25(2)(a).
  - Assignability - a ptr's right in specific pship property is not assignable except in connection with rights of all of ptrs in the property. § 25(2)(b).
  - Attachment - A ptrs' interest in specific pship property is not subj to attachment or execution by an individual ptr's creditors. It is subject to attachment or execution on a claim against the pship. § 25(2)©.

- Death - upon ptr's death his rights in pshp property vest in surviving ptrs (or in executor of last surviving ptr). Thus pshp property is NOT part of the ptr's estate when determining the value of his interest in the pship. § 25(2)(d),(e). In addition specific pshp prop can't be left in a will.
  - Can leave right to share his profits.
  - But cannot leave his right to participate in mngmt absent unanimous consent.

(e) Assignee's Rights
- Assignee is not automatically a Ptr. Therefore, no right to inspect books. No personal resp for pshp oblig. Cannot interefere in mngmt of bus. § 27(1).
- Dissolution and Assignee - gets whatever the prt would have received, and may require an acctg only from date of last acctg agreed by all Ptrs. § 27(2).

(f) Assignor Consequences
- Ptr who assigns his financial interest in pshp remains a ptr and continues to have right to participate in mngmt. He also remains liable for all pshp oblig,e ven those arising after assignment.

E. Financial Interests in partnership
a. Overview
- UPA § 9, 10, 13-18, 24-27, 40

b. Personal Liability
(a) Liability - partners are jointly and severally liable for the debts of the partnership (i.e. liable individually for entire amount if P chooses). They can get insurance to help with this. Can seek indemnification form pshp, ptrs.
- Must first determine that there was a pshp arrangement. Do this by looking at the factors. Intention, Profits, Loss/Risk, Control (management and operations), Conduct, Rights of parties on dissolution/ termination, Duration.

c. Sharing of Profits and Losses
- Kovick
- Sharing of return is prima face evidence that pship exists. But it can be rebutted.

d. Specific Property and Transfer of Interests
- Putnam

F. Fiduciary Obligations of Partners
a. Overview
- UPA § 9, 10, 19-22
- Also see above under fiduciary duties of agents
- Duty of loyalty and Due Care

b. Scope of Duty
- Exist so long as pship exist. With the exception of trade secrets, where the duty extend afterwards.
- Attorneys may have special obligations concerning leaving and clients.
- Cases
  - Meinhard
  - Meehan
  - Lawlis

c. Opting out of Fiduciary Duties
1) Stat Comparison
a) UPA versus Cal Corp Code 16103(b)(3)

G. Partnership Dissolution
a. Dissolution
(a) Two Types
a) Automatic **(UPA 31**) - the following will automatically dissolve pship
- Explusion - wanting to get rid of someone is not bad faith. Fact that you are in a better position to go it alone is not bad faith. Just require that you not take opp that belong to the pship (but is enough that disclose the

opp and let the mkt value it when the bus is sold)
- Death
- Bankruptcy of any ptr or the pship
- Express will of any partner when not for a definite term
- Any event which make it unlawful to carry on bus of pship

b) Court Ordered (i.e. judicial dissolution § 32)
- Hard to get = there are circ, see below

(b) Components

a) Winding Up
i) Pship will need to sell its assets (liquidation)
□ Just need to make sure that appropriate valuation. Market valuation is sufficient so long as there is no showing that any info affecting value is undisclosed.
ii) Then pay its debts
iii) Anything leftover will be distributed to the partners

b) Termination
i) End of the pship. If new partners come on board this is not the same pship but a new one, so it may look like it continues BUT the original one terminated.

(c) Automatic Dissolution. § 31.

i. General rule is that a partner can dissolve a pship at any time and trigger winding up

ii. Exceptions
i) Term Pship
□ Analysis: if a ptr tries to end when it's a term pship and not an at-will pship then he will be liable for wrongful termination (breach of f.d.)
□ Argument that it was a term pship may be IMPLIED (e.g. argue that the lease of the underlying pship property implied that would continue for that length)
ii) Continuation Agreement

(d) Judicial Dissolution - VERY hard to get.

- **UPA 32**
- Will grant where
  - Declared lunatic, incapable of performing his part of pship k
  - guilty of such conduct that prejudicially affects carrying on of business,
  - Willful or persistent breach of pship agreement or otherwise conduct self in matters relating to pship bus that is not reasonably practicable to carry on bus in pship with him.
  - Can only carry on bus at a loss - but rare
  - Other circ make dissolution equitable
  - After term of specified term or particular undertaking
- If pship for a term, ct is much less willing to grant one to a ptr that has in some way breached f.d. (e.g. if bank officer and influenced the denial of loan continuation which led to pship's inability to meet payback terms)
- Will also grant (although much harder to satisfy) where:
  - Business can only be carried on at a loss. No clear definition of this and some courts have said fact that business unprofitable not enough.

(e) Impact of Wrongful Breach

- Ptr who wrongfully try to end before term is liable for any damages due to the breach (K damages), but no longer liable for future debts of pship
- Rightful ptr get to use the pship property and delay repayment until after pship end. Also can sue for wrongful breach. But repayment of loans is done per agreement.

(f) UPA § 29-43
- UPA 38(2)
  - ptr who wrongfully try to end pship before term end will mean that the other ptrs get to keep the pship property and delay repayment until after pship term.
  - Wrongful ptr no longer liable for any pship debts incurred after he leave
  - Rightful ptrs can sue wrongful ptr for any damages due to the breach

(g) Difference btwn UPA and California (Revised UPA)
- At-Will
  - UPA says that can dissolve any time
  - California (Revised UPA) says that dissolution requires
    - Affirmative act
    - May still require continuity for T
    - There are valuation rules for buyout
- Term
  - UPA says that there must be unanimous consent amongst the ptrs to continue pship
  - California requires at least half of remaining ptrs consent

b. Rules for Distribution § 40
- In settling accounts btwn ptrs after dissolution, following rules shall be observed, subject to any agreement to contrary:
  - Assets of pship are: pship property and the contributions of ptrs necessary for payment of all liabilities specified in paragraph.
  - Liabilities of pship shall rank in order of payment as follows:
    1. Those owing to creditors other than Ptrs
    2. Those owing to Ptrs other than for capital and profits (Ptr as creditor)
    3. Those owing to Ptrs in respect of capital (contribs before profit)
    4. Those owing to Ptrs in respect of profits (leftover is split)
- Businesses are valud based on their assets and profits. Some bus are more valuable than tangible assets because of reputation (good will) and other factors.

c. Cases
- Owen - stands for the proposition that cannot willfully breach f.d. to your ptr and then expect the ct to keep the pship arrangement. The ptr no help out in anyway and talk degradingly about him. He tried to argue it was a pship for term (i.e. that they would stay in business so long as profitable)
- Collins - cafeteria business. Ptr wanted to dissolve just as they were starting to make a profit. Ct found an implied term (for the length of the lease) and instead the ptr who sought dissolution was found to breach k. There was evidence that the ptr had influenced the pship's inability to meet repayment terms because of his position at the bank. Rightful ptr got to keep the pship property and postpone repayment until after pship end.
- Page - linen company owned by the brothers. He was alleging bad faith because his bro wanted to get rid of him not that there was a valuable future opp (navy coming to town). That is not bad faith. It just requires that the info is disclosed so mkt can value appropriately at liquidation.
- Prentiss - at the winding up the original partners were allowed to bid to get the business using their shares (not a breach of f.d.) just so long as disclosed everything so that pship get a fair price. Stands for point that in at-will pship, ptrs don't owe f.d. when it ends.

H. Planning

a. Partnership Agreements
- Can modify governance rules (voting rights, duties, limits)
- Can define fiduciary duties
  - But cannot eliminate f.d. and rights to accounting

- Cannot alter f.d. and rights owed to Third Parties
- Often buy-out, continuation, and valuation planning is forgotten

I. Clark's Key Issues

III. Corporate Formation, Limited Liability, Corporate Governance

A. Overview

a. Basic Structure

- Analysis Parts
  - Formation
  - Liability
  - Management Form
  - Transferability of Interests
  - Continuity of Life

b. Intro

- Reasons to Incorporate
- Comparison to Partnerships
  - Formation - pship is informal whereas corp requires formalities be followed
    - Filing with state
    - Articles of Incorp/Bylaws/Other Corp Docs
    - Comply with other Corp Codes
  - Liability - pship there is personal liability, corp is ltd liability
    - Pships may protect self through indemnification or insurance
    - Corp shareholders may lose their ltd liability if creditors require guarantee, veil pierced, etc.
  - Management - pship is decentralized whereas corp is centralized mngmt
    - Pships the partners are agents of the pship, but can K to limit mngmt/auth
    - Corp - sep or ownership and control (but freeze out for smaller corp?)
  - Transferrability - pship is easily transferred whreas corp is not
    - Pship - only intr freely transferred is profit rights but can K to alter this & allow transfer (using continuation agrmts)
    - Corp - shares freely transferrable, encourages passivity in control because can easily exit
  - Continuity - pship is at will whereas corp is indefinite
    - Pship can be easily dissolved, but can limit (pship for term) or enter into agrmt for continuation of bus
    - Corp is separate from shs and indefinite

B. Formation of Corporation

a. Overview

- Incorporator - person that starts up the corp
- File with state, sell shares, Org meets to elect directors to serve until 1st sh meeting, Sh mtg to elct directors, adopt bylaws, ratify/approve other corp bus.
- Board elects the managers

b. Articles of Incorporation and Bylaws

a) Cert of Incorp

- Del Corp. Code 102a (required)
  - Business Name
  - Address of Registered Office and Agent
  - Purpose of Business
    - Can be a broad statement
    - Narrow purpose will restrict what corp is able to do and affect directors' fiduciary duties (i.e. express limit on authority)
      - If make specific this can later make liable for waste if not op within purpose
  - Nature of Stock (# of shares, par value, classes)
    - Par Value - face value of the stock

- Gives you sense of corp's minimal valuation
- Board may not allow corp to dip below this minimal valuation
- Many states do not require a statement of par value and if it does then it may be set at a minimal amount (e.g. penny)

◇ Incoproator Info - name and address
◇ Board's Initial Directors - ONLY if Incoprorator's power terminates upon filing

◆ Del Corp. Code 102b (may have)
◇ Mngmt Provisions - Limits/Defining/Regulating powers of corp, directors, shareholders
► But can't be contrary to state laws
◇ Shareholder/Director Voting Provisions - requiring vote of larger portion of stock/class/directors for certain corporate action than chapter requires
◇ Term Limits - limit duration of corp's existence
◇ Bylaw Provisions
◇ Liability Provisions - imposing pers liab for corp debts
◇ Liability Limit Provisions
► Eliminate or limit pers liab for Directors or Shareholder for fiduciary duty breaches, but can't limit for:
- Breach duty of loyalty to shareholders
- Acts/omissions not in g.f. or that intentional/knowing viol
- Improper personal benefit transactions of Directors

c. State Corporation Codes

C. Limited Liability and Protection of Third Parties
a. Overview
a) Propmoters & Pre-Incorp Acts
◆ There is no principal yet (corp not yet formed) so can't be true agency theory of liability
◆ Promoter still may be liable or may/not be able to take advantage of P's benefit.
◆ Distinguish that the CORP may be the person who holds the cause of action (not the person who is duped by the promoter that formed the corp)
b) Relevance of Incorp
◆ Relevant for taxes, relevant for Ps trying to go after managers or board because need to know what state law applies
◆ But irrelevant regarding enforcement of K - can't use to escape K liab
c) Typical Hypos
◆ Someone wants to enforce a pre-incorp K against a promoter or newly formed corp
◆ Someone wants to get out of a K and trying to use lack of incorp as excuse

b. Role of Promoters
a) Intro & Fiduciary Duties
◆ Promoters owe fiduciary duties to the future corporations that they form (step in for agency liability)
◇ Thus, for transactions that are a part of the corp's formation, they must either disclose or disgorge secret profits
◇ Examples
► Art owns land, he sells the land to a corp that he formed for a profit. If he disclosed this to the board or to the shareholders and they approve then he doesn't need to disgorge. If he does not then he must disgorge even if the price was fair.
► Art sells land to Paula who then forms a corp to place the land into it,
► Art forms corp with 200k, the corp then buys the land from Art for 200k which is approved by his family board. Assuming there was a

preconceived plan to sell the corp to Paula for 200k. There are two arguments regarding whether there is liability
- These are two separate transactions: Paula is buying the shares not the land. Art was not a promoter of Paula's corp, this is an arms length transaction and he doesn't owe any duties and can keep the profits.
- These transactions are linked (i.e. this was the plan all along). Then he was a promoter of Paula's corp and he would have had to disclose the profit or he will be req'd to disgorge it.
- So in this instance to find liability do you have to see Paula as buying the shares and forming a new corp? Or is she considered a shareholder in the original corp by virtue of the fact that this was a preconceived plan?

b) Promoter Liability & Defective Incorporation
  (a) Rules
    i) Pre-Incorporation Ks
      i. Promoters are liable on pre-incorporation Ks. Post incorp they are still liable unless:
        (a) Corp is formed,
        (b) K is formally ratified, **and**
        (c) Initial K or subsequent novation expressly removes promoter's liability
      ii. Corporations are liable on pre-incopr Ks only if they ratify the K.
        - Ratification can be express or implied.
    ii) Existence of Corp
      i. Parties that acknowledge they are dealing with a corp (even though not yet formed) are estopped from later denying the existence of that corp
        - But can deny if there is a good reason that not same corp (e.g. Carribean incorp versus Del Corp - but in that case they ratified the difference because notified and didn't object)
      ii. Del Corp Code § 124, 329
        - No act of corp or conveyance/trasn shall be invalid because lack capacity or power at time
        - No corp shall be permitted to assert that not legal org as defense to any claim
          - Not construed to prevent judiciary inquiry into reg or validity of org of corp or lawful possession corp power to assert suit
  (b) Cases
    i) Southern Gulf
      - K for the sale of a boat. The K was signed by the promoter on behalf of a corp that was not yet in existence. The K said it was going to be incorp in Delaware. But the corp was later incorporate in West Indies. Seller wanted to back out and tried to say that the K was invalid because there was no corp in existence at time of K and so K was invalid. Ct said that estopped from denying existence. It had been informed that incorp in West Indies and didn't object.
    ii) Illinois Controls
      - Promoter liability. The corp and the promoter were liable for the K to sell a corp. The corp adopted the K by receiving the K's benefits with knowledge of its terms (ratify).

c. Piercing the Corporate Veil (Shareholders Liability)
  a) Overview

(a) Two Prong Test - see jdx split
    1) Unity of Interest
        - Factors
            - Lack of corp formalities
            - Commingling of Funds/Assets
            - Undercapitalization
    2) Promote Injustice or sanction fraud
        - This prong is not applied in Delaware
        - Some jdx only apply this prong for K breaches (not tort)
        - Some jdx (like Cali) apply this prong regardless of type of claim

(b) Types
    1) Vertical Piercing
        - Could be to the shareholders
        - Could be parent-subsidiary type relationship and pierce to parent
    2) Horizontal Piercing
        - Same analysis, but the liability will only be horizontal (amongst the corps, not the shareholders themselves)
        - Aka Enterprise Liability
    3) Reverse Piercing
        - First pierce up, then pierce down.
        - Allows you to get at assets of another owned corp, but no require that the two corps be commingling assets, etc. It is about the common shareholder who has the unity of intr and promotion of injustice prong met in both directions of the piercings

(c) Factors Analysis
    1) Lack of Corp Formalities
        - No corp records, meetings
    2) Commingling of funds/assets
        - Treating corp's assets as own, commingling of accounts
        - It could be that you are giving money (e.g. parent give to subsidiary) not just taking money
    3) Undercapitalization
        - But be careful to balance whether this is just the business being unprofitable. Because corp's purpose is to protect investors and limit liability

(d) Issue Spotting
    - Relevant when see sole shareholder
    - Hard to prove but it is easy to get into court so annoying
    - Unlikely to see if large publicly held corp because of the unity of intr prong

(e) Analysis Process
    1) First, do the corp veil test to see if can pierce to make liable
    2) Next, analyze under agency theory of liability
        - There must be some level of control that is greater than what a typical shareholder would have
        - That control must be directly related to the harm
    3) Lastly determine if there is direct liability through a tort or regulatory claim.

(f) Involuntary Creditors
    (a) Walkovszky
        - Taxicab corps, pleading problem because named the individual shareholder but he was alleging facts to support horizontal liability
        - Enterprise Liability - hiding assets within multiple corp's to prevent single corp from getting sued for very much. Shady behavior. That this is really a single entity. Horizontal piercing.

- ◇ Each cab company had the minimum coverage. But there was no promotion of injustice. Ct felt like it was within the legisl intent to allow an individual to limit their liability by forming multiple corp's each with the minimum coverage.
- ◇ Tort Ds

(b) In re Silicone Gel Breast Implant

- ◇ Pierced to the parent company.
- ◇ Example of vertical piercing.
- ◇ Unity of intr analysis: Bristol agents were calling the shots. Several corp's execs said didn't even know there was a board, the board was not holding meetings.
- ◇ Commingling of Assets analysis: filed joint taxes, Bristol controlled corp's accounts, Bristol was giving corp money (helping with loans, paying for expenses and using it's property.
- ◇ Undercapitalization: grossly undercap for this type of company.
- ◇ Promotion of injustice - insuff funds of corp to pay tort victims, Bristol vouched for product
  - ► But ct says that unclear if the inj/fraud reqmt is necessary for tort claims (versus K ones)
- ◇ Fact that made assurances regarding the product created another sourc of liability.

(g) Voluntary Creditors

(a) Sea-land

- ◇ Example of reverse piercing.
- ◇ The D was the primary shareholder in a corp. He was also a shareholder in several other corps (but not sole sh). First pierced up to the D, then pierced down to his other corporations.
- ◇ This is different from horizontal piercing because no need to show commingling of assets between the corporations.
- ◇ Unity of Interest Analysis (for first vertical piercing)
  - ► No annual meetings
  - ► Used account to pay personal expenses
  - ► Undercapitalized because take money out nilly will
- ◇ Ct Also said that adherence would promote injustice and sanction fraud (second prong) - so pierced up
- ◇ Next analysis for down piercing btwn D and his other corps. Unity of Interest Analysis:
  - ► Corporations did not have bylaws.
  - ► D used the money across corporations. He treated like his own personal account.

(b) Arbchbishop of SF

- ◇ Example where no piercing because no meet the second prong regarding promotion of injustice or sanctioning of fraud
- ◇ Purchased dog from a catholic monastery in Switzerland. Sued the Catholic church, including pope and Archbishop in California.
- ◇ The ct said that perhaps there was Unity of Interest between the Pope and the Swiss Monastery. But there was no showing of the second prong regarding promotion of injustice and sanctioning fraud. P showing that he is unable to collect is not sufficient to meet this prong. Must show inequitable conduct that the Ds are using to hide behind a corporate veil.
- ◇ He could not horizontally pierce because no evidence that the Archbishop of LA and the Swiss Monastery were connected in anyway besides the Pope.

d. Liability (Corporate Agents)
    a) Generally, no liability
        - Under corp law, limited liability provisions are about shareholder protections. Generally, not liable.
        - Under agency law, directors and officers are NOT personally liable for debts of the Principal
    b) Shareholder Exceptions
        (a) Promoter Liability
        (b) Defective Incorporation
        (c) Piercing the Corporate Veil (no exist for d/o)
        (d) Watered Stock
            ◇ Del 162 - shareholder pays difference when stock is issued for less than par or stated value
            ◇ Del 102a4 - (Contents of Cert of Incorp) - info about if only 1 class stock, total numbers shares corp has authority to issue, and par value of the shares or a statement that shares without par value. If authority to issue other classes, their par value or lack. Statement of designation and power, preferences, rights, qual, limits, rtx permitted by 151 on any classes.
            ◇ Del 151a - (classes and series of stock; redemption; rights) - may issue stock, classes stock, series stock with p.v. or without, may have full, limited or no voting powers, desig rights special, limits, etc, as stated in cert of incorp or any amendment **or in resolution providing for issue of stock adopted by board pursuant to express authority from cert of incorp to do so.** Can make limits/rtx that dependent on facts outside cert of incorp or amendment or outside resolution provided that manner in which affect is clearly and expressly set forth in cert of incorp or resolution - these facts include occurrence of any event, a determ or action by person/body. Power to increase/decrease/adjust capital sotck apply to all or any classes.
            ◇ Del 152-153 - Issuance of Stock; Consideration for Stock) - Board can determine how pay for stock issued, consider can be case, property or benefit to corp or combo. In absence of fraud, the board's jdgmt of consideration value shall be conclusive. May not issue for a value less than par value (unless can issue without a par value). Can dispose of treasury shares. If cert of incorp reserves right of shs to determine consid of issued shares then do by majority vote of outstanding stock entitled to vote (unless cert of incorp require greater %).
        (e) Excessive Dividends
            ◇ Del 170 & 154 - test for excessive dividends
                ► 170 - may pay out of surplus or out of net profits when no surplus
                ► 154 - capital is excess of aggregate par value of issued shares (but corp can specify lesser amt so long as not below par value aggregate). Surplus is the excess of net assets of corp above amt determined as capital. Net assets is the amt by which total assets exceeds total liabilities.
            ◇ Del 174 - shareholder liable when have knowledge
            ◇ Cal 500-501, 506
                ► 500 - express provision that sum of assets of corp (exclusive of goodwill, cap research, dev exp, & deferred charges) at least equal to 1.25 times its liab; and current asset at least equal to current liab or if avg earnings before taxs and intr exp for preceding fiscal ears less than avg intr expense of corp, at least 1.25 times current liab. In determinig assets profits from exng of assets are not included

unless currently realized in cash. May include A/R. But not applicable if no use GAAP. Amt distrib must be carried on fin stmts per GAAP. If distrib is cash or property in connection with shares than must add back any previous deductions incurred in connection with repurch of shares but not in excess of oblig's principal immediately unpaid prior to distrip

- 501 - can't make distr if make it like that unable to meet its liab
- 506 - Liab for excessive dividends. If sh receive prohib distr with knowledge impropriety then liab to corp for bene plus intr. If it was proper than liab for FMV at time of illegal distr plus intr. Standing - suit may be brought in name of corp to enforce liab to creditor for viol against any/all sh liable...

(f) Insolvency and Fraudulent Transfers (UFTA)

c) Exceptions for Director/Officer Liability

- Under agency law, directors and officers are NOT personally liable for debts of the Principal

(a) Promoter Liability
(b) Defective Incorporation
(c) Fraud or misrepresentation by agent (usually D/O)
(d) Watered Stock

- Board liability when the valuation is bad faith or a clear statutory violation

(e) Excessive Dividends

- Del 174 - Board Liability. Willful and negligent violation make them j&s liable at any time within SIX YEARS of paying dividend or after unlawful stock purchase/redemption.
  - If dissent on vote can be exonerated, at same time or immediately after. Must be on books.

(f) Insolvency and Fraudulent Transfers Act

d) Analysis Tips

- First think about what role the D is in (i.e. shareholder or d/o)
- Then talk about the different theories of liability within that role (the cause of action)
- First talk about the general rule, then the exceptions.

e. Corporate Governance: Roles of Managers & Shareholder Voting

a) Formalities Required for Shareholder Action

- Kidsco Inc. v. Dinsmore
  - Bylaws gave directors right to amend bylaws at any time. Thus, even though code says that can't take away or impair sh remedy against corp or officers for liablility and even though Del Code says power to adopt, amend, or repeal bylaws belong to sh except that cert of incorp may also confer to directors, there was no cause of action when the directors amended the bylaws.
  - The shareholders were trying to demand a meeting. The directors changed the number of days required to call a meeting. Since at the time the change was made the shareholders hadn't yet demanded meeting there was no right that was violated.
- Matter of Auer v. Dressel - dissent?
  - The shareholders were trying to get the president to call a meeting to remove director.
  - Corp's cert of incorp had a provision that authorized board to remove director on charges but the ct said this was IN ADDITION TO THE SHs traditional, inherent power to remove their directors. Ct see as an addtl method.
  - Stands for general rule that have the ability to remove directors for cause.

- Fraud or breach of fiduciary duty is grounds for removal.

b) Stats:
   - Del Corp Code § 101, 102, 109, 141, 142, 211, 212a, 216, 223, 228, 242b, 251b-c, 271, 275 (shareholder vote reqmt only)
   - Cal Corp Code § 151-153, 301.5a-d, 303-305, 603-603, 708, 710

c) Liability for Not following Corp Guidelines
   a) Analysis Tips
      i) First ask if it can be done.
         - First look at the cert of incorp (cert trumps bylaws)
         - Then look at the bylaws
      ii) Next see if proper procedure was followed
   b) Key Overview of Corp Terms/Roles
      i) Code
         - 223 - normal, default rules in the code. But can vary in the cert of incorp or bylaws unless it is a mandatory rule.
      ii) Certificate of Incorp
         - Governed by 102
         - Includes name, purpose, address, etc.
         - Cert of corp is a special K btwn the state and the corp, but it provides guidelines for corp that affect sh-dir rship
         - 109b - The cert of incorp will trump bylaws if there is a difference
         - Decide to put something here if the Code requires it or if you want to make it difficult to change that provision (as opposed to placing in bylaws)
      iii) Bylaws
         - Governed by 109
            - 109a - shareholders have power to adopt bylaws, but there is an exception before stocks are issued (the initial board can adopt bylaws)
         - This is about internal governance of the corp
         - It is much easier to change bylaws than cert of incorp
         - Code creates limits that the bylaw cannot change, so need to make sure bylaws no viol
            - Is this the cert of Del. Code or Cert of Incorp that is referenced?
         - The cert of incorp may give directors the power to amend/repeal/adopt bylaws BUT this would be in addition to shareholders having that power (**cannot** divest sh of that right)
      iv) Officers
         - Governed by 142
            - 142b - chosen as stated in the cert of incorp or if not stated then by the board of dir
         - Run the day to day operations of the corp
         - 102b - this is a broad catch all, you can give broad management powers in the cert of incorp
      v) Directors
         - Governed by 141
         - Direct and manage the corp
         - Powers and duties are what is typical of directors, if want to change that then this needs to be in the cert of incorp
         - As a director you can't K to delegate your duties.
            - You cannot be a mere puppet
            - Raises breach of fiduciary duty coa
            - Distinguish where authorize committee to approve ordinary

business action (just can't be fundamental business matter)
- Potential exam issue: distinguish power by being majority shareholder versus legally obligated control

- Removal
  - General rule is that directors can be removed with or without cause, unless otherwise is specified in cert of incorp
- Classified Board - staggered terms
  - 141d- talks about creating a classified board
  - Exception to the general rule about removal; Generally these directors cannot be removed without cause
- **Cumulative** Voting
  - 141k - another exception to the removal rule. It is a sophisticated voting mechanism that must be in cert of incorp
  - Vote all at once and votes only count once, the directors who have the most votes win

vi) Meetings
- 211d - special meetings may be called by board or however entity's cert of incorp authorizes
  - Generally, shareholders do not have the power to call a special meeting
- Code specifies that there are annual meetings
- 216 - annual meeting has quorum requirements for voting

c) Powers of Shareholders
- Clark points out that not express in code, but buried in diff sections
- Clark's summary: shareholders don't get to nit pick and manage the corp

i) Meetings
- 211b - unless elected by written consent in lieu of annual meetings
- Shareholders don't have the power to call meetings, unless cert of incorp gives them that power
- Shareholders can introduce proposals, but they don't speak on behalf of corp and their actions must go through managers

ii) Bylaws
- 109 - bylaws created by incorporators, initial board, or directors (but after stock issued sh have power to adopt)
- After issue stock, power goes to sh
- There is no reqmt that sh pass board resolutions regarding bylaws, nor is their info about voting reqmts to pass (unlike the reqmt for cert of incorp amendments)
- 142e- filling of officer vacancies per bylaws
- 216 - A bylaw amendment adopted by shareholders that specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors

iii) Inspecting Books
- 220

iv) Dissolving Corp
- This is an option for closely held corp

v) Cert of Incorp
- 242b - Shareholders can't decide to change the cert on their own, must have a resolution first
  - This is impt if want to change the way officers elected for example

vi) Filling Vacancies
i. Board Power to Fill

- Vacancies
  - 223a1 - board can fill vacancies and new directorships
  - 223a2 - is sh entitled to elect 1+ directors by cert of incorp, vacancies and new directorships may be filled by majority of directors elected by such class then in office or by sole remaining director so elected by that sh class
  - 223 b - any director so chosen holds office till next election and until successor elected and qualified
  - 223d - unless otherwise provided in cert of incorp or bylaws, when 1+ director resign the majority of directors then in office may fill vacancy
  - 142a,b - officers filled by how set out in bylaws OR by the board
  - 142e - bylaws will determine how officer vacancies filled. Provision regarding how officers elected should go in the bylaws.
- 109b - Special powers of the board must be placed in the cert of incorp
  - Power to amend/repeal bylaws
- Board elects officers

ii. Shareholders Power to Fill

- Elect Directors
  - 211b default voting requirement
  - Annual meeting of shareholders
    - 216 - quorum requirement for voting. Majority (51%) constitutes quorum.
  - 212a - one share is entitled to one vote, this can only be modified in the cert of incorp
  - 216 - directors are elected by plurality of votes of shares (in person or by proxy) **entitled to vote**
    - Plurality - means most votes will elect the director
    - Distinguish 216(2) - just the majority of shares **present** (or rep by proxy) to vote on regular business
    - Other fundamental matters that have special voting requirements:
      - Merger
      - Dissolution
      - Amendments to Cert of Incorp
    - Amendment adopted by s/h specifying votes necessary for election of directors shall not be further amended or repealed by board
- NOT to elect officers (that is directors)

vii) Removal of Director

i. Default rule is that can remove directors with or without cause at election meeting, unless the cert of incorp provides otherwise.

ii. Staggered boards require that the removal be for cause.

- 141d- talks about the creation of a staggered board.
- 141k - talks about cumulative voting. This creates an addtl hurdle to removal of directors. But this must be in the cert of incorp.

iii. 216

viii) Written consent in lieu Vote (applies majority SHs consensus)

- § 228 - Unless cert of incorp say otherwise: If have written consent

of the shareholders who would have the votes necessary to authorize action at mtg then can take action without mtg, without prior notice and without vote.

- Must deliver to corp's registered office.
- Must be signed by each sh or member. Action can only be taken if rec'd within 60 days of earliest dated written consent.
- Must give prompt notice of taking of action without mtg to other shs who would have been entitled to vote at a mtg.

d) Shareholder Checks on Directors
   i) Exit (sell stocks) - limited because when sell, its value suppressed by mismngmt. Only really works for publicly traded corp.
   ii) Litigation - based on claim that not mnging correctly (e.g. viol f.d.)
   iii) Voting - for mngmt, for mngmt proposals. But limited.
   iv) Takeovers - require wealthy/sophisticated individual. Hand in hand with voting.

f. Summary of Key Provisions for Valid Corporate Acts
   a) Number of Votes Necessary to Approve Ordinary Business (e.g. comp package
      - 141b - to vote must have quorum at meeting, the code's default is 1/3 of the directors.
      - 141 - to approve must be majority of directors present
      - 141c - the interested directors could approve a special committee (i.e. the disinterested directors) to approve the act. Otherwise they need to be there to approve the act and they could be needed to disclose material info.
   b) Number of Votes Necessary to Ratify (i.e. "Cleanse") Self-Interested Transaction
      - 144a1 - majority of the disinterested directors. NOTE this is not of the full board.

g. Other Protections for Third Parties - DISCUSSED ABOVE
   a) Watered Stock Liability
      (a) Statutes: Del § § 102a4, 151a, 152-153, 162
         i) Del § § 102a4, 151a, 152-153, 162
   b) Liability for Excessive Dividends
      (a) Statutes: Del § 154, 170, 174 VERSUS Cal § 500-501, 506
   c) Insolvency & Fraudulent Transfers
      (a) UFTA: Uniform Fraudulent Transfer Act

IV. Corporate State Fiduciary Duties & Shareholder Litigation

A. Business Judgment Rule

i. Cts will presume that directors/officers (i.e. management) are:
   1) Disinterested
   2) Fully informed
   3) Acting in good faith, and
   4) Acting in best interests of the corporation.

ii. Ordinary Business Judgment versus Fundamental Business Matters
   - Examples Ordinary Business Judgmt
     - Declaration of dividends, Executive compensations, Hours of Operations, Reinvestment of profits, Development of Profit Lines
   - Examples of Fundamental Business Matters
     - Mergers
     - These cannot be delegated.

B. Elements of Cause of Action

1) Duty
   - This is based upon the fiduciary duties we learned about in agency law section.
   - Perform in good faith and with the degree of care an ordinary prudent person would use in similar circumstances.
   - Caremark rejected the rule that the board must be on notice of wrongdoing before a

duty arises. The modern rule is that the board has a duty to keep itself informed and discover wrongdoing. But practically speaking this is easily met, and damages to corp are minimal.

2) Breach
   - Usually rejecting and resigning is enough not to breach duties. But there are exceptions where must do more, i.e. try to prevent the harm.
3) Causation
4) Damages

C. COA Hurdles
   a. Plead with Particularity
      - Must plead facts with particularity, but not allowed to do discovery at this stage. Instead, use Del 220 (i.e. sh right to inspect books) to meet this requirement.
      - Still hard to survive though, example, of the expert who said it was a bad deal.

D. Overview of Types of Claims
   a. Failure to take due care/ neglect (limited to procedural due care)
      - It may include malfeasance and nonfeasance (inaction)
      - Duty to inform self of all material information before making a business decision.
      - Process-Oriented
      - Materiality determination:
        - Information that might influence the decision of a reasonable and prudent person in similar circumstances
   b. Ultra Vires
      - Actions taken outside of the corp purpose considered void or voidable
      - Similar to waste, and seldom used now
      - Is this limited to "corp purpose" or is it also acts where no follow Corp Code or Cert of Incorp's modified limits?
   c. Waste/ Bad Faith
      - Waste Test - was it unconscionable, irrational, or so "one-sided decision that no bus person of ordinary, sound jdgmt could conclude that the corp has received adequate consideration."
        - Extremely hard to meet. Cts don't really get involved in exec comp unless self-dealing alleged.
      - Charitable Contributions
        - Usually can go show that the contrib is okay by basing it upon corp good will and tying that back to profits.
        - Considerations re Whether or Not Charity is Waste
          - Some benefit to corp intr?
          - Indiscriminate or considered action
          - Pet charity in furtherance of personal rather than corp ends?
          - Amount reasonable/modest?
            - In comparison to profits or
            - In comparison to past practice
      - The burden will be on the P to show that there is an illegitimate purpose.
      - Fairness is NOT a defense to successful waste claim
   d. Self-Dealing
        - Friendship not enough to be self dealing (see Disney)
        - Look for whether there is a potential claim of self-dealing. All you need to do at first is to show where there is potential self-dealing.
        - This is the strongest claim to bring because **motive is unimportant**.
        - The burden shifts to the D to show that the self-dealing transaction is fair.

   (a) Rules re Interested Director Transactions
      1. Old Rule
         - Transaction is voidable
      2. Modern Rule

- ◇ Transaction is voidable UNLESS ratification by disinterested board AND transaction is fair

3. Bayer Rule (most recent)
   - ◇ Transaction okay so long as ratification by disinterested board OR the transaction was fair
     - ► Key here is that there was disclosure though, it is just that the disinterested board did not ratify. That is why it is okay that fairness will mean that the transaction is okay (whereas normally must disgorge).
     - ► This doesn't seem to be reflected in the Chart that Summarizes SH Challenges to Board Action. There, the question is just whether there is entire fairness to corp.

(b) Can arise from:

1. Taking a **corporate opportunity**
   - ◇ Liability for director/officers (i.e. agents of the corp)
2. Conflict of interest
   - ◇ Liability for directors/officers (i.e. agents of corp)
   - ◇ Interested parties. Same people on boards of both corps (one approving transaction and the one getting the benefit of the transaction). On both sides of transaction.
   - ◇ Using Corp Property for Personal Benefit
   - ◇ Dilution of Voting Power - corp action may not be taken for sole or primary purpose of entrenchment
   - ◇ Outsider status is different from Disinterested status
3. Dominant shareholders benefiting at minorities' expense
   - ◇ Liability for dominant shareholder

(c) Corporate Opportunity Analysis

- ◆ Determining whether something is a corp opp
  1. Opp is in corp's line of business
     - ► i.e. Singer test. The car case, where they didn't provide that type of svc.
  2. Corp has intr or expectancy in the opp
     - ► Narrower than if it's in line of business
  3. Corp financially able to take the opp
     - ► This would have meant that in Singer there was no conflict bc not corp opp where can't finance entering into that new bus
     - ► Is this a lower standard than in typical agency law that would hold this is an opp. If so, is the distinction just where a corp is involved?
  4. By embracing the opp the officer or director would create a conflict btw his/her own self-intr and that of the corp
- ◆ Rules re D/O's Duty with Respect to Corporate Opportunities
  - ◇ 144 - Disclosure to the Corporation
    - ► Disclosure to board and vote by disinterested directors to reject the opportunity
    - ► Disclosure to shareholders
  - ◇ Ratification of transaction is subject to procedural due care and good faith duties

(d) Dominant Shareholders Fiduciary Duty to Minority Shareholders

- ◆ The general rule is that shareholders do NOT owe a fiduciary duty to other shareholders.
- ◆ Exception is where:
  1. SH dominates or controls the corporation, and
     - ► Look at percentage of share ownership, whether nominated the directors, whether employ the directors/officers

- But mere fact that nominated the directors NOT enough. Okay to exercise sh power to vote for whom wish.
- It is NOT just number of shares, but some extra level of control

2. Controlling SH receives benefit to the exclusion and at the expense of the minority shareholders, then
   - Similar to self-dealing analysis (i.e. whether corp opp, whether on both sides of transaction, magnitude of benefit)
3. Burden shifts to controlling SH to prove intrinsic fairness of the transaction.
4. BUT ratification by disinterested shareholders can shift the burden back to P to prove unfairness.

(e) Steps to Analysis of Self-Dealing

1. The P must show that there is self-dealing (i.e. this is a corp opp, there is a conflict of interest, or the dominant shareholder benefits at minorities' expense)
2. If establish that self-dealing then burden shifts to D to show that fair.
3. But before relying on showing that inherently fair, D will try to show that ratification occurred.
4. If D can show that ratify (and comply with procedural due care and good faith reqmts for approval, i.e. fully disclose all material info to approval of disinterested board or of shareholders) then burden shifts back to P to overcome BJR (i.e. P will need to show unfair)
5. But if cannot show proper ratification then must show inherent fairness.

e. Cross-Pollination of Claims
   - The board acts as a body. Therefore, where one director is self-dealing then it raises the issue that the other directors who approve the transaction have breached procedural due care or committed waste.

E. Director/Officer Defenses/Limits on Liability

a. Procedural Due Care Violation Defenses

(a) 141e (Reliance on Experts)
- Protected if rely in reasonable good faith upon reports/recc of experts (professional or competence expertise) that were reasonably selected on behalf of corp
- Can be useful with regard to compensation claims

(b) 141c (Deleg of responsibilities)
- Can delegate board responsibilities to special committee. The committee can exercise all powers and authorities of board to extend allowed in bylaws of corp or resolution of the board **EXCEPT cannot deleg:**
  - Amend cert of incorp, approve merger, recc sale lease or exchange of all or substlly all of corp's assets, dissolution, amend bylaws
  - Dividend, issue stock or adopt cert of ownership and merger (Unless resolution, blaws or cert of incorp provides that can).

(c) Fairness
- Fairness of the transaction (i.e. not detrimental to shareholders) is a defense to due care violation.

(d) Entire Fairness to Corporation (REQUIRED FOR MERGERS)
- If breach due care with regard to a MERGER, the board must show ENTIRE FAIRNESS.
  - Procedural fairness by which the judgment was made AND
  - Fairness in the substantive result (i.e. fair price/good deal)
  - Fair procedure

b. Ratification by Disinterested and Informed Parties (144a1)

(a) Overview
- This is NOT a defense to waste
- Can be ratification by board OR by shareholders

- Can cleanse a self-dealing problem so that the burden doesn't shift (remains on the P to prove)
- Can also make it harder to prove waste because a disinterested board has determined it was reasonable
- For disinterested board ratification § 144 says that it is okay if the disinterested directors are less than quorum
- Result if board or shareholders properly ratify is that the P loses unless can show waste

(b) Analysis Tips
- Look for whether the board knew about the potential conflict of interest
- Look for whether the board knew everything about the conflicted individual's role
  - Goes to show whether truly informed.
- If not informed about something, analyze whether this is **material**
- Determine if the ratification complies with requirements of procedural due care and good faith duties

(c) Requirements (for both Board or Shareholder Ratification)
1) Majority ratification
2) Fully informed
3) Disinterested

c. 102b7 - Limitation of Liability for Procedural Due care Violations
- This is what MAY go into cert of incorp
- Directors liability limit
  - Personal liability
  - No eliminate duty of loyalty, not in good faith or intentional or knowing violation, improper personal benefit.
  - Basically only limit damages (the payment for procedural due care breaches)
  - Only by directors

d. Fairness Defenses Compared

(a) Fairness
- Fairness of the transaction (i.e. not detrimental to shareholders) is a defense to due care violation.

(b) Entire Fairness to Corporation (REQUIRED FOR MERGERS)
- If breach due care with regard to a MERGER, the board must show ENTIRE FAIRNESS.
  - Procedural fairness by which the judgment was made AND
  - Fairness in the substantive result (i.e. fair price/good deal)
  - Fair procedure

(c) Inherent Fairness (required for DOMINANT SHAREHOLDER trans)
- If self-dealing violation because dominant shareholder then must show inherent fairness. Entire fairness if burden has shifted because no ratification by disinterested board. But if burden hasn't shifted then P must show it was not intrinsically fair.

(d) Not A Corporate Opportunity (defense to the Self-Dealing claim)
- See test above for whether something is a corp opp

e. Director and Officer Insurance

F. Exam Tips
1. Structure based upon board action.
2. Identify the possible claims of each action.
- Argue self-dealing first because that is easier to meet than waste.
  - Common Types of Self-Dealing
    - Exec compensation (interested directors or controlling sh)
    - Loans to D/O
    - Secret compensation

- ◇ Using corp property/funds for personal purpose

3. Address the rules within each claim.

G. Case Examples

a. Francis v. United Jersey Bank
   - □ Shows nonfeasance can be breach of duty. Shows the standard held to.
   - □ Mother was on the board of directors. Her sons were also on board. She did not participate in decision-making. The sons took money and used it for fraudulent purposes. Mother failed to stop the illegal actions of her sons.
   - □ Her estate was liable for losses. It did not matter that she only had 41% of shares and could not have voted out her sons.
   - □ Goes to show procedural due care requirements to satisfy a directors duty: held to standard of a reasonable director (not to a regular person). Thus, she was required to get enough knowledge to be able to understand the statements, to know what questions to ask. And you also cannot stick your head in the sand.
   - □ Here she was required to do more than just reject/resign. Ct said this was an example where she had a duty to report the violations.

b. Disney
   - □ Shows ordinary business matters and the benefit of the BJR presumption.
   - □ Dispute regarding exec compensation package and the terms of his termination.
   - □ Goes to show that can delegate some of directors' responsibilities. The board had an excec compensation committee that had determined this was reasonable.
   - □ Goes to show the difficulty of surviving a claim of waste. Goes to show that will look to whether procedural due care satisfied, not substantive due care.
     - ◆ Ct said there were reasons for the decision - no want the ceo to sue, at the time he was heavily recruited, at the time eisner was having difficulty getting along with ceo.
   - □ Goes to show difficulty of meeting pleading hurdles in a derivative suit. It was not enough that the expert said after the fact that he did not present a table with the amount of money that would be paid in each circumstance and that this was a bad deal.

c. Caremark
   - □ Rejects the old rule that a board has to be on notice of wrongdoing before a duty arises. Instead, must take steps to keep self informed and aware of wrongdoing (even in remote areas of corp).
   - □ Regulatory climate played a role in the heightened duty. It must be a breach that is beyond good faith, but systematic and utter failure to exercise oversight.
   - □ But goes to show that even where a duty is breached the damages may be nonexistent. Here, it was enough that the corp had put into place some p&p (the ct issued specific performance that had to do these things).
     - ◆ The only winners were the attorneys (got fees), the corp didn't get any damages. The derivative suit originally asked for personal liability of the directors (reimburse the corp for the cost of the penalties). Cts unwilling to award usually because want directors to serve.

d. Kamin
   - □ Shows the BJR presumption can be a powerful shield.
   - □ Declaration of dividends versus sale of the stock. The sale of the stock would have been more beneficial to the corporation financially because of tax savings. However, the ct was allowed to presume that this was not waste because it was reasonable for the ct.
   - □ The fact alone that the directors were officers who got some financial incentive by choosing an option that did not affect the bottom line no mean that this became an issue of self-dealing. Must plead with sufficient particularity, not just assert conclusions.

e. Dodge

- Example where the BJR presumption was overcome with regard to ordinary business matters (declaration of dividends, and reinvestment of profits). This was an unusual case because the CEO basically said that he was not basing his decision upon profits. He made statements that said that he felt the corp made too much profits.
- Substantive violation?

f. Van Gorkam
- Example of where Ps overcame the BJR presumption with regard to fundamental matter. The directors breached their fiduciary duties owed to shareholders. They did NOT reach an informed business decision with regard to the sale. Example of procedural due care violation.
- Rail car company, the company had lots of write offs that could not take because no taxable income. CEO wanted to sell to a larger corp that needed tax write offs.
- The reports could not be relied upon because they did not receive them prior to the meeting, the reports were based upon uninformed assertions.
- They were not informed because did not realize that the price for the buy out was set by the CEO. So there was no ratification by the board (assuming the CEO was an interested party).
- Ds tried to argue fairness because of the market test. But the cts no buy because the agreement no allow them to do a true market test because could not solicit bidders and could not provide them with corp information that would want to know. And the amendment to the agreement was also problematic because the terms and time limitations make a market test meaningless.
- The damages were any difference btwn the fair value of the shares and the price/share that they shareholders received in the buyout.

g. Lewis v. SLE, Inc.
- Goes to show that the self-dealing claim is easier to meet because no care about motive. The conflict of interest arose because the same people who owned and were running the bus corp were also running the land corp. Their interests were directly opposite. Interests as agent-mngmt versus interest as shareholders.
  - That's because for self-dealing claims the burden is on the D to show fairness. Whereas, in waste claims the burden is on the P to show illegitimate purpose.
- This was a family business. Two corps were set up, one that owned the land. And the other corp was the business itself. When dad passed away he left the corp that owned the land to all his children but made them sign an agreement that would sell the shares in the corp to the children who owned the business corp after a certain period of time.
- They sued claiming that breached fiduciary duty of loyalty. They were self-dealing because the children that owned the bus corp were also on the board of the land owning corp.
- Also sued claiming waste. They paid rent to that land corp below market.
- The cts remedy was that they had to provide for an accounting of the fair value of the rents that should have been paid. This was owed to the shareholders of the land corp.

h. Cohen (Sears)
- Self-dealing claim
- The shareholders had originally approved stock options that the board later changed to reflect the downward price in the stock. The derivative suit was based upon the fact that some of the board were interested parties (employees who can take advantage of stock options).
- However, there was ratification both by the disinterested members of the board (the non-employees who were fully informed) and by the shareholders.
- Goes to show that because of ratification, the burden no longer shifted to the Ds to show fairness. Instead, the burden remained on the Ps to rebut the BJR.

i. Benihana
- Self-dealing claim brought against the directors of the corp because they were issuing

more shares and diluting his voting power.
- Self-interest claim came because one of the directors was on both sides of the deal. He was the majority sh in the corp that would be buying up the shares in Benihana.
- The board ratified the decision but there was an issue over whether they were fully informed because the person negotiated the deal. Ultimately the board met the defense that there was entire fairness to the corporation.
  - Ct ultimately said that they were informed enough.
- Also it was entirely fair to the corporation. They had outside experts come in and talk about the value of the shares. Thus, the corp met its burden that had fair price and fair procedure (there was lots of deliberation).

j. Broz
- Goes to show that there was no self-dealing because not deemed a corporate opportunity.
- Cell phone contracts case. He asked several people on the board if they were interested in the K. They all refused. Further, it was in line with the corp's plans to exit that market.
- No liability was found for that individual director or for the board.

k. Ebay
- Founders of ebay accused of violating the f.d. owed as d/o of the corp - breach the duty of loyalty. They were taking the corp opp by getting first crack at new ipos (spinning - make immediate profits because buy at low ipo price and sell to higher mkt).
- The holding was that there was enough evidence to survive summary judgment.
- This involved a claim of self dealing. It could also involve a claim that they breached the fiduciary duties owed as agents of the corp. Under the agency theory of liability if the money was a reward for doing business with the financial brokerage firm then it was secret profits that owed to ebay (i.e. profits obtained personally by agent in connection with transaction related to principal).
  - Clark says this is harder to prove than the self dealing claim because motive is assessed.
- Under self dealing you need to determine if this was a corp opp
  - In ebay's line of business?
    - Look at whether this is a part of ordinary course of business. The ct said yes because ebay regularly invested in marketable securities. The D tried to argue this was a collateral investment opportunity.
  - Does ebay have an interest or expectancy in this opp?
    - The difference to above analysis is whether opp is essential to corp and whether came to Ds because of role within corp
    - The ct said yes because they routinely invested in businesses and it was integral to ebay's cash management and a significant part of its business. D tried to argue that these investments were too risky.
    - Ct also felt that the opp came to the founders because of their position within ebay. D tried to argue that opp that presented to them by virtue of being wealthy individuals.
  - Is ebay financially able to take advantage of the opp?
    - The ct said that they had the finances to do so
  - By embracing the opp does the d/o create a conflict of interest btwn own self intr and the intr of the corp?
    - Gut check - yes conflict

l. Sinclair Oil Corp. v. Levin
- Self-dealing claim based upon breach of fiduciary duty controlling shareholder own to minority shareholders.
- Shows how you structure analysis based upon corp action
  - First analyze whether Excessive Dividends was self-dealing

- Next whether there was self-dealing because usurp corp opp
- Lastly, whether the breach of contract was self-dealing

- The excessive dividends analysis based upon controlling sh breach of f.d. theory of liability (dominate/control?, benefit to exclusion at expense minority?, then burden shift to D to show intrinsic fairness)
  - Did Sinclair dominante/control Sinven?
    - Yes, because Sinclair was the majority shareholder (97% of shares), it nominated the entire Sinclair board, and the Sinven officers and directors were employees of Sinclair.
  - But Sinclair no benefit to exclusion and at expense of Sinven's other minority shareholders because all shareholders shared equally in the dividends. Further, the dividends complied with § 170 (can declare dividends even when no net profits if it is out of surplus capital).
  - Thus, burden no shift and BJR applies.
- Usurp Corp Opp Analysis
  - Already find dominate/control
  - But not a corp opp (so no receive benefit to exclusion and at expense of minority SH)
    - The opp not within Sinven line of business because exist in other parts of the country (but counter is could say line of business was oil drilling)
    - There was no intr or expectancy in these opp because came to Sincalir (not Sinven), Sinven's cert of incorp no say beyond Venzuela, past conduct btwn the parties indicate that drilling was within that country
  - Thus, no shift burden and BJR applies
- Breach of K Analysis
  - Already found dominate/control
  - But self-dealing because on both sides of transaction (so receive benefit to the exclusion and expense of minority SH)
    - Sincalir was on both sides of the contract (their own wholly owned corp, International, contracted to buy up Sinven's production at a minimum amount)
    - Sinclair stands to benefit more from International than Sinven (because own them 100%). This was at expense of Sinven because could have gotten contract enforcement or damages from the breach
    - International was breaching because not paying on time and not purchasing guaranteed minimum.
- Planning: Sinclair could have made this a 100% Parent-Sub relationship - avoid minority sh. They could have made Sinven's purpose in the cert of incorp a narrow one - avoid question of whether usurping corp opp.

m. Zahn
- Calling the shares did not breach fiduciary duty but failing to disclose the company's true worth (the value of its assets) was a breach.
- Here, the burden shifted to the Ds to prove fairness because Transamerica was a controlling shareholder that benefited to the exclusion and expense of the minority shareholders
  - Majority share ownership, nominated most of the board, their agents were on the board of directors and were officers in the corp
  - The majority shareholder got to share in the lucrative assets after liquidation but the minority shareholders in class a were not able to share.
- But note damages the Class A shareholders got was NOT what they originally wanted (they wanted the greater portion of the assets that entitled to as A holders). Instead, ct recognize that a disinterested board would have called the shares. But they also would have informed the shareholders of the company's true value which in turn would have made them use their conversion option. So damages were limited to

what would have gotten if had converted to Class B shares (less the amount they had already received when bought out as A shareholders).

H. Direct versus Derivative Claims

a. Overview

(a) Terms

- Demand - requires SHs to inform Board and request that it take action to remedy a deriv suit before filing suit

(b) Difference

- Direct is a suit where P suffered a personalized injury, distinct from status as a shareholder
- Derivative is an injury that is to the corp
- Procedural hurdles apply to derivative claims.
  - ◇ Derivative requires demand first (unless satisfy exception). Whereas, direct suits no require demand.
  - ◇ Some states require contemporaneous ownership, certain amount of stock (e.g. 5% ownership or 2k) and bond.
    - ► Deriv suit may require security (but not direct, even if it's a class action representative suit). Security is a substantive law that fed cts must apply - but note there could be a question of which state law applies.
- Corp is required to pay atty-fees in successful derivative suit

b. Test re Direct v Deriv Claim

- Difference depends on the nature of the relief sought and the wrong that is alleged
- Is there a special injury test that distinct from the two prong test below that we are responsible for?

1) Who suffered the alleged harm, the corp or the suing shareholders individually?
   a) P's claim is separate and distinct from the harm suffered by other shareholders
      - ◇ Think of this more as a PERSONAL harm versus a distinct one
   b) Wrong involves a contractual right of a shareholder
      - ◇ If so, then this is a derivative suit That is voting, dividend, liquidation, and other rights specified in stock purchase agreement/cert.
2) Who receives the benefit of a recovery or other remedy, the corp or the shareholders individually?

c. Examples

- □ Dodge v Ford
  - Challenge of the Dividends
    - ◇ This could be seen as a direct suit because they were seeking the remedy of money
    - ◇ But also could be a derivative suit because they wanted a dividend declared and so perhaps it gets to a contractual right of the shareholder. Here though the dividend was based upon past practice rather than cert of incorp. More likely direct though because seeking money.
  - Challenge regarding the expansion plans as waste/ bad faith
    - ◇ This is a derivative suit because seeking injunction. The corp would benefit
- □ Lewis
  - Deriv - waste claim because fail to increase rent, money back to corp
  - Direct - seeking proper accounting based on updated corp value (enforcement of shareholder agreement to purchase sales)
- □ Benihana
  - Deriv - self-dealing, seeking injunction against stock issuance plan; bad faith
  - Direct - challenge to plan on grounds that it deprived BOT (sh) of voting control
    - ◇ How is this distinct from a contractual right that would be deriv?

- ◇ Example of suit brought to protect certain shareholder rights (direct)
- ◇ Versus a suit to prevent mngmt practices calculated to prevent challenges to current mngmt (deriv)

- □ Grimes
  - ◆ SH upset about exec comp. Made a demand (in the form of a letter asking board to abrogate the agreements). Board refused the demand.
  - ◆ He was alleging waste and due care breach so these were derivative claims. But he also alleged abdication of their duties which the ct felt was a direct claim. Monetary recovery no accrue to corp, instead agreements just invalid.
  - ◆ Once he make demand, he cannot later claim that it was excused. He can still ciam that it was wrongfully refused though.
- □ Cohen v. Beneficial
  - ◆ stands for proposition that fed cts must apply state law regarding the security requirement because this is not just procedural, it is also substantive. This affects whether the P will be allowed to bring suit because may not be able to post bond.
- □ Eisenberg
  - ◆ stands for proposition that bond is not required for direct suits and that the fed ct still has to decide which state law to apply.
- □ Derivative
  - ◆ Give value of stolen opp back to corp (e.g. Broz, Ebay)
  - ◆ Waste because bad op decision or irrational charitable contribution (e.g. Kamin stock sale, Barlow charity, Wrigley field, Disney exec comp)
- □ Direct
  - ◆ Paid insufficient money for shares, Failed disclosure prevented informed decision to sell or convert or informed vote, Merger strategy deprived minority shares of voting rights (Van Gorkum rails, Zahn stock classes, WTI pay insuff and fail disclose prevent informed vote, Cohen merger strategy deprived minority shares of voting rights).

d. Demand Requirement
- □ Purpose behind demand
  - ◆ Legal claim belongs to corp: managers entrusted with right to decide whether to assert the claim and control it (Avoids harassment by minority SH and interference with mngmt chosen by pluarlity)
  - ◆ Allows board to resolve prob without lit
  - ◆ Discourages "strike suits" commenced by SHs (attys) for personal gain
- □ If a demand is required but not made then the suit is dismissed
- □ Even if demand is made, the board can decide to reject it. Their rejection decision will receive the benefit of the BJR.
- □ Once you make the demand you cannot later claim that it was excused just because the board rejected it. But you can claim that the rejected demand was wrongfully refused.
- □ Demand Excused
  - ◆ Demand requirement is excused when it would be futile
  - ◆ Reasonable Doubt Demand Excusal Test (on page 228)
    i. Demand is futile when there is **reasonable doubt** over the board's independence. This is typically shown when:
      1) Majority of board has a material **financial** or **familial** interest,
         - ▸ Financial interest could be just that on both sides of trans (e.g. directors of both corps)
      2) Majority of board is dominated or controlled, OR
         - ▸ Cannot just conclusively state. Need facts with particularity. Will either be clearly met (e.g. Zahn or Sinclair) or not.
      3) Underlying transaction was not product of valid business judgment

- Would you be referring back to analysis under the self-dealing claim? Seems to make more sense if referring back to procedural due care analysis. <-- This would be waste. Self-dealing would only come into play if the board was controlled by the Bayer CEO right?

- Examples
  - SLE - likely excused because material financial and familial interest AND domination/control of majority board
  - Sinclair - likely excused because domination/control of majority of board
  - Bayer (celanese) - probably not excused because majority board not fin/familiy interested and was not alleging domination/control majority of board, whether product of valid bus jdgmt assed in merits and likely ok per BJR

- Demand Required but Rejected
  - If the board (or SLC) rejects the demand then the P must show that the decision was wrongful refusal (i.e. must trump the BJR)
    - No discovery is allowed
    - Note the focus is on the decision to reject, not the underlying transaction
    - Note that this is different from where demand was excused and then a SLC recommend dismissal…there the burden of proof is on the D
  - Practically speaking, impossible to do. But this would go to show wrongful:
    - Utter disregard for demand, did not even discuss. Board's actions are only judged post-demand.
- Demand Excused but Board forms SLC that Recommend Dismissal
  - If demand is excused because the board is interested parties (i.e. excused under one of first two prongs), the board can still form a Special Lit Committee (144) that can review the derivative suit and decide whether or not to recommend dismissal
  - P has more chance of winning if fall into this category (because BOP on D)
  - If SLC recommend dismissal:
    1. Burden on Ds (e.g. board) to show that SLC recc satisfy the BJR presumption (i.e. disinterested, fully informed, and acting in corp's best intr)
       - BUT the analysis will go beyond just family and financial interests. Scrutinize to anything that would compromise independence - down to the level of human nature (remember the Stanford Proffs)
       - The acting in corp's best intr analysis can take into acct "SOFT" factors - ethical, public relations, charitable role, employee relation - because the board can tie that back into the bottom line and corp profit.
    2. In some jdx (e.g. Del, but not NY), courts will also use its own judgment and review the merits of the SLC's decision before deciding whether to dismiss based upon the SLC recc
       - In jdx that don't follow this they simply apply the BJR if meet step 1

e. Analysis Tips
   1) Analyze the merits of the claim.
      - Does this mean whether it violates self-dealing because of domination/control by shareholder, both sides of the transaction, etc.?
   2) Next identify the procedural hurdles
      - Whether the made a demand, whether the demand was excused, etc.
      - Standing (§ 327)
      - SHs post bond
        - Del does not require this
      - Ct review of settlement

V. Corporate Federal Law Duties
  A. Securities Fraud
    a. Securities Exchange Act Overview
      a) Overview of Claims
        - 10b5 Insider Trading
          - ◇ Insider and Outsider Liability
        - 10b5 Misstatement Material Facts
        - 14a Proxy Fraud
        - 14e3 Tender Offer Trading on basis of Material Non-public Info
        - 16b Short Swing Profits
    b. Classic Insider Trading & Duties of Disclosure
      a) Gaps in Common Law Protection
        (a) What Gap?
          - ◇ The insider (the director or officer) cannot be sued based upon her status as a shareholder, she has purchased or sold information with knowledge that arise from her role. Generally shareholders do not owe fiduciary duties to one another.
          - ◇ So Ps tried to argue that the role as d/o made the purchase/sale of the stocks a breach of fiduciary duties - either because took a corp opp or because committed fraud when fail to disclose that information to shareholders
          - ◇ But there is generally no fiduciary duty requiring the d/o to disclose information relating to business management to shareholders - remember there is a separation btwn ownership and control of a corp.
          - ◇ Some states have dealt with the gap by saying that d/o do have a fiduciary duty to shareholders to communicate material information either in a face-to-face transaction or under any circumstances.
          - ◇ Otherwise no fiduciary duty to disclose information when purchasing shares on the public market because see as an arms length transaction.
          - ◇ Another Gap is Regarding Non-Agents
            - ▶ If someone is an outsider (not a d/o) there is no basis for liability under state law.
        (b) Summary of State Law Approaches to Insider Trading
          1. Goodwin's Moderate Approach
            i. Directors and Officers have a duty to disclose material information to shareholders only when buying and selling shares in a face to face transaction.
            ii. Material information is defined as what a reasonable person would want to know before buying and selling shares.
              - ▶ Factors for materiality:
                1. Magnitude of the information's impact upon the value of the corp
                2. Likelihood that the information will occur
          2. Pro Director Approach
            i. Directors and officers do not have a duty to disclose information to shareholders under any circumstances.
          3. Pro Shareholder Approach
            i. Directors and officers must disclose all material information when buying or selling shares, regardless if it is face-to-face or anonymous.
        (c) Elements to Prove State Law Claim
          1. D director/officer committed fraud
            - ▶ By violating their fiduciary duties to shareholders when fail to disclose material information in a face-to-face transaction

2. Reliance/Damages - P shareholders sold/purchased shares at an artificially depressed/elevated price.

b) Result: Federal Law create Individual & Corp Liab under 10b5

(a) Rationale for Why Insider Trading Wrong

- ◇ Violates prohibition on using corp property for private benefit
- ◇ Crates unfair playing field that undermines faith in mkt (& discourages investment)
- ◇ Creates conflict that makes nondiscl look like self-intr v good faith (esp in dumping cases)
- ◇ Violates' existing shareholders' expectations (esp in dumping cases)
- ◇ Trumps the downsides:
  - ► Eliminates form of exec comp
  - ► Might discourage willingness to serve as d/o
  - ► Elimiates strong signal to others in mkt (insider trading itself as discl)

c. Cases

a) Goodwin

- ◆ Assessment of actions under state law
- ◆ Geologist had a report that said there was a good possibility that there was copper on the land. The directors/officers bought up shares in the corp. Shareholder who sold his shares was upset when copper was later discovered and was suing the directors/officers for fraud. He claimed that they had breached their fiduciary duty when they failed to disclose the possibility of copper on the land.
- ◆ Ct felt that this would be too great of a burden to place upon d/o, and want to encourage people to serve on the board.
- ◆ This was unlike the tobacco case because there was too much speculation regarding the existence of copper on the land. (Unlike tobacco case where the d/o were supposed to declare that the corp's assets were undervalued because of how the tobacco was carried on the books.).

b) Texas Gulf

- ◆ Assessment of actions under fed law
- ◆ Difference from Goodwin
  - ◇ Here they didn't just withhold information, they actively denied information
  - ◇ Also they had found strong indication that oil was present. So much greater likelihood that material information.
  - ◇ Federal Law involved
- ◆ Buying up land based upon results of initial exploration results. Also issuing press releases that deny the existence of oil strike.
- ◆ Directors/employees/engineering consultant were buying up shares when they had information about the oil strike.
- ◆ 10b5 violation

B. Rule 10b-5

a. 10b 5 Rule

i. Prohibits any person, directly or indirectly, from using the means or instrumentality of interstate commerce, mails or an exchange to

a) Employ any device, scheme, or artifice to defraud

b) Make any untrue statement of material fact or omit to state material fact necessary in order to make statements made, in light of circ under which they were made, not misleading, or

c) To engage in any act, practice, or course of business which operates or would op as a fraud or deceit upon any person.

ii. In connection with the purchase or sale of a security

b. Overview
- Who can be liable under 10b5 Insider Trading/Fraud/Outsider?
  - Anyone in possession of material inside info must either disclose or abstain from trading in or recommending securities concerned
  - Types of People
    - Directors and Officers (classic insiders)
    - Key employees (insiders if have duty)
    - Consultants (e.g. Corporate Counsel are temporary insiders)
    - Outsiders who have violated a fiduciary relationship (Chiarella not liable)
      - Tipper-Tipee Liability
      - Misappropriation Theory of Liability

c. 10b5 Insider Trading

a) Elements for 10b5 Insider Trading
- ***Starred elements only for private causes of action (not brought by SEC)

1. Jurisdictional Element
   - D must use means or instrumentality of i.c., mails, or exchange to:
2. Violate 10b5 (which is:)
   i) Trading
   ii) On basis of
      - More relevant with regard to outsiders. There is a presumption that traded on basis of the info. SEC has defined to just mean "**with knowledge**."
   iii) Material
      1) General rule is that material information is what a reasonable investor would want to know when deciding whether to buy or sell shares
      2) Speculative events can be material but it depends on:
         (a) Magnitude of the event - what effect it would have on stock's value
            – Fundamental business changes (e.g. merger) have greater effect on value/health corp
         (b) Likelihood that the event will occur
            – Consider "indicia of interest" (resolutions, experts, negotiations), timing of info, agreement not reqd
   iv) Non public information
3. In connection with purchase or sale of securities
4. Standing - must have purchased or sold shares contemporaneously with the insider.***
5. Reliance - that the P would not have bought/sold if had known the nonpublic info. Fraud on the market theory can help to establish reliance.
6. Damages - would be the difference btwn value the P sold/bought shares at and what true value of the shares was had the info been disclosed. ***

b) Options to avoid Insider Trading Liability under 10b5
   a) Disclosure (but if disclosure is not in the best intr of the firm then D/O may violate state law fidciary duty) **OR**
   b) Refrain from Trading

d. 10b5 Misleading Statements

a) Elements
1. Jurisdictional Element
   - D must use means or instrumentality of i.c., mails, or exchange to:
2. Violate 10b5 (which is:)
   i) Making a **material misstatement or omission of information.**
   ii) With the requisite Scienter - recklessness will suffice, no need to intend

that it be fraud (i.e. material misstatement or omission)

3. In connection with purchase or sale of securities
4. Standing - must have purchased or sold shares AFTER the misstatement was made.***
5. Reliance - "fraud on the market theory" will help the P establish reliance upon the misstatement. But the D-insider will try to rebut. ***
6. Damages - difference btwn value of shares P sold/bough and what true value of shared had been had the info been public. ***

b) Defenses to 10b5 Fraud Claims

a) Rebut key 10b5 elements that give rise to presumption
- Materiality - claim info isn't
- Falsity or that misleading - claim true or not misleading
- Scienter - recklessness is enough, but can claim just negligent

b) Challenge damages
- Claim can't value the speculative nature of the event
- Claim market price already reflected the true info (believed rumors)

c) Challenge Reliance
- Claim the Ps would have traded anyway

e. ***Private Cause of Action under 10b-5

a) Distinguish from SEC Action
- Private causes of action have additional elements to prove than if SEC was going after Ds for violation
- If a private individual has a COA, the SEC could definitely bring suit

b) Elements
- Everything under 10b5 (Jurisdictional Element, 10b5 violation in form of Materiality Element, and Connection to Purch/Sale Securities Element)
- Reliance (transactional causation) - buy or sell information based upon the misinformation
- Damages (loss causation)
  - shares sold at artificially low price or purchased at artificially high price
  - Or suffered other loss (e.g. corp forced to pay a higher price in the transaction, like in O'Hagan where buy up stocks in target corp)
- Standing (THIS can be thought of in combo with the purchase/sale securities element)
  - You must have purchased or sold shares. There is no standing for individuals that claim the conduct made them "not buy" or "not sell."
    - NOTE: Do not confuse standing here for standing rqd for derivative actions (which is just that you are a shareholder)

c) Fraud on the Market Theory
- This is a theory of liability that works in the Ps favor towards going to show reliance. It presumes causation.
- The theory is that the corp's market price is based upon the information that is disclosed/not-disclosed. So if the stock's value in the market changes that goes to show fraud.

f. Remedies for Private Parties in 10b5 violations
- Rescission, if possible
- D's profits disgorged
- Difference in value based on disclosure (get the true value)

g. Govt Enforcement of 10b5 Fraud

a) SEC Enforcement
- Injunction
- Disgorgement of profits
- Civil penalties up to 3x profits realized or losses avoided
- Bounty rewards (up to 10% of penalty collected)

b) DOJ Criminal Sanctions
- Willfulness required (distinguish where recklessness suffice for civil liab)
- Fines up to $5M
- Jail up to 20 years

h. Cases
- Basic Inc. v. Levison
  - Company found liable under 10b5. Making misleading statements, fraud, and for not disclosing information.
  - Over the course of one year it made three denials about the corps plan to with another corp. They had been in talks though. The D tried to argue that because there was no agreement in place they had nothing to disclose and that the denials were therefore accurate.
  - Ct felt that merger had high magnitude of relevance because it is fundamental change to corp that effects financial health/stock price. There were also enough indicia of interest to show that likely to occur (resolutions, experts, negotiations).
  - Ct accepts the fraud on the mkt theory here. It creates a rebuttable presumption of reliance upon the misstatements of the company based upon the change in the stock within the mkt. Can rebut by showing that the mkt knew he was lying.
  - NO matter that omit/mislead without having a fraudulent motive. Just fact that mislead market enough.
  - Clark says that to avoid the fraud claim they should have said "No Comment."
  - Here the jurisdictional element was met because they used the mails to issue the press release (or is it because involve i.c.?)

C. Outsider Violations of 10b5

a. Overview
- This is liability for trading with the same elements required (i.e. Jurisdiction; 10b5 violation - trading, on basis of, material, nonpub info; in connection with purch/sale of securities, standing, reliance, and damages). But because these are outsiders (i.e. not agents of the corp whose shares are being traded) we must find a source of duty elsewhere to be liable.
- General rule is that mere possession of material, nonpublic info is not enough for 10b5 violation. There must be a fiduciary relationship that has been violated.

b. Tipper/Tippee Liability

a) Overview
- Both the tipper and tippee will be liable just for breaching duty if know or should know breach and trades or cause other to trade
- Goes to hold an outsider liable. Outsider in the sense that they do not have a role within the corp whose shares are being traded which would give rise to source of a fiduciary duty breach when trade using undisclosed material information

b) Elements to find Tipper-Tippee Liable
1. Tipper Discloses info in breach of a fiduciary duty
   i) Tipper must owe fiduciary duty to the source of info
   ii) Tipper must disclose for an **improper personal benefit** (whistle blowing is a legitimate purpose)
2. Tippee knows or should know that there has been a breach
   - ◇ He inherits the tipeer's duty (and this is the source of liab)
3. Tippee trades or causes others to trade
   - ◇ Note: don't need to trade yourself, can still be liable as tipper or as tippee if you make someone else trade

c) Avoiding Liability
- Options

- ◇ Disclose the information **OR**
- ◇ refrain from trading

- Defenses
  - ◇ Show that the info was not disclosed for an improper purpose (e.g. whistle blowing)
  - ◇ Show did not know there was breach
  - ◇ Challenge that there was a duty
  - ◇ Challenge that it was trading done "on the basis of" the information - but uphill battle bc of SEC interp as with knowledge

c. Misappropriation Theory

a) Rule

i. D misappropriates confidential information in breach of a duty owed to the source of the information.

- ◇ Misappropriate means dishonestly or unfairly take something for your own use

b) Avoiding Liability

- Options
  - ◇ Disclose to the source of the information that will be trading using the confidential material information (public disclosure not required) **OR**
    - ◇ But the practical impact of this disclosure is that the individual may become liable under state law for breaching his fiduciary duties to the source of the info (agency theory) if the principal no give consent.
    - ◇ And if the principal does give consent then they might become liable for 10b5 because of Rule 14e3
  - ◇ Refrain from trading
- Defenses
  - ◇ Challenge that there was a duty
  - ◇ Challenge that it was done "on the basis of" that knowledge - but uphill battle because SEC has interp so that it mean with knowledge

d. Combination

- □ Tipper misappropriate info, then Trader is Tippee of that misappropriated info, who has liab under Tipper-Tipee
- □ Liability can be like a chain. Where the tippee turns into the tipper and the sub-tipee becomes liable too so long as knew duty and breached

e. Cases

- □ Chiarella
  - Shows that where there is no fiduciary relationship there is no 10b5 violation
  - The employee figured out that his company's parent company was going to be acquiring another corp. He was able to piece this info together even though his company tried to keep it a secret from him. He bought up shares in the target company prior to the merger disclosure.
  - The attorneys didn't argue misappropriation here (because fail bring up at lower ct level).
  - Issue was whether he was liable under 10b5 because he purchased sales while in possession of material information that he failed to disclose. The ct said NO. He did not have a fiduciary duty to the corporation whose shares were traded (he did not work for the target company).
- □ Secrist
  - Whistleblowing is a legitimate purpose. No liability even though he was telling people who ended up trading (selling their shares because of allegations of fraud).
- □ O'Hagan
  - Attorney representing the acquiring company purchased shares in the target

company. Similar to Chiarella in that he did not owe any fiduciary duties to the company whose shares he traded.
- However, the attorney breached his fiduciary duty to the company he represented. He had a duty to keep this information confidential (attorney-client privilege) and a duty of loyalty to his firm and to his client not to use information he obtained in this role for his own personal benefit. Thus, he violated 10b5 under the misappropriation theory of liability
- Duty of trust and confidence breached

D. 14e3 Liability (Tender Offers)
   a. Overview
      - 14e3 creates liability for a person who trades while in possession of material non public info relating to tender offer which was acquired from person or entity making the offer ("Offeror") once the offeror has taken substantial steps toward making the offer.
      - This solves the problem re the fact that the trader is not an insider in the corp whose shares he is purchasing (e.g. O'Hagan). And the target company probably would want him to buy up shares anyway so not really misappropriation in all situations. Thus, this creates liability where tender offers involved.
      - Note: only creates liab for info re t.o. trans. Further, no duty is required.
   b. Rule re 14e3 Liability
      1) Person in possession of material information relating to tender offer (but not a t.o. being made by the person) and
      2) Person knows or has reason to know that nonpub info came from offeror, target company, an o/d/a/ee or insider and
      3) Trades without first disclosing the info to the person with whom the recipient is trading, if and only if
      4) Offeror has commenced or taken substl steps toward acquring the target

E. Prophylactic Rules for Insiders & Outsiders
   a. Regulation FD & Analysts (Dirks)
      - Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities—generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information—the issuer must make public disclosure of that information. In this way, the new rule aims to promote the full and fair disclosure.
      - If unintentional no liab so long as take acts to publicly disclose soon after the slip
   b. Tender Offers & 14e3 (O'Hagan)
      - No trade or disclose
      - Makes person liable if trade while in possession of material, non-public info relating to tender offer.
        - Different from 10b5 because no require be an insider.

F. § 16B Liability: Short Swing Profits
   a) Overview
      - Liability based upon short swing profits
      - Only applies to companies registered under SEA of 1934
      - Pay attention to the distinction btwn d/o (timing is an OR) and b.o. (timing is an AND)
        - Easier to run afoul as a d/o
      - If you are d/o then no need to rely upon b.o. status
   b) Application Test (does company qualify?)
      1) Company is traded on the national exchange
      2) Company has assets over ten million and over 500 shareholders
   c) Disgorgement of Profits Test (STRICT LIABILITY)
      1) Must disgorge profits made
         a) Within a six month period
         b) By certain insiders

i) Director or Officer of company at the time of **either** purchase OR sale, OR
ii) A beneficial owner (someone with over ten percent of shares) at time of **both** purchase AND sale

2) Key Points
- Strict liability - intent is irrelevant
- Cause of Action belong to the corporation (only in derivative suits)

d) Analysis Steps
1) Identify if the company is publicly held (traded on national exchange and assets over 10M and over 500 shareholders)
2) See if you can match **any purchase and sale** within a six month period that yields profits. BUT IT MUST BE A PURCH & SALE - not two sales.
- Buy low then sell high
- Sell high then buy low
3) Identify if D is a director, officer, or beneficial owner
- If D is d/o then was he a d/o at EITHER time purchase OR sold
- If D is beneficial owner (more than 10% shares) then was he b.o. at BOTH time purchase AND sold
4) If so then strict liability, must disgorge profits (the corp holds the coa & get profits)

e) Exception to 16b (Rule 16a2)
- A trade by a d or officer generally cannot be paired with a transaction that occurred **prior to his or her appointment**.
  - Relevance is that can't be liable if you are matching to shares buy before become d/o BUT can be liable if you match to shares sold/buy after you are no longer d/o (SO CANNOT RESIGN AS d/o AND THINK YOU CAN ESCAPE LIABILITY)
    - Note this is different from a b.o. who can sell his shares to make him hold less than ten percent in order to escape liability

i. Cases
- Reliance
- Foremost-McKesson

G. State Regulation of Proxy Solicitation & Contests

a. Comparison of State Regulation versus Fed Regulation

a) State Regulation
- Record date/notice/quorum
  - The record date fixes the identity of the sh who have the ability to vote and who will be sent info re mtg and actions.
- Proxy authorization
- Shareholders' inspection rights (220)
- Proxy expenses
- Disclosure (fiduciary duty law)

b) Federal Regulation - ONLY applies to public corps
- Fraud prevention
- Proxy content

b. Stats Del Code § § 211-220

a) Del 219 (Shareholder Lists)
- Corp mngmt may try to send out the SH's info, but the SH may want the list because want to target certain individuals.

b) Del 220 (Inspection Rights)
- Allowed to demand upon writing and under oath stating the purpose for demand. Corp must give if it is for proper purpose.
  - For corp records - burden on SH to show proper purpose
  - For SH list - burden on corp to show improper purpose
- Distinguish other jdx with heightened reqmt.

c. Scope of Shareholders' Inspection Rights

a) Inspection Rights Jdx Differences

i. In del it is "any shareholder" with a proper purpose
ii. In some jdx you must also have a minimum ownership requirement (e.g. NY state requires six months ownership or 5% of shares)

b) Proper Purpose Rule
i. It must be "reasonably related to the person's interest as shareholder"
ii. Cannot sell shareholder lists
◆ Examples
◇ Desire to communicate about matters that affect value and future of firm is proper purpose (e.g. tender offer)
◇ Info affects other shareholders' interest in the firm and ability to make informed decision
◇ SH must have bona fide investment interet or concern about long or short term economic effects on firm
► CANNOT be solely political purpose
◇ To determine if fiduciary duty is breached or fraud committed

c) Burdens
i. SH seeking SHAREHOLDER LIST: **Company** has burden to prove SH has improper purpose
ii. SH seeking access to CORPORATE RECORDS: **SH** has burden to show proper purpose

d) Exception to Internal Affairs Doctrine
a) State Regulation of Resident's Access to Courts
i) States can regulate their own residents' access to courts to enforce corporate law rights
► Impact: In Crane the fed court applied NY statute to say that sh no have inspection rights (even though Anaconda was a Montana corp).
► The sh could have opted to sue in Montana but it may not have been practical

e) Cases
a) Crane
◇ There was a fight to takeover the corp. Crane wanted access to the sh list but the corp's board sought to deny access claiming that it was not for a proper purpose. They characterized it as not in the corp's best intr but rather as the sh trying to get access for their own purposes/intr. The ct said that this is a proper purpose. A takeover is something that is of intr to the other sh audience and so the corp granted access to list.
b) Honeywell
◇ Improper purpose. Could NOT get access to sh list. He was seeking access to the list solely to communicate his beliefs that the corp was wrong in building bombs for use in the Vietnam war. He was solely interested in sh list and the records concerning war manufacturing for a purely social/political agenda and he was not interested in the company's economic interests.

d. Proxy Contest Strategy & Reimbursement
1) Rule re Reimbursement
i. The board/management may use corp assets to pay for communications in a proxy contest.
ii. The new board/management may seek reimbursement from the corp for communications in s proxy contest they won.
i) Reimbursement becomes a potential self-dealing issue. So will need to show ratification by SHAREHOLDERS.

2) Analysis
1. Did proxy fight concern a matter of corp policy or personal concern?

- If personal, then no reimb
- If corp policy dispute, were the expenses reasonable and proper?
  - Norm is that entertainment is reasonable. But if excessive can make argument that not.

2. Were the expenses reasonable and proper?
   - If no, no reim
   - If yes, then next step…
3. Incumb or Insurgent?
   - Incumbents can get reimb even if lose
   - Insurgent reimb, but only if 1) win and) get Sh approval

3) Cases

a) Levin - goes to show that okay for current board to use corp funds to pay for its proxy solicitations, p.r. consultants, and attorney in a proxy fight. NO matter that some of the current board rep the insurgents. So long as this was a true corp policy difference and not personal then can get reimb. This was truly corp policy dispute because had fundamental differences on how to run the business - how many pics to make, how much corp assets to keep on reserve, etc.

b) Rosenfield - goes to show that okay for new board to seek reimbursement for expenses used in proxy solicitation when the shareholders ratify the decision. It must be regarding a corp policy (not personal) and the expenses must be reasonable and proper (but here entertainment expenses seen as reasonable).

H. Federal Regulation of Shareholder Action

a. Stats SEA § 14a & Rules 14a1-14a13

a) Overview

- § 14a8 Creates SH Procedural Right to Submit Proposals at Corp's Expense
- § 14a7 Access to SH Lists
- § 14a COA Proxy Fraud
  - i) § 14a Prohibitions
    - Using i.c., mails, exchanges (jdx)
    - In violation of proxy rules
  - ii) Rule 14a Prohibitions
    - False statement or misleading omission
    - About a material fact
    - In a proxy solicitation (broadly defined)

b. Shareholder Proposals (§ 14a8 Procedural Right)

a) Overview

- Enables shareholders to submit proposal to other SHs to be mailed in firm's own proxy at the firm's expense
- But it must involve publicly held company and SH must meet certain eligibility requirements

b) Eligibility Requirements

1. Own at least 1% or $2k for at least 1 year prior to proposal submission date (and through the date of meeting)
2. Only 1 proposal per shareholder per meeting
3. 500 words maximum
4. For annual meeting - proposal must be submitted not less than 120 days before company sends out its proxy

c) Corp's Response

- If company includes proposal, it can include reasons not to vote in favor of proposal and it MAY EXCEED 500 words
- If company excludes proposal it must be for certain reasons (see 14a8ic)
  - Company bears burden of showing proposal can be excluded
  - Company must give SH opp to fix certain defects

- ◇ SEC provides critical oversight in process

d) Corp's Bases for Exclusion (§ 14a8iexam

1. Not proper under state law
   - ◇ Most proposals are framed as recc to avoid run afoul of state corp law (i.e. requiring board to act)
2. Requires illegal act
   - ◇ Example: illegal discrimination
3. Violates proxy rules
4. Personal grievance/interest
5. Relevance/"small stakes". Test:
   - i) Less than 5% of company's assets/earning/sales
   - ii) AND not otherwise significantly related to issuer's business.
     - ◆ Ethically and socially significant proposals can't be excluded. Evidence of significanceL state and federal laws, social movement by priv orgs
6. Lack of power/authority
7. Management/Ordinary Business
   - ◇ For example: eval of risks and benefits are matters of ord bus. But can argue not ord if enviro is ethically and socially significant and have impact on firm rep and value.
   - ◇ Exec comp proposals don't win under this or ("small stakes") because SH successfully argue that impacts corp and sh ability to check mngmt abuse/neglect
8. Election to Office
9. Conflicts with company proposal
10. Moot (substantially implemented)
11. Duplication
12. Resubmissions
13. Relates to specific dividend amounts

e) Cases

- ◆ Lovenheim - foie gras case. Goes to show that the shareholder's proposal regarding study about the impact of force feeding geese not successfully excluded by corp on the basis that it is small stakes. The ethical and social significance of the issue meant that had to include in proxy. Evidence of significance was the state and federal laws around animal cruelty and number of orgs who represent this social movement.
- ◆ AFSCME -
- ◆

c. Access to SH List

a) Rule 14a7

- ◆ 5 days turn around from request.
- ◆ Can opt to mail or provide list.
  - ◇ SO it's state law that gives sh the right to a list?

d. Proxy Rule Violations

a) Overview

- ◆ Ctrs treate this as a deriv claim because see as failure to disclose information and a breach of fiduciary duties that hurts all of corp and shareholders. Not really direct although look like it because deceived and defrauded. Result is that it came up with the essential link test.
- ◆ Fairness will not be a defense here because this is about procedural violation.
- ◆ Does require you to be a sh entitled to vote.
- ◆ 14a9 claims will often come with traditional fiduciary state law breaches.

b) Elements of Plaintiffs' 14a-9 Claim (Proxy Fraud)
(Careful - a lot of people confuse 10b5 and 14a9)

1. Involves publicly held company (10M assets, over 100 shareholder, exchange tdg)
2. Affirmative misstatement or misleading omission
   - ◇ Not disclosing a conflict can be an example
3. Materiality
   - ◇ Test: whether shareholder would consider the fact important in deciding how to vote
   - ◇ In the case of a conflict of interest - the minority shareholders may still be sufficiently alerted to the board's rship to their adversary to be on guard (i.e. not material)
4. Reliance (Causation)
   - i) Essential Link Test - was the proxy solicitation itself an essential link to accomplish the transaction?
     - ◆ Look to see if the minority shareholders' votes required for the transaction. If it is then presume reliance. Note that if Del Corp law applies, then a true majority (50% + 1 vote of outstanding shares entitled to vote) can mean that there is no essential link because minority sh not reqd to approve.
     - ◆ Different from traditional fraud reliance test (where the sh would have need to show that they relied upon the proxy's misstatement/omission) because shifts to presume reliance
5. Damages
   - ◇ Fairness is not a defense to the violation (because 14a9 protect proc) but it can go to show damages (e.g. difference btwn fair and actual merger price where the value of share price in merger is misstated)

c) Defenses to Proxy Fraud (14a-9 Claim)
- ◆ Fairness is NOT a defense to 14a-9 claim, because the rule protects procedure NOT the substantive merits of the transaction

d) Possible Relief
- ◆ Injunctive (stop action
- ◆ Rescission (set aside the action - e.g. merger)
- ◆ Damages

e) Cases
- (a) Borak
- (b) Mills v. Auto Lite - proxy fraud case.

VI. Shareholder Control in Closely Held Corporations

A. Abuse of Control: Fiduciary Duty Protections & Limits

a. Overview
- □ Generally shareholders are not entitled to participate in management of corp. But in closely held corps there may be a management right
- □ Generally shareholders do not owe fiduciary duties to other shareholders.
  - ◆ We saw the exception of controlling shareholders who can't benefit to the exclusion and at the expense of minority shareholders.
  - ◆ Now this is an exception where there are shareholders in a closely held corp.

b. Majority Shareholder Breach F.D. in Closely Held Corp (Wilkes' Freeze Out Test)
1. P-SH has a reasonable expectation of managerial rights and financial return that has been frustrated. Factors to consider:
   - ◆ History of participation
   - ◆ Investment/ expectations regarding the form of return
   - ◆ If D win, would minority SH be deprived of returns
   - ◆ I D offered to buy out P was it fair?
   - ◆ Are other SHs getting "excessive comp" or constructive dividends?
2. There is no legitimate business justification for the D-SHs decision.
3. Or if one is articulated, P-SH demonstrates that the same legitimate concern could

have been achieved through an alternative course of action that is less harmful to the minority's interest.

c. Cases
    a) Wilkes - Ousted him as an employee and on the board. They could not provide a legitimate business reason for the decision. They were getting excessive comp/constructive dividends in the form of salaries for themselves. There was a long history of participation as employee and director. His only form of return was the salary. And they tried to buy him out at a price that they would not have accepted. Thus, the ct held that violated f.d. Owed him back salary, place on board and a position within the corp.
    b) Ingle - Ingle lost here because the contract said that should he no longer be an employee for any reason then the shares would be purchased by the majority shareholder. Thus, he couldn't stand on the argument that the majority shareholder was breaching his f.d. when he fired him (there was no contract provision that said he would be employed unless he failed to reasonably perform, etc.)
    c) Brodie - Goes to show that the remedy is limited to salary and board position (reinstatement of reasonable expectations) and prospective relief. BUT the ct cannot force a fair buyout.
    d) Smith - Rich guy who was actually the minority sh but because of provision that said unanimous decision to act he was able to effectively act like a majority. His refusal to declare dividends was seen as a breach of his f.d. because it was resulting in tax penalties to the corp. The ct awarded reimb for tax penalties, rqd the corp to issue dividends, BUT it did NOT oust Wolfson from the board.

B. Planning - Shareholder Agreements (in Closely Held Corp)
    a. SH proxies
        - Del § 212b, e, 218 c, d
        - Transfer of right to vote shares only
            - May contain instructions
            - To a third person so that not just left with a K claim
        - Self-Executing
        - Irrevocable versus Revocable
            - Irrevocable proxies must be coupled with an intr - 212e
    b. Voting Trusts
        - Del § 218 a, b
        - Legal arrangement where title is transferred from owner to trustee
            - Contains intx for how to vote shares
        - Trustee must vote for benefit of shareholder
        - Use when want someone to have right vote. Use when have a broader interest when want someone to vote you shares
    c. Statutory Close Corps
        - Close versus Closely Held Corp
            - Need to look to statute
            - Close is typically less than thirty, whereas closely held is typically less than 100
            - Close is a creature of statute - expressly say that want to run like pship, but want incorp for ltd liab. Allows sh to run corp.
                - Increases flexibility without increasing risk of veil piercing.
                - Express approval for control by shareholders
                - But can lose status easily
    d. Involuntary Dissolution
        - Not really an option, unless you agree to it up front.
        - But it's a statutory right in some states
        - Usually requires significant number of shares
        - Can be hard to satisfy grounds for dissolution
            - e.g. persistent breach, extreme deadlock

- It is also an extreme remedy that still does not address damages caused by prior breach

e. Other Planning Tools
   a) To Enhance SH Voting Control
      - Different classes of stock
      - SH agreement that Pool Votes - combined with proxies or voting trusts
   b) To Prevent Freeze Outs & Protect Minority Control
      - Put into Cert of Incorp (§ 141a) - like Wolfson did
      - Close Corp Status
      - Employment agreements - be careful if you tie it to share ownership
      - Buy out agreements - be careful about setting price or form of valuation

f. SH Agreements
   a) Rules re Validity of SH Agreements
      (a) McQuade Rule - Independent Business Judgment
         i. Directors may not abrogate their independent business judgment because that violated public policy. If an agreement attempts to do this then it is void.
      (b) Clark Compromise - Unanimity and No Harm
         i. Shareholder agreements that control Directors actions are okay if:
            1. Unanimous SH agreement AND
            2. No actual or potential harm
      (c) Galler Modern Rule - Close Corp
         i. Shareholder agreement that control Directors actions are okay if:
            1. It is a close or closely held corp (less than 30 or less than 100 sh)
            2. There is no objecting minority interest AND
            3. No actual or potential harm

g. Cases
   a) McQuade - magistrate judge was upset that the other shareholders were not upholding their agreement to appoint him as a director and officer. The ct said that it was okay for shareholders to make an agreement about electing each other as directors. But it is not okay to make an agreement that as directors they would appoint each other as officers, specify salaries they would get as officer, and restrict changes absent unanimous consent because this restricts a director's judgment. Reason is that this violates a directors duty to represent all shareholders.
   b) Clark - the agreement to keep him as GM was upheld because there was some discretion given to the director's judgment (i.e. keep so long as 'faithful, efficient, and competent' AND his salary was a portion of net income so this gave board discretion to protect corp by estab expenses). There were also only two shareholders here and they unanimously agreed to the decision.
   c) Galler - The agreement was between the two shareholders who composed the majority of shares. Felt there was no evil inherent in an agreement to provide income to the wife of deceased owner for life. There was a provision that limited so long as earned surplus of 500k was maintained. The fact that the salary was gift of corp prop and so ultra vires no invalidate the provision because there were no minority shareholder injured by this provision.

VII. Other Business Structures

A. Overview of Different Business Forms

- Partnership
  - Informal, decentralized - owner managed, Unlimited liability, not freely transferrable, no continuity
  - Cost upfront is low but can be deceptive, low prestige, extensive default rules, great flexibility, pass-through tax
- Corporation
  - Formal, centralized - manager managed, freely transferable, limited liability, unlimited

duration
    - Cost upfront high (require filing fees and atty), high prestige, much more extensive default rules, not as great flexibility, double-taxation
- Other Forms
    - Limited Partnerships (requires GP)
    - Limited Liability Partnerships (only liable for own actions)
    - Limited Liability Companies (hybrid of corp and pship)
    - S-corp

B. S-Corp
- Must elect s-corp status
- Gives you pass through taxation status (like pship) and limited liability (like corp)
    - But the taxation is not as flexible as pship
- Allocations of profits and losses among investors are less flexible than for partners
- Must satisfy restriction on investors - can lose status involuntarily
    1. Only one class of stock allowed
    2. Must be less than 100 shareholders (supplement is outdated)
    3. Shareholders must be real people (individuals, not a corp, trust, etc.)
- If you lose your status then the govt can go back and ask for the difference in taxes with what you would have owed if you were the corp

C. Limited Liability Partnerships

a. Overview
- Don't exist in every state. Exists where state wants to create protection for certain kinds of businesses.
- Same as general pship, but…
    1. Requires a filing
    2. Liability is still unlimited for P's own tortious acts (only limits the liability for that bad Ps acts amongst the rest of the partners. Unless you satisfy **vicarious liability** - e.g. some control over that Partner or the d-m)
- Ps liability can be limited to investment for others' acts that were not under Ps control
- Very rare
- May only be available to certain industries
    - e.g. law, architecture, accounting

b. Cases

a) Holzman v. DeEscamilla

D. Limited Liability Companies

a. Overview
- Best of both pship and corp
- Characteristics
    - They get the benefit of pass through tax (pship) and limited liability (corp)
    - Can be either member-managed or manager-managed
        - Can be member controlled or centralized, separate mngment
    - Can decide whether not freely transferable interests or is freely transferable
    - Can decide if want to be at-will or perpetual duration
- Cannot have more than two corp characteristics
    - Limited Liability (always want that so then can only have one more of below…)
    - Centralized Management
    - Perpetual duration
    - Interests freely transferrable
- Bullet Proof Statute
    - Some states create rule to make sure that guarantee remain a LLC by:
        i. Requiring unanimous consent of member for transfer and continuation
            - This eliminates the characteristics of perpetual duration and eliminates free transferability of interest so can't convert to corp
- Law governing LLCS are part of corp code

- Formation
  - Need to pay attention to state rules re creation. Typically, there is lots of flexibility.
  - Need to pay attention to fed rules re favorable tax treatment
  - Filing is required
  - Op agreement required
    - There is flexibility, but subject to tax considerations
    - If member-managed, be clear about how voting is allocated (e.g. according to share of profits, cpaital, etc.)
- Some states prohibit "professional" LLCs.
  - See the Meyer case for other regulatory issues
    - Where cannot get the alcohol license.
    - Example where it is unclear whether LLC is the type of entity that can get the license. Need to make sure that someone can be personally on the hook. Therefore, the ct felt that could not get license even though at time of stat the LLC had not existed.
- Piercing corp veil apply to LLC? Unclear so that uncertainty mean that hard to know if should choose.
  - Case said not prepared to say can never pierce. But where one of the big is that did not follow corp formalities and since LLC gives you lots of flexibility (so not as many formalities) means that hard to know if can pierce.

b. Cases
   a) Kaycee Land & Livestock v. Flahive (piercing veil) - just said that corp veil may be pierced, but require ct to look at facts and also consider that the llc gives greater flexibility
   b) Meyer & Okalhoma Alcoholic Beverage

c. How Owners Make Money

E. Selecting an Entity (Considerations)