AGENCY

I. Agency relationship

A. Definition
1. Agency is a relationship in which
    a. By mutual consent
        i. Forma or informal
        ii. Express or implied
            (1) i.e., can be created in action alone (no words necessary)
    b. One person/entity ("agent")
    c. Undertakes to act on behalf of another person/entity ("principal")
    d. Subject to the principal's control

B. Creation
1. An agency relationship is created when
    a. Manifestation of consent by the one person [principal] to another [agent] that the other [agent] shall act on his [the principal's] behalf and subject to his [the principal's] control, and consent by the other [agent] so to act.
        i. As long as the manifestation of consent by both the principal and agent is made, it doesn't matter whether the parties intended to form an agency relationship.
            (1) Basile v. H&R Block: H&R Block does tax preparation, offered refund anticipation loan (RAL) where they refer customers to Mellon Bank, who gives customers a loan for giving their tax refund to MB minus the fee MB takes. MB made their money from the fees, which were essentially interest rates (up to 115%). Once the customer signs the check, they also sign a K. H&R Block gets a fee from MB for the referral and a share of the profits from the RAL program. π claims breach of fiduciary duty by H&R Block. If there is an agency relationship, then there is an affirmative duty imposed on H&R Block to disclose the relationship w/MB. Held, no agency relationship b/c H&R Block wasn't authorized to bind π--π still had to authorize and sign.

C. Implications
1. Principal is in control of the relationship
2. Agent has the authority to bind the principal to third parties and bind third parties to the principal

D. Termination
1. Either agent or principal can end the relationship at any time.
2. Common ways to terminate relationship:
    a. Expiration of specified time period;
    b. Accomplishment of agent's purpose;
    c. Occurrence of event/condition
3. Effects of termination
    a. Actual authority is terminated.
    b. Apparent authority is terminated once the 3rd party learns of the termination or the 3rd party can no longer reasonably believe the agent has apparent authority.

II. Binding the Principal to Third parties

A. An agent has the power to bind the principal through:
1. <u>Actual Authority</u> (both express and implied)

A. An agent has the power to bind the principal through:

a. Authority is the power of the agent to affect the legal relations of the principal by acts done in accordance with the principal's manifestations of consent to him. [Rest. 7]
   i. A principal is bound to 3rd parties by anything the agent does that is in accordance w/the principal's "manifestation" to the agent.
   ii. The principal's manifestation is determined by the agent's reasonable interpretation in light of the circumstances.
   iii. Actual authority extends to collateral acts that are reasonably necessary to complete the task.

2. Apparent Authority
   a. Apparent authority is the power of the agent to affect the legal relations of the principal by transactions w/3rd persons, professedly as agent for the principal, arising from and in accordance with the principal's manifestations to such third persons. [Rest. 8]
   b. Apparent authority is created when
      i. The apparent **principal** makes an **objective manifestation**
      ii. Which reaches a 3rd party and
      iii. Causes the 3rd party to **reasonably believe** that another party (apparent agent) is authorized to act for the apparent principal.
         (1) *In the Matter of McDuffie*: McDuffie borrows money from MS&L, secured by two pieces of land. Defaults, MS&L wants to foreclose. Farrior is the trustee hired by the bank to bid on the property at the auction. They authorize $43k, Farrior goes on vacation, comes back the day before the sale. MS&L sends Farrior a letter reducing the bid to $1k, Farrior doesn't get the letter in time, bids $43k and wins. MS&L brings suit to rescind the bid. Held, although Farrior didn't have actual authority to bid $43k, he did have apparent authority b/c the other people at the auction (debtor's attorneys) reasonably believed Farrior had the authority to bid $43k.

3. Estoppel
   a. Principal is liable to third parties who have changed their position in reliance upon their belief that the agent's action was authorized (even if there was no actual or apparent authority) if the principal caused--intentionally or carelessly--the belief or if the principal knew of the mistaken belief but did not notify the third party.

4. Power of Position
   a. When a principal that is an entity appoints an individual to a particular position (such as VP of Purchasing), the appointment may carry w/it a great deal of implied actual authority even where the entity is vague about the actual authority expressly given to the person.
   b. Such an appointment may also carry w/it a great deal of apparent authority.

5. Ratification
   a. If the principal ratifies an agents action by manifesting assent to it, even if there was no actual or apparent authority before the act, then the principal is bound by the act.

6. Restitution
   a. The principal is liable to make restitution to 3rd parties where the principal is unjustly enriched by the agent's actions that are not w/in the agent's actual or apparent authority.

B. Principal's Liability to Third Parties for Actions Actually or Apparently Authorized

1. **Disclosed Principal** = When the party dealing with agent has notice that the agent is acting for a principal and knows the principal's identity. [Rest. 4(1)].
   a. Principal is liable to the third party.
2. **Partially Disclosed Principal** = When the party dealing with the agent has notice that the agent is or may be acting for a principal but doesn't know the principal's identity. [Rest. 4(2)]

        a. Principal is liable to the 3rd party
    3. **Undisclosed Principal** = When the other party dealing w/the agent has no notice that the agent is acting for a principal. [Rest. (4(3)]
        a. Principal is liable to 3rd party.
        b. An agent for an undisclosed principal can never have apparent authority.
- C. Principal's liability for Agent's Torts (respondeat superior)
    1. Where the principal authorizes (actual or apparent) an agent to engage in conduct that is tortious, that principal is liable even though the principal may not have intended the conduct to be tortious so long as the agent qualifies as a **servant** and the conduct was i**n the scope of employment.**
        a. <u>Servant status</u>
            i. To determine whether the agent tortfeasor is a servant (making principal liable) or an independent contractor (relieving principal of liability), consider the following:
                (1) Extent of control the agreement allows the master to exercise over the details of the work
                (2) Whether or not the one employed is engaged in a distinct occupation or business;
                (3) The kind of occupation, w/reference to whetehr, in the locality, the work is usually done under the direction of the ER or by a specialist w/o supervision;
                (4) The skill required in the particular occupation;
                (5) Whether the ER or the workman supplies the instrumentalities, tools, and place of work for the person doing the work;
                (6) The length of time for which the person is employed;
                (7) The method of payment, whether by the time or by the job;
                (8) Whether or not the work is a part of the regular business of the ER;
                (9) Whether or not the parties believe they are creating the relation of master and servant;
                (10) Whether the principal is or is not in business.
        b. <u>Scope of employment</u>
            i. A servant's conduct is w/in the scope of employment if:
                (1) It is of the kind he is employed to perform;
                (2) It occurs substantially w/in the authorized time and space limits;
                (3) It is actuated, at least in part, by a purpose to serve the master; and
                (4) If force is intentionally used by the servant against another, the use of force is not unexpectable by the master.

<u>III. Liability of 3rd Parties to Principal</u>

- A. Basically reciprocal
    1. Exceptions
        a. Agent falsely represents that he/she is not acting for the specific principal and the agent or principal knows that the 3rd party would not have dealt w/the principal.

<u>IV. Duties and obligations of Agents and Principals</u>

- A. Duties of agent --> principal
    1. Fiduciary duties
        a. Agent may not gain any material benefit from the agency relationship (tip/gratuity) from a third party.
        b. Agent may not compete with nor act adversely to, the principal.
        c. Agent must use the principal's property only for agency purposes and cannot communicate confidential information to others.
            i. Fiduciary duty to act loyally for the principal's benefit.
    2. Non-fiduciary duties

a. Duty to act only w/in the scope of actual authority.
b. Duty to comply w/all reasonable instructions from the principal
c. Duty to comply w/any contractual obligations b/t the agent and principal.
d. Duty to use reasonable care and act reasonably so as not to damage principal's enterprise.
e. Duty to render info to the principal that the agent believes the principal would want to know.

B. Duties of Agent --> Third Parties
1. Liability on K
a. Disclosed Principal = agent is not liable
i. Agent has the burden of proving that agent/principal relationship was disclosed to 3rd party.
(1) *Benjamin Plumbing, Inc. v. Barnes*: RHN is a corporation, Whitcomb is acting as agent. Whitcomb enters a K w/BP, then defaults. Whitcomb claims he is protected b/c RHN is the principal and is bound not him personally. Held, Whitcomb is personally liable b/c RHN was an undisclosed agent. Whitcomb did not disclose the name of the principal (even though it was on letterhead); If there is only constructive notice of agent/principal relationship and the status of the principal then the burden is on the agent
b. Partially disclosed principal = agent is liable
c. Undisclosed principal = agent is liable.
2. Liability in tort
a. Agent is liable, but usually π wants to try to get respondeat superior b/c of deeper pockets.

C. Duties of the Principal
1. Principal **does not** owe a fiduciary duty to the agent.
2. Principal must deal fairly and in good faith w/the agent
3. Principal must honor any K duties b/t agent and principal.
4. Principal must indemnify the agent for out of pocket costs in performing agency duties and whenever else indemnification would be fair.

PARTNERSHIPS

I. Formation of the Partnership

A. Definition
1. A partnership is an association of two or more persons to carry on as co-owners a business for profit, whether or not the persons intend to form a partnership. [RUPA 202]

B. Factors indicative of a partnership
1. Clear manifestation of intent to establish partnership
a. Manifestation = words or conduct
2. Contribution and/or promotion of the enterprise
3. Right of mutual control
4. Right to share in the business' profits (this is **required**)
a. *Tondu v. Akerly*: M and P got together and decided to raise pure bread cattle. Each was going to contribute money, time, skills, and each would get 1/2 of interest. They moved in together and shared income, but filed separate taxes and had separate bank accounts. Personal relationship ends, so does the business relationship. M left and sued when she felt the split wasn't fair. TC granted M a little bit, some went to a third party and the rest went to P. M is suing to get her half, b/c she argues it was a partnership. M has the burden of proving the partnership existing (party asserting the partnership has burden). Held, there was no partnership--there was no clear manifestation of intent to establish a partnership (they never registered a partnership name, never put their agreement in

writing) and there was no agreement to share profits (however, M put in $ and P put in services, and both had control).

C. Whether there is a partnership is a question of law; the court is not restrained by the parties' characterization of their relationship.
   1. A third party can assert a partnership relationship b/t two parties.
      a. *MacArthur Co. v. Stein*: S owns roofing company called Midland Roofing. P and B are storm trackers who move their business around to take advantage of bad weather. S applied for loan on his own to expand business but was denied. S, P & B enter an agreement and form Midland Roofing and Gutters (they wanted a similar name), one phone line, S had first crack at business, Gutters would take all other business. B & P take out a loan and then skip town. Lender comes after S as a partner. Court uses same test as *Tondu*, *held*, there is a partnership. (Same business name, number, goodwill, S had right to exercise quality control, S made money, intent is established from the circumstances).

D. Adding a partner
   1. Default rule: No one can be admitted as an additional partner without unanimous consent of the existing partners. [UPA 401(i)]

E. Types of partnerships
   1. Partnership at will
      a. Each partner has the right to end the partnership at any time w/o cause
   2. Partnership for a term
      a. Partnership comes to an end at the end of a time specified in the agreement.
   3. Partnership for a particular undertaking
      a. Partnership comes to an end when the particular task/goal specified in the agreement has been accomplished.

F. Consequence of a Partnership
   1. Personal liability
      a. All partners are personally liable for all debts/obligations of the partnership
         i. **Exhaustion** rule
            (1) A partnership creditor cannot levy on the assets of the partners until the assets of the partnership are exhausted and the creditor obtains a judgment against the partner. [UPA 307(d)]
         ii. Partners are j**ointly and severally** liable for all partnership obligations. [UPA 306(a)]
            (1) If a partner pays more than his share of partnership debts, he or she may recover contribution from other partners when the partnership is dissolved. [UPA 807(c)]
      b. Exceptions to personal liability
         i. New partners
            (1) Default rule: newly admitted partner is not personally liable for preexisting partnership debts [306(b)]
         ii. Dissociated partners
            (1) Remain personally liable for partnership obligations incurred before dissociation and may be liable for partnershp obligations incurred after dissociation. [UPA 703(a)]
               (a) A dissociated partner remains liable for partnership obligations incurred w/in two years after dissociation to persons who reasonably believed at the time of the obligation that the dissociated partner was a partner and who is not deemed to have had notice that the partner was dissociated. [UPA 703(b)]

(2) Can file a statement of dissociation, which cuts off post dissociation liability after 90 days. [UPA 704]

2. Partners are agents of the partnership
   a. Can bind the partnership same ways an agent can.
   b. If no actual or apparent authority, a partner can bind the partnership if he acts in a way apparently s/in the ordinary course the partnership business, or business of the kind carried on by the partnership. [RUPA 301].
      i. Exception: Partner did not have the authority to so act and the 3rd party knew the partner had no authority.

II. Financial Aspects of a Partnership

A. A partner's basic return
   1. Default rule
      a. A partner has a right to share in the profits of the partnership AND
      b. A partner has a right, when the partnership ends, to receive the value of any property that the partner contributed to the partnership.

B. Rules for sharing profits and losses
   1. Profits
      a. Default rule = each partner receives an equal share. [RUPA 401(b)]
   2. Losses
      a. Default rule = partners share losses in the same % that they share profits. [UPA 18; RUPA 401(b)]
         i. Loss sharing arrangement does not affect a partner's personal liability on a partnership obligation.
   3. Timing
      a. Default rule = partner does not have a right to receive a distribution of the profits credited to his account unless there is a majority vote in favor of distribution. [RUPA 401]

C. Partner's right to Indemnity
   1. The partnership must indemnify every partner in respect of payments made and personal liabilities **reasonably incurred** by him in the **ordinary and proper conduct of its business**, or for the preservation of its business or property.

D. Remuneration for labor provided by partners to partnership
   1. Default rule: A partner is not entitled to remuneration for working for the partnership, except when the partnership is being dissolved. [UPA 401(h)]

E. Partner contributions
   1. Some courts insist that a partner contribute something to form a partnership, but the UPA simply defines it as co-ownership.
   2. The division of partnership interests may be completely unrelated to the relative value of their contributions.

F. Partnership Property
   1. Partnership property belongs to the partnership rather than to the partners collectively. [UPA 203, 501]
   2. Determining whether property is partnership property
      a. Property is partnership property IF [UPA 204]:
         i. Acquired in the name of the partnership OR
         ii. Acquired in the name of one or more of the partners w/an indication in the instrument transferring title of either
            (1) Their capacity as partners or
            (2) The existence of a partnership (even if name is not indicated.

b. Rebuttable presumptions [UPA 204]

i. Property purchased w/partnership funds is presumed to be partnership property.

ii. Property acquired in the name of one or more of the parntners, w/o indication of their capacity as partners and w/o use of partnership funds or credit, is presumed to be the partners' separate property.

G. Partners' Interest in the Partnership

1. Partners' interests

a. Transferable interests [UPA 502]

i. Right to an allocation of profits and losses.

ii. Right to receive distributions from the partnership.

iii. Charging Order [UPA 504]

(1) A partners' transferable interest can be involuntarily seized by a judgment creditor of the partner.

b. Non-transferable interests

i. Use or possession of partnership property. [UPA 501]

ii. Partner's equal right to manage the partnership [UPA 401(f), 503(a)(3)]

2. Transferee's interests

a. Transferee does not become a partner

b. Transferee does gain the right to seek a winding up of the partnership's business on the grounds that it would be equitable. [UPA 503(b)(3)]

III. Management of the Partnership's Business

A. Management Rights

1. Right to information [UPA 19; RUPA 403]

2. Right to manage

a. Default rule: Every partner has an equal right to participate in the management of the partnership. [UPA 401(f)].

i. Default rule: Matters in the ordinary course of business are decided by a majority of partners but other matters, including amending the partnership agreement, require unanimity. [UPA 401(j)]

3. Right to be involved [UPA 18(e); RUPA 401(h)]

4. Right to bind the partnership

a. Each partner is an agent of the partnership for purposes of its business. [UPA 301(1)]

i. If there is no actual or apparent authority, the only other way to bind the partnership is for a partner to act in a way apparently carrying on in the **ordinary course the partnership business** or **business of the kind carried on by the partnership**, unless the partner had no authority to act for the partnership in the particular matter and the person w/whom the partner was dealing knew or had received notification that the partner lacked authority.

(1) *Kansallis Finance Ltd. v. Fern*: Plaintiff brought suit against attorneys, alleging that they were vicariously liable for fraud committed by their law partner. The United States District Court for the District of Massachusetts, entered judgment for attorneys, and plaintiff appealed. The Court of Appeals for the First Circuit, affirmed fact findings and certified questions of relevant Massachusetts law. The Supreme Judicial Court held that: (1) to find that certain act is within scope of partnership for purpose of applying doctrine of vicarious liability, plaintiff need not show that act was taken at least in part with intent to serve or benefit the partnership, and (2) partners may be found vicariously liable for authorized conduct by partner that violated consumers protection statute even if they were entirely unaware and uninvolved with that conduct.

ii. Every partner has actual authority to do anything outside the partnership's business that all the partners authorize.
iii. The partnership is liable for a partner's actions "in the ordinary course of business of the partnership or with authority of the partnership. [UPA 305(a)]
iv. The partnership is strictly liable for the misapplication of money or other property received by a partner in the course of the partnership's business or otherwise w/in the scope of the partner's actual authority. [UPA 305(b)]

5. The partnership may file a statement of authority w/Sec. of State that grants or limits a partner's authority. [UPA 303]
   a. If the statement grants authority, a 3rd party may bind the partnership for an action in accordance w/ the grant, even if the 3rd party didn't know about the statement of authority.
   b. If the statement limits authority, a 3rd party is bound only if the 3rd party had actual knowledge of the limitation or the transfer involved real estate.

IV. Fiduciary Duties b/t Partners

RUPA 404

A. FULL AND ADEQUATE DISCLOSURE OF ALL MATERIAL FACTS

1. Two questions to ask:
   a. What does the partner need to disclose?
   b. When does the partner need to disclose?
      i. *Meinhard v. Salmon* (Not decided under UPA): A joint venture existed in which two partners pooled their money in order to lease a building for shops and offices. Δ partner was more business savvy and, in an effort to increase his wealth, he entered into an agreement with another businessperson to purchase surrounding property as a leasehold estate. The specifics of this transaction were not disclosed to π partner, and he subsequently sued for breach of the joint venture agreement when he discovered the transaction. *Held*, Δ would not have been in the rewarding leasehold position if it were not for the joint venture, and Δ breached his fiduciary duty to his partner π by not telling him of the potential deal.

B. Duty of Loyalty

1. Duty not to compete [UPA 21; RUPA 404]
2. Taking business opportunities
3. Using partnership property for personal gain
   a. *Baltrusch v. Baltrusch* (Decided under UPA): Two brothers (O & W) have a farming partnership. O transferred equipment to his sons' partnership (G & G) in exchange for payment of wages of O & W's EEs. O&W partnership dissolves, W sues O for brach of fiduciary duty of loyality for using O&W property for his own benefit (through the benefit of his sons). *Held*, no breach, b/c the equipment WAS paid for (by G&G paying O&W EE wages)
4. Conflict of interest

C. Good faith and Fair Dealing

D. Modification of fiduciary duties

1. Fiduciary duties can't be waived, but the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not **manifestly unreasonable**. [RUPA 103]

V. Disassociation and Dissolution

A. <u>Dissociation</u>

1. A partner is dissociated in 5 settings
   a. Upon the happening of an agreed-upon event.

1. A partner is dissociated in 5 settings

    b. When the partner becomes a debtor in bankruptcy.
    c. When a partner is expelled.
        i. When the partnership can expel a partner
            (1) If they modified the default rule
            (2) The partners can unanimously expel a partner when it is unlawful to continue the business w/ the partner or where a partner that is a corporation has dissolved.
            (3) Partners can unanimously expel a partner who has transferred all of his transferable interest in the partnership.
        ii. A court may order a partner's expulsion on equitable grounds [UPA 601(5)]
    d. When a partner dies
        i. Deceased is no longer co-owner, but deceased's estate/heirs succeed in deceased partner's transferable interests.
    e. Express will
        i. This power CANNOT be contracted away.
2. Dissociating partners' interests
    a. If dissociation doesn't cause dissolution, the dissociated partner's interest is bought out by the partnership.
        i. Price is based on a hypothetical value of the dissociating partner's account as if the partnership had dissolved on the date of dissociation and the assets sold for the greater of [UPA 701(b)]:
            (1) Liquidation value or
            (2) Value as a going concern w/o the dissociated partner.
        ii. Price is reduced by any amount dissociating partner owes the partnership, even if the obligation is not due, and reduced by any damages the partnership suffers if dissociation is wrongful.
    b. Dissociating partner's right to management ends unless the partnership is being dissolved.
    c. Partner is no longer under a fiduciary duty and can enter competition
        i. Still has a fiduciary duty as to past obligations.
3. Wrongful dissociation
    a. Dissociation is wrongful only if it breaches an express agreement or if the partner dissociates by the following:
        i. Express will;
        ii. Becoming a debtor in bankruptcy;
        iii. Expulsion by court order.

B. <u>Dissolution</u>

1. A partnership ceases to exist in 6 instances
    a. Where it becomes unlawful to continue all or substantially all of the partnership's business. [UPA 801(4)]
    b. All the partners agree. [UPA 801(2)(ii)
    c. If it was a term partnership and the expiration of time or completion undertaking occurs [UPA 801(2)(iii)]
        i. Term partnership = partnership formed for a particular length of time or for a particular undertaking,
    d. If a partner in a term partnership ceases to be a partner for certain reasons, half the remaining partners may opt to dissolve the partnership. [UPA 801(2)(i)]
    e. Courts have equitable power to dissolve a partnership on several grounds.
        i. If the economic purpose of the partnership is likely to be unreasonably frustrated

e. Courts have equitable power to dissolve a partnership on several grounds.

    ii. Where it is not otherwise reasonably practicable to carry on the business in conformity w/the partnership agreement
    iii. Where it is not reasonably practicable to carry on the busienss in partnership w/a particular partner.

f. A partnership at will gives each partner the absolute right to compel the partnership's dissolution at any time. [UPA 801(1)]

2. Payment of liabilities
    a. The partnership's liabilities shall be paid as follows:
        i. Those owing to creditors;
        ii. Those owing to the partners other than for capital and profits;
        iii. Those owing to partners in respect of capital;
        iv. Those owing to partners in respect of profits.

VI. LLP's

A. General partnerships that have elected to become LLPs.
1. Becoming an LLP shields all partners from personal liability for all partnership debts.
2. Partners remain liable for their own actions as partners.
3. Partnership is also liable for action of a partner.
    a. However, the other partners are not personally liable.

CORPORATIONS

I. Aspects of the corporate form

A. Limited Liability
1. Each SH is normally liable only for the amounts that he contributes to the corporation.
2. If the corporation runs up large debts, the SH are usually not responsible.

B. Taxation
1. If a corporation makes a profit and reinvests it instead of paying it to SH (dividend), it pays taxes instead of the SH.
    a. Corporate tax rates are generally lower than personal tax rate

C. Free transferability of interest
1. Ownership interests are embodied in stocks/shares and are freely transferable.

D. Centralized Management
1. SH participate only in electing board of directors.
2. Board of directors then appoints officers.
    a. Day to day control --> officers

E. Perpetual existence
1. The fact that ownership changes hands does not in anyway affect the corporation's continued existence.

F. Internal Affairs Doctrine
1. The law of the state in which you incorporate will regulate the internal corporate governance.

II. Mechanics of Incorporating

GO TO SEPT. 19 AND REVIEW THE QUESTIONS ON ROYAL PLUMBING'S ARTICLES OF INCORPORATION

A. Articles of Incorporation
1. DE = "Certificate of incorporation; CA/MBCA = "Articles of Incorporation"
2. Mandatory provisions (MBCA/DE =A RAINS: **A**ddress; **R**egistered **A**gent; **I**ncorporators; **N**ame; **S**hare information, but DE has general purpose requirement)

a. Corporation's **name**
   i. Reserving the Name
      (1) A corporate name may be reserved, usually for 90 to 180 days, with the payment of a small fee. [MBCA 4.02]
         (a) The name must be distinguishable from the name of every other corporation on file with the secretary of state. [DGCL 102(a)(1) and MBCA 4.01]
            (i) In some states this is a narrow requirement, in other states its a broad requirement.
      (2) The corporate name must contain some evidence that the entity is a corporation and must not contain words falsely suggesting that the new corporation will engage in certain businesses.
         (a) Under DE law the name must contain the word or abbreviation of on of the following:
            (i) Association, Company, Corporation, Club, Foundation, Fund, Incorporated, Institute, Society, Union, Syndicate, Limited.
         (b) Under MBCA, the name must contain either 'corporation', 'incorporated', 'company' or 'limited.
            (i) CANNOT contain the following:
               1. Bank (ing; er); Trust; Cooperative; Any combination of "industrial" and "loan", or two or more of "building," "savings," "loan," "home,", "association", and "society."
   ii. Registering the name
      (1) Foreign company (company whose PPB is not in state of incorporation) must register name
         (a) Must renew registration
b. Name and address of each person who is incorporating
c. Name and address of an agent upon whom service of process may be made
d. Capitalization
   i. Number of shares the corporation is authorized to issue
   ii. If the shares have different rights, must state how the shares will differ from one another.
      (1) Must authorize at least one class of shares that has voting rights [MBCA 6.01]
      (2) Must authorize at least one class of shares that is entitled to receive corp assets upon dissolution.
      (3) Par value must be stated in the Articles for each class of stock
e. Purpose
   i. Usually broad (i.e., "for the purpose of doing business.")
   ii. Not required by MBCA
   iii. DE and CA require general purpose statement that the corp "is empowered to engage in all acts in which corporations may lawfully engage."
      (1) If they want to limit purpose, it can add limits.

B. Review by State official
   1. You submit the documents to the secretary of state and they review them
   2. If the documents are approved, you need to get a certificate from the secretary of state to prove that you are a valid corporation.
   3. Process
      a. Deliver the Articles to the secretary of state.
      b. Execute the Articles by an incorporator
         i. No SH yet b/c corporation isn't formed, so anyone can sign as an "incorporator"
      c. The secretary of state reviews the documents, stamp them and return them to the corporation.

d. The corporation comes into existence as of the close of business on day Articles are filed. [MBCA 1.23]

C. Organizing the New Corporation

1. Once formed, the corporation has no officers or bylaws or even owners.
2. Need an organizational meeting (an actual meeting may be unnecessary if there is unanimous consent)
   a. Elect directors if not named in Articles
      i. If directors are named in Articles = organizational meeting of the directors; if not named = organizational meeting of the incorporators
   b. Adopt bylaws
      i. Bylaws are rules governing the corporation's internal affairs
         (1) Date, place and time of annual meeting
         (2) Number of directors
         (3) Whether cumulative voting is allowed
         (4) Listing of the officers
         (5) What constitutes a quorum.
      ii. Who creates?
         (1) Bylaws are adopted, amended or repealed by majority approval of either the board or SH's entitled to vote [RMBCA 10.04(a)(1)]
      iii. Usually not filed w/Sec. of State and are not a matter of public record.
      iv. If the bylaws conflict w/the Articles, the Articles control.
   c. Appoint officers
3. The corporation is not required to issue stock at the organizational meeting.
   a. However, most courts hold that the corporation cannot engage in business until it has received valid consideration in exchange for shares.

III. Ultra Vires Doctrine

A. Definition: Doctrine that limits corporate action to the ends and means stated in the Articles of incorporation or corporation statute and validly approved by the corporation.

1. Essentially it is invoked when the corporation is without power/capacity to enter into the action that is being challenged.
2. Not really effective any more, since corporations can have a general purpose.

B. Comes up in two situations

1. The corporation uses a narrow purpose clause
   a. Even then, the courts tend to infer broad implied powers to the corp to conduct all business incidental to that stated in its purpose.
2. Waste activity
   a. No boarrd can claim that it is authorized to make a decision that constitutes waste
   b. Waste goes beyond the authority of a corporation and beyond what is permitted by law.
      i. Waste is an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.
         Waste is hard to prove.

IV. Pre-Incorporation Transactions by Promoters

A. Definition of promoter

1. Promoter = the person who takes initiative in founding and organizing a business or enterprise.
   a. Typical Activities

1. Promoter = the person who takes initiative in founding and organizing a business or enterprise.

    i. Arranging for necessary capital;
    ii. Acquiring needed assets or personnel;
    iii. Arranging for the actual incorporation of the business

B. Promoter's liability on an obligation
  1. Corporation not named
    a. Promoter is liable (even if intended to assign K to corp once it formed)
  2. K in corporation's name
    a. K purport's to be in corp's name, does not indicate that the corp has not formed as of K date, other party to K does not know corp hasn't formed.
      i. Situation: Promoter knows the corp hasn't been formed
        (1) Promoter liable if corp never forms. [MBCA 2.04]
        (2) Promoter liable if corp forms but does not adopt the K
      ii. Situation: Corp later forms and adopts K
        (1) Must be novation
          (a) Novation occurs where a previous valid obligation is extinguished by a new valid K, accomplished by substitution of parties or of the undertaking, w/the consent of all the parties, and based on valid consideration.
  3. Promoter unaware that corporation hasn't formed
    a. Go to Defective Incorporation [Sec. V]
  4. K states that corp is to be formed
    a. If corp never forms = promoter is probably liable;
    b. If corp forms but does not adopt = promoter is probably liable;
    c. If corp forms and adopts K = depends on the facts (which party is more culpable?)
      i. Adoption = manifestation of intent to take over the K.

C. Corporation's liability on an obligation entered into by a promoter
  1. The corporation becomes liable IF
    a. Validly formed
    b. K entered into by promoter provides that performance is to be the obligation of the corporation; AND
    c. The corporation formally adopts the K.
      i. *Moneywatch Companies v. Wilbers*: LL = Moneywatch, T = Wilbers. Wilbers signed lease as Wilbers dba Golfing Adventures. Wilbers later incorporates under J&J Adventures, Inc., dba Golfing Adventures, and has that named substituted onto the lease. Wilbers is therefore a promoter. LL sues Wilbers personally for rent due. Wilbers argues there was a novation. *Held*, Wilbers is liable b/c there was no novation and therefore no valid release of liability. The K did not provide that the corporation would be exclusively liable, Wilbers' individual signature was still on the K, and there is no evidence that the corporation formally adopted the K.

V. Defective Incorporation

A. De facto corporations (not available under MBCA).
  1. An equitable defense used to shield individual SH from liability, predicated on defective incorporation.
  2. Elements required for the defense to be available
    a. Good faith attempt to incorporate;
    b. Exercised Corporate powers;
    c. Some defect in incorporation prevents it from being a de jure corporation; AND

            i. de jure corporation = validly organized corporation in compliance w/statutory requirements.
      d. Actively involved SHs did not know of defect.
            i. *Hill v. County Concrete Company, Inc.*: Hill and Newman were going to form a corporation "C&M Builders." Opened a checking account, got the name on a bunch of other things. Articles were rejected b/c the name was already taken. Came up w/new name "H&N Construction Corp." They go out and do business under C&M Builders b/c they have contracted to do work before their articles were rejected. Essentially, they got in trouble b/c the lawyer made a mistake by not reserving the name. Countly Concrete issued C&M credit and they defaulted, so County Concrete sues. County Concrete goes after Hill and Newman individually b/c the corporation is insolvent. Hill and Newman argue that they were a de facto corporation. *Held*, no de facto corporation b/c Hill and Newman didn't act in good faith by not telling County Concrete that they weren't really C&M, but were actually H&N. (Arguably CC got what they bargained for--they thought they were dealing w/a corp. and they were; however, as a matter of policy risks should be allocated to the "corporation," not the 3rd party)
   3. MBCA abolishes de facto doctrine [MBCA 2.04]
      a. The Rule
            i. All persons purporting to act as or on behalf of a corporation
            ii. Knowing that there was no incorporation
               (1) If no knowledge = no liability
            iii. Are jointly and severally liable for all liabilities
               (1) *Harris v. Looney:* H sold his business to J&R Construction. J&R's Articles were signed by J; L, and R were in the room. On the day of closing the Articles had been executed but not filed. H is getting paid by the revenue of the business, which depends on the ability of J, L and R to run the business. They can't, and stop paying H. Since the Articles hadn't been filed on the day the sell was finalized, J&R wasn't a de jure corporation. *Held*, J is liable b/c he was purporting to act under the authorization of the state (as a valid corp.) when in fact there was no corporation.
B. Corporation by estoppel
   1. An equitable defense to individual liability predicated on defective incorporation.
   2. Rule
      a. A third party can be estopped from denying the existence of a corporation when:
            i. The third party **reasonably believes it is dealing** only w/an existing **corporation** AND
            ii. The SH who is asserting the defense **did not know of the defective** incorporation**.**
               (1) *AVS, Inc. v. Morse:* M owned a car wash, sold it to two attorneys acting on behalf of AVSI. AVSI's Articles weren't filed until AFTER the day the deal closed. M asserted personally liability against the attorneys. The attorneys argue corporation by estoppel. *Held*, the attorneys cannot invoke the doctrine of corporation by estoppel b/c they both had actual or constructive knowledge that AVSI did not legally exist as a corporation.

<u>VI. Accounting</u>

A. Balance Sheets and Income Statements
   1. Background
      a. In CA, financial statements are required to be prepared in accordance w/Generally Accepted Accounting Practices (GAAP)
      b. Two principles that guide the preparation of financial statements
            <u>i. Matching principle</u>

b. Two principles that guide the preparation of financial statements

(1) Requires company to report all revenues that were earned in a particular period and all expenses incurred.
  (a) Cannot shift expenses/revenues into other periods
  (b) Crucial in order to be able to compare corporations

ii. <u>Conservatism</u>
  (1) Accountants have to deal w/revenue recognition problems
    (a) Accountant should err on the side of being cautions
      (i) Portrays things more accurately
      (ii) Allows people/companies to be held accountable.

2. Preparation of the Income Statement
  a. Revenues - legitimate expenses = profits --> Owner's equity
    i. In the case of sole proprietor, profits go to sole proprietor
    ii. In the case of a partnership, it goes to the partnership accounts
3. Preparation of the Balance Sheet
  a. The balance sheet
    i. Assets of business - liabilities of the business = owner's equity (Or, assets = liabilities + equity)
      (1) Sum of all assets must = Sum of all liabilities
        (a) EXA: Propp = sole proprietor w/bank account of $10k. He has no liabilities. So he has equity in the business of $10k.

Balance Sheet

(i)

Assets		Liabilities
Cash	$10k	
		Owner's equity $10k
	$10k	$10k

(b) EXA: Now suppose Propp buys new polisher for $1k.

Balance Sheet

(i)

Assets		Liabilities
Cash	$9k	
Tool	$1k	Owner's equity $10k
	$10k	$10k

(c) EXA: Now he has $10k in cash, but wants to make a big purchase. So he borrows $10k from the bank.

Balance Sheet

	Assets	Liabilities
(i)	Cash $20k	$10k Bank Loan
		Owner's equity
		$10k
	$20k	$20k

(d) EXA: Instead of equipment, Propp wants to take a vacation that costs $3k.

(i) Cash down to $7k, equity down to $7k.

a. This is a **distribution--**but the balance sheet keeps balancing.

ii. Book value

(1) Value of assets - Value of liabilities

(a) This is not necessarily the value of the business (keep in mind valuation)

b. Assets

i. Carried at historic value, not appreciated/depreciated value

ii. Two types of assets

(1) Current = Asset that is expected to be sold/used up in the near future

(2) Fixed = Assets that cannot be easily liquidated

c. Liabilities

i. Current = Corp expects to settle in cash w/in a year

ii. Long Term = Liabilities payable over a year

iii. Contingent liabilities = Liabilities that aren't on the balance sheet but could reduce the company's value

(1) For example, if a corporation anticipates being sued.

d. Owners Equity

i. Partners' Equity

ii. SHs' Equity

4. Taxation of the Business Entity

a. <u>Partnership taxation</u>: Flow through treatment

i. Income - expenses = gross profit before tax

(1) The partnership does not pay income tax on the profit earned from the partnership

(a) It is a flow through--it reports its income taxes, but only the individual partners are responsible for paying the tax

(2) Instead, the partnership files a partnership return (reports revenues, expenses, etc.), but the gross profit is allocated to the partners

(a) Each individual partner has to include their allocation to their income

(b) In the year that the profit was earned, they have to pay a tax, whether or not the money is distributed from the partnership fund to the individual partner.

b. <u>Corporate Tax</u>: Double tax burden

i. Revenues - expenses = gross profits - corporate taxes = profits after tax - dividend = retained earning

(1) Corporation is taxed as a separate entity (must file it's own taxes)

(2) Profits after tax are in the bank account

        (a) If the corporation makes a dividend distribution, cash goes down and the common stock equity goes down (this keeps both sides of the balance sheet equal).
        (b) SH receiving the dividend has to pay taxes on it.

B. Types of Securities/Capital to help run the business
    1. Debt v. Equity
        a. Equity
            i. Management powers
            ii. Ownership interest in the business
        b. Debt
            i. No management powers
            ii. Entitled to an interest payment and the principal is paid back
            iii. Advantage over equity
                (1) Interest on borrowed capital is deductible
                    (a) And equity carries the double tax burden
                (2) Reduces the amount of revenues needed to be reported
    2. Hybrid Securities
        a. Securities that have some debt features and some equity features
C. Types of Equity Securities
    1. Attributes of common stock
        a. Rights are established in Articles of Incorporation
            i. Numbers of shares must also be set forth in Articles
        b. Preferred Stock receives priority over common stock
            i. Preferred stock must be in the Articles
            ii. It has some priority over the common stock
        c. Common stock = residual claimants
            i. After everyone else gets paid, the common stock owner gets paid
        d. Voting rights = control
            i. Default rule: 1 vote per share
            ii. The ones w/voting rights control things
        e. Financial rights = right to receive distributions
            i. Dividends
                (1) Payment by the company while the company is a going concern
            ii. Distribution in Liquidation
                (1) Company winds out business, pays creditors, preferred stock, then common stock
        f. Liquidity of common stock
            i. Publicly traded = highly liquid/easy to sell
            ii. Closely held = not liquid/difficult to sell
    2. SH distributions = payments to SHs
        a. Distributions include dividends paid to SHs
        b. Distributions = payments to SHs on liquidation or dissolution
        c. Distributions = payments to SHs to acquire ("redeem") their stock
            i. Redemptions/repurchases--different from distribution
        d. Right to receive dividend

        i. No SH has a right to dividend until the Board, in its discretion, declares the dividend.

3. Preferred Stock: Use of Multiple Classes of Stock
    a. Preferred stock = senior security
    b. Authorized shares = max number a corp. can sell
    c. Issued shares = number of shares actually sold
    d. Outstanding shares = number sold and not reacquired
    e. Statement of authorized capital **must** be set forth in Articles of Incorporation [MBCA 2.02 and 6.01-6.03]
4. Different types of preferences
    a. Cumulative Dividend
        i. If the dividend is not paid, it will keep adding up --> Dividend overhang
            (1) Before the company can make payments to common stock holders, they have to pay the dividend overhang
            (2) Starts to look like debt
                (a) But there is no legally enforceable claim until the corporation declares a dividend
    b. Non-cumulative dividend
        i. If dividend isn't paid, it goes away
    c. Voting or non-voting preferred stock
        i. Voting rights give SHs some right to control/monitor the corporation
            (1) Preferred stock usually don't have voting rights, but can be bargained for
    d. Liquidation or dissolution preference
        i. When a corporation is dissolved: Creditors claims (secured and unsecured) --> preferred SHs (to the extent of their preference in any further distribution of any remaining assets) --> Common stock SH (residual claimants)
    e. Use of participating or non-participating preferred stock
        i. <u>Participating preferred stock</u> (hybrid security)
            (1) Get paid amount of dividend preference and then get paid again along side the common stock
                (a) Hypo: The board of directors of C Corp. decides to declare dividends totaling $400,000. 100,000 shares of common and 20,000 shares of $2 preferred that is participating. Participating means "pay again." So these 20,000 shares get paid twice - first in its preferred capacity and again in its participating capacity. Preferred means "pay first" - so multiply 20,000 shares by $2 preference, which equals a total preference of $40,000. Pay that amount first, which leaves $360,000. How will the remaining $360,000 get distributed out?
                    (i) So take 20k x $2 preference = $40 paid out to preferred stockholders
                    (ii) $360 left, 100k common stock and 20k preferred stock (120k total)
                        1. So preferred stock gets $5 per share total ($2 preferred, $3 in further distribution)
        ii. <u>Non-participating preferred stock</u>
            (1) Gets stated preference but does not participate in further distributions after preference
    f. Making changes in rights, preferences and privileges of outstanding preferred stock
        i. The terms of an outstanding class of preferred stock cannot be amended w/o first obtaining the preferred stockholders' consent to such changes, even if such shares are otherwise non-voting
            (1) Consent is usually obtained by a majority vote of such class [MBCA 10.03-10.04]
            (2) Board cannot unilaterally amend terms of its outstanding preferred stock.
    g. Authorize different classes (or series) of preferred stock

h. Authorize blank shares
    i. Blank stock = stock authorized in the Articles as non-common stock, the terms of which have not been determined. The characteristics of the stock are set by the board of directors.
    ii. Blank check preferred stock [MBCA 6.02]
        (1) Allows the board flexibility to establish financial terms of a particular class/series of shares at time of issuance
        (2) Board files a certificate of determination--the board has determined how to fill in the blanks

5. Redeemable preferred stock
    a. Callable preferred stock = Redeemable at the option of the corporation
        i. This is bargained for in the Articles
            (1) Can avoid dividend overhang by allowing the company to pay a redemption price and call in the dividend overhang.
    b. Demand indebtedness = Redeemable at the option of the holder
        i. Preferred stock that is redeemable at the option of the investor is often referred to as a form of demand note.
6. Convertible preferred stock
    a. Convertible at option of the holder
        i. VC investors want this so they can have preference over the common on distributions
            (1) They get their money out before anything is paid to the common
            (2) If things look good, can convert into common stock.
7. Redeemable common stock
    a. At the option of the holder?
    b. At the option of the corporation ? (callable common stock)
        i. Most states (CA) say you cannot have redeemable common stock since it is a residual claim.
8. Convertible common stock
    a. Convertible into another class of stock (i.e. preferred-->common or vice versa)
    b. Convertible into debt?
        i. True upstream conversion
        ii. Most states say you cannot have common stock convertible into debt, to protect true lenders.
9. MBCA's "Freedom of K" approach

D. Debt Financing
    1. Types of debt securities
        a. Whether you have debt or not is important for 2 reasons
            i. Interest on your debt is tax deductible
            ii. If it is debt, you have priority in liquidation
        b. Classes of debt
            i. Short term
                (1) To help w/cash flow problems
            ii. Long term
                (1) Usually to finance the purchase of a capital asset
        c. The Types of Debt Securities
            i. Bond = Corporate debt that is secured
                (1) Security interest in some asset of the company
            ii. Debenture = Unsecured interest

(1) Companies issue far more debt than they do equity.

iii. Option/Right/Warrant (treat all as options)

(1) The right to buy something

(a) Right to purchase

(i) Usually granted to existing SH for limited amount of time

(b) Warrants

(i) Usually go to 3rd parties giving them the right to buy some security of the issuer

(ii) Typically have a longer period of time to decide whether they want to exercise their warrant.

(c) Option

(i) EE stock options

(ii) Granted by the issuer

(iii) To incentivise people to work hard

1. When should the option vest and become exercisable?
    a. Most say at a minimum the stock must go up in value
    b. Exercise price = price on date of hire.

iv. Debt covenants

2. Leverage
    a. The attractiveness of debt = leverage (using other people's money to work for you)
    b. Inside or outside debt?
        i. Outside debt (loans made by 3rd parties)
        ii. Inside debt (loans made by SHs)

(1) Tax friendly way to get money out of the business

(a) Reduce/minimize the impact of double taxation

3. Economic and legal risks of thin capitalization (high debt/low equity ratio)
    a. Debt/equity ratio
        i. Interest rates on debt can be HIGH
        ii. Debt is a fixed cost--but if you don't pay it (default), you lose everything
        iii. High debt/low equity makes you a likely candidate for audit by the IRS.

(1) You can't get all the money out of the company as a tax-deductible interest.

(2) IRS can decide that a loan is actually equity

(a) Company loses deduction, must take it all back into income, which means they have a higher income and have to pay a larger tax.

iv. Increases chances of PCV.

b. Thin capitalization
    i. A corporation whose capital is supplied primarily by loans from SH rather than stock investment.
    ii. The main tax advantage attempted is that the distributions of interest on the debts may be deducted by the corporation as Interest, whereas distributions on stock are nondeductible Dividends. If the debt-to-stock ratio becomes excessive, the IRS may contend that the capital structure is unrealistic and the debt is not Bona Fide. The acceptable debt-to-stock ratio varies according to industry norms. If the corporation's debt is recast as stock, the corporation loses its deductible interest expense.

4. Venture capital financing

E. Mechanics of Issuing stock

1. Subscription agreements
    a. Written K to buy stock on whatever terms are set out in the subscription agreement.
    b. If you're making your subscription agreement b/f you incorporate, there is no issuer b/c the company is not in existence.
        i. Usually only required in small privately held companies, b/c the people have more on the line and want more than a verbal agreement.
2. Issuing stock: terminology
    a. Issuance v. trading transactions
        i. Issuance
            (1) Raising capital
            (2) Issuing stock
                (a) Authorized shares
                    (i) Articles must recite the maximum number of shares the company is able to sell
                    (ii) If they want to issue more, must amend the Articles.
                (b) Once issued, they remain outstanding until they are reacquired by the company.
        ii. Trading
            (1) The buying and selling of stock.
3. Number of Authorized shares: Herein of "dilution"
    a. Dilution = reduction in a SH's ownership interest caused by the issuance of more shares.
    b. Disparate contributions of founding SHs
    c. Valuation of non-cash consideration
        i. Board determines the value of non-cash consideration--determination is binding if in good faith
4. Par Value
    a. Definition
        i. An arbitrary value, usually nominal, for a class or series of shares, which is stated in the Articles.
        ii. Shares may not be issued for less than par value.
            (1) No par value rule in CA (but yes in DE)
    b. Balance Sheet accounts
        i. Stated capital
            (1) The par value of every share sold goes into the stated capital.
            (2) Can never make a distribution to SH out of stated capital.
        ii. Capital surplus
            (1) The excess over par value for which stocks are sold
            (2) Can always make a distribution to SH out of capital surplus.
        iii. Must allocate b/t stated capital and capital surplus
            (1) EXA: Par value = $2/share. Sell 300 shares at $5/share, the cash received = $1,500. $600 is allocated to stated capital (par value x number of shares sold); $900 goes to capital surplus (balance sheet is balanced).
        iv. In CA you can make a distribution to SH so long as after that distribution the company is not insolvent.
            (1) Two tests for insolvency in CA
                (a) Bottom line test
                    (i) Liabilities exceed assets
                (b) Equity test

        (i) Business is not able to pay its debts as they come due.

   v. Retained earnings
      (1) Tracked in SH equity portion of balance sheet

c. Watered stock liability

d. Par value in modern practice
   i. Guarantees that all contemporaneous stock purchasers pay the same price

5. What types of consideration can be used to acquire stock
   a. MBCA approach [6.21(b)-(d)]
      i. Consideration can be any tangible or intangible property or benefit to the corp.
      ii. Board must determine that the consideration is adequate.
   b. CA approach [CA 409]
      i. Consideration can be the following
         (1) Money; labor; services rendered; debts/securities cancelled; tangible or intangible property.
   c. DE approach [DGCL 151-154, 161]
      i. Consideration can be any benefit to the corp., as determined by the board.

6. Preemptive rights
   a. The equitable right of SH to purchase shares proposed to be issued so that their respective economic and managerial interests will be preserved.
   b. Default rule in DE/MBCA = no preemptive rights unless added in Articles.

F. Public offerings v. Private placements
   1. Securities Act of 1933
      a. Traditional considerations b/t permitted (eligible) and prohibited (ineligible) forms of consideration
   2. Blue Sky Laws {CCC 25000]
   3. IPO's
   4. Additional rounds of debt or equity financing by publicly traded companies

VII. Distributions to SH: Dividends and Redemptions

A. Dividend Distributions
   1. Board discretion
      a. A corporation cannot pay dividends unless its board of directors approves.
         i. When the board authorizes the dividends they are said to have been declared.
         ii. Most states have rules that allow the SH to compel a distribution, but typically only if the board is oppressively or fradulently abusing its discretion not to declare a distribution.
   2. Statutory Restrictions
      a. Some statutes limit the board's ability to declare a distribution even if it wants to.
         i. Not waivable and directors are held personally liable for knowing/negligent breach.
      b. Insolvency Test [MBCA 6.40]
         i. Corporation can't declare dividend if afterward the corporation would not be able to pay its debts as they become due in the usual course of business OR asset's are less than liabilities plus the amount necessary to pay the preferred shares their liquidation preference.
      c. Legal Capital Test [DE/par value states]
         i. Distributions can only be paid out of capital surplus (net assets - stated capital)
   3. Mechanics of paying dividends
      a. Once the board has passed a resolution declaring a dividend SH as a group become creditors to that dividend.

            i. Board resolutions typically fix a future date on which the dividends will be paid.
        b. 3 important dates
            i. **Declaration date** = Date on which dividend is declared
            ii. **Record date** = The date that determines which SH is eligible to receive the dividend.
                (1) Default rule: SH at the close of business on record date is entitled to dividend even if he transfers it b/f payment date.
                    (a) *McIlvaine v. AmSouth Bank, N.A.*: M has a trust that provides that the net income of the trust (including stocks) would be paid to T and two other children. If T dies, income is to be paid to his lawful issue (G). T dies on record date. Trustee needs to know whether the stock dividend goes to G or to T's estate. *Held*, court says that its not going to slice up a day, so T was SH on the record date; dividend goes to G.
            iii. Payment date = Date you get paid and have to take it into account for tax purposes.
    4. Stock Splits
        a. A stock split is the division of the outstanding shares into more shares (cutting the pie into more pieces).
        b. Ownership interest doesn't change, is just represented by more shares.
            i. Nothing is created, no assets are transferred.
                (1) *Lynam v. Gallagher*: Husband and wife married in 1959. Husband has 960 shares. Sold 100 shares to a 3rd party, transferred 100 shares into a joint account w/wife. Left w/760 shares. Over time, the company declared a stock split, so that on the date of divorce he had 6,080, and the joint account was up to 800. Husband claims ownership of full 6,080, half of 800. Wife is claiming that the amount of shares has increased, so its part of marital property and she is entitled to half. *Held*, the stock splits are not new property.
B. Redemption
    1. Two limits on a corporation's power to repurchase its shares
        a. These purchases are subject to the same economic test as dividends.
        b. At least one such share must remain outstanding at all times.
    2. Impact of repurchased shares
        a. Repurchases shares are not outstanding
            i. Cannot be voted
            ii. Do not count as being present for quorum purposes
            iii. Cannot receive dividends
        b. Two possibilities
            i. Retired stock
                (1) Default rule = reacquired shares become authorized but not issued.
                    (a) But if Articles provide that reacquired shares cannot be issued, they "evaporate" (become retired stock)
                        (i) Number of authorized shares is reduced by the number of shares reacquired.
            ii. Treasury stock
                (1) Reacquired shares remain authorized, issued, but not outstanding.

VIII. Piercing the Corporate Veil

A. PCV Doctrine
    1. An equitable doctrine that holds a corporation's SH liable for the corporation's debts if the corporation is unable to pay.
        a. In practice only applies to closely held corporations.

2. General rule: Corporate form will be respected unless there is a **sufficient reason** to pierce the corporate veil.
    a. Sufficient reasons
        i. Corporate form is being used to
            (1) Defeat public convenience;
            (2) Justify wrong;
            (3) Protect fraud; or
            (4) Defend crime
    b. Two part test
        i. Unity of interest and ownership so that the separate personalities of the corporation and its SH, officers or directors = indistinct/non-existent;
            (1) Factors
                (a) Undercapitalization;
                (b) Failure to observe corporate formalities;
                (c) Absence of corporate records;
                (d) Payment by the corporation of individual obligations;
        ii. Adherence to the fiction of separate corporate existence would sanction fraud, promote injustice or inequitable consequences or lead to an evasion of legal obligations.
            (1) Factors
                (a) Fraudulent misrepresentation by corporation directors;
                (b) Use of corporation to promote fraud, injustice or illegality.
3. PCV in K arena (less willing to pierce b/c K claimants = **voluntary creditors of the corp--presumed to assume risk of limited liability)**
    a. *Brevet Int'l v. Great Plains Luggage*: Brevet (consulting co.) hired by Great Plains to implement a management system. Cost was $35k plus everyday expenses. Crosby (on behalf of Great Plains) made an agreement w/Brevet. On reliance of Brevet's assurance that they could help, Crosby invested $100k of his own money. All invoices were paid, but the $35k was not. Brevet sues Crosby for breach of K. *Held*, there was a K b/t Great Plains and Brevet, not Crosby and Brevet. Brevet failed to establish no distinct corporate identity--Crosby paid w/corporate checks.
4. PCV in Torts arena (more willing to pierce b/c tort claimants = **involuntary creditors of the corp**)
    a. *Baatz v. Arrowhead Bar*: Arrow Bar serves alcohol to visibly intoxicated man, he drives and causes an accident. π sues driver (judgment proof), Arrow Bar, Inc., and it's parent company. Arrow Bar doesn't have enough assets to pay, so π asks the court to PCV to get to its parent company, owned by the Neuroths. The Neuroths incorporated and put $5k in, then borrowed $145k and personally guaranteed the loan. *Held*, sufficiently distinct, so no PCV. The fact that they personally guaranteed a loan wasn't commingling, they were just guaranteeing a corporate obligation. In this case (unlike Brevet), it doesn't matter that the Neuroths didn't follow the corporate form, b/c there is no course of dealings b/t π and the corporation.

B. Enterprise liability
1. Enterprise liability seeks to aggregate corporations into a single enterprise and hold the entire enterprise liable.
    a. Vertical aggregation
        i. Creditor seeks to hold the debtor corporation's corporate parent liable (parent/subsidiary)
        ii. Greater tendency to pierce
        iii. Veil will not be pierced so long as

(1) Proper corporate formalities are preserved;
(2) The public is not confused about whether it is dealing w/parent or subsidiary;
(3) Subsidiary is operated in a fair manner w/some hope of making profit for itself (not just for parent's benefit)
(4) There is no other manifest unfairness

iv. Factors leading to PVC
(1) Intertwined operations
(2) Separate corporate formalities are not followed
(3) Unified business and subsidiary undercapitalized
(4) Misleading to the public
(a) Parent and subsidiary don't make it clear to the public which entity is handling each particular aspect of the business.
(5) Intermingling of assets
(6) Unfair manner of operation
(a) Operation of subsidiary for benefit of parent and not benefit of subsidiary.

b. Horizontal aggregation
i. Creditor seeks to aggregate one or more corporations that are under common control (brother/ sister corporations).

2. 4 approaches to Enterprise Liability
a. Treat it exactly the same as PCV;
b. Impose enterprise liability where the court finds that the distinction b/t the corporations are sufficiently indistinct that equity is best served by aggregating the corporations;
1. *Smith v. McLeod Distributing, Inc.*: Smith is Δ, he set up Colonial Mat Co., which made vendor arrangement w/McLeod. Smith set up another company Colonial Industrial. Smith sent letter to McLeod telling him that Colonial Industry was going to be buying the mats, under the name Colonial Carpets, Co. Colonial stops paying, McLeod sues all three. McLeod wants to go after Colonial Mat. When McLeod entered agreement w/Colonial Mat, he decided that they were credit worthy--but Smith gave a personal guarantee. McLeod doesn't want to go after Smith, though (no assets). McCloed is trying to say that the business really consists of an enterprise made up of Colonial Mat, Colonial Industrial and Colonial Carpeting. *Held*, there was sufficient evidence to find a single enterprise. Although Smith had a legit business reason for forming separate corporations (marketing), he had the burden of making it clear that they were separate and distinct.

c. Aggregate affiliated corporations that perform complimentary aspects of a single business;
1. *In re U-Haul International Inc.*: π was injured by a tow dolly designed and manufactured by U-Haul. π sued U-Haul, a third party driver and whoever hooked up the dolly to the car. COA against U-Haul was probably products liability. π wants all data from any dolly accident involving a U-Haul produced dolly. Specifically, π wants documents from Republic Western Ins. Co, U-Haul's insurers. UHI and Republic are subsidiaries of the same parent company, Amerco. Republic refused to turn over documents when U-Haul requested them, court sanctioned U-Haul for failure to comply w/discovery request. The sanction order established liability on U-Haul, so π would only have to establish damages at trial. *Held*, for the purposes of legal proceedings, subsidiary corporations and parent corporations are separate and distinct "persons" as a matter of law and the separate entity of corporations will be observed by the courts even where one company may dominate or control it, even treat another company as a mere department, instrumentality, or agency.

d. Where a single business is separated into separate corporations, each of which performs the same (or nearly the same) functions

1. *Goldberg v. Lee Express Cab Corp.*: Accident involving taxi cab. π sued a ton of people under different theories. Nathan (common owner of 17 cab companies); driver of the cab; Lee Express Cab Co. π not just content going against company that owned that particular cab; P went against all 17 companies owned by Nathan. Inside the cab company are the cars, their value, and the personal property that is involved in the corporation. Presumably Lee Cab Co.'s assets weren't sufficient to make π whole, so π wanted enterprise liability and PCV. *Held*, Nathan is liable--all of the companies shared supplies, funds, etc.

C. Equitable Subordination Doctrine

1. A doctrine that protects creditors of a bankrupt corporation. The bankruptcy court may subordinate (i.e., give a lower preference to) debt that the court deems to resemble a SH's ownership interest more than debt.

a. *Pepper v. Litton*: (Decision is now codified in bankruptcy law). Litton was the sole SH of Dixie Splint. He owed royalties to Pepper. Pepper sued Dixie for breach of K. After Pepper brought the law suit, Litton brought a back wages claim against Dixie Co. Now there are two claims against Dixie (Pepper v. Dixie and Litton v. Dixie). Litton (CEO of Dixie) causes Dixie Splint to confess judgment to the claim for back wages. As a judgment creditor, Litton sells the assets of the company to pay his judgment. Dixie Splint then files bankruptcy. Pepper is left out to dry on his royalty claim. Pepper wants to have the back wages judgment set aside. Ordinarily, creditors get paid, then SH. *Held*, Litton's claim gets lower priority.

IX. The Role of Directors and Officers

A. The Board of Directors

1. The Statutory Norm

a. The board is going to manage the business affairs of the corporation

i. The board will not actually conduct the day to day business--> officers

b. The board creates a centralized management function

i. Every action of a corporation must have its genesis in the board of directors.

ii. But the board is NOT an agent of the corporation; officers are agents

c. The board cannot abdicate its powers

i. *Grimes v. Donald*: G is π/SH. Sues the board of DSC for abdicating it's management authority. DSC signed an EE K w/D (CEO/chairman), with a provision that if D reasonably believed the board was interfering w/his duties, he could terminate the K and get paid $6 mil. over 6 years. G wants a judicial declaration to say that the K is invalid and the court should set it aside b/c the board has given up its power to manage. *Held*, the board did not abdicate its responsibility because the board still has the power to manage--they could decide to fire D and pay the penalty.

2. Selection of Initial Directors

a. Number and Selection of Initial Directors

i. The board must consist of one or more individuals.

ii. One corporation may own shares of another and may be able to elect directors to the other's board, but cannot serve as a director of the other corporation.

iii. Stated in Articles or bylaws

(a) Restrictions on scope of change

(1) Board can only increase/decrease number of directors by 30% or less w/o SH approval [MBCA 8.03(b)]

(2) Boards can have a variable size (if in Articles) that has a set min and max, and either the directors or SH can change the number of directors [MBCA 803(c)]
    (i) Only SH can change the range

3. Election and Term of Board Members
    a. Directors are <u>almost</u> (vacancies) always elected by the SH
    b. At least one director must be elected at every annual SH meeting.
    c. Default rule = all directors are elected annually by all SH (normal term = 1 year)
        i. Can be varied in two ways
            (a) Create a classified board
                (1) Under this model, the power to elect at least one director is vested in, or denied to, at least one class/series of stock.
            (b) Divide the directors into two or three classes w/each class holding staggered terms of two or three years.
                (1) Typically the board is divided into thirds so that each director has 3 yr. terms.
        ii. Expiration of term does not by itself oust the director from office
            (a) Director remains in office until he/she is reelected, another person is elected to fill his/her slot, the board is reduced in number at the end of the director's term, or the slot becomes vacant.
                (1) Holdover director = director who remains in office after expiration of term.
        iii. Vacancies
            (a) Created by resignation, death, or removal of an incumbent.
            (b) Default rule = Either the board or the SH can elect somebody to finish out the term [MBCA 8.10(a)].
                (1) CA = if vacancy is created by removal, only SH can fill the vacancy
                (2) Board is generally able to do this first
            (c) Term
                (1) Two approaches
                    (i) Replacement director serves full unexpired term
                    (ii) Replacement director must stand for re-election at the next annual meeting. [MBCA 8.05(d)].
        iv. Removal
            (a) The board itself has no power to remove a director.
            (b) SH vote (amotion)
                (1) SH power to remove directors during their term
                (2) MBCA default rule = SH may remove one or more directors with or without cause [MBCA 8.08(a)]
                    (i) MBCA: Directors elected to classified board may only be removed by the same set of SH that elected them.[8.10(b)]
                    (ii) DE: Directors elected to staggered board can only be removed for cause.
            (c) Court order
                (1) Court can remove a director in a proceeding commenced by either the corporation or a 10% SH if
                    (i) The director engaged in fraudulent or dishonest conduct; OR
                        1. Gross abuse of authority or discretion; AND
                        2. Removal is in the best interest of the corporation.

4. Mechanics of the Board Meeting

a. Directors have little to no individual power/rights
    i. Only have the right to information--but can't act on behalf of the corporation solely due to their status as director.
b. Common law rules governing the board
    i. Board has no power to remove a director;
    ii. The default term of office is one year;
    iii. Nonunanimous board action w/o a meeting is invalid;
    iv. Board meetings may be called in any manner approved in advance by the board;
    v. Each director has one vote on all matters;
    vi. Directors may not vote by proxy--must vote in person.
c. Boards take action in two ways (Boards CANNOT take action by proxy)
    i. Unanimous written consent (no meeting necessary)
    ii. Board Meetings
        (a) Two types of board meetings
            (1) Regular
                (i) Occurs at a regular interval, specified in bylaws.
            (2) Special
                (i) Any other meeting
        (b) Procedural requirements for a board action taken at a meeting to be valid
            (1) Call
                (i) Decision to hold a meeting at a particular time and place, usually for a particular reason.
            (2) Notice
                (i) DE default rule = each member needs "due notice"
                    a. *Alderstein v. Wertheimer*: A formed SpectruMedix (corporation) in 1992. Corporation fell on hard times, so A loaned the company $500k, and in turn he got 73% ownership (voting majority). Alderstein was convinced to elect W, and then M (outside directors--part timers). A was an inside director (actively involved in running the company). In 2001, M and W found R, who was going to put in money ONLY IF he got a majority of voting stock (to balance against the risk of investment). M and W don't tell A that they are having these discussions w/R. Corporation's law firm wants to w/draw (hasn't been paid); A agrees to have a meeting to discuss this. At the meeting, M and W tell A of R's proposal; A objects b/c it will dilute him and squeeze him out. At that point, M and W make a motion to issue the shares and bring R on, and put it to a vote--they win 2 to 0 (A didn't participate--either abstaining or voting no). M and W then remove A for cause, and bring R in as new CEO. A is PISSED. A brings 225 proceeding in DE to challenge board election results. A claims that none of the actions were valid b/c it wasn't a valid meeting. If the meeting was not valid, then A continues to own a majority of the voting stock, and can remove M and W by written consent. *Held*, the meeting was not valid b/c A was entitled to know ahead of time of the plan to issue new stock; a basic requirement of corporation law is that the board of directors conduct their affairs in a manner that satisfies minimum standards of fairness.
                (ii) MBCA
                    a. Default rule for regular meetings = no notice is required.

(ii) MBCA

b. Default rule for special meetings = 2 days notice of location and time, but don't need purpose.

(iii) Waiver

a. A director who does not receive proper notice waives any objection by attending the meeting unless the director immediately protests the insufficient notice and does not vote in favor of any measure at that meeting.

1. As long as you can hear the proceedings, you are present (usually telephonic)

(3) Quorum

(i) Default rule = Unless the Articles or bylaws say otherwise, quorum = a majority of directors (even if vacancies exist)

a. EXA: 9 directors on board, quorum = 5. Even if 2 vacancies exist, quorum = 5, not 4.

(ii) If there is a variable board, quorum = majority of # of directors in office at beginning of meeting. [MBCA 8.24(b)]

(iii) Must be present at the time the vote is taken (can break quorum by leaving before vote)

(4) Sufficient Vote

(i) Default rule: Majority of the directors present must vote yes [MBCA 8.24]

d. Objection

i. If a director wants to disassociate herself from board action, she must make sure it is registered in the minutes.

(a) This can help protect dissenting board members from personal liability.

5. Committees

a. Committees are often appointed to take certain specified action on behalf of the board.

i. A majority of the entire sitting board must approve the creation of a committee and the appointment of members to it.

ii. Not allowed to take certain actions

(a) Fill vacancies;

(b) Amend Articles/bylaws;

(c) Approve/propose to SH actions that require SH approval;

(d) Authorize issuance or re-purchase of shares

b. Standing committees

i. Audit committee (mandatory)

(a) Oversees internal management control

(b) Responsible for prepairing income statement and balance sheet on an annual basis for distribution tot SHs.

ii. Nominating committee

(a) Nominates candidates to run for vacancies on the board.

(b) Should have at least a majority of outside directors.

iii. Compensation committee

(a) Usually conduct negotiations w/respect to terms of negotiations for EEs.

iv. Executive committee

(a) Meet in b/t regular meeting dates

(b) Can be delegated some functions

(1) Cannot declare dividends

(b) Can be delegated some functions

(2) In most states, cannot make recommendations about fundamental changes (liquidate, merger, amend articles, etc.)

B. Senior Executive Officers

1. Officers are agents of the corporation
   a. SEC definition = Someone who has a title and policy making function of the corporation
      i. Officers are agents, but it is important to figure out whether the person you are going after is an agent, EE or an officer.
         (1) Important b/c of fiduciary duties.
            (a) When there is an agency relationship, the law imposes fiduciary duties
            (b) If EE is also an officer, they have a heightened degree of fiduciary duties
            (c) Officers are often subject to personal liability by statute
            (d) As a matter of state law, very often there are employment statutes that extend liability to officers if they fail to live up to certain obligations that are imposed by law.
      ii. CA follows common law tradition
         (1) Every corporation is required to have
            (a) President
            (b) Secretary
               (i) Responsible for maintaining the company's books and records (custodian of records)
                  1. By statute in most states, the Sec. is able to authenticate those books and records as official company docs.
                  2. Typically president and secretary can't be the same person
            (c) Treasurer
               (i) Responsible for maintaining the company's funds.
   b. Authority of officers to act for the corporation
      i. Power of position
         (1) The officer has the power to take actions w/in the ordinary course of business
         (2) As long as the action is in the ordinary course of business, the corporation is bound.
            (a) *H-D Irrigating, Inc v. Kimble Properties, Inc.*: π sued Hobble Diamond Cattle and Kimble for recovery of damages for misrepresentation/breach of duty to disclose material defects in the irrigation system sold to them. Kimble was president of both Kimble Properties, Inc. and Diamond Cattle. *Held*, Kimble liable. He acted as an agent, but he lied. Kimble was acting w/in the scope of his EE under KP, but not Diamnod Cattle. Hobble Diamond wasn't held liable, only Kimble and KP, Inc. b/c the misrepresentations concerned the irrigation, not the land.
      ii. Actual authority to bind the corporation
         (1) Duly adopted board resolution
            (a) In the case of a corporation, how are you going to know whether there is actual authority?
               (1) One possibility: Sit in on the meeting.
                  (i) High transaction costs
               (2) At common law, the solution was "the seal."
                  (i) The officer could present a document w/the corporate seal as proof that the action is authorized.
                  (ii) Today we have moved away from the seal. (see Snukal below)
      iii. Apparent authority to bind the corporation

(1) I.e., by wearing the CEO hat, etc., presents outwardly that the officer is authorized to do certain things in the ordinary course of business.

(a) So the question is, does the particular activity w/the particular 3rd party fall reasonably w/ in that officer's authority?

(1) *Snukal v. Flightways Manufacturing*: Snukal leased a property to Flight Ways, Inc. The lease was entered into by Lyle, who signed the lease as president of Flight Ways (he was also the CFO and Secretary). Snukal sues Flight Ways for back rent. Lyle may have personal liability b/c of his misrepresentation; his lie was that he was housesitting was not to the LL, it was to the corporation. But under agency law if agents acts on behalf of a disclosed principle, the principle is bound--so Snukai has no basis to go against Lyle, only Flight Ways. Snukial's COA = Breach of K. Flight Ways defends on the grounds that Lyle was not authorized to act on their behalf and bind the company. *Held*, Flight Ways is liable. Under CA Corp. Code 313, the court cannot invalidate a written instrument if it is signed by the chairman of the board, president or any vice president AND a secretary, any assistant secretary, CFO or any assistant treasurer. Lyle was both the president and secretary/CFO--therefore the instrument is valid and Flight Ways is liable.

X. The Role of SHs: Publicly Traded Corporation

A. Mechanics of SH Voting

1. Actions SH can take

a. Typically, SH vote on one matter only-->who shall serve as directors.

b. SH are also required to approve fundamental changes (but cannot initiate these changes)

i. Amending the Articles;

ii. Selling all/substantially all of the corporation's assets;

iii. Mergers;

iv. Dissolving/ending the corporation's power to engage in business.

c. The board may choose to present certain matters to the SH even though not required.

d. SH have the power to act in 2 settings w/o board concurrence and w/o the possibility of the board overriding the decision

i. SH can, in certain settings, remove (amote) some or all of the directors and replace them.

ii. Amend the bylaws (power of SH to do this can be eliminated in the Articles).

2. Annual v. Special Meetings

a. Call

i. Annual meetings

(1) Bylaws/Articles provide the call

(a) Failure to hold annual meeting will not make the corporation's subsequent action invalid.

(2) SH elect directors and other valid SH action

(3) Required by statute

(4) If board fails to hold annual SH meeting, SH can bring suit to compel the meeting.

ii. Special meeting

(1) Any SH meeting other than the annual meeting.

(2) Who can call a special meeting

(a) MBCA = 10% of SH can call a special meeting

(b) DE = only directors or person authorized in the bylaws

b. Notice

i. Notice to the SH is regulated by statute
  (1) Annual meeting
    (a) B/t 10 and 60 days notice required
      (i) *McKesson Corp v. Derdiger*: McKesson mailed proxy statement. Under DE law the record date can't be set more than 60 days in advance of the meeting date. Derdiger challenges the record date b/c there is 61 days. McKesson relies on case law saying that there can be 60 days b/t record date and meeting. Derdiger wants to record date, which would mean postponing the meeting. The meeting goes forward, Derdiger argues that the board action taken at that meeting should be voided. McKesson brings suit seeking declaratory relief to declare that it was a valid assembly (they want to be able to move business forward w/o having to look back over their shoulder). McKesson makes equitable argument that b/c of a holiday, the record list wouldn't have changed if record date was on the next business day. Court says thats no good b/c if Congress meant it that way, they would have written it that way, and also this can lead to a slippery slope. BUT, judge gives him a free pass (no new meeting), but don't mess up again (McKesson or anyone else).
    (b) Notice must tell SHs date, time and place.
    (c) Generally the notice doesn't have to give the purpose of the meeting
      (i) Default rule: No agenda, any SH can raise any issue
  (2) Special meeting [7.05(c)]
    (a) Date time and place
    (b) Notice must state the particular issues to be voted on/purpose for calling the meeting

ii. Notice can be waived
  (1) Waiver can be express or implied
    (a) Express
      (i) Written waiver signed by SH delivered to corporation
        1. Can be signed either before or after the meeting
    (b) Implied waiver [7.06(b)]
      (i) Arises when the SH attends the meeting w/o objecting to the defect in the notice.
        1. If you believe notice is defective, you must object at the beginning of the meeting to preserve your complaint.

c. Quorum of shares must be present
  i. Quorum = minimum amount of voting power that must be **present** at a meeting for the actions to be valid.
    (1) Default Rule [CA/MBCA/DE]: Quorum for SH meetings = majority of outstanding shares
      (a) Can be raised or lowered in Articles.
        (i) DE, cannot be lowered below 1/3
        (ii) MBCA = as low as they want it to be
        (iii) CA = no less than 20%
      (b) EXA: 1000 outstanding shares, need at least 501 for a quorum to be present.
    (2) Once established, valid for remainder of meeting (unlike board meetings)
    (3) When determining whether present, must distinguish b/t registered owners and beneficial owners
      (a) Record owners are entitled to vote, and so must be present (unless voting by proxy)

d. Sufficient Vote

i. General votes
   (1) DE default rule: Quorum = majority of votes present
      (a) Requires a majority of the shares present to affirmatively vote yes--abstention has the same effect as a 'no' vote.
         (i) EXA: 600 shares present, need 301 affirmative votes.
   (2) MBCA default rule: Quorum = simple majority (regardless of how many votes are actually cast)
      (a) Need a majority of outstanding shares to be present (so if 1000 outstanding, need 501 for a quorum)
      (b) Need a simple majority of votes present--abstenation is a true abstenation
         (i) EXA: 600 present, do not necessarily need 301 affirmative votes; 250 yes, 240 no and 10 abstain will pass)
   (3) CA Default rule:
      (a) Majority of shares present and voting AND
      (b) Majority of required quorum.
         (i) EXA: If 1000 outstanding shares, at least 501 must be present, and must have at least 251 affirmative votes.

ii. Fundamental changes
   (1) Two standards
      (a) Absolute majority (majority of outstanding shares, not just voting power present) [DE]
      (b) Super Majority (2/3 of all outstanding shares)

iii. Electing/removing directors
   (1) CA: 602(a)
      (a) Majority of required quorom
      (b) Majority of shares present and voting
         (i) So 602(a) would basically undo the protection that cumulative voting gives minority SHs.
            1. 303(a)(1): No director may be removed when "no" votes would be sufficient to elect the director under cumulative voting, even if the number of yes votes would otherwise be sufficient for removal.
   (2) MBCA = As long as yes votes are greater than no votes, director is elected/removed. [MBCA 7.25]
      (a) However, if a corporation has cumulative voting, a director cannot be removed if the number of votes cast against his removal would have would have been enough to elect him. [MBCA 808(c)]
   (3) DE = majority of shares present elects/removes a director. [216]

e. Being "present"
   i. Physically present
   ii. Virtual presence
   iii. Proxy
      (1) Agency relationship in which a SH appoints another person to attend a SH meeting on the SH's behalf and vote.
         (a) Irrevocable proxy = States it is intended to be irrevocable and is coupled with an interest.
         (b) Limited = Authorized to vote in a particular way
         (c) General = Authorized to use discretion

(2) Proxy relationship can be created only by a writing or electronic transmission.
    (a) Must name the agent/proxyholder

3. SH Action Without Meeting (Consent)
    a. DE
        i. Consent can be obtained and submitted electronically
        ii. SH action **does not have to be unanimous**
        iii. Resolution to seek consents = call
        iv. Request for consent = notice to SH that consent solicitation is taking place; if not every SH is solicited, must give prompt notice.
        v. Sufficient vote = majority of shares
        vi. All consents must be delivered no later than 60 days after the date of the earliest dated delivered consent.
    b. MBCA
        i. Consent cannot be obtained and submitted electronically
        ii. SH action w/o meeting **must be unanimous.**
        iii. Consent is revocable until consents from all SH are delivered.
        iv. All consents must be delivered no later than 60 days after the date of the earliest dated delivered consent.
4. Methods of voting
    a. Straight voting (Default in MBCA/DE)
        i. Definition
            (1) In a straight vote, each share may be voted for as many candidates as there are slots on the board, but no share may be voted more than once for any given candidate.
            (2) Directors are elected by a plurality (directors that get the most votes win)
                (a) EXA: Closely held corp, A and B are sole SH. A holds 72 shares, B holds 28. 3 directors. A's Candidates are A1, A2, and A3; B's candidates are B1, B2 and B3. If there is straight voting, A cannot cast more than 72 votes for any single candidate, and (most importantly), B cannot cast more than 28 votes for any candidate. Therefore, A's three candidates will receive 72 votes each, B's will receive 28 votes each, and **A's candidates will get all the seats on the board.**
    b. Cumulative voting (CA default; opt in in MBCA/DE)
        i. Definition
            (1) Entitles a SH to cumulate or aggregate his votes in favor of fewer candidates than there are slots available, including aggregating for just one candidate. The consequence is that a minority SH is far more likely to be able to obtain at least one seat on the board.
                (a) EXA: 5 person board, A (minority SH) has 18 votes, B (Majority SH) has 82 votes.
                    (i) A can nominate 5 candidates (A1, A2, A3, A4, A5)
                        1. A has 18 x 5 = 90 votes total and can use them however he wants (i.e., all 90 to A1, etc)
                    (ii) B can nominate 5 candidates (B1, B2, B3, B4, B5)
                        1. B has 82 x 5 = 410 votes total and can use them however he wants.
            (2) Minimum number of shares required to elect at least 1 director
                (a) So in above example, A would want to figure out if his 18 shares are enough to elect one director
                    (i) Formula: [S/(D+1)] + 1 = # shares needed to elect 1 director
                        1. S = # shares voting (not # shares outstanding)

(i) Formula: [S/(D+1)] + 1 = # shares needed to elect 1 director

2. D = # directors that are to be elected
   a. So, in above example: [100/(5+1) +1 = 17.67 (round up to 18) shares
      i. Multiply the 18 shares by the number of votes (18 x 5 = 90), so you need to vote 90 for one board member to guarantee he gets elected. A would need to vote all of his shares on one candidate in order to elect 1 director.

(3) Minimum number of shares required to elect *n* number of directors
   (a) Formula: [(*n*S)/(D+1)] + 1

ii. Reducing the impact of cumulative voting
   (1) Reduction in board size
      (a) EXA: A has 80 shares and B has 20. If there are five seats on the board, cumulative voting assures B of getting a seat. But if the board is reduced to three seats, B will lose his guaranteed seats. By using the formula, B needs at least [100/(4+1)] +1 = 26 of the shares to elect one seat.
      (b) Statute/default rule guaranteeing cumulative voting only guarantees the right to vote cumulatively; it does not guarantee the effectiveness of the vote.
   (2) Board classification
      (a) *Humphreys v. Winous*: 2 statutes the court had to reconcile. 1701.58 authorized cumulative voting; 1701.64 allows the board to be classified. With an unclassified board, only certain classes are up for election each year. This company only has three directors, and they classified the board into 3 classes. This means that each year, only one member is up for election. This had the effect of nullifying the effect of cumulative votes. *Held*, π still had the right to vote cumulatively; that doesn't mean he is guaranteed success in his vote.
      (b) CA = no board classification allowed for private corporations, so default rule = all directors are up for election
         (i) Publicly traded companies can stagger terms [301.5(b)]
            1. If 2 classes
               a. Need to have at least 6 directors
                  i. 3 and 3, with 2 year terms.
            2. If 3 classes
               a. Need at least 9 directors
                  i. 3 and 3 and 3, with 3 year terms
         (ii) Public policy in CA
            1. Continuity of institutional memory
            2. Best protection from unwanted takeover
               a. Staggered terms
               b. Removal only for cause

B. SH right of Inspection
   1. Rule: Proper Purpose Test for Inspection right
      a. A SH has the right to inspect the corporations books and records if they show a **proper purpose** for doing so.
         i. Proper purpose = **purpose reasonably related to such person's interest as a SH.**
            (1) Evaluating investment/desire to deal w/other SH = usually a proper purpose.
            (2) Pursuing personal goals unrelated to ownership, including social or political goals = usually improper.
   2. 2 categories of company documents
      a. Organizing documents (books and records) --> Easier to get

2. 2 categories of company documents

    i. Burden is on corporation to prove there is no proper purpose

  b. Financial info (K's, etc.) --> Harder to get.

    i. Burden is on SH to prove three things:

      (1) Request was made in **good faith** and for a **proper purpose**;

      (2) Purpose and records are described with **reasonable particularity**;

      (3) The records are **directly connected** w/proper purpose

3. Corporations will almost never grant the request, and will require the SH to litigate to gain access

  a. *Compaq Computer Corp v. Horton*: π = SH who was suing Δ for mismanagement. This suit concerns π's desire to inspect the stock ledger/share ledger in order to get the names of other SH and try to get them to join his main lawsuit. Δ refuses demand, saying that π had no proper purpose. *Held*, the corporation has no legitimate interest in avoiding the payment of compensatory damages which it owed to SHs. π's main law suit regarded the mismanagement of the company, and so is for the ultimate good of the company.

C. Federal proxy rules

1. Apply to publicly traded companies (aka reporting companies)

  a. Two ways to qualify as PTC

    i. Get stock listed on a national securities exchange (NASDAQ/NYSE)

    ii. Meet 2 requirements

      (1) Assets must be greater than $10 mil.

      (2) Must have class of SHs of at least 500

2. Filing requirements

  a. Periodic reports w/SEC (Form 10Q)

  b. Annual report (Form 10K)

    i. More detailed than 10Q

  c. Form 8-K

    i. Material changes b/t 10-Q filings

3. Proxy rules control how a corporation puts together its proxy package

4. Proxy statement

  a. Must accompany every proxy solicitation

  b. Must disclose

    i. Conflicts of interest;

    ii. Details of compensation plans to be voted on;

    iii. Compensation paid to the five most highly paid officers;

    iv. Details of any major corporate changes

5. Proxy fraud rule [14(a)(9)]

  a. If proxy statement is false/misleading, company can be sued

    i. Means that SHs are entitled to ALL MATERIAL FACTS

6. SH proposal rule

  a. Proposals made by SH that make their way into proxy statement

7. Proxy vote

  a. Most SH are only beneficial SH, and hold their shares in street name only

  b. Voting by proxy = gives the record holder the proxy/ability to vote on their shares

  c. The recipient of the proxy must vote the proxy as the SH has indicated.

  d. Proxies are generally revocable

i. Irrevocable proxy states that it is irrevocable and is coupled with an interest.

XI. Fiduciary Duties of Directors

A. Duty of Care

1. Definition
   a. A director/officer must, in handling the corporation's affairs, behave w/the level of care that a **reasonable person** in **similar circumstances** would use.
   b. No duty to in fact detect wrongdoing
      i. Fear that it would lead to a corporate system of espionage.
      ii. But if there are actual grounds for suspicion, the directors are deemed to be on notice, and must act.
2. Business Judgment Rule--Defense to claim of Breach of Duty of Care
   a. The presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interest in the company.
      i. Obligation to act on an informed basis--directors have all material info reasonably available to them.
         (1) SH π has the burden of overcoming that presumption.
   b. Overcoming the Business Judgment presumption
      i. SH must prove either:
         (1) The directors are interested or lack independence relative to the decision (self dealing);
         (2) The director did not act in good faith;
         (3) The director acts in a manner that cannot be attributed to a rational business purpose; OR
            (a) *Shlensky v. Wrigley*: Stockholders derivative suit against the directors for negligence and mismanagement. π sought damages and an order that Δ install lights at Wrigley Field and schedule night games. π alleged that every member of the MLB other than the cubs scheduled substantially all home games in 1966 at night. Allegedly this was done to maximize attendance and therefore revenue and income. From 1961 to 1965 the cubs sustained operating losses. π attributes those losses to inadequate attendance at Cub's home games. π concludes that if the directors continue to refuse to install lights and schedule night games, the Cubs will continue to sustain losses. π alleged that Δ refused to install nights not out of good faith decision for the business, but b/c he thought baseball was a day game and was worried about the potentially negative effect on the surrounding neighborhood. *Held*, this decision is one for the board to decide, and Δ's alleged motives showed no fraud, illegality, or conflict of interest.
         (4) The director makes an uninformed decision
            (a) *Smith v. Van Gorkom*: Class action brought by SHs of Δ corp., seeking of a cash-out merger. CEO/board member Van Gorkom negotiated the deal, and only one of the other directors was involved in the negotiation. The other directors were not even aware of the negotiations until they attended a special meeting of the board of directors and were asked to approve the sell (a two hour meeting). *Held*, the board's decision to approve the proposed cash-out merger was not the product of an informed business judgment--it was based on a 20 minute oral presentation by Van Gorkom, there were no documents present, and no report was available.
3. Duty of Care and Business Judgment Rule
   a. Duty of Care = Procedural requirements
      i. Director must get all reasonably needed information before deciding
   b. Business Judgment Rule = substantive requirements
      i. Decision is upheld as long as it is rational (lower threshold than reasonable)

b. Business Judgment Rule = substantive requirements

(1) Rationale:
  (a) Encourage risk taking/innovation by directors;
  (b) Courts are poor judges of business reality.

B. The Duty of Loyalty
1. The duty generally
  a. The fiduciary duty of a director to take and approve only those actions the director believes to be in the corporation's best interest.
2. **Usurpation of a Corporate Opportunity** doctrine
  a. A corporate opportunity is a business opportunity presented to an officer or director that is so closely associated with the corporation's current business activities that the officer or director may not accept the opportunity for himself or herself in place of the corporation.
    i. Must distinguish business opportunity (which is generally up for grabs) from a corporate opportunity (which must be given to the corporation first).
  b. The Tests (For whether it was a corporate opportunity and not just a business opportunity)
    i. Line of business test
      (1) A director or officer cannot seize an opportunity for himself if it is one which:
        (a) The corporation is financially able to undertake;
        (b) Is, from its nature, in the line of business of the corporation's business;
        (c) Is of practical advantage to the corporation;
        (d) Is one in which the corporation has an interest or a reasonable expectancy; and
        (e) The director taking the opportunity will conflict w/interest of the corporation.
    ii. Fairness test
      (1) The doctrine rests on the unfairness in the particular circumstances of a director, whose relation to the corporation is fiduciary, taking advantage of an opportunity [for her personal profit] when the interest of the corporation justly calls for protection. This calls for application of ethical standards of what is fair and equitable in a particular situation.
    iii. Mix of line of business and fairness test
      (1) The opportunity needs to be in the line of business of the corporation and the director's action must be unfair to the corporation.
    iv. ALI approach
      (1) Director or senior exec may not take a corporate opportunity unless
        (a) Offer to corp and disclose conflict of interest;
        (b) Corporation rejects it;
          (i) Rejection = fair to the corporation OR
          (ii) The opportunity is rejected in advance, following disclosure, by disinterested directors, in a manner that satisfies the standards of the business judgement rule; OR
          (iii) The rejection is authorized in advance or ratified following disclosure, by disinterested SH, and the rejection is not waste of corporate assets.
      (2) Definition of corporate opportunity
        (a) Any opportunity to engage in a business activity of which a director or senior exec becomes aware, either
          (i) In connection w/the performance of functions as director or senior exec, or under circumstances that should reasonably lead the director/exec to believe that the person offering the opportunity expects it to be offered to the corporation; OR
          (ii) Through the use of corporate info or property if the opportunity is one the director should reasonably be expected to believe would be of interest to the corporation; OR

(b) Any opportunity to engage in a business activity of which a senior exec becomes aware and knows is closely related to a business in which the corporation is engaged or expects to engage in.

v. **DE summary of the test**

(1) A corporate officer or director may not take a business opportunity for his own if:

(a) The corporation is financially able to exploit the opportunity;

(b) The opportunity is within the corporation's line of business;

(c) The corporation has an interest or expectancy in the opportunity; and

(d) By taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation.

(2) Alternatively, a director or officer may take a corporate opportunity if:

(a) The opportunity is presented to the director/officer in his individual and not his corporate capacity;

(b) The opportunity is not essential to the corporation;

(c) The corporation holds no interest or expectancy in the opportunity; and

(d) The director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity.

c. Avoiding liability

i. Disclosure

(1) Full disclosure of opportunity to corporation first

(2) Corporation rejects opportunity by majority vote of disinterested directors or SH

ii. Ratification

(1) Director accepts opportunity, convinces board of directors to ratify.

3. <u>Self-Dealing</u>

a. Self dealing occurs when a director or officer enters into a contract w/the corporation, usually to buy something from, or sell something to, the corporation.

b. A director/officer must act in good faith toward the corporation and the transactions must be fair to the corporation and in its best interest.

i. Good faith = full and honest disclosure of all material facts to allow disinterested decision maker to exercise informed judgment.

(1) *Geller v. Allied-Lyons*: G worked for DD. Allied told G they wanted to acquire DD, and would pay him a finder's fee. G told DD of Allied's interest, but no sell. There was an attempted hostile takeover of DD, G tells the board that Allied might be interesting in protecting DD from the takeover. G goes to Allied, they agree to buy DD. G sues b/c he didn't get his finder's fee. *Held*, the finders' fee agreement is not enforceable on policy grounds, b/c G could have been self-interested--finders' fees aren't bad, but a certain process must be followed to ensure there is no self-dealing going on. Disclosure alone is not enough--need evidence of agreement.

ii. Fairness = the transaction benefit the corporation and SH and not confer undue/unjust advantage on the fiduciary.

(1) *Tomaino v. Concord Oil of Newport, Inc:* T = 25% owner of CO, formed new company--> CO of NP (T owned 32%, CO owned 68%). T bought land and equipment for $1, then transferred ownership of the equipment to CO of NP for $5k. T quits, CO of NP cancels leases of 3 locations. T couldn't relet the land becasue there were underground tanks which were a liability. T paid to have the tanks removed. T sues CO of NP for damages/lost rent. CO of NP claims conflict of interest/self-dealing in the $5k deal, b/c T sits on both sides of the transaction. If transaction can be set aside, then CO of NP never took ownership of the

tanks, and so doesn't have to compensate T for removing them. *Held*, there is a conflict of interest, but T did not breach his duty of loyalty b/c there was full + adequate disclosure.

c. **The Standard of Entire Fairness**
   i. Burden is on the Δ director/officer to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.
   ii. Two components
      (1) Fair dealing
         (a) Factors include when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approval of the directors and the stockholders was obtained.
      (2) Fair price
         (a) Factors include the economic and financial considerations of the proposed merger, including assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.
            (i) *HMG/Courtland Properties, Inc. v. Gray*: Real estate sale b/t HMG and two of it's directors, F and G. F's self-interest was fully disclosed, but G's wasn't. G negotiated the trx. *Held*, this wasn't a fair transaction b/c G lacked pure seller side incentives, and took the lead in discussing the transaction w/both sides; in terms of fair price, although the sell price was in the range of fairness, HMG likely could have got a higher price if all the cards were on the table.

d. Remedy for Breach
   i. Old CL Rule: Conflict of interest trx. were void or voidable at the option of the corporation.
   ii. Modern rule:
      (1) If conflict of interest trx. is unfair = it is set aside
      (2) If conflict of interest trx. is fair = it is enforced
         (a) Interested directors have burden of showing (1) fair price and (2) fair dealing.

e. Avoiding liability for breach of fiduciary duty
   i. Self-cleansing statutes: CA 310 [DON'T NEED TO KNOW DE OR MBCA]
      (1) Statutes that allow a trx. w/an interested director to be enforced
         (a) Interested director = direct or indirect material financial interest in the trx.
      (2) Goals
         (a) Create procedural approval by disinterested directors/SH
         (b) Give greater predictability as to whether an agreement will be enforceable
      (3) Ways to cleanse
         (a) Burden on party claiming trx is **invalid**
            (i) SH approval [310(a)(1)]
               1. Full disclosure of all material facts
               2. Good faith approval
               3. By a majority of disinterested shares
               4. No requirement that Trx be fair to corp
                  a. Court will not second guess fairness if SH approve
            (ii) Brd. Approval [310(a)(2)]
               1. Full disclosure of all material facts
               2. Good faith approval of disinterested directors;
               3. By vote sufficient w/o counting vote of interested director
               4. Trx is fair to corporation

a. If these requirements are met, trx can only be voided if it violates the business judgement rule

(b) Burden on party claiming trx is **valid**

(i) 310(a)(3)

1. Trx. is fair to corporation

a. Standard of Entire Fairness

ii. Reliance on Experts and Committees

(1) Board can rely on reports made for them by board committees and others inside the corporation (reliance is presumed to be appropriate)

(a) In DE, to overcome the presumption that reliance is warranted π must show that

(i) Directors did not in fact rely on the report;

(ii) Reliance was not in good faith;

(iii) Director's did not reasonably believe that the expert's advice was w/in the expert's professional competence;

(iv) The expert was not selected w/reasonable care by or on behalf of the corporation, adn the fault selection process was attributable to the directors;

(v) The subject matter that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent; OR

(vi) The decision of the Board was so unconscionable as to constitute waste or fraud.

(2) Special litigation committee

(i) When some, but not all, directors are sued for breaching their fiduciary duties, the board frequently constitutes the nondefendant directors as a committee (special litigation committee) to investigate the allegations and recommend whether pursuing those allegations is in the best interest of the corporation.

C. Personal Liability

1. A director or officer who violates his duty of due care and thereby injures the corporation may be held personally liable for the corporation's damages.
2. Limiting the duty of Care (Raincoat provisions)
   a. Charter limitations
      i. Corporations are permitted to add a provision to its Certificate/Articles of incorporation capping or eliminating monetary liability of directors for breach of their fiduciary duties
3. Directors cannot shield themselves with a Raincoat Provision in 3 scenarios: [DE 102(b)(7)]
   a. Breach of duty of loyalty;
   b. Acts/omissions not in good faith, illegality or intentional misconduct;
   c. If the director received an improper personal benefit.

D. SH Derivative claims

1. Derivative suit v. direct suit
   a. Derivative suit
      i. A SH's derivative suit is a suit in which the SH sues "on behalf" of the corporation, on the theory that the corporation has been injured by the wrongdoing of a 3rd person, typically an insider.
         (1) For example, SH sues the board b/c they are buying their supply from a vendor that charges more than other vendors.
   b. Direct suit
      i. SH brings suit on own behalf
         (1) For example, if the SH's right of inspection is denied
2. Procedural requirements

a. π was SH when alleged wrong took place;

b. π continues to be a SH

c. π made a demand on the board

i. Demand is a written request to the board asking them to bring a suit or take other corrective actions to redress the wrongdoing.

d. Board refuses to act

i. Exception: Demand is excused when it would be futile (No exception under MBCA--demand must be made in all cases)

(1) It is only futile if a majority of directors are both interested and not truly independent.

(1) *Beam v. Stewart*: Claim that Stewart's insider trading constituted a breach of duty of loyalty; the board didn't take any action on that (remove Stewart as a CEO, etc.) -> breach of duty of care. RULE: Demand is excused (in DE) on the grounds that it will be futile when the board could not have properly exercised its independent and disinterested business judgment in responding to a demand. Stewart is disqualified automatically; Patrick is disqualified b/c she was personal friends w/Stewart (she's not interested b/c she has a personal/financial interest, the issue w/her is that she is not independent). π would have to show that 4/6 directors can't be trusted. *Held*, only Martha Stewart and Sharon Patrick were not trustworthy, the other 4 were trustworthy, so demand is required.

3. Committees

a. The situation:

i. Demand is made, board forms a committee to review demand and ultimately refuses, SH sues, board files a motion to dismiss.

b. Court reviews adequacy of the process and the independence of the committee members

i. **NY Standard:** Court reviews the independence and disinterestedness of the committee and the appropriateness of the procedures used in reaching its decision (sounds like business judgment)

(1) If they agree it was appropriate, claim is dismissed

ii. **MA Standard/Modified Business Judgment Rule**: The corporation has the burden of establishing that the decision makers' independence, lack of bias, good faith and thoroughness of its investigation is fair and just.

iii. **DE Standard:** When demand is excused, the corporation has the burden to demonstrate that the special litigation committee was independent, acted in good faith, and had a reasonable basis for its decision.

(1) If the corporation meets that burden, then the court, in its discretion, may apply its own business judgment in determining that the dismissal was in the best interests of the corporation or, alternatively, can choose to terminate the suit based on the fairness to the corporation.

(2) If demand is required and refused, then the burden is on π to show that we should not trust the board's decision to refuse to bring the lawsuit (Business judgment rule)

c. Demand is usually never made

i. Once you make a demand, you concede that the board is trustworthy.

E. Executive compensation

1. Evaluate in terms of duty of loyalty and duty of care--also check for waste.

a. I.e., business judgment rule, entire fairness

XII. The Role of the SH in the Modern Closely Held Corporation

A. Voting Arrangements

1. Preemptive Rights

a. The decision to issue more shares can dilute SH voting power

1. Preemptive Rights

    i. Preemptive rights permit each current SH to maintain proportionate interest/voting power by purchasing to-be-issued shares.
        (1) Default rule = no SH preemptive rights (unless the Articles so provide).
        (2) Preemptive rights are unavailable in certain situations
            (a) The newly issued shares were to be issued for non-cash consideration;
            (b) The newly issued shares were to be issued as part of the corporation's initial plan of financing; or
            (c) The newly issued shares were to be of a different class than those outstanding.
2. Supermajority Provisions
    a. A provision in the Articles or bylaws that requires a greater than majority vote at either the board or SH level.
        i. Supermajority provision for board meetings
            (1) Must be placed in Articles or bylaws
        ii. Supermajority provision for SH meetings
            (1) MBCA = must be in the Articles [MBCA 7.27]
            (2) DE = can be in either the Certificate or the bylaws.
    b. *Whetstone v. Hossfeld Mfg. Co.*: President of corp. initiated changes to Articles/bylaws. First and second provisions required written consent of every SH who owned 30% or more of outstanding stock to elect a board director, officer or employee, unless the nominee himself owned 30%. Third provision Required a majority vote by the board to appoint a manager; an assistant manager was subject to the 30% limitation as well. Fourth provision would allow fundamental change by 75% vote. π owned 36%, president + wife owned 50.93%. Special meeting of both the board and the SH. Board voted, 2-1 vote to amend Articles; enough SH votes to amend. President refused to buyout π's shares. Minn. Statute provided that a SH is entitled to receive payment for the fair value of his shares when an amendment of the Articles materially and adversely affects the rights/ preferences of the shares of a dissenting SH by excluding or limiting the right of the SH to vote on a matter or cumulate votes. *Held*, this is amendment materially and adversely affects π's rights, so he is entitled to payment. The mistake: π's didn't bargain to have the Articles amended to provide veto right on board
        i. Minority SH will never be able to push own agenda, but will be able to veto if there is a supermajority provision.
    c. Minority SH needs to make sure that the same super-majority vote is needed for amendment of a provision--otherwise the majority can always just change the super-majority requirement.
        i. This protection is automatic under MBCA
3. Voting Trusts
    a. Definition
        i. Stock as to which:
            (1) The voting rights are separated from the other attributes of ownership;
            (2) The voting rights granted are intended to be irrevocable for a definite period of time; AND
            (3) The principle purpose of the grant of voting rights is to affect voting control of the corporation.
    b. Valid as long as they meet statutory requirements (DGCL 218/MBCA 7.30)
        i. Max term = 10 years [MBCA 7.30--no max for DE]
            (1) Can be extended at any time by agreement.
        ii. Disclosure
            (1) MBCA: Trust's terms must be publicly disclosed so that other SH can inspect it [MBCA 7.30(a)]

ii. Disclosure

    (2) DE: Copy of agreement must be on file in the registered office of the corp. [DGCL 218(b)]

iii. Writing

    (1) Trust must be in writing [MBCA 7.30(a)/DGCL 218]

iv. Trustees have fiduciary duty to beneficial SH.

c. Mechanics

    i. Owner gives stock to the trust

    ii. Trust gives owner a voting trust certificate

        (1) SHs become beneficial owners

        (2) Trust = SH of record

    iii. Trust has voting rights

d. Generally valid

4. Pooling Agreements

    a. Definition

        i. An agreement in which two or more SH agree to vote together as a unit on certain or all matters.

    b. Generally valid

    c. Generally can remain in force for an indefinitely long period

    d. Enforcement

        i. Agreement must have an enforcement provision to be effective (self-enforcing agreement);

        ii. Best way: Require SHs to sign irrevocable proxy over to 3rd party to vote according to agreement

            (1) Proxy must be coupled w/an interest so that it is irrevocable.

    e. Remedy

        i. Generally, specific enforcement

        ii. Specific enforcement--nullify votes not in accordance w/agreement

            (1) *Ringling Bros. Case*: Aubrey and Edith each own 315 shares. They agree to vote together--which gives them a majority (North has 370 shares). They wanted to combine forces so that they can elect 5 of 7 directors. The agreement had a few provisions: Before each annual SH meeting they'd agree on how to vote; in the event they could not agree, it would be arbitrated by their attorney. They disagreed. There was cumulative voting. Edith's votes: 882 for Edith, 882 for her son, 441 for Dunn; Aubrey's votes: 1102 Mr. H, 1102 for her; North's votes: 864 for Woods, 863 for Griffin, 863 for himself. Edith sued (but together Edith and Aubrey elected 5 directors). They control a majority of the seats--she's suing to get one more person on the board b/c she's worried about losing control, and to make a point. All the voting agreement does is get you a seat on the board--once on the board, you can't control. This is the main difference b/t pooling agreements and SH agreements. TC and SC both found that she breached; they differed in the relief. TC gave Aubrey's votes to Edith and let her vote by proxy. Supreme Court didn't like the implied proxy b/c they make the mechanics of conducting a SH election impossible--on what criteria is the election inspector going to accept implied proxies? DE SC invalidated all of Aubrey's shares and elected the 6 people receiving votes to the board and left a vacancy.

5. Classified Stock

    a. Definition

        i. Corporation sets up two ore more classes of stock, and then gives the classes differing voting powers or financial rights.

            (a) So there can be equal voting rights even though there aren't equal financial rights.

    b. Can guarantee representation of the minority

c. Class of stock may be created even if there is no financial rights, for the sole purposes of breaking ties.
   i. *Lehrman v. Cohen*: Two families own Giant Food Co. 50/50. Lehrman owns class AL stock, get to elect 2 directors. Cohen owns Class AC stock, get to elect 2 directors. Worked well until death of founders. Resolution: Agreement to create a 5th director for tie breaks (Danzansky). The families get together as SH and directors and agree to amend the Articles, to create a 3rd class of stock (Articles must describe rights, preferences and privileges). Danzansky's shares give him the right to elect one director; has no financial rights other than getting back his $10 investment. Participates for 15 years, votes are unanimous. The issue: Danzansky elected president w/15 year K--he cast the deciding vote, 3-2. Dansansky resigned as director and used his share to elect West (former class AL director) to fill the vacancy. Board then formed a committee to ratify his election (new director who wasn't there when K was originally under consideration, and one of AL directors). If you sue over the EE K, the standard is entire fairness. In order to get it approved, it took 3 votes to pass the K. Cleansed itself--so the burden was on the interested director to show that the decision was fair and reasonable. Cohens sue in order to set aside the original agreement to amend by claiming it was an invalid voting trust. *Held*, not a voting trust b/c they didn't separate the voting rights from the other rights of ownership (**no divestiture of voting rights**--it's just a dilution of voting power).

B. Agreements Restricting the Board's Discretion
1. The issue
   a. Sometimes acting in accordance w/SH agreement may conflict w/duties of board of directors.
      i. Courts generally hold that fiduciary duties override SH agreements
         (1) Exceptions
            (a) All SH were parties to the agreement;
            (b) SH agreement contained a provision requiring adherence only where doing so was in the interest of the corporation; AND
            (c) The infringement on the directors' power was "slight"
2. California closed corporation [CCC 158]
   a. Definition
      i. Max 35 SH
      ii. Statement in Articles that "This corporation is a close corporation."
         (1) Some court's won't invalidate b/c of technical defects
            (a) *Zion v. Kurtz*: Court upheld a SH agreement even though the Articles didn't have a sentence saying "This is a closed corporation." But this is a NY case, may be different in CA.
   b. Benefits
      i. Can enter SH agreements even if they fetter the board's discretion [CCC 300(b)]
         (1) Must be written and unanimous [CCC 168]
3. NY
   a. *McQuade*: Majority SH (Stoneham) and 2 minority SH (McQuade and McGraw) agreed that all would use their best efforts to keep one another in office as directors at specified salaries. Stoneham and McGraw didn't do this. *Held*, the SH agreement was invalid b/c **SH may not, by agreeing among themselves, place limitations on the power of directors to manage the business of the corporation** by the selection of agents at defined salaries.
      i. Board must be left free to exercise its own business judgment.
   b. *Clark v. Dodge*: π owned 25%, Δ owned 75% of two corporations. Signed an agreement whereby Δ was to vote for π as director and general manager, and to pay him 1/4 of the business' income, so long as he remained "faithful, efficient and competent." Δ argued that this agreement violated

McQuade, b/c it restricted the discretion of the board. *Held*, the agreement is **valid** b/c (1) **all SH signed the agreement** (so no one would be injured by the K); (2) the **impairment of the board's powers was negligible** (π could be dicharged for cause.

c. NY Rule (*McQuade* + *Clark*)
   i. A SH agreement is valid IF
      (1) It does not harm creditors, the public or non-consenting SH;
      (2) Involves only an "**innocuous variance**" from the rule that a corporation's business should be managed by the board.
         (a) May be a requirement that all SH consent

4. Other Jdx.
   a. *Galler v. Galler*: 2 owners 50/50. Signed SH agreement in which they agreed to pay certain dividens each year and to pay, in the event either should die, a specified pension to his widow. Ben died, Isadore refused to carry out agreement. *Held*, agreement valid even though it limited director discretion b/c: (1) **no minority interest was injured**; (2) **no injury to the public or creditors**; (3) **agreement did not violate any statutory prohibition**.

C. Stock Transfer Restrictions and the Use of Buy-Sell Agreements
   1. Corporate norm
      a. Stock is freely alienable.
      b. Traditional view = share transfer restrictions --> restraints on alienability --> unreasonable
   2. Reasons for restrictions
      a. SH in close corporations care about who the other SH are.
      b. 3 main reasons why SH in close corporations think restrictions are good
         i. Veto over new colleagues
         ii. Balance of control
         iii. Estate liquidity
   3. Techniques
      a. Right of first refusal
         i. SH can't sell his shares to an outsider w/o first offering it to the corporation or other current SHs a right to buy those shares at the same price and terms as those at which the outsider is proposing to buy.
      b. First option at fixed price
         i. Same as right of first refusal but the price is determined by the agreement creating the option.
      c. Consent
         i. SH transfer of stock may be made subject to the consent of the board of directors or other SHs
      d. Buy-back rights
         i. Right of the corporation to enable it to buy back a SH's shares on the happening of certain events, whether the SH wants to sell or not.
      e. Buy-sell agreement
         i. Same as buy-back right except corporation is **obliged** to go through w/the purchase upon the happening of a certain event
   4. Who has the right to buy
      a. Either the corporation or the remaining SH.
         i. SH typically have the right to repurchase in proportion to their existing holdings.
   5. Determining at what price the shares will be transferred
      a. 3 approaches
         i. The parties may establish a formula for determining the price

a. 3 approaches

   (1) Usually based on accounting principle
      (a) Book value
      (b) Earnings
      (c) Cash flow
  ii. The parties may establish a price in the agreement and may agree that, in the future, they will review or revise the price
   (1) Usually never reviewed in practice
  iii. Parties may provide that one or more neutral appraisers or arbitrators will determine the price based on a standard such as "fair value," "fair market value," or "value as a going concern."

6. Requirements for restriction to be valid
 a. Restriction must be **reasonable at the time the restriction is agreed to**;
  i. Outright prohibition on transfer = most likely unreasonable
  ii. Some courts will apply equitable power if it is a vesting agreement
   (1) i.e., if shares vest after 5 years, and π works for 4 and then is fired (for cause), the court may hold that it is unfair to deprive π of his stocks. (*Man O' War Restaurants*)
 b. SH must have **notice** of restriction
  i. Subsequent purchaser w/o notice
   (1) Subsequent purchaser w/o notice is bound by the restriction unless:
      (a) Subsequent purchaser has **actual knowledge**; OR
      (b) Restriction is **conspicuously noted** on **stock certificate**
        (i) Conspicuous = reasonable person ought to have noticed it.
  ii. Non-consenting minority holder
   (1) Situation: Requisite SH vote to amend Articles or bylaws to create the restriction, but a current SH does not consent.
      (a) Courts are split, trend --> restriction not valid.

D. Dissension and Deadlock
1. Definition
 a. Dissension = disagreements among SH; Deadlock = corporation is paralyzed and prevented from acting.
 b. 3 common ways a corporation becomes deadlocked
  i. 2 50/50 owners;
  ii. Even number of directors;
  iii. Minority SH has a veto
2. Solutions
 a. Arbitration
 b. Compromise
 c. Buy-out
  i. No right of minority SH to compel a buyout
  ii. Minority SH is usually in a bad position--majority SH can usually low-ball minority
 d. Dissolution
  i. Voluntary
   (1) Requires board resolution and SH vote
  ii. Involuntary
   (1) Court ordered
   (2) Requirements for dissolution

(a) MBCA
(i) Director deadlock OR
(ii) Oppression OR
(iii) SH deadlock OR
(iv) Waste
(3) If the corporation is profitable, the court is less likely to use its discretion to dissolve.
3. Fiduciary Duties of Controlling SH
a. A majority SH in a close corporation may have fiduciary obligations to minority SHs.
i. Court can impose damages instead of having to dissolve the corporation.
b. MA rule (*Donahue)* = **strict good faith standard** upon SH in a closely held corporation (Roughly the same standard as a partnership. Factors: Small # SH; lack of available ready market for the corporate stock; substantial majority SH participation in the management, direction and operation of the corporation)
c. PA rule (*Orchard)* = **controlling interest owes a duty of loyalty and fairness to minority SH** (where a majority SH stands to benefit as a controlling SH, the law requires that the majority's action be "**intrinsically fair**" to the minority interest).
i. *Fought v. Morris*: Billy and Elza sue Brady and Corporation. In 1974 Billy, Brady, Clayton and John organized Corp. Each got 25 shares. There was a stock redemption agreement: If SH wanted to dispose of stock, (1) Corp-->(2) other SH in equal proportion-->(3) other SH if some SH didn't want to buy in (2)-->anyone else. Clayton sold his stock in 1979, equally among the other 3. In 1982 John sold all of his to Brady w/o adhering to the redemption agreement. *Held*, Billy wins (PA rule adopted)
d. DE rule = fiduciary duty is breached only if the conduct of the majority SH results in the m**ajority receiving benefits to the exclusion of the minority SH**s.
i. *Sinclair Oil*: Sinven = subsidiary of Sinclair Oil. π = minority SH of Sinven. Most of Sinven's business is conducted in Venezuela. Sinclair owns 97% of Sinven and controls the board. Sinven board declares dividends (97% of dividends-->Sinclair). π sues for 3 things: Dividends are excessive, a breach of K b/t Sinven and another one of Sinclair's subsidiaries, and the decision by Sinclair to limit Sinven just to Venezuela. <u>Dividends:</u> The claim is self dealing, court holds there is no self dealing b/c the dividends weren't getting paid out to Sinclair at the exclusion of Sinven--everyone was receiving the dividends; <u>Breach of K:</u> Other subsidiary didn't pay on time, Sinven didn't sue, Sinclair benefits from decision not to sue-->Sinclair is receiving benefit to exclusion of Sinven; <u>Being limited to Venezuela:</u> π claimes Sinclair took business opportunity, court says no way--π didn't point to any opportunity that belonged to Sinven.
4. Oppression
a. Statements of the rule
i. Reasonable expectations test
(1) A visible departure from the standards of fair dealing and a violation of fair play on which every SH who entrusts his money to a company is entitled to rely; or
(2) A breach of the fiduciary duty of good faith and fair dealing; or
(3) Whether the reasonable expectations of the minority SH have been frustrated by the actions of the majority; or
(4) A lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or
(5) A deprivation by majority SH of participation in management by minority SH.
ii. Conduct of the majority
(1) Factors
(a) Exclusion of management

(1) Factors

(b) Withholding of dividends
(c) Excessive salaries to majority SH
(d) No income stream to minority SH

INSIDER TRADING

I. Securities Fraud

A. Common Law Fraud and Rule 10b-5: Constraints on Stock Issuance
1. Rule 10b-5
a. Rule 10b-5 is not limited to buying stock--Defrauded buyers and defrauded sellers can sue
b. Applies to *any person* who engages in *prohibited behavior* in connection w/a *securities transX.*
c. Rule 10b-5 is not limited to PTC
d. Rule 10b-5 gives an **implied private action**
i. Supreme Court has never spoken as to how to calculate damages

B. Disclosure of "Material" Information
1. Material information = information that a **reasonable** investor would consider important in making a decision.
a. Are merger talks reasonable? Two tests:
i. Brightline test: Mergers aren't material until the day they are announced
(1) B/c before then they are i**nherently speculative**
(a) Inherently speculative events tend not to be material.
ii. Pro-investor test: Weigh **probability** of event occurring w/**magnitude** of event.
2. Rule 10b-5 is not the source of a duty to disclose
a. You can be silent ("no comment")
3. Sources of a duty to disclose
a. If you speak, you must be completely truthful.
b. Public Company
i. Periodic reports must be truthful
(1) 10-Q
(2) 10-K
(3) A-K
ii. Listing requirements w/NYSE and NASDAQ
(1) When you list your shares for trading, the NYSE insists that you sign an agreement that you will make timely disclosures to the market.
c. State law fiduciary duties

II. Elements of Implied Cause of Action under Rule 10b-5

A. Federal Jurisdiction
1. Interstate Commerce
a. The transX, at some point, must touch interstate commerce
i. Expansive view
(1) A fully intrastate phone call will qualify (*Dupuy*)
(2) Cashing a check will qualify
ii. Limited view (1975-present)
WHAT IS THE LIMITED VIEW?
2. Fraud occurred in connection with purchase or sell of a Security
a. Consist of 2 classes

2. Fraud occurred in connection with purchase or sell of a Security

    i. Equity
    ii. Debt

B. Standing to Sue for Rule 10b-5 Violations
  1. Actual Buyers or Sellers
    a. Only the π has to be a buyer or seller
    b. Δ doesn't have to be a buyer or seller--Δ only has to engage in conduct that violates 10b-5
      i. Fraud
      ii. Insider trading
      iii. Tipping
  2. The SEC
C. The Scienter Requirement
  1. Intent to deceive, manipulate or defraud
    a. Negligence is not good enough
  2. Will recklessness suffice?
    a. Most courts of appeal say that recklessness will do the trick
      i. But Supreme Court hasn't decided it yet.
D. Material Fact
  1. Material fact must be misrepresented or omitted.
    a. Material = information that a reasonable investor would deem important w/respect to buying or selling shares
  2. Retrospective information
    WHAT IS THE RULE?
  3. Inherently speculative information
    a. Weigh probability that event will occur against the magnitude of the event
E. Reliance and Causation
  1. Actual Reliance
    a. Reliance by π on the misstatements by Δ
      i. In other words, π must demonstrate causation
    b. Causation
      i. Transactional Causation
        (1) π would not have bought/sold shares had they known all the information
        (2) In *Basic, Inc. v. Levinson*, the SC accepted the "fraud on the market theory," which generally will give rise to a **rebuttable presumption of reliance** (i.e., **transactional causation**) in cases involving:
          (a) Misrepresentations in open market transactions
          (b) Non-disclosure
        (3) Fraud on the market theory
          (a) When you make a public misrepresentation, all the investors will take that misrepresentation into account in making decisions on how to act--the market price is relied on by investors to reflect accurate information.
    c. Loss Causation
      i. In *Dura Pharmaceuticals, Inc. v. Broudo*, the SC established that the π must prove that the Δ's misrepresentation (or other fraudulent conduct) proximately caused π's economic loss (i.e., **loss causation**)

(1) Loss could have been caused by something other than the open market misrepresentation.

F. Conduct that violates Rule 10b-5

1. Fraud

a. Material misrepresentation

i. Common Law Rules

(1) EXA: If you find oil on your property, you probably want to buy your neighbor's land too. Do you have a duty to disclose that you found oil on your land?-->Nope. But if he asks you "Did you find oil on your land?" you don't have to answer, but if you do it has to be truthfully. If he asks "Did you find natural gas?" you can say no, b/c it's true.

(a) **Doctrine of half truths**--answering "no" may be misleading, and that may trigger a duty to disclose the discovery of oil.

(2) *Goodwin v. Agassiz*: Δ president/director of Cliff Mining bought 700 shares of Cliff Mining from π. Transaction occurred on public stock exchange. π wanted to sell b/c he was disappointed w/the way Cliff Mining was performing. Δ wanted to buy b/c of favorable information re: geologist theory. B/c the trx took place on open market, π and Δ did not know one another. π claims Δ committed insider trading b/c he went into the market based on material, non-public info, and claims that if π knew the info he would not have sold his shares. But b/c the info was purely speculative, today whether this info is material would be determined under *Basic v. Levinson* rule. π couldn't bring a fraud claim against Δ b/c there is no affirmative misrepresentation or half-truth, b/c there are no dealings b/t π and Δ. In order for there to be a duty to disclose there would have to be some sort of fiduciary relationship b/t π and Δ. π claims there was a fiduciary duty b/c Δ was a director, and therefore had access that the typical SH would not have access to--but the fiduciary duty that Δ had runs to the company, not the SH. **There might be a duty that runs from Δ to the SH, but only when it is a direct face to face trx.** (**Special facts doctrine**: In a face to face dealing when company insider knew company was going to be sold and bought SH stock at lowball price, the insider violated a fiduciary duty that they owed to the SH--the director would have to disclose the material non-public information.

(a) However, if an insider has inside info that will hurt the company and is not known to the public and sells to a non-SH, there is no duty. Otherwise, the director would owe a fiduciary duty not only to SH, but to all potential SH--that would mean everyone, so no good.

2. Insider Trading--Violation of Duty to Disclose or Abstain

a. The Genesis of the Rule 10b-5 **Duty to Disclose or Abstain**" from Trading

i. *In the Matter of Cady, Roberts & Co*.: The board voted to reduce the dividend. The company is hurting. During a break in the board meeting, one board member (who was a broker) called his office and told them that the company was going to reduce its dividend, and one of the brokers in the office sold the stock. The announcement that the dividend was reduced caused the stock to go down. The SEC brought the suit. SEC states that the **insiders (certainly officers and directors), before they can trade, have an affirmative duty to disclose material non-public information. If he cannot disclose it, then he must abstain from trading on the information until full and adequate disclosure is made.** ..

ii. SEC v. Texas Gulf Sulphur Co.: TX Gulf Sulphur started speculative mining. Preliminary testing showed huge deposits. They covered up the hole and didn't tell the board of directors. Senior executive officers wanted to keep it secret, b/c they wanted to buy the land around it for cheap. Insiders load up on stock. Even though preliminary testing wasn't complete (still speculative), this was enough to show that the info was material. Insiders bought at 37, w/in a day of the announcement it was over 50.

(1) The decision of this case reflects the "parity of information" theory for insider trading violations under Rule 10b-5
  (a) Parity of information = all investors expect to be trading on the same info
  (b) Rule: You cannot trade when you are know material non-public information.
    (i) You can resume trading once there is full and adequate disclosure of all material facts.
    (ii) The information must also be adequately disseminated.
      (a) This will depend on the type/size of company and what kind of coverage it gets --> question of fact.

b. The Modern View
  i. The SC Scales back on the scope of Rule 10b-5's Duty to Disclose or Abstain from Trading
    (1) *Chiarella v. US:* Chiarella was employed by printshop that promised its customers it would safeguard their information (financial documents). They were hired by Bidder companies. The Bidder company was planning to buy a Target company, and made a tender offer to buy over the fair price. Target company and SH didn't know until it was announced. Before announcement, the printing company had to print documents concerning the tender documents. Chiarella figured out who was going to be bought, and would go invest in Target companies. Once the announcement was made, Chiarella would sell his stock at the higher price. SEC sues, lower court holds that Chiarella violated the 10b-5 duty to disclose based on the rule in TX Gulf Sulphur. SC holds that there is no 10b-5 violation--his **non-disclosure is not actionable by itself unless there is some independent source of a duty that gives rise to an affirmative obligation to make a disclosure.**
      (a) The SC establishes that insider trading violations of Rule 10b-5 are tied to the insider's breach of fiduciary duty and rejects the "parity of information" theory set out in *Texas Gulf Sulphur* and it's progeny
        (i) There was no relationship b/t Chiarella and the selling SH, and he was not an insider, so there was no independent source of a duty to disclose.
        (ii) So the requirements are:
          (a) Possession of material information that is non-public
          (b) Fiduciary duty
            Derived from state law
      (b) The SEC responds to the Court's ruling in *Chiarella* by promulgating Rule 14e-3, which applies only in the context of tender offers.
        (i) Derived from relationship b/t SHs (depends on facts surrounding relationship b/t seller and buyer)

3. Tipper-Tippee Liability Under Rule 10b-5
  a. *Dirks v. SEC*: Secrist (tipper) was an insider that left Equity Funding, Inc. He was trying to tell everyone about insider scandal. No one believes him. He tells Dirks (tippee), who is a financial analyst. Dirks tells his clients about Equity Funding, and his clients dump their holdings. The institutional investors avoided a loss that was inevitable once the information became public. The SEC went after Dirks, but not Secrist. The SEC's theory that Dirk is liable for a 10b-5 violation is pairity of info. SC rejects the pairity of information theory, and holds that tippee liability exists only in order to prevent the tipper from breaching it's fiduciary duty. The tipper is liable when he will gain directly or indirectly from the disclosure. **Tippees are prohibited from trading if the information was received in breach of the tipper's fiduciary duty and the tippee knew or should have known that the duty was breached. The tipper breaches his fiduciary duty when he will gain directly or indirectly from the disclosure.**
    i. Tippee only inherits the duty not to trade if the tipper has breached it's fiduciary duty.

b. Tipper/Tippee liability exists not b/c the tippee is in possession of non-public info; he's only liable if he trades on that information if the tipper breached his fiduciary duty when he passed that information along to the tippee,
   i. Tippee scienter requirement
      (1) Tippee has to have known or should have known of the breach
         (a) If so, then tippee has duty to disclose or abstain.

4. The Misappropriation Theory of Liability for Insider Trading Violations Under Rule 10b-5
   a. *US v. O'Hagan*: O'Hagan = lawyer at D&W. D&W client = Grand Net, who is about to make a tender offer to target company (Pillsbury). O'Hagan steals from client funds to gamble, is in deep. One of his partners tells him about the tender offer on deck. O'Hagan becomes the single largest holder of call options in Pillsbury stock. The bid is announced, and he flips his holding for a $4.3 mil profit. O'Hagan argues that there is no 10b-5 violation b/c there is no duty--claims he owes a duty to Grand Net, not the Target company. SC holds that he violates a duty that he owes to the source of the info (Pillsbury)--in essence, he's stealing/converting information that is not his and using it to his own advantage. Different from Ciarella b/c the **duty is owed to the source of the info.**

G. Damages
1. Economic Loss
   a. Cannot have punitive damages under 10b-5 cause of action
      i. But if they plead fraud based on state law, they can include punitive damages in the claim

III. <u>Section 16(b) Liability for Short Swing Trading</u>

A. Requirements
1. π must be a "reporting company"
2. Δ must be a "statutory insider"
   a. Director
      i. **Either** at the time she bought or sold
   b. Officer
      i. **Either** at the time she bought or sold
   c. Beneficial owners of more than 10% of the company's shares (so 10.000001%)
      i. **Both** at the time she bought and sold
3. Δ Must have bought and sold **equity** securities (debt won't suffice) w/in a rolling six month period (short swing trading)
   a. No fraud required
   b. No requirement that trading be based on Δ's use of inside information
4. All "profits" from such short swing trading are recoverable by the corporation
   a. It's the company's COA--therefore if a SH brings the suit, its a derivative action.
   b. Multiply profit per share by the number of shares.
      i. If there are more than one buy combined w/more than one sell, or one buy w/many sells, or many buys w/one sell, you take the highest sell price and match it against the lowest purchase price; then the next highest sell price and next lowest purchase price, etc.
      ii. But there must be an offsetting trade--1 to 1 buy and sell.

<u>UNINCORPORATED PARTNERSHIPS</u>

I. <u>Limited Partnerships</u>

A. What is a limited partnership?
1. Must file documents w/the state;

A. What is a limited partnership?

2. Must be a written agreement;
3. Two kinds of partners
   a. General partners are personally liable on all debts of the partnership;
      i. General partner can be a corporation, thus limiting liability even further.
   b. Limited partners are liable only to the amount of their capital contributions
      i. Limited partners cannot participate in management

B. Organizing a Business as a Limited Partnership

C. Operating a Business as a Limited Partnership
1. Who decides what?
2. Who is liable to whom for what?
   a. Old ULPA standard
      i. Limited partner becomes liable to a general partner if they try to take part and control management the partnership
   b. RULPA
      i. Keeps common law standard;
         (1) New limitation on scope of liability
            (a) Limited partners are liable only to parties that reasonably believe you are a general partner
               (i) Delaney v. Fidelity Lease: Promoter wants to set up a franchise, go to investors. They don't want to be a partner--they want a limited liability. In order to purchase the franchise, the promoter needed 19 investors who insisted that they would only invest if all of the losses that would pass through down to the individual investors--so that they could write it off on their income taxes. Need partnership form for flow through taxation; investors wanted limited liability, so it had to be an LLP. The promoters (general partners) form a corporation, and the corp is the general partner in the LLP. LLP then leases land from Delaney. The LLP then is on the lease. The general partner has liability on the lease--problem is, they have no money. LL sues the 19 investors. Investors get dismissed--the LL knew the corporation was the general partner and all info was fully and adequately disclosed, so LL knew there was limited liabilty.

II. **Limited Liability Companies**

A. What is an LLC?
1. Limited liability no matter how involved they are in the day to day operations
   a. "Members", not "partners" or "SH"
2. Taxed like partnership = pass through taxation

B. Organizing as an LLC
1. There is a filing requirement
2. *Member-managed* = look like a partnership; (C-Corp)
3. *Manager managed* =look like corporation (S-Corp)

C. Operating a Business as an LLC
1. Who decides what?
2. Who is liable to whom for what?
   a. Members' liability to 3rd parties
   b. Members and managers' liability to the LLC