Business Associations, Guttentag, Fall 2017

Wednesday, November 1, 2017   5:51 PM

I. Agency/Principal Relationship

A. Overview

- Agency indicates the fiduciary relationship that exists where one person acts for another.
- RSA 2nd §1: The fiduciary relationship that results from a **manifestation of consent** by one person (the principal) to another (the agent) that **the other shall act on his behalf** and **subject to his control** and **consent by the other** so to act.
- Sources of Law: Common Law & Restatements (effort to summarize CL)
- Why create an agency relationship?
  - You can't do everything yourself, and you need someone to act on your behalf.
  - Exists when a sole proprietor takes on employees to work for her.
- Guttentag: An agency relationship is like dating, or a dominatrix relationship.

B. Formation of Agency Relationship

1. Formation
   - Agency Formation Test - An agency relationship exists where a:
     1. Principal manifests (through any kind of action) a desire to have the agent work on their behalf,
     2. Subject to the principal's control, and
     3. The agent consents so to act.
        - A contract is not required.
        - No intent needed to create a principal/agent relationship (just intend to have someone work on your behalf).
        - The relationship exists only for the duration of the task.
        - A principal need not exercise **physical control** over the actions of the agent, so long as the principal may **direct the result or ultimate objectives** of the agent relationship.
        - No need for compensation or consideration.
   - Why does ease of creating a principal/agency relationship matter?
     - Actions of the agent may create liability for the principal
     - Agents owe fiduciary duty to principals
   - *Gorton v.* Doty: Teacher (Doty) approached the high school football coach and asked if he had enough cars to transport the team to their away game. Coach told her they needed one more. Teacher volunteered her car on the condition that Coach drove it. Coach was then involved in an accident where a football player (Gorton) was injured. Player sued Teacher under a theory that Coach was Teacher's agent.
     - **Holding:** The court found that a P/A relationship did exist. Teacher exerted control over Coach when she told him that only he could drive. Guttentag disagrees with holding: Teacher's direction to coach was not enough to establish that Coach was acting on her behalf. She did not approach the Coach as if it was her objective to get the team to the game, and she needed his help. The school should be the principal, since coach is really working on its behalf. Also, perhaps not sufficient control, but up to the judge. Perhaps teacher can best bear the cost b/c of insurance on the car.
       1. Manifestation of Consent by Principal: Teacher --> "Coach, I want you to be my driver."
       2. Subject to Control: Teacher --> "Coach, only you can drive."
       3. Manifestation of Consent by Agent: Coach --> "I will be your driver."
     - Court did not accept Teacher's argument that she merely loaned the car as a gesture of good will.
       - If the car was borrowed, no agency relationship would have been created because Coach wouldn't be acting on Teacher's behalf.
       - Dissent: Coach was a gratuitous bailee --> liable for loss of property only if the loss is caused by the bailee's gross negligence.
     - How could Doty have avoided forming a P/A relationship?
       - Make it clear she was loaning the car via a contract.
       - Exert less control, so that prong is not met.
       - Don't offer the car, or drive the car herself.
2. Exceptions to Formation
   1. Lender/Creditor Exception
      - Lenders (aka creditors) are allowed to exert a certain amount of control and still not become a principle over the lendee (aka debtor), because the law doesn't want to stifle lending (e.g., venture capitalists and

banks).

- RSA 2nd § 14(o): When does a lender become a principal?
  - Lender becomes a principal when it assumes de facto control over the conduct of the lendee.
    - (see *Cargill* for nine factors the court cited as evidence of de facto control).
  - Does not matter what a contract says -> the nature of the relationship determines whether a P/A relationship has formed.

2. Supplier Exception
   - RSA 2nd § 14(k): One who contracts to acquire property from a third person and convey it to another is the agent of the other **ONLY IF** it is agreed that he is to act **primarily for the benefit of the other** and not for himself.
   - Factors indicating that one is a supplier rather than an agent**,** are
     1. Supplier is to receive a fixed price for the property irrespective of price paid by him (most important).
        - Ernie sells watermelons to grocery stores.
          - If Ernie charges a fixed price of $15 per melon no matter what price he buys them for, he takes a risk. Melons from CA are more expensive than the ones from Mexico, so depending on where Ernie's supply is from on a given day, he makes less/more profit.
          - If Ernie charges a fixed finders fee of $1 per melon on top of the cost he pays to get them from CA or Mexico, he is guaranteed a profit on each melon no matter what. So no risk.
          - Ernie is a supplier in situation 1, but an agent of the grocery stores in situation 2.
     2. Supplier acts in his own name and receives the title to the property which he thereafter is to transfer.
     3. Supplier must have an independent business in buying and selling similar property.

- *Gay Jenson Farms v.* Cargill: Cargill is a large grain company. It had Warren, a local company, collect grain from farmers (e.g., Gay Jenson). Cargill loaned money to Warren, and in exchange for the financing, Cargill had authority over some of Warren's internal operations. When Warren went bankrupt, the farmers who sold grain to Warren sued Cargill for recovery of $2 million, alleging that Cargill was liable for Warren's contractual obligations as its principal.
  - **Holding:** Warren was Cargill's agent because it was collecting grain on Cargill's behalf. Warren had a contractual obligation to the farmers, and the farmers were able to enforce that contractual obligation against Cargill after Warren defaulted.
    Guttentag disagrees with holding: Cargill argued that Warren was a supplier, and when Cargill exerted control over Warren, they were only acting as a lender normally would. Guttentag agrees that a lot of what Cargill was doing was part of a standard loan agreement.
    1. Manifestation of Consent by P: Cargill --> "Warren, I want you to buy grain from the farmers for me."
    2. Subject to Control: Cargill --> "Warren, I get to tell you how to run your business."
       - Evidence of De Facto Control:
         i. Cargill's business recommendations to Warren;
         ii. Cargill's right of first refusal on grain;
         iii. Warren's inability to enter into mortgages, to purchase stock, or to pay dividends without Cargill's approval;
         iv. Cargill's right of entry onto Warren's premises to carry on periodic checks and audits;
         v. Cargill's correspondence and criticism regarding Warren's finances, officers salaries and inventory;
         vi. Cargill's determination that Warren needed "strong paternal guidance";
         vii. Provision of drafts and forms to Warren upon which Cargill's name was imprinted;
         viii. Financing of all Warren's purchases of grain and operating expenses; and
         ix. Cargill's power to discontinue the financing of Warren's operations.
    3. Manifestation of Consent by A: Warren --> "I will buy grain for you."
  - There are four simultaneous relationships between Warren and Cargill:
    i. Cargill is a lender who loans Warren money for "working capital" (like a line of credit).
    ii. Cargill is Warren's grain agent at the Commodity Credit Corporation (Cargill is Warren's Rep).
    iii. Cargill has a right of first refusal to purchase grain sold by Warren at terminal market.
    iv. Warren to act as Cargill's agent for Bounty 208 and sunflower seeds.

C. Liability to Third Parties

- Principal Liability Overview:

- **Contract Liability:** If an agent has authority to enter into a contract, then the principal is bound by that contract.
- **Tort Liability:** There must be a master/servant relationship, and generally speaking, the action must be within the scope of employment.

- Agent Liability Overview:
  - **Contract Liability:** An agent is liable when there is a partially disclosed or undisclosed principal, but NOT liable when there is a disclosed principal. If there is fraud, however, the agent is also liable, regardless of its principal's status.
  - **Tort Liability:** An agent is liable for its own tortious conduct.

- **Contract Liability**

I. Contract Liability for Principals

- The only agent that can bind the principal is an agent that has been authorized.
  - RSA 2nd §144: A principal is **subject to liability upon contracts made by an agent while acting within his authority** if made in proper form and with the understanding that the principal is a party.
  - RSA 3rd §6.01-6.03: An agent with **authority** can bind a principal to a contract.
    - This allows the 3rd party to reliably negotiate with an agent.
    - If the agent has no ability to bind the principal, then negotiating with anyone but the principal would be a waste of time; conversely, if an agent can do too much, principals won't delegate to agents.
- **Types of Principals** – RSA 2nd §4; RSA 3rd §1.04
  1. Disclosed
  2. Partially disclosed (2nd)/Unidentified (3rd)
  3. Undisclosed
- **How to Establish Authority**
  1. Actual Express Authority (AEA)
     - Look to agent's reasonable belief.
  2. Actual Implied Authority (AIA)
     - Incidental to transaction, usually accompany it, or are reasonably necessary to accomplish it.
  3. Apparent Authority
     - Look to 3rd party's reasonable belief, and must be traceable to principal's manifestation.
     - There cannot be apparent authority if the agent is undisclosed.
  4. Inherent Agency Power
     - Exists when there is an undisclosed principal.
  5. Ratification
  6. Estoppel

1. **Actual Express Authority (AEA)**
   - An express communication from the principal to the agent authorizing the agent.
   - Look to the reasonable belief of the agent.
     - RSA 3rd §2.01: An agent acts with actual authority when the agent reasonably believes that the principal wishes the agent so to act.
2. **Actual Implied Authority (AIA)**
   - When the authorization is implied, either by words or circumstances.
     - RSA 2nd §35: Unless otherwise agreed, authority to conduct a transaction **includes** authority to do acts which are:
       1. Incidental to the transaction,
       2. Usually accompany the transaction, or are
       3. Reasonably necessary to accomplish the transaction.
     - RSA 3rd §2.02(1): An agent has actual authority to take action designated or implied in the principal's manifestations to the agent and acts **necessary or incidental** to achieving the principal's objectives
   - *Mill Street Church v. Hogan*: Church hired Bill to paint the steeple. When Bill needed help, Church said he should ask Gary. Bill usually asked his brother Sam to help him with these jobs, and the church had authorized him to do so in the past, so Bill thought it was reasonable to ask Sam. Sam then broke his arm while painting the church. The church paid Sam for the amount of time he worked on the job. Sam filed for workers comp. for his injury, but he could only collect if Bill was authorized to hire him.
     - **Holding:** No actual express authority because the church did not specifically tell Bill to hire Sam. However, there was actual implied authority because hiring Sam was both reasonable and incidental to completing the job.

- Note: Actual authority has to do with the **communication between the principal and the agent**.
    - Sam's belief that his brother Bill had authority to hire him is <u>irrelevant</u> as to determining whether there was actual authority.
    - Only look to the reasonable belief of the agent, not to the 3rd party.
    - Fact that Church paid for Sam's labor -> goes towards <u>ratification</u> and not to whether Bill had actual authority.

3. **Apparent Authority (AA)**
    - Deals with the relationship between the **principal and the third party.**
    - Look to **3rd party's reasonable interpretation** of principal's intent, traceable to **principal's manifestation.**
        - The most obvious case is where the principal tells the 3rd party directly that the agent is authorized to enter into a contract on its behalf.
        - If an agent appears to have authority, the agent has to take countermeasures to make sure the 3rd party knows that the agent is not authorized.
        - Inaction cannot create apparent authority --> the principal's manifestation NEEDS to be an ACTION.
    - **Types of Principals**
        1. Disclosed
            - The 3rd party knows who the principal is.
        2. Partially Disclosed (RSA 2nd) / Unidentified (RSA 3rd)
            - The 3rd party know there is a principal, but doesn't know who it is.
        3. Undisclosed
            - The 3rd party doesn't know that the agent is working on behalf of someone else.
            - **CANNOT** have apparent authority if principal is <u>undisclosed</u>.
    - **Differences between RSA 2nd and RSA 3rd for AA:**
        - RSA 2nd §8: Apparent authority is the power arising from the principal's manifestations to such third person.
        - RSA 2nd §27: Apparent authority is created by written or spoken words or other conduct of the principal, which reasonably interpreted, cause the third person to believe the principal consents to have the act done on his behalf.
        - RSA 2nd §159: A disclosed or partially disclosed principal is subject to liability upon contracts made by an agent within his apparent authority.
        - RSA 3rd §2.03: Apparent authority is the power held by an agent to affect a principal's legal relations with third parties <u>when a third party reasonably believes the actor has authority to act</u> on behalf of the principal and that belief is <u>traceable</u> to the principal's manifestation.
        - Guttentag: RSA 3rd explains the current law better.
            - RSA 2nd focuses on the principal's manifestations directly to a 3rd party.
            - RSA 3rd adds "traceable," which makes it broader.
                - E.g., Burns tells Smithers to wear the company hat and then Smithers tells Lisa he is Burns' agent. Even though Burns (principal) didn't talk directly to Lisa (3rd party), her reasonable belief that Smithers has authority is traceable to Burns' manifestation (telling Smithers to wear the company hat).
                - If Smithers stole the hat and lied to Lisa, Smithers wouldn't have authority under either RSA 2nd or RSA 3rd – not traceable to something that Burns actually did for RSA 3rd and not a direct communication to the third party for RSA 2nd.
    - *370 Leasing v. Ampex*: 370 Leasing Corporation, operated by Joyce, entered into a agreement with Kays, an Ampex sales rep, to buy some servers from Ampex. Kays appeared to have the authority to enter into the sales agreement, but he actually did not. Joyce thought that Kays was authorized. Kays sent a form sales contract to Joyce that had two signature lines, one for 370 and one for Ampex. No one from Ampex signed the contract. An Ampex internal memo was circulated that said Kays was responsible for dealing with Joyce. A few days later, Kays sent a letter to Joyce confirming the delivery dates and installation instructions for the servers. Ampex then wanted to get out of the deal, but 370 wanted to enforce the contract against Ampex.
        - **Holding:** The court held that Kays had apparent authority, so the contract was enforceable against Ampex. Joyce was reasonable in believing that Kays had apparent authority. Even though Joyce did not see the office memo that said Kays was the point-person for the 370 deal, under the RSA 3rd, Kays' assertion that he had authority is traceable to an actual manifestation by Ampex.
            - Note: In order for Ampex to protect itself, it should have made it clear to Joyce that only a VP could enter into a sales agreement (which Kays was not), or that Kays did not have authority -> then Joyce could no longer reasonably believe Kays had authority.

4. **Inherent Agency Power (IAP)**
   - Kicks in when other theories of liability do not apply, but for policy reasons, we want to hold the principal liable.
     - Only available when there is an <u>undisclosed principal</u>.
   - RSA 2nd §8A: Inherent agency power indicates the **power of an agent** which is derived not from authority, apparent authority, or estoppel, but **solely from the agency relation** and exists for the protection of persons harmed by or dealing with a servant or agent.
   - RSA 2nd §195: An **undisclosed** principal "is subject to liability to third persons with whom the agent enters into transactions **usual in such business**.
   - RSA 3rd §2.06(1): An undisclosed principal is subject to liability to a third party who is **justifiably induced** to make a **detrimental change** in position **by an agent** acting on principal's behalf and **without actual authority** if the principal **having notice** did not take reasonable steps to notify them of the facts (sounds like an extension of estoppel, but where there is an undisclosed principal).
   - *Watteau v. Fenwick*: Fenwick, a brewing company, purchased a bar from Humble but kept the name "Humble's," and Humble remained an employee. Fenwick told Humble that he could "only buy bottled ales and mineral waters" (therefore Humble had actual express authority to purchase those items). Yet, Humble bought cigars and Bovril from Watteau. Although Humble did not have express authority to purchase these items, they are normally bought in the course of such a business. Fenwick was an undisclosed principal (wanted it to still look like the bar was locally owned). Watteau believed that Humble was acting as the owner of the bar.
     - **Holding:** Fenwick had inherent agency power to enter into the contracts with Watteau because Watteau reasonably believed that she was dealing with the entity that owned and operated the bar. An undisclosed principal is strictly liable for any usual business transactions of its agent, even if the agent wasn't authorized.
       - <u>No Actual Authority</u>: Humble couldn't reasonably believe he had actual authority.
       - <u>No Apparent Authority</u>: While there's a reasonable belief Humble had authority, there's no basis for a reasonable belief that Humble had authority to work on behalf of the principal Fenwick, because Watteau didn't know Fenwick existed.
     - Note: Discrepancy between RSA 3rd and *Fenwick* – under RSA 3rd, in order to have liability, Fenwick would have had to have **notice** and then **not take reasonable action to notify the third party**. Here, Fenwick did not have notice, so he would not be liable under RSA 3rd. RSA 3rd thus misstated the common law on this point.

5. **Ratification (R)**
   - When an agent does not have authority to enter into a contract at the time of formation, but the principal later authorizes the act.
   - RSA 2nd §82: Ratification is the affirmance by a person of a prior act which did not bind him but which was **done or professedly done on his account**, whereby the act is given effect as if originally authorized by him
   - RSA 3rd §4.01: Ratification **is** the affirmance of a prior act done by another, whereby the act is given effect as if done by an agent acting with actual authority
   - RSA 3rd §4.03: A person **may ratify an act if** the actor acted or purported to act as an agent on the person's behalf.
     - Note: distinct from IAP because here there is a <u>disclosed principal</u>, it's just that the agent doesn't actually have authority.
   - **<u>Caveat on Ratification</u>:** RSA 2nd §89
     - If the **affirmance** of a transaction occurs at a time when the **situation has so materially changed** that it would be inequitable to subject the other party to liability thereon, the other party has an election to avoid liability.
     - E.g., An agent purporting to act for a principal, but without power to bind him, contracts to sell Blackacre to a third party. The next day, the house burns down. A later ratification by the principal cannot bind the third party, for it would be unfair for the principal to gain.

6. **Estoppel (E)**
   - Only a doctrine for disclosed or partially-disclosed principals.
   - Covers a situation where the principal did not cloak the agent in authority, but the principal knew that a 3rd party thought the agent was authorized, and the principal didn't do anything to correct them.
   - RSA 2nd §8(B): A person who is **not otherwise liable** as a party to a transaction purported to be done on his account, **is** nevertheless **subject to liability** to persons who have **changed their positions if:**
     1. He intentionally or carelessly caused such belief, or
     2. Knowing of such belief, did not take reasonable steps to notify them of the facts.

- Change in position indicates:
  - Payment of money,
  - Expenditure of labor, or
  - Suffering a loss or legal liability.

II. Contract Liability for Third Parties

- When can a principal enforce a contract entered into by their agent against a 3rd party?
  - Actual Express Authority (AEA) – YES
  - Actual Implied Authority (AIA) – YES
  - Apparent Authority (AA) – YES
  - Inherent Agency Power (IAP) – YES
  - Ratification (R) – Sometimes
    - Note the "Caveat on Ratification" above: A principal can only ratify if circumstances have **not materially changed**.
  - Estoppel (E) – NO
    - The 3rd party can enforce the contract against the principal, but the principal cannot enforce it against the third party.

III. Contract Liability for Agents

- RSA 2nd §320: An agent for a disclosed principal does not become a party to the contract ---> therefore agent is not liable.
- RSA 2nd §321: An agent for a partially disclosed principal is a party to the contract --> therefore agent is liable.
- RSA 2nd §322: An agent for a undisclosed principal, purporting to act on his own account, is a party to the contract -> therefore agent is liable.
  - E.g., Paul signs a contract with Annie to in turn hire a manager for a grocery store. Annie to be paid $1000. Annie shows the contract to several candidates, including Thomas. Paul sends a letter to Annie revoking Annie's authority to hire a manager for the store, but the revocation is not communicated to Thomas.
    - A – As to Thomas, Annie has actual implied authority to hire a manager for Paul's store.
      - AIA is a sup-category of actual authority; actual authority looks at the reasonable belief of the agent, and Annie can no longer have a reasonable belief that she has a authority due to the letter.
    - B – As to Thomas, Annie has no authority to hire a manager for Paul's store.
      - Annie was cloaked in authority, and the 3rd party still has a reasonable belief that she has authority, so there is apparent authority.
    - C – As to Thomas, Annie has apparent authority to hire a manager for Paul's store.
      - **Correct answer**: When Paul signed the contract with Annie, he took an action that cloaked Annie in authority. The fact that he then revoked it is not sufficient to remove that authority. In order to remove the apparent authority, Paul would have to communicate to the 3rd party that the agent no longer had authority.
    - D – As to Thomas, Annie has inherent agency power to hire a manager for Paul's store.
      - The only situation in which someone can have inherent agency power is where the principal is undisclosed and the agent is doing something in the ordinary course of business. IA is also only available if the other theories don't work, and there is AA.
    - E – None of the above

Tort Liability

I. Tort Liability for Principals

- When is a principal liable for torts committed by its agent?
  - Can still sue the negligent agent -> this is just a question of whether you can also sue the principal, who likely has deeper pockets.
- RSA 2nd §219: A master is subject to liability for the tort of his (1) **servants** committed while acting (2) in the **scope of their employment.**
  1. There must be a **Master/Servant Relationship** and
     - RSA 2nd §2(2): A servant is an agent whose "physical conduct is controlled or subject to the right of control by the master."
       - Unlike in forming a regular principal/agent relationship, here physical control is required (higher level of control).

- RSA 2nd §2(3): An <u>independent contractor</u> is a person who contracts with another but is **NOT** controlled or subject to control of <u>physical conduct</u>. *He may or may not be an agent.*
    - Types of independent contractors in the Restatement 2nd:
        1. **Independent Contractor (Agent-Type)**
            - Subject to limited control by principal with respect to the chosen result.
            - Agent <u>has power</u> to act on principal's behalf.
        2. **Non-Agent Independent Contractor**
            - Perhaps less control on principal's part **BUT**,
            - Agent has <u>no power</u> to act on the principal's behalf.

2. The agent must be working **within the scope of their employment.**
    - <u>Frolic and Detour</u> --> acts done outside of normal business duties do not create liability for the principal.

(1) There must be a **Master/Servant Relationship**.

- **Is the agent a servant?** Consider these factors: RSA 2nd §220(2)
    1. Extent of control which, by the agreement, the master may exercise over the details of the work
        - More control = more likely to be servant
    2. Whether or not the one employed is engaged in a distinct occupation or business
        - A specialized employee is less likely to be a servant because they have more autonomy over how they do their job (e.g., specialized colorist at the barber shop vs. a normal stylist)
    3. Whether customarily done with or without supervision in this locality
        - If customarily done without supervision, less likely to be a master/servant. If customarily done with supervision, more likely
    4. The skill required in the particular occupation.
        - More skilled, less likely to be a servant
    5. Whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work
        - If principal provides the tools, more likely to create master/servant relationship
    6. The length of time for which the person is employed
        - The longer an employee works for an employer, the more likely they are a servant
    7. The method of payment
        - Hourly pay = more likely to be servant
        - Flat pay for the whole job = less likely to be servant
    8. Whether or not the work is a part of the regular business of the employer
        - If part of regular business, employer is more likely to take control of the physical conduct, thus more likely master/servant
    9. Whether or not the parties believe they are creating a master/servant relationship
        - If you think you have a master/servant relationship, more likely you do.
    10. Whether or not the principal is in business
        - If in business, more likely to be master/servant relationship
    - *Humble Oil & Refining v. Martin*: Schneider's, a gas station, had a contract with Humble Oil. Humble Oil owned the property and the gas but wanted to have hands-on, entrepreneurial supervisors, so they contracted with Schneider to run the station. Love, a customer, left her car at the station for repairs, but Love did not set the hand brake when she handed over the car, and no employee made sure the car was secure. The car rolled downhill and struck plaintiff and his children. Humble Oil argued that they are not liable because Schneider was an independent contractor.
        - **Holding:** Court said that this was in the scope of employment, and Humble Oil asserted enough control over the station for Schneider to be a servant (there were Humble Oil signs, they owned the property, and leased the equipment, supplies, and gasoline to Schneider). Therefore, Humble Oil had tort liability for the actions of its servant. The court relied heavily on the contract provision which said Humble Oil could make direct orders in regards to how the business was run.
    - *Hoover v. Sun Oil Company*: A gas station is owned by Sun Oil and operated by Barone. A station employee caused a fire while filling plaintiff's car with gas due to his negligence (smoking a cigarette). The dealer's agreement allowed Barone to sell products from competing oil companies, but required him to sell the Sun products under the Sun label. The service station had large signs advertising Sun products, but Barone's name was posted as proprietor. A Sun representative, made weekly sales calls to the service station where

the Sun rep would discuss various business issues with Barone and advise him on station operations. But, Barone was not required to follow Sun's advice.

- **Holding**: The Sun Oil contract said that Barone did not need to abide by Sun's recommendations. Therefore, Sun did not have the physical control necessary to establish a master/servant relationship, and Sun was not liable.
  - This case was 20 years after Humble, so Sun Oil learned how to structure their relationship with Barone in order to avoid liability.

- Comparing *Humble Oil* and *Hoover*
  - The extent to which the agreements in both cases did or did not give physical control to the principal had the greatest bearing on whether it was found that there was a master/servant relationship or not
  - The courts in both cases essentially go through the factors as seen in RSA 2nd §220(2):

	RSA Section	Humble Oil	Sun Oil
1	**Extent of control over work details**	May give orders	Recommendations*
2	**Whether it is a distinct business**	Schneider does repairs	Barone may sell other products
3	**Trade practice of supervision in locality?**	Local custom?	Local custom?
4	**Skill required of agent**	Moderate	Moderate
5	**Who provides supplies?**	Humble owns the property and stock	Sun Oil owns the property and stock
6	**Term of Relationship**	At will	30 day/annual notice
7	**Method of Payment**	Volume-based rent	Volume-based but cap
8	**Is the agent's work part of the principal's regular business?**	Core part of business	Core part of business
9	**Principal and Agent's belief about the relationship**	No belief	?
10	**Is the principal in business?**	Humble in Business	Sun Oil in Business

  - Guttentag's theory is that if the principal benefits from the relationship, it should have liability for its agent's torts.
    - But the law's theory is, if the principal has control over the physical conduct of its agent, then it should have liability for their torts.
    - Guttentag's barber shop example: If Guttentag can suck money out of his company, he should have to bear the cost of one of his barbers snipping someone's ear (internalize costs into the business). If Guttentag doesn't tell the barbers exactly what to do (i.e., no physical control so no M/S relationship), he won't have liability, but he's still benefitting from the business and not internalizing the cost of accident --> Guttentag thinks this a crazy loophole in the law.
  - Advice for the gas station?
    - Find economic ways to exert control.
    - E.g., The ability to pull out of an agreement at any time --> a credible threat that forces the agent to behave the way the principal wants them to without having to put it in writing.

(2) The agent must be working **within the scope of their employment.**

- **Is the conduct in the agent's scope of the employment ?** RSA 2nd §228
  - Conduct is within the scope of employment if:
    1. Of a kind employed to performed,
    2. Substantially within authorized time and space limits,
    3. At least in part to serve master, and
    4. If force used, the force used must be not unexpected by the master.
       - E.g., Security guard/bouncer who pushes someone, expected by master that bouncer could get physical so likely within scope of employment.

- **Is <u>unauthorized</u> conduct (e.g., cashier discriminating against a customer) within the scope of employment?** Consider these factors: RSA 2nd § 229
  1. Whether or not the act is one commonly done by such servants
  2. The time, place, and purpose of the act
  3. The previous relationship between the master and the servant
  4. The extent to which the business of the master is apportioned between different servants
     - If you have a narrow role (e.g., just the colorist) and you go do something you're not supposed to do, then that's not likely to be considered within the scope of employment; But, if you're in charge of the whole beauty salon and you're not supposed to use the curling irons but you do, that's still probably going to be determined to be within the scope of employment.
  5. Whether or not the act is outside the master's enterprise or, if within the enterprise, has not been entrusted to any servant
  6. Whether or not the master has reason to expect that such an act will be done
  7. Similarity in quality to an authorized act
  8. Whether or not the instrumentality by which the harm is done has been furnished by the master to the servant
     - E.g., Steam roller given to employee by employer --> even if Burns didn't tell Smithers where to drive the steam roller, Burns provided the steam roller, so more likely that the actions would fall under the scope of employment.
  9. The extent of departure from the normal method of accomplishing an authorized result
  10. Whether or not the act is criminal
- **When is a principal liable for actions <u>outside</u> the scope of employment?** RSA 2nd §219(2)
  - A master is liable for a servant's torts **outside** the scope of employment if:
    1. Master intended the conduct or consequences, or
    2. Master was negligent or reckless.
- *Arguello v. Conoco*: There are three separate incidents of harassment/discrimination that occurred at Conoco branded or owned gas stations:
  - **Arguello Incident**: P tried to pay for gas at a <u>Conoco-owned</u> store. Cashier asked to see P's ID, which was from out of state. The cashier rejected the ID, knocked a 6-pack of beer at P, and screamed obscene/racist epithets. P called a district manager to complain. The manager said that the cashier was wrong and reprimanded the cashier.
  - **Ivory Incident**: Employee at a <u>Conoco-branded</u> store refused to serve P, saying "we don't serve people like you." P called the cops and the cops told the cashier he had to sell to P.
  - **Escobedo Incident**: Employee at a <u>Conoco-branded</u> store refused to supply P toilet paper. When P complained, the customer service rep. said Conoco couldn't help because they didn't actually own the store.
  - Conoco-Owned vs. Conoco-Branded
    - Conoco has complete control over the Conoco-owned stores, but much less control over the branded stores.
    - The branded stores were covered by a Petroleum Marketing Agreement (PMA) which explicitly said that no principal/agent relationship was to be created -> but it doesn't matter what the agreement says; rather, look at the course of conduct.
  - **Holding**: The court held that the employees in the <u>Conoco-branded</u> stores were not agents of Conoco. However, for the <u>Conoco-owned</u> stores, the court held that Conoco was liable because the cashier was acting within the scope of her employment under the RSA 2nd § 229 factors.
    - Just because an owner doesn't condone the actions of an employee doesn't mean it isn't within the scope of employment.

II. <u>Tort Liability for Agents</u>

- RSA 2nd §343: An agent is subject to liability to a third party harmed by the agent's tortious conduct.

D. Roles and Duties within Agency Relationship

- **Roles**
  - **Principal**: Sets out what he wants and ask the agent to do so
  - **Agent**: Either accepts or denies the request
- **Duties**
  - Fiduciary relationship
  - Arises regardless of whether there is a contract
- **Agent's Fiduciary Duty to Principal**

- RSA 2nd §376: **General Rule:** The existence and extent of the duties of the agent to the principal are **determined by the terms of the agreement** between the parties
- RSA 2nd §379: **Duty of Care and Skill: Unless otherwise agreed,** an agent is subject to a duty to the principal to act with **standard care** and with the skill that is standard.
- RSA 2nd §381: **Duty to Give Information: Unless otherwise agreed,** an agent is subject to a duty to **give his principal information** which is relevant to the affairs entrusted to him.
  - Affirmative duty to speak, silence is not an option.
- RSA 2nd §387: **Duty of Loyalty: Unless otherwise agreed,** an agent is subject to a duty to his principal to **act <u>solely</u> for the benefit of the principal.**
  - Also, includes duty to:
    1. Account for any profits arising out of employment
    2. If do something adverse, must be fair/disclose
    3. Not to compete in subject matter of agency
    4. Not act with conflicting interests
    5. Not to use/disclose confidential information

- *General Automotive v. Singer* : Singer worked for General Automotive making a salary in addition to 3% commission. In his contract, Singer had to "devote his entire time" to his work at GA and not engage in other "permanent" vocation. Singer decided that for jobs that couldn't be filled by GA due to capacity, he would take the order and fill it through a different machine shop and take a small middleman commission without telling GA. GA sued, arguing that Singer violated his fiduciary duty in regards to a side deal he made with Husco, for which he made $64,000 in profits.
  - **Holding:** The court held that Singer breached his fiduciary duty of loyalty, duty to disclose, and duty to not compete. He should have notified GA to see if they wanted to expand capacity, and taking profits for himself was not acting for the sole benefit of the principal. An agent has a fiduciary duty to act in good faith and to further the interests of the principal. If an agent competes with the principal's business, the agent has violated his or her fiduciary duty and is liable to the principal for profits made in the competitive enterprise. Singer directly competed with his employer by secretly filling orders meant for GA and then surreptitiously forming his own venture that conducted the same type of business in which GA engaged.
    - Arguments that Singer didn't breach his fiduciary duty:
      - GA is benefiting from Singer and his expertise and his ability to generate business.
      - Singer has used his own money to fund the operations when needed.
      - Singer took the loss when parts were mis-manufactured.
    - What was the **revenue from the sale** to Husco?
      - We know Singer received $10,183 based on his 3% commission of total sales.
      - $10,183 /.03 = $340,000 (Sale to Husco)
        - (commission earned) / (commission percent) = revenue
    - What is Singer's **profit margin** on the Husco sale?
      - We know the profit (net income) on the Husco sale was $64,088.
      - $64,088 / $340,000 = 19% profit margin
        - (profit) / (revenue) = profit margin
    - What **share of the profit** does Singer need to receive to make the same amount as commission?
      - $10,183 / $64,088 = 16%
        - (commission earned) / (profit)
    - Singer's contract specified in Section 8A that he must "devote his entire time to the business" and "not engage in other business of a permanent nature." Is it possible for him to breach the contract and not breach his duty of loyalty? Vice versa?
      - If you contracted to waive the duty of loyalty in your employment agreement, then breach of contract but not duty of loyalty.
      - If the contract was silent about non-compete, but did talk about loyalty, then then breach of duty of loyalty but not contract.
    - Why didn't GA just sue under breach of contract?
      - Remedy for breach of contract is expectation damages --> if you believe Singer, then the expectation damages would be $0, since GA did not have the capacity to fill the order anyway.
      - Under breach of fiduciary duty however, GA's remedy would have been <u>disgorgement of profits</u>**.**
        - Whatever money ended up in Singer's pocket, he needs to give back to GA.
        - GA would get the entire $64,088 profits made by Singer, rather than just their lost profits.
      - What advice would you give to Singer?
        - Disclose your side business to GA and get consent.

- Stop working for GA and go run your business on your own.
- Just abide by the contract and don't have a side business.

E. Termination of Agency

- Either party can terminate the relationship at will.
- RSA 2nd §118: **Revocation and Renunciation**
  - Authority terminates if the principal (by revocation) **OR** the agent (by renunciation) manifests to the other dissent to its continuation.
    - Has to be manifested directly to the other party
    - Manifestations can be actions rather than statements (but must be some kind of activity)
- RSA 2nd §124(A): **Effect of Termination of Authority upon Apparent Authority**
  - The termination of authority does not terminate apparent authority.
- RSA 2nd §136: **Notification Terminating Apparent Authority**
  - Apparent authority terminates when **third party has notice**.
  - Must take away the third party's reasonable belief that the agent is working on behalf of the principal.
- RSA 2nd §396: **Agent's Fiduciary Duties to Principal After Termination**
  - Using Confidential Information After Termination of Agency
    - **Unless otherwise agreed,** after termination of the agency, the agent:
      - i. Has **NO** duty to not compete
      - ii. Has a duty **NOT** to use or disclose trade secrets, but the agent is entitled to use general information and the names of customers retained in his memory.

II. Partnerships

A. Overview

- UPA § 6(1): A partnership is an association of two or more persons to **carry on as co-owners** of a **business for profit**.
- Sources of Law:
  - Uniform Partnership Act (1914) – UPA
    - All 50 States have adopted the UPA.
  - Uniform Partnership Act (1997) – RUPA
    - About 2/3 of States have adopted the RUPA, and some states made modifications.
  - Differences between the UPA and RUPA
    - Mandatory vs. Default Fiduciary Duties
    - Financial consequences of wrongful termination
- Why create a partnership?
  - Sometimes there needs to be more than one owner.
  - Two people may have complimentary skills: one person has money, the other has the skills for the specific business.
- Guttentag: A partnership is/is not like a marriage.
  - Like a marriage because there's assets involved.
  - Termination looks like a divorce.
  - Unlike marriage because partnerships do not require a formal process for formation.

B. Formation of a Partnership

- Partnership is **default** business association, and you must affirmatively state that you are not creating a partnership in order to opt out and rebut the presumption that one has been created.
- How do you know if you formed a partnership?
  1. Look to the definition of a partnership.
  2. Consider if UPA (1914) Section 7(3) and 7(4) are relevant.
  3. Look at the nine common law factors listed in the *Fenwick* case.

1. Look to the definition of a partnership:
   - A partnership is an association of two or more persons to **carry on as co-owners** of a **business for profit**.
     - Carrying on --> the moment you develop a plan/idea and pursue it.
     - No formality required.
2. Consider if UPA (1914) Section 7(3) and 7(4) are relevant:

- UPA §7: **In Determining Whether a Partnership Exists**
  - (3) The sharing of gross returns **DOES NOT** establish a partnership.
  - (4) The receipt by a person of a share of the profits is **PRIMA FACIE** evidence that he is a partner. No such interference shall be drawn if such profits were:
    i. (b) Received in payment as wages of an employee (*Fenwick*)
    ii. (d) As interest on a loan
  - Note: The idea here is if you receive gross returns, you don't care how the business is actually doing overall, just that revenue is up. However, when you get a piece of the profit, then you really care about the business, are much more interested and committed, and are more likely to be a partner in the business.
    - What is the difference between eggs and bacons, and what does this have to do with forming a partnership?
      - The difference between eggs and bacon is that chickens may feel a little sad about eggs being eating, but the pig is pissed that bacon is on the breakfast table.
      - The difference between eggs and bacon is the chicken is interested but the pig is committed.
      - The chicken is like Sections 7(3) and the pig is like Section 7(4).
        - Chicken can live to see another day
        - Pig is all in -> profits vary more than gross returns

3. Common law partnership factors from *Fenwick*:
   1. Intention of the parties
   2. Right to share in profits (not conclusive)
   3. Obligation to share in losses
   4. Ownership and control of partnership property
   5. Contribution of capital
   6. Right to capital on dissolution
   7. Control of management
   8. Conduct toward third parties
   9. Right on dissolution
   - *Fenwick v. Unemployment Compensation Commission*: Fenwick employed Chesire as a cashier and receptionist at his beauty parlor. Chesire initially worked for $15 per week, but after several months she demanded a raise. Not wanting to lose Chesire, Fenwick and Chesire executed an agreement which described their association going forward as a "partnership." The agreement provided that Chesire would continue her current duties and be paid her existing salary plus 20 % of the profits, "if the business warrants it." The agreement also stipulated that Chesire would make no capital investment in the beauty parlor, and that Fenwick would retain complete control of it and be solely responsible for its debts. Chesire continued to work for three years but then quit her job to stay home with her child. The unemployment compensation committee had to determine whether Chesire was Fenwick's partner or employee, because if she was his employee, Fenwick would be responsible for paying into the state unemployment compensation fund.

Terms of the Fenwick "Partnership Agreement"	
Return	Chesire: $15/week + 20% of profits ("if they had a good year") Fenwick: $50/week + 80% of profits
Risk	Fenwick bore all losses
Control	Fenwick had all management control
Duties	Both full time: Fenwick manager and Chesire clerical
Duration	Either could sever (10 days notice)

  - **Holding:** Considering the nine factors above, the court found that Chesire was an employee and not a partner, despite the wording of the contract. The main issue was that Chesire did not demonstrate ownership, management, or control of the business.
    1. Intention of the parties
       - It seems that the parties thought they were entering into a partnership.
    2. The right to share in profits
       - Yes, but not prima facie evidence, because they were received as wages (UPA § 7(4)(b)).
    3. Obligation to share in losses
       - No
    4. Ownership and control of the partnership property and business

        - All Fenwick
    5. Contribution of capital
        - All Fenwick
    6. Right to capital on dissolution
        - All Fenwick
    7. Control of management
        - All Fenwick
    8. Conduct of the parties towards 3rd parties
        - No sign on the door, but reported taxes as partnership.
    9. The rights of the parties on dissolution
        - Either could terminate at will.

C. Liability of Partners to Third Parties

- UPA §15: All partners are **jointly liable** for all debts and obligations of the partnership.
    - **Contract Liability** - UPA §9:
        - Every partner is deemed to be **an agent of the partnership**, and
        - The **act of every partner carrying on in the usual way** the business binds the partnership,
        - **Unless** the partner has **no authority and the person** with whom he is dealing **has knowledge** of this fact.
    - **Tort Liability** - UPA §13:
        - Where wrongful act or omission of any partner acting in the **ordinary course of the business of the partnership,** the partnership is liable.
- __Hypo__: Retro Sound (Guttentag, Brittany, and Victor's Business)
    - Victor has a 10% interest, while Guttentag and Brittany each have a 45% interest
    - Having a profit share triggers UPA §7(4) (prima facie evidence that someone is a partner).
    - If Guttentag charges $300,000 on a credit card but can't pay, Victor and Brittany are held personally liable for the money.

D. Roles and Duties in a Partnership

- The fiduciary duties partners have to one anther vary under the UPA and RUPA.
- Substantive Duties:
    - Duty of Care
    - Duty of Loyalty
    - Duty of Information
- Ability to Modify:
    - Mandatory vs. Default

	DUTY OF CARE	DUTY OF LOYALTY	DUTY OF INFORMATION
UPA	RSA 2nd §379	RSA 2nd §387 – 394 (default) UPA §21 (mandatory)	RSA 2nd §381 (default) UPA §20 and §22 (mandatory)
RUPA	RUPA §409(c)	RUPA §409(b) and (e)	RUPA §408

- **Partnership Duties and the Ability to Modify Duties**

I. __Fiduciary Duties Among Partners under UPA__
    - **Default:**
        - UPA §9: Every partner is deemed to be an agent of the partnership.
        - Agency law is made the default rule.
            - RSA §376-396 apply (i.e., RSA's rules regarding Duty of Care, Loyalty, Information, and Duties After Termination).
        - You cannot contract around the mandatory UPA rules (below).
            - In agency law, fiduciary duties are all default, but you CAN contract around all of it.
            - In partnership law, there are some restrictions as to what you can or cannot contract around.
    - **Mandatory:**

        - UPA §20: Obligation to render true and full information **on demand**.
            - The information requested must be related to the partnership.
        - UPA §21: Must account for profits from any transaction connected with partnership.
        - UPA §22: Each partner has a right to a formal accounting.

II. <u>Fiduciary Duties Among Partners under RUPA</u>
    - <u>Note</u>: The following duties can be modified under RUPA §105 (see below), but they are **<u>mandatory</u>**.
    1. Duty of Loyalty
        - RUPA 409(b): The fiduciary duty of loyalty of a partner includes**:**
            i. **No secret profits:** Account and hold as trustee any property, profit, or benefit derived by the partner from the appropriation of a <u>partnership opportunity</u>,
            ii. **No dealing in conflicting business** : Refrain from dealing as or on behalf of a party with an interest adverse to the partnership, and
            iii. **No competing** : Refrain from competing with the partnership in partnership business before dissolution.
        - RUPA 409(e): **Self-interest** is <u>not</u> dispositive of a breach of duty of loyalty.
            - As compared to agency, the agent must act solely for the principal, but the RUPA says partners can be a little self-interested and still be loyal to the partnership (e.g., allowed to take a salary).
            - **<u>Hypo</u>**: Two people are camping when they hear a bear.
                - Under agency law, the agent would have to sacrifice himself for the benefit of the principal.
                - Under partnership law, some self-interest is okay. So here, one partner could probably tell the other that there is a bear, say good luck, and start running without violating the duty of loyalty.
        - RUPA 409(f): All partners **may** authorize or ratify, after full disclosure of all material facts, a specific act or transaction by a partner that would otherwise violate the duty of loyalty
            - So a partner *can* authorize, but doesn't have to.
            - If the partners do not authorize the transaction, then even though the other partner disclosed all of the material facts, that partner cannot pursue the transaction without violating his duty of loyalty.
    2. Duty of Care
        - RUPA §409(c): Gross negligence, reckless conduct, intentional misconduct, or a knowing violation of law is a violation of duty of care.
            - Obligation to not be wrongfully negligent in carrying on the business.
    3. Information Duties
        - RUPA §408 (<u>not</u> fiduciary duties)
            a. Maintain books and records
            b. Provide access to books and records
            c. Furnish information **unless** not required to exercise rights and unreasonable
                - Information regarding the business, financial conditions, and other circumstances that are material to a partner's exercise of his rights must be furnished without demand (affirmative duty to disclose).
                - Other information concerning the business only needs to be disclosed on demand, assuming the demand is not unreasonable.

III. <u>Ability to Modify Duties under RUPA</u>
    - RUPA §105 -> Allows some, but not complete, modification of duties.
        a. Relations between partners are governed by agreement.
        b. To the extent the partnership agreement does not provide for a matter described in subsection (a), RUPA governs the matter.
        c. A partnership agreement may not:
            - (4) Unreasonably restrict access to books and records as required by RUPA §408 (above).
            - (5) Alter or eliminate the duty of loyalty or duty of care, **except** as otherwise provided in §105(d).
        d. (3) If not **<u>manifestly unreasonable</u>**, the partnership agreement may:
            A. Alter or eliminate the aspects of the duty of loyalty stated in §409(b).
                - No secret profits
                - No dealing in conflicting business
                - No competing
            B. Identify specific types of categories of activities that do not violate the duty of loyalty.
            C. Alter the duty of care, but may not authorize conduct involving bad faith, willful or intentional misconduct, or knowing violation of the law.
                - Can contract to a requirement lower than gross negligence, but not willful misconduct.

e. The court shall decide as a matter of law whether a term of a partnership agreement is **manifestly unreasonable**. The court:
    1. Shall make its determination as of the time the challenged term became part of the partnership agreement and by considering only circumstances existing at the time, and
    2. May invalidate the term only if, in light of the purposes and business of the partnership, it is readily apparent that:
        A. The objective of the term is unreasonable, or
        B. The term is an unreasonable means to achieve the term's objective.

IV. Comparing Duties under UPA and RUPA

- **Duty of Loyalty**
    - Under the UPA
        - Must account for profits from any transaction connected with the partnership (same as RUPA).
        - Note: Must follow the RSA as well --> Unless otherwise agreed, an agent must act solely for the benefit of the principal.
    - Under the RUPA
        - Must account for profits from any transaction connected with the partnership (same as UPA).
        - Note: Adds an additional provision --> **self-interest is NOT dispositive**.
            - UPA relies on the RSA and has the more onerous obligation that agents have to act solely for the benefit of principal. The RUPA softens that obligation by including that self-interest is not dispositive.
- **Duty of Care**
    - Under the UPA
        - Follows the RSA -> Must act with ordinary/standard care.
    - Under the RUPA
        - Gross negligence or worse constitutes a violation of the duty of care.
            - If the standard was "ordinary/standard care," we would have partners suing each other all the time, so the threshold is higher under the RUPA.
            - In this way, the law is stepping back from the role of managing the business, but in other ways, it has become more intrusive. For example, partners now have an affirmative obligation to keep partners informed under the RUPA.
- **Information Duties**
    - Under the UPA
        - UPA §20: Obligation to render information **on demand** (CANNOT CONTRACT AROUND).
        - UPA §22: Each partner has a right to a formal accounting
        - RSA: Unless otherwise agreed, an agent is subject to a duty to give his principal information which is relevant to the affairs entrusted to him (CAN CONTRACT AROUND THIS).
    - Under the RUPA
        - Maintain books and records
        - Provide access to books and records
        - Furnish information unless not required to exercise rights and unreasonable
        - (CANNOT UNREASONABLY RESTRICT THE INFORMATION).

V. Comparing Allowable Modifications of Duties under UPA and RUPA

- Under the UPA
    - Duties under the RSA can be modified.
    - The UPA does not contain a provision to modify UPA §21-§23 (partnership fiduciary duties).
- Under the RUPA
    - May not unreasonably restrict access to books.
    - May not eliminate duty of loyalty or care, but can alter/eliminate aspects of it and specify categories of activities that do not violate it, as long as the modifications are not **manifestly unreasonable.**

- *Meinhard v. Salmon*: Salmon leased a corner lot of land for $200,000 for a 20 year term in order to develop it (1st Lease). Salmon created a joint venture with Meinhard, where Meinhard provided half the money in return for 50% of the profits. Both parties would bear any losses equally. Four months before the lease expired, Salmon negotiated a deal where he would lease the land, including adjacent lots, and continue to develop them (2nd Lease). Salmon did not inform Meinhard about the transaction. When Meinhard found out about the deal, he demanded it be considered an asset of his joint venture with Salmon.
    - **Procedural Posture**
        - Referee – Judgment for Meinhard -> awarded him 25% interest in the 2nd lease

        - Appellate Division – Affirmed, but increased Meinhard's interest to 50%
        - Cardozo solution – Affirmed, so continue to be 50/50 partners, but Salmon gets 1 extra share, since he's managing the lease.
    - **Holding:** "Joint partners owe to one another, while the enterprise continues, the duty of finest loyalty. Not honesty alone, but the punctilio (strict observance) of an honor most sensitive is the standard." The 2nd lease was an opportunity of the joint venture, so Salmon should have told Meinhard about the opportunity, not necessarily so Meinhard could join Salmon in the deal, but so that Meinhard could compete for the deal. Or Salmon could have included Meinhard in the deal.
        - What was the basis of Salmon's defense?
            - Their relationship ends when the lease ends. Salmon's new lease would not start until after the original lease ended, so it's not part of the joint venture.
        - Suppose you represented Salmon. What provision would you include?
            - Each party can independently pursue opportunities that arise out of the joint venture, for they are not property of the joint venture.
            - Define what the parties are co-owners of --> there was some ambiguity in this case. If the co-ownership was more specified, then opportunities not relating to the co-ownership would not have to be disclosed.
        - What would Cardozo think about RUPA §409(e)?
            - RUPA: Self-interest is not dispositive of a violate of duty of loyalty.
            - Cardozo would disagree --> he says all sense of self should be renounced, but he does says that disclosing would have been enough.
        - Would disclosing the opportunity to Meinhard have allowed Salmon to proceed under the RUPA default?
            - Under the RUPA default, disclosing the opportunity is not enough (even though it was enough in Cardozo's opinion in Meinhard).
                - RUPA §409(f) --> Must get every partner to agree if you want to do something that violates the duty of loyalty.
            - To get around this, could sign a "Generic Related Party Waiver."
    - **Sample Partnership Opportunity Waiver**
        - No Person shall be obligated to present any particular investment or other opportunity to the Company or any Partner by virtue of this Agreement even if such investment or other opportunity is of a character that, if presented to such Person, could be taken by such Person. In addition, nothing in this Agreement shall restrict or otherwise prohibit any Person from taking, for its own account or to recommend to others any such particular investment or other opportunity.
    - **Generic Related Party Waiver**
        - Partners Dealing with the Company. Upon receiving the approval of a Majority of the Partners, a Partner shall have the right to contract and otherwise deal with the Company with respect to the sale or lease of real or personal property, the rendition of services, the lending of money, and for other purposes, and to receive compensation, fees, commissions, interest, and other forms of consideration in connection therewith, without being subject to claims for self-dealing or conflict of interest.
- *Meehan v. Shaughnessy*: Meehan and Boyle, were partners at the law firm Parker Coulter (PC). They decided form their own firm and wanted to take some associates with them. PC allowed partners leaving the firm to take clients they brought in, as long as they paid a fee and the client agreed to leave. In preparation of their leaving, Meehan and Boyle started to meet with clients. They used PC letterhead when contracting the clients about following them to their new firm. When asked by another partner at PC, Meehan denied that he was leaving. PC asked for a list of clients that had been contacted so it could inform them they could stay with PC if they wished. Boyle waited several weeks to provide that list. Meanwhile, Meehan and Boyle obtained authorizations from many PC clients, agreeing to become clients of the new firm.
    - **Holding:** Meehan and Boyle cannot compete with the partnership until they leave it, but they are allowed to prepare to compete (common law doesn't want to stifle business). Meehan and Boyle violated their fiduciary duty when they lied and said they were not leaving after being explicitly asked (violation of UPA §20). Additionally, Meehan and Boyle contacted clients in a way that did not fairly give them a chance to stay with PC.
        - **Rule**: Fiduciaries may **plan to compete** with the entity to which they owe allegiance provided that in the course of such arrangements they do not otherwise act in violation of their fiduciary duties.
            - Don't need to inform the firm that you are preparing to compete.
            - Can soliciting clients, but cannot actually start working for them.
            - Can lease office space.
        - **Rule**: When asked, a partner must provide true and complete information of any and all things affecting the partnership.

        - Under UPA, silence is acceptable when it comes to preparing to compete, but on demand, must answer truthfully. (I thought under RSA, there was an affirmative duty to disclose?)
        - Under RUPA, affirmative obligation to inform.
      - When PC found out Meehan and Boyle were leaving the firm, what should they have done?
        - Should have gone after the clients right when they found out (think *Jerry Maguire*) instead of waiting two weeks for the list from Boyle.
      - Did the associates have a duty to inform PC?
        - As an agent, there is an affirmative obligation to inform the principal.
        - The principal is all the partners.
        - Guttentag: Talking to one principal satisfies the affirmative obligation to inform.
      - Note: Firms can explicitly ban soliciting clients privately in partnership agreements.

- **Partnership Roles**

- **Management Role of a Partner**
  - Note: The following provisions are **default** rules and apply, unless otherwise agreed via contract.
  - UPA §9(1): **Every partner** is an agent of the partnership for purposes of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member **binds the partnership**, **unless** the partner so acting has in fact **no authority** to act for the partnership in the particular matter, **and** the **person with whom he is dealing has knowledge** of the fact that he has no such authority (see *NABISCO*).
    - Similar to apparent authority in agency --> In order for a partner's authority to be revoked, the 3rd party with which he is dealing must be given notice of the revocation.
  - UPA §18(b): Every partner can spend partnership money if "reasonably incurred" in "ordinary and proper" conduct of business.
  - UPA §18(e): Partners have "equal rights" to management.
    - In a partnership where one brings in money and one brings management skill, they probably have very different interests and would want to contract around the default of having equal rights.
    - Additionally, a partnership could create an executive committee that has rights other partners do not (like in *Day v. Sidley Austin*).
  - UPA §18(h): Difference in "ordinary matters" decided by the "majority."
    - If there is no majority decision, then the issue remains unresolved, and the partners default to UPA §18(b).
- *NABISCO v. Stroud*: Stroud and Freeman formed a general partnership to sell groceries. The partnership agreement did not limit either partners' authority to conduct ordinary business on behalf of the partnership. Several months before the partnership was dissolved, Stroud told a NABISCO rep that he would not be personally liable for any bread bought by the partnership. Freeman subsequently ordered more bread from NABISCO on behalf of the partnership. Shortly thereafter, the partnership was dissolved, and Stroud refused to pay for the bread delivered at Freeman's behest. NABISCO sued the partnership and Stroud for the price of the bread.
  - **Holding:** Each partner has an equal right in the management and conduct of a partnership, and differences within a partnership are decided by a majority of the partners. However, when there are only two partners there can be no majority, and neither partner can prevent the other from binding the partnership in the ordinary course of business. Freeman's purchase of bread was a binding transaction because he had authority and it was done pursuant to the partnership's ordinary business. Stroud is thus liable for the bread because all partners are jointly liable (Note: Could have contracted around the default rule UPA §18(e) and given Stroud a majority vote to revoke Freeman's authority).
- *Day v. Sidley & Austin*: Day was the senior partner in the Washington D.C. office of Sidley & Austin. S&A's partnership agreement provided that all matters of firm policy would be decided by the executive committee, of which Day was not a member. S&A's executive committee discussed merging S&A with the Lieberman firm. The discussions occurred in multiple meetings over a few months, but Day didn't attend any because they were in Chicago and because S&A told him, "nobody will be worse off" because of the merger. Day voted in favor of the merger and signed the new partnership agreement. After the merger, Day was demoted to co-chairman of the D.C. office and the firm moved to a new office. Day resigned and subsequently filed suit against S&A claiming (1) fraud and (2) breach of fiduciary duty: it wasn't true that "nobody would be worse off" because of the merger, and the firm was secretive about the merger consequences.
  - **Holding:**
    1. Fraud Claim: Court says Day was not deprived on any legal rights, because the executive committee had the right to make changes all along (demotion, office changes, etc.), so Day did not suffer any harm. Also, it was unreasonable to believe there would be no changes.
    2. Breach of Fiduciary Duty Claim: Court said S&A did not have a disclosure obligation because the partnership agreement replaced the default obligation to disclose by allowing the executive committee to

operate without disclosure.

  - Guttentag: Court was too quick to dismiss the fraud claim --> The harm suffered was that Day was denied his contractual right to vote and lobby other partners against the merger. Fraud is a problem here, not because Day ended up as a co-chairman, but because it disempowered his ability to vote and lobby.

E. Termination of a Partnership

1. The Power vs. Right to Dissolve
   - *Owen v. Cohen*
   - *Collins v. Lewis*
   - *Page v. Page*
2. The Consequences of Dissolution
   - *Prentiss v. Sheffel*
   - *Pre-Saver v. Vasso*
3. Sharing Losses
   - *Kovacik v. Reed*

- **Power vs. Right to Dissolution**
  - **<u>Note</u>**: You always have the <u>power</u> but not necessarily the <u>right</u> to dissolve a partnership.

I. <u>Dissolution Under the UPA</u>
   - UPA §29: A partnership is **dissolved** when one of the partners is no longer "carrying on."
   - UPA §31: Dissolution is <u>caused</u>:
     1. **Without violation** by:
        i. Termination of the definite term or particular undertaking specified in agreement,
        ii. The express will of any partner when no definite term or particular undertaking is specified,
        iii. Expulsion of any partner from the business in accordance with powers conferred by the agreement between the partners.
     2. **With Violation:** Where the circumstances do not permit dissolution under any other provision.
     3. By **Decree of Court**
        - UPA §32: On application by a partner, the court shall decree a dissolution whenever:
          i. A partner has been **declared a lunatic** in any judicial proceeding or is shown to be of unsound mind;
          ii. A partner becomes in any other way **incapable** of performing his part of the partnership conduct;
          iii. A partner so conducts himself in matters relating to the partnership business that it is **not reasonably practicable** to carry on the business in partnership with him;
          iv. The business of the partnership can only be **carried on at a loss.**
   - **Three things can happen after dissolution:**
     1. Sale of Assets/Business (Winding Up) (default rule)
        - UPA §30: On dissolution the partnership is not terminated, but continues until the "winding up" period is completed.
        - "Winding Up" = assets are put up for sale
     2. Continuation Following Wrongful Dissolution
        - UPA §38(2): If a partner leaves without the right, the remaining partner(s) are allowed to continue carrying on in the business.
     3. Continuation Per Agreement
        - You can agree to continue the partnership after a partner has left.
        - E.g., When a partner leaves a law firm, the remaining partners agree to make a new firm consisting of the remaining partners.

II. <u>Dissolution Under the RUPA</u>
   - RUPA §601: A partner is **disassociated** from a partnership upon occurrence of any of the following events:
     1. The partner's express will
     2. An event agreed on in the partnership agreement
     3. The partner's expulsion pursuant to the partnership agreement
     - **<u>Note</u>**: Under the RUPA, a partner's "disassociation" does not constitute a "dissolution" of the partnership (see RUPA §801).
   - RUPA §801: A partnership is **dissolved** and its business must be "wound up" upon the occurrence of the following events:

1. In a partnership at will, the partnership has notice of a partner's express will to withdraw
2. An event agreed on in the partnership agreement

III. <u>Comparing the UPA and RUPA</u>
   - <u>Terminology</u>: Dissolution v. Disassociation (UPA § 29 vs. RUPA § 601)
     - Under the RUPA, if there is a <u>continuation following wrongful dissolution</u> or <u>continuation per agreement</u>, the statute calls that disassociation (a partner disassociates from the partnership).
     - Dissolution only occurs when the assets are sold (winding up).
   - <u>Goodwill</u>: An intangible balance-sheet asset --> the company's excellent reputation, its brand names, or its patents, all of which have real value
     - Goodwill is not deducted after wrongful dissolution in RUPA.

- *Owen v. Cohen*: Owen and Cohen entered into an oral agreement to become partners of a bowling alley. Owen made a $7,000 loan to start the business with the understanding that he would be reimbursed via business profits. They began disagreeing over business matters. Owen wanted to make sure he had both the power and the right to dissolve the partnership, but he was worried about an implicit term -> the partnership agreement implied a term for as long as reasonably expected to repay Owen.
  - UPA § 40(b): **Repayment is in the following order:**
    1. The claims of the firm's creditors are paid, other than partners
    2. Claims of a partner other than those for capital and profits
       - A loan is not a capital investment.
    3. Those owing to partners in respect of capital
    4. Those owing to partners in respect of profits
  - **Holding:** The court gave Owen the right to dissolve because he and Cohen weren't getting along and this hurt their business, making it impracticable for the partnership to continue.
    - The assets were put up for auction (eBay Rule). Owen bid $7k for the bowling alley and won.
    - Because he had both the power and right to dissolve, he was paid out for his loan (Category 2) before he and Cohen had to split anything for their respective capital investments into the bowling alley or profits (Categories 3 and 4).
- *Collins v. Lewis*: Collins and Lewis each owned a 50% interest in a partnership formed to open and operate a cafeteria. Their partnership agreement provided that Collins would provide funds to build the cafeteria, while Lewis would oversee the construction of the cafeteria and manage it. Lewis guaranteed repayment to Collins at a minimum rate of $30k plus interest the first year, and $60k plus interest annually thereafter until it was repaid. Lewis's initial estimate of the cost to build the cafeteria was $300k, but after delays, the cost was actually $697k. Collins sought to dissolve the partnership. Lewis accused Collins of interfering with the management of the business when Collins started pressuring him about the profitability of the cafeteria.
  - **Holding**: The court would not dissolve the partnership per Collins' request because, while Lewis met all of his obligations, Collins himself did not. Collins was supposed to furnish all up front costs, but he only furnished $636k while the cost of opening the cafeteria was $697k. Therefore, Lewis effectively met his obligation to pay back Collins $30k + interest in the first year by paying for the remaining upfront costs of opening the business, and Collins failed to meet his obligation to furnish all up front costs. Since Collins had not fully performed his obligations, he may not obtain an order to dissolve the partnership.
- *Page v. Page*: Two brothers entered into an oral partnership agreement to run a linen supply business. Each brother put in $43Kk. They did not discuss a specific term for the partnership, but agreed that the partnership should stay in existence long enough to make a profit and pay its debts. The partnership was unprofitable for eight years. P's corporation lent the partnership $47k and had a demand note saying that he could demand payment at any time. The company turned profitable after an air force based opened up nearby, but P sought to dissolve the partnership.
  - **Holding**: The court found that the partnership was at will and could be ended at any time by either brother. The partnership was not for a specified term, and the brothers' respective $43k investments did not create a term (their investments were <u>not</u> considered a loan, like in *Owen*). They didn't each put in the $43k with the understanding that they would each get repaid, but rather, they would just share the profits (compare to *Owen*, where there was a loan, which created a term for as long as reasonably expected to repay the loan). The $47k loan made by P's company did not create a term because it was (1) made by an outside entity, not a partner, and because (2) it was payable on demand. Accordingly, P had both the power and the right to dissolve the partnership.
    - **Debt:** Funds borrowed by the firm --> *Owens v. Cohen* involved debt because repayment was expected.
    - **Equity:** Funds invested in the firm --> *Page v. Page* involved equity because repayment was <u>not</u> expected.

- **The Consequences of Dissolution**

I. <u>Dissolution With Power and Right</u>

- *Prentiss v. Sheffel* : Prentiss, Sheffel, and Iger entered into a partnership to develop a shopping center, but never had a written agreement. Prentiss had a 15% interest in the partnership and the other two had 42.5%. Prentiss was not paying his share of the business, and therefore no longer "carrying on," so Sheffel and Iger subsequently excluded Prentiss from all management duties and sought dissolution of the partnership and sale of assets, alleging that Prentiss had been derelict in his duties. Trial court found the partnership dissolved by freeze out, no bad faith, appointed a receiver, and ordered sale of the property. Sheffel and Iger bid and won for $2.25 million, and that amount was distributed among the partners based on their shares (and they got rid of Prentiss). Prentiss appealed, arguing that Sheffel and Iger should not have been able to buy the property.
    - **Holding**: Partners may dissolve a partnership-at-will by excluding another partner from management duties, as long as they act in good faith. Any partner acting in good faith may then bid for the assets. Also, Prentiss was not disadvantaged by Sheffel and Iger's participation in the asset sale. He actually benefited because his 15% of the profits increased in value when Sheffel and Iger competed with other bidders, upping the final sale price (Guttentag: Prentiss wouldn't have brought the suit if he thought he was benefitting).
        - Why continue to inform a minority partner?
            - As to not be acting in bad faith (cannot violate the fiduciary duty of information while still partners).

II. <u>Dissolution Without Right</u>

- UPA §38(2): When dissolution is caused wrongfully, the remaining <u>non-breaching partners</u>:
    a. Have right to damages for breach of the agreement
    b. May continue the business if they choose
    c. <u>Partner who caused wrongful dissolution</u> gets:
        - If business terminated, remaining cash less damages.
        - If business continues, the continuing partners do owe the partner who left some money, but when it comes to valuating the business, goodwill is not included (so look to value of the scissors, stools, etc. only, and not at reputation), and also deduct damages they caused.
            - This goodwill exclusion only applies if the non-breaching partner <u>continues the business</u>.
            - <u>Note</u>: Under RUPA §701(b) goodwill <u>is</u> included in the value of the business.
- *Pav Saver v. Vasso*: Pav Saver had technology for paving roads, and Vasso had money to finance the scaling and production of the invention, so they formed a partnership. Pav Saver contributed the patent/licenses, and Vasso contributed the money. Their partnership agreement said that upon expiration of the partnership, the patents would be returned to Pav Saver. The partnership was expected to be permanent, but if terminated, the terminating partner owed the other liquidated damages. They started to disagree, so Pav Saver got a lawyer, who wrote a letter to Vasso saying that Pav Saver wanted to end the partnership. Vasso received the letter and decided to exercise its statutory right to continue the business after Pav Saver's wrongful disassociation. Vasso claimed it was entitled to liquidated damages and the patents because, without them, it couldn't exercise the right to continue the business under UPA §38(2)(b).
    - **Holding**: Because the agreement said the partnership shall be permanent unless upon mutual termination, Pav Saver wrongfully terminated the partnership. Because the UPA gives Vasso the right to continue the business, and because the patents are essential to that business, statutory law overrides the partnership agreement. Since the business is continuing, Pav Saver gets the value of its interest in the business (excluding goodwill --> i.e., the patent), minus damages. The court found the value of the partnership, not including goodwill, was $330k, so Pav Saver was entitled to half of that as the wrongfully terminating party. But Pav Saver also owed liquidated damages of $385k to Vasso.
        - What argument can you offer that the majority decision is incorrect?
            - The intent of the partnership agreement was that the patents would go back to Pav Saver and the leaving party would pay liquidated damages; there was no intent for the partnership to continue on after one partner left.
                - They could have contracted around UPA §38(2), but here, the contract was ambiguous.
        - Would the Pav-Saver remedy be different under the RUPA provisions?
            - RUPA does <u>not</u> deduct goodwill; therefore, the value of the patents would be included in the business valuation, and Pav Saver would have received half of the higher valuation.
            - <u>Note</u>: UPA is more punitive by deducting goodwill.
        - How important is the language in the partnership agreement about forming a permanent partnership?
            - If it weren't for this express term, when Pav Saver sent the letter, it would have had both the power and the right, and Vasso would not have been able to continue to business.
            - Pav Saver should have sought judicial dissolution to avoid wrongfully terminating.

- **Sharing Losses**

- UPA §40(b): Unless otherwise agreed, upon dissolution, partnership assets should be distributed as follows:
  1. Those owing to creditors other than partners.
  2. Those owing to partners other than for capital and profits.
  3. Those owing to partners in respect of capital.
  4. Those owing to partners in respect of profits.
  - Note: In the absence of an agreement, partners split 50/50 (default treats partners equally).
- UPA §18(a): The rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them, by the following rules:
  - Each partner shall be repaid his contribution and share equally in the profits and surplus remaining, after all liabilities (including those to partners) are satisfied; and must contribute towards the losses, whether capital or otherwise, sustained by the partnership according to his share of the profits.
    - Default rule is that partners contribute equally to the losses.
    - Otherwise, they contribute in proportion to the share in profits as per agreement.
- UPA §40(d): Partners shall contribute as provided by §18(a) the amount necessary to satisfy the liability set forth in §40(b).
- **Hypo:** Homer and Bill Gates enter into a partnership to sell beer. Homer earns a salary of $40 and Bill invests $100. Mo sells beer to the company for $30. Homer and Bill agree to split profits 50/50. If they dissolve the business after a year and sell the assets, how will the proceeds be split?
  - If they sell the business for $300:
    - First, repay Mo $30 under §40(b)(1) – those owing to creditors other than partners.
    - Second, pay Homer's $40 salary under §40(b)(2) – those owing to partners other than for capital and profits.
    - Third, Bill gets his $100 of capital under §40(b)(3) – those owing to partners in respect of capital and profits.
    - Fourth, profit is then $130 to be split 50/50 between Homer and Bill – each get $65 from final profits under §40(b)(4) – those owing to partners in respect of profits.
  - If the business only sold for $150:
    - After Mo and Homer are paid, Bill only gets $80 of his $100 investment. The $20 shortfall is then split between Homer and Bill, so Homer must pay Bill $10.
- *Kovacik v. Reed*: Kovacik and Reed entered into a partnership to remodel kitchens. Kovacik contributed $10k investment. Reed contributed labor and skill, acting as an estimator and superintendent of the projects without compensation. They agreed to a 50/50 profit share, but didn't discuss sharing losses. The company lost $8,680. Kovacik asked Reed to help pay for the losses, but he refused to contribute, so Kovacik filed suit to dissolve.
  - **Holding**: Generally, when there is no explicit agreement as to losses, losses are to be divided equally between the partners (UPA §18), without regard to the amount each partner contributed to the venture. The court decided, however, that UPA §18 only applies in cases where each partner contributed capital to the enterprise. Here, because Reed did not contribute any capital, he is not liable for any losses sustained by the partnership.
    - The justification is that the person who contributed labor essentially takes a loss because they are not paid for their time and effort. If Reed also had to pay for half of the losses, he would be hurt twice.
      - Under UPA §18, Reed is out 10 months of labor + $4,340, and Kovacik is out $4,340.
      - Under the *Kovacik* ruling, Reed is out 10 months of labor and Kovacik is out $8,680.
        - This is the payoff structure of an option, which is a different payoff structure from ownership.
        - Reed has an option on the partnership interest --> only benefits, because he can't lose money.

    - Guttentag: The value of Reed's share depends on what the business is worth, not the true value of his labor. We don't know what the decision would have been if Reed contributed a nominal amount. If one partner doesn't need to share in the losses, that partner who has nothing to lose is incentivized to show up and work hard. *Kovacik* is still precedent in CA, so need to analyze under UPA §18 and *Kovacik* on the exam.

III. Corporations

A. Overview

- Association that dominates the economy; requires formal creation under state auspices.
- A legal "person" possessing the following:
  1. Separation of ownership and control

2. Limited liability for owners
3. Criminal liability
4. Constitutional free speech right

- Why create a partnership?
    1. Ability to accumulate capital from many sources
    2. More permanent ownership of assets
    3. Able to handle larger size tasks

- **Sources of Corporate Law**

I. Individual State Law
    - **Internal Affairs Doctrine**: A corporation's internal affairs will be determined by the state in which it is formed.
    i. Model Business Corporations Act ("MBCA")
    ii. Delaware General Corporation Law ("DGCL")
        - More than 850,000 companies are incorporated in Delaware including:
            - 60% of Fortune 500 corps.
            - 50% of the companies listed on the New York Stock Exchange
        - Why?
            - Race to the bottom
                - Argument that Delaware is a state that corps. choose because it's good for business and bad for people; Delaware gives corps. the best ability to be evil.
                - William L. Cary, Federalism and Corporate Law: Reflections on Delaware, 83 Yale L. J. 663 (1974).
            - Race to the top
                - Delaware is succeeding because it's creating shareholder value; Delaware is good for corps. and good for America (efficient).
                - Ralph K. Winter, State Law, Shareholder Protection and the Theory of Incorporation, 6 J. Leg. Stud 251 (1977).

II. Federal Law
    i. Securities and Exchange Acts ('33, '34)
        - Stemmed from the stock market crash in 1929 / Great Depression --> FDR's first 100 days, started regulating corps by regulating stock markets and exchanges.
        - Prohibition against insider trading is an outgrowth of the first two acts.
    ii. Sarbanes Oxley Act of 2002
        - Stemmed from ENRON.
    iii. Dodd Frank Act of 2010
        - Stemmed from Great Recession 2008.
    iv. JOBS Act of 2012
        - Primarily covers "public" corporations.

- **Critical Attributes of a Corporation**

1. **Legal personality**
    - The corporation is an entity with a separate legal existence from its owners.
    - Possesses (some) constitutional rights:
        - Free speech (*Citizens United*)
        - But no personal privacy (*FCC v. ATT*)
    - Separate taxpayer
    - More stable than a partnership --> the legal identity of a corp. gives it more permanence, while a partnership can dissolve easily.
2. **Limited Liability**
    - MBCA §6.22(b): Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation, except that he may become personally liable by reason of his own acts or conduct.
        - Inconsistent with economic theory in tort law --> people should be liable for the harms their activities cause.
        - Shareholders can only lose the amount of money they put in.
        - Intended to enable and encourage large business

3. Separation of ownership and control
    - MBCA §8.01(b): All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors.
        - Every corp. is managed by a board of directors (not by the individual owners).
        - Allows a centralized group to make decisions instead of having to gather all of the shareholders.
        - Allows shareholders to easily switch in and out without impacting the corporation's operations.
    - Shareholders vote for directors, and directors are responsible for running the company
    - Note: Directors are neither agents nor shareholders of the corporations; they are **principals** of the corporation.
    - Note: Shareholders are not agents.
4. Formal Capital Structure
    - Capital Structure
        - The debts, securities, and equity together constitute the firm's capital structure.
        - Corps. have formalized the relationship between the people bringing the investments and the people managing the business.
            - If put money into a corp., get a security or stock certificate.
            - Creates an easier way to raise money, since people get something predictable.
    - **What is a share of stock worth?**
        - **Step 1:** Determine the firms **total** value.
            - Two ways to determine the value of assets:
                1. Liquidation value
                2. Value of future cash flows
        - **Step 2:** Determine the firm's **equity** value.
            - Subtract obligations (liabilities/debts) from the value of the firm.
        - **Step 3:** Calculate equity value **per share.**
            - Divide the firm's equity value by the number of shares outstanding.
5. Liquidity
    - Due to a corporation's characteristics, ownership can be easily traded on secondary trading markets (NYSE, NASDAQ, etc.).
    - They trade actual shares in ownership.

- **Unincorporated Limited Liability Entities (5)**

- Five Types of "Unincorporated" Limited Liability Entities
    1. Limited Liability Partnerships (LLP)
    2. Limited Partnerships (LP)
    3. Limited Liability Limited Partnerships (LLLP)
    4. Limited Liability Company (LLC)
    5. S Corporation
- Somewhere between a partnership and a corporations.
- Generally, the trade-off with these unincorporated limited liability entities is that there is not the kind of formal capital structure you would have in a normal corporation, but they create some tax benefits and limit liability.
    - Do not have the kind of liquidity of a corporation --> can't buy and sell for the most part; no well-defined return for shareholders.
    - Better for small business that look like partnerships, but with the added benefit of limited liability.
    - Pass through means the entity does not pay taxes, only the individual that receives profits.

Attributes	**General Partnership**	**Corporation**	**Unincorporated Limited Liability Entity**
Limited Liability	None	Yes	Some
Formation	Informal	Formalities Required	Formalities Required
Tax Treatment	"Pass-through" (no taxes on actual partnership since	"Double Taxation" (unlike a partnership, a corporation is a legal person/entity therefore has to pay taxes - on top	"Pass Through" (benefit of limited liability without double taxes)

	not a legal person)	of that, individual shareholders are taxed as well on the dividends)	

1. **Limited Liability Partnerships (LLP)**
    - General partnership with limited partner liability (RUPA §306(c)).
        - No liability for remote harms caused by partner.
    - Formed by filing a "statement of qualification" with the secretary of state.
        - General partnership can convert to LLP by filing.
    - Not all partners have limited liability.
        - Partner that is responsible for the conduct causing harm has liability (this is the distinction between LLC, where no partners have liability).
    - States won't allow law firms or architecture firms to be LLCs --> can't get that kind of liability protection (so most are LLPs).
2. **Limited partnerships (LPs)**
    - General and limited partner(s)
        - General partners have full personal liability.
        - Usually, limited partners have no control and limited liability --> only limited partners who participate in control can be held liable.
        - Consider *Meinhard v. Salmon* where one money partner and one managing partner --> limited partner would be money partner.
            - Limited partner gets limited liability and tax benefits.
            - General partner just gets tax benefit.
    - Formed by filing documents (usually with Secretary of State).
    - Corporation can act as a general partner.
    - Popular in oil and gas industry because a lot of the drilling and wells will fail and business will lose money. Partners want to be able to recognize the loss directly from the business --> fact that there isn't a separate tax-paying entity is important.
3. **Limited liability limited partnerships (LLLP)**
    - Limited partnership in which general partners get limited liability.
    - More protection to partners than an LLP.
4. **Limited liability company (LLC)**
    - LLC introduced in Wyoming in 1977.
    - In 1988, IRS ruled LLC could qualify for partnership-like tax treatment.
    - Two types of LLCs:
        1. Member managed = All members are managers.
        2. Manager managed = Some owners are not managers and have no right to vote.
    - Formed by filing with State.
    - Allows you to manage the business and invest with no liability --> full benefit of forming a corporation in terms of limited liability.
        - Could put in money and be involved and not risk liability beyond the amount you invested.
        - AND, the LLC still isn't a separate tax-paying entity --> has tax structure like a partnership.
        - Still no formal capital structure, so not easy to buy and sell, but ideal vehicle for small business.
    - Varies by state if treated more like corporation or partnership, but generally treated more like a partnership.
        - Default rules you can contract around.
        - Complicated part is that there has to be an agreement.
            - Whereas corporation has ready-made corporate structure you can step into.
    - Flexibility: Like partnership, most aspects of management and sharing dictated by the LLC's operating agreement.
    - Limitations on capital structure complexity and share transferability.
    - Unfavorable state franchise taxes in some states.
5. **S corporation**
    - Creation of tax code (actually a corporation).
    - Advantages: Pass-through taxation and limited liability.
    - Disadvantages: Constraints on the number of shareholders, source of corporate income, types of shareholders (one class only), deductions on pass-through losses.
    - Can't go public (only corporations can go public, generally speaking).

B. Formation of a Corporation

1. **Pick a State:** Can pick any state to be incorporated in regardless of where you do your business; governed by that state's laws.
2. **Draft Foundational Documents**
   A. **Articles of Incorporation**
      - Articles of Incorporation = Certificate of incorporation = Corporate Charter.
      - Must include: Name, number of shares, address, people incorporating the firm – MCBA §2.02(a)
      - May include: Initial directors, management, limits on rights, liability on a shareholder – MCBA §2.02(b)
         - Advantage of including the "may" factors is that you have a lot of flexibility when writing articles of incorporation, but it's hard to change it later because you need votes of the board members, so better to put it all in the beginning.
      - DGCL §102(a) and (b)

   B. **Bylaws**
      - Easier to change than the Articles of Incorporation.
      - Must Include: (In Delaware) the purpose of the corporation.
      - May include: Provision for managing the business and regulating the affairs of the corporation – MBCA § 2.06(b)
         - DGCL §109(b)
3. **File Articles and By-Laws with Secretary of State** – MBCA §2.03
4. **Have Organizational Meeting**
   - Finalize directors – MBCA §2.05
   - Appoint officers – MBCA §2.05
   - Adopt by-laws – MBCA §2.06

C. Liability to Third Parties

- One of the issues of limited liability is that it allows businesses to avoid the costs of their activities.
- Members of a Corporation:
   - **Shareholders** (own the firm by holding equity; vote for the board of directors).
      - MBCA § 6.22(b): A shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.
         - Shareholders' losses are limited to the amount the shareholder has invested in the firm.
         - It is the corporation that incurs the debt or commits the tort (legal person).
         - "**Piercing the Corporate Veil"** Doctrine
            - Limited liability protection goes away.
            - Often something to plead in a case if shareholders have the deep pockets.
         - To protect yourself as a shareholder and avoid piercing the corporate veil, must:
            - Respect formalities,
            - Have annual meetings and keep records of those meetings,
            - Set up separate bank accounts so no comingling off funds.
   - **Creditors**
      - Are owed money by the firm.
   - **Board of Directors**
      - Controls the firm.
      - Appoints company officers to manage the firm.
   - **Officers**
      - Manage the firm.

- **Piercing the Corporate Veil**

- Piercing the Corporate Veil Test
   1. **Unity of Interest (factors)**
      - Lack of corporate formalities
         - Keep a book of records, hold regular board of director meetings, document those meetings, and record minutes for the meetings.
      - Comingling of funds and assets
         - Have separate bank accounts for yourself and each entity.
      - Severe under-capitalization

                • Capitalization relates to capital structure -> under capitalization means there is not enough money left in the firm to run the business.
            ▪ Treating corporate assets as one's own
    2. **Refusing to allow for piercing of the corporate veil would:**
        a. Sanction fraud, and/or
        b. Promote injustice.

- *Walkovszky v. Carlton*: Walkovszky was hit by a cab owned by Carlton's corporation. Walkovszky tried to pierce the corporate veil to sue Carlton directly. Carlton owned 10 corporations, and each corporation had 2 cabs. He specifically structured it this way to limit his liability (at worst he would lose the 2 cabs of a single corporation, but they couldn't go after the other 18 cabs). This structure also allowed Carlton to take out the minimum amount of insurance on each cab. At the end of every night, Carlton took the money from the day out of the business.
    - **Holding:** There was no evidence that Carlton was using the cab companies as shells. He kept the cab companies undercapitalized by taking out a dividend every night, but this is not illegal, nor does it constitute comingling of funds. It would be comingling if all of the entities funneled into Carlton's personal bank account, if all the sister corporations used a joint bank account, or if he used money from one to cover expenses from another. The fact that Walkovszky was unable to fully recover from the small corporation was not a good enough reason to pierce the corporate veil and get to Carlton--> if this was allowed then any time a corporation didn't have the money to cover damages, the shareholders would be liable. Carlton, as a shareholder, does not have liability because he respected the formalities necessary to prevent piercing the corporate veil.
        - <u>Note</u>: **Enterprise liability** (all the sister corporations being jointly liable) is different from piercing the corporate veil. In order to pierce the corporate veil to recover from a shareholder, the plaintiff must show Carlton was doing business in an individual capacity (e.g., shuttling personal funds in and out of the corporation). Enterprise theory allows a plaintiff to go after the sister companies to get more money. To do this, plaintiff must show Carlton did not respect the separate identities of the corporations by co-mingling back accounts.
- *Sea-Land Services, Inc. v. Pepper Source*: Sea-Land shipped peppers for Pepper Source. Pepper Source then stiffed Sea-Land on the shipping costs. Sea-Land sued Pepper Source to recover the shipping payment, but it had dissolved for failing to pay taxes. Therefore, Sea-Land wanted to pierce the corporate veil to go after Marchese's (owner) other businesses for payment. Marchese owned five other business entities and ran all of the companies out of a single office. The companies shared expense accounts and lent funds to each other, as well as regularly lending money to Marchese for his personal expenses. None of these companies had internal governing documents such as bylaws.
    - **Holding:** On remand, the court found that both prongs of piercing the corporate veil test were satisfied. Marchese's firms (1) lacked formalities (bylaws, articles of incorporations, or minutes from regular board meetings), comingled funds, and were undercapitalized (Marchese often withdrew money from Pepper Source) and (2) refusing to pierce the corporate veil would sanction fraud.
- **Reverse Piercing**
    - Very hard to do.
    - Says that if someone is a shareholder of a corporation, you can have access to the assets of the corporations of the other corporations that the shareholder owns.
    - Same test as piercing the corporate veil --> Must prove (1) unity of interest between the corporation and the shareholders and (2)unity of interest between the shareholder and other corporations (not necessarily sister corps).
- **Enterprise Liability**
    - When you hold sister corporations jointly liable because they comingled their funds.
    - For enterprise liability, you have to prove they are part of the same enterprise.
- <u>Difference between Enterprise Liability and Reverse Piercing</u>
    - Enterprise liability doesn't allow access to the shareholder's personal assets.
    - Enterprise liability only requires comingling of funds, and not the second prong needed for piercing the corporate veil.
- <u>Limited Liability with Defective Formation</u>
    - Doctrine that protects shareholders of a corp. with the benefits of limited liability, even if failed to comply with all the requirements of a formation.
    - In order to qualify for de facto, can only mess up a little. For incorporation by estoppel, can mess up a lot, and still be protected.
    - **De Facto Incorporation:** Treat improperly-incorporated entity as a corporation if the organizers:
        1. Tried to incorporate in good faith,
        2. Had a legal right to do so, and
        3. Acted as if a corporation.
        - E.g., Know you have to mail something to Secretary of State to file for incorporation, but you mail something to Rex Tillerson, the U.S. Secretary of State, and it was supposed to go to Alex Padilla, CA

Secretary of State, and then you went to CA website and you thought you had been successful, but you weren't.

- **Incorporation by Estoppel**: Treat as proper corporation if person dealing with the firm
  1. Thought the firm was a corporation and
  2. A windfall to the other party would result if allowed to argue that firm was not a corporation.
     - I.e., Party on the other side of the transaction is taking advantage of the fact that you are not properly incorporated. They would be estopped from imposing personal liability against you.

C. Roles and Duties in a Corporation

- **Roles and Duties with Respect to Creditors**

- Creditors**:** People who loan capital to a firm.
- Governed by contract law.
- Legal analysis turns on:
  - Interpretation of express terms and
  - The implied duty of good faith and fair dealing.
- No fiduciary duty to debt-holders.

	Duties	*Roles*
 Board of Directors	Fiduciary Duties (Case law and MBCA § 8.30 - 31)	Manage business (DGCL § 141(a), MBCA § 8.01(b))
 Shareholders	None Unless controlling	Vote, Sue, Sell

1. Duties

- **Director Duties**

I. Director's General Fiduciary Duties
- Two competing theories about who directors have obligations to:
  a. Stakeholder Theory:
     - Directors' obligation is to take care of the constituencies that make up the firm (community, employees, shareholders, officers, and clients/customers).
  b. Shareholder Primacy:
     - Directors' fiduciary duties are owed solely and exclusively to shareholders.
       - They're the owners, invested money, and voted for the board members.
     - Sometimes decisions that benefit other stakeholders also benefit the shareholders.
       - Even though it costs money, Starbucks gives employees free online college. As long as Starbucks claims this is done to make the company and shareholders better off, its allowed.
       - Some state statutes incorporate stakeholder theory ideas --> Hershey was offered a bunch of money to move out of PA. PA rewrote a statute about what is in the best interest of shareholders so Hershey could stay in PA, which saved jobs.
     - Exception: **Benefit corporations** can put a provision in their Certificate of Incorporation that says the corp. is not just going to take care of our shareholders; commit to serve another constituency.
- *Dodge v. Ford Motor Co.*: Ford sold his first car for $900, but as profits increased, he kept reducing the price. As the company kept doing well, Ford paid special dividends in addition to regular dividends. Ford owned 58% of the company, and the Dodge Bros. owned 10%. Ford wanted to stop paying the special dividends to keep the Dodge Bros. from using that money to start a competing car company. Ford also wanted to make a new giant factory to manufacture cars. The Dodge Bros. demanded Ford pay the special dividends, or buy them out for $35M. The Dodge Bros. sue Ford, claiming (1) Ford has to start paying special dividends again because its keeping too much cash on hand, and (2) it's crazy to build the giant factory, and its just a way to spend money in order to not pay the special dividend.

        - **Holding**: Ford has to pay the special dividend, but can build the factory. In Ford's testimony, he suggested his goal was not to maximize profits for shareholders. He said he cared about the workers and the customers. Court said his role as director is just to answer to the shareholders. The factory, however, was a business decision and therefore not scrutinized by the court.
    - Who is bound by fiduciary duties?
        - Traditional theory is that <u>board of directors</u> are the people bound by fiduciary duties.
            - Two exceptions:
                - Delaware cases suggests certain <u>officers</u> may have fiduciary duties.
                - If you are a <u>large shareholder</u>, may have fiduciary obligations to the other shareholders (very rare).

II. <u>Director's Duty of Care</u>
    - **Overview:**
        - Actions taken by the board of directors mostly covered by Business Judgment Rule:
            - *Kamin v. American Express*
            - Unless not acting in shareholders' best interest
                - *Dodge v. Ford*
            - Or information gathering process is flawed
                - *Smith v. Van Gorkom*
        - Inaction of a Director is not covered by Business Judgment Rule:
            - *Francis v. United Jersey*
            - The law encourages you to make decisions.
    - MBCA § 8.30: **Standard of Conduct**
        a. Each member of the board of directions, when discharging the duties of a director, shall act:
            1. In good faith and
            2. In a manner the director reasonably believes to be in the best interests of the corporation.
        b. When becoming informed or devoting attention, use standard of care a person in a similar position would reasonably believe is appropriate.
        c. Directors shall disclose material information.
    - MBCA § 8.31: **Duty of Care Liability**
        - Director may be found liable if:
            - Corporate charter indemnification or cleansing does not preclude liability; and
            - Director did not act in good faith, or
            - Director did not believe he was acting in the best interest of the corporation, or
            - Director was not informed, or
            - A lack of objectivity due to Director's lack of independence
            - Director failed to devote ongoing attention to oversight, or devote timely attention when particular facts arise.
    - <u>Note</u>: Standard of conduct is aspirational while breaching duty of care results in legal trouble.
    - **Business Judgement Rule (Delaware)**
        - A court will defer to the Board of Director's business judgment <u>unless</u> their actions:
            1. Are not in the honest belief that action is in the <u>best interests of the corporation</u>, or
            2. Are not based on an <u>informed investigation</u>, or
            3. Involve a <u>conflict of interest.</u>
        - Rationale for Business Judgment Rule:
            - Shareholders can elect new directors (if not happy, vote for someone else).
            - Competition will result in poorly managed firms failing (let capitalism run its course).
            - Do not want to discourage risk taking.
            - Business decisions are not for the court to decide.
    - *Kamin v. American Express*: AmEx purchased 2 million shares of stock in another company, DLJ, for $30m ($15/share). AmEx decided to distribute the stocks as dividends. Kamin, an AmEx shareholder, said the company would have been better off selling the shares on the open market since the value of the share had decreased from $30m to $4m. Thus, if AmEx sold the stocks, they could record a $26m loss to offset their future taxable gains. The value of the tax savings would have been about $8m.
        - **Holding:** The Board's decision should be evaluated to see if there was a breach of the Duty of Care. The Board had a special meeting to decide what to do with the DLJ stock and understood the potential tax benefit, but decided to give the stock as a dividend anyway. Therefore, no bad faith, and the decision was informed. Stock is valued on reported income, and taking the loss would subtract from AmEx's income, and the Board wanted to avoid that. Also, the loss would impact P/E because it's reflected on AmEx's earnings.

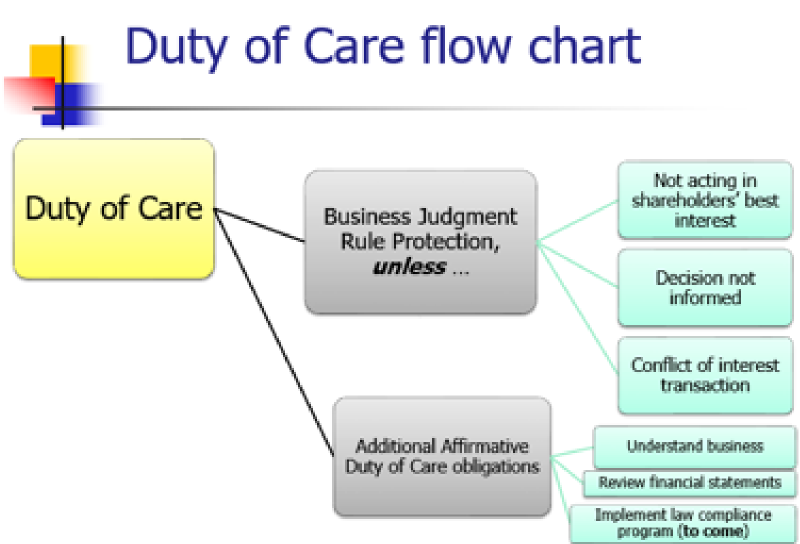
            - AmEx's reasoning was suspect --> Loss was already reflected in AmEx's stock price per ECMH, since people already saw that DLJ went way down and knew AmEx had bought before the drop.
            - Duty of Loyalty claim? --> 4 board members had their compensation tied to reported earnings (giving out the DLJ shares allowed them to avoid reporting the loss and reducing their bonuses). But this claim fails because there were 16 other directors who weren't compensated this way and still decided to distribute the DLJ stock as dividends.
            - How should employee compensation contracts be drafted?
                - Tied to stock prices and not financial statements.
                - Stock will go up when people believe the company is more valuable.
                - This better motivates directors to act in the best interest of shareholders.
    - *Smith v. Van Gorkom*: Van Gorkom, CEO of Trans Union, engaged in his own negotiations with a third party (Ptitzker) for a leveraged buyout of the company. Van Gorkom determined the value of Trans Union to be $55 per share, but there is no evidence showing how Van Gorkom came up with this (Trans Union's market price at the time was $38 per share). Board of Directors ultimately approved the buyout. It made its decision based mostly on an oral presentation by Van Gorkom. The meeting lasted two hours and the board did not have an opportunity to review the merger agreement before/during the meeting. Van Gorkom then signed the agreement at the opera without reading it or having an attorney look it over. After this approval, shareholders were mad. Van Gorkom and Pritzker agreed to some revisions to allow for a market bidding period to see if $55 was the best price. Van Gorkom signed the amended deal without reading it. The shareholders also approved the amended deal with 70% approval. Smith, a shareholder, brought suit against Van Gorkom and the board, alleging that their decision was uninformed.
        - **Holding**: The Trans Union board did not make an informed business decision in voting to approve the buyout. The directors did not adequately inquire into Van Gorkom's role and motives behind bringing about the transaction, including where the $55 per share came from. As a result, the plaintiffs are entitled to the fair value of their shares that were sold in the merger, which is to be based on the intrinsic value of Trans Union.
            - Did Board's subsequent action cure?
                - Agreements board signed to open up for further bid actually prevented people from bidding.
                    - They never read the actual agreement before signing
            - Did the shareholder vote cure?
                - Usually a shareholder say vote will cure.
                    - Not here, because information shareholders were voting on was incorrect, so vote doesn't count.
                    - Didn't know how Van Gorkom set the price.
            - Party attacking the board's decision has the burden of proof.
                - What must be proved? – gross negligence
                - Directors rarely lose on these grounds
            - What was the dissent's argument?
                - The directors are experienced businessmen, and they likely know the inner workings of the company without having to hire an investment banker to run the numbers and tell them information they already know.
            - Aftermath
                - Lots of competitors filed for bankruptcy.
                - Implication is that the buyout was a good move; the directors sold a pile of trash (the industry was going down).
                - Casebook says the dissent was right.
        - **Leveraged Buy Outs**
            - An acquisition of all the firm's outstanding shares
            - Using borrowed funds
            - Secured by the assets of the company (like a mortgage on a house)
        - **Management Buy Out**
            - A management buyout is an LBO in which the purchaser is the company's own management.
    - <u>Protecting Directors from Liability</u>
        1. Business Judgment Rule
            - Courts defer to judgment as long as decision is informed, in good faith, and doesn't involve a conflict of interest
        2. Indemnification
            - MCBA § 8.51-8.56

- DGCL § 145
  - A corporation shall have power to indemnify a person who is or was a director against expenses (including attorney's fees), judgments, fines, and amounts paid in settlement if the person acted in good faith and no reasonable cause to believe conduct was unlawful. Termination by settlement does not create a presumption not in good faith or conduct was unlawful.
  - No indemnification if person has been adjudge liable to the corporation unless Court of Chancery permits.
  - If successful on the merits such person shall be indemnified.

3. Directors and Officers Insurance
   - MBCA § 8.57
   - DGCL § 145 (g)
     - A corporation shall have power to purchase and maintain insurance on behalf of a director for any liability, whether or not the corporation would have the power to indemnify such person against such liability.

- Legislative reaction to *Smith v. Van Gorkom*
  - DGCL § 102(b)(7)
    - May include in certificate of incorporation a provision eliminating or limiting the personal liability of a director . . . For monetary damages for breach of fiduciary duty . . . Provided such provision do not limit liability: (i) for breach of director's duty of loyalty; (II) for acts or omissions not in good faith or which involve intentional misconduct;
  - MBCA § 2.02 (b)(4)

- <u>Inaction of a Director</u> is not covered by the business judgement rule because no decision was made --> punishes directors who fail to do their duties.
  - *Francis v. United Jersey Bank*: Pritchard Sr. is a reinsurance broker (reinsurance is insurance on insurance claims). Upon his death, Pritchard Sr. gave his two sons 26% of the company each, and 48% to Mrs. Pritchard. The sons handled the management of the firm, and their mother was a director. The sons embezzled money through multiple "shareholder loans" from the firm. By taking these loans, the balance sheet is not affected, because the accountants see the IOU notes and believe the directors are monitoring it. Even though Mrs. Pritchard took over her husband's director position, she was not involved in the company at all (didn't go to board meetings, never reviewed the company's financials, etc.). The firm went bankrupt due to the siphoned funds. Creditors brought suit against Mrs. Pritchard.
    - **Holding**: Mrs. Pritchard breached her duty of care because she had an "obligation of basic knowledge and supervision." Her failure to read and understand the financial statements was a breach of that duty. There is also an obligation to object to misconduct when discovered, and if necessary, resign. The court had to determine if Mrs. Pritchard's breach was the cause of the loss. They decided if she had shown up at board meetings, the sons likely would not have taken all those loans (but Guttentag says this is false, because the sons took loans before their mom took over).
    - Affirmative Director Duties
      1. Obligation of basic knowledge and supervision,
      2. Read and understand the financial statements,
      3. Object to misconduct when discovered, and if necessary, resign.

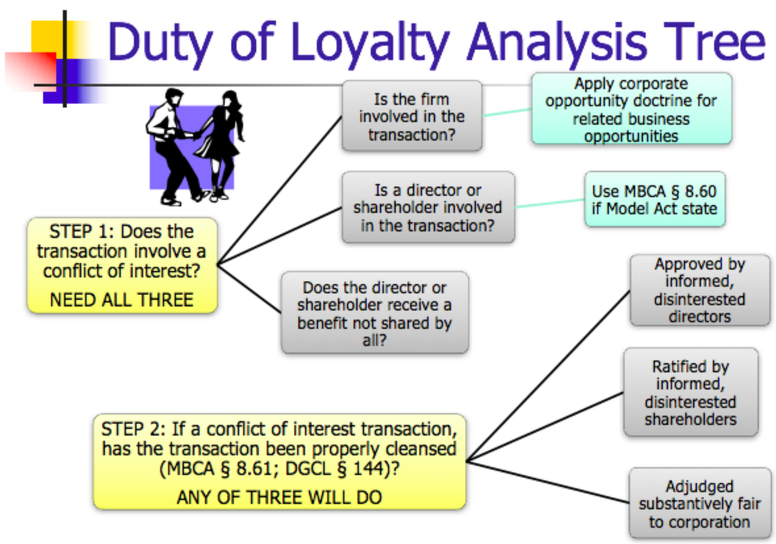


III. Director's Duty of Loyalty

- Note: Business Judgment Rule covers ONLY Duty of Care and NOT Duty of Loyalty.
- Duty of loyalty regulates self-dealing transactions.
- Mandates that the **best interests of the corporation** and its stockholders **take precedence over any interest possessed by a director** and **not shared by the stockholders** generally.
  - For a long time no related party transactions were allowed, but now we have reached a middle ground --> disinterested directors can approve the decision, independent shareholders can ratify it, or the court can judge the transaction fair.
- Duty of Loyalty Analysis:
  - **Step 1: Does the transaction involve a conflict of interest?**
    - Is a director or shareholder receiving a benefit from the firm not received by all?
    - To answer Step 1, three questions must be answered affirmatively:
      a. **Is the firm on one side of the transaction?** (corporate opportunity doctrine, see more below)
         - A corporate opportunity exists where (Guth Factors):
           1. Corporation is financially able to take the opportunity.
           2. Opportunity is in the corporation's line of business.
           3. A corporation has an interest or expectancy in the opportunity.
           4. Embracing the opportunity would create a conflict between the director's self-interest and that of the corporation.
      b. **Is a director or shareholder on the other side of the transaction?**
         - MBCA §8.60: A conflict of interest occurs when:
           1. Director is a party to the transaction
           2. Director had knowledge and a material financial interest in the transaction; or
           3. A transaction which the Director knew a related party had an interest in.
              - This includes the individual's spouse, a child, step-child, grandchild, sibling, half-sibling, nephew, niece, or person living in the same house (but not cousin!!).
           4. Plaintiff has the burden of proof to show there is a conflict of interest
      c. **Is the transaction providing a benefit from the firm not received by all?**
  - **Step 2: Has the transaction been properly "cleansed"?**
    - How to Cleanse a Transaction Under MBCA:
      - MBCA §8.62: Qualified disinterested directors cleanse.
      - MBCA §8.63: Independent Shareholders ratify the transaction.
      - MBCA §8.61(b)(3): Transaction can be cleansed if adjudged fair.
    - How to Cleanse a Transaction Under DGCL:
      - DGCL §144: No contract or transaction between a corporation and one or more of its directors or officers shall be void or voidable if:
        1. Informed, disinterested directors approve; or
        2. Informed shareholders ratify; or
        3. Transaction is substantively fair to the corporation.
    - Comparing the MBCA and DGCL
      - DGCL gives more latitude when adjudging the transaction fair in court --> it only has to be "substantially fair."
      - DGCL doesn't say "disinterested" or "independent" shareholders --> so all shareholders get to vote, even those getting a benefit.
  - **Corporate Opportunity Doctrine**
    - Use the Guth Test: (factors from *Guth v. Loft*) --> A corporate opportunity exists where:
      1. Corporation is financially able to take the opportunity.
      2. Opportunity is in the corporation's line of business.
         - Activity as to which it has fundamental knowledge, practical experience, and ability to pursue.
         - Consonant with its reasonable needs and aspirations for expansion.
           - Like *GA v. Singer*, because manufacturing side job very similar to General Automotive's business.
         - This test covers more opportunities than the prong #3 interest/expectancy test.
      3. A corporation has an interest or expectancy in the opportunity.
         1. **Interest**: Something to which the firm has a right or legal entitlement.

            - If officer bought land to which the corporation had a contractual right, the officer took an "interest."
        2. **Expectancy**: Something which, in the ordinary course of things, would come to the corporation.
            - If the officer took the renewal rights to a lease the corporation had, the officer took an "expectancy."
    4. Embracing the opportunity would create a conflict between the director's self-interest and that of the corporation.
        - E.g., If an officer buys a supplier to his company.
- *Broz v. CIS*: Broz was the sole shareholder of RFB Cellular, but was also on the board of CIS. A third party cellular company reached out to RBF to see if they wanted to buy its license to cover a certain area, Michigan-2. The license was not offered to CIS. Broz spoke informally with other CIS directors, who told him that CIS was not interested in the license and could not afford it even if they were interested. At about the same time, PriCellular had undergone discussions to purchase CIS. Six CIS directors agreed to sell their CIS shares to PriCellular, contingent on successful tender offer. PriCellular had also been in negotiations to purchase Michigan-2. In September 1994, PriCellular got an option to buy Michigan-2 for $6.7m as long as nobody bid over $7.2m. On November 14, 1994, RFB Cellular offered $7.2m for Michigan-2, beating PriCellular's option. On November 23, 1994, PriCellular closed its tender offer for the purchase of CIS. CIS then brought suit against Broz, alleging that Broz breached his fiduciary duties to CIS by purchasing the license for RFB Cellular when the newly formed PriCellular/CIS corporation had had the option open to make the same purchase.
    - **Holding**: Broz was under no duty to consider the "contingent and uncertain plans of PriCellular." The purchase of Michigan-2 was not a corporate opportunity of CIS. The court looked at the four *Guth* factors and determined that (1) CIS was unable to purchase because it was going bankrupt, (2) the opportunity was sort of in CIS's line of business, but they were in the process of pulling out of that business, (3) CIS had no legal right to the opportunity because the third party did not approach CIS about the opportunity, and (4) because Broz already owned Michigan-4, Michigan-2 did not create a conflict. Therefore, Broz did not usurp a corporate opportunity.
    - **Tender offer**: The legal process one must go through to buy shares necessary to complete an acquisition.
    - Guttentag thinks the judge got this case wrong:
        - The case focuses on the timing of how Broz got Michigan-2 before PriCellular got CIS in determining whether Broz stole a corporate opportunity from PriCellular. Guttentag says that the court gave Broz a break by how they interpreted the chronology of events. According to the court, the deal for PriCellular was not done until it was closed on Nov. 23 and Broz closes his Michigan-2 deal on Nov. 14.
        - However, Broz only "agreed" to the deal on that day, but in reality the deal was not closed until after Nov. 23 (a fact not included in the opinion). Thus, PriCellular was actually ahead of Broz, so the court should have found Broz usurped a corporate opportunity.
        - The court uses Broz's Michigan-2 agreement date, not close date, but the use the PriCellular close date, not agreement date.
    - **<u>HYPO</u>**: Suppose PriCellular had no financial problems (and no delay in tender offer) and could easily have invested enough money in CIS to buy Michigan-2. What result?
        - (1) Financially able?
            - Yes
        - (2) Opportunity in line of corp. business?
            - Yes
        - (3) Corp have interest or expectancy?
            - Indirect -> if PriCellular handed that bid to CIS, then CIS would be the actual bidder
        - (4) Create a conflict? <- this is different from what is in the email outline and slides
            - If PriCellular completed the deal with CIS, then it would clearly be a corp. opp. problem, b/c Broz would be bidding against the company it was a director of
    - Could Broz have cured?
        - Yes --> Could have resigned if he could also show he didn't get the opportunity b/c of his capacity as a director of CIS
        - Or could have presented it to the board more formally (he only chatted to some board members)
        - If the board at a formal meeting had allowed Broz to pursue it, then it would be fine

        - Why did PriCellular not simply outbid Broz and buy Michigan-2 for itself?
            - Didn't want to spend more money and felt betrayed by a director of what was now effectively their company.
    - **Delaware Law and Board Approval**
        - Relevance of board approval or lack thereof on corporate opportunity:
            - Not required.
            - Board approval creates safe harbor.
            - Meeting individually with board members does not count.
    - **Requirement for Formal Board of Directors Action** --> Action only occurs when:
        - MBCA §8.20: Board meetings are either regular or special.
        - MBCA §8.21: Action without meeting requires unanimous written consent (varies by state).
        - MBCA §8.22: No notice necessary for regular meeting; two-day notice required for special meeting.
        - MBCA §8.23(a): A director may waive notice and must be in writing (except as in subsection b).
        - MBCA §8.23(b): A director's attendance at a meeting waives any required notice unless director objects.
        - MBCA §8.24: Quorum – default rule – majority; Minimum quorum requirement acceptable – 1/3. Vote is decided by the majority of those present.



IV. Directors' Obligation of Good Faith

- The obligation of good faith is not a separate fiduciary duty --> it is a **subset of the duty of loyalty.**
- Now part of the Delaware legal doctrine and has implications for roles and duties of a Director.
- A "grab bag" of duties Delaware thinks directors should have that don't fall under the duty of loyalty or care.
    - Duty to set up programs to monitor legal compliance with the law.
- *Stone v. Ritter*: Banks have to file "suspicious activity reports" for transactions that seem sketchy. AmSouth was fined $50m in penalties because they failed to file these reports. Angry shareholders filed a lawsuit against the directors for breach of fiduciary duty for failing to file the report which led to the fines. The claim is the directors didn't have the appropriate safeguards in place to make sure that the company was complying with the law.
    - The law used to be that directors are allowed to rely on the honesty of their subordinates until something occurs to put them on notice. If they are put on notice and then fail to act, liability may follow --> "One Free Bite" rule (*Graham v. Allis-Chalmers*).
    - **Current rule**: Director's obligation includes a duty to assure that a corporate information and reporting systems exists, and that failure to do so may render a director liable for losses caused by non-compliance with legal standards (*In re Caremark*).
    - **Holding:** The court says that inputting a compliance program falls under the director's duty of good faith, but this is not an independent duty on the same level as duty of care or loyalty. Therefore, the court put the failure to gather information to avoid violations of the law under duty of loyalty.
        - Guttentag -> The court put it under Duty of Loyalty instead of under Duty of Care, because majority of companies adopted 102(b)(7) which said you could not bring a lawsuit for duty of care
        - What would an adequate law compliance program include?
            - Policy manual

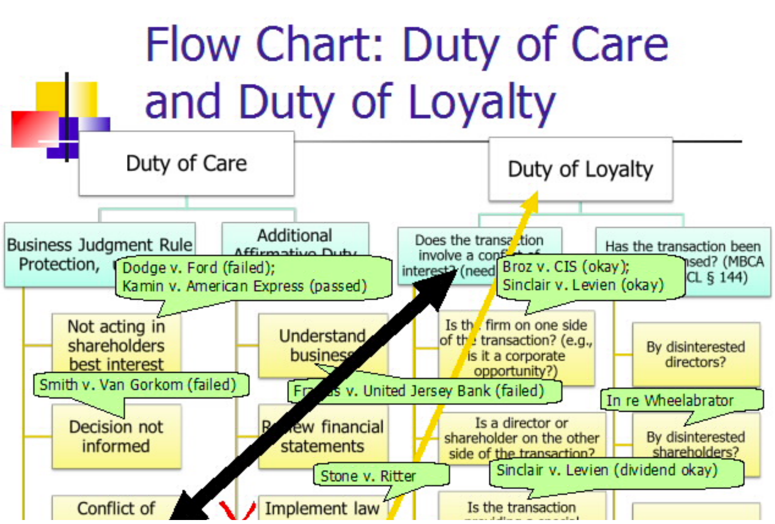
            - Training of employees
            - Compliance audits
            - Sanctions for violations
            - Provisions for self-reporting of violations to regulators
        - In *Caremark*, the failure to gather information to avoid violations of the law was considered a violation of good faith. In *Stone v. Ritter*, good faith is not an independent standard of liability.

- **Shareholder Duties**

- No duties unless one is an <u>controlling shareholder</u> (50% or greater).
    - Controlling shareholders owe fiduciary duties to minority shareholders.
- *Sinclair Oil v. Levien*: Sinclair is a giant oil company with many subsidiaries around the world. For the most part, Sinclair owns 100% of their subsidiaries, but they only owned 97% of their Venezuelan sub, Sinven. Therefore, Sinclair owes the 3% minority fiduciary duties. The minority objected to 3 transactions relating to the Sinclair/Sinven relationship. Sinven brought suit against its parent, Sinclair, for the damages it sustained as a result of Sinclair requiring Sinven to pay large dividends, as well as breach of contract. The question is whether Sinclair was improperly engaging in self-dealing.
    - Were any of these transactions a conflict of interest?
        - Sinven paid a huge dividend to its shareholders ($108 million).
        - Minority shareholders said this was a breach of fiduciary duty of loyalty.
        - Court looks to see if there is a conflict of interest:
            1. Is company involved? Yes
            2. Is controlling shareholder involved? Yes
            3. Director getting a benefit not realized by all shareholders? No --> No special treatment; Every shareholder got the dividends they were entitled to ($105 million to Sinclair Oil and $3 million to minority shareholders).
            - The court found no conflict of interest.
    - Was Sinven prevented from expanding its business outside of Venezuela?
        - Court said nobody came to Sinven independently with an expansion opportunity. Therefore, Sinclair did not usurp a business opportunity of Sinven.
            - Guttentag --> Court did not go through the *Guth* factors, but they should have in order to determine if the opportunity was a corporate opportunity of Sinven.
                1. Financially able to take the opportunity?
                    - Yes, before the dividend was taken by Sinclair.
                2. In the corporation's line of business?
                    - No, they are a Venezuela-only company.
                3. Legal right?
                    - No, they weren't approached with the opportunity.
                4. Create a conflict between the director's self-interest and that of the corporation?
                    - No.
    - Was the contract between Sinven and Sinclair International breached?
        - International's payments for oil were supposed to be made upon receipt but were up to 30 days late.
        - Also International didn't comply with the minimum amount of oil to be purchased.
        - Step 1: Court looks to see if there is a conflict of interest:
            1. Is company involved? Yes, Sinven was the seller.
            2. Is controlling shareholder involved? Yes, Sinclair was the owner of the buyer.
            3. Director getting a benefit not realized by all shareholders? Yes, the minority shareholders were not able to buy the oil.
    - Step 2: Was this transaction properly cleansed?
        - No, independent shareholders did not ratify and qualified directors (disinterested) did not cleanse with a vote.
            - But there was no way to cleanse because there were no independent directors (all directors were also Sinclair employees).
                - To avoid this, could have hired uninterested directors to cleanse.
                - Also, the only independent shareholders were the minority that were suing, so there's no way they would ratify the transaction.
                - Could have bought out the minority shareholders.
    - Intrinsic fairness is one of the way to cleanse a conflict of interest transaction. The court adjudges it fair.

- Why does this case fall under the **intrinsic fairness** prong of the conflict of interest review provision - DGCL §144(a)(3)?
    - Now that there is a conflict of interest, business judgement rule not available and the burden shifts to the defendant.
- What does the court decide about the intrinsic fairness of this transaction between Sinven and Sinclair?
    - Adjudged not fair.

- *In Re Wheelabrator*: Waste Management owned 22% of the shares of Wheelabrator Technologies, Inc. Waste Management wanted to buy a bunch of stock so that it would own 55% of WTI. To evaluate the transaction, the WTI directors had a special meeting (the board has 11 members, 4 of which are from Waste Management). The 4 Waste Management board members left the room and the 7 remaining directors consulted for 3 hours and considered the proposal by reviewing copies of the agreement. They also brought in investment bankers as experts for advice. The board approved the deal. Then the disinterested shareholders approved the deal. WTI shareholders brought suit, claiming that the board breached its duty of loyalty.
    - DGCL §144(a)(2): **Effect of ratification by majority disinterested shareholders depends on type of claim:**
        - **Duty of Care claims**: Extinguished; shareholder vote will cure board's uninformed business judgment (minority shareholder has no claim once a majority ratifies the decision).
        - **Duty of Loyalty claims against directors:**
            - If there was a conflict of interest transaction by the director….
            - Wheelabrator case came under this type of transaction because at the time of the action, Waste Mgmt. was not a controlling shareholder.
            - Shifts burden of proof to plaintiff to show wasteful transaction.
            - E.g., If the company bought the director's house = conflict of interest transaction.
                - If majority of shareholders approve the transaction, and the minority shareholders want to raise a claim, the burden is now on the plaintiff to prove that it was wasteful.
                    - Waste is a very forgiving standard --> have to prove they got absolutely nothing for it.
                - A vote almost completely wipes out the claim.
        - **Duty of Loyalty claims against controlling shareholder**
            - If controlling shareholder and the transaction involved the controlling shareholder, then just show unfair deal.
            - Shifts the burden of proof to the plaintiff to show unfairness
            - The only time when shareholder vote not as powerful in terms of cleanse
                - Without vote, burden would have been on the company to defend itself
                - Now the burden shifts to plaintiff to show the transaction was unfair
                - Shareholder vote is less useful as against a controlling shareholder
                    - Thought behind this is that if there is a controlling shareholder and you are a minority shareholder, you are pretty powerless
    - In *Smith v. Van Gorkom* why was the shareholder approval not a complete defense?
        - Case where wanted to do management buyout but sold to someone else instead; shareholder voted yes to that deal
        - Claim brought against directors for breach of duty of care
        - Effect of shareholder vote on duty of care claim? Should be extinguished, but wasn't, because it was not an informed vote



2. <u>Roles</u>

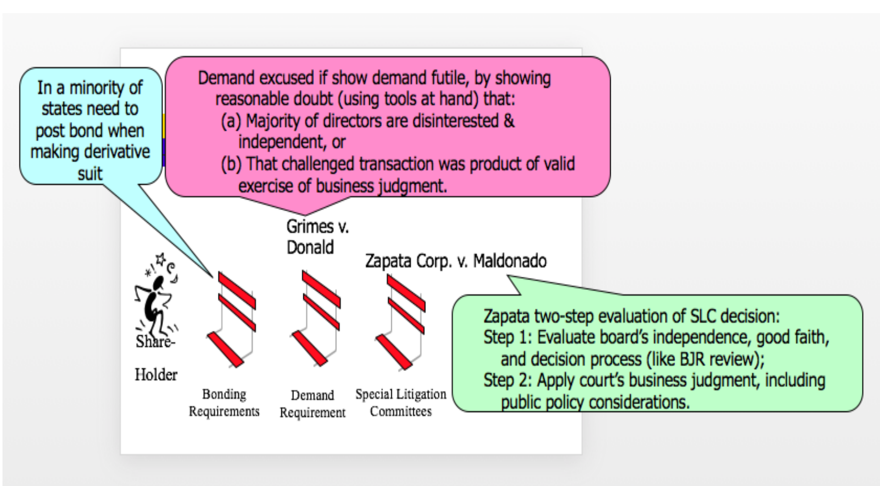
- **Shareholder Roles**
  - <u>Note</u>: Shareholders can (1) sue, (2) vote, (3) sell.

A. <u>Shareholder Suits</u>

- Two legal remedies shareholders can use to enforce the contract that they enter into when they buy a share:

1. **Direct suits:** A suit alleging a direct loss to the shareholder (i.e., a term of the contract has been violated).
    - Shareholders have a contractual relationship with the corporation through their stocks, so they are alleging a breach of that contract.
    - **Bases for direct suits:**
        1. Force payment of promised dividend;
        2. Enjoin activities that are ultra vires;
            - Outside the scope of the directors' power (e.g., illegal use of corporation's assets).
        3. Claims of securities fraud;
        4. Protect participatory rights for shareholders.
2. **Derivative suits:** Two suits in one: (1) who can represent the company and (2) the substantive, underlying suit against the board.
    - It alleges an indirect loss to the shareholder.
    - **Bases for derivative suits:**
        1. Breach of duty of care
        2. Breach of duty of loyalty
    - In a derivative action, the harm is to the corporation, and the shareholder brings the lawsuit on behalf of the corporation to recover from that harm.
    - Have to convince the court that (1) the directors did something bad and (2) the directors are so corrupt that they can't bring the lawsuit, and that the shareholder is the person that should bring the lawsuit.
    - **Remedies for a derivative suit:**
        - The shareholder is suing on behalf of the corporation so:
            a. **Remedy** from principal suit goes to the **corporation.**
            b. Corporation is required to pay shareholder **attorney's fees** if the suit is successful or settles.
                - No individual shareholder is going to invest the money for litigation to recover the amount of the harm, because the damages won are dispersed between billions of shares. Therefore, attorneys bring the suits for the legal fees.

- <u>Who can bring a derivative suit</u>?
    - MBCA §7.41(1): Must be a shareholder at the time of the alleged wrongdoing.
        - In many states, must continue to be a shareholder.
    - MBCA §7.41(2): Named plaintiff must be a fair and adequate representative of the corporation's interest.
- <u>Procedural Hurdles for a Derivative Action</u>



1. **Bonding Requirement**
    - Only shows up in certain states.

- In some states (not Delaware) a derivative claimant with low stakes must post security for corporation's legal expenses --> court wants to deter frivolous suits.

2. **Demand Requirement**

- Most states require shareholder in a derivative suit to approach the board of directors first and demand that they pursue legal action (unless the shareholder can claim a valid excuse) (recognition that directors manage the business affairs).
- In Delaware, shareholders must make a demand before filing suit <u>unless</u> it is "futile."
  - The complaint shall allege the **efforts**, if any, made by plaintiff **to obtain the action the plaintiff desires from the directors** and **the reasons for the plaintiff's failure** to obtain the action **OR for not making the effort.**
  - Real trick in Delaware is to argue **demand excuse/demand futility.**
    - As soon as you've asked the board of directors, you've lost in Delaware --> what you want to do is say that these people are so crooked, there's no reason to tell them what I'm about to do (plead futility).
- What is a formal demand?
  - Letter from shareholder to board of directors:
    1. Request that board bring suit on alleged cause of action,
    2. Must be sufficiently specific as to apprise the board of the nature of the alleged cause of action and to evaluate its merits.
- When is the demand requirement excused?
  - Demand is deemed futile if plaintiff creates a reasonable doubt that:
    1. Directors are disinterested and independent, or
    2. The challenged transaction was the product of valid exercise of business judgment
  - No discovery available yet --> limited to "tools at hand."
    - Have to plead these things with reasonable specificity but without the tools of discovery.
    - Can look at corporate documents, piggy back on lawsuits and federal investigation (e.g., *Stone v. Ritter*).
- Demand Requirement under MBCA
  - MBCA §7.42: Shareholder has to make a demand and <u>wait 90 days</u> to file the derivative lawsuit, unless there will be <u>irreparable harm</u>.
  - MBCA §7.44: Dismissal:
    - (a) Court will **dismiss if independent directors** or panel find **in good faith**, proceeding with suit not in best interest of the corporation.
    - (b) Evaluation by (1) a majority of independent directors, or (2) a majority of committees of independent directors.
    - (c) Derivative suit can proceed after board denies demand request, **if** complaint alleges (a) majority of **board not independent** or (b) **review not in good faith** or reasonable.
    - (d) **Burden** of proving in good faith and reasonable **shifts to board** if majority of directors not independent.
- *Grimes v. Donald*: CEO Donald had a very favorable employment agreement with DSC (e.g., board not able to unduly interfere; income continuation plan where after employment ends, still gets paid; health insurance for life). Grimes, a shareholder, alleges (1) abdication of board powers to managers and (2) excessive compensation. The abdication claim is a direct claim because it's a violation of the contract (circumvents his right to vote). The excessive compensation is a derivative claim because Grimes is claiming the board made a bad business decision and hurt the company.
  - **Holding**: To make a demand, you can do one of two things, but you can't do both:(1) Write a letter telling the board they messed up and asking the board of directors to sue themselves, or (2) go to court and say the board can't be trusted, no point of even writing a letter to them. Here, Grimes did both: he wrote the letter and went to the court and said we wrote the letter, but we didn't have to write the letter, because these guys are crooks. But the court said that by writing the letter, Grimes acknowledged that the directors were independent, so he can't come back now and tell the court demand is futile.
    - When the directors read the demand letter, they will then take it to their lawyers and do an "investigation." Once they decide no wrong was done or that the wrong is now fixed, it becomes a business judgement decision, so the court will defer to the board. Thus, you could only go to the court to claim the board did not read the letter carefully or that they wrongfully ignored the demand.

3. **Special Litigation Committee**

- Even if a plaintiff goes to court first and gets excused from the demand requirement, they may still face the corporation's special litigation committee (SLC).
- An SLC is a group of untainted members of the Board, either existing or newly appointed, that decide whether or not to drop the incoming derivative lawsuit.
  - Almost always formed after lawsuit.
  - Tainted board members can appoint untainted board members to the SLC.
- *Zapata Corp. v. Maldonado*: Maldonado, a shareholder, brought a derivative suit on behalf of Zapata against its board of directors, alleging breach of fiduciary duty. Maldonado had not made a prior demand on the board and instead argued that demand was futile, because all of the board members took part in the challenged transactions. Zapata then formed an SLC with new board members, who ultimately dropped the lawsuit. The court reviews the decision of the SLC under the business judgment rule.
  - Delaware Standard for reviewing SLC Recommendations --> Zapata Test:
    1. **Step 1:**
       - Inquiry into the independence and good faith of the committee.
       - Inquiry into the bases supporting the committee's recommendations.
    2. **Step 2:**
       - Court applies its own business judgment as to whether the case should be dismissed.
  - Zapata is a far more intrusive judicial review than normal – Why?
    - Court uses its own business judgment.

B. <u>Shareholder Voting</u>

- <u>Who votes?</u>
  - **Shareholders of record.**
    - Holder on the record date gets to vote (MBCA §7.07)
      - Record date can be any date, but can be no more than 70 days before the vote.
    - Default rule is that one share = one vote (MBCA §7.02)
      - Unless Article of Incorporation provides otherwise (e.g., founder might give himself special stock that gives him 10 votes).
- <u>When do shareholders vote?</u>
  - **Shareholder meetings.**
    - Annual meetings (MBCA §7.01)
      - Time set in bylaws.
    - Special meetings (MBCA §7.02)
      a. By request of board of directors, or
      b. At written request of at least 10% of shares.
    - Unanimous written consent (MBCA §7.04)
      a. If unanimous vote, don't need a meeting.
      b. Unlikely in a public company, because you would need all of the millions of shareholders to unanimously agree.
- <u>How do shareholders vote?</u>
  - Most matters require a majority of shares present at a meeting at which there is a quorum (MBCA §7.25(c))
    - Don't need absolute majority.
    - <u>Note</u>: Under MBCA, need majority of shareholders present to pass; Under DGCL, need majority of **all** shareholders to pass.
  - Shareholders vote either **in person** or **by proxy** (MBCA §7.22)
    - **Proxy Voting**
      - Proxy is someone else who votes on your behalf.
      - Typically voting is done by proxy.
      - Shareholder appoints a proxy (aka proxy agent) to vote his shares at the meeting.
      - Appointment effected by means of a proxy (aka proxy card).
        - Can specify how shares to be voted or give agent discretion.
        - Proxy appointment is revocable.
- <u>What do shareholders vote on?</u>
  1. **Election of Directors** (MBCA §8.03-§8.08)
  - Which directors can you vote for?

- Incumbent board nominates a slate of directors.
  - It's a little corrupt because the directors decide what names appear on the ballot, so it's a self-selecting/sustaining process.
- The company sends out the official proxy solicitation materials.
- A competing slate can be offered in **separate proxy materials.**
  - Insurgents pay the costs (including mailing).
- *Rosenfeld v. Fairchild*: Insurgents sought to get their own directors on the board so they could fire the over-paid CEO. The insurgents convinced enough shareholders to vote for their proposed slate of directors. The company paid for the old directors' expenses to defend their positions, and then reimbursed the new directors' expenses after they won, even though they were not a part of the company when they incurred the expenses. The reimbursement was ratified by a majority vote of the stockholders.
  - **Holding**: It was proper for the company to pay for the defense of the old board as well as reimbursing the expenses of the victorious new board members. However, the insurgent's costs are only reimbursed if they win (Froessel Rule). The majority accepted the insurgents' argument that since the stockholders voted for it, justifies the reimbursement.
    - **Froessel Rule (judges name):** Incumbent board proxy costs paid regardless of outcome; insurgent costs may be reimbursed if they win.
  - Dissent says that the reimbursement for the victorious insurgents is outside the purpose (ultra vires) because the company is giving money to them for when they weren't working for the company.

- Dodd-Frank/SEC allows director nomination (of one or more, up to 25% of the board) if >3% of shareholders for three years, and that nomination gets on the company's proxy materials.

2. **Amendments to the Articles of Incorporation under MBCA and DGCL**

- MBCA §10.03: An amendment to the <u>Articles of Incorporation</u>:
  - (a) must be adopted by the board of directors, and
  - (e) approved by **a majority of the votes of the shareholders present** (as long as a quorum).
- DGCL §242(b)(1): In order to amend the <u>Certificate of Corporation</u>:
  - The directors shall adopt a resolution and holders of a **majority of the outstanding stock** must vote in favor of the amendment.
- <u>Note</u>: Differences in terminology and required votes.

3. **Modifying the Bylaws under MBCA and DGCL**

- Bylaws set out the procedural rules of how a corporation will run.
  - Harder to change the Articles of Incorporation than Bylaws because need BOTH directors and shareholders, but for bylaws, can have either voting independently to modify.
- MBCA §10.20:
  - (a) Shareholders may amend or repeal, and
  - (b) Directors may amend or repeal, unless pertaining to director election or bylaws prohibit.
- DGCL §109(a): The power to adopt, amend, or repeal bylaws shall be in the stockholders entitled to vote (plus, directors may also have this power if so provided in the Articles of Incorporation).

4. **Fundamental Transactions** (e.g., mergers) (MBCA §11.04)
5. **Odds and Ends, such as "Precatory" Measures**

- While most corporate matters are governed by state law, following the Securities Exchange Act of 1934, the federal government stepped in to regulate shareholder voting as a matter of federal securities law.
- **Shareholder Proposals**(Rule 14a-8)**:**
  - Allows qualifying shareholders to put a proposal before their fellow shareholders
    - And have proxies solicited in their favor in the company's proxy statement
    - Expense thus borne by company
  - **Selected Eligibility Requirements:** Time, holdings, and length.
    - Who is eligible to submit a proposal and how do I demonstrate to the company that I am eligible?
      - Rule 14a-8(b)(1): Must have owned at least 1% or $2,000 (whichever is less) of the issuer's securities for at least one year prior to the date the proposal is submitted.
        - To calculate whether the $2,000 minimum is met, multiply the number of securities the shareholder held for the one-year period by the highest selling price during the 60 calendar days before the shareholder submitted the proposal.
      - Must be submitted at least 120 days before the date on which proxy materials were mailed for the previous year's annual shareholder's meeting.

            - Rule 14a-8(d): Proposal plus supporting statement cannot exceed 500 words (can link to website).
    - **Reasons the Company can Exclude Shareholder Proposals** (Rule 14a-8(i))
        1. If the proposal is **not a proper subject of action for shareholders** under the laws of the jurisdiction of the company's organization
        2. Implementing would violate law
        3. Implementing would violate proxy rules
        4. Proposal involves personal grievance or special interest
        5. Proposal is not relevant to firm's operations
            - Something is relevant to the firms operations if it relates to operations that account for more than 5% of the company's total assets or net earnings of the most recent year.
            - Something can also be relevant if it is "otherwise significantly related to the company's business."
        6. Company lacks power to implement
        7. Proposal deals with company's ordinary business operations
            - Note tension between (5) and (7)
                - So you have to propose something relevant to the firm, but that does not have to do with the firm's business operations
                - Been used for social and political issues that the firm's business touches on
        8. Relates to electing officers
        - These ballot measures have zero binding power on the board
            - Shareholders however have voting power to elect board members and decide on management compensation, so some motivation for board to listen to their proposals
        - *Lovenheim v. Iroquois Brands*: Shareholder Lovenheim wants to propose a resolution for the corporation to form a committee to research the methods their foie gras supplier uses to force feed geese to see if its humane. The foie gras operations were not economically significant to the corporation ($79,000 in revenues out of firm-wide revenues of $141 million).
            - **Holding**: Lovenheim's concern about the inhumane treatment of the geese falls under the "otherwise significantly related" provision which includes matters of ethical or social significance. It does not matter that foie gras is not economically significant to the company. Therefore, the resolution should be included in the proxy.
    - **SEC Response:**
        - Usually company won't want to include any shareholder proposals– they go to SEC and argue that the proposal doesn't qualify, and then SEC will agree or not
            - If SEC wants to include it, they will say that they will carry out enforcement action if the firm rejects it
        - SEC is the reluctant referee of the shareholder proposal process
            - Staff level action:
                - If SEC staff determines proposal can be excluded, they will send a no-action letter
                - If staff determines the proposal should be included, they will notify the issuer of possible enforcement action if they choose to exclude

6. **Non-binding "say on pay" vote at least every 3 years** (per Dodd-Frank Act (2010/SEC)).
    - For all public companies, shareholders get to vote on whether the people at the company are earning too much.

C. Shareholders Selling Shares & Insider Trading

- **Federal Securities Statutes**
    i. Securities Exchange Act of 1933
        - Regulates the **public** offering of new securities.
        - Disclosure at the time of the public offering.
        - Key section:
            - §5 – regulates offering procedure
    ii. Securities Exchange Act of 1934
        - Regulates **trading activity.**
        - Ongoing disclosure required.
        - Key sections:
            - §10(b) – no fraud
            - §14(a) – proxy contest

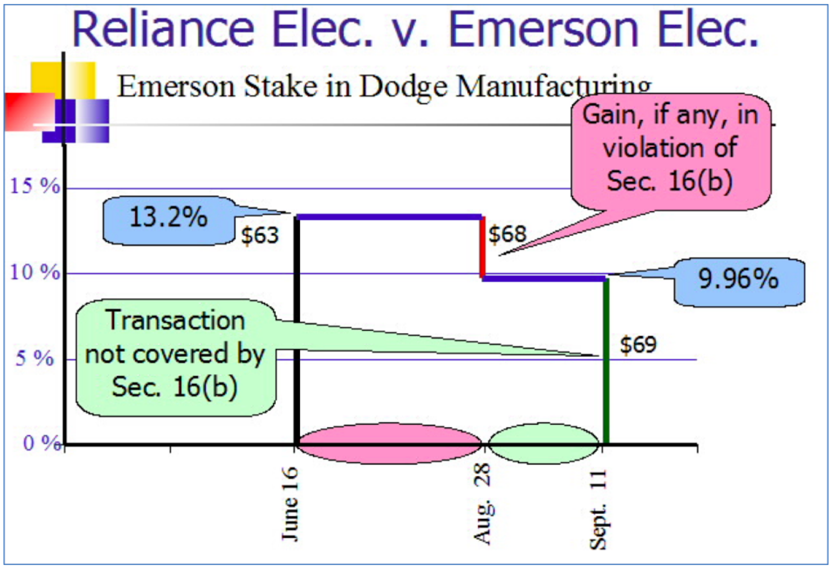
- §14(e) – tender offers
- §16 – insider trading

iii. Sarbanes Oxley Act of 2002
iv. Dodd Frank Act of 2010
v. JOBS Act of 2012

- **Issues in Selling Shares**
  - Are you selling a security?
    - If yes, then federally regulated.
  - Is your sale a "public offering"?
    - If no, avoid §5 but §10 still applies.
  - Is your sale insider trading? Yes, if…
    1. **Statutory Insider Trading** (*Reliance Electric Co. v. Emerson Electric Co.*)
       - Securities Exchange Act of 1934 – §16 applies
       - All gains made within 6 months by statutory insiders are forfeited to the firm
    2. **Classical Insider Trading** (*SEC v. TGS*)
       - A fiduciary trades in shares of his or her own firm, based on information gained as a fiduciary (Rule 10b-5).
    3. **Tipper /Tippee Liability** (*Dirks v. SEC*)
       - Insider trading prohibition extends to those who use nonpublic material information they know was provided by a tipper for personal benefit (Rule 10b-5).
    4. A fiduciary trades using information that was **misappropriated** (*US v. O'Hagan*)(Rule 10b-5).

1. **Statutory Insider Trading**
   - The only people potentially liable are people who are "statutory insiders."
   - This type of insider trading won't send you to jail, just have to give any profits earned back to the company.
   - Act of 1934 – §16
     - <u>Statutory Insider Definition</u>: If own **over 10%** or are a **director** or **officer** ("Statutory Insiders"), must report ownership stake and changes to SEC --> people exposed to crucial information are statutory insiders.
     - Statutory Insider <u>profits</u> from a purchase and sale **or** sale and purchase within **6 months** are <u>recoverable by the firm</u>.
       a. Must be statutory insider at both the time of purchase and time of sale.
       b. Firm gets the profits generated by the sale.
          - Courts interpret the statute to **maximize the gains the company recovers.**
            - If purchased shares at different times for different amounts, the court uses the lowest price in order to get the highest profit.
              - E.g., Buy 5 shares for $10, then buy 5 shares for $20.
              - Then sell 5 shares at $20.
                - The shareholder wants to say that they made no gain --> they bought 5 shares for $20 and sold those same shares for $20.
                - But court will interpret the sale in order to maximize the recovery by the company --> thus, court looks at the lowest price the shareholder purchases shares for (here, $10), and say that there was a $10 profit per the 5 shares sold = $50 goes to company.
                - Policy is to maximize the penalty in order to deter insider trading.
          - Textbook says this is both under and over-inclusive.
            - Over-inclusive because there could be other reasons for a quick turn-around in sale, other than insider trading.
              - E.g., Shareholder thinks he won the lottery, so buy lots of stock in your company only to realize it was a scam so you have to sell the stock
            - Under-inclusive because if you sell after 6 months and 1 day, but use insider information, you are outside of the scope of the statute and escape liability.
   - *Reliance Electric Co. v. Emerson Electric Co.*: On 6/16, Emerson purchased 13.2% of Dodge Manufacturing. Then Dodge merged with Reliance, so Emerson wanted to dump its stock, but didn't want all the profits to go to Reliance. So on 8/28, Emerson sold some of the stock so it only owned 9.96% of Dodge and would no longer be a statutory insider. Then on 9/11, Emerson sold the rest of its Dodge stock. Reliance sued to recover the profits from the 9/11 sale.
     - **Holding**: Emerson was a statutory insider from 6/16 to 8/28 because it owned more than 10% of Dodge during that period. However, after the 8/28 sale, Emerson dropped below 10%, so it was no

longer a statutory insider. Accordingly, Emerson did not commit statutory insider trading with the 9/11 sale, so Reliance cannot recover those profits.

- 

1. **Classical Insider Trading**
   - Firm "insider's" use of material, non-public information to trade in their firm's shares violates Rule 10b-5.
   - Rule 10b-5: Applies whether or not it is a public offering:
     - It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce:
       a. To employ any device, scheme, or artifice to **defraud**, or
       b. To **make any untrue statement of material fact** or to **omit to the state a material fact necessary** in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
       c. To engage in any act, or course of business which operates or would **operate as a fraud or deceit** upon any person,
     - in connection with the purchase or sale of any security.
       - Whenever you purchase or sell security, can't do so in a deceptive manner or you're violating the law.
       - Can't make profits against shareholders that you're working for.
   - *SEC v. Texas Gulf Sulfur Co.*: TGS started drilling for oil in Eastern Canada, but found gold instead. TGS starts buying up as much land as possible in the area. Some of the directors also started buying TGS stock. By March, the land acquisition was complete. In April, an unauthorized news article was published about TGS finding gold. TGS denied the story and said it was way overblown. Four days later, TGS issued an official statement about its gold discovery. From the time the gold was initially discovered, the stock price grew because executives at TGS and their friends were buying stock. The SEC started an investigation and eventually brought suit.
     - **Holding**: The gold discovery was material information. Individuals with knowledge of material nonpublic information must either disclose it to the public, or abstain from trading in the securities concerned while such inside information remains undisclosed. Because the information was material, the defendants were not entitled to acquire TGS stock until public disclosure of the high mineral content was made. Their doing so before public disclosure constituted classical insider trading in violation of Rule 10b-5.
       - The court also needed to evaluate whether the company's denial of the news story was an "untrue statement of material fact." The court said it was not misleading because everyone knows companies lie a little, and TGS was only fudging the truth when it underplayed the significance of the find. The court looked at TGS's stock price to see what people believed in response to the press release denying the article. Evidently, the company's denial was not strong enough because the stock went up after the article, so clearly nobody believed TGS's denial.
     - **Test for Materiality:**
       - Whether there is a substantial likelihood that the reasonable shareholder would consider the fact important.
   - *Chiarella v. U.S.*: Chiarella worked at a printing company that handled documents concerning corporate takeovers. He figured out that one of the documents he was printing was a tender offer from the firm he

was printing the material for to take over another company. He took that info and bought a bunch of the other company's stock.

  - **Holding**: Chiarella is not liable for insider trading because he didn't owe a fiduciary duty to the company who's stock he bought. Thus, he had no duty to disclose the information he uncovered. He was not trading in the shares of the firm for whom he got the information.
  - **NO LONGER GOOD LAW**

2. **Tipper/Tippee Liability**
   - Insider trading prohibition extends to those who use **nonpublic material information** they **know** was provided by the tipper for a **personal benefit.**
     - **Personal Benefit** includes:
       1. Monetary gain,
       2. Reputational gain,
       3. Quid pro quo,
       4. Gift to a family member or friend,
       5. But NOT desire to provide public good.
     - Tippee must know or have reason to know of the breach and personal benefit to the tipper.
   - *Dirks v. SEC*: A disgruntled employee of Equity Funding of America knew that the company was a fraud, so after he left, he called Dirks, a stock picker. Dirks flew to LA and visited Equity Funding of America, and it was obvious to him that it was a fraud, so he told his clients. The clients traded on that info and made a bunch of money. As a result of the stock sales, Equity Funding's stock fell abruptly and the SEC opened an investigation. The SEC found that Dirks aided and abetted insider trading in violation of SEC Rule 10b-5.
     - **Holding**: The court had to decide whether Dirks inherited an obligation to not trade for a profit based on the info be received from the Equity Funding employee. SCOTUS said only in certain circumstances. When you get a tip, sometimes you can trade on that tip. In order to inherit the liability (1) the person who provided the tip has to personally benefit from giving you the information, and (2) you have to know that what they were doing was a breach. Here, the court said the employee's motivation in telling Dirks about the fraud within Equity Funding was for the purpose of exposing the fraud, not to benefit personally. Accordingly, Dirks did not inherit the obligation to not trade on the nonpublic information.
       - Guttentag: The Equity Funding employee was a disgruntled employee and might not have really been acting for public good so much as personal benefit.
     - **Constructive Insider**
       - A person is a "constructive insider" and violates classical insider trading prohibitions when they:
         1. Obtain material nonpublic information from the issuer,
         2. With an expectation on the part of the corporation that the outsider will keep the disclosed information confidential, and
         3. The relationship at least implies such a duty.
         - **Example**: Lawyers for a company obtain insider information. The lawyer becomes a constructive insider and is liable for classical insider trading if they use that info.
         - If the lawyer tips off best friend, would count as personal benefit and give him tippee liability.

3. **Misappropriation of Information**
   - A fiduciary who trades using non-public material information that was **misappropriated** violates insider trading prohibitions.
     - Trading stock of a company you don't work for based on information you gained from a company you do have a fiduciary duty to.
   - Before *O'Hagan*, there would be no breach of fiduciary duty to a company if you were not an employee.
     - The court pointed to 10b-5 to justify the decision --> can't have act of deception.
   - *U.S. v. O'Hagan*: D was working for a law firm that represented a potential buyer for a tender offer for Pillsbury. D took that info and bought a bunch of Pillsbury stock. When the tender offer was announced, Pillsbury stock went up $60 per share and D made $4.3m.
     - **Holding**: D was a constructive insider and breached his fiduciary duty to the buyer he represented. If you misappropriate information, you commit fraud. Then if you use that information to trade securities, you've committed securities fraud and violate Rule 10b-5. The failure to disclose was the "deception" by a trader in connection with the "purchase/sale of securities," as explained in Rule 10b-5.
     - If D was counsel to Pillsbury instead of the buyer, he would be liable under classical insider trading --> this ruling adds consistency and symmetry to Rule 10b-5.

- What if D told Pillsbury and his firm he was going to trade on the info and they all said it was ok?
  - There would be no deception, so no liability under Rule 10b-5, but might be liable under state law for duty of loyalty breach.
  - The key to liability is that the info has to be "ill-gotten."
- What happens when you misappropriate info and tip it to a friend?
  - It's mis-gotten info, so for the friend to be liable, the tipper would have to get a personal benefit --> combine the two tests.
- Rule 14e-3: Never allowed to trade on information regarding a pending tender offer. Even if you did nothing wrong in getting the information, you can't trade on it.
- Rule 14e-3(d): Prohibits anyone connected with a tender offer from tipping material, nonpublic information.
  - Not premised on breach of fiduciary duty.

A. Termination of a Corporation

- Without action towards termination, corporation goes on in perpetuity.
- **Voluntary Dissolution**
  - Board submits and shareholders vote on proposal to dissolve (MBCA §14.02(b))
  - Submit Articles of Dissolution to state
  - Can only carry on to wind up
- **Involuntary Dissolution**
  - Arises if there is a deadlock (MBCA §14.30)

IV. Accounting/Finance Terms

- **Accounting Terminology:**
  - Revenue (Gross)**:** the amount of money that results from selling products or services to customers. Also known as sales.
  - Profit (Net): Revenues less expenses (where expenses include taxes) Also known as Net Income. The "bottom line" of the income statement.
  - Income Statement: Financial statement that indicates results of operations over a specified period. Also, known as the profit and loss (P&L) statement.
  - Balance Sheet: Summarizes the company's financial position at a given point in time, usually the end of the month, quarter, or year.
    - Describes the assets of the business, and the claims on those assets, either of creditors in the form of debt, or owners in the form of equity.
  - Both Income Statement and Balance Sheet are prepared in accordance with General Accepted Accounting Practices (GAAP).
  - Profit Margin: The percentage of every dollar of sales that makes it to the bottom line. Profit margin is profit divided by revenue. Also known as the Return on Sales (ROS).
- **Finance Terminology:**
  - **Debt:**
    - Funds borrowed by the firm.
    - In exchange for claims **of a fixed amount** against the firm's assets and future earnings.
    - *Owens v. Cohen* was debt because expected repayment.
  - **Equity:**
    - Funds invested in the firm. Owners of the firm.
      - You pay in to become an owner, don't expect repayment.
    - In exchange for residual (left over) value of the firm.
    - **Rights to firm's earnings** and, in liquidation, firm assets **after** all other claims are satisfied.
    - *Page v. Page* considered equity because no implication of a term for repayment.
- **Capital Structure Terminology:**
  - Capital Structure: The debts, securities, and equity together constitute the firm's capital structure.
  - Securities: Permanent, long-term claims on the corp's assets and future earnings issued pursuant to formal contractual instruments.
  - Shareholders: Owners of a corporation (Equity in the Corp.)
    - Elect directors and vote on major corporate decisions.
    - May receive firm's earnings in the form of dividends**.**
    - In liquidation, get firm assets after all other claims are satisfied.

        - Like the "pig" because they have more to gain or lose depending on the corporation's performance.
    - Lenders/Creditors: Lends money to the firm (Debt for the Corp.)
        - At "maturity" the firm returns the principal to the lender.
        - Less risk, but less upside.
        - Like the "chicken" because less engaged in the rise and fall of the corp., since their position remains the same no matter the corp's performance.
    - Assets = Equity + Liabilities --> Both equity and debt are "claims against the firm's assets."
    - Authorized Shares: Number of shares the corporation can issue.
    - Outstanding Shares: Number of shares the corporation has sold and not repurchased.
        - The shares that are out there and represent valid claims against the equity of the firm.
        - These are the only shares that matter for figuring out how much a particular share is worth.
    - Authorized but Unissued: Shares that are authorized but not yet sold.
    - Treasury Shares: Shares issued and then repurchased by the firm.
        - This creates fewer shareholders but also less equity to divide among them so **shouldn't really affect the value of each share**.
    - Efficient Capital Market Hypothesis (ECMH): The price of a stock reflects all publically available information. Therefore, the share price should give a more accurate valuation than book value.
    - Price / Earning Ratio (P/E): The ratio between the price you pay for an asset and the amount that asset earns in a year. P/E gives a rough estimate of how many years it will take to earn your investment back = **Valuation / 1 Year's Earnings (net income)**.
        - The average P/E of a company is around 18x.
        - That means it would take roughly years to earn back your investment.
    - Dividend: A distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. Dividends may be in the form of cash, stock or property.
- **Ways to Value a Company**
    - **Two views of a firm's equity value:**
    1. **Book Value**
        - **Cost-based** valuation of the firm assets goes to **book value** of the firm's equity.
        - Firm owes some people a fixed dollar amount and what's left is the book value.
    2. **Market Value/Capitalization**
        - **Market capitalization** of the firm's equity (# of outstanding shares) goes to the **enterprise value** of the firm's assets.
        - When added to debt = enterprise value
            - Debt people and equity people are investing in the company
            - Debt is getting a fixed return back and equity getting variable amount back based on value of company
        - Mathematically:
            - Assets less debt = equity
            - Total value have to pay some people off and what's left is the equity
            - Which means that if I add debt to both sides, value of debt + equity = enterprise value.
    - Book Value: Measure of the equity value of the firm provided by the balance sheet. Determined by the accountants.
    - Market Capitalization: Measure of the equity value of the firm implied by the **trading value** of the firm's stock (determined by multiplying the trading value of one share of stock times the total number of shares outstanding).
        - Measures the same thing as book value --> the equity value of the firm.
        - The difference here is that an accountant doesn't take goodwill into account for the balance sheet but the market capitalization will include reputation, IP, etc.
            - E.g., Mickey Mouse
    - Enterprise Value: Measure of the total value of the firm's assets implied by the trading value of the firm's stock (determined by adding the market value to the firm's obligations).
        - Total value of the firm as determined by adding market capitalization to the firm's obligation.
        - Market Capitalization + firm's debt (and other liabilities) = Enterprise Value
- **What is a share of stock worth?**
    - **Step 1:** Determine the firms **total** value.
        - Two ways to determine the value of assets:
            1. Liquidation value
            2. Value of future cash flows
    - **Step 2:** Determine the firm's **equity** value.
        - Subtract obligations (liabilities/debts) from the value of the firm.
    - **Step 3:** Calculate equity value **per share.**

        - Divide the firm's equity value by the number of shares outstanding.
- **Disney Example: What is a firm worth (enterprise value)?**
    - Enterprise value is stock price x number of outstanding shares + firm's debt (and other liabilities) = value of firm's assets
    - Value of assets on balance sheet for Disney = $88 billion, but people trading stock (market capitalization = trading value) think the value of Disney is $164 billion.
        - One share = $92
        - 1.6 billion outstanding shares
        - Debts = $17 billion
        - Enterprise value = $164 billion
- Statutory Insider Calculations
    - Courts interpret the statute to **maximize the gains the company recovers.**
    - If purchased shares at different times for different amounts, the court uses the lowest price in order to get the highest profit.
        - E.g., Buy 5 shares for $10, then buy 5 shares for $20.
        - Then sell 5 shares at $20.
            - The shareholder wants to say that they made no gain --> they bought 5 shares for $20 and sold those same shares for $20.
            - But court will interpret the sale in order to maximize the recovery by the company --> thus, court looks at the lowest price the shareholder purchases shares for (here, $10), and say that there was a $10 profit per the 5 shares sold = $50 goes to company.
            - Policy is to maximize the penalty in order to deter insider trading.