·C·O·R·P·O·R·A·T·I·O·N·S·

Contents

Major questions to be able to answer

- How to form and operate a given kind of business
- Management and control
- Responsibility for company's debts
- Return on investment
- Tax consequences
- Ownership of assets of company

AGENCY LAW

- **Questions to Ask**
  - **1. Has an agency relationship been formed?**
  - **2. If so, is the principal liable?**
    Principal is liable for authorized acts only
    - **Actual** (§§ 1.01, 2.01)
      - created by P → A communication
      - must be manifested under § 1.03
    - **Apparent** (§§ 2.03, 3.03)
      - created by P → T communication
      - must be manifested under § 1.03
  - **3. What if the agent's acts are not authorized?**
    - **Estoppel** (§ 2.05)
      cf. detrimental reliance in contracts
      - Estoppel would enforce the agency relationship
      - Protects third party from principal's misrepresentations
      - Liability coextensive with degree of detrimental reliance

- Doesn't grant both parties full contract remedies; principal is estopped to deny the agency
- Although principal may have been blameless in creating the situation, the principal was the "least-cost avoider" and, as a matter of policy, is expected to take corrective action

- **Ratification** (§§ 4.01–4.08)
  - Timeline:
    - 1. Unauthorized act
    - 2. Act later ratified as if it had been originally authorized
      - retroactively assigns actual authority
  - Elements
    - Affirmance
    - By a person (§ 1.04(5))
    - Of a prior act
    - That did not bind the principal
    - → Act given effect as if originally authorized

- **General Matters**
  - Agency law is a default set of rules that provides the terms of an agreement that create a fiduciary relationship.
  - **Why have agency law?**
    - Need for apportionment of liability
      - Create harmony between risk of action and benefit of action
      - Agent acts for benefit of principal → principal should bear the risk of harm from the agent's acts. *The responsibility should follow the benefit*
    - Principals need agents as much as third parties need the protections of agency law
    - Comes from CL; originated during Industrial Revolution
    - Two branches
      - One from the courts; one from contracts
  - **Why do people appoint agents?**
    - People can get more done if they have multiple other persons working in their stead
- **A principal is liable for the authorized acts of the agent.**
  - **Actual authority**
    - Communicated principal → agent *(§ 2.01, 3.01)*
  - **Apparent authority**
    - Communicated principal → third party *(§ 2.03, 3.03)*
      - cannot be created by the agent alone

- **Forming an agency relationship:**
  ***A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (1981)** *(41)*
    - **Question**: did Cargill, in its course of dealing with Warren, become liable as a principal on contracts made by Warren? *(yes)*
    - Summary
        - Plaintiff farmers *(individuals, partnerships, corporations)* sued Warren Seed & Grain Co. *(family business organized as a corporation)* and Cargill *(large, private company that financed Warren)* because Warren defaulted on $2m worth of contracts to buy grain from the **π**s. Plaintiffs claimed that Cargill was liable as a principal on Warren's debt; Cargill claimed it was only a creditor to Warren. Judgment for **π**s.
    - Reasoning *(bottom 44–45)*
        - Cargill assumed daily control of Warren's grain elevator and business
        - Cargill memo saying Warren needed "strong paternal guidance"
        - Cargill's name was on Warren's forms and drafts
        - Cargill allowed continuous overdrafting of Warren's revolving credit account with them because Cargill wanted the grain
        - 100% of Warren's operating expenses financed by Cargill
        - Cargill essentially owned Warren; Warren was completely dependent on Cargill.
    - What *(of elements listed on p. 45)* would be present in a normal borrower/lender relationship?
        - (3): lender would want to be sure their account retains higher repayment priority
        - (1): advice—at least partially
        - (9): power to discontinue financing
        - (4): auditing

- **Extent of actual and apparent authority:**
  ***Fennel v. TLB Kent Co.** (48)*
    - Lawyer's actual authority regarding litigation
        - Hiring the attorney created some degree of authority to litigate
        - Could have been specified in a client letter
    - Lawyer's actual authority regarding settlement
        - No authority
        - Decision to settle is strictly the client's (MRPC 1.2(a))
    - Lawyer's apparent authority regarding settlement
        - No authority *(although the trial court held otherwise)*
            - concern was that if a client could reject his attorney's settlement agreement after it had been made, would "open the door to a mild form of chaos"

- Appellate court: "A client does not create apparent authority for his attorney to settle a case merely by retaining the attorney"
  - despite burden on trial courts, primary concern is allowing cl to have final decision on settlement
- **Δ's counsel has the burden of determining the scope of π's counsel's authority to settle.**

- **Extent of actual and apparent authority:**
  U.S. v. Int'l Brotherhood of Teamsters
  - Lawyer's actual authority regarding litigation
    - Conduct settlement negotiations
  - Lawyer's actual authority regarding settlement
    - Implied actual authority to conduct settlement negotiations *(para. 2, p. 53)*
    - **Actual authority can be inferred from words or conduct**
      - Teamsters' old atty said in open ct that his cl had given him authority to settle; cl did not contradict
      - Teamsters ofcrs offered thru atty to resign; that they did resign showed their consent to their lawyer as agt (§ 1.03)
      - Resignation proposal spurred new negotiations
      - Teamsters' new atty never claimed lack of authority as a basis for invalidating settlement made thru & by old atty
    - *Note difference btw agent's representations as* evidence *of the agent's authority & using the agent's representation as the* origin *of that authority. Agent's representations are evidence. Principal's representations create the authority.*
  - Lawyer's apparent authority regarding settlement
    - It existed. *(para. 3, p. 53)*
    - After settlement made, Teamsters directed atty to deliver the gov't their resignation proposition (in open court)—same atty that the Teamsters said lacked authority to conduct settlement in the first place

- *Fennell* vs. *Teamsters*
  - In *Fennell*, settlement was out of court and client immediately objected to his atty's having made the settlement at all. In *Teamsters*, settlement was made in open court and the client made no objection.
    - Courts more concerned with preserving the outcome of in-court proceedings because (a) the proceedings are on the record and (b) finality necessary so court can get on with its business

CHAPTER 1. INTRODUCTORY MATTERS

- **§ 1.01 Agency Defined**
  - Agency is the fiduciary[1] relationship that arises[2] when one person[3] (a "principal") manifests assent[4] to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agenct manifests assent or otherwise consents so to act.
    - Creation of agency relationship ≠ require consideration
    - Need not be specifically intended by the parties; parties need only intend to complete the acts that form the agency. Agency relationships can arise even when parties specify to the contrary. See § 1.02.
    - Agency can be formed through Power of Attorney form: see § 1.04(7).
      - Don't need the form to create agency relationship, but is useful for medical purposes, conservatorships . . .
- **§ 1.02 Parties' Labeling and Popular Usage Not Controlling**
  - An agency relationship arises when the elements of § 1.01 have been met and not otherwise.
- **§ 1.03 Manifestation**
  - Assent or intention = "written or spoken words or other conduct."
- **§ 1.04 Terminology**
  - **(2)(a) Disclosed principal**
    - Third party interacting with an agent knows that the agent is acting for a principal and has notice of the principal's identity
  - **(2)(b) Undisclosed principal**
    - Third party does not know that the agent is acting for a principal.
  - **(2)(c) Unidentified principal**
    - Third party knows that the agent is acting for a principal but does not know the identity.[5]
  - **(5) Person**

[1] Fiduciary = obligation to act on behalf of a party's best interests and only on behalf of that party's best interests; see § 8.01

[2] Arises = as a matter of law. Need not be explicitly agreed upon.

[3] "Person" = defined in Rest. 3d Agency § 1.04(5) as an individual, corporation, etc.—any "entity that has legal capacity to possess rights and incur obligations."

[4] Assent = defined in Rest. 3d Agency § 1.03 as including "written or spoken words or other conduct."

[5] Principal might not want to be identified because some third parties might not want to do business with the principal, or to avoid disclosing financial status, which could mean better bargaining power for the principal.

- An individual, organization, government entity, or "any other entity that has legal capacity to possess rights and incur obligations"
- **(7) Power of Attorney**
  - Instrument that states an agent's authority

CHAPTER 2. PRINCIPLES OF ATTRIBUTION

- **§ 2.01 Actual Authority**[6]
  - Agent reasonably believes when taking action for the principal that the principal "wishes the agent so to act."
    - belief must be based on "principal's manifestations to the agent."
- **§ 2.02 Scope of Actual Authority**
  - **(1)**
    - Action designated or implied
    - Acts necessary or incidental to achieving the principal's objectives
      - as agent "reasonably understands the principal's manifestations and objectives"
  - **(2)**
    - Agent's interpretation of manifestations is reasonable if:
      - reflects "any meaning known by the agent to be ascribed to the principal" *and*
      - is (in the absence of meanings known to the agent) as a reasonable person would interpret the manifestations in context
  - **(3)**
    - Agent's understanding of objectives is reasonable if:
      - accords with principal's manifestations and the inferences that a reasonable person would draw from the circumstances
- **§ 2.03 Apparent Authority**[7]
  - When a third party reasonably believes that the actor has authority to act on behalf of the principal *and*
  - belief traceable to the principal's manifestations
- **§ 2.04 Respondeat Superior**
  - Employers are subject to liability for torts committed by employees while acting within the scope of their employment
- **§ 2.05 Estoppel to Deny Existence of Agency Relationship**
  - A person can be held liable as a principal even absent an agent's actual or apparent authority if a third person makes a "detrimental change in position" as a result of the would-be agent's actions if:

[6] See also § 3.01.
[7] See § 3.03, creation of apparent authority.

        - **(1)** the person intentionally or carelessly caused such belief, *or*
        - **(2)** upon notice of such belief, and knowing that others might change their positions based on that belief, the person did not take reasonable steps to notify them of the facts
- **§ 2.06 Liability of Undisclosed Principal**
    - **(1)**
        - Subject to liability to a third party *justifiably induced* to make a detrimental change in position by an *agent without actual authority* if the principal (1) had notice of the agent's conduct and (2) knew that others might change their positions but (2) did not take reasonable steps to notify the others of the facts
    - **(2)**
        - Agent's authority assumed to be no less than the authority a third party would have reasonably believed the agent to have under the circumstances if the principal were disclosed, regardless of principal's instructions purporting to limit the agent's authority.
- **§ 2.07 Restitution of Benefit**
    - Principal is unjustly enriched at another's expense by action of an agent or one who appears to be an agent → the other may claim against the principal for restitution

CHAPTER 3. CREATION AND TERMINATION OF AUTHORITY AND AGENCY RELATIONSHIPS

- **§ 3.01 Creation of Actual Authority**[8]
    - Created by a principal's manifestations[9] to an agent that, as reasonably understood by the agent, expresses the principal's assent that the agent take action on the principal's behalf.
- **§ 3.03 Creation of Apparent Authority**[10]
    - Person manifests that another has authority to act with legal consequences for the person
    - Third party reasonably believes the actor to be authorized
    - Belief traceable to the manifestation
- **§ 3.04 Capacity to Act as Principal**
    - **(1)**
        - Principal must have capacity at the time the agent takes action: principal could have done the same if he were present[11]
    - **(2)**

[8] § 2.01 defines "actual authority."
[9] § 1.03 defines "manifestation."
[10] § 2.03 defines "apparent authority."
[11] Note that corporations do not have capacity before formation. Corporations can later *adopt* but not *ratify* contracts entered into on their behalf before formation.

        - Law applicable to persons not individuals governs whether the person has capacity to be an agent
            - also governs effect of the peron's lack or loss of capacity on those who interact with it
    - **(3)**
        - Non-delegable acts cannot be performed by an agent
- **§ 3.05 Capacity to Act as Agent**
    - Any person, ordinarily
    - Capacity determines extent of duties and liabilities to principal/third parties

CHAPTER 4. RATIFICATION

- **§ 4.01 Ratification Defined**
    - **(1)** Affirmance of a prior act done by another; given effect as if done by an agent with actual authority.
    - **(2)** A person ratifies an act:
        - **(a)** by explicitly manifesting assent
        - **(b)** through implicit conduct "that justifies a reasonable assumption" of consent
    - **(3)** Ratification does not occur unless
        - **(a)** the act is ratifiable under § 4.03
            - *§ 4.03: actor must have acted or purported to act on the person's behalf*
        - **(b)** the person ratifying has capacity under § 4.04
            - *§ 4.04: (1)(a) the person must have existed at the time of the act and (b) the person must have capacity under § 3.04; (2) a principal may avoid ratification made earlier if it lacked capacity under § 3.04.*
        - **(c)** the ratification is timely under § 4.05
            - *§ 4.05: Ratification must precede circumstances that would cause the ratification to have "adverse and inequitable effects on the rights of third parties," including (1) third party's manifestation of intent to withdraw from the transaction; (2) changes in circumstances that "would make it inequitable to bind the third party," unless the third party consents to be bound; and (3) "a specific time that determines whether a third party is deprived of a right or subjected to a liability."*[12]
        - **(d)** the ratification encompasses the act in its entirety under § 4.07.
            - *§ 4.07: "A ratification is not effective unless it encompasses the entirety of an act, contract, or other single transaction."*

[12] Smiddy says: "Essentially what this is saying is that at the time one ratifies, one has to have knowledge of all material facts. But if the ratification is essentially to shift the burden of adverse consequences to an adverse party, you can't do that." Can't use ratification to get the benefits and shift the burden.

- **§ 4.06 Knowledge Requisite to Ratification**
  - Ratification not binding if the person did not know of material facts involved in the original act and the "person was unaware of such lack of knowledge"
- **§ 4.08 Estoppel to Deny Ratification**
  - Ratification binding if a person manifests ratification and a third party detrimentally relies on the manifestation

- *Connecticut Junior Republic v. Doherty*, 478 N.E.2d 735 (1985) *(59)*
  - Facts
    - Will named seven charities as beneficiaries
    - Updated to a codicil with eleven charities named, only one of which was in the original will
    - 2nd draft of codicil reverted to the seven original charities by accident
      - Despite knowledge of the change, testator didn't demand a fix
    - Unauthorized act = substituting seven orig. charities for the eleven
    - Agent = lawyer
    - Principal = testator
  - Question
    - Did the testator's knowledge of the change, combined with his inaction on the matter, result in ratification of the change? (yes)
  - Ratification = testator's failure to object
    - VP of the trust dept read new codicil to testator; testator followed on a copy; VP answered testator's Qs for a 45-minute period; testator made no cmt abt change in beneficiaries
    - testator later remarked to a friend/fin. advr. that he had "reverted or gone back to his original list of charities"
    - testator executed the codicil
  - Argument that testator didn't fully understand the change
    - 2nd codicil only drafted in response to a change in the law, testator may have been focused on the law; despite being sound of mind and hearing a list of names both different from and shorter than the list in the first codicil, testator might not have registered the change because his attention was elsewhere

CHAPTER 6. CONTRACTS AND OTHER TRANSACTIONS WITH THIRD PARTIES

- **§ 6.01 Agent for Disclosed Principal**
  - Agent makes contract on behalf of a disclosed principal:
    - (1) principal and third party are parties to the contract

        - (2) agent **not** a party unless the agent and third party agree otherwise.
- **§ 6.02 Agent for Unidentified Principal**
    - Agent makes contract on behalf of an unidentified principal:
        - (1) principal and third party are parties to the contract
        - (2) agent **is** a party unless agent and third party agree otherwise.
- **§ 6.03 Agent for Undisclosed Principal**
    - Agent with actual authority[13] makes contract on behalf of undisclosed principal:
        - (1) Principal is a party unless excluded by the contract
        - (2) Agent and the third party **are** parties to the contract
        - (3) . . .
- **§ 6.04 Principal Does Not Exist or Lacks Capacity**
    - Purported agent is a party to the contract if:
        - knows or has reason to know that the purported principal does not exist or lacks capacity
        - third party does not agree otherwise
- **§ 6.10 Agent's Implied Warranty of Authority**
    - A purported and unauthorized agent who does business with a third party gives an implied warranty of authority to the third party; the third party is subject to liability for breah of that warranty unless:
        - **(1)** the principal or purported principal ratifies the act;
        - **(2)** the purported agent gives notice to the third party that no warranty of authority is given;
        - **(3)** the third party knows that the purported agent has no actual authority
- **§ 6.11 Agent's Representations**
    - **(1)** Agent misrepresents authority on behalf of a *disclosed* or *unidentified* principal → principal not liable unless
        - agent had actual or apparent authority in making the representation *and*
        - third party does not have notice that the representation is false
    - **(2)** Agent's representation incident to a "contract or conveyance" on behalf of a *disclosed* or *unidentified* principal is attributed to the principal as if made directly when:
        - agent had actual or apparent authority to make the c or c
        - *unless*
            - third party knew or had reason to know that the representation was untrue *or* that the agent had no actual authority

[13] Apparent authority is impossible when acting on behalf of an undisclosed principal.

- **(3)** Agent's representation incident to a c or c on behalf of an *undisclosed* principal attributed to the principle as if made directly when:
  - **(a)** agent acted with actual authority in making the representation *or*
  - **(b)** agent acted without actual authority but had actual authority to make true representations about the same matter

  If third party knew or had reason to know that the representation is untrue, it is not attributed to the principal.
- **(4)** If agent for undisclosed principal says he's not an agent, the third party may avoid the c or c if the principal or agent had notice that the third party would not have dealt with the principal.

CHAPTER 7: TORTS—LIABILITY OF AGENT AND PRINCIPAL

- **§ 7.01 Agent's Liability to Third Party**
  - Agent is liable to third parties for tortious conduct whether acting as an agent or employee, with actual or apparent authority, or within the scope of employment.
- **§ 7.03 Principal's Liability—In General**
  - **(1)** A principal is subject to ***direct*** liability to a third party harmed by an agent's conduct when
    - **(a)** [identical to § 7.04] the agent acts with actual authority *or* the principal ratifies the agent's conduct and
      - **(i)** the agent's conduct is tortious, *or*
      - **(ii)** the agent's conduct, if that of the principal, would subject the principal to tort liability; *or*
    - **(b)** the principal is negligent in selecting, supervising, or otherwise controlling the agent under § 7.05, *or*

        - **(c)** the principal delegates performance of a duty of care to an agent and the agent fails to perform the duty

    - **(2)** A principal is subject to ***vicarious*** liability to a third party harmed by an agent's conduct when
        - **(a)** the agent is an employee who acts within the scope of employment under § 7.07, *or*
        - **(b)** the agent commits a tort when acting with apparent authority in dealing with a third party or "purportedly on behalf of the principal"
- **§ 7.04 Agent Acts with Actual Authority**
    - [identical to § 7.03(1)(a)]
- **§ 7.05 Principal's Negligence in Conducting Activity Through Agent; Principal's Special Relationship With Another Person**
    - **(1)** A principal who conducts an activity through an agent is subject to liability to a third party caused by the agent's conduct if the harm was caused by the principal's negligence in selecting, training, retaining, supervising, or otherwise controlling the agent.
- **§ 7.07 Employee Acting Within the Scope of Employment**
    - **(1)** Employer is subject to liability for tort committed by employee within the scope of employment.
    - **(2)** Act is within the scope of employment if when performing work assigned by the employer or under the employer's control.
        - Not within scope of employment if within an "independent course of conduct not intended by the employee to serve any purpose of the employer."
    - **(3)** For the purposes of this section:
        - **(a)** employee = an agent whose principal controls or has the right to control the manner and means of the agent's performance of work
        - **(b)** work performed for free ≠ no principal liability

- ***Tarnowski v. Resop*, 51 N.W.2d 801 (Minn. 1952)** *(70)*
    - Facts
        - Agent misrepresented quality of product to principal and accepted bribe ("secret commission") from sellers
        - Plaintiff sued sellers, rescinding contract; favorable verdict for return of $; settled
    - Now **π** sues agent, charging breach of fiduciary duty
        - (1) Recovery of bribe money
            - Principal is entitled to *all* profits that the agent receives in course of agency
            - Meant to ensure *fidelity in the agent*

        - (2) Other damages: (i) operating losses; (2) loss of time; (3) expenses in connex with rescission; (4) nontaxable litigation expenses; (5) atty's fees
            - When **Δ**'s wrongful act necessitates **π**'s involvement w/ litigation to protect his interests, **π** may recover atty's fees from **Δ**—atty's fees "treated as legal consequences of the original wrongful act and may be recovered as damages" *(73)*
    - Principal need not show harm in fact. Agent may make no unauthorized gains from the agency relationship; principal may recover such gains as damages.
        - Policy = remove all incentives for the agent to violate fiduciary duties.

CHAPTER 8. DUTIES OF AGENT AND PRINCIPAL TO EACH OTHER

- **§ 8.01 General Fiduciary Principle**
    - An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship.
- **§ 8.02 Material Benefit Arising Out of Position**
    - Agent has duty not to acquire any material benefit from third parties in connection with the agent's business as an agent.
- **§ 8.03 Acting as or on Behalf of an Adverse Party**
    - Agent must not deal with principal as or on behalf of an adverse party in a transaction connected with the agency relationship.
- **§ 8.04 Competition**
    - Agent cannot compete with principal or aid competitors while serving the principal.
    - Agent may prepare for competition following termination of agency relationship.
- **§ 8.05 Use of Principal's Property; Use of Confidential Information**
    - Agent has a duty
        - **(1)** Not to use principal's property other than for the principal.
        - **(2)** Not to use or communicate principal's confidential information for purposes other than the principal's.
- **§ 8.06 Principal's Consent**
    - **(1)** Agent's conduct that would breach §§ 8.01–05 ≠ breach if principal consents *and*
        - **(a)** in obtaining principal's consent, the agent
            - **(i)** acts in good faith
            - **(ii)** discloses material facts that would affect the principal's judgment unless the principal already knows or does not want to know
            - **(iii)** otherwise deals fairly with the principal, *and*

        - **(b)** the principal's consent concerns a specific act or transaction or type of transactions that would occur in the ordinary course of the agency relationship
    - **(2)** Agent acting for more than one principal in a transaction between or among them has a duty
        - **(a)** to deal in good faith with each principal
        - **(b)** to disclose to each principal
            - **(i)** that the agent acts for the other principal(s)
            - **(ii)** all facts that would affect the principal's judgment . . .
        - **(c)** otherwise to deal fairly with each principal
- **§ 8.07 Duty Created by Contract**
    - Agent must act in accordance with express and implied terms of any contract between the agent and the principal.
- **§ 8.08 Duties of Care, Competence, and Diligence**
    - Agent must act with normal care, competence, and diligence.
    - Agent's special skills or knowledge to be taken into account in estimating what would be normal c, c, & d.
- **§ 8.09 Duty to Act Only Within Scope of Actual Authority and to Comply With Principal's Lawful Instructions**
    - **(1)** Agent must act only within the scope of actual authority.
    - **(2)** Agent must comply with all the principal's lawful restrictions on the scope of permissible actions.
- **§ 8.10 Duty of Good Conduct**
    - Agent must act reasonably and refrain from conduct likely to damage the principal's enterprise
- **§ 8.11 Duty to Provide Information**
    - Agent must make reasonable efforts to let the principal know facts that the agent knows, has reason to know, or should know when
        - **(1)** based on the principal's manifestations, the agent knows or should know that the princpal would want to know the facts *and*
        - **(2)** the facts can be provided to the principal without violating a superior duty that the agent owes to another
- **§ 8.14 Duty to Indemnify**
    - Principal must indemnify agent
        - **(1)** in accordance with any contract between them *and*
        - **(2)** unless otherwise agreed,
            - **(a)** when the agent makes a payment
                - **(i)** within the scope of actual authority *or*
                - **(ii)** that is beneficial to the principal, unless the agent acts officiously in making the payment; *or*
            - **(b)** when the agent suffers a loss that fairly should be borne by the principal in light of their relationship.
- **§ 8.15 Principal's Duty to Deal Fairly and in Good Faith**

- Principal must deal fairly and in good faith with the agent.
- Principal must let agent know of risks of physical harm or pecuniary loss entailed in the agent's work.

- **The four key categories of fiduciary obligations, running from A → P**
  - Duty of loyalty (§ 8.01)
  - Duty of care (§ 8.08)
  - Duty not to compete (§ 8.04)
  - Duty not to disclose confidential information (§ 8.05(2))

SOLE PROPRIETORSHIPS

SOLE PROPRIETORSHIPS

- Simplest form of business in the U.S.
- Formation and Operation
  - One-owner business
  - No requirements to begin operating
    - Unless using a trade name, no filing; no filing if running the business under an individual's name
- The sole proprietor:
  - Owns
  - Controls
  - Profits from (enjoys returns from)
  - Assumes the risk of the business
- Management
  - …
- Tax
  - Taxed as individual

PARTNERSHIPS

- **Partnership law creates default terms of agreement for the relevant business relationships.**

- **General matters**
  - Flexible business structure
  - Well-developed body of law; including for LLPs
  - General Partnerships
    - Fading from popularity, although most popular form of business in colonial times (LLPs popular today)
  - Why do people form partnerships?

- Shared control → shared risk
- Greater manpower → greater productivity
- Take advantage of multiple peoples' talents

- **Partnership Formation (UPA § 202)** *(statute book 51)*
  Elements
  - An association (no K needed)
  - Two or more persons (§ 101(10): any legal or commercial entity)
  - To "carry on"
  - As co-owners
    - share control, risks, benefits
  - Of a business (§ 101(1): every trade, occupation, and profession)
  - For profit
    - Earnings dist'd to investors
    - ([gross revenues – expenses] = [profit])

- **Stuff to know**
  - Formation
  - Management
  - How investments are made
  - Who bears the risk
  - How investors get return on investment
  - Dissolution

UNIFORM PARTNERSHIP ACT

ARTICLE 1. GENERAL PROVISIONS

- **§ 101. Definitions**
  - **(1)** "Business" includes every trade, occupation, and profession.
  - **(5)** "Limited liability partnership" = SoQ filed under § 1001; no similar statement filed in other jurisdictions.
  - **(6)** "Parnership" = "an association of two or more persons to charry on as co-owners a business for profit formed under § 202" or comparable law
  - **(7)** "Partnership agreement" = written, oral, or implied agreement concerning the partnership; includes amendments thereto
  - **(9)** "Partnership interest" or "partner's interest in the partnership" = all of a partner's interests in the partnership, including the partner's transferrable interest and all management and other rights
  - **(10)** "Person" = individual, corp . . . any legal or comm'l entity
- **§ 103. Effect of Partnership Agreement; Nonwaivable Provisions**
  - **(a)** Partnership agreement controls, except for restrictions in (b); if pship agreement is silent on a point, UPA controls

        - *default is UPA*
    - **(b)** The partnership agreement may not:
        - **(1)** Vary § 105 duties except eliminate duty to provide copies of stmts to all ptrs
        - **(2)** unrsbly restrict right of access to books & recs under § 403(b)
        - **(3)** eliminate duty of loyalty under § 404(b) or § 603(b)(3), but
            - **(i)** pship agr may identify specific types or categories of acts that do not violate the duty of loyalty, if not manifestly unrsbl; or
            - **(ii)** all ptrs (or #/% specified in pship agr) may authorize or ratify, *after full disclosure of all material facts*, a specific act/transaction that would otherwise violate the duty of loyalty;
        - **(4)** unrsbly reduce duty of care under § 404(b) or § 603(b)(3)
        - **(5)** eliminate the obl of good faith & fair dlg under § 404(d)
            - but can prescribe stds for det'ing whether obl met, if stds not manifestly unrsbl
        - **(6)** vary power to dissociate under § 602(a)
            - but can require notice under § 601(1) to be in writing
        - **(7)** vary the right of a court to expel a ptr under § 601(5)
        - **(8)** vary the reqmt to wind up the pship bus in cases under § 801(4),(5), or (6)
        - **(9)** . . .
        - **(10)** restrict rights of third parties under the UPA
- **§ 106. Governing Law**
    - **(a)** Except under (b), law of the jurisdiction in which a pship has its chief exec ofc governs
    - **(b)** The law of this state (state of pship formation) governs if LLP

ARTICLE 2. NATURE OF THE PARTNERSHIP

- **§ 201. Partnership as Entity**
    - **(a)** Partnership is an entity distinct from the partners
    - **(b)** An LLC is the same entity before LLCing under § 1001

- **§ 202. Formation of Partnership**
    - **(a)** Association of two or more persons to carry on as co-owners a business for profit → partnership.
        - Persons need not *intend* to form a partnership; need only to have intended the *acts* that legally result in a partnership
    - **(b)** Partnerships only legally recognized under the UPA if formed under the UPA
    - **(c)** Rules relevant to whether a partnership has been formed:

- **(3)** Person receiving share of profits presumed to be a partner, unless the profits received in payment of:
  - (i) debt; (ii) services; (iii) rent; (iv) annuity; (v) interest or other loan charge; (vi) sale of goodwill or other property

- ***Holmes v. Lerner*, 88 Cal. Rptr. 2d 130 (1999)** *(84)*
  - **Facts**
    - H & L came up with the idea for a business; held reg mtgs. Lerner was well financed & business-wise; Holmes was a horse trainer. Holmes was on the Board of Directors, but not an officer of the co; said the co was her idea.
    - Original idea was to build up the co & sell it.
    - Holmes pushed out of the business; given a 1% interest in the company.
    - Holmes sued, saying Lerner breached pship agr; won at trial; affirmed on appeal.
  - **Issue: Did the two women form a partnership? *(yes)***
    - **Sharing of profits not a required element of partnership formation; merely evidence of.** (Minority view)
  - **Elements of partnership**[14]
    - Association (yes)
    - Two or more persons (yes)
    - Carry on
      - Course of dealing supported: Holmes' attendance at bd mtgs; involvement in creating product line; work in warehouse
    - Co-ownership
      - Debated; Lerner's past statements supported Holmes's story
      - Holmes contributed a major part of the idea for the co, even though Lerner was more involved in mgmt & growth
    - Business (yes)
    - For profit (yes)

ARTICLE 3. RELATIONS OF PARTNERS TO PERSONS DEALING WITH PARTNERSHIP

- **§ 301. Partner Agent of Partnership**
  Subject to the effect of a statement of partnership authority under § 303:

[14] Cf. *Warren* case – association? yes—2 or more ppl? yes—carry on? yes—co-owners? … arguably not shared control. risk? . . . mostly on cargill, ultimately; not completely clear.

- **(1)** Each partner is an agent of the partnership for the purposes of its (pship's) business.
  - **Partner is both principal (as partner) and agent (of pship)**
  - Partnership bound by:
    - Acts of partner "for apparently carying on[15] in the ordinary course the partnership business" *or* "business of the kind carried on by the partnership"
      -

    unless
    - Partner had no authority to act in that matter *and*
    - Person dealing with partnership knew or had notice of the lack of authority
  - *Agency law:* partnership liable if partner was "apparently carrying on" (had apparent authority, Rest. 3d Agency § 2.03)
  - *Partnership law:* if partner was acting within the scope of business (still § 301)
    - American rule: in ordinary course of pship's business
      - *Hypo:* Law firm only does real estate. If an attorney drafts a will, characterize it as a law firm, not a real estate firm to fit with broad authority.
    - English rule: in course of business of kind carried on by pship (broader)
- **(2)** Act not apparently for carrying ordinary business *does not* bind the pship *unless* the other partners authorized the act

- **§ 305. Parnership Liable for Partner's Actionable Conduct**
  - **(a)** liability for acts "in the ordinary course of business of the partnership or with authority of the partnership"
  - **(b)** pship liable for financial losses a ptr causes under std of (a)
- **§ 306. Partner's Liability**
  - **(a)** Partners jointly and severally liable, except as provided under (b) and (c)
  - **(b)** New partners not personally liable for pship obls incurred before
  - **(c)** LLP obls are only the obls of the pship. No pers liab for ptrs.

- ***Kansallis Finance Ltd v. Fern*, 659 N.E.2d 731 (1995)** *(106)*
  - Partner (Jones) in a law partnership wrote a fraudelent letter to Kansallis, which Kansallis detrimentally relied upon to the tune of $880,000. Jones was indicted and convicted of fraud. Kansallis sought to recover the $880k from Jones' other partners, alleging fraud.
    - Two theories of recovery: vicarious liability under (1) partnership law and (2) agency law.

[15] Apparent authority: Rest. 3d Agency § 2.03. P → T communication. Looking to agency law for supplementary provisions is authorized by UPA § 1.04(a), which states: "Unless displaced by particular provisions of this [Act], the principles of law and equity supplement this [Act]."

- *It's possible to act within the scope of employment without having apparent authority*

- **Agency law: was Δ acting with apparent authority?**
  - Was it reasonable for **π** to think that Jones was acting on behalf of the partnership?—Did the letter communicate that Jones was authorized?
- **Partnership law: was Δ acting within the scope of the partnership?**
  - *cf. Rest. 3d Agency § 7.07(1)*
  - UPA § 305: partnership liability for partner's acts in scope of business.
  - UPA § 306: partners have joint & several liability for partnership liabilities → access to deep pockets.
    - applies if pship itself can't satisfy a claim.
    - but under § 306(c), doesn't apply if it's an LLP.
  - **Three-part test from *Kansallis***
    - (1) Act must have been "the kind of thing a law partner would do."
    - (2) Act must have "occurred substantially within the authorized time and geographic limits of the partnership."
    - (3) Act must have been "motivated at least in part by a purpose to serve the partnership."

ARTICLE 4. RELATIONS OF PARTNERS TO EACH OTHER & TO PARTNERSHIP

- **§ 401. Partner's Rights and Duties**
  - **(a)** Each partner deemed to have an acct that is:
    - **(1)** credited w/ money plus value of any property, net liabilities, that partner contributes,[16] plus partner's share of profits; and
    - **(2)** charged with money plus property, net liabilities, dist'd by pship to partner, plus partner's share of losses.
  - **(b)** Each partner entitled to equal share of profits; chargeable with share of losses proportionate to share of profits.
  - **(f)** Each partner has equal management rights.
  - **(h)** Partners ≠ entitled to pmt for services performed for pship, except in winding up.
  - **(i)** New partners req consent of all partners.
  - **(j)** Differences arising "in the ordinary course of business": majority vote. "Outside the ordinary course of business" or amdt to pship agr: unanimous vote req'd.

[16] Does not include services

- Need for unanimous votes in extraordinary matters
  - no real guidelines for this outside of § 401(i),(j)
  - voting matters should be worked out ahead of time because of lack of statutory guidelines

- **§ 403. Partner's Rights and Duties with Respect to Information**
  - **(a)** books and records to be kept at chief executive office
  - **(b)** pship must provide ptrs & their agts access to records
  - **(c)** ptrs & pship must provide, on demand, to ptrs:
    - **(1)** any info concerning pship's business & affairs rsbly req'd for the proper exercise of the ptr's rights and duties
    - **(2)** any other info re: pship's business & affairs unless improper under the cirucmstances
- **§ 404. General Standards of Partner's Conduct**
  Only ptrs—that to whom the duty is owed—can sue for a breach of fiduciary duty
  - **(a)** Only duties ptr owes pship & other ptrs = duty of loyalty & duty of care.
  - **(b**) Duty of loyalty limited to:
    - **(1)** must account to pship & hold as trustee any property, profit, or benefit derived by ptr in conduct/winding up or by use of pship property, "incl. the appropriation of a pship oppty"
    - **(2)** refrain from dealing w/ pship (conduct or winding up) as or on behalf of an adversely interested party
    - **(3)** refrain from competing with the pship *before dissolution*
  - **(c) Duty of care** limited to:
    - in conduct & winding up, refraining from **grossly negligent** or reckless conduct, intentional misconduct, or a knowing violation of the law
      - previous std: ordinary negligence
      - policy: foster care in the choice of ptrs; keep pships together by preventing frivolous suits
  - **(d)** Obligation of good faith & fair dealing
  - **(e)** Furtherance of ptr's own interest ≠ violating duty to pship/other ptrs
  - **(f)** ptr may lend money to & db w/ pship w/ same rights as a 3p
  - **(g)** (last-surviving-ptr thing)

- ***Meinhard v. Salmon*, 164 N.E. 545 (1928)**[17] *(98)*
  Hallmark of what level of loyalty partners owe
  - Joint venture = limited term & scope for the adventure
  - Suit based on breach of fiduciary duty of loyalty
    - Duty of loyalty[18]

[17] More on this in Class 13 notes.
[18] "Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. . . . A trustee is held to something stricter than the morals of the market place.

- Act in the interests of the joint venture
- No putting one's own interests above those of the j.v.

- Fiduciary duties under agency law
  - Loyalty, § 8.01; Duty of Care, § 8.02; Provide Information, § 8.11; Good Faith, § 8.15

- Salmon, manager of j.v. with Meinhard, both of whom dealt with Gerry, entered into a private agreement with Gerry that would commence after the intended dissolution date of the j.v. Salmon told Meinhard nothing of the agreement with Gerry.
- Court found that Salmon breached the duty of loyalty to Meinhard because Salmon had put his own interests above those of the j.v. while the j.v. was still carrying on.
  - remedy = constructive trust for Meinhard for one half of shares of stock (minus one) *or* constructive trust attaching to the lease (new agr btw Salmon & Gerry)

ARTICLE 5. TRANSFEREES AND CREDITORS OF PARTNERS

- **§ 501. Partner Not Co-owner of Partnership Property**
  - Ptr ≠ co-owner of pship prop & has no interest in transferrable pship property.
- **§ 502. Partner's Transferable Interest in Partnership**
  - Only transferable interest = **share of profits and losses** and **right to receive distributions.** This interest is personal property.
- **§ 503. Transfer of Partner's Transferable Interest**
  - **(a)** A transfer, in whole or part, of a ptr's transferable interest:
    - **(1)** is permissible
    - **(2)** does not by itself cause the ptr's dissociation or a dissolution & winding up of the business
    - **(3)** does not entitle the transferee to participate in the mgmt of the pship
  - **(b)** transferee has a right:
    - **(1)** to receive distributions that the transferor would have
    - **(2)** to receive, upon dissolution and winding up, the net amount otherwise distributable to the transferor

- ***Rapoport v. 55 Perry Co.*, 50 A.2d 54 (N.Y. App. Div. 1975)** *(117)*
  - Two families had partnership; each owned 50%. **π**s asked **Δ**s to execute new pship agr including **π**'s kids as ptrs; **Δ**s refused.
    - Trial court had found ambiguity of intent in language of agreement; App. Div. disagreed; case disposed of on SJ.

Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate."

- *See language on top of p. 118 for arguable exception that **π**s tried to use*

- UPA default: *(118)*
  - new partners may be added only with consent of all current partners
  - partnership interests freely assignable; assignee may only receive profits attendant to the assigned interest.
    - management rights not freely transferable.

ARTICLE 6. PARTNER'S DISSOCIATION

- **§ 601. Events Causing Partner's Dissociation**
  A partner is dissociated upon the occurrence of any of the following:
  - **(1)** partnership has notice of partner's express will to withdraw at a particular time;
  - **(2)** an event agreed to in the pship agr as causing dissociation;
  - **(3)** partner's expulsion as provided by the pship agr;
  - **(4)** partner's expulsion by unanimous agr of the other ptrs if:
    - **(i)** carrying on business with that ptr would be unlawful;
    - **(ii)** ptr has transferred (substantially) all of his transferable interest in the pship for reasons other than security purposes, or there has been a court order charging the ptr's interest, which has not been foreclosed;
    - (iii) [corporate partner provision];
    - (iv) [partnership partner provision];
  - **(5)** expulsion by judicial termination, following application from pship or another ptr, because:
    - **(i)** ptr's conduct wrongfully, adversely, materially affected pship business;
    - **(ii)** ptr willfully or persistently commited a material breach of the pship agr or a fiduciary duty under § 404;
    - **(iii)** ptr's conduct relating to the business has made it "not rsbly practicable" to carry on business of the pship with the ptr;
  - **(6)** the partner's:
    - **(i)** becoming a debtor in bankruptcy;
    - **(ii)** executing an assignment for the benefit of creditors;
    - (iii), (iv) . . .
  - **(7)** for individual ptrs:
    - **(i)** ptr's death;
    - **(ii)** appointment of guardian or gen'l conservator for the ptr;
    - **(iii)** judicial determination of ptr's incapacity to perform his duties under the pship agr;
  - (8) [provision re trust as ptr]

- (9) [provision re estate as ptr]
- (10) [misc]

- **§ 602. Partner's Power to Dissociate; Wrongful Dissociation**
  - **(a)** Section 601(1) gives a ptr the power to dissociate at any time, whether rightfully or wrongfully.

ARTICLE 7. PARTNER'S DISSOCIATION WHEN BUSINESS NOT WOUND UP

- **§ 701. Purchase of Dissociated Partner's Interest**
  - **(a)** Partner dissociates without causing dissolution → partnership buys out dissociating partner for a price det'd under (b)
  - **(b) Buyout price =** distributable amount under 807(b) based on:
    - liquidation value of the partnership *or*
    - sale of business as a going concern without the dissociated partner
      - —whichever is greater
  - **(c)** Any damages from wrongful dissociation under § 602(b), etc. offset against buyout price.
    - Interest calculated from data amount owed becomes due
  - **(e)** No buyout agreement w/in 120 days of written demand for pmt → pship must pay the dissociated ptr *in cash* whatever amount it estimates to be the buyout price

- Dissociation is often the result of a dispute between partners.
  - Frequently, each side wants to keep the business and buy the other out.
    - Some-time solution: each party submits to a third party the price at which they would buy the business & the price at which they would sell. Neither party knows which would be the buyer or seller in such cases.
  - § 701(e) designed to encourage quick settlements of dissociating ptrs' claims.

  - Since a partnership must buy out a dissociating partner—even one dissociating wrongfully—"the threat of liquidation is a constant cloud over an at-will partnership." *(121–22)*
    - at-will partnership = default = "unstable" *(122)*

ARTICLE 8. WINDING UP PARTNERSHIP BUSINESS

- **§ 801. Events Causing Dissolution and Winding Up of Partnership Business** A partnership is dissolved, and its business must be wound up, only upon occurrence of any of the following events:
  - **(1)** In an at-will pship, pship has notice from a ptr (other than one dissociated under §§ 601(2)–(10) of that ptr's express will to withdraw as ptr, or on a later date specified by the ptr;
  - **(2)** in a pship for a definite term or particular undertaking:
    - **(i)** w/in 90 days after a ptr's dissoc by death or otherwise under §§ 601(6)–(10) or wrongful dissoc under § 602(b), the express will of ≥1/2 of the remaining ptrs to wind up, for which prupose a ptr's rightful dissoc under § 602(b)(2)(i) = the expression of the ptr's will to wind up the pship;
    - **(ii)** the express will of all ptrs to wind up; *or*
    - **(iii)** the expiration of the term or the completion of the undertaking;
  - **(3)** an event agreed to in the pship agr resulting in winding up;
  - **(4)** an even that makes it unlawful for (substantially) all of the pship business to be continued, *but* a cure of illegality w/in 90 days after notice to the pship of the evnt is effective retroactively to the date of the event for the purposes of this section;
  - **(5)** on application by a ptr, a judicial determination that:
    - **(i)** the economic purpose of the pship is likely to be unrsbly frustrated;
    - **(ii)** another ptr has engaged in conduct relation to the pship business that makes "not rsbly practicable" to carry on the pship with that ptr; *or*
    - **(iii)** it is not otherwise rsbly practicable to carry on the pship business in conformity with the pship agr; *or*
  - **(6)** on application by a *transferee* of a ptr's transferable interest, a judicial determination that it is equitable to wind up the pship business:
    - **(i)** after the expiration of the term or the completion of the undertaking […]
    - **(ii)** any time, if the pship was at-will @ time of transfer […]
- **§ 807. Settlement of Accounts and Contributions Among Partners**
  - **(a)** when winding up, pship assets go first to paying back creditors, including partner–creditors. Surplus distributed to partners.
  - **(b)** when settling accounts, profits and losses from liquidation credited and charged to ptrs' accounts.
    - distribution to a given ptr = excess of credits over charges in the ptr's acct
    - if charges > credits, ptr pays in that amount (unless § 306 precludes personal liability)
  - **(c)** if a ptr doesn't contribute all he should under (b), other ptrs must make up the difference, proportionate to the ptrs' share of

losses, up to the amount needed to satisfy obligations for which they are personally liable under § 306.
    - right of recovery from undercontributing ptr.
- **(d)** [reqmt of contrib for pship obls not known at time of settlement]
- **(e)** estate of deceased ptr liable for ptr's obligations to contribute
- **(f)** [creditors' assignees may enforce ptr's oblig to contrib]

- ***Girard Bank v. Haley*, 332 A.2d 443 (Penn. 1975)** *(123)*
    - Facts
        - Pship btw Reid & three **Δ**s to manage real property; Reid put in the cash; **Δ**s to do labor.
        - Reid wrote letter expressing desire to terminate; later died
            - **Δ**s said letter didn't dissolve pship.
    - Issue
        - Whether pship dissolved on Reid's death or @ letter's writing.
            - Pship agr was silent on windup/dissolution, but addressed death of ptr in considerable detail (and more favorably to **Δ**s).
    - **At-will partnership requires no justification for dissolution.**
        - Pship dissolved @ letter's writing.

- ***Dreifuerst v. Dreifuerst*, 280 N.W.3d 335 (Wisc. App. 1979)** *(126)*
    - Facts
        - Three brothers formed pship to operate two feed mills. **π**s wanted to dissolve & wind up; bros couldn't agree on wind-up plan. **Δ** wanted pship sold, then **π**s could buy it out; lower court improperly ordered in-kind distrib.
    - Holding
        - **If there's a dissolution, default is liquidation in absence of agreement to the contrary.**
    - **Policy: *creditors' rights*** ← *most important thing in this case*
        - Value of business may be lower if assets are broken up & dist'd in-kind; can adversely affect creditor's rights.
            - (a) lower value may keep creditor from collecting entire debt.
            - (b) creditor would have to go after individuals rather than the partnership as a whole.
            - . . . also, if there is third-party interest in the business, sale as a whole provides better estimate of value.
        - "[J]udicial sales . . . may cause economic hardships, [but] these hardships can be avoided by the use of partnership agreements." *(129)*

- ***Drashner v. Sorenson*, 63 N.W.2d 255 (S.D. 1954)** *(130)*

- Facts
  - Pship agr stipulated that the pship would last at least until **Δ**s' $7500 advance had been repaid from the gross earnings of the business
  - Plaintiff sought dissolution before $7500 repaid
- Issues
  - Was pship at-will?
  - What must the court consider in calculating the value of the business?
- Holding
  - Pship agr was not at-will because of the provision requiring repayment of **Δ**s' advance.
    - → **π** caused dissolution wrongfully.
  - As a sanction due to **π**'s wrongful dissolution, goodwill not included in valuation of pship (despite goodwill being the pship's biggest asset). *(133)*
    - however, this was under UPA (1914); UPA (1997) includes intangibles as property—§ 101(11)

ARTICLE 10. LIMITED LIABILITY PARTNERSHIP

- **§ 1001. Statement of Qualification**
  - **(b)** Becoming an LLP requires vote
  - **(c)** Need a Statement of Qualification (SOQ) containing:
    - **(1)** name of the pship
    - **(2)** address of pship's CEO, or (if diff) addr of office in the State
    - **(3)** if no in-state ofc, addr for agent for service of process
    - **(4)** stmt that pship elects to be LLP
    - **(5)** deferred effective date, if any
  - **(d)** process agent must be State resident/licenced to db in the State
  - **(e)** effective date = filing date/date specified in stmt, whichever later
  - **(f)** errors in (c) ≠ affect status as LLP or liability of partners
  - **(g)** filing SOQ = pship satisfied conditions reqd for formation as LLP
  - **(h)** . . .
- **§ 1002. Name**
  - Name of an LLP must end with one of several appropriate indicators
- **§ 1003. Annual Report**
  - Annual report must contain:
    - **(1)** Name of LLP & State/juris under whose laws LLP formed
    - **(2)** [same as § 1001(2)]
    - **(3)** [same as § 1001(3)]

- LLPs = no indiv. ptr liability for company debts.
  - Reduces ptrs' risk of db

- shifts risk to 3rd parties db with LLP
- why permit the burden shift? why so pro-business?
- LLPs came into vogue around time corps started developing
-

LIMITED LIABILITY COMPANIES

- Difference from an LLP is often slight
- Has more flexibility in structure than LLP
  - does not have the well-developed body of law that LLP does.
  - "essentially a write-your-own" → unpredictable outcomes if LLC agreements not well written

CORPORATIONS GENERALLY

ADVANTAGES OF THE CORPORATE FORM *(136)*

- Limited liability of shareholders *(136)*
- Centralized management structure *(137)*
  - Usually three-tied: directors, officers, shareholders
  - Variable by agreement, e.g., via MBCA § 8.01(b) *(138)*
    - agreement in AoI
    - Shareholders' agreement, MBCA § 7.32
  - Management rights not tied to shareholder status
- Flexible capital structure *(138)*
  - Stock, promissory notes, debt
  - Convertible interests
    - e.g., bond might be convertible into common or preferred stock at the option of the bond holder
- Separate-entity status *(139)*
  - Death or bankruptcy of an owner has no institutional effect on the corporation
- Usual form for most businesses *(139)*
  - "In the business world, things work more smoothly if one operates in the usual way."

- The corporation is a business-organization form designed to allow a company to amass large amounts of capital from a wide range of sources.
  - Widespread investors carry much of the risk but get returns; usually have little control over the business (esp. in public corps; not so much in close corps).

DISDVANTAGES OF THE CORPORATE FORM *(140)*

- Expense and trouble of formation and maintenance *(140)*

- Charter, bylaws
- Annual reports & fees; continuing legal fees
- Cost of drafting charter and bylaws

- Required initial and continuing formalities *(141)*
  - Shareholders and directors must have meetings, or take action by formal written consent in lieu of meetings
  - Record-keeping requirement
- Tax treatment *(141)*
  - usually double taxation:
    - taxation on corporate earnings
    - taxation on dividends to shareholders
  - double taxation sometimes avoidable
    - S-type corporations
    - possibly avoidable (or at least deferrable) if corp does not pay dividends *(142)*
    - through reinvestment of available cash & salaries to owner-managers

Governed by state law

- Formation, operation, dissolution
- Concerned with management and shareholders
  - investors left to contract law
  - employees left to employment law

CORPORATIONS are a LEGAL FICTION.

- invented for efficiency purposes in dealing with an economic unit
  - management;
  - employees;
  - products/services being sold;
  - customers;
  - supplies providing to the company;
  - investors

the economic unit of a corporation

Why have corporations become symbols for many people of what's wrong with business?

- Nontransparent; nonaccountable; nondemocratic
- Primary accountability is to shareholders, not community or country

Organizing and forming a corporation

- **Where to incorporate** *(227)*
  - If going to start out small and grow, okay to start in home state
    - 35 states follow the Model Act
    - and there's Delaware—highly influential in corporate law
  - If planning on getting big quickly and selling shares, might want to incorporate in Del. or one of the industrial states

        - lots of competition among states for hosting corps → states keep their laws largely uniform
        - worry was that there's be a "race to the bottom": the states would pass laws more and more favorable to mgmt at the expense of shareholder rights, but that didn't happen
- **How to incorporate**[19] *(230)*
    - "astonishingly easy!"
    - "corporate kits"
    - fill out Certificate of Incorporation (Handout 11) → you're a corp
        - naming issues
            - must contact a trade-name-checking service: can't name yourself something too similar to an existing business
        - naming directors in the Certificate helps speed the process: no need to elect directors at first meeting
    - "written consents": can conduct the first meeting entirely through pre-written documents
    - yearly fees & reports
- **MBCA § 3.02—General Powers**
- **Preincorporation Agreements** *(235)*
- **Features of corporations**
    - Treated as a person under the law once AoI are filed
    - similar to rights/powers that individuals have (but, e.g., less protection against search and seizure)
    - What if you took away personhood?
        - Who to sue?
        - Where does liability fall?
        - Would it just drive corps to incorporate outside the U.S.?

"Whatever you think the tax policy should be, you should think about what the consequences will be of shifting the burden to another group within the economic unit we call a corporation."

Promoters' Contracts *(222)*

- Promoters = entrepreneurs responsible for bringing together all the components required to transform a business opportunity into a business operation
    - Organize business aspects of company—find investors, arrange for office space, hire employees, etc.

- **Liabilities of Corporations on Promoters' Contracts** *(222)*

[19] Articles of Incorporation = Corporate Charter = Articles of Association

- At the time of contracting, the promoter acts on behalf of a nonexistent principal → corporation ≠ bound by contract unless, after formation, it takes some action to make the contract its own
- Ratification is impossible *(223)*
- **Adoption**
  - like ratification but without retroactive effect
    - formal: Bd of Dirs passes resolution: safest course
    - informal: most common: corporation begins performing obligations under the contract

  - ***McArthur v. Times Printing Co.*, 51 N.W. 216 (Minn. 1892)** *(223)*
    - Adoption means that a contract becomes binding as of the date of adoption, not as of the date of original signing or agreement → has implications for Statute of Frauds issues *(224–25)*

- **Rights and Liabilities of Promoters on Promoters' Contracts** *(225)*
  - Generally turns on parties' intent and how K was drafted

  - Promoter's Liability After Adoption
    - Promoter still bound unless (1) K has language re: automatic novation upon adoption, or (2) novation effected post-adoption, whether formal or informal *(225–26)*
  - Intent of the Parties
    - Not enough that promoter signs on behalf of the to-be-formed corporation and then the corporation starts performing on the K; this is covered by the general rule that the promoter is liable and the corp is not
  - Drafting of the Contract *(226)*
    - Include explicit language in the K saying that the other contracting party will look only to the to-be-formed corporation for performance
    - "Most artful way" to avoid promoter liability
      - Secure written option from other contracting party allowing the to-be-formed corporation to enter into a specified contract

CORPORATE OBJECTIVE AND SOCIAL RESPONSIBILITY

- ***Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. 1968)** *(558)*
  - Basis of complaint: Lack of lights on Wrigley Field. Δ Corp, Chicago Nat'l League Ball Club, Inc., could make more money if they did night games. Stockholders alleged that managers of Wrigley Field were irresponsible in their failure to seek increased profitability, and sought an injunction forcing installation of lights.

- Issue on appeal: whether the complaint stated a claim
  - Mgmt **Δ**s said they didn't install lights because of a broader community concern: negative impact on neighborhood from bright lights at night.
  - Court said that **π**s would have to show fraud, illegality, or conflict of interest (breach of fiduciary duty of loyalty), and they didn't.
    - deference to business judgment; court surmised that directors may have considered long-term interests of the corporation in making their decision.

- ***Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919)** *(561)*
  - Ford wanted to reduce the price of the car to the benefit of the public (because, Ford said, the company made too much money).
  - Court said that was impermissible: corporations are for the benefit of shareholders.
    - Corp wouldn't exist without capital contribution of shareholders
    - *. . . but couldn't a lower price result in a higher volume of sales and greater goodwill that would ultimately be to the benefit of the company?—wasn't it shortsighted and arrogant of the court to mandate how a business genius like Ford should run his company?*

- Other-Constituencies Statutes *(561)*
  - > half of states have statutes authorizing directors to consider the interests of groups other than shareholders
    - e.g., PA statute *(562)*
      - In determining best interests of corp, can consider:
        - "[t]he effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers, and creditors . . . and upon communities in which offices or other establishments of the corporation are located"
        - short-term and long-term interests of the corp
      - In determining whether to take action, no particular group's interests, whether the corp's or other's, need be considered "dominant or controlling"
  - such statutes controversial
    - some say they're merely codifications of the case law, e.g., Del. S.Ct.: "directors may consider other constituencies so long as there is 'some rationally related benefit accruing to the stockholders'"
  - such statutes are likely to decrease the liability of directors, since they increase directors' discretion

- ALI Principles: § 2.01 *(563)*
  - Primary obligation is to the shareholders, but corp can "take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of the business" and may spend some money on public-welfare, humanitarian, educational, and philanthropic stuff
  - commentary emphasizes that corporate goal isn't just short-term profits; short-term costs for long-term gains are good *(564)*
- Corporate Code *(565)*
  - E.g., Johnson & Johnson's Credo: first responsibility is to those "who use [their] products and services"; then to employees, and communities; final responsibility to stockholders
- Ethics Codes *(565)*
  - Sarbanes-Oxley Act required SEC to make rules requiring companies to adopt codes of ethics for their senior financial officers or explain why they didn't
- Corporate Governance Reforms *(566)*
  - Sarbanes-Oxley required independent auditing

CAPITALIZATION

Type of Security	**Debt**	**Equity Preferred Stock**	**Equity Common Stock**
Relation to company	contractual	Statutory/articles of incorporation	Statutory/articles of incorporation
Duration of Investment	5+ years: bond/debenture bond = secured; debenture = unsecured[20] >5 years: notes (may be secured or unsecured)	Perpetual	Perpetual
Priority of Payment	Highest security Secured/unsecured	After debt/before common	Lowest security
Return on investment	Interest	Dividends (cumulative/non-cumulative);[21]	Dividends

[20] higher interest rate because riskier; debenture holders get paid with general creditors: lower priority.
[21] cumulative = dividends accumulate: if not pd one quarter, must be paid next quarter before that quarter's dividends are paid. most pref'd stock is cumulative.

		cumulative if earned[22]	
Return of investment	Principal	Capital (price paid for shares)	Capital (price paid for shares)
Level of risk	Lowest[23]	Higher than debt; lower than common	Highest of securities
Control	Usually none	Vote if dividends not pd over time	Vote

- **Issuing Shares**
  Stock must be:
  - **Duly authorized**
    - When shares of stock are issued, the corporation had sufficient shares authorized in its charter to cover the issuance
      - ***Number*** and ***type*** of securities must be authorized
      - *accord* Del. GCL § 102(a)(4)
    - Only equity is in the articles; debt = contractual

  - **Validly issued** *(255)*
    - Did corporation and Bd of Dirs take proper steps to issue the shares?
      - Did the Board approve the issuance?
      - Consideration set by board of proper amount and type?
      - Officers of corp followed proper procedure in issuing?

    - ***Toms v. Cooperative Mgmt. Corp.*, 741 So. 26 164 (La. 1999)** *(247)*
      - Bd of Dirs, by majority vote, issued 150 new shares of no-par stock and sold them to a single person in settlement of a legal claim. Bd allocated proceeds of sale to capital surplus; $0 to stated capital.
        - *didn't work.*
        - AoI reqd issuances to be approved by 85% of stockholders. Directors voting for issuance didn't have 85% of stock.
        - **Can't allocate $0 to stated capital when issuing new stocks.** Must put *some* amount of capital in stated capital.

[22] if co. had $ to pay but didn't, dividends accumulate; but otherwise not.
[23] If company goes out of business, creditors get paid first.

- Argument that new stock was equivalent to the treasury stock that had previously been cancelled, and which itself had made no difference to stated capital, didn't fly because that didn't change the fact that new stock was being issued

- **Fully paid** *(255)*
  - Proper type and amount of consideration given in exchange for a share of stock
    - Del. GCL § 152: Allowable kinds of consideration (board "may" authorize): cash, (in)tangible property, any benefit to the corporation, any combination of the above *(244)*
    - Del. GCL § 153: Issuing price set by directors. For par value stock, issuing price cannot be less than par value; for non-par value, left to directors' discretion *(243)*
    - Del. GCL § 154: Consideration must be expressed in $, regardless of what forms of consideration accepted *(244)*
      - Must put at least [par value] x [# shares issued] into Capital account; the rest can go into capital surplus, but need not (no statutory limit on Capital)

    - MBCA § 6.21(b): allowable consideration (Board "may" authorize) is "(in)tangible property, benefit to the corporation, including cash, promissory notes, services performed, contracts for services, other securities of the corporation"
      - Cmt: "benefit" to be broadly construed, incl. "reduction of liability, release of a claim," etc.

    - NY Bus. Corp. Law § 5.04(a): consideration "shall" take one of the following forms
      - cash, tangible property, future services (as long as expressed as binding obligations with an agreed value—expressly requires valuation)
      - permits payment by services before incorporation

- Nonassessable = corporation can't go after the shareholder for further payments. Fully paid stock is usually nonassessable.
  - MBCA § 6.21(d): Adequate consideration → nonassessable & fully paid. *(256)*

- ***Hanewald v. Bryan's, Inc.*, 429 N.W.2d 414 (N.D. 1988)** *(257)*
  - **When shares are fully paid, they become nonassessable, and the personal assets of shareholders are not available for satisfaction of company debts.**
  - **Shareholders personally liable to the extent of their capital contributions plus any amount not yet paid for the stock** *(260)*

- **Watered stock** *(256)*
  - Stock issued for less than full amount of permissible consideration; stock remains outstanding & less than fully paid. Dilutes value of other issued shares.
  - Two ways for stock to be watered:
    - (1) Shareholder didn't pay amount legally required
      - e.g., pmt of less than $1000 for 100 shares of $10 par value stock *(257)*
    - (2) Consideration used to pay for stock had inflated value
      - e.g., $500 worth of property, stated at $1000, used to pay for $1000 worth of stock
  - MBCA § 6.21 cmt: no need for par value → no such thing as watered stock based on issuance at less than "an arbitrarily fixed price" → main Q is whether consideration is fully paid

- **Dividends and distributions** *(246)*
  - must be paid from earned surplus or capital surplus accounts
    - Del GCL § 170: dividends can be paid from surplus
      - *cannot pay dividends from capital account*

  - Del. GCL § 154: Bd of Dirs can transfer capital surplus → stated capital; restricts company's ability to make distributions
  - Del. GCL § 244: Bd of Dirs can transfer stated capital → capital surplus, as long as they leave at least aggregate par value in the stated-capital account

  - MBCA § 6.40: Distributions to shareholders
    restrictions on issuing dividends, particularly common-stock holders, when there are outstanding liabilities
    - § 6.40(c): No distribution may be made if:
      - (1) so doing would render the corp unable to pay its debts as they come due in the usual course of business
        - (look at current assets)
      - (2) total assets would be less than liabilities + amt that would be needed (if corp dissolved) to

pay debts to preferred stockholders

- **Thin incorporation and subordination** *(263)*
  - ***Obre v. Alban Tractor Co.*, 179 A.2d 861 (Md. Ct. App. 1962)**[24] *(266)*
    - Capitalization was reasonable at time of incorporation → not a thin-incorporation problem
      - **When capitalization reasonable at time of incorporation, owners' debts to corporation considered *bona fide* and will not be treated as risk capital contributions, and thus owners' debt claims against the corporation will not be subordinated to other creditors**
      - reasonableness of the particular capital structure supported by the facts of the situation—one owner had lent the co $35k in exchange for a note rather than contributing capital because owner & co-owner sought eventual equal ownership

  - ***Fett Roofing & Sheet Metal Co. v. Moore*, 438 F. Supp. 726 (E.D. Va. 1977)** *(269)*
    - SP (Fett) inc'd; capitalized with $4900
    - Fett transferred $ to his corp 3x ($7.5k, 40k, 30k)
      - had personally borrowed from bank; transferred $ to corp; took back "demand promissory notes"
    - Corp became insolvent → Fett recorded 3 deeds of trust to secure notes & backdated to when money had actually been borrowed; shortly thereafter, corp became bankrupt
    - @ time of bankrupcty:
      - <$5k equity; >$400k debt to secured creditors
      - D:E ratio ~80:1
    - Effect of deeds of trust securing notes
      - Notes became secured debt → would put notes at top priority for repayment in bankruptcy
      - Court found this fraudelent
    - Fett's claim subordinated to creditors.
      - "Where a director or majority shareholder asserts a claim against his own corporation, a bankrupty court . . . will disregard the outward appearances of the transaction and determine its actual character and effect." *(271)*
      - Factors
        - high D:E ratio
        - Fett's disregard of corporate formalities

[24] See class 24 notes for factual situation

        - $ were used for functioning of business
    - **When a corporate insider arranges his dealings with his corporate principal to give himself an unfair advantage over outside creditors dealing at arm's length, insider's claim subordinated to other creditors** *(273)*

ORGANIZING THE CORPORATION *(295)*

- **Bylaws** *(303)*
    - ***Roach & the Legal Center, Inc. v. Bynum*, 403 So. 2d 187 (Ala. 1981)** *(305)*
        - Keep distinct whether the vote of a certain % of *stockholders* is needed or certain % of *shares being voted*
            - usually % of shares, not votes
        - Language of bylaws crucial here
            - Unanimity effectively required: 3 shareholders & 3 directors
                - need for 70% of shares to be represented in order to form a quorum
                - quorum met → need vote of 70% of shares at meeting
                    - including for amdt of bylaws
        - Here, provision for changing the bylaws was written into the bylaws rather than the AoI, so court found provision void → MBCA controlled
            - **changes to voting requirements must be in the AoI**
                - AoI = public record of a corporation; any 3rd party dealing w/ corp is thus on notice; those db with the corp need to know what constitutes approval of a particular act → must be included in the AoI, which, unlike bylaws, is a public document
                - **Default = simple majority of quorum at a shareholder's meeting can alter bylaws** *(309)*
        - **Take away!** *(308)*
            - **Relevance of hierarchy of controlling documents**
            - **Role of shareholders vs role of directors**
            - **Pay close attention to what needs to happen in order to change the default rules: what the statutory requirement is for change**

    - ***Datapoint Corp v. Plaza Securities Co.*, 496 A.2d 1031 (Del. 1985)** *(310)*
        - Same 3 indivs are directors & shareholders
        - Case deals with **written consents**
            - Law here: 8 Del. C. § 228

- Action consented to may be taken w/o meeting, w/o prior notice, w/o vote; only need as many consents as votes would be req'd in person: § 228(a) *(310)*
  - votes based on *shares*
- cf. MBCA § 7.04
  - need consent from *all* shareholders entitled to vote
  - why all?
    - MBCA largely followed by close corps, so getting unanimous input relatively easy (compared to pub corp); everyone is likely to be informed already
- Why does Del. have lower reqmt?
  - efficiency; easier to get >51% consent than 100%

- Here, Edelman owned >10% stock;[25] announced intent to take over corp, replace Bd, etc. through written consents
  - Board didn't like that
  - Board made rule forestalling action until 45 days after vote: regulation of consents
- Court said: you can't do that
  - Forestalling action can be done by filing lawsuit
  - **Written consents are a statutory right of shareholders designed to give them a way to vote & act quickly—directors can't take that away**

- ***Jones v. Wallace*, 628 P.2d 388 (1981)** *(316)*
  - Changes to quorum requirements must be in the AoI, not bylaws; such bylaws cannot be construed as contracts binding a shareholder, at least not in this context

CORPORATE AUTHORITY *(333)*

- **Function and Authority of Shareholders** *(334)*

- ***In re the Walt Disney Company Derivative Litigation***
  - *see class 29 notes*

- ***Gashwiler v. Willis*, 33 Cal. 11 (1867)** *(335)*
  - Shareholders (who were also directors) unanimously voted in favor of resolution to sell all corporate assets; trustees executed conveyance

[25] Federal securities laws require disclosure of intent when a shareholder amasses 10% of stock in a corp

        - Held invalid
    - Under Corp Act, only Bd of Dirs can authorize sale of corporate assets; directors were acting as *stockholders*, not directors
    - Same goes for Trustees: they had met as shareholders, not trustees.

- **Inspection Rights** *(343)*
    - ***State* ex rel. *Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406 (Minn. 1971)** *(343)*
        - Shareholder must have "proper purpose" in seeking access to corporate books and records
        - **Proper purpose = concern with economic return**, not, e.g., moral disagreement with the corporation's business
            - proper purpose must be shown, not just stated
        - "The power to inspect may be the power to destroy"
            - "[I]nspection can be more akin to a weapon in corporate warfare"
            - → Need to limit access to books in order to keep business running smoothly
        - **Disapproved by Del. S.Ct. in 1972: *Credit Bureau Reports, Inc. v. Credit Bureau of St. Paul, Inc.*, 290 A.2d 691 (Del. 1972)** *(347)*
            - **Inspecting shareholder list OK for soliciting proxies**

- **Special Meetings of Shareholders**
    - ***MMI Investments, L.L.C. v. Eastern Co.*, 701 A.2d 50 (Conn. Super. Ct. 1996)** *(347)*
        - Conn. statute said that special meeting could be called by a person holding 10% of stock or by a group holding 35% of the stock
        - Cede & Co. held >10% of stock… but also held 70%–90% of stock of hundreds of corps; rarely voted its shares in its name, instead granting "omnibus proxies" to those for whom Cede held the stock
            - Allowing Cede to call meeting would make 10% requirement meaningless
        - **Holding companies cannot call special meetings**

- **Function and Authority of Directors** *(351–77)*
    - **Chairman of the board** *(370)*

PIERCING THE CORPORATE VEIL *(447)*

- Generally, shareholders' liability limited to the amount of their deliberate investment; not personally liable for corporate debts

- But this "veil" of limited liability will be "pierced" under certain "equitable" circumstances—judge-made doctrine
  - e.g., when the corporation is the "alter ego," "instrumentality," or "dummy" of the shareholders: basically a farce to allow shareholders' invidivual action to be shielded from otherwise-attendant financial risks

- **Questions to ask**
  - **(1) Who are the π's?**
  - **(2) Who are the Δs, and if the Δs are shareholders, are they individuals or corporations?**
  - **(3) What is the theory under which the case is brought?**
    - **Enterprise theory (horizontal piercing)?**
      - Several companies being operated as a single entity; parent company should be held liable, or group should be held liable as a single entity

      or

    - **Piercing theory (vertical piercing)?**
      - Corporation is a "dummy" for the actions of the shareholders themselves; shareholders should be personally liable
        - courts won't allow use of corporate form to perpetrate fraud
        - going after shareholder's personal assets
      - → is the shareholder sought to be held liable an *individual* or a *company?*

- **Tort-based claims**
  - ***Walkovszky v. Carlton*, 223 N.E.2d 6 (N.Y. Ct. App. 1966)** *(452)*
    - Plaintiff got hit by taxi cab
    - Defendants:
      - Seon Corp. (owner of this & one other cab)
        - Seon had $10k liability ins.; statutory minimum
      - Carlton (indiv) (shareholder in 10 corps just like Seon)
    - Plaintiff's argument for piercing veil
      - Enterprise theory
        - Says all the individual corps are being operated as a single enterprise
        - *Court rejected this claim*—that the **Δ** "'organized, managed, . . . and controlled' a fragmented corporate entity" doesn't result in liability. **Would have to show that the Δ was using corps to conduct business in his individual capacity**

- *Re: issue of $10k ins being inadequate: court referred π to the legislature.*
- *Complaint said that corps were undercapitalized & assets intermingled, but no "sufficiently particularized statements" re: ⊿s db in their pers capacities.*

- Piercing theory
  - Said that taking out minimum statutorily reqd insurance was defrauding the public
    - But law allowed that amount of insurance; running multiple companies with minimum insurance wasn't fraudulent. *(455)*

- **Factors re: piercing** *(457–59)*

- **Contract claims**
  - ***Sea-Land Services, Inc. v. Pepper Source*, 941 F.2d 519 (7th Cir. 1991)** *(460)*
    - Sea-Land shipped peppers for Pepper Source (PS). PS didn't pay the $87k bill. Plaintiff got a default judgment, but PS had dissolved. (Shortly afterward, PS reformed.)
    - Plaintiff sought to hold PS liable, as well as owner Marchese, and then "reverse pierce" (*cf.* enterprise theory) back down to Marchese's several other corps

    - ***Van Dorn* test for piercing under enterprise theory** *(461)*
      - **(1)** Unity of interest/ownership that corporation and individual are indistinguishable
        Factors:
        - (1) Failure to maintain adequate corporate records or comply with corporate formalities
          - *Here, no corporations but one had even a single meeting; no AoI, bylaws, other agrs*
        - (2) Commingling of funds or assets
          - *Here, runs all of his corps out of one office, one phone line, uses corp money as his own for personal expenses—lots of interest-free "loans"; money shuffled freely*
        - (3) Undercapitalization
          - *Shuffling of money left PS completely out of capital when Sea-Land bills came due*
        - (4) Treating assets of another corp as one's own
          - …

- **(2)** Showing that failure to pierce would "sanction a fraud or promote injustice" (disjunctive) *(462)*
  - Failure to collect on a debt does not satisfy this standard—need "something more" *(464)*

- Case remanded for further development on whether failing to pierce would result in some kind of "wrong" sufficient to satisfy *Van Dorn* pt. 2 (judgment for **π** at trial had been on SJ).

- **Other stuff** *(464–70)*

FIDUCIARY OBLIGATIONS OF DIRECTORS[26] *(273)*

- Two major fiduciary duties, owed to *corporation* and *shareholders*
  - **Duty of care:** nonfeasance & malfeasance
  - **Duty of loyalty:** *link back to* Meinhard *(98)*
  - applies to close & public corps

- *Duty of care. MBCA § 8.01, 141*
  - *Burden on **π**, and it stays there.*
  - *Negligence standard.*
    - *failure to monitor (Caremark, Pritchard)*
    - *uninformed decision (Van Gorkom)*
  - *Business judgment rule attaches by default.*
  - *Exculpatory provision: Del. GCL § 102(b)(7)*
  - *Procedural fairness*
- *Duty of loyalty. Del. GCL § 144*
  - *Burden on **Δ** dirs to show that § 144(a)(1,2,3) applies*
    - *BJR doesn't attach unless this burden is met; then burden is on **π** to show gift or waste.*[27] *But see* Cookies, *p. 591: directors must also show they have acted in good faith, honesty, and fairness (IA).*
  - *"Intrinsic fairness" test (§ 144(a)(3)):* Marciano, *p. 586: Procedural & substantive fairness*

- Some questions
  - What degree of deference do courts give directors when they make a mistake?
  - If you can tell after the fact that a decision was a bad one, how much leeway is given for the simple risk of doing business?
  - If courts are too strict, individuals will either be dissuaded from serving as directors or directors will become too risk averse (which

[26] *Cf.* Officers, who are *agents* of the corp., so all of agency law applies to them. Directors, not being agents, are subject to a different and more limited set of fiduciary obligations. Without some express or implied agency relationship between a director and corporation, agency law does not automatically apply.
[27] If it comes to **π** showing gift or waste, "for all practical purposes, the case is over"

is/can be bad for business & the economy in general)

- **Duty of care** *(508)*
  - **MBCA** *(cf. Del. GCL § 141(a))*
    - **§ 8.01(b):** Corporate powers reserved to Bd of Dirs, subject to § 7.32 shareholder agreements
    - **§ 8.30:** Standard of **conduct** for directors
      - **(a) (1)** reqmt of good-faith action; **(2)** must act in what is rsbly believed[28] to be best interests of the corp[29]
      - **(b)** reasonable care in discharging duties **(ordinary negligence standard)**
    - **§ 8.31:** Standard of **liability** for directors
      - **(a)** director not liable to corp/shareholders unless:
        - **. . . (2)(iv)** "a sustained failure of the director to devote attention to ongoing oversight" (nonfeasance)

  - *See also* **Corporate Director's Guidebook** *(excerpt) (518–19)*

  - ***Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981)** *(508)*
    - Mrs. Pritchard became despondent when her husband died and no longer conducted regular oversight of the corporation
      - Commingling of funds of reinsurers & ceding cos with its own; single account
      - Series of "loans" to the Pritchard kids began 1/31/70 (who were also directors)
        - $ 12m+ by 10/75

    - **Claim: breach of fiduciary duty of care**
      Negligence standard: nonfeasance
      - Duty: "[A]cquire at least a rudimentary understanding of the business of the corporation" *(512)*
        - keep informed about corporate activities
        - monitor corporate affairs and policies *(no need for "detailed inspection of day-to-day activities")*
        - attend regular monthly meetings (public corp)
          - small family corp, maybe only annual meetings *(def. dicta)*

[28] Cmt: **"reasonably believes"** = both subjective and objective. **Subjective**: what the director, acting in good faith, actually believes. **Objective**: focuses on "reasonably"; could a reasonable person in like position and acting in similar circumstances have arrived at that belief?
[29] Cmt: "best interests of the corporation" is "key to explication of a director's duties." Director has "wide discretion" in weighing near- vs. long-term opportunities/benefits and in balancing interests of various shareholder groups

- regularly review financial statements
- take reasonable means to prevent illegal conduct by co-directors; *may include threat of suit*
- manage business & affairs

- **Duty of care in close vs public corps** *(513)*
  - Responsibility usually more limited in close corp; but a close corp "affected with a public interest" has a higher dut y (e.g., bank, or, as here, a reinsurance corp)

- *Pritchard's sons knew that she, the only other director, was not reviewing their conduct; Pritchard's neglect of her duty contributed to the climate of corruption; failure to act contributed to continuation of that corruption (516)*

- **Duty to inquire & to monitor**
  - ***In re Caremark Int'l Inc.*, 698 A.2d 959 (Del. Chancery 1996)** *(520)*
    - *Problem with a large business like this vs. a small one like Pritchard: impossible for the directors to know everything that's going on*
    - Caremark followed a policy of uncertain legality (although, over time, they attempted to figure it out, hired outside counsel for advice, disclosed to shareholders that their policy was dubious, made management and policy changes, and set up an information-reporting hotline allowing anonymous tips re: illegal conduct)
      - Court held that Caremark's directors didn't breach their duty of loyalty
      - *This case was in the context of a review of a settlement agreement; the parties proposing the settlement bear the burden of persuading the court that the agreement is fair & reasonable. Agreement would be fair & reasonable if directors didn't breach their duty of care; if they had, they would have been responsible for exposing the company to "enormous legal liability" and in that case the settlement—requiring Caremark to pay $250m—would have been for too little & thus unfair.*
    - Absent grounds for suspicion, directors/officers not liable for assuming that their employees are dealing honestly *(525)*
      - **Need information reporting systems** to satisfy obligation to be "reasonably informed" *(526)*
    - Standard for plaintiffs—**π**s must show:
      - Directors knew/should have known that legal violations were occuring
      - Directors took *no* steps to fix situation
      - Failure to act proximately caused losses

      *. . . high standard for **π**s. Difficult to hold directors*

accountable for a failure to take action. Fairly protective of directors.

- **Business Judgment Rule (BJR)**
  - Automatically applies when (a) directors have made conscious business decisions *(i.e., not a case of nonfeasance)*, (b) no charge of breach of loyalty *(i.e., is a duty-of-care case)*, and (c) directors' decision does not constitute illegal conduct
    - Classic formulation: behavior that is not grossly negligent or reckless, or that has "any rational business purpose," satisfies the BJR *(531–32)*
    - *Not a rule of conduct; rule of conduct = duty of care.*
    - BJR = rebuttable presumption that directors acted in good faith, were informed, and acted in best interests of company.

  - ***Joy v. North*, 692 F.2d 880 (2d Cir. 1982)** *(530)*
    - Expresses policy reasons behind BJR
      - (1) assumption-of-risk aspect to investors' choice to put their money in a particular company
        - investors make free choice to buy stock
      - (2) post-hoc litigation is a poor vehicle for evaluating corporate business decisions
        - hindsight skews view of the many decisions that corporate managers need to make on short timeframes
      - (3) correllation between risk & reward counsels against encouraging corporate decision makers to be overly risk averse

  - **Informed Decisionmaking**
    ***Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)** *(536)*
    Considered a turning point in courts' willingness to scrutinize directors' decision-making process; up to this point, particularly in Delaware, there was often a much more deferential attitude toward the workings of the Board than there is today.
    - **BJR ≠ protect "an unintelligent or unadvised judgment"**
      - directors, in representing others' financial interests, must "proceed with a critical eye" in dealing with things like mergers
      - directors should have made "reasonable inquiry" *(546)*
        - market price was fallacious basis for valuation of shares (price was historically depressed)
        - no valuation study
        - approval of merger based on 20-minute oral presentation; meeting lasted two hours;

amendments to agreement approved without their contents being known
- shareholders' vote did not constitute ratification of the merger because the shareholders were not fully informed at the time of their vote.
  - **Was the proxy information submitted to the shareholders "fair[] and complete[]"?** *(554)*

- **Legislative responses to *Van Gorkom*** *(566)*
  - Statutory requirement of limited liability for *directors* but not *officers*
    - must be in AoI (→ must be approved by shareholders)
    - only for monetary damages; only for breach of duty of care
      - *cf.* MBCA § 8.30 (standard of conduct for directors) *(209)*
    - Del. GCL § 102(b)(7) *(108)*
    - MBCA § 2.02(b)(4) *(179)*
      - *cf.* MBCA § 8.42 (standard of conduct for officers)

- ***Malpiede v. Towson*, 780 A.2d 1075 (Del. 2001)** *(571)*

- **Duty of Loyalty** *(577)*
  - Courts much more willing to evaluate substance of decisions that directors have made when there is a challenge to duty of loyalty.
    - Burden of proof is on **Δ** directors to show that they did *not* breach their duty of care.
    - Greater concern with duty-of-loyalty charges because of the way the transaction is structured.
  - **When dealing with duty-of-loyalty cases:**
    - Determine where the structural problem was.
    - Determine who must be affected/noticed in order for transaction to be valid.

  - **Del. GCL § 144:** Interested Directors
    - **(a)** If a director is on both sides of a transaction (directly or indirectly), transaction can become voidable
      - unless (safe harbor provisions):
        - **(a)(1)** Approval of action[30] by a majority of fully informed & disinterested directors *(even if disinterested dirs are less than a quorum)*

[30] Where "action" = "contract or transaction"

        - [burden on **Δ** director]
      - **(a)(2)** Approval of action by vote of fully informed and disinterested shareholders, *or*
        - [burden on **Δ** director]
      - **(a)(3)** Action is fair to the corporation, procedurally and substantively, as of the time it is authorized, approved, or ratified
  - If (a)(1),(2), or (3) met, BJR attaches; burden shifts back to **π** to show gift or waste (high burden; "for all practical purposes, the case is over"). But see *Cookies*, p. 591: directors required to show good faith, honesty, and fairness.
  - *Also*, "intrinsic fairness" test under *Marciano v. Nakash (586)*

- ***Lewis v. S.L. & E., Inc.*, 629 F.2d 764 (2d Cir. 1980)** *(579)*
  - Charge that SLE had grossly undercharged LGT for real-estate rental → SLE stock undervalued
    - same three people were directors/officers of LGT & SLE
  - court referred to CL rule
    - **this kind of transaxn voidable unless Δs show that transaction was fair & reasonable to the corp.**
  - Court examined both procedure & substance of transaction
    - Director **Δ**s considered SLE to exist for the benefit of LGT
    - Defendants hadn't shown that SLE couldn't find a more financially healthy tenant than LGT; SLE simply hadn't looked around.
    - Remanded w/ directions to lower court to determine what the proper rental value would have been

- ***Marciano v. Nakash*, 535 A.2d 400 (Del. 1987)** *(586)*
  - Nakashes made loan from Guess (corp co-directed by **π**s and **Δ**s) to Gasoline (corp directed by **Δ**s)

  - By the time things got nasty:
    - Marcianos wouldn't show up to board meetings
    - In order for Nakashes to invoke safe-harbor provisions of § 144, they would have had to obtain a vote of the disinterested shareholders (Marcianos), which was impossible
  - Court said: § 144(a) not the only safe harbor.
    - **"Intrinsic fairness" test**
      - **Was there a valid business purpose for the loan?**
        - Yes; Gasoline needed financing.
      - **Were the terms of the loan fair and reasonable?**

- Yes; the loan to Gasoline was equivalent to other loans that it could have gotten from third parties
- Burden on **Δ** directors to show that transaction is fair or that § 144 applies

- ***Cookies Prods. v. Lakes Warehouse*, 430 N.W.2d 447, 452–53 (Iowa 1988)** *(591)*
  - Burden always on **Δ** to show fairness (§ 144(a)(3))

- **Effect of safe-harbor procedures** *(592–98)*
  - ***In re Wheelabrator Technologies, Inc. Shareholders Litig.*, 663 A.2d 1194 (Del. Chancery 1995)** *(592)*

- **Defending against tender offers**
  - **Terminology** *(682)*

  - ***Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986)** *(694)*

PRIVATELY (CLOSELY) HELD CORPORATIONS[31]

PREEMPTIVE RIGHTS *(273)*
- When a corporation issues more stock, certain buyers have priority on option to buy; particularly important in close corps
- Preemptive rights attach to the *stocks themselves*
- If a corp already has 100 shares outstanding and issues 100 more, what can happen?
  - Control diluted if shares bought by other than the current majority shareholders
  - Value of shares may go down
  - Dilution of dividends
  - Effect on liquidation rights
- Difficulties
  - Implementation can be complicated esp. if there are multiple classes of stocks with different dividend and voting rights
  - Preemptive rights can interfere with accomplishing mergers and acquisitions

[31] Dissolvable at will by shareholders. Law relating to closely held corps represents an attempt to adapt the corporate structure to a kind of business for which it wasn't really meant. Corporate business structure not really intended for small business groups that are directly involved with both management and investment.

- In publicly held corporations, ability to take quick action is more important than protecting proportionate interests, especially because there is an open market for more shares and stockholders can *(at least theoretically)* increase their share at will

- **MBCA § 6.30. Shareholder's Preemptive Rights**
  - **(a)** No preemptive rights unless specified in AoI
  - **(b)** If AoI say something like "the corporation elects to have preemptive rights":
    - **(1)** shareholders have proportionate rights to buy new shares
    - **(2)** preemptive rights waivable; waiver irrevocable if in writing
    - **(3)** no preemptive rights for:
      - **(i)** compensatory shares for directors, officers, agents, employees . . .
      - **(ii)** conversion/option shares for the above
      - **(iii)** shares authorized in AoI & issued within six months of incorporation
      - **(iv)** shares sold other than for money

- ***Katzowitz v. Sidler*, 249 N.E.2d 359 (N.Y. 1969)** *(277)*
  - Sets up role that courts will play in breach-of-loyalty cases
  - Divergence from usual deference to Bd of Dirs
  - **Threshold for judicial relief:**
    - Issuing price "markedly below book value" in a close corp; Remaining shareholder-directors benefit from issuance
      - → Corp's dirs must show issuing price is justifiable by valid business reasons
        - Is there a legit business reason to raise additional capital?
        - Is price being used to disadvantage other shareholders?
  - Factors re: fairness of price
    - Market value; liquidation value; book value; cash flow; possible discounts for minority share
      - Issuing price below actual worth, when shareholder opts not to buy, dilutes his interest and impairs the value of his original holding *(280)*

TRANSFER RESTRICTIONS *(281)*
- For close corps, meant to overcome limitation of not having a ready market for shares
- Can identify potential purchasers
  - Family corp: could limit purchasers to family members
  - Subchapter S corp: could limit purchasers to those that would not cause corp to lose its Subchapter S designation

- Directors of close corps usually want to keep a handle on any new shareholders, since close corp directors (shareholders?) usually work closely together—much like a partnership

BUYOUT AGREEMENTS *(286)*

- Provides a market for shares; allows close corps to be bought out
  - Unlike in partnerships, directors in close corps can't just leave and have their shares bought out
  - *Default rule = shares freely transferable*
- Corp should be a party to the agreement
  - Agreement *can* be between the shareholders
  - Corp can have the first option for purchase[32]
- Goal is to have the transaction treated as *capital transaction*, not a dividend
- **Big question = how to value the shares** *(288)*
  - ***Denkins v. Zinkan Enterprises*, 1997 WL 775660 (Ohio App. 1997)** *(291)*
    - Shareholder agreed to purchase shares; as inducement to get Denkins to buy stock, given right to sell shares back to corp either @ predet'd amt or 2.5x book value
    - Owner of shares controlled timing of sale—"put"
    - Denkins goes to exercise his put . . . but has problems.
      - Wanted to base stock value on a bank statement that had no year-end equity or tax info → bank statement irrelevant
        - unclear how to calculate book value in a put
      - Denkin's hadn't shown equity value of the corp
    - Method of calculation for the put should have been clearly set out.

DISTRIBUTING CORPORATE CONTROL *(379)*

- **Voting: cumulative and straight** *(380)*
  - MBCA § 7.28
    - (a) directors elected by plurality (unless AoI says otherwise)
    - (b) default is **straight voting** (AoI can alter)
      - one vote per share
      - **voting in blocks**; one vote per candidate to be elected
        - can't vote for the same person multiple times → maj. shareholder can always make selections & win over minority s.holders
      - vs. **cumulative voting**
        - votes = [# shares] x [# dirs to be elected]; allocted freely

[32] If corp is a potential purchaser, either "take corporate tax" or "go down the hall and consult a corporate tax attorney"

        - 100 shares & 2 dirs = 200 votes; can split 100/100 or 1/199 or whatever
    - minority shareholder has much better chance of electing at least one director
    - minority coalitions can make voting power more effective
    - *potential problems with cumulative voting*
        - can provide too much voice for minority shareholders
        - if a director knows he was elected via a minority vote, he may be more inclined to represent the minority's interests than those of the whole corp (dir's fiduciary duties run to the whole company)
        - removal issues—see MBCA § 8.08

- **Election of directors**
    - MBCA § 8.06: provides for staggered terms of directors (optional)
        - having the whole board turn over at once can be somewhat chaotic

- **Removal of directors**
    - MBCA § 8.08: directors can be removed without cause by shareholder vote
        - safeguard: § 8.08(c): cumulatively elected directors can't be removed if as many votes are cast *against* removal as the director needed to get elected *(but variable in AoI)*

- **Class voting & weighted voting** *(382)*
    - MBCA § 8.04: allows multiple classes of stock
    - e.g.:
        - Class A: elect one director
        - Class B: "
        - Class C: "
        - . . . if Anderson has all A shares, and Baker has all B shares . . . → they can each cast all their votes toward themselves
    - multiple classes of stocks → ineligible for Subchapter S
    - can be hard to raise capital with multiple classes; buying all shares of a class might not give majority control

    - **Weighted voting**
        - Del.: restricting votes of large investors OK *(383)*
            - variations in voting power of *shareholders* permissible, but not variations in voting power of *stocks*
        - can't have different voting rights within a class

        - can change voting power between/among, but not within, classes *(384)*

- **Charter Provisions** *(385)*
    - MBCA gives "virtual free hand" in allocating power

    - MBCA § 2.02: AoI can include provisions re: management & power of corporation, directors, shareholders
    - MBCA § 8.01(b): Bd of Dirs has control of corp, subject to limitations in AoI or as set forth in an agreement
    - MBCA § 10.01: Corporate charters can be amended at any time

    - MBCA § 7.32: Shareholder agreements
        - Allows power reallocation by agreement of shareholders

    - Most common change = super-majority voting requirement: usu. for most important corp. funx, e.g., electing dirs, sale of certain corp assets, or impeding hostile tender offers (e.g., reqmt of 90% vote to approve merger)
        - MBCA § 7.27(b):
            - An amdt to the AoI that adds, chgs, or deletes a greater quorum reqmt must meet the same quorum reqmt and be adopted by the same vote and voting groups required

- **Oppression and dissention among shareholders** *(398)*

  Judicial dissolution may be sought as a remedy for oppressive conduct. (Cf. *dissociation of a partner in a pship—Partners have a right to be paid under UPA § 7.01. Dissociation forces compulsory buyouy; structure of buyout agreement is flexible.*)

  The following three cases represent the spectrum of approaches to dealing with dissention among shareholders; see also pp. 421–24

    - ***Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975)** *(398)*
        - Facts
            - Initial shareholders were Rodd (majority) & Donahue (minority)
            - Rodd gave 39 shares to each of his kids; sold 2 back to corp; left himself 81; then sold 45 to corp at $800/share
            - Donahues wanted to sell their 50 shares at same price
                - company said no

- Holding
  - Rodd either had to buy back his 45 shares at the same price (total $36k), or corp had to purchase Donahues' shares (all 50 of them) for $36k[33] *(407)*
  - **In any case in which the controlling stockholders have exercised their power over the corporation to deny the minority such equal opportunity, the minority shall be entitled to appropriate relief.** *(405)*
    - *extended to minority shareholders in close corps—* ***A.W. Chesterton Co., Inc. v. Chesterton*, 128 F.3d 1 (1st Cir. 1997)** *(407)*
- Reasoning
  - Shareholders generally don't owe each other fiduciary duties . . . but this kind of business arrangement—among shareholders in a closely held corp—is like that of joint venturers and partners
  - Rodds were "freezing out" Donahues
    - → trapping Donahues in a "disadvantageous situation"
    - Donahues couldn't vote to dissolve the corp (didn't have the votes, & unlike a pship, can't just leave)
    - can't sell the shares
    - → can't get capital back very easily
- Fiduciary duty at issue here: **loyalty**
  - Rodd (or his kids) on both sides of sale: (a) as seller and (b) as majority holder of corp
  - This "strict duty of loyalty" extended "to all stockholders in closely held corporations" *(404)*

- ***In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. Ct. App. 1984)** *(408)*
  - Petrs, holding 20.33% of stock, said majority was being "fraudulent and oppressive"—fired from co., not given any distribution of co's earnings
  - Petitioned under NY stat for dissolution
    - Statute allowed petn if petrs had ≥20% of stock and could show "special circumstances"
      - Parallel MBCA section: § 14.30(a)(2)—more liberal: allows petn by "a shareholder"
  - **"[O]ppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were reasonable under the circumstances**

[33] This seems to discount the value of the remaining 5 shares—court didn't make it clear why Donahue should get $36k instead of $40k. Speculation: discount because Donahue had only minority interest?

and were central to the petitioner's decision to join the venture." *(411)*
- Some reasonable expectations:
  - ownership → job
  - ownership → share of corporate earnings
  - ownership → place in corporate management

- **Remedies**
  - **Either dissolve the company or buy out the minority shareholders**
  - "[W]hen there has been a complete deterioration of relations between the parties, a court should not hesitate to order dissolution. . . . conditioned upon permitting any shareholder of the corporation to elect to purcahse the complaining shareholder's stock at fair value" *(411)*

- ***Nixon v. Blackwell*, 626 A.2d 1366 (1992)** *(414)*
  - Barton formed corp; had two classes of stock: Class A (given to eight employees/directors); and Class B (given as gift to family members)
    - Class A = voting shares
    - Class B = non-voting; lower per-share value; represented 75% of corp. equity (holders "basically just have to sit there and take what comes their way")
  - *Class B shareholders complained that maj shareholders breached their duty of loyalty and were trying to force Class B shareholders to sell their shares at a discount*
  - Corp created market for Class B shares:
    - buy-back offers (self-tender offers): at less than book value
    - ESOP: gave liquidity to employee holders but not non-employee holders
    - Key Man Insurance: provided funds for corp to buy back Class A shares from certain key execs
  - Court said:
    - **we use "entire fairness test"—only have to be *fair*, not *equal*.**
      - **and this was fair because . . .** *(418)*
    - Class B stock was a gift anyway.
    - "Independent legal significance" test
      - this corp was organized like a close corp and described as one, but wasn't a statutory "close corp" because it didn't meet the statutory reqmts *(420)*

- *no independent legal significance to description as close corp*

- **Contractual Arrangements**
  MBCA more flexible than CL on these matters

  - **Voting trusts** *(424)*
    - Specifically enforceable; creates a separate legal entity: a trust gains legal title to the shares, but transferor retains equitable title (& proceeds from stock); trustee votes shares according to terms of the trust

    - MBCA § 7.30 (cf. Del. GCL § 218)
    - Typical provisions
      - Initial ten-year duration; option to extend
      - Trust agreement must be in writing
      - Copy of agreement (under MBCA, also list of beneficiaries) must be given to corp
    - Some uses
      - family corp gives younger generation financial interest without relinquishing control: stock issued to younger gen in voting trust, sr family member as trustee
      - use to maintain particular ctrl struct or protect a creditor making heavy loans: in exchange for loan, shareholder puts shares in trust with creditor as trustee → creditor has control until loan paid off
    - **Voting trusts not popular**
      - est'ing voting trust = "drastic measure"
        - also, ltd duration is a con
      - "Much more popular" = shareholder voting or pooling agreements (although these must be carefully drafted to avoid the risk of the agreement being found, upon legal challenge, to constitute an illegal & void voting trust)
        - voting agreements = contractual
        - voting agreements also specifically enforceable (*Ramos v. Estrada*, p. 430)

  - ***Lehrman v. Cohen*, 222 A.2d 800 (Del. 1966)** *(425)*
    - Corp had 3 classes of shares
      - AC = elect two board members
      - AL = same
      - AD = elect one board member
        - "tie-breaking class"—only one stock issued @ $10 par; no dividends; no liquidation rights

- Plaintiffs claimed that AD stock was an illegal voting trust; court held AD legitimate.
  - **Criteria for voting trust**
    - **(1) voting rights separated from other aspects of ownership**
    - **(2) voting rights irrevocable for a definite period**
    - **(3) purpose of grant is to acquire voting control of the corp**
  - Plaintiff argued that AD was equivalent to pooling of AC & AL & transferring portion of their voting power to a trustee; AC & AL then only had 40% control
    - arg didn't work; AC & AL holders retained complete control over their stocks; issuing new stocks tends to dilute voting *power* of preexisting shares, but does not affect voting *rights*
  - **Perfectly legal to have stock with voting rights but no attendant proprietary rights.**
- Court unwilling to use voting-trust statute to dismantle something otherwise legitimately organized
  - (1. What did you decide to do? 2. Legitimate purpose? 3. Anyone else harmed? 4. Does this come within the statutory provisions?)

- **Shareholder voting/pooling agreements**
  - ***Ramos v. Estrada*, 10 Cal. Rptr. 2d (Cal. App. 1992)** *(430)*
    - **Shareholder agreements specifically enforceable—** MBCA § 7.31
    - Tila Estrada voted in violation of a shareholder agreement she entered into; penalty by agreement = compulsory sale of shares back to the corp
      - Estrada argued that the agreement represented expired proxies; court unmoved
      - Proxy = authorizing another person to vote for you (appointing an agent)—no such appointment here
    - State statute authorized voting agreements
      - Intended for close corps (which TV Inc wasn't, although it was a lot like one); court held agr enforceable anyway
      - Cal. statute specifically said it didn't invalidate other agreements "including voting agreements

of corps other than close corps"[34]

- **Shareholders' agreements allocating control** *(436)*
  - ***Galler v. Galler*, 203 N.E.2d 577 (Ill. 1964)**[35] *(437)*
    - "[B]asically controlling factor" in whether to uphold shareholders' agreement is "the absence of an objecting minority interest, together with the absence of public detriment." *(439)*
      - controlling factor ≠ inequitable treatment of some subset of stockholders
    - *Public-policy argument for flexible structure of close corps:*
      - *"There is no reason why mature men shuld not be able to adapt the statutory form to the structure they want, so long as they do not endanger other stockholders, creditors, or the public, or violate a clearly mandatory provision of the corporation laws.* ***In a typical closely held corporation the stockholders' agreement is usually the result of careful deliberation among all initial investors.****" (440)*

- **Employment contracts** *(443–45)*

PUBLICLY HELD (TRADED) CORPORATIONS

HEADER

- la la la

# # #

… stuff that doesn't fit in anywhere yet

Forming corps:

- Filing Articles of Inc (§ 2.02 et al; see handout 10, p. 73)
  - Corporate name; whether ltd liablilty
  - Name initial directors
  - Describe capital strux
  - Capitalization: pref'd/common stock

Opt-in jurisdictions: define preemptive rights

Organizing Corp

[34] *Cf.* MBCA—"sprinkle approach." "Peppered" with provisions intended for use by close corps, but usable by public corps as well.

[35] Smiddy mentioned this case when saying that majority shareholders may have fiduciary obligations to minority shareholders, but I don't really see it here

- After AoI filed
- should be routine… but requires a lot of planning
- All options should be gone over in advance, written out
    - → organizational meeting (dirs & s.holders)
        - can be done in person
        - or thru 'written consents'[36]
    - directors/s.holders given papers with each option written out so they can vote yes or no.
    - "at these meetings you do not want anything to be a surprise. *anything*."

- roles…
    - directors
        - elect officers
        - should be named in AoI
        - approve corp seal
            - cost $60–$80; smiddy says "make the the corp actually buys it cuz they need it"
        - issue shares & approve opening a bank acct
        - review/approve promoters' Ks
    - shareholders
    - officers
- problems occur when you have the same people acting in multiple roles
    - one person can wear all three hats, but that person should understand the different reqmts of the different roles
- bylaws
    - subordinate to AoI
    - says when meetings must be convened
    - what vote is required for certain matters
    - not filed w/ Sec of State
        - kept in corp Secretary's office for reference
    - critical aspect: bylaws must be consistent with state law, AoI
        - biggest problem that arises: making sure that the forms they use (from the gobs of form books out there) are actually consistent with state law
        - corporate kits… readily available but not always up to date

- Common for close corps to require more than a majority for both quorum & vote
    - cf. default rule:
        - dirs
            - quorum = majority of indiv directors

[36] written consents = very useful when people hold multiple positions in the corp; makes clear when people are acting in which roles

        - vote = majority of those present
      - s.holders
        - quorum = majority of shares
        - vote = majority of those present
    - why require greater agreement for close corps?
      - close corps = often family/tight-knit corps; high voting reqmts = reduce likelihood that outsiders can impact control
      - s.holders in close corps often depend on the corps for livelihood, feel a sense of ownership, & want to make sure business is done in a way they approve of
    - the higher the quorum & vote required:
      - shifts power to minority shareholders
      - small block of voters can veto
      - greater risk of corporate deadlock
- § 6.01 . . . shares stuff

these days, shareholders are still spoken of as the owners of the corp, but they don't run the business.

- shareholders elect directors;
  - election by a plurality;
    - mere plurality ensures that directors will get elected;
  - can remove them at any time with or without cause;

Shareholders vote on:

- fundamental corporate changes
- amendments to AoI
- mergers
- dissolutions
- sale of substantially all of assets
- Voting Entitlement of Shares: MBCA § 7.21
- *shareholders don't have management power.*

directors:

- have oversight responisibilty;
- set company policy;
- must be individuals (not agents);
- act by meetings convened either electronically or in person;
- elect officers;

etc

- *shareholders are not agents of the company.*
- *individual directors are not agents of the company.*
  - *only by acting collectively are directors agents of the company.*
- *officers are agents of the company.*

Traditional partnership voting allocation = per-capita
- can transfer fin interest independently of mgmt interest
- can only get mgmt interest if you're a partner
-

Corporations – you can have a fin. investment with little or no voting power
- investors (shareholders) elect directors (individuals)
    - shareholders may be individuals or legal entities
    - directors provide oversight; set policy; collective decision-making authority; not agents of corp
    - officers (appointed/elected by dirs) run day-to-day operations; are agents of the corporation
- Q: Who gets to make decisions?
    - one quandary: see *Toms*, p. 247: needed approval of stockholders; Board didn't have the power
    - another: *Gashwiler*, p. 335: needed approval of Bd. of Trustees; stockholders didn't have the power

You buy a stock → you get a vote, maybe a dividend, liquidation rights, inspection rights
Where do the voting rights come from?
- articles of incorporation

What about dividend rights?
- also AoI

Hypo time.
- A owns a company
- A borrows $1000 from B (liability)
- A invests $99,000 (owner's equity)
- → co. is worth $100,000
    - loan is a small percentage of equity/co. worth → comfortable loan to make.
- **what axns might B take to ensure repayment?**
  what if it were a $99k loan on $1k o.e.?
    - get a security interest!
        - perhaps in both the co.'s assets as well as those of the onwer
        - acquire liens
            - recourse loans: can recover value from persons if the secured property isn't enough to cover the debt
            - non-recourse loans: can't go after persons → riskier loan
    - other rights such as management control

  but that comes at the risk of creating an agency relationship (!)
- direct correlation btw:
    - risk & interest rate

  - risk & desire for control

Investor's primary interest in lending is the return on the investment through payment of interest and repayment of principal.
- relationship btw borrower & lender = contractual
- relationship btw management & equity investors = statutory(?)

Valuing a Business

Book value: value of a co. based on its own financial statements; value of assets based on historical cost

Liquidation value: what you'd get if you sold all the assets of the company

Cash flow: looking at earnings/income stream along with operating expenses

(partnerships)
- equal rights in control among partners (§ 401(f))

Need for unanimous votes: extraordinary matters
- no real guidelines for this outside of UPA (1997) § 401(i),(j)
- voting matters should be worked out ahead of time because of lack of statutory guidelines

Should we have bailouts ? !
- purpose
  - save & create jobs
    - cutting jobs = common way of cutting costs
    - getting rid of employees = reducing liabilities (unpaid salaries), reducing expenses, but not affecting assets
      - *shedding employees as "getting fit"*
  - preserve credit
  - increase working capital & consumer confidence
  - restore assets
- negative implications
  - encourages corp irresponsibility
    - *but* can characterize govt as a "big bank" that can actually make a return on the "investment" in bailouts
  - anti-free market
  - running the gov't into a deficit (with taxpayer money)
  - $ may not correct
  - dilute shareholder stock in the corp in question

- how to structure to avoid negatives?