

Agency – Restatement 2d

1. Generally

- a. **Principal** – one for whom an action is to be taken
 - i. Capacity to be a principal [capacity: person w/ capacity to K can appoint A]
 - 1. Ex: minors and incompetents cannot appoint an agent if they could not themselves do the act in question
- b. **Agent** – one who is to act [capacity: anyone can be an agent]
 - i. **General** – agent authorized to conduct series of transactions involving continuity of service **R2d § 3**
 - ii. **Special** – agent authorized to conduct single/series of transactions **NOT** involving continuity of service **R2d § 3**
- c. **Agency** – fiduciary relationship that results from a manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act **R2d § 1**
 - i. Parties mutually agree that
 - 1. Agent will act on behalf of Principal
 - a. Where one undertakes to transact business or manage some affair for another by authority and on account for the latter
- d. Note ubiquity of agency in business law – pervade nearly all aspects

Sole proprietorship (P) with one employee (A)	Shareholders (P) and Board of Directors (A)
General Motors (Corporation as P) with CEO (A)	Board of Directors (P) and CEO (A)
- e. Default rules are rules that apply in the **absence** of contrary agreement between the parties

2. **Formation**: One person (P) consents that another (A) shall act on P's behalf and under P's control and agent consents to do so

- a. **Manifestation by Principal that Agent will act on his behalf**
- b. **Agent is subject to principal's control**
- c. **Agent manifests consent to act for the principal (by agreement or conduct)**
- d. **Consent** – express or implied

i. **Manifestations of Consent by P that A Act**

R2d § 14

- Directs what contracts may or may not be made
- Right of first refusal
- Right of entry
- Strong paternal guidance
- Financing everything
- Constant recommendations
- Consent to mortgage/dividends/stock
- Correspondences re: finances and salaries
- C's name on draft forms
- Power to discontinue financing

ii. May raise to level of formal contract

1. **But does not** necessarily require:

- a. Contract
- b. Compensation (i.e. gratuitous)

i. But presumption is that agency relationships are **not** gratuitous

c. Matter of business

iii. May arise although parties did **NOT** call it agency and did **NOT** intend legal consequences of the relation to follow

e. **Behalf** – coach drives car so that teacher did not have to (*Doty*)

- f. **Subject to Control** – what A shall/not do **circumstantial evidence**
- i. Manner and means of agent work
 - ii. Setting the boundaries of what A is supposed to do on P's behalf
 - iii. Within any relationship of agency the principal **initially states** what the agent shall and shall not do, in specific or general terms
 - iv. P's right to give **interim instructions or directions** to the agent once their relationship is established
 1. Power to give interim instructions distinguishes from those who contract to receive services provided by non-agents
 2. Control as practical matter: **incomplete** – no agent is an automaton who mindlessly but perfectly executes commands
 - v. **BUT** Physical control over actions **NOT** necessary
 1. **So long as:** P directs result or ultimate objectives of agent relationship
 - a. Ex: ask friend to do slight service – return for credit goods recently purchased from store – agency exists even though no compensation or other consideration was contemplated
 - vi. Buyer/Supplier Relationship re: Principal Agent
 1. Supplier has independent business before conclusion he is **NOT** agent
 - i. Note: ~ must in restatement
 2. One who contracts to acquire property from 3P and convey it to another is agent of the other party **ONLY IF** it is agreed that he is to act primarily for the *benefit of the other* and not himself
- 3. Factors yielding Buyer/Seller**
- a. ****Sell** products at fixed price irrespective of price paid
 - b. Act in own name and receive title to goods he will then transfer
 - c. Independent business in buying and selling similar property

3. Agency Relationship: Liability

a. P liable for acts of A

i. **Vicarious Liability** arising between Principal and 3P

1. For whoever employs another is answerable for him and undertakes for his care to all that make use of him

a. Master subject for liability of torts of his servants omitted while acting in scope of employment

b. Agent may interact with TP

i. Ability of A to bind P differs between Tort and Contract

c. Liability of P to 3P in Contract

Restatement 2d § 144

i. A principal is subject to liability upon contracts made by an agent acting within his **authority** if made in proper form **and** with understanding that principal is a party

4. Agent's Authority – ways of classifying **proof** must offer to bind principal to a contract

Except for execution of instruments . . . required by statute to be authorized in a particular way, authority to act can be created by written or spoken words or other conduct of the Principal, which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principal's account

R2d § 26

a. **Actual Authority** – what agent reasonably believes authority to act

i. **Communications**: what could A have reasonably believed scope of his authority to be . . . in face of explicit instructions not to do something, agent has no actual authority to do it

ii. **By custom**: Unless otherwise agreed, authority to conduct a transaction includes authority to do acts which are incidental to it, usually accompany it, or are reasonably necessary to accomplish it **Restatement 2d § 35**

1. *What is objectively or customarily done in these circumstances*

iii. An agent has actual authority to take action designated OR IMPLIED in the principal's manifestations to the agent and acts necessary or incidental to achieving the principal's objectives, as the agent reasonably understands the principal's manifestations and objectives when the agent determines how to act **Restatement 3d § 2.02(1)**

1. *Agent's subjective reasonable belief*

- iv. **Express Actual** – instruction (P tells A to do this) . . . look @ agreement
- v. **Implied Actual** – agent has implied actual authority to use all means reasonably necessary to carry out a particular result that was expressly mandated by Principal

1. *So express manifestation requirement = manage building (ex.)*

a. **While not expressly granted, is implied by law because such acts are *necessarily incidental***

i. **P does not have to say something explicitly, because it is *reasonable* for an agent to infer from the context that P wanted A to go make this contract**

2. Ex: Publisher hires author to write about foreign country

a. Author does field work and has to communicate with locals who don't speak English so he hires interpreter

b. K exists with interpreter and publisher

3. **Subagent** – person appointed by an agent empowered to do so, to perform functions undertaken by the agent for the principal, but for whose conduct the agent agrees with the principal to be primarily responsible **Restatement § 5(1)**

b. **Apparent Authority** – what did 3P reasonably believe agent was entitled to do?

i. Power to affect legal relations of another person by transactions with 3Ps, **R2d § 8**

1. Professedly as agent for another,

a. Arising from and in accordance with other's manifestations to such 3Ps

ii. Use P's past or present conduct **but CANNOT prove** with mere statements

1. Factor: nature of task/job

2. Existence: similar practices → **most important**

iii. **Express** or **Implied**– act of putting agent in such position that leads 3P to reasonably believe agent has authority

1. By written or spoken words or by any other conduct of the principal, which, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf by the person purporting to act for him **R2d § 27**

iv. Need **some connection** between **3P + Principal**

1. **Always** look: **how 3P learned of the A's alleged authority** AND

- a. Ask whether the principal **reasonably** can be said to have been the source of that knowledge

v. *Principal's **manifestations** to 3Ps are what count with apparent authority*

1. If the **actions or words** of the principal have led the **3P to reasonably believe** that the agent was authorized to enter into a contract then the contract is valid against the Principal AND 3P

- a. **NOTE:** requisite connection between the Principal and 3P could be affected by persons **other than the Principal**

b. ***Prior conduct may be evidence of manifestation (Mill Church)***

vi. Absent knowledge on part of 3P to contrary, agent has apparent authority to do things that are **usual and proper to conduct of business which he is employed to conduct**

1. Absent knowledge of such limitation, limitation will **not** bar claim of apparent authority

- a. Salesman has authority to bind employer to sell

vii. P-landlord, A-manager/tenant, 3P-janitor

1. A can impact P's legal relationship to 3P as long as 3P has received manifestation of that apparent authority

- a. **By putting someone in charge whom any 3P would presume has such [agent] authority**

viii. **DEFEAT apparent authority**

1. Plaintiff must reasonably believe agent had authority
2. Make any such belief **unreasonable** by notice (actual/constructive)
3. Train agents and give notice to potential 3Ps
4. Form contract requiring approval by contract manager

ix. **Concept of cheaper cost avoider**

1. Loss should be put on the party who could have most <\$\$ avoided it

2. Avoiding social losses

- a. Step 1 – find actor who can achieve the greatest reduction of accident costs with the lowest expenditure of precaution costs

i. Seeking to minimize total social costs

b. Step 2 – place liability on that individual

c. Inherent Authority

i. Power of agent derived not from authority but SOLELY from agency relationship and exists for protections of 3P harmed by or dealing with a servant or other agent . . .

R2d § 8A

ii. RARE but arises under two circumstances

1. Agent who exceeds his authority

2. Undisclosed Principal

a. When 3P reasonably believes actor has authority to act on behalf of the principal . . . belief traced to P's manifestations

b. Contracts entered into on P's behalf by A lacking actual authority can still be binding on the principal *if the agent has apparent authority*

c. *Watteau* [classic shirking] – hotel sold to Δ but old owner retained as manager. License taken out in manager's name but he had no authority to buy any supplies excepted bottled ales and water

i. He bought but did not pay for things outside scope

d. *Principal is liable for all the acts . . . which are within the authority usually confided to an agent of that character*

i. *Agent enters into transactions that are usual in such business and on the principal's account* **Rest. § 195**

e. Partially Disclosed Principal

i. If the other party to transaction has notice that the agent is or may be acting for the principal but has NO notice of principal's identity, principal for whom the agent is acting is a partially disclosed principal

ii. Scope of authority: Principal liable for all acts that are within authority usually confined to an agent of that character

iii. Agent enters into transactions that are usual in such business and on principal's account

5. Agent as Fiduciary

- a. Agent is a fiduciary with respect to matters within the scope of his agency **R2d § 13**
 - i. Held to higher standard than arms-length
 - ii. Agency is the **fiduciary relationship** that arises when Principal manifests assent to Agent that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act
 - iii. Cannot act as though simply participating in the ordinary marketplace
 - iv. May be greater remedies vs. breach of contract
- b. One of the parties is duty bound to act with the utmost good faith for the benefit of the other party
- c. Fiduciary Duties:
 - i. **Care**
 1. Obligation to do your best to avoid negligence
 2. Paid agent must possess and exercise the degree of care and skill that is standard in the locality for the kind of work the agent performs
 3. A gratuitous agent need only exercise the care and skill required of non-agents who perform similar gratuitous undertakings
 4. **Cannot waive** - To devote his or her entire time, skill, labor, and attention to said employment ... and not to engage in any other business or vocation of a permanent nature
 - ii. **Loyalty – avoid conflict of interest**
 1. Not putting your interests ahead of the principal's
 - iii. **Kickbacks**
 - iv. **Secret profits**
 1. Agent has a duty to act **solely** for the benefit of the principal in all matters connected with his agency **Rest. § 387**
 2. From transactions with principal or use of position
 3. Agent not allowed to make profits *through* his position as A:P

4. If the servant takes advantage of his service and violates his duty of honesty and good faith to make a profit for himself, he is accountable for it to his master
 - a. If assets which he controls, the facilities which he enjoys, or the position which he occupies because of the agency relationship are the predominant cause of him obtaining he money
 - i. Distinguish from cases where the service merely gives the opportunity of making money
5. If servant takes advantage of his service and violates his duty of honesty and good faith to make a profit for himself, in the sense that the *assets of which he has control, the facilities which he enjoys, or the position which he occupies*, are the real cause of his obtaining the money as distinct from merely affording the opportunity for getting it

v. Usurping business opportunities from principal

1. Failing to disclose competing business venture
2. Throughout the duration of an agency relationship, an agent has a duty to refrain from competing with the principal and from taking action on behalf of or otherwise assisting the principal's competitors

vi. Disclosure

1. Conflict? First thing fiduciary must do is disclose!
2. Conduct by an agent that would otherwise constitute a breach of duty ... does not constitute a breach of duty if the principal consents to the conduct, provided that
 - a. Obtains consent
 - i. Good faith
 - ii. Discloses all material facts that knows/reason to know/should know unless P manifested knowing these
 - b. Otherwise deals fairly with P

vii. Grabbing and leaving

1. Even where a business owner does not operate under the banner of his former employer, he still may not solicit the latter's customers who are not openly engaged in business in advertised location whose availability as patrons cannot be readily ascertained...
 - a. Unless otherwise agreed, **after** the termination of the agency, the agent ... has a duty to the principal **not to use ... *written lists of names*** ... given to him only for the principal's use **[BUT]** The agent is entitled to use ... the names of the customers retained in his memory
2. Even though the defendant did not solicit plaintiff's customers until they were out of the plaintiff's employ, they only solicited to these customers...
 - a. Would be different if these customers had been equally available to both parties, but these customers were screened at considerable effort and expense, without which their receptivity and willingness to do business would not have been known
3. So here the standard is that the List of names is protected depending on type of client – are they openly engaged in business in advertised locations as opposed to those whose trade and patronage have been secured through years of business effort.
4. Key fact: trade secret status of the customer list – trade secret as default rule

viii. Miscellaneous

1. Duty to obey the P's reasonable instructions for carrying out the agency business
2. Generally **no duty** to obey orders to behave illegally or unethically
3. **Notify - agent must promptly tell the principal of anything within the agent's knowledge:**
 - a. Reasonably relevant or material to the agency business; or
 - b. That should concern the principal

6. Duties of Principal to his Agents

- a. Compensate the agent
 - i. Agency contract generally controls the compensation the agent is to receive
 1. **BUT** if no contract provision, a principal is not required to pay for:
 - a. Undertakings that she did not request
 - b. Services to which she did not consent
 - c. Tasks typically undertaken without pay
 - ii. Reimburse the agent for money spent in the principal's service
 - iii. Indemnify the agent for losses suffered in conducting the principal's business

7. The Principal-Agent "Problem" – Agency Costs

- a. Sum of three sets of costs incurred to prevent shirking:
 - i. Monitoring expenditures by P + Bonding expenditures by A + Residual loss (shirking)
- b. **Shirking**= any action by a member of a production team that diverges from the interests of the team as a whole...e.g., agents have preferences of their own...
 - i. Culpable of cheating...and negligence oversight, incapacity, honest mistakes
 - ii. Inevitable consequence of bounded rationality and opportunism within agency relationships
- c. The principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking
 - i. Agent's productive value to the principal, but agent gets non-pecuniary benefits of shirking
 1. Necessary to keep agent in line with the objectives of the principal via incentives

8. Terminating Agency Relationship

By agreement of parties (K states end)	By operation of law (death = automatic)
Agency at will – by any party <u>after notice</u> Renunciation – A notifies P they quit Revocation – P revoked A's authority to act	Fulfillment of purpose (task completed)

General Partnerships – Revised/Uniform Partnership Act

§ 2 – Uniform Partnership Act (1914)

Business – every trade, occupation or profession

Person – individuals, partnerships, corporations, and other associations

Bankrupt – bankrupt under Federal or insolvent under state

Conveyance – every assignment, lease, mortgage, or encumbrance

Real Property – land and any interest in estate or land

§ 3 – Uniform Partnership Act (1914)

Person has **knowledge** of a fact not only when he has actual knowledge but also when he has knowledge of such other facts as in circumstances shows bad faith

Person has **notice** of a fact when the person who claims benefit of the notice

States the fact to such person OR

Delivers through means of communication, a written statement of the fact to such person or proper person at his place of business or residence

1. Generally

a. **Partnership** – Have **two or more persons** associated together to carry on as co-owners as a business **for profit**

UPA § 6

i. **BUT** any associate formed under another statute is not a partnership **unless** such association would have been a partnership in this state prior to the adaptation of this act

1. **BUT** act shall apply to LPs except in so far as the statutes relating to such partnerships are inconsistent with UPA

b. *You can stumble into it!!!*

i. *NOT THE SAME AS A JOINT VENTURE – limited to specific activity*

c. Each partner deemed to be **agent** [therefore **fiduciary**] of the other

i. There may be **imputation** of liability

- d. **Partnership as Legal Entity** – an organization having a legal existence separate from that of its members; the RUPA considers a partnership a legal entity for nearly all purposes
 - i. Sue and be sued
 - ii. Have judgments collected against it's assets, and individual partners' assets
 - iii. Own and convey partnership property
 - iv. Keep its own books
 - v. File its own federal/state tax returns

- e. **Partnership as Legal Aggregate** – a group of individuals not having a legal existence separate from that of its members; the RUPA considers a partnership a legal aggregate for few purposes
 - i. Partnership pays no federal income tax
 - ii. Joint and several liability of partners

2. **Formation**

§ 7 – Determining Existence of Partnership

Persons not partners to a each other are not partners as to 3Ps

Tenancy (joint, common, entirety), property (joint, common) or part ownership **does not** of itself establish a partnership **regardless** of whether co-owners share any profits made by use of property

Gross return sharing **does not itself** establish a partnership

Receipt of a share of profits of a business is *prima facie* evidence that he's a partner in the business **but no such inference** shall be drawn if payments were received for:

Debt by installments

Employee wages or landlord rent

Annuity to widow or deceased partner's rep

Interest on a loan

Consideration for sale of a good-will of a business or other property

a. **No formalities required . . . formed by:**

i. Agreement of partners AND

ii. Compliance with requirements of contract law

b. **Duration**

i. Term

ii. At will

c. Capacity – partners must have legal capacity

d. Partnership **agreements** can be oral unless Statute of Frauds requires a written agreement

i. *Practically speaking, agreements should be in writing*

e. Two types of partners

i. **General Partners – 1+**

1. Manage partnership and have **unlimited liability**

2. Usually charged with operation and day-to-day management of the partnership's affairs and business, takes on personal liability for the obligations and debts of the partnership and the actions of the other partners.

ii. **Limited Partners – 1+**

1. No liability for partnership debts beyond capital contributions and investments in partnership

- a. Shielded from such liability and traditionally is not as involved in the day-to-day affairs of the limited partnership

f. **Elements**

See
UPA § 7

i. Intention of the parties

1. The agreement itself is evidential, although not conclusive of intention
 - a. Need not be written
2. The testimony and conduct of the parties may be more indicative

ii. Right to share in profits

1. Not every agreement that gives the right to share in profits is a partnership agreement
2. *This point is not conclusive*
 - a. *“The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business.”*
 - i. *Shifts burden of proof!*
3. A person who receives a share of the profits of a business is presumed to be a partner in the business, unless § 7 exceptions

iii. Obligation to share in losses

iv. Ownership and control of the partnership property and business

1. UPA Section 18 – the rights and duties of the partners in regulation to the partnership shall be determined, subject to any agreement between them, by the following rules...al partners have equal rights in the management and conduct of the partnership business

v. Communication power in administration and the reservation in the agreement of exclusive control of the management of the business

1. Meaningful control and management

vi. Language of the agreement

1. Partnership agreement can be oral or written – no formalities required...

vii. Conduct of parties towards third persons

1. Do the parties hold themselves out to customers/suppliers/governmental tax agencies as a partnership?
2. Trade name of the business registered as a partnership?

viii. Rights of the parties on dissolution

1. UPA 31 – dissolution is caused: (1) without violation of the agreement between the partners by express will of any partner when no definite term or particular undertaking is specified
2. UPA 18 – each partner shall be repaid contributions...and share equally in the profits, surplus

g. Partnership By Estoppel

- i. Plaintiff must establish a representation (express/implied) that one person is the partner of another—
 1. i.e., that there was a **holding out** of a partnership
- ii. The making of the representation by the person sought to be charged as a partner or with his consent
- iii. A reasonable reliance in good faith by the third party upon the representation
- iv. A change of position, with consequent injury, by the third person in reliance on the representation

§ 18 – Rights & Duties of Partners

Rights and duties determined, subject to agreement, by these rules

- (a) Each shall be **repaid contributions** by way of capital or advances and **share equally in profits and surplus** remaining after all liabilities are satisfied; **must contribute toward losses**, capital or otherwise, sustained by **partnership according to his share in profits**
- (b) Must **indemnify** every partner in respect of payments and personal liabilities **reasonably incurred** in the **ordinary and proper conduct of its business**, or for the preservation of its business or property
- (c) Partner who makes payment or advance in aid of partnership beyond capital, **paid interest from date of interest**
- (d) Receive interest on capital contributed **only from date when repayment should be made**
- (e) Equal rights in **management and conduct** of partnership business
- (f) **No partner entitled to remuneration** for acting in the partnership business *except* that surviving partner entitled to reasonable compensation for services in winding up affairs
- (g) **No person** can become member of a partnership **without consent of ALL partners**
- (h) Any difference as to ordinary matters may be decided by a **majority of the partners; but NO act in contravention of any agreement** may be done rightfully **without consent of ALL partners**

3. Governance

a. Partnership Agreement

i. Governing rules of the partnership

1. Where it's silent, R/UPA governs

ii. **BUT may not contract around RUPA § 103 provisions:**

1. May not unreasonably restrict right of access to books and records
2. Eliminate duty of loyalty but
 - a. Can ID specific types or categories of activities that do not violate provided not *manifestly unreasonable*
 - b. All partners or number or % specified may authorize or ratify, after full disclosure of all material facts, specific act or transaction
3. Eliminate duty of good faith and fair dealing but
 - a. But may prescribe standard by which performance is measured, *not manifestly unreasonably*
4. Disassociate partner under § 602(a) except to require notice under § 601(1) in writing

5. Vary right of court to expel partner under § 601(5) requirements
 6. Vary requirement to wind up in cases specified in § 801(4), (5), or (6)
 7. Vary law applicable to LLP under 106(b)
 8. Restrict rights of 3Ps under this act
- b. Whether a provision that allows an interested partner to count its votes in the total required for ratification is “manifestly unreasonable”?
- i. Ratification of an act is one way a partner can show good faith, fairness (no breach of duty)
 - ii. But interested partners SHOULD NOT be allowed to count their votes in a ratification
 - iii. Upon a showing of proper ratification by the partners, any claim against the partner for violation of the duty of loyalty is extinguished
 - iv. Examples
 1. Here, majority approval was NOT achieved unless the votes of the affiliated/interested/conflicted partners were counted
 - v. The provision of the partnership agreement that allowed interested partners votes to be counted was INVALID as manifestly unreasonable
 1. Note: for corporation – the statute mandates that conflicted actions be ratified in elections with the shares owned by the interested director or directors NOT being entitled to vote
 2. The same rule applies for partnership...allowing an interested partner to participate in ratification election subverts the very purpose of the ratification itself

c. Partnership Management

- i. Each of the partners expects to play a role in conducting the business of the partnership
- ii. Right of each partner to participate in the operation of the business – implicit term of the partnership agreement
- iii. UPA 18(e) – in the absence of an arrangement to the contrary, “all partners have equal rights in the management and conduct of the partnership business”
- iv. UPA 18(h) – “any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners”
 1. Thus, the majority can deprive the minority partner of the authority to act for the partnership

2. Any agreement the minority tries to enter would not be binding on the partnership
3. If there are only two partners, there can be no majority vote that will be effective to deprive either partner of authority to act for the partnership

4. Executive Committee

- a. Consensus vs. authority decision making
 - i. **Consensus** – collective decision making
 1. Used when constituents have similar interests, comparable information, low collective action problems
 2. Partnership is authorized for these characteristics
 - ii. **Authority** – central decision making body
 1. Needed when constituents have differing interests, asymmetric information, serious collective action problem
 2. Corporation is optimized for these characteristics

5. Deadlock

- a. Partner **cannot** have apparent authority where the third party with whom the partner dealt knew that the partner has no actual authority to make the contract.
- b. Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the **usual way** the business of the partnership of which he is a member **binds the partnership, unless** the partner so acting has in fact **no authority to act** for the partnership in the particular matter, and **the person with whom he is dealing has knowledge of the fact that he has no such authority**
- c. As between the partners and some 3P: all partners = **partnership agents**
 - i. Power to bind the partnership
- d. As between the partners: all partners have **equal rights** to participate in management of partnership
- e. Partners have equal rights to conduct the business of the firm
 - i. Only a majority vote could have limited partner's authority
 1. In a 2 person partnership with equal votes, therefore, deadlock results

- f. Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners
 - i. Here suit was brought by 3P seeking to hold partnership liable
- g. **Partnership matters are (absent an agreement to the contrary) decided by majority vote, this requires a majority vote**
 - i. Ex: S+D have equal stakes, S hires a third guy but D disagrees. S went ahead and did it anyway → S loses: act in contravention of implied agreement
 - 1. Contract not binding because “a majority of the partners did not consent to the hiring of the third man”
 - a. This was a case brought by one partner vs. the other
- h. Between partners: an act involving the partnership business **may not** be *compelled* by the co-partner
 - i. Even divide to matter re: partnership – power to exercise discretion on behalf of the partners **suspended** so long as the division continues

UPA
§ 18(h)

i. **Liability**

i. **Personal Liability** - All partners are **jointly and severally** liable for everything chargeable to the partnership under UPA § 13 and § 14 – torts, breach of fiduciary **UPA § 15**

1. **AND jointly** for other debts and obligations of the partnerships – contracts etc.

ii. Setting accounts after dissolution payment-rank:

1. 3rd party creditors - those owing to creditors other than partners,
2. Partner-made loans – those owing to partners other than for capital and profits
3. Subordinates loans by partners to loans by 3P creditors

iii. In order for a partner’s tortious conduct to throw vicarious liability upon the partnership and her fellow partners, the partner must have been acting either in the **ordinary course** of partnership business or with authority from the partnership

1. Instead, a plaintiff need only show that the partner’s overall course of conduct was of the type broadly authorized

UPA § 9(1)	RUPA § 301(1)
Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority	Each partner is an agent of the partnership for the purpose of its business. An act of a partner, including the execution of an instrument in the partnership name, for apparently carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership binds the partnership, unless the partner had no authority to act for the partnership in the particular matter and the person with whom the partner was dealing knew or had received a notification that the partner lacked authority

6. Partnership Property & Capital

§ 24 – Extent of Partner Property Rights

Partner's property rights are (1) rights: specific property, (2) interest: partnership, (3) right: participate in management

§ 25 – Rights in Specific Partnership Property

Partner is co-owner of specific partnership property as tenant in partnership

Incidents of TIP:

Equal rights to possess property for partnership purpose **BUT NO** right for other purpose without consent of partners

Not assignable except in connection with assignment of rights of all partners in same property

Right in SPP **not subject to attachment or execution** *except* on claim against partnership when attached for debt of any partners or deceased's rep, cannot claim any right under homestead or exemption laws

Death of partner – right in specific vests in surviving partners *except* if he was last surviving partner, when his right in such property vests in legal rep . . . surviving partners or legal rep has **no right to possess for any but partnership purpose**

Right in SPP **not subject** to dower, curtesy, or allowances to widows, heirs, or next of kin

§ 26 – Nature of Interest in the Partnership

Partner's interest in partnership is share of profits and surplus, and the same is personal property

§ 27 – Assignment of Partnership Interest

Partner's conveyance of interest **does not dissolve partnership nor does it entitle assignee to interfere in management of partnership or to require any info or to inspect books . . . ONLY** receive profits which assigning partner otherwise entitled

Dissolution: assignee entitled to receive interest and may require account of last account agreed by all partners

§ 28 – Partner's Interest Subject to Changing Order

Court, etc. may charge interest of debtor-P with payment of unsatisfied amount with interest and may then appoint receiver of share in profits and any other money due or to fall due and make all other orders, directions, accounts and inquires which DP might have made or which circumstances may require

Interest charged may be redeemed at any time before foreclosure or if sale . . . may be purchased causing dissolution

With separate property, by anyone or more of the partners or

With partnership property, by any one or more of partners with consent of all whose interests are not charged or sold

Nothing shall deprive partner of right, under exemption laws as regards his interest in partnership

a. Profits & Losses . . . [where PA silent/subject to any agreement]:

i. Each partner shall be repaid his contributions, whether by way of capital or advances to the partnership property **and**

1. Share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied; **and**

2. Must contribute towards the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits

a. Losses follow share of profits

ii. Partnership property rights consist of

1. Rights in specific partnership property

a. Specific partnership property = the partnership tenancy possessory right of equal use or possession by partners for specific partnership purposes

i. Possessory right is incident to the partnership

ii. Does not exist absent the partnership

iii. The possessory right is not an interest

b. Capital

i. UPA silent on initial capital contributions

ii. Service partnerships exists where on partner contributes *only* labor

iii. **Capital Account** – running balance reflecting each P's ownership equity

1. Note: Draw = distribution

a. P not entitled to remuneration for services provided to partnership → only entitled to draw

iv. Rule for Distribution

1. Those owing to creditors other than partners

2. Those owing to partners other than for capital and profits

3. Those owing to partners in respect of capital

4. Those owing to partners in respect of profit

c. Partnership Interest

- i. Interest = share in P/L
- ii. Membership in the Partnership **NOT** Fungible
 1. Co-Tenants in Partnerships have **no** right to possess or transfer partnership property other than for partnership purposes
 - a. **NOT** assignable except in connection with an assignment of the entire property
- iii. No person can become a member without consent of all the partners
 1. But, even if all members consent – still cannot be sold
 2. There is NO primary or secondary market for partnership interests
- iv. Partner's **interest in partnership** = his share of profits/surplus and the same is [*that is*] his personal property
- v. **Effect of assigning one's partnership interest – UPA § 27**
 1. Partner who has transferred her interest remains a partner
 2. Conveyance by a partner of his interest in the partnership **does not** of itself dissolve the partnership
 - a. **DOES NOT**, against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, *to interfere in the management or administration of the partnership business or affairs*,
 - b. **DOES NOT** require any information or account of partnership transactions, or to inspect the partnership books
 - c. *Merely entitles* the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled
- vi. Raising Additional Capital
 1. If NO Provision in the Partnership Agreement That Covers the Need for Additional Capital
 - a. No partner can be forced to contribute anything...
 - b. No partner can be added without the consent of all existing partners...
 - c. No partner's share can be changed without his or her consent...

vii. Pro Rate Dilution

1. A commonly used provision permits the managing partner to issue a call for additional funds
2. And provides that if any partner does not provide the funds called for, his or her share is reduced according to the existing formula

viii. Penalty Dilution

1. Partnership agreement might provide that if the managing partner determines that additional funds are needed, new points will be offered to the partners at a fixed price

ix. Another similar approach...

1. Requires partners to make loans to the partnership, pro rata, when called upon by the managing partner to do so...
2. Loans would bear interest...with no distributions to be made to the partners until the full amounts of the loan and interest are paid
3. Problem – specifying consequences of failure of a partner to comply with request for loan money

7. Fiduciary Duties

a. Corporate Opportunities Doctrine

- i. Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency

b. Partner does not violate duty or obligation

- i. Merely because conduct furthers his own interest
- ii. Lends money and transact other business as creditor with partnership
- iii. They can transact business *so long as they disclose the opportunity so it can be equalized*

c. Duties

i. Loyalty – Punctilio of honor most sensitive

1. A partner has an obligation to render on demand true and full information of all things affecting the partnership to any partner

ii. Care

iii. Account

iv. Not Compete

1. Fiduciaries may plan to compete with the entity to which they owe allegiance provided that in the course of such arrangements they do not otherwise act in violation of their fiduciary duties

v. Not Deal Adversely

vi. Good Faith & Fair Dealing –discharge duties of partnership and other Ps

d. Grabbing and Leaving – note extent parties can deal via K

- i. Ex: M&B breach fiduciary–unfair advantage over former partners
 1. Preparation for obtaining clients' consent,
 2. Secrecy concerning which clients they intended to take,
 3. Substance and method of their communications with clients

<p style="text-align: center;">Permissible</p> <ul style="list-style-type: none"> - Locate office space - Negotiate merger with another firm - Contact clients before leaving firm - Keep plans confidential - Remind clients of right to have counsel of own choice 	<p style="text-align: center;">Impermissible</p> <ul style="list-style-type: none"> - Take client files - Not inform clients of right to have counsel of own choice - Denied plans when asked
<p>Depends on what's said</p> <ul style="list-style-type: none"> - Contact clients before announce departure - Negotiate with associates 	

e. **Expulsion** – Wrongful Dissolution

- i. When a partner is involuntarily expelled from a business, his expulsion must have been bona fide or in **good faith without** violation of PA
- ii. No Cause Clause ex: Where the remaining partners in a firm deem it necessary to expel a partner under a **no cause expulsion clause** in a partnership agreement freely negotiated and entered into, the expelling partners act in ‘good faith’ regardless of motivation if that act does not cause a wrongful withholding of **money or property** legally due the expelled partner at the time he is expelled
- iii. If the power to involuntarily expel partners granted by a partnership agreement is exercised in bad faith or for a “predatory purpose”...the partnership agreement is violated
 1. Gives rise to an action for damages partner has suffered as a result of his expulsion
- iv. No Predatory Purpose
 1. Ex: Permitted him to remain a partner while he sought treatment
 - a. Proposal for severing Lawlis’s partnership did not recommend an immediate expulsion, but would allow him to remain a partner for 8 months while he looked for work, and allow him to remain insured
- v. “For Cause” vs. Good Faith
 1. Under a no-cause expulsion provision in a freely negotiated partnership agreement...all that is needed is good faith, otherwise-court would be engrafting a for-cause requirement

8. Dissolution

a. Change in the relationship of partners caused by a partner ceasing to be associated in carrying on the firm's business

- i. Not the same as going out of business
- ii. Always **power** to dissolve but not right to

1. Subject to fiduciary duties!!!

b. Caused by express will of partner in partnership with no definite term BY:

- i. Act, operation of law, court-order
- ii. Express will of any partner when no definite term or particular undertaking is specified
- iii. Without violation of the agreement between the partners:
 1. Termination of the definite term or particular undertaking specified in the agreement
 2. Express will of any partner when no definite term or particular undertaking is specified
 3. Express will of all the partners who have not assigned their interests or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking,
- iv. Expulsion of any partner from the business bona fide in accordance with such power conferred by the agreement between the partners;
- v. In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time;
- vi. Any event which makes it unlawful for the business of the partnership to be carried on or for the members to carry it on in partnership
- vii. Death of any partner
- viii. Bankruptcy of any partner or the partnership
- ix. Decree of court under where partner's conduct: (§ 32(1))
 1. Lunatic or of unsound mind (judicial proceeding)
 2. Incapable of performing part of contract
 3. **Prejudices** the carrying on of the business or

- 4. Willfully and persistently **breaches** the agreement or
 - 5. Conducts himself in such a way as to make it **impractical** to carry on
- c. After dissolution, the partnership must be wound up, absent agreement among the partners to carry on the business
- i. Assuming that the business will not be continued, the winding up process generally contemplates that the firm's assets will be distributed to the partners
- d. Continuation – creates a new partnership [technically]
- i. If a new partner joins the firm when it continues new partner is also liable for the firm's old debts,
 - 1. BUT such liability can only be satisfied out of partnership property
 - a. The new partner cannot be held personally liable for the old debts, unless he or she expressly agrees to be so held
 - ii. Legal right to dissolution rests in equity, as does the right to relief from any legal contract
- e. Departing partner entitled to “accounting” of:
- i. Fair value of partnership
 - ii. Interest from date of dissolution in event of unreasonable failure to pay
 - iii. Remains liable on all firm obligations unless released by creditor
- f. Wrongful Dissolution
- i. Those partners who have **not** wrongfully dissolved business have a statutory right to continue the business
 - ii. Unilateral withdrawal is one of most common means
 - 1. Also: egregious breach of fiduciary
- g. Term Partnership
- i. Cf. “term partnership” vs. “partnership at will”
 - 1. An at will partnership can be dissolved at any point without adverse consequences
 - 2. Subject to good faith / fiduciary duties (see PAGE v. PAGE)
 - ii. **Explicit term**
 - 1. Duration specified in partnership agreement
 - 2. Specific purpose / objective specified in partnership agreement

iii. Implicit Term – fiduciary duty prevents P from walling back to dissolution and abusing situation

1. Court will look at whether the parties have identified a **particular undertaking** that is capable of accomplishment at some specific time even though the exact time may be unknown and even not ascertainable at the date of the agreement
2. **Implied found** - When partner loans money to the firm to be repaid from profits, an implied term is created that does not expire until the loan is repaid
 - a. BUT Parties' *hope* to repay start-up loan out of partnership profits not enough

h. Synthesize cases

<p>A partner may not, however, by use of adverse pressure 'freeze out' a co-partner and appropriate the business to his own use. A partner may not dissolve a partnership to gain the benefits of the business for himself, unless he fully compensates his co-partner</p>	<p>Where the remaining partners in a firm deem it necessary to expel a partner under a no cause expulsion clause in a partnership agreement freely negotiated and entered into, the expelling partners act in 'good faith' regardless of motivation if that act does not cause a wrongful withholding of money or property legally due the expelled partner at the time he is expelled</p>
<p>- Primacy of contract - Illustrates importance of having expulsion clause rather than relying on power of dissolution</p>	

i. Winding Up Period Consequences of Dissolution

- i. Proceeds are used to pay creditors and then what is left is returned to the Ps as return of capital or distribution of profits
 1. Collect debts
 2. Sell assets
 3. Pay of partner creditors
 4. Final termination
 5. Distribution of money
- ii. Involves liquidation – a sale of assets of the partnership
 1. Absent breach of fiduciary, former partner can bid on the firm in sale

- a. No indication that exclusion was wrongful purpose of obtaining the partnership assets in bad faith
 - i. Inability of the partners to harmoniously function
- b. Δ failed to demonstrate injury by the participation in sale
 - i. Participation in the sale drove up the sale price
- iii. When dissolution is caused in contravention of the partnership agreement the rights of the partners shall be as follows:
 - 1. Each partner who has *not* caused dissolution wrongfully shall have
 - 2. The right, as against each partner who has caused the dissolution wrongfully, to *damages* for breach of the agreement
 - 3. The partners who have not caused the dissolution wrongfully, if they all desire to continue the business in the same name, either by themselves or jointly with others, may do so,
 - 4. The innocent partners also have the option to continue the business in the firm name provided that they pay the partner causing the dissolution the value of his interest in the partnership
 - a. The partner who caused the wrongful dissolution gets the value of his interest, minus any damages caused by his dissolution
 - b. When calculating the value – “goodwill” of the business is excluded
 - i. **Goodwill** – an intangible asset made up of the prestige which a business has acquired beyond the mere value of what it sells

j. Final Termination & Distribution

- i. Subject to PA – each partner shall be repaid contributions whether by way of capital or advances to the partnership property and share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied . . . **AND**
 - 1. *Must contribute towards the losses, whether of capital or otherwise sustained by the partnership according to his share in the profits*
- ii. Subject to contrary agreement, upon dissolution partnership assets should be distributed as follows . . . owing to:
 - 1. Creditors other than partners
 - 2. Partners other than for capital and profits,
 - 3. *Partners in respect of capital*, and

4. Partners in respect of profits
- iii. Partners **shall contribute** as provided by § 18(a) – amount necessary to satisfy about liability (ii.)
- iv. Upon loss of the money the party who contributed it is not entitled to recover any part of it from the party who contributed only services
 1. Loss – each would lose *his own capital*—the one his money and the other his labor

2. EXCEPTIONS

a. Service partner

- i. Compensated for his work or
- ii. Made capital contribution, even if nominal

9. Buy-Out Agreements

- a. Definition: a buy-out (or buy-sell) agreement is an agreement that allows a partner to end his or her relationship with the other partners and receive a cash payment, or series of payments, or some assets of the firm, in return for his or her interest in the firm...
- b. Serve as a vehicle to allow the partnership to continue
- c. Difficulties re funding the buyout clause and negotiating its provisions
- d. Triggered by death
 - i. Key man life insurance funds buyout
- e. Triggered by retirement
 - i. Pension fund
- f. By partners or partnership
 - i. Lump sum or installment

UPA §§ 34-41

Limited Partnerships – ULPA

1. Generally

- a. Alternative to GP
- b. Means to protect one group against unlimited liability
- c. Greater flexibility
- d. Widely used in investment world
 - i. Buyout funds
 - ii. Hedge funds
 - iii. Venture capital

2. Other Limited LPs and LLs

- a. There are “LP’s” which offer limited liability only to investors
- b. There are LLP’s: “**Limited Liability**” Partnerships, which offer “LL” to all the partners – many major law firms are now LLP’s
- c. And there are now even LLLP’s: “**Limited Liability**” LP’s which offer even a natural person GP in an LP “limited liability”
- d. Finally, there are LLC’s: **Limited Liability Companies**, an altogether different animal that we will examine after we introduce “limited liability” itself more thoroughly

3. Limited Partnerships vs. General Partnerships

General Partnerships	Limited Partnerships
<ul style="list-style-type: none"> • Unlimited liability (go after your house) • No central management <ul style="list-style-type: none"> ○ Authority v. consensus • Transferability issues • End of life problems • Can K around some of these issues as we have seen but not easily done 	<ul style="list-style-type: none"> • Limited liability for LPs • GP manages centrally • Can easily transfer LP interest <ul style="list-style-type: none"> ○ Secondary market in LP interests in PE world now • Continuity eased - as long as the GP stays on, LPs can come and go • Single level tax as with GP

- a. See buyout above

Limited Liability Companies

1. Generally

- a. Cross between partnership and corporation
 - i. Tax advantage of partnership
 - ii. Limited liability of corporation
 - iii. No restricts applied to S corporations
- b. Wyoming 1977, Delaware 1992
- c. Offer an attractive alternative for both small businesses and special projects
- d. Favor private ordering with some states reserving right to impose fiduciary duties and to pierce veil
- e. Funding
 - i. Members contribute capital
 - ii. Contribution cash, property, services, promissory note **ULLCA § 401**
- f. Liability
 - i. Members stand to lose capital contribution but personal assets NOT subject to attachment
- g. Tax Consequence
 - i. Income passes through to members
 - ii. LLC does not pay taxes

2. Formation

- a. Articles of organization – ULLCA § 202(a)
 - i. Required and optional contents in ULLCA § 203 ** add these
 - ii. Filing Fees
 - iii. Choose and register name and have LLC
 - iv. Designated office and agent for service of process
 - v. Draft operating agreement ** most important**
 - vi. Add need for annual report to tickler list

3. Member's Interest

a. Financial interest

i. Distribution and liquidation

ii. Profit and Loss Sharing

1. Absent contrary agreement – allocate profits and losses based on value of members' contribution

a. Compare partnership law's equal division

- i. ULLCA § 405(a) uses partnership like equal shares rule

iii. Withdrawal

1. Member may withdraw and demand payment of interest upon giving notice specified in statute or LLC's operating agreement

iv. Assignment

1. Unless otherwise provided in operating agreement – may assign financial interest
 - a. Assignee may acquire other rights only by being admitted as member of company IF ALL REMAINING members consent or operating agreement provides

b. Management rights

i. Member-Managed (like partnership)

1. One member, one vote OR proportional to capital contribution
2. Members rule and run firm on day to day business
3. Absent contract agreement, each member has equal rights to manage – § 404(a)(1)
 - a. Most matters decided by majority vote – § 402(a)(2)
 - b. Significant matters require unanimous
 - i. Merger, admission of new member, dissolution – § 404(c)

ii. Manager-Managed – single person or committee and delegate to them operations

1. Board of directors, a CEO, or both
2. Must be specified in articles
- 3.

c. Fiduciary Duties

i. Manager-Managed

1. Managers – duty of care any loyalty
2. Members – NO duty by virtue of membership

ii. Member-Managed – all members have duty of care and loyalty

iii. Derivative Actions

1. Member may bring action on behalf of LLC to recover judgment in its favor if members with authority to bring action refuse to do so

d. Effect of Operating Agreement

i. Contracting out fiduciary duties

1. Liberal/Delaware – freedom of contracting (*McConnell: NHL Case*)

- a. An operating agreement may limit or define the scope of the fiduciary duties imposed upon its members
- b. § 103(b)(2) – may not eliminate duty of loyalty but may identify specific types or categories of activities that do not violate the duty of liability *if not manifestly unreasonable*

2. Substitution – Imply Covenant of Good Faith and Fair Dealing

- a. But very narrow remedy – can't use it as a way to protect members when they neglected to negotiate for fiduciary duties
 - i. If parties thought about this problem, what would have they negotiated up front?

1. Courts can imply/draft new form to fill the gap

e. Liability for Members or Manager's Actionable Conduct

- i. **LLC is liable for loss or injury caused to a person**, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable **conduct, of a member or manager** acting in the ordinary course of business of the company or with authority of the company

1. **LLC face entity liability in contract and tort – member is an agent of LLC for this purpose**

- ii. § 303 – Liability of Members and Managers

1. (a) -Except as otherwise provided in subsection (c), the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company

a. **A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager**

b. SO personal creditors of the members cannot reach assets of the firm and creditors of the firm cannot reach personal assets of the members

BUT SEE

2. (b) – Failure of LLC to observe usual company formalities or requirements relating to exercise of its company powers or management of its business in not a ground for imposing personal liability on the members or managers for liabilities of the company

f. Piercing LCC Veil

- i. Court will pierce if
1. Failure to observe usual company formalities and acts as the **alter ego** or instrumentality of a shareholder AND
 2. Liability limitations of the corporate form results in *injustice or is fundamentally unfair*

Corporations

Formation and Pre-Incorporation Transactions

Artificial person or legal entity created by or under authority of the laws of a state or nation

1. Critical Attributes

- a. **Formal creation as a matter of state law (Secretary of State)**
- b. **Legal personality/fiction – MBCA § 3.02 – unless articles provide different, legal person?**
 - i. Separate existence from owners
 - ii. Possesses some constitutional rights
 - iii. Separate taxpayer
- c. **Limited Liability**

**MBCA
§ 6.22(b)**

 - i. Unless otherwise provided in articles of incorporation, **shareholder** is **NOT** personally liable for acts or debts **except** that he may become personally liable by reason of *his own acts or conduct*
- d. **Separation of ownership and control – § 8.01(b)**
 - i. All corporate powers shall be exercised by or under authority of and the business and affairs of the corporation managed by or under the direction of its board of directors
 - ii. Management is vested in board of director -> officers -> employees
 1. Fiduciary obligations
 - iii. Shareholders have no control over day-to-day life (**passive** B acts vs. S: react)
 - iv. Shareholders **entitled** to vote on:
 1. Election of directors – **§ 8.04**
 2. Any amendments to articles of incorporation and generally speaking, by-laws – **§ 10.03, 10.20**
 3. Fundamental transactions
 - a. Mergers – **§ 11.04**
 4. Odds and ends: approval of independent auditors

v. Other Shareholder Rights

1. **Vote** on limited range of issues
2. Receive payment of **dividends** when and as declared by board
3. **Inspect** corporate books and records
4. Receive **distribution** upon termination
5. Purchase **proportionate share** of new issuance or corporate stock to maintain current ownership percentage – preemptive right
6. File **derivative suits** to redress wrong suffered by corporation

e. **Liquidity**

f. **Flexible Capital Structure**

i. Terminology

1. **Authorized shares** – articles must specify number of shares corporation is authorized to issue
2. **Outstanding shares** – number of shares corporation has sold and not repurchased
3. **Authorized but unissued shares** – shares authorized by charter but which have not been sold by the firm
4. **Treasury Shares** – once issued and outstanding but repurchased by corporation

ii. Permanent and long-term contingent claims on the corporation's assets and future earnings issued pursuant to formal contractual instruments – securities

iii. Many ways to package such claims – stocks, bonds, etc.

iv. Bonds and other debt securities consist of two distinct right

1. Bondholder entitled to receive **stream of payment** in form of interest over period of years
2. At end of bond's prescribed term [maturity] bondholder is entitled to the **return of the principals**

v. Creditors; not owners

- vi. **Equity securities** [aka shares] represent units into which proprietary interests in corporation are divided
 - 1. **Residual claimants** – equal right to participate in distributions of earnings and in event of liquidation, to share equally in the firm's assets remaining after all prior claims have been satisfied
 - 2. Limited right to participate in corporate decision-making by electing directors and voting on major corporate decisions

2. **Fundamental Distinctions**

- a. Not-for-profit vs. for-profit corporations
- b. Public vs. private corporations
 - i. Public corporations are created by the government to carry out some public function
 - ii. Private corporations are created/owned by private individuals to carry out private functions
- c. Close vs. Public
 - i. Close corporations**
 - 1. Closely held corporations
 - 2. Generally tend to be smaller
 - 3. Stock is not listed on a market
 - ii. Public Corporations**
 - 1. Publically held corporations
 - 2. Stock is listed for trading on a secondary market –
 - 3. NYSE or NASDAQ – major advantage in raising funds = liquidity, availability of markets

3. **Alternative Non-Corporate Formations**

a. General Partnerships

- i. Partnership = an association of two or more persons to carry on as co-owners a business for profit
- ii. One type of investor – a partner having full rights of management, control and profit sharing

b. Limited partnerships

- i. Have two classes of partners
- ii. General partners, and limited partners
- iii. Less expansive rights, but obligations are correspondingly limited
- iv. Tax advantageous vehicle in some situations

c. Limited liability company (LLC)

- i. Unincorporated business organization providing its members with pass through tax treatment, limited

4. **Sources of Corporate Law**

a. State corporate law – corporation statutes of the state of incorporation

- i. Judicial interpretations of such statutes
- ii. “Internal affair doctrine” – conflict of law holding that corporate governance matters are controlled by the law of the state incorporation

b. Federal corporate law

- i. Where public corporations are concerned – federal law is more important
- ii. Dual regulatory scheme – federal securities law and state corporate law

c. State law is concerned with the substance of corporate governance, while federal law is concerned with disclosure and limited number of procedural aspects of corporate governance

§ 2.01 – Incorporators

One or more persons may act as the incorporator or incorporators of a corporation by delivering articles of incorporation to the secretary of state for filing

State may not exclude foreign corporation engaged in interstate commerce (foreign/alien)

§ 2.02 – Articles of Incorporation . . . must set forth:

Corporate **name** satisfying § 4.01

Number of shares the corporation is authorized to issue;

Street **address** of the corporation's **initial registered office** and the name of its initial registered agent at that office; and

Name and address of each incorporator

§ 2.03 – Incorporation

Existence begins when the articles of incorporation are filed *unless* a delay effective date is specified

Secretary of State's filing AOI is **conclusive proof** that incorporators satisfied all conditions precedent except in state proceeding to cancel/revoke incorporation or involuntarily dissolve it

§ 2.04 – Liability for Pre-Incorporation Transactions

All persons **purporting** to act as or on behalf of corporation, **knowing there was no incorporation**, are *jointly and severally liable* for all liabilities created while so acting

Promoter – someone who purports to act as an agent of business prior to its incorporation

§ 2.05 – Organization of Corporation (After Incorporation)

AOI Names Directors– meet, appoint officers, adopt bylaws, and carrying on other stuff ✓

AOI NOT NAMED – meeting to elect directors, complete organization OR elect BOD ✓

Meeting required/permitted to be taken by incorporators may be **taken without meeting** if action taken is **evidenced by 1 or more written consents and signed by each incorporator (in/out state ok)**

§ 2.06 – Bylaws

All incorporators or BOD adopt initial bylaws for corporation

Bylaws may contain any provision not inconsistent with laws re: AOI

May contain either/both: proxy statement; corporation reimburse shareholder for proxy-expense

If SH amend bylaws: may not limit BOD's authority to amend/repeal any condition to bylaw in order to provide for reasonable, practicable and orderly process

5. Pre-Incorporation– Liability

a. Once articles filed

i. Corporation to 3P Contract: YES: NOT AUTOMATIC → **novation/adopt**

1. **Expressly or implicit (ratification by acceptance of benefits)**

ii. Promoter is liable if Corporation breaches:

1. **YES → MBCA § 2.04 UNLESS**

a. Released by the 3P or novation which is **very express**

b. No Articles Filed/Defective Incorporation

i. Promoter is liable on contract

1. Absent agreement to contrary **MBCA § 2.04**

a. Novation

b. Let promoter go

ii. Defectively formed entities or individuals

1. 3P who dealt with the firm as though it were a corporation and relied on the firm, not the individual Δ , for performance is ESTOPPED from denying the existence

2. De Facto Corporation

a. In good faith tried to incorporate

b. Had a legal right to do so

c. Acted as corporation

3. **Corporation by Estoppel** – treat firm as though it were corporation if person dealing with firm

a. Thought it was corporation all along

b. Would earn windfall if now allowed to argue that the firm was not a corporation

c. **NO GOOD FAITH EFFORT - kicks in when 3P gets windfall**

6. Corporate Liability

- a. Not improper to
 - i. Incorporate business for express purpose of avoiding personal liability
 - ii. Split a single business enterprise into multiple corporations so as to limit the liability exposure of each part of the business
- b. **Corporate Veil**
 - i. Where shareholder uses control of corporation to further **his own**, rather than corporation's business, he will be liable for corporation's acts and debts on a **Principal/Agent Theory**
 - ii. **Alter Ego** – basically person has the shield of corporate liability but corporation and individual are basically the same entity
 - iii. **TEST: Piercing Corporate Veil** [avoid: follow formalities] **CA laundry***
 1. **Corporation was controlling shareholder's alter ego:**
 - a. Commingling of funds
 - b. Undercapitalization
 - c. Disregard for corporate formalities:
 - i. Failure to hold shareholder meetings
 - ii. Failure to hold board meetings
 - iii. Failure to keep minutes of said meetings
 - iv. Failure to keep separate books
 - v. Failure to issue stock
 - vi. Failure to appoint a board
 - vii. Failure to adopt charter or by-laws
 2. **Adherence to limited liability would *sanction a fraud or promote injustice* (Marsh – measures length of Chancellor's foot)**
- c. **Enterprise Liability (Going after multiple corporations)**
 - i. Reconnect separate businesses and make them one large enterprise – like multiple cab companies
 - ii. Only larger corporate entity would be held financially responsible
 - iii. π burden of proof (avoid following + careful accounting for supplies etc.)
 1. Δ did not respect separate identities of corporations
 - a. Separate bank accounts
 - b. Who hires and trains: individually or people don't really know which ones

Corporations

Governance – Management and Control

1. **Shareholders (corporation primarily for SH profits)**
 - a. Own company
 - b. Participate in profits of enterprise
 - c. Limited involvement in company's affairs
2. **Board of Directors (elected by SHs but AOI or Bylaws may prescribe qualifications)**
 - a. **MBCA § 6.40** – BOD may authorize and corporation make distributions to SH
 - b. **DGCL § 141(a)** – Business/affairs of every corporation shall be managed by or under direction of BOD except as otherwise provided in chapter or AOI
 - i. **DGCL § 141(b)** “The board of directors of a corporation shall consist of 1 or more members, each of whom shall be a **natural person**.
 1. Number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate
 2. Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws note **DGCL § 141(c) limits!!**
 - c. Individual directors **NOT** agents: Only board whole = agent and bind corporation
 - d. **Oversight**, Select, evaluate, replace senior management

§ 8.30 – Conduct Standards

Good faith + manner reasonably believes in best interest of corporation

Disclose material info not already known to board unless violates other duty under law

D w/o knowledge that makes reliance unwarranted is entitled to rely on performance by any of persons in (f)(1)/(3) whom BOD may have delegated, in/formally, the authority to perform 1+ board's functions:

Reliable officers with competency in functions performed; **Legal counsel**, CPAs, or others retained by corp. (within expert competence or merits confidence); **Committee of BOD** of which D is not a member if director reasonably believes committee merits confidence

- e. Absent abuse, court does not second guess or alter way in which dividend policy is set
 - i. Directors have power to declare dividends and their value
 - 1. Courts interfere only where fraud, misappropriation, or where surplus of money that can be issued as dividend without harming business
 - a. Where refusal is almost fraud and breach of good faith to shareholder (*Dodge v. Ford*)
- f. **Officers/Management** (appointed by board)
 - i. Act as agents for corporation
 - ii. Have fiduciary duties
- g. **Employees**

Corporations

Governance: Fiduciary Duties of Directors

1. Fiduciary Duties [generally] – *directors and officers = fiduciaries of corporation*

a. Duty of Care

- i. Directors/officers are expected to act in good faith and the best interests of corporation
- ii. Duty of care to shareholders
- iii. Failure to exercise due care may mean individual directors or officers are personally liable

b. Duty of loyalty – subordination: personal interests to corporate welfare

- i. No competition with corporation
- ii. No taking corporate opportunity
- iii. No conflict of interests
- iv. No insider trading
- v. No transaction that is detrimental to minority shareholders

2. Standards of Liability . . . § 8.31 basically = BJR (gets you in trouble)

3. Business Judgment Rule: Overview

a. Standard of *liability*

- i. No liability for negligence
- ii. Liability based on:
 1. Fraud, Illegal conduct, Self-dealing

b. *Abstention* doctrine

- i. Court will not review BOD decision
- ii. Preconditions: No fraud, illegality, self-dealing

c. Inherent tension between:

- i. Need to preserve BOD's decision-making discretion AND
- ii. Need to hold BOD accountable for its decisions

4. Business Judgment Rule

a. *Absent a showing of fraud, illegality, or conflict of interest, the court must abstain from reviewing the director's decision*

i. *Directors are entitled to exercise their honest business judgment on information before them and to act within their corporate powers*

1. Courts must defer to the board of director's judgment absent highly unusual circumstances

a. Mere errors of judgment are not sufficient as grounds for equity interference – largely discretionary to directors

b. Did directors reach an informed business judgment

i. If they did not, were their actions taken subsequent to that date adequate to cure any infirmity in their action taken on that date

c. **Presumption:** making business decision, directors acted on informed basis, in good faith, and in honest belief that action was taken in best interest of company
[**Rebuttable: breached duty: care/loyalty/bad faith**]

i. Attacking board decision as **uninformed** → **MUST** rebut presumption

1. **Informed** – have directors informed themselves prior to making a business decision, of all material information reasonably available to them (*Brehm* – reasonable reach)

2. **NO** protection: **unintelligent and unadvised** judgment

a. **Unavailable:** failed to inform themselves of *all material* info reasonably available to them (*Smith v. Van Gorkom*)

b. **BUT:** Full protection in relying in good faith on reports made by officers

3. **Gross Negligence [by failing to inform themselves]** = Standard for determining BJR reached by Board of Directors

ii. Rebuttable if breached duty of care, loyalty or acted in bad faith

d. **Informed Decision** – all information readily available to them – what a reasonable shareholder would consider important in deciding whether to approve decision

i. **Time pressures** – boards that have failed to exercise due care are frequently boards that have been rushed . . . but quick decisions *can* be made

ii. **Negotiations** – need a little pain on both sides / evidence of testing boundaries

Just because an alternative course of action *exists* does not mean BOD must follow or where not following gets courts intervention

Procedure

Π burden to rebut BJR via breach GF/L/C

Shift: Δ to show entire fairness



iii. **Duty of Inquiry** – [no blind reliance] + **continuing duty: remain informed**

1. Reports (defense) = informal personal investigation by officers – must be pertinent to subject matter upon which board is called to act and otherwise be entitled to good faith, not blind, reliance
2. Valuation study
3. Discussion: course of negotiations
4. Review an actual contract

iv. **Consultations** [get onboard] early with senior management

- v. **Setting the price** – must focus on one primary objective – to secure transaction offering at best value reasonably available for all stockholders
- vi. Market valuation vs. intrinsic value

vii. **Control premium** – market for corporate control – i.e., buying all the shares of a company's stock

1. Market: \$38 but buyout pays \$55

viii. **Suspicious aroused?**

1. **Absolve** of liability – informing directors of impropriety and voting for proper course of action
 - a. **Conversely** – may be liable to corporation for benefit of its creditors or shareholders to extent of any injuries suffered by such persons

2. So:

- a. Inquire into doubtful matters
- b. Object to apparently illegal or questionable behavior
- c. Resign if corrections NOT made

ix. Good faith and with degree of diligence, care, and skill which ordinary prudent men would exercise under similar circumstances and in like positions

1. Owe degree of care that businessmen of ordinary prudence would exercise in management of his own affairs
 - a. Should acquire at least a rudimentary understanding of corporation's business/similar with fundamentals of business

x. Cannot set up Δ : lack knowledge needed to exercise requisite care

1. If unfamiliar: acquire knowledge by inquiry or refuse to act

5. Preconditions –directors get BJR defense = **GOOD FAITH + INHERENT FAIRNESS**

a. Exercise of Judgment

- i. Directors actually exercised business judgment
- ii. No protection: no decision made Vs. decision refrain from action [inaction subject to review]

b. Disinterest and independent decision makers

i. Business judgment rule presupposes that directors have no conflict of interest

1. Self-dealing one of classic triad of ways in which the rules presumptions are rebutted
2. “A director is [self] interested if he will be materially affected, either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the shareholders”

a. Also interest by virtue of indirect connections (e.g., spousal)

ii. Director must also be independent

1. Independent if he can base his decision ‘on the corporate merits of the subject before the board rather than extraneous considerations or influences
2. Note: where the board has acted collectively, it is not enough to show that a single director was interested of or lacked independence
 - a. Business judgment rule will insulate the board unless the plaintiff can show a majority of the board was interested and/or lacked dependence

c. Absence: Fraud/Illegality

- i. Key issue: whether the board has a duty to act lawfully
- ii. Illegality of a board decision should not deprive the directors of the protection of the business judgment rule
 1. Allowing shareholder derivative suits is not a deterrent for corporate crime
 2. Windfall to the plaintiff bar, and not the nominal shareholders

d. Rationality

6. Reconcile: Duty of Care and BJR

- a. Substantive Standard vs. Abstention
 - i. Abstention - Creates a presumption against judicial review of duty of care claims
 - 1. Courts abstain from reviewing the substantive merits of the director's conduct unless the plaintiff can rebut the business judgment rule by showing one or more preconditions are lacking
- b. DOC: don't be negligence vs. BJR: insulates negligence liability
 - i. BJR raises bar from mere negligence to say, gross negligence or recklessness

7. DGCL § 141(e)

- a. BOD member or member of any committee designated by the BOD, shall, in the performance of such member's duties, be
 - i. **Fully protected** in relying in **good faith** upon
 - 1. Records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any **other** person as to matters
 - a. Member **reasonably believes** are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation

8. Principal-Agent Theory

- a. Goals of principals and agents may conflict
 - i. Difficulty or expensive for principal to verify what agent is actually doing
 - 1. Hard for board of directors to confirm that managers are actually acting in shareholders interests
 - 2. Managers may opportunistically pursue their own interests
- b. Principal and agent may have different attitudes and reference toward risk

Corporations

Business Judgment Rule: Board Process & Good Faith

1. **Obligation of Good Faith [somewhat independent basis of liability but triad too]**
 - a. Good faith acting directors get indemnification for legal fees **§ 145**
 - i. Only directors who rely in good faith on corporate books and records or reports from corporate officers or certain advisors are “fully protected” against shareholder claims **§ 145(e)**
 - b. Related party transactions are partially insulated from judicial review only if they are approved by disinterested directors or shareholders in good faith
 - c. Courts recognize longstanding notion:
 - i. Conduct motivated by subjective bad faith
 - ii. Intentional dereliction of duty, conscious disregard for one’s responsibilities
 - iii. But gross negligence does NOT equal bad faith
 - d. **De Facto Officer** – one who actually assumes possession of office under claim and color of election or appointment and who is actually discharging duties of that officer, but for some legal reason lacks *de jure* legal title to that office
 - e. Process – due care and affirmative inquiry
 - i. Grossly negligent in failing to inform of all material information reasonably available to it
2. **Three categories: fiduciary behaviors might = “bad faith” BUT gross negligence cannot without more = bad faith (missing intent)**
 - a. **Subjective bad faith** – fiduciary conduct motivated by actual intent to do harm
 - b. **Lack of due care** - fiduciary actions taken solely reason of gross negligence **and** without any malevolent intent
 - i. Sharp distinction: exercise due care vs. no bad faith
 - c. **Intentional dereliction of duty** – a conscious disregard for one’s responsibilities
 - i. Intentionally acts with purpose other than advancing best interests of corporation
 - ii. Intent to violate applicable positive law
 - iii. Intentionally fails to act in face of known duty to act: **conscious disregard**
 - iv. *Functional equivalent of waste*

3. Defense – **DGCL § 141(e)**

a. BOD member or member of any committee designated by the BOD, shall, in the performance of such member's duties, be

i. **Fully protected** in relying in **good faith** upon

1. Records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any **other** person as to matters

a. Member **reasonably believes** are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation

b. Pre-Condition: duty of inquiry

4. Waste Claim [irrationally throwing away money: marble bank]

a. Transaction “that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration”

b. *Absent irrationality, compensation is a matter of BJR and court will not review*

c. π who fails to rebut the BJR presumptions is **not** entitled to any remedy **unless** that transaction constitutes waste

d. π burden of proof: **exchange so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration**

e. Claim of waste will **ONLY** arise in *rare* unconscionable cases

i. Irrationally squander or give away corporate assets

f. **Best Practices seen in compensation**

i. **Spreadsheet** or similar document with help or prepared by compensation **expert**

ii. Spreadsheet would **disclose amounts** that each officer would receive under employment agreement

iii. Spreadsheet would be **explained** to committee members – expert who prepared or committee member similarly knowledgeable about subject

iv. Spreadsheet would **form the basis** of the committee’s deliberations and decision

v. Spreadsheet would ultimately become an **exhibit** to minutes of compensation committee meeting

5. Good Faith seen in Oversight (NOT INDEPENDENT COA) within DOL

- a. Lack of good faith is necessary condition to liability
- b. Monitoring management – one of the 3 principle functions of BOD
- c. BJR rarely insulates BOD from liability in connection w/ this fx
 - i. BJR applies only where BOD exercised business judgment (affirmative decision making)
 1. Most oversight cases arise because the board has FAILED to act
- d. Absent cause for suspicion – NO duty to install and operate system of espionage to ferret out wrongdoing which they have no reason to suspect exists
 - i. Absent grounds to suspect deception, neither boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings of their company's behalf
- e. **Standard of liability** where directors are **unaware** of employee misconduct that results in corporation being held liable
 - i. Sustained or systematic failure of BOD to exercise oversight will establish lack of good faith that is a necessary condition to liability
- f. Conditions for Liability – **BJR: good faith + rational process**
 - i. Directors knew they were not discharging fiduciary obligations **AND**
 1. Directors **utterly failed** to implement any reporting or information system or control **OR**
 - a. Having implemented system/control
 2. **Consciously failed** to monitor/oversee operations thus disabling themselves from being informed of risks or problems requiring attention
 - ii. Directors are entitled to rely on the honesty of their subordinates until something occurs to put them **on notice** that illegal conduct is taking place
 1. **Notice and then fail to act** or if they **recklessly** place their confidence in an obviously untrustworthy employee = Liability
 - iii. Note: Red Flags
 1. When to **investigate**
 2. When should BOD be **informed**
 3. When does BOD conduct **inquiry**

6. Compliance Programs



- a. Directors are entitled to rely on the honesty of their subordinates until something occurs to put them **on notice** that illegal conduct is taking place
- b. If they are put **on notice** and then fail to act, or if they recklessly repose confidence in an obviously untrustworthy employee, liability may follow
- c. Policy manual
- d. Training employees
- e. Compliance audits
- f. Sanctions for violation
- g. Provisions for self-reporting of violations to regulators

7. Key Compliance Steps

- a. Clearly identify who will oversee the investigation
- b. Determine if independent outside advisers should be hired or if existing outside advisers can be used
- c. Establish the scope of the investigation, but be prepared to expand the investigation as necessary
- d. Ensure that investigators behave legally and ethically
- e. Determine appropriate form of report and if it should be passed on to regulators and prosecutors

8. Roadmap for a New Director

Step 1	Step 2	Step 3
Duty of Care – be aware Duty of inquiry	Explain BJR <u>but</u> Fraud, illegality, self dealing (DOL), informed, egregious decision	DOC returns if no BJ exercised or shield lifted Bad faith? Part of overall obligation esp. DOL
<i>Dodge, Wrigley, Caremark</i>	<i>Disney, Caremark</i>	<i>Disney, Stone</i>

Corporations

Exculpation & Indemnification

1. Indemnification

a. Liability Limitation Statutes

i. **Only Directors/Not Officers** - **DGCL § 102(b)(7)** - corporation's articles of incorporation may (but need not) include:

1. Provided that such provision **shall not** eliminate or limit the liability of a director:

- a. Breach director's **duty of loyalty** to the Corp/Shareholders
- b. Not in good faith or which involve intentional misconduct or a knowing violation of law
- c. For act relating to liability for unlawful dividends
- d. For any transaction from which director derived improper personal benefit (self-dealing)

ii. Exculpates

1. No exercise of business judgment – yes
2. Waste – yes
3. Uninformed decision – yes (*Disney*)
4. Fraud – if known, no (because intent/scienter)
5. Conflict of interest – no (breach DOL)
6. Illegality – no (knowing violation of law)
7. Bad faith – no

iii. Noteworthy

1. Applies only to directors...
 - a. Although officers are also subject to a duty of care, they are denied exculpation by this provision
2. Limits only monetary liability of directors
3. Equitable remedies are still available – and, since attorney's fees may be recovered, the incentive to bring litigation remains
4. Affirmative defense

5. Defendant directors have burden of proving they are entitled to exculpation under statute
6. Harder to 12(b)(6) π's complaint for failing to state a cause of action
7. πs more likely discovery – drives up settlement value of claims up
8. Distinguishes between self-dealing and duty of care
9. πs can avoid 102(b)(7) by characterizing claims as a loyalty violation

Indemnification Statutes - § 145(a), (b), (e) and (f) must be written into the AoI, § 145(c) is mandatory . . . DGCL § 145 – all indemnification must be consistent with § (broader ok)

9. Distinguishes: direct and derivative suits against a D/O:

- a. § 145(a) – authorizes the corporation to indemnify the director or officer who acted in *good faith/not opposed to best interest* for expenses **plus**
 - i. Judgments, fines, and amounts paid in settlement of both civil and criminal proceedings
 - ii. *145(a) covers direct suits by shareholders or 3d parties suing in their own name*
 - iii. If implemented in the AOI a board member can get reimbursed for expenses, AND judgments, fines, settlements.
 - iv. If necessary the Director pays the 3P and Company reimburses the Director
- b. § 145(b) – **Only for expense**, including attorney's fees
 - i. Derivative litigation – authorizes indemnification
 - ii. If the person *acted in good faith* and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation”
 - iii. If the director or officer was held liable to the corporation, he may only be indemnified with *court approval*

10. Distinguishes: mandatory and permissive indemnification

- i. § 145(c) – a corporation must indemnify a director or officer who “has been successful on the merits or otherwise
 1. **Merits** – went to trial and won or **otherwise** – settlement
 - a. Note: only escape not moral exoneration
 - b. **Unsuccessful? Check § 145(a) or (b)**
 - i. Permissive so long as it’s not precluded by statute
 2. It is a mandatory not permissive provision
 - a. When Director or officer **is successful** on merits in suits referred to in A or B, they **must** be indemnified for their expenses, but expenses **only**
 3. Why omit a good-faith exception in 145(c)?
 - a. Intended to avoid collateral litigation – no need for further litigation were director succeeds on merits but in a way that does not resolve his issue of good faith
 - b. Intended to permit indemnification for those who acted in bad faith, but who nonetheless prevail...does not chill directors from taking risks
 - c. Encourage people to serve as directors of corporations in Delaware (encouraging Delaware incorporation) by providing maximum protection

11. Advancement of Expenses

- a. § 145(e) – corporation *may advance expenses* to the officer or director provided the latter undertakes to repay such amount if it turns out that he is not entitled to indemnification

12. Further Indemnification through AoI (note: no new powers)

- a. § 145(f) – may enter into written indemnification agreements beyond statute
 - i. Statute authorizes indemnification agreements mandating payments that the statute permits (i.e., permissive)
 - ii. Authorizes indemnification agreements *mandating* payment of expenses that the statute merely permits
 1. Also allows indemnification of certain expenses not contemplated by statute
 - iii. **CANNOT** bypass good faith

Corporations Shareholder Litigation

	Direct	Derivative
Brought by:	Shareholder in his name	Shareholder on C's behalf
Cause of Action:	Belongs SH: individual capacity	Belongs to C as entity
Arises b/c:	Injury directly to SH	Injury done to C entity
Characterized as:	Direct in nature <ul style="list-style-type: none"> • Oppression of minority shareholders • Proposed reorganization favoring one class of shares over another • Compelling declaration of a dividend; inspection of corporate books and records • Shareholder voting rights; preemptive rights • Injunctive relief where directors improperly abdicated authority to corporate officers 	Derivative in nature <ul style="list-style-type: none"> • Corporate rights arising out of torts or contract • Monetary damages based on corporate mismanagement • Executive compensation; waste of corporate assets • Adequacy of consideration for issuance of corporate stock
Note:		SH to hold D accountable SH helplessness

1. Competing Policy Concerns

- a. Derivative – mechanism of managerial accountability
 - i. Potential for bias
 1. Directors cannot be expected to sue themselves
- b. Cause of action belongs to corporation
- c. Shareholder may have interests diverse from those of corporation
 - i. Shareholders lawyer often real party in interest
- d. Therefore BOD should have some say

2. Traditional Tests

- a. Who **suffered**? (Corporation = derivative)
- b. To whom did Δ 's **duty** run? (Corporation = derivative)
- c. **Delaware's Alternative**
 - i. Who suffered the alleged harm?
 1. Corporation or the suing stockholders individually?
 - ii. Who would get the benefit of the remedy/recovery?
 1. Corporation or the stockholders individually?
 - a. Generally: any monetary recovery from a derivative lawsuit will be paid over to corporation vs. named shareholder π s
 - b. But – individual recovery possible where equitable in circumstances and adequate provision has been made for creditors or corporation
 - c. Avoid board of directors from benefitting from an award to the corporation

3. Who should recover?

- a. In the case of individual recovery, the amount awarded is pro rata based on share ownership ratios. So plaintiffs do not get a piece of the defendants' share.
- b. Plaintiff Incentives
 - i. Any recovery goes to corporate treasury, whether by settlement or trial victor
 - ii. Lawyer is real party in interest
 1. Lawyer can get contingent fee out of any recovery
 2. BUT corporation also must pay plaintiff's legal fees if there is a substantial non-monetary benefit
 - a. Courts quite liberal in finding such benefit
- c. Defendant Incentives
 - i. Strike suits – settle to go away
 - ii. Meritorious suits against insider defendants:
 - iii. Indemnification: Corporation must reimburse director's expenses if successful defense
 - iv. Settlement in which director doesn't pay anything deemed a success

4. Plaintiff Qualifications

- a. **MBCA § 7.41** limits standing to shareholders, Creditors may not bring derivative suit
- b. **MBCA § 7.41(1)**: Must be a shareholder *at the time of the alleged wrongdoing*
- c. **MBCA § 7.42**: *Must be a shareholder when suit commenced*,
- d. Many states say also must remain a shareholder *through final judgment*
- e. **MBCA § 7.41(2)**: Named plaintiff must be a fair and adequate representative of the corporation's interest

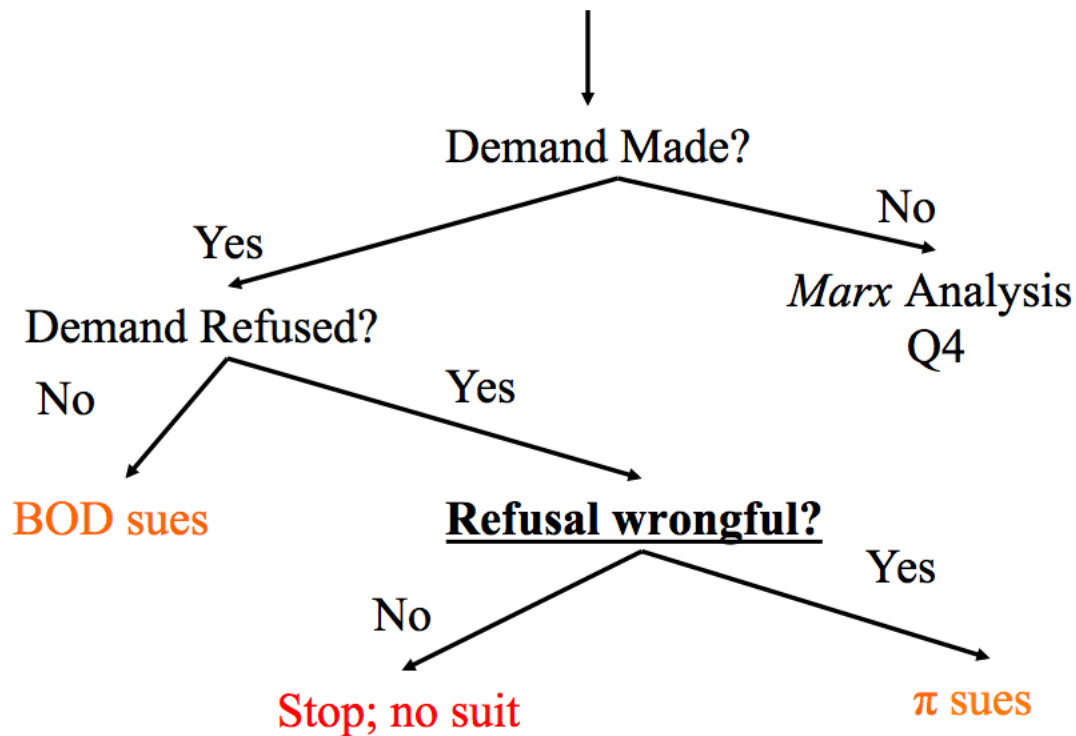
5. Strike Suits

- a. Non-meritorious actions brought by people who might be interested in getting quick dollars by making charges without regard to their truth, so as to coerce corporate managers to settle worthless claims
 - i. Real party in interest is the plaintiff's attorneys
- b. Recognized that shareholders would not bring derivative suits if they were obligated to bear the legal costs of suit in all cases
 - i. Both federal and state law provide for payment of the π 's legal fees in derivative action
 - ii. Note: usual rule – each party pays its own legal fees + other expenses
- c. Derivative context, corporation may be ordered to pay the plaintiff-shareholders fees and expenses if the litigation results in a monetary recovery or confers a substantial nonmonetary benefit on the corporation

6. Problems re Derivative Litigation

- a. Creates incentive for π 's attorneys to bring non-meritorious claims...at the same time
 - i. Encourages plaintiff's attorneys and managerial Δ to collusively settle meritorious cases
- b. Because a manager who is dismissed from the litigation, for whatever reason, without having to make a monetary payment is deemed to have succeeded
 - i. Individual defendant faces no risks because corporation will indemnify and reimburse costs

DERIVATIVE LITIGATION DECISION TREE (2)



7. Demand Requirement (if excused → π can go forward with suit)

- a. There is a critical pre-requisite to the filing of a derivative lawsuit in the name of a corporation by a shareholder: namely, the requirement that the shareholder *first file a demand* with the corporation that it pursue the claim itself
- b. Demand is required UNLESS it would be futile [FRCP 23.1- demand requirement]
 - i. **Note:** refusing demand is protected by BJR!
 - ii. **Reasonable doubt as to whether BJR applied to decision to refuse demand**
- c. Demand- typically a letter from shareholder to BOD
 - i. **Request:** BOD bring suit on alleged cause of action
 - ii. **Specific to apprise** board on nature of cause of action to evaluate its merits
 - iii. **Minimum-** must identify alleged wrongdoers, describe factual basis of wrongful acts, the harm caused to corporation and request relief

8. Is Demand Futile?

- a. **Delaware (*Grimes*)** stockholder filing derivative suit must allege that
 - i. Board rejected his pre-suit demand **OR** Allege w/particularity (pre-discovery using tools at hand) creating a reasonable doubt that the board is capable of making good faith decision on suit
 - 1. Majority of board has material, financial or familial interest OR
 - 2. Majority of board lacks independence (domination or control) OR
 - 3. Challenged transaction is not a product of valid exercise of BJ (Illegal, irrational)
- b. **New York (*Marx*) – Basis excusing demand . . . alleges with particularity:**
 - i. Majority of directors interested in challenged transaction OR
 - ii. Directors failed to inform themselves to degree reasonably appropriate OR
 - iii. Challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors
- c. **Note:** Where no BJ made (oversight), court must determine whether/not particularized factual allegations of complaint create a RD as of the time the complaint is filed . . . BOD could have properly exercised its independent & disinterested BJ in responding

9. Special Litigation Committee – Did BOD Employ One?

- a. When individual members of BOD prove to have personal interests which may conflict with the interests of the corporation such interested directors must be excluded while the remaining members of the board proceed to consideration and action
 - i. **Burden on SLC to establish its own independence by a yardstick that must be “like Caesar’s wife”**
- b. SLC could be broken down into two parts:
 - i. The selection of procedures appropriate to the pursuit of its charge.
 - 1. The courts are well equipped by long and continuing experience and practice to make these determinations.
 - ii. The ultimate substantive decision.
 - 1. These decisions, however, fall squarely within the business judgment doctrine and are thus outside the scope of review

- c. Key legal issue: whether court should defer to a SLC recommendation that suit be dismissed
- d. BJR **does not** foreclose inquiry by court into disinterested independence of those members of Board chose to make corporate decision on its behalf
 - i. Rule shields deliberation and conclusion of chosen reps of board ONLY IF they possess:
 1. **Disinterested independence and**
 2. **Do not stand in dual relation which prevents an prejudicial exercise of judgment**
 - ii. While court may properly inquire as to adequacy and appropriateness of committee's investigative procedures and methodologies, it may not under guise of consideration of such factors **trespass** in domain of business judgment
- e. **How Much Deference Should A Court Afford the SLC Recommendation to Dismiss the Suit? Independent + Disinterested + Conducted GF/R Investigation**
 - i. **Step 1:**
 1. Inquiry into the independence and good faith of the committee
 2. Inquire into the bases supporting the committee's recommendations
 - a. Must be good faith and reasonable - BJR
 - ii. **Step 2:**
 1. Court may go on to apply its own business judgment as to whether the case is to be dismissed
 - a. Allows meritorious suits to go forward
 - b. Accounts for structural bias problem
 - iii. **BOP: C – independence, good faith, and a reasonable investigation**
- f. **Zapata Two-Step:** If a committee, composed of independent and disinterested directors, conducted a proper review of the matter before it, considered a variety of factors and reached, in good faith, a business judgment that the action was not in the best interest of the corporation, the action must be dismissed.
 - i. The final substantive judgment whether a particular lawsuit should be maintained requires a **balance of many factors** – ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal.
 - ii. The motion should include a thorough written record of the investigation and its findings and recommendations

- g. Board decision to cause derivative suit to be dismissed as detrimental to the company, after demand has been made and refuse, will be respected unless it was **wrongful** – it generally falls under business judgment
 - i. If **not wrongful** – demand refusal terminates legal ability to initiate derivative action
 - 1. But where demand is properly excused, stockholder does possess ability to initiate action on corporation’s behalf
- h. After objective and thorough investigation of derivative suit, SLC may cause its corporation to file pretrial motion to dismiss
 - i. Motion: thorough written record of investigation, findings, and recommendations
- i. First: Court inquires into independence and good faith of committee and on the bases supporting conclusions . . . [if court is satisfied]
- j. Court applying own independent judgment – whether motion should be granted

10. SLC Independent?

- a. **New York** SLC recommendation implicates a two-tiered set of questions
 - i. Challenged transaction (here, the illegal payments)
 - ii. Committee’s recommendation that the action be dismissed
 - iii. Judicial inquiry **permitted** with respect to
 - 1. Disinterested independence [factors]**
 - a. Is there bad blood?
 - 2. Adequacy of investigation**
 - a. Completeness of areas and subjects of inquiry
 - b. Good faith inquiry
 - i. Not half-hearted, etc.

b. **Delaware** – less deferential

- i. After an “objective and thorough investigation,” the committee may cause the corporation to file a motion to dismiss the derivative action
 1. Motion should include a written record of the committee’s investigation and its findings and recommendations
 2. Note: each side is given a limited opportunity for discovery
- ii. Burden of Proof – corporation – look into file cabinet for underlying transaction
- iii. In deciding whether to dismiss the action, the court is to apply a two-step test
 1. Independence and good faith of the committee
 2. Basis supporting the committee’s recommendation
 3. This step differs from AUERBACH...Delaware court looks not only at the procedures used, but also at the reasonableness of the basis for the committee’s decision
- iv. If the first step is satisfied, the court *may* but need not apply its own business judgment
- v. Judges should not dismiss meritorious derivative suits merely because the board and its committee jumped through all the procedural hoops
- vi. But...no real standard by which judges should apply their own business judgment
- vii. Court should consider such things as the corporation’s interest in having the suit dismissed and matters of law and public policy

11. SLC Independence Context

- a. Independence and disinterested decision makers key precondition to BJR
 - i. Demand futility
 - ii. SCL recommendation
 - iii. Approval conflicted interest transactions
 - iv. M&As – especially defenses against hostile takeover bids
 - v. Special litigation committee (SLC) has burden on its motion to terminate the derivative action, must convince the court that there is no material issue of fact calling into doubt its independence

- b. SLC Must prove
 - i. Independent
 - ii. Disinterested
 - iii. Conducted good faith and reasonable investigation
 - iv. Conclusion has reasonable basis
- c. Special litigation committee (SLC) has burden on its motion to terminate the derivative action, must convince the court that there is no material issue of fact calling into doubt its independence
- d. Fact that you're dependent on other directors or CEO to get reelected isn't enough
 - i. Material benefits or detriments

Corporations

Duty of Loyalty: Interested Director Transactions

The 'business judgment rule,' however, yields to the rule of undivided loyalty. This great rule of law is designed 'to avoid the possibility of fraud and to avoid the temptation of self interest

1. Interested Director Transactions

- a. Directors have a duty to maximize shareholder wealth...
 - i. In many settings, the Business Judgment Rule precludes judges from evaluating the shareholder wealth effects of board decisions...but also
 - ii. Business Judgment Rule does NOT preclude judicial review of self-dealing transactions
- b. Negligence and self-dealing
 - i. Both reduce shareholder wealth; both are forms of shirking

2. Conflicted Interest Transaction

- a. **Direct transaction** –director is dealing directly with the firm, such as where the director sells property to the firm
- b. **Indirect transaction** – third party or entity, in which the director has an interest, is dealing with the firm
 - i. More likely to escape ex ante notice- deliberate concealment or inadvertence
 - ii. But...also, the director's interest may be more attenuated and may not rise to a legitimate conflict of interest
- c. Regulatory Options? Such personal transactions of directors with their corporations: scrupulous care
 - i. Require proof of **fairness**
 - ii. Require **disclosure AND**
 - iii. Disinterested approval
- d. **Not improper** to appoint relatives of officers or directors to responsible positions in a company
 - i. **BUT** where close relative of CEO and one of dominant directors takes position closely associated with new and expensive field of activity – question motives

Burden on D to prove:

Good faith of transaction
AND **Inherent fairness** from
C/interested viewpoint

Factors: reckless?
Unconscionable?

3. Authorization

DGCL § 144(a)

No contract or transaction **between a corporation and 1 or more of its directors** or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, **shall be void or voidable solely for this reason, if:**

(1) The material facts as to the director's or officer's *relationship or interest and as to the contract or transaction* are **disclosed** or are known to the board of directors or the committee, **and** the board or committee in *good faith authorizes* the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; **or**

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is *specifically approved in good faith* by vote of the shareholders

(3) Contract or transaction is *fair* as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders

Fair: range of reasonableness

- Same parties as bargaining at arms-length might reach
- Another hired person wouldn't have made a difference
- Cost is not disproportionate
- Contract standard form, negotiated by agent
- Compensation same as paid for comparable work
- Appeared more than others but no undue prominence
- Company products ads came first.

DGCL § 144(b)

Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction

a. Effect of Shareholder Approval

- i. Duty of care claims – extinguished by informed vote
 1. NO BOD effect
- ii. DOL vs. directors – fully informed vote shifts BOP to π to show waste
 1. BOD approval has same effect
- iii. DOL vs. controlling shareholders – fully informed vote shifts burden of proof to π to show unfairness
 1. NO BOD effect

4. Quorum Rules

DGCL § 141(b)

The vote of the **majority of the directors present at a meeting** at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number

RESCUE: § 141(i)

Unless otherwise restricted by the certificate of incorporation or bylaws, members of the board of directors of any corporation, or any committee designated by the board, **may participate** in a meeting of such board, or committee by means of conference telephone or other communications equipment by means of which all persons participating in the meeting can **hear** each other, and participation in a meeting pursuant to this subsection **shall constitute presence in person**

- a. *Directors acting separately and not collectively as a board cannot bind the corporation.* There are two reasons for this:
 - i. That collective procedure is necessary in order that action may be deliberately taken after an opportunity for discussion and that an interchange of views
 - ii. That directors are the agents of the stockholders and are not given by law no power to act except as a board
- b. **Bayer** – When there are *personal transactions of directors* with their corporations: Their dealings with the corporation are *subjected to rigorous scrutiny* and
 - i. Where any of their contracts or engagements with the corporation are challenged the *burden is on the director* not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein
- c. **Benihana** – There is a safe harbor under **§ 144 (a)(1)**
 - i. If the material facts as to the director's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors and the board in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors
 - ii. *After approval by the disinterested directors, the court reviews the transaction according to the business judgment rule*

Corporations

Duty of Loyalty: Corporate Opportunities

1. Overview

- a. **Objective** – deter appropriations of new business prospects belonging to the corporation
- b. **Targets** – officers, directors, dominant shareholders with active role
- c. **Doctrine** – if there is presented to corporate officer or director a business opportunity which corporation is financially able to undertake, is from its nature, in line of corporation's business and is of practical advantage to it, is one in which corporation has an interest or a reasonable expectancy and by embracing opportunity, self-interests of or director will be brought into the conflict with that of the corporation – **law will not permit** him to seize opportunity for himself

2. Exists where

- a. Corporation financially able to take the opportunity?
- b. Opportunity in the corporation's line of business?
 - i. Activity as to which the corporation has fundamental knowledge, practical experience and ability to pursue
 - ii. Intended to be profitable . . . issuance of stock does not generate income → slicing pie into smaller pieces
- c. Does the corporation have an interest or expectancy in the opportunity?
 - i. *Some tie between that property and the nature of the corporate business*
 - ii. **Expectancy**- something should have come to the corporation as opposed to individual directors in flow of the ordinary operation of business...
 1. E.g., corporation has contractual right vs. more ephemeral corporate claim
 - iii. **Interest vs. Expectancy**
 1. **Interest**- an officer bought land to which the corporation had a contractual right
 - a. Firm has better *right* than someone else
 - b. Property, contractual right
 - iv. **Expectancy** – reason to think that the corporation would be offered an opportunity

1. Something that comes to doorstep because it's part of your ordinary flow of business
- d. Does an officer or director create a conflict between his self-interest and that of the corporation by taking the opportunity for himself?
 - i. So long as no insider trading/bad faith – officers and directors can buy and sell shares of that corporation at will
- 3.

Corporations

Shareholder Transactions

1. Basic Principles

- a. Shareholders acting *as* shareholders owe one another no fiduciary duties
- b. Controlling shareholders owe fiduciary duties to the minority
 - i. Analogy to vicarious liability

2. Scenarios

- a. Where the *parent owns all the stock of the sub* - that is a wholly owned subsidiary.
 - i. Unlikely to get fiduciary claims there because you have basically just one owner. There is no minority shareholder to whom the parent would owe a duty.
- b. Situation where you have minority shares outstanding, and the Parent shareholder is only in partial control,
 - i. Situations where the *Parent owns a majority of the stock in the sub* - so-called "Majority-controlled subsidiaries," or
 - ii. It can arise where the Parent owns less than a majority of the stock but still sufficient shares to exercise control - so-called "minority-controlled subsidiaries"

3. Standards of Review

- a. Business Judgment Rule – BOP: π to rebut
- b. Intrinsic Fairness – BOP: Δ show transaction fair to minority
 - i. Applied in any self-dealing transaction by a parent corporation whose majority ownership places a fiduciary duty upon the parent corporation, but the transaction only be self-dealing if the transaction is to the detriment of minority shareholders.
 1. When the situation involves a parent and a subsidiary, with the parent controlling the transaction and fixing the terms, the test of intrinsic fairness, with its resulting shifting of the burden of proof, is applied
 2. The basic situation of the application of the rule is the one in which the parent has received a benefit it to the exclusion and at the expense of the subsidiary

c. **How court selects standard of review**

i. Used when parent received benefit to **exclusion** of minority shareholders of subsidiary and at the **expense** of the minority shareholders of the subsidiary

1. If parent did **NOT** exclude → BJR

2. If parent **did** exclude → Intrinsic

a. Effectively turns into self-dealing

d. Case application

i. *Sinclair Oil Corp. v. Levien* – with regards to the dividend issue, Sinven's minority shareholders got just as much dividend as Sinclair did, so there was no self-dealing, the *intrinsic fairness* didn't apply and the business judgment rule should be used. However, the Court found that with regards to the contract issue, Sinclair was self-dealing by having their subsidiaries enter into contract with one another and then breach them without penalty. Therefore *intrinsic fairness* applied, and damages to the minority shareholders caused by the breach of contract are affirmed

4. 3 Situations: Breach of Contract

a. Non-enforcement of contract had been approved by majority of the *interested* directors → burden of proof on the Δ

b. Non-enforcement of contract had been approved by a majority of the disinterested directors and then also by a majority of the disinterested shareholders

i. Shifts BOP to plaintiff to show transaction was unfair – *Wheelabrator*

c. Non-enforcement of contract had been approved by a majority of the disinterested directors – no shareholder action

i. Shifts BOP to plaintiff to show that there was waste in order to overcome the BJR shield

d. Zahn v. Transamerica Corporation → “a disinterested board of directors of Axton-Fisher would **undoubtedly have exercised its powers to call the Class A stock before liquidation**, disclosing the intention to liquidate together with full information as to the appreciated value of Axton-Fisher’s tobacco inventory”

i. Basic rule: Dominant shareholder cannot use power to exclude minority from pro rata share in benefit

1. Applies to dual class shares as well

Corporations

Financing a Corporation & Shareholder Voting

1. Common Stock

a. Economic Rights

- i. Receive dividends when and as declared by board
- ii. Residual claim on assets in liquidation

b. Voting Rights

- i. Elect directors
- ii. Approve some extraordinary matters

iii. MBCA § 6.01(b)

1. At least one class with unlimited voting rights
2. At least one class with residual claim

iv. MBCA § 6.01(c)

1. Authorizes nonvoting stock and other variants on one share one vote

v. Meetings [annual]

1. Special: Who can call? Compare MBCA § 7.02(a)(2) vs. DGCL § 211(d)

vi. Action without meetings – written consent

1. Must be unanimous
 - a. Compare DGCL § 228(a) – action by consent

vii. Compare: 339 in favor/398 opposed/3 abstain

1. MBCA § 7.25(c) – matter approved if votes cast in favor > votes cast against
 - a. Result = Pass

viii. DGCL § 216 – decisions must be approved by the vote of a majority of shares present

1. Result = Fail

2. Concepts

- a. Par Value – minimum price at which shares may be sold
 - i. Specified in articles of incorporation

3. Shareholder Voting

- a. Act expresses intent of legislature to be that parties to corporate entity may create whatever restrictions and limitations they may want with regard to their corporate stock by expressing such restrictions and limits in the articles
 - i. Proprietary interests represented by shares of stock consist of:
 - 1. Irremovable
 - a. Management or control rights
 - ii. Economic/Removable
 - 1. Rights to earnings and assets
- b. Fact that corporation makes IPO and does not render less valid
- c. Shareholder voting is not part of the corporate governance system BUT accountability mechanism
 - i. Collection action problems
 - ii. Rational apathy

4. Securities Exchange Act § 14(A)

- a. It shall be unlawful for any person . . . in contravention of to solicit any proxy in respect of any security registered pursuant to § 12 of this title

5. Proxy Contest

- a. **Proxy** – I'll vote for you at the meeting
- b. Shareholder solicits votes in opposition to incumbent BOD
 - i. Electoral contests – insurgent runs a slate of directors in opposition to slate nominated by incumbent board
 - ii. Issue contests- shareholder solicits votes against some proposal
 - 1. Shareholder urges fellow stockholders to vote no on a merger
- c. Reimbursement of expenses
 - i. Can management use corporate funds to pay for expenses they incur in conducting their proxy solicitation?
 - 1. YES as long as amounts are **reasonable and** contest involves **policy** questions **rather than just** purely personal power struggle
 - 2. Can be difficult to get a quorum – that costs money
- d. Relatively Rare
 - i. Costly
 - 1. Only reimbursed if win
 - 2. Most of benefits go to free riders
 - ii. Shareholder apathy
 - 1. 100 votes out of 30 million
 - 2. Opportunity cost of being informed
 - 3. Why bother?
 - 4. Wall Street Rule: SELL

6. Proxy Voting

- a. Shareholder appoints proxy to vote shares at meeting
- b. Appointment effected by means of proxy (proxy card)
 - i. Card can specify how shares to be voted or give agent discretion
 - ii. Revocable at literally any time

7. Proxy Disclosures

- a. Information about meeting
- b. Background info directly related to issues to be voted on
 - i. Biographical info about candidates for director vacancies
 - ii. Financial data about merger partners if any
- c. Increase use of therapeutic disclosure
 - i. Executive compensation
 - i. Audit committee report

8. Shareholder Access to Proxy

- a. SEC Rule Proposal to Amend § 14(a)11
 - i. Grant piggy back rights to shareholders
 - ii. Would force company to finance board seat challenges
 - iii. Limited by ownership and holding requirements
- b. Rule 14a-8 Shareholder Proposals
 - i. Allows qualifying shareholders to put a proposal before fellow shareholders
 - 1. And have proxies solicited in favor of them via company's proxy statement
 - 2. Expense thus borne by the company
 - 3. Can use this route to change by-laws to allow proxy access for future proxy fights
 - ii. Exclusion
 - 1. Procedural
 - a. Proponent does not meet ownership/format guidelines
 - b. Proposal not timely
 - c. Issuer must provide proponent with opportunity to cure most errors within 14 days after submission
 - 2. Substantive
 - a. Improper under law issuer's state domicile

- b. Personal grievance/special interest
 - c. Management functions
 - d. Ordinary business ops
 - e. Substantially implemented
 - f. Others
 - g. 14a-8(i)(5):
 - i. If the proposal relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, **and is not otherwise significantly related to the company's business**
 - h. Otherwise significantly related to issuer's business – yes must be included (*Lovenheim v. Iroquois Brands*)
3. Permit exclusion of some proposals related to nomination or election of directors or procedures related thereto
- a. Disqualifying board nominees who are standing for election
 - b. Removing director from office
 - c. BUT NOT PERMITTED to exclude
 - i. Qualifications of directors or board construction (so long as proposal will not remove current directors or disqualifying current nominees)
 - ii. Voting procedures
- iii. Issues
- 1. What happens if precatory proposal passé and board refuses to act
- iv. *CA v. AFSCME*
- 1. Delaware does not throw out idea
 - a. Not inconsistent with § 109 – bylaws
 - b. Purpose of bylaw is to promote integrity of election process by facilitating the nomination of director candidates by stockholders or groups of stockholders

- c. But cannot mandate that board reimburse board reimburse expenses, that is a business judgment reserved to the board under 141

9. Shareholder Inspection Rights

- a. DGCL § 220(b)
 - i. Any stockholder has the right during usual business hours to inspect and to make copies and extract from
 - 1. Stock ledger
 - 2. List of
- b. Why inspect? SEC Rule 14a-7
 - i. Proxy contest . . . incumbent manager must (slide 62)
 - ii. Grimes v. Donald Slide 64
 - iii. Delaware SC held § 220 should
- c. Policy Concern
 - i. Shareholders have legitimate interest in using proxy system to hold board accountable
 - ii. Nobody wants junk mail distributor to get access to shareholder or competitor to get trade secrets and other proprietary information
- d. Delaware § 220(b)
 - i. Shareholder – proper purpose
 - 1. Corporate management for mismanagement
 - 2. Collecting for relevant to valuing shares
 - 3. Communicating with fellow shareholders in proxy contents
 - 4. Communicating with other shareholders about tender offer was a proper purpose
 - i. Improper: Discover propriety business info for competitor benefit or only on political goals rather than economic interest
- e. Delaware § 220(c)

Securities Regulation Overview

1. Capital

- a. A socio-economic relationship
- b. One way of defining capital: as a social relationship between an entrepreneur (known as the capital-IST) and the physical and human inputs needed to make a product or service.
- c. **Represented by:**
 - i. Stock – common + preferred
 - ii. Bonds – senior + junior

2. Lemons Problem

- a. The core of the problem is the information asymmetry between buyers and sellers. Sellers always know more about the good for sale than a buyer.
- b. Stock exchanges attempt to deal with this problem in a number of ways.
 - i. Underwriters put companies through rigorous due diligence before they are willing to list their shares.
 - 1. Then the exchanges themselves impose disclosure and governance requirements on those companies.
 - a. Protections are reinforced by state and federal securities laws

3. Governing Statutes – 2 ways stock can be offered

- a. **Securities Act of 1933**
 - i. Offering and sale of new securities
- b. **Securities Exchange Act of 1934**
 - i. Secondary market activity

4. Mandated Disclosures

- a. Securities Act 1933
 - i. Transactional
 - 1. Registration statement filed with SEC
 - 2. Prospectus distributed to investors
 - ii. Required in connection with any public sale
- b. Securities Exchange Act of 1934
 - i. Periodic
 - 1. Form 10 (once)
 - 2. Form 10-K (annual)
 - 3. Form 10-Q (quarterly)
 - 4. Form 8-K (episodic)
 - ii. Only required of registered companies

5. Purpose of Securities Laws

- a. **Full disclosure** - Make sure that investors have all the information they need to make informed decisions
- b. **Prevent fraud** - Agency cost problem re disclosure – how to make a credible bond?

6. Three Roads to Registration

- a. Listing on a national exchange → Section 12 (a) & (b)
- b. Over the counter stocks → Section 12(g) and Rule 12(g)
- c. Filing a registration statement → Section 15(d)

7. Disclosures and Fairness

- a. Trading in corporate securities [stocks or bonds] takes place on types of markets:
 - i. **Primary market** –in which the issuer of the securities, i.e., the company that created the securities sells them to investors
 1. Securities Act: principally concerned with the primary market
 - a. Two goals:
 - i. Mandating disclosure of material information to investors
 - ii. Fraud prevention
 - b. Follows a transactional disclosure model – mandating disclosures by issuers in connection with primary market transactions
 - ii. **Secondary market** – investors trade securities among themselves without any significant participation by the original issuer
 1. Securities Exchange Act: primarily concerned with the secondary market transactions
 - a. Concerned with: insider trading, securities fraud, short swing profits by corporate insiders, regulation of shareholder voting via proxy solicitations, and regulation of tender offers
 - b. Requires periodic disclosure by publicly held corporations

8. Defining Security

- a. Two broad categories in **Securities Act § 2(1)**
 - i. Instruments commonly known as securities: stocks, notes, bonds
 - ii. Instruments **specified** by the Act to be securities: fractional undivided interest in oil, gas, or other mineral rights **and** broad, **catch-all** phrase “investment contract”
- b. Knowing if something is a security is relevant because
 - i. Tells you if registration requirements of SA33 apply to transaction
 - ii. Relates to antifraud provisions
 1. Plaintiffs have a much easier time when they bring suit under the securities laws than they would if they had to bring suit under state common law fraud rules

9. Do We Have A Security?

- a. In determining if an investment is a security *Howey Test* or *Landrith Test*
 - i. *Howey* – focuses on expectation of profits on effort of others
 - ii. *Landrith* - focuses on attributes typically associated with stock – negotiable, alienable, control rights, proportional profits
- b. *Howey* Defines security – any transaction in which a person
 - i. Invests money (or something of the like)
 - ii. In a common enterprise and
 - iii. Is led to expect profits
 - iv. Solely from the efforts of others
 1. Meaning someone other than the investor has contributed the predominant managerial effort in the common enterprise
- c. **Investment Contract**
 - i. Contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits *solely from the efforts of the promoter or a third party* [Relaxed standard]
 - ii. **To determine whether an investment scheme may qualify as investment contract, the court looked into the *economic reality* of the situation:**
 1. The question is whether an investor, as a result of the investment agreement itself or the factual circumstances that surround it, is left unable to exercise *meaningful control over his investment*
 - a. Passive investor relying on the efforts of others, or a knowledgeable executive actively protecting his interest and position in the company
 - iii. **Stock:** The characteristics typically associated with common stock are
 1. Right to receive dividends contingent upon an apportionment of profits
 2. Negotiability
 3. Ability to be pledged or hypothecated
 4. Conferring of voting rights in proportion to the number of shares owned;
 5. Capacity to appreciate in value
 - iv. Where an investor has a level of control that allows him to actively protect his interest, which is inconsistent with passive investment, his interest does NOT qualify as an investment contract and thus is not within definition of “security” under federal securities laws.

10. Three Periods of Transaction

- a. Pre-filing period → No or limited selling activity
- b. Waiting Period → Offers permitted but no sales
 - i. SEC review: adequacy of disclosure, not merits
- c. Post-Effective Period → Sales allowed
 - i. Prospectus must be delivered

11. Costs Associated With Registration: Regulatory Arbitrage in Primary Market

- a. Public offerings can be useful – especially IPO **BUT**
 - i. Very expensive
 - 1. Costs associated with registration process
 - 2. Lawyers; Accountants; Printers; Delay
 - 3. Costs associated with registration process
 - 4. Disclosure costs

12. Securities Registration Process – Securities Act of 1933 § 5

- a. Prohibits sale of securities unless issuing-company has registered them with the SEC
- b. § 5 Basic Rules
 - i. Security may not be offered for sale through the mails or by use of other means of interstate commerce unless a registration statement has been filed with the SEC
 - ii. Securities may not be sold until the registration statement has become effective
 - iii. Prospectus must be delivered to the purchaser before a sale

13. § 5 Exemptions from Registration

- a. Exempts some securities entirely and exempts some transaction in securities not otherwise exempt
 - i. An exempt security need never be registered, either when initially sold by the issuer or in any subsequent transaction
 - ii. Exempt transaction, in contrast, are one time exemptions

14. § 5 Exemptions Get You

- a. No Mandatory Disclosure
 - i. (Registration statements and periodic filings)
- b. No coverage by gun jumping rules
- c. No obligation to distribute prospectus
- d. No obligation to update prospectus
- e. Escape coverage by Section 11 and 12(a)2
- f. But Sec. 10b and Rule 10b-5 still count

15. Public Offering vs. Private Placement

- a. § 4(2) provides exemptions for **private offerings**:
 - i. “Provisions of § 5 shall not apply to transactions by an issuer not involving any public offering”
- b. **Private Placement Test [Factors] to qualify for exemption**

i. Number of offerees and relationship to issuer

1. Focus: *information available* to the offerees by virtue of that relationship. This can be shown in two ways:

- a. Corporation actually *disclosed* the information that a registration statement would normally provide, OR
- b. Offeree had *effective access* to that relevant information.
- c. 25 person rule of thumb

2. Sophistication is not enough

ii. Number of units offered

iii. Size of the offering

- iv. **Manner of offering** [no general advertising or solicitation]

- c. **SEC v. Ralston Purina Co.** — court held that offering *did not qualify* for the 4(2) exemption when Purina sold \$2 million of common stock to employees. Offers were made to about 500 employees, restricted to those “key” employees that took the initiative to inquire about the stock
- d. **Doran v. Petroleum Management Corp** – Doran bought shares in a limited partnership formed to drill for oil. Doran paid cash and also took over a promissory note owed by the partnership. Issuer did not register its offering [remanded]

Safe Harbor: Reg. D

§ 504 – small offerings under \$1 million

§ 505 – larger offerings up to \$5 million

§ 506 – unlimited offerings but to a limited number and character of offeres

Offering and Sale of Securities

Securities Act of 1933

1. § 11 Liabilities: Misstatements/Fraud in Registration Statement

- a. Deal team liability –covers issuer, CEO, CFO, Directors, Bankers, Auditors
 - i. Powerful tool because no scienter/intent, causation or reliance required
 - ii. Attorneys not liable
 1. Attorneys know the law (hopefully) and have considerable access to company information.
 2. On the other hand, imposing liability on attorneys as experts will:
 - a. **Chill information** flows from the company to the attorneys;
 - b. **Relieve all other defendants** of a duty to engage in “reasonable investigation” to the extent they are non-experts; and
 - c. **Raise legal fees substantially**
 3. At a minimum, imposing liability on lawyers as experts would require imposing more stringent duties on non-experts [*Escott*]

2. § 11 Liability Defense

- a. **Due Diligence – § 11(b)(3)(A)**
 - i. No person other than the issuer shall be liable as provided therein who shall sustain the burden of proof that as regards to any non-expertised part of the registration statement he had
 1. After a reasonable investigation
 - a. Reasonable ground to believe and did so believe
 - i. At the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading
 2. Reasonableness – prudent man in management of own property **§11(c)**

- b. Due diligence requirements vary with relationship of individual to the company and his respective expertise

Experts	Non-Experts
<p>Expertised</p> <ul style="list-style-type: none"> • Reasonable investigation • Reasonable and actual belief in statements • §11(b)(3)(B) • Ignorance is no excuse 	<p>Expertised</p> <ul style="list-style-type: none"> • No investigation • No reason to believe untrue • 11(b)(3)(C) • Ignorance is excuse
<p>Non-Expertised</p> <ul style="list-style-type: none"> • No liability • §11(a)(4) 	<p>Non-Expertised</p> <ul style="list-style-type: none"> • Reasonable investigation • Reasonable and actual belief in statements • § 11(b)(3)(A)

- i. *Escott* – due diligence requires what a prudent person would do. At the very least due diligence requires not ignoring red flags and looking at easily obtainable written documents to verify oral disclosures by company insiders
- ii. *World-Com* – court held that the unaudited interim financials were non-expertised for three reasons:
1. SEC acted in 1979 to assure auditors that review of interim financials would not result in their facing § 11 liability as experts
 2. Audits require a detailed formal process under which the auditor will study and evaluation the company’s internal accounting control system, test accounting records, obtain corroborating evidential matter, among other procedures
 3. Comfort letters do not require any of these extra procedures and are therefore less reliable.
- c. Liability requires that the fact which is falsely stated in a registration statement, or the fact that is omitted when it should have been stated to avoid misleading, be **material**
- i. **Material** is limited to what average prudent investor ought to reasonably to be informed before purchasing the security registered
- d. Liability of a director who signs a registration statement does not depend upon whether he read it, or whether he understood what he was reading
- e. Imposes liability in the first instance upon a director, no matter how new he is, he is presumed to know his responsibility when he becomes a director, he can except liability only by using that reasonable care to investigation in the facts which a prudent man would employ in the management of his own property
- f. Imposes liability for untrue statements regardless of whether they are intentionally untrue. The way to prevent mistakes is to test oral information by examining the original written record

3. § 12 Liabilities

a. Failure to Register a Public Offering - § 12(a)(1)

i. Any person who offers or sells a security in violation of § 5 shall be liable to the person purchasing such security from him ...

1. To recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

ii. Pre-Filing

1. **Section 5(a)** forbids sales before the registration statement before it has been declared effective

2. **Section 5(b)(2)** requires that a final prospectus accompany or precede the delivery of the security (Moot point: no one actually delivers securities physically anymore.)

3. **Section 5(b)(1)** forbids the transmission of non-conforming prospectuses

4. **Section 5(c)** Offers are forbidden until the registration statement is on file with the SEC

iii. Cause of Action under § 12(a)(1)

1. Plaintiff must show

a. Offer or sale involved an instrumentality of interstate commerce **AND**

b. Securities were not registered

c. **DOES NOT** have to show reliance . . . **Unlike § 11** no requirement: material misstatement/omission

2. Defendant bears burden of showing exemption

b. Misstatements in Selling a Public Offering (Anti-Fraud Provision) – § 12(a)(2)

i. Applies to information in the actual prospectus (and possibly other information used in documents associated with the public offering process)

1. At the time the prospectus is used (which can be after the effective date of the registration statement)

ii. **Written document prospectus does not include**

1. Written documents prepared for a privately negotiated transaction

After *Gustafson*, if there is material misstatement or omission in a private offering memorandum, the purchaser of these unregistered securities will not be able to bring an action under § 12(a)(2)

Secondary Market Activity

Securities Exchange Act of 1934

1. Violation Under Securities Exchange Act and Rule 10b-5

- a. In order to claim a violation of Securities Exchange Act and Rule 10b-5, one must prove fraud in connection with the purchase of securities
 - i. **Security** – any note, stock, treasury stock, security future, bond, debenture, investment contract or in general any interest or instrument commonly known as a security

2. Liabilities under § 10

- a. **Rule 10b** –It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange
 - i. **Rule 10b-5** – In connection with the purchase or sale of any security
 - a. To employ any device, scheme, or artifice to defraud,
 - b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,
 - c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person
 - ii. **Rule 10b-5 applies regardless of whether or not**
 1. Security is registered or listed on an exchange, and
 2. Security is exempt from § 5
 - a. Applies to both issuer transactions–i.e., offerings, public or private–and secondary market transactions

3. Goals of 10b-5 = Deterrence (lemons problem) + Compensation – encourages Investors to participate

- a. D – Fraud means securities will be systematically overpriced
- b. D – Rational investors will discount what they are willing to pay if they know fraud is going unchecked
- c. D – Issuers who tell the truth will be better off if issuers who commit fraud are sanctioned – e.g., less discounting will occur if level of fraud is reduced Effective sanctions for fraud facilitates sorting of investment, avoid lemons effect Supplement to SEC enforcement

4. Elements of 10b-5

a. Standing (Jurisdictional and transactional nexus)

- i. Interstate commerce (web, mail, phone call) **AND** only purchasers and sellers

b. Material misrepresentation or omission of information

- i. Materiality will depend at any given time upon the balancing of both the ***indicated probability*** that the event will occur and ***the anticipated magnitude*** of the event in light of the totality of the circumstances ***Basic v. Levinson***

1. To ***assess the probability*** that the event will occur, a fact finder will need to ***look to indicia of interest in the transaction at the highest corporate levels***

- a. Look to board resolutions, instruction to investment bankers, and actual negotiations between principals or their intermediaries

2. To ***assess the magnitude*** of the transaction to the issued of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value

- ii. Probability and magnitude are fact based:

1. Board resolutions, investment bankers, negotiations are all indicia of interest that may indicate an increased probability of merger;
2. Also look at merger premium, relative capitalizations of the two companies to determine magnitude of the merger to a company's shareholders.

c. Reliance

- i. Reliance proves the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury
- ii. Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance

- iii. Fraud on the Market

1. Presumption that investor relied on **integrity of market price** – so investor need not have seen misrepresentation

- a. Observing that the reality of modern securities markets is such that face-to-face transactions are rare, Justice Blackmun noted that requiring a showing of ***actual reliance*** would effectively prevent plaintiffs from ever proceeding as a class action

- d. **Deception (look to fiduciary duties if 10b-5 fails)**
 - i. Full disclosure negates deception
 - ii. **Manipulative:** generally refers to practices, such as wash sales, matched orders, or rigged process, that are intended to mislead investors by artificially affecting market activity *Santa Fe Ind.*
 - 1. Manipulative in this technical sense of artificially affecting market activity in order to mislead investors
 - 2. Nondisclosure is usually essential to the success of a manipulative scheme
- e. **Scienter – state of mind – PSLRA** (strong inference Δ acted with requisite intent)
 - i. **Actual motive:** intent to defraud
 - ii. **Knowledge:** had facts and understood market would be misled if not disclosed
 - iii. **Recklessness:** “so highly unreasonably and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent ... obvious that the defendant must have been aware of it”
 - 1. **Negligence** – not enough under 10b-5 and **Strict Liability** – not available under 10b-5
- f. **Pleading Requirements:** state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind
 - i. PSLRA § 21D(b)(1) –misstatements be pled with particularity and why they are misleading but not detailed proof: pleading validity

Insider Trading

1. Arguments Against

- a. Insider trading transfers trading profits from random outsiders to insiders
 - i. May harm liquidity
 - ii. Increase trading costs
- b. Insider trading may undermine property rights in valuable information
- c. Insider trading may encourage the choice of more volatile investment projects

2. Arguments For

- a. Form of incentive compensation to insiders
- b. Shareholders invest to incentivize risk taking
- c. Improves market efficiency
 - i. Would allow “strong form” efficiency to prevail
 - ii. Today, insiders still profit

3. State Common Law

- a. *Goodwin v. Agassiz* – Whether the defendants had a duty to disclose the theory before trading in the firm’s securities
 - i. A purchaser of stock on the market does not owe a fiduciary duty to a seller to disclose the information that the purchaser may know, even when the purchaser is in a position that provides insider information.
 - ii. Where a director personal seeks a stockholder for the purpose of buying his shares without making disclosure of material facts within his peculiar knowledge and not within the reach of the stockholder, the transaction will be closely scrutinized and relief may be granted in appropriate instances
 - 1. Fraud cannot pre presumed it must be proven

4. Three Rules

- a. **Majority Rule** –Officers and directors’ may trade with shareholders without disclosing material information
- b. **Special Circumstances Rule** – Duty to disclose might be imposed when there were special circumstances
 - i. Highly material information
 - ii. Concealment of identity or other active fraud
 - iii. Especially vulnerable plaintiff
- c. **Minority Rule** – Insiders have a duty of full disclosure material information whenever they purchase shares from shareholders

Federal Law

5. Legal rule re: insider trading – disclose or abstain

- a. Where an insider has material nonpublic information the insider must either disclose such information before trading or abstain from trading until the information has been disclosed
- b. Silence is not fraudulent absent a “duty to disclose arising from a relationship of trust and confidence between parties to a transaction” *Chiarella*
 - i. *Chiarella* tells us that a duty to disclose confidential information or abstain from trading only applies if the defendant owes a fiduciary duty, or similar relationship of trust and confidence, to the party on the other side of the transaction.
- c. **The rule:** If one party to a transaction involving purchase or sale of a security occupies a fiduciary relation, or similar relation of trust and confidence, to the other party (*i.e.*, the shareholders)
 - i. Rule 10b-5 imposes an affirmative duty of disclosure of (1) material, (2) nonpublic information (3) that may affect the security's value known to him and unknown to the other party.
 - ii. Absent the requisite disclosure, the fiduciary must abstain from trading.
Chiarella

6. Has there been tipping?

- a. When someone comes into possession of corporate information, that they know is confidential and know came from a corporate insider, they must either publicly disclose that information or refrain from trading
- b. **Test**
 - i. Did the insider's (the tipper's) tip constitute a breach of the insider's fiduciary duty?
 1. Depends largely on the purpose of the disclosure (sometimes insiders mistakenly think that the info has been disclosed already)
 - ii. Will the insider (the tipper) personally benefit, directly or indirectly, from this disclosure
 1. Absent some personal gain, there has been no breach of duty to stockholder
 2. Absent a breach by the insider, there is no derivative breach
 - iii. *If YES, the tippee has a fiduciary duty.*
- c. ***Dirks v. SEC*** – if no violation of a fiduciary duty then there can be no violation of rule 10b-5
 - i. *Tipping* requires a breach of fiduciary duty by the tipper (duty of loyalty)
 1. Reciprocal benefit, either directly or indirectly → pecuniary gain or reputation
 2. Intention to make a gift
 3. Careless disclosure not a breach
 - ii. Tippee must be aware that tipper has breached fiduciary duty by disclosing

7. Has there been Misappropriation?

- a. A person commits fraud in connection with a securities transaction, and thereby violates §10(b) and Rule 10b-5 when he *misappropriates confidential information* for securities trading purposes, in breach of a duty owed to the source of the information
 - i. **10b5-2:** what relationships are close enough to count under a misappropriation theory – if promised to keep information silent, pattern/practice of keeping things silent, relationship of spouse/spouse, parent/child or sibling/sibling.
 - ii. An outsider who misappropriates confidential information for his own personal benefit violates §10(b) because there is deception in connection with the purchase or sale of a security (it defrauds the person of the exclusive use of that information)
- b. *This theory focuses on the duty owed not to a trading party, but to the source of the information*

8. **Rational** - Based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information

9. Who is an Insider?

- a. **Exchange Act § 16(b):** Officers, directors, and 10% shareholders
- b. **Rule 10b-5:** “anyone in possession of material inside information must either disclose it to the investing public, or ... must abstain from trading”

10. Penalties

- a. *Administrative hearings* against defendants under the SEC’s direct regulation (brokers, dealers, etc.)
- b. *Equitable relief in civil case* brought by the SEC:
 - i. Injunctions; e.g., forbidding violator from being employed in the securities industry
 - ii. Disgorgement of profits
 - iii. Treble money sanction under ITSA
- c. *Criminal indictment:* 20 years jail and up to \$5 million fine for individuals and \$25.5 million for corporate defendants per count
- d. *Private suits*—rare