Business Associations outline, Fall 2004. Professor Anderson

I. Foundations

A. The firm

B. Agency

1. **Authority**
   a) **Actual:** where the principal actually consents, directly to the agent, wrt. the agent's authority.
      (1) **Express:** where the principal does this expressly.
      (2) **Implied:** where the principal does this by implication from its conduct (e.g., by acquiescing repeatedly over time to certain actions by the agent).
   b) **Apparent:** where the principle manifests *to the third-party* its consent wrt. the agent's authority.
      (1) **Inherent:** where the principle, simply by making the agent and agent and giving him a title and responsibilities, indicates to third-parties that the agent has authority. This doctrine is (1) used by courts to reach fair results and (2) not well-liked by Anderson.
2. **Alternatives to authority:** if you can't find authority in the agent, look to see if have one of these things:
   a) <u>Ratification:</u> did the principal ratify whatever it was that the agent did?
      (1) <u>Implied ratification:</u> did the principal reap a benefit from what the agent did? (This could also be unjust enrichment.)
   b) <u>Estoppel:</u> did the principal find out what the agent did with time to stop the third-party from relying? If it did, then the principal may be estopped from claiming the agent had no authority.
   c) <u>Unjust enrichment:</u> the third-party might be able to reclaim what the principal got out of its agent's unauthorized action.

II. Business Associations

A. Partnerships

1. **Formation and startup issues**
   a) **Is it a partnership?**
      (1) **RUPA 202:** a partnership is the association of two or more people to carry on as *co-owners* in a business for profit.

Comment: Formation of Partnership.

(a) Except as otherwise provided in subsection (b), the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intent to form a partnership.

...

(c) In determining whether a partnership is formed, the following rules apply:
(1) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property.
(2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived.

(3) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:
(i) of a debt by installments or otherwise;
(ii) for services as an independent contractor or of wages or other compensation to an employee;
(iii) of rent;
(iv) of an annuity or other retirement benefit to a beneficiary, representative, or designee of a deceased or retired partner;
(v) of interest or other charge on a loan, even if the amount of payment varies with the profits of the business, including a direct or indirect present or future ownership of the collateral, or rights to income, proceeds, or increase in value derived from the collateral;
(vi) for the sale of the goodwill of a business or other property by installments or otherwise.

(a) (2): sharing of gross returns alone doesn't make for a partnership.

(b) (3): when profits are shared, though, there's a presumption that it's a partnership.

(2) ***Bailey v. Broder*****:** here, the question is whether, where attorney Bailey shares the gross proceeds for attorney Broder's litigation activities, the two are in a partnership. The court doesn't decide whether, but suggests that they don't have a partnership because Bailey didn't share in expenses or losses.

2. Course of business issues

a) Fiduciary duties

(1) Care: the question here is whether there should even be a duty of care in the partnership setting. Older partnership statutes are silent. The RUPA imposes a limited duty of care.

(a) RUPA 404(c): the only duty of care a partner has to the partnership and his partners is to not do anything grossly negligent or reckless, any intentional misconduct, or knowingly violate the law.

Comment: (c) A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

i) Mutability: under RUPA 103(b)(4), the partnership agreement can't unreasonably reduce the duty of care.

(b) ***Ferguson v. Williams*****:**

(2) Loyalty

(a) RUPA 404(b): a partner has three types of loyalty duties.

Comment: (b) A partner's duty of loyalty to the partnership and the other partners is limited to the following:
(1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;
(2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and
(3) to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.

i) The RUPA loyalty duties:

a. Don't take stuff, including opportunities, from the partnership.

b. Don't deal with the partnership when you have an adverse interest.

c. Don't compete with the partnership.

ii) Mutability: under RUPA 103(b)(3), the partnership agreement can't eliminate the duty of loyalty. It can, however, identify specific things that don't violate the DoL (if not unreasonable) and the partnership can ratify specific acts that would otherwise violate the DoL (after full disclosure and UOWA unanimously).

Comment: (b) The partnership agreement may not:
...
(3) eliminate the duty of loyalty under Section 404(b) or 603(b)(3), but:
(i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or
(ii) all of the partners or a number of percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

a. *Problem 2-2*: Reconsider the facts of *Meinhard v. Salmon*. What result if the venturers' agreement contained the following provision?

"The Parties agree that Salmon shall maintain books and records adequate to reflect fully the income and expenses of the venture. These books and records shall be available at all times for Meinhard's inspection. Salmon agrees to use his best efforts to further the interests of the venture during its specified term, but *reserves the right to pursue his own business interests to the extent not harmful to the venture. Satisfaction of these obligations shall constitute full performance of Salmon's fiduciary duties*, implied obligations of good faith and fair dealing, and obligation to provide information to Meinhard."

This probably won't work, because the agreement does not *explicitly exclude* particular acts, as required by RUPA 103(b)(3).

(b) ***Meinhard v. Salmon***

(3) Informational

(a) UPA 20: partners have to give other partners true and full information about anything affecting the partnership--but only *on demand*.

Comment: Duty of Partners to Render Information.

Partners shall render on demand true and full information of all things affecting the partnership to any partner or the legal representative of any deceased partner or partner under legal disability.

(b) RUPA 403: partners have to give other partners some information without demand, some on demand only:

Comment: Partner's Rights and Duties with Respect to Information.
...
(c) Each partner and the partnership shall furnish to a partner, and to the legal representative of a deceased partner or partner under legal disability:
(1) without demand any information concerning the partnership's business and affairs reasonably required for the proper exercise of the partner's rights and duties

under the partnership agreement and this [Act]; and
(2) on demand, any other information concerning the partnership's business and affairs, except to the extent the demand of the information demanded is unreasonable or otherwise improper under the circumstances.

i) Without demand: any information about the business reasonably required for the partner to meet his rights and duties

ii) With demand only: other info about the business, unless the demand or the info is unreasonable.

(c) ***Meinhard v. Salmon*:**

b) Allocating power

(1) Defaults: the cookie-cutter partnership that you get if you don't change anything. Note that you can change a default rule without knowing it *was* the default.

(a) UPA 18

Comment: Rules Determining Rights and Duties of Partners.

The rights and duties of the partners in relation to the partnership shall be determined subject to any agreement between them, by the following rules:

(a) Each partner shall by repaid his 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 must contribute towards the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits.

(b) The partnership must indemnify every partner in respect of payments made and personal liabilities reasonably incurred by him in the ordinary and proper conduct of its business, or for the preservation of its business or property.

(c) A partner, who in aid of the partnership makes any payment or advance beyond the amount of capital which he agreed to contribute, shall be paid interest from the date of the payment or advance.

(d) A partner shall receive interest on the capital contributed by him only from the date when repayment should be made.

(e) All partners have equal rights in the management and conduct of the partnership business.

(f) No partner is entitled to remuneration for acting in the partnership business, except that a surviving partner is entitled to reasonable compensation for his services in winding up the partnership affairs.

(g) No person can become a member of a partnership without the consent of all the partners.

(h) Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners.

i) Partners share equally in profits and losses, by default.

ii) Partners have equal management rights, by default.

iii) Partners don't get remuneration except for winding up the partnership, by default.

iv) New partners require unanimous consent, by default.

v) Ordinary matters decisions can be made by a majority, by default.

vi) But nothing can be done in contravention of a partnership agreement can be done without unanimous consent, by default.

(b) RUPA 401

Comment: Partner's Rights and Duties.

(a) Each partner is deemed to have an account that is:
(1) credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership and the partner's share of the partnership profits; and
(2) charged with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, distributed by the partnership to the partner and the partner's share of the partnership losses.

(b) Each partner is entitled to an equal share of the partnership profits and chargeable with a share of the partnership losses in proportion to the partner's share of the profits.

(c) A partnership shall reimburse a partner for payments made and indemnify a partner for liabilities incurred by the partner in the ordinary course of the business of the partnership or for the preservation of its business or property.

(d) A partnership shall reimburse a partner for an advance to the partnership beyond the amount of capital the partner agreed to contribute.

(e) A payment or advance made by a partner which gives rise to a partnership obligation under subsection (c) or (d) constitutes a loan to the partnership which accrues interest from the date of the payment or advance.

(f) Each partner has equal rights in the management and conduct of the partnership business.

(g) A partner may use or possess partnership property only on behalf of the partnership.

(h) A partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership.

(i) A person may become a partner only with the consent of all the partners.

(j) A difference arising as to a matter in the ordinary course of business of a partnership may be decided by a majority of the partners. An act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the consent of all of the partners.

...

i) Same as UPA 18, except the unanimity is required for all acts outside the ordinary course of business and for amendments to the partnership agreement. So:

a. Ordinary course of business decision: majority required, only.

b. Outside the ordinary course of business decision: unanimity required.

c. Amendment to the partnership agreement: unanimity required.

(2) ***Summers v. Dooley*:** where there are two partners, a majority is *both*.

(3) ***Covalt v. High*:**

c) Unauthorized acts

(1) UPA 9(1): each partner is an agent of partnership and when he's apparently carrying on the partnership's business, he binds the partnership--unless he (a) had no actual authority and (b) the third-party knew that.

Comment: Partner Agent of Partnership as to Partnership Business

(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.

(2) RUPA 301: similar to, but more detailed than, UPA 9(1).

Comment: Partner Agent of Partnership

Subject to the effect of a statement of partnership authority under Section 303:

(1) 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.

(2) An act of a partner which is not apparently for carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership binds the partnership only if the act was authorized by the other partners.

(a) Each partner is an agent of the partnership, like UPA.

(b) When he's apparently carrying on in the ordinary course of business *or* business of the kind, he binds the partnership--unless he (a) had no authority and (b) the third-party either knew that *or* had notification of it.

i) <u>RUPA 303 statements of partnership authority</u>: partnerships can file these statements to say what certain partners are and/or aren't authorized to do. *But*, third-parties are only deemed to know of limitations on a partner's authority wrt. real property if the statement if filed with the recording office for that property. They *aren't* deemed to know of limitations on a partner's authority wrt. non-real property.

(c) When he's *not* apparently carrying on in the ordinary course of business or business of the kind, he doesn't bind the partnership unless the other partners authorized what he did.

(3) ***RNR Investments*:**

(4) ***Haymond v. Lundy*:**

d) Actionable acts

(1) Tort law recovery

(a) **Respondeat superior**

(b) **Direct tort**

i) **Negligence**

a. **Selection**

b. **Supervision**

(2) **BA law recovery**

(a) **RUPA 305:** the partnership is liable for a partner's torts if the partner was either (a) acting in the ordinary course of business or (b) acting with the partnership's authority. Same if the partner misapplies money received for the partnership.

Comment: Partnership Liable for Partner's Actionable Conduct

(a) A partnership 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, or a partner acting in the ordinary course of business of the partnership or with the authority of the partnership.

(b) If, in the course of the partnership's business or while acting with authority of the partnership, a partner receives or causes the partnership to receive money or property of a person not a partner, and the money or property is misapplied by a partner, the partnership is liable for the loss.

(3) ***Vanacore v. Kennedy***

3. **Dissociation and dissolution issues**

a) **Theories of ownership**

(1) **Aggregate theory (UPA):** that the partnership's property is just the aggregate of the partners' property. This makes things weird, because it's not clear how the partnership can "own" property, since there's no entity to own it. So, what the courts do is say that the partners own the partnership property in a special tenancy--a tenancy at partnership. The partners can use that property for partnership purposes only, and only creditors of the partnership--not individual partners--can get at that property.

(2) **Entity theory (RUPA):** that the partnership is an entity. An entity that can own property. This makes it all a lot simpler.

b) **Settling accounts**

(1) **UPA 18(a):** partners share profits and losses equally, by default.

Comment: The rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them, by the following rules:
(a) Each partner shall be repaid his 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 must contribute towards the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits.

(2) **RUPA 401:** intending to make no changes from UPA 18(a) (but does it??).

Comment: (b) Each partner is entitled to an equal share of the partnership profits and chargeable with a share of the partnership losses in proportion to the partner's share of the profits.

(3) **UPA 40(b):** the priority list for partnerships--creditors, then partners' loans, then partners' capital contributions, then partners' profit share.

Comment: Rules for Distribution.

In settling accounts between the partners after dissolution, the following rules shall be observed, subject to any agreement to the contrary:
(a) The assets of the partnership are:
(I) The partnership property,
(II) The contributions of the partners necessary for the payment of all the liabilities specified in clause (b) of this paragraph.
(b) The liabilities of the partnership shall rank in order of payment, as follows:
(I) Those owing to creditors other than partners,
(II) Those owing to partners other than for capital and profits,
(III) Those owing to partners in respect of capital,
(IV) Those owing to partners in respect of profits.

(4) ***Kessler v. Antinora*****:** here, one partner contributes only money and one only services. The court doesn't like the UPA 18(a) outcome--that the services guy has to share equally in the losses. The court solves this problem for itself by saying that the services guy's sweat equity was his contribution to the losses: "rendering services to an ultimately losing venture represents a valuable contribution, even though the laboring venturer risked no money capital."

(a) Anderson questions this result. After all, he posits, if that's what the partners here wanted, they could have demonstrated it by agreement. Furthermore, after the money losses, the money guy doesn't have his money. Anymore. The services guy, on the other hand, still has his services.

c) Breaking up

(1) Rules

(a) UPA: where there's dissolution, or not, and that's it.

i) UPA 29: what dissolution is: it's what changes in the partnership when a partner ceases his association with carrying on the business.

Comment: Dissolution defined.
The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.

ii) UPA 31: taxonomy of dissolution causes

a. If there hasn't been a violation of the partnership agreement: (so, if there's a violation of the partnership agreement, there is *not* a dissolution unless one of these things happens).

1) End of the term (in a partnership-for-a-term).

2) Express will of a partner in a partnership-at-will.

3) Rightful expulsion (i.e., pursuant to a provision in the partnership agreement).

4) Express will of *every* partner who hasn't assigned or been charged for his interests. (This is "whoa, nevermind" dissolution.)

b. If there has been a violation of the partnership agreement:

1) Express will of a partner.

c. In whatever case:

1) Death of a partner.

2) Court decree.

3) Bankruptcy of a partner, or of the partnership itself.

4) An event making it unlawful for the partnership to carry on its business.

iii) UPA 38: partners' rights when there's a dissolution

a. **(1): rightful dissolutions:** that is, dissolutions where the partnership agreement hasn't been violated. In that case, the partnership simply settles its accounts once and for all--discharging all liabilities and paying the surplus out in cash to the partners.

Comment: (1) When dissolution is caused in any way, except in contravention of the partnership agreement, each partner, as against his co-partners and all persons claiming through them in respect of their interests in the partnership, unless otherwise agreed, may have the partnership property applied to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners. But if dissolution is caused by expulsion of a partner, bona fide under the partnership agreement and if the expelled partner is discharged from all partnership liabilities, either by payment or agreement under section 36(2), he shall receive in cash only the net amount due him from the partnership.

1) <u>Special rule for rightful expulsions:</u> if dissolution is caused because a partner is rightfully expelled and also discharged from his partnership liabilities, he just gets the net amount due him.

b. **(2): wrongful dissolutions:** the rightful partners can either continue the partnership or not--their call.

Comment: (2) When dissolution is caused in contravention of the partnership agreement the rights of the partners shall be as follows:
(a) Each partner who has not caused dissolution wrongfully shall have,
(I) All the rights specified in paragraph (1) of this section, and
(II) The right, as against each partner who has caused the dissolution wrongfully, to damages for breach of the agreement.
(b) 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, during the agreed term for the partnership and for that purpose may possess the partnership property, provided they secure the payment by bond approved by the court, or pay to any partner who has caused the dissolution wrongfully, the value of his interest in the partnership at the dissolution, less any damages recoverable under clause (2)(a)(II) of this section, and in like manner indemnifying him against all present or future partnership liabilities.
(c) A partner who has caused the dissolution wrongfully shall have:
(I) If the business is not continued under the provisions of paragraph (2)(b) all the rights of a partner under paragraph (1), subject to clause (2)(a)(II), of this section,
(II) If the business is continued under paragraph (2)(b) of this section the right as against his co-partners and all claiming through them in respect of their interest in the partnership, to have the value of his interest in the partnership, less any damages caused to his co-partners by the dissolution, ascertained and paid to him in cash, or the payment secured by bond approved by the court, and to be released [read: indemnified] from all all existing liabilities of the partnership; but in ascertaining the value of the partner's interest the value of the goodwill of the business shall not be

considered.

1) <u>If the rightful partners decide to continue the partnership</u>: (which they can do) then they get to keep the partnership's property, but they have to pay the wrongful partner his interest *(not* including goodwill), less any damages he owes them for breaching the partnership agreement. Actually, they can either pay him or secure a court-approved bond for the amount. *And*, they also have to indemnify the wrongful partner against present and future liabilities of the partnership.
2) <u>If the rightful partners decide to end the partnership:</u> the partnership settles its accounts once and for all, just like in a rightful dissolution, except that the wrongful partner's payment is less any damages he owes the rightful partners for breaching the partnership agreement.

(b) RUPA: where there's dissociation, which may or may not mean dissolution.

i) RUPA 601: taxonomy of dissociation causes

a. Express will of a partner to withdraw.

b. Death of a partner.

1) (Or the appointment of a guardian for a partner, or a court's declaration that a partner is incapable of performing the partner's duties under the partnership agreement.)

c. A partner goes bankrupt.

d. Rightful expulsion (i.e., pursuant to a provision in the partnership agreement).

e. Unanimous (of the other partners) expulsion, in certain circumstances:

1) It's unlawful to carry on the business with that partner.
2) The partner has transferred away all or substantially all of his interest in the partnership.
3) A court order has charged all or substantially all of the partner's interest in the partnership.
4) The partner is a partnership that's been dissolved and is being wound up.
5) The partner is a corporate partner that's dissolving, has had its charter revoked, has had its right to do business suspended--and there's no revocation of the dissolution/revocation/suspension within 90 days.

f. Court-ordered expulsion, in certain circumstances:

1) The partner did something bad that hurt the partnership.
2) The partner willfully or persistently breached the partnership agreement or a fiduciary duty.
3) The partner did something that makes it unreasonable to continue with him.

- **g.** Any other event that the partnership agreement says causes a dissociation.
- **ii) RUPA 602: wrongful dissociation:** if a partner wrongfully dissociates, he's liable to the partnership and the partners for damages. But a dissociation is wrongful only in certain circumstances:
  - **a.** The partner breached of an express provision in the partnership agreement.
  - **b.** The partner expressed the will to withdraw from a partnership-for-a-term before the end of the term.
  - **c.** Court ordered expulsion.
  - **d.** The partner goes bankrupt.
- **iii) RUPA 801: taxonomy of dissolution causes**
  - **a.** <u>Partnerships-at-will:</u>
    - **1)** Express will of a partner to withdraw.
  - **b.** <u>Partnerships-for-terms:</u>
    - **1)** Unanimous express will of the partners to wind up.
    - **2)** End of the term.
    - **3)** The 90-day window: when there's a death, a partner's bankruptcy, or a wrongful dissociation--if *at least half* of the remaining partners express the will to wind up, then the there's a dissolution. And remaining partners can express the will to wind up, here, by rightfully dissociating.
  - **c.** Court order:
    - **1)** That says the economic purpose of the partnership is probably going to be unreasonably frustrated.
    - **2)** That says it's not reasonable to carry on the partnership.
    - **3)** That says a partner did something that makes it unreasonable to continue with him.
    - **4)** That was pursued by a transferee of a partner's interest, in certain circumstances.
  - **d.** An event making it unlawful for the partnership to continue (unless it cures the illegality within 90 days).
  - **e.** Any other event that the partnership agreement says causes a dissolution.

(2) Taxonomy of break-up scenarios

- **(a) At-will partnerships**
  - **i) Events**
    - **a. Expression of will**
    - **b. Death**
- **(b) For-a-term partnerships**
  - **i) Events**
    - **a. Expression of will**
    - **b. Death**

(c) **Explusion**

i) ***Bohatch v. Binyon*:** due to a provision of the partnership agreement here, the partners are able to expel a partner without winding up the partnership. Nevertheless, the court considers whether there is a fiduciary duty to not expel a partner for certain reasons--here, whistleblowing. The court says (over a dissent) that generally, expulsion is protected by a sort of business purpose rule. This means the expelled partner here is limited to whatever remedies she may have for specific contract breaches.

(d) **Court order**

d) **Withdrawal**

(1) **UPA 35**

(2) **RUPA 701**

(3) ***Meehan v. Shaughnessy*:**

e) **Transferral of partnership rights**

(1) **UPA 27**

(2) **RUPA 50x**

f) **Third parties**

(1) **UPA 35(1)**

(2) **UPA 704**

(3) ***King v. Stoddard* (The *Walnut Kernel*):**

B. **Corporations**

1. **Pre-formation issues**

a) **Before anyone thinks the articles have been filed:** here, the courts look to the intent of the parties to determine what to do. Was there an intent for immediate liability on the part of the signer? (If so, was the intent for the signer to continue to be liable, or for the corporation to replace him as liable?) Or was there an intent for later liability, on the part of the corporation? (And if so, there, was the intent for there to be a revocable offer or an irrevocable offer to the corporation?)

(1) ***RKO-Stanley Warner Theatres, Inc.*:** the court looks at the intents possible when there's a transaction between a promoter and a third-party. If their agreement is ambiguous, the court prefers an interpretation of it that's equitable, usual, and reasonable. The promoter might:

(a) Take an offer from the third-party on behalf of the proposed corporation--which the corporation can accept after formation.

(b) Bind himself, but with the understanding that the corporation will take his place when it's formed.

(c) Bind himself. Period. (And then it's up to him to get the corporation, when it's formed, to indemnify him.)

b) **After somebody thinks the articles have been filed:** here, it's going to depend what rule your jurisdiction has adopted. There are five basic ones.

(1) **Absolute liability:** that is, the partnership rule--the individuals are liable. Period.

(2) **Estoppel corporation:** if the equities demands it, a court might enforce

corporate capacity:

- **(a)** *Thompson Optical Institute*: where defendant organized the corporation, then had it buy his shares and his agreement not to compete. When he later violate the noncompete agreement, the court employed the corporation by estoppel doctrine to prevent the defendant from complaining that the corporation wasn't properly formed. Courts generally will invoke estoppel in situations like these.
- **(b)** On the other hand, courts are less likely to employ estoppel when individuals inside the faux-corporation try to escape liability by contending that the creditor thought the firm was a properly formed as a corporation. The basic test is an intent-based test.

(3) **De facto corporation:** in certain situations, a court that's adopted the de facto corporation doctrine can say you're a corporation (as to everyone but the state itself) even though you haven't actually been incorporated by the state:

- **(a)** If there's a statutory provision allowing incorporation for the particular type of business you've got.
- **(b)** And there's been an attempt at incorporation. (Some jurisdictions require that the articles actually have been mailed but lost; other's don't.)
- **(c)** And the business must have used to corporate form in transactions (especially the transactions at issue).
- **(d)** And, all of those things must have been done in good faith.

(4) ***Timberline*****:** the court determines liability based on whether the individual was active in the business, or passive in it. Active people are liable. Passive people aren't. "Silly," says Anderson.

(5) **MBCA 2.03:** the MBCA tries to rid the world of the de facto corporation doctrine: "corporate existence begins when the articles of incorporation are filed." Period, it seems to want to say.

2. Formation and startup issues

a) Articles of incorporation

(1) **The corporate name:** has to include one of a list of limited-liability signifiers, like "Inc." (MBCA 4.01, e.g.)

b) Issuing shares

c) Initial capitalization

3. Course of business issues

a) Fiduciary duties

(1) Care

(a) Non-decisional setting

- **i)** ***Hoye v. Meek*****:** DoC breach where the respected dad director goes off to Vermont while his ne'er-do-well son leverages a debt toilet and puts the company in it.

(b) Decisional setting

i) Decisional procedure problems

- **a.** ***Van Gorkom*****:** DoC breach where the board of respected directors decides in a couple hours on a Saturday to sell the company for an apparently less-than-ideal price per share.

1) In response to *Van Gorkom*, Delaware and the MBCA added provisions that enable the articles to exculpate directors from DoC liability when sued for money damages (but not, n.b., for injunctive relief). (MBCA 2.02(b)(4); DGCL 102(b)(7))

ii) Decisional substance problems

(2) Loyalty

(a) Corporate opportunity

i) Variables

a. Status

b. How the opportunity arose

c. What the actor did after the opportunity arose

ii) Rules

a. The line of business test: if an officer or director can't take, without offering it to the corporation first, a business opportunity that:

1) Is in the corporation's line of business. (This is, note, a hard thing to determine.)

2) And the corporation is financially able to undertake.

3) And the corporation has an interest in it, probably.

4) And the officer or director will bring himself into to conflict with the corporation by taking the opportunity.

b. The fairness test: and officer or director can't take an opportunity if it's unfair to the corporation, under the particular circumstances.

c. The line of business + fairness test: do the line of business test first, and if the opportunity is in the corporation's line of business, ask about the fairness--before, at, and after the taking--of the director or officer taking it.

d. The ALI 5.05 test: which divides the problem of formulating a standard here into two parts:

1) <u>What a corporate opportunity is:</u> (a) an opportunity that the offeror expects to be offered to the corporation; or (b) an opportunity that the director or officer becomes aware of by using corporate information or property; or (c) an opportunity that the director or officer should have reasonably expected the corporation would be interested in; or (d), *if* the person is a senior executive (not if he's a director) an opportunity that he knows is closely related to a business that the corporation is in or expects to be in. (This demonstrates that the ALI is telling that you that if you're both a director of one corporation and a senior executive at another, you owe most of your loyalty to the one you're a senior executive of.)

2) <u>What has to happen if it's a corporate opportunity:</u> the director or officer has to offer the opportunity to the corporation and disclose his conflict of interest. Then, the corporation has to reject the opportunity. And the *rejection* of the opportunity has to be fair to the corporation.

iii) ***Northeast Harbor Golf Club***:

iv) ***Broz v. Cellular Information Systems, Inc.***

(b) Conflicting interest transactions

i) Self-dealing

a. ***Globe Woolen Co. v. Utica Gas***

b. ***Shapiro v. Greenfield***

ii) Domination

a. ***Sinclair Oil Co. Levien***

(c) Altruism

i) ***Shlensky v. Wrigley***

ii) ***Dodge v. Ford Motor Co.***

b) Derivative litigation

(1) Demand futility

(a) ***Aronson*****:** the court sets up a two prong inquiry for determining whether demand would be futile. The plaintiff must plead the two prongs *with particularity*:

i) Were the *majority* of the directors disinterested? (This is an arbitrary line, but it's the line.)

a. ***In re The Limited, Inc.*****:** the court considers whether there's a majority of disinterested directors. To show interestedness, the plaintiff has to plead, with particularity, that either:

1) The directors had a financial interest in the challenged transaction.

2) Or, the directors were motivated by a desire to retain their position.

3) Or, the directors were dominated or controlled by someone interested in the transaction.

ii) If so, was the challenged transaction within the scope of valid business judgment?

(2) Independent litigation committees: many jurisdictions now allow the directors to create a special committee of independent directors to take over the derivative action and determine whether it should go forward. (Some jurisdictions, such as Iowa, allow such a committee but don't allow it to take over control of the action.) If such a committee can take over the action, then a plaintiff's only hope, assuming the committee is squeaky clean (as it should be (otherwise it's a DoL breach), is to challenge the decision on DoC grounds. (And that's a pretty long shot, considering the committee will be protected by the business judgment rule, and so its decision would have to be "grossly grossly" negligent to be overturned.)

(a) ***Zapata*****:** the Delaware court, hoping to blaze a middle trail between killing the derivative action or otherwise having the plaintiffs' bar run amok, uses *its own business judgment* in determining whether a litigation committee's decision will be upheld. Specifically:

i) First, inquire into the independence and good faith of the committee. The corporation has the burden of proving this.

ii) Second, apply the court's own business judgment as to whether the committee-induced motion to dismiss should be granted. (The *Zapata* court even says that the court should give consideration to *public policy*, in addition to the corporation's interests, in making this decision. (!!) (Anderson thinks the court just could not mean this.))

(b) **MBCA 7.44:** allowing a litigation committee (or a majority of disinterested directors, or a court-appointed panel) to decide whether a derivative action should go forward, as long as the decision is made in good faith after a reasonable inquiry.

c) **Unauthorized acts**

(1) **By agents**

(a) ***General Overseas Films*****:** the court considers whether apparent authority protects a creditor in an extraordinary transaction. Because of the extraordinary nature of the transaction, however, the court says that the creditor had not fulfilled its "duty of inquiry"--that is, the creditor should have been alerted to the danger of fraud and found out whether the agent actually had the principal's authority.

i) <u>Nature of the third-party:</u> the court says that "who the contracting third party is" matters. A bank, for instance, may have reasons to deal swiftly in some transactions, and so may have less of a duty of inquiry in those transactions.

ii) <u>Nature of the transaction:</u> the nature of the transaction also, obviously, matters. With extraordinary transactions, watch out.

(b) ***Menard, Inc.*****:** the court considers the "inherent" agency doctrine, to see whether it protects a third-party. Inherent agency inquiries look generally to the status of the agent and the customary authority that such a status brings, but also look to three specific factors:

i) Was the agent's acts ones that "usually accompany" transactions that the agent is authorized to conduct?

ii) Did the third-party reasonably believe the agent is authorized to do those acts?

a. Note that this is different from the apparent authority reasonability test, which looks to whether the third-party was reasonable in relying on the apparent authority that the *principal* imputed to the agent.

iii) Did the third-party have notice that the agent was *not* authorized to do those acts?

(2) **By the corporation itself: ultra vires**

4. **Closely held corporations**

a) **Contracting around majority rule**

(1) **Shareholder agreements wrt. director actions**

(2) **Shareholder agreements wrt. shareholder actions**

b) **The partnership analogy**

(1) **The *Donahue* equality of treatment rule:** directors and stockholders have to act with "utmost good faith and loyalty" to each other--and this means, the *Donahue* court says, that they must give each other equal opportunities. They may *not* obtain special, disproportionate advantages in comparison to the others.

(2) **The *Wilkes* equality of treatment when no legitimate business purpose rule:** the *Wilkes* court thinks that the *Donahue* rule might hamper legitimate actions. So, they look first for a legitimate business purpose:

(a) No legitimate business purpose means that the aggrieved party has to get equal treatment (in *Wilkes* itself, the freezed-out guy gets the salary he would have received had he remained an officer and director.

(b) But even if a legitimate business purpose is found, the aggrieved party may show that that purpose could have been achieved through a less harmful alternative. Then, the court has to weigh the purpose against the practicability of the alternative.

(3) ***Zidell v. Zidell*:** illustrating courts' traditional deference to the majority's discretion--*not* employing the partnership analogy.

c) **Involuntary dissolution:** the power to dissolve is in the discretion of the court, no matter what the situation. It must consider, in the totality of the circumstances, whether ID is the only feasible means to protect the aggrieved party and whether dissolution is reasonably necessary. ID may not be used coercively. And even if a dissolution is ordered, though, the corporation still gets to buyout the aggrieved party rather than liquidating.

(1) **MBCA 14.30:** a shareholder can get a court to dissolve the corporation in certain situations:

Comment: 14.30. Grounds for Judicial Dissolution.

The court may dissolve a corporation:
(2) in a proceeding by a shareholder if it is established that:
(i) the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock;
(ii) the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;
(iii) the shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired; or
(iv) the corporate assets are being misapplied or wasted.

(a) If the directors (or whoever's controlling things) acts in a way that's illegal, *oppressive*, or fraudulent.

(b) If the corporate assets are being misapplied or wasted.

(c) If the directors are deadlocked, and the shareholders can break the deadlock, and it's causing (is threatening to cause) irreparable injury to the corporation. Or it's causing a situation where the business can't be conducted to the advantage of the shareholders.

- **(d)** If the shareholders are deadlocked, and have been for two years.
- **(2) "Oppressive" actions:** use the "reasonable expectations" test if it's appropriate; if not, use the "inherent oppression" test.
  - **(a) The *In re Kemp* reasonable expectations test:** "oppressive" actions by those in control are actions that "substantially defeat that *reasonable expectations*" of the minority shareholders. "Reasonable expectations," in turn, are expectations that, objectively viewed, were reasonable *and* central to the shareholder's decision to join the venture.
  - **(b) The *Gimpel* inherent oppression test:** when "oppressiveness" can't be analyzed using the reasonable expectations test (as when all shareholders are far removed from the original venturers), this court looks to "inherent oppression." An act is inherently oppressive if it's "burdensome, harsh and wrongful conduct, lacking fair dealing to the prejudice of some members of the company" *or* "a visible departure from fair dealing and fair play that every shareholder is entitled to."

d) Share repurchase agreements

- **(1) *Concord Auto Auction, Inc.***
- **(2) *Gallagher v. Lambert***
- **(3) *Pedro v. Pedro***

5. Limited liability issues

a) Veil piercing

(1) Piercing at real people

(a) Contract actions

- **i) Factors:** but there's got to be some wrongful use, or abuse, or the corporate form before there's going to be *any* veil piercing.
  - **a. Control**
  - **b. Undercapitalization**
  - **c. Corporate formalities**
- **ii) *Consumer's Co-op v. Olsen*:** the court declines to pierce, largely because the third-party could have protected itself, since the primary issue here was undercapitalization, rather than control or informality.
- **iii) *K.C. Roofing Center v. On Top Roofing, Inc.*:** the court pierces, largely because the guy here didn't follow the corporate formalities much at all, and was being nearly fraudulent all along.

(b) Tort actions

- **i) Alternatives to piercing**
  - **a. Tortious negligence:** e.g., negligent supervision of an employee. Or, simply, any tort committed directly by one of the corporate insiders.
  - **b. The *Deep Rock* equitable subordination doctrine:** a court in equity can push an insider's contract claims down on the priority list, so that a third-party can get his money first.
- **ii) *Western Rock Co. v. Davis***
- **iii) *Baatz v. Arrow Bar***

(2) **Piercing at other corporations**
   (a) ***Craig v. Lake Asbestos*****:** the court adopts a test for parent "control" of a subsidiary that's pretty stringent. Just the potential for control (i.e., majority ownership) is not enough. Rather, the parent must pretty much truly be the alter-ego of the subsidiary.
   (b) ***United States v. Bestfoods*****:** sometimes, there's other things besides veil piercing that can get you at someone inside the corporation--here, there's a federal law, CERCLA, that does it.

6. **Mergers**
   a) **Avoiding dissenters' rights**
      (1) **Alternative transaction forms**
         (a) **Taxonomy of alternative forms**
            i) **Assets sales:** the acquiring corporation simply buys up all the assets of the target. The target can then dissolve its asset-less self, leaving an end result that's the same as a merger, in substance.
            ii) **Triangular mergers:** one corporation creates a subsidiary, for the purposes of the merger. Then this subsidiary merges with another corporation. In a forward triangle, the subsidiary swallows the target. In a reverse triangle, the "target" swallows the subsidiary. In either case, the parent ends up controlling the target.
            iii) **Compulsory share exchanges:** a statutory creature, where one corporation can acquire all the shares of another corporation without killing the other corporation. The target's shareholders can make this happen with a simple majority vote, and nonconsenting target shareholders have to give up their shares, but get appraisal rights. The acquiring corporation's shareholders, however, do not get appraisal rights.
         (b) **The de facto merger doctrine**
            i) ***Applestein v. United Board & Carton Corp.*****:** the court says it will disregard a transaction's form if the transaction's characteristics are virtually identical to those of a statutory merger. (Why? Because the merger statutes are their to protect shareholders.) However, the de facto merger determination is a case-by-case determination.
            ii) ***Hariton v. Arco Electronics, Inc.*** **(Delaware):** the court refuses to employ the de facto merger theory, noting that the sale-of-assets statutes are just as much statutes as the merger statutes are. So, the merger statutes aren't due any special attention.
   b) **Cash-out mergers**
      (1) **Exclusivity of appraisal**
         (a) **Pre-*Weinberger***
            i) ***New England Patriots Football Club, Inc.***
         (b) ***Weinberger***
         (c) **Post-*Weinberger***
            i) **Elements of valuation**

a. ***Cede & Co. v. Technicolor*****:** in this two-step merger (tender offer, then merger), the question is whether the dissenters should get paid for the value added after the company was revived following the tender offer (but before the actual merger). Despite that the Delaware statute says that valuation should *not* take into account "value arising from the accomplishment or expectation of the merger," (DGCL 262(h)), the court says that this language is very narrow. Rather, the only value elements that should be left out are *speculative* ones related to the "accomplishment or expectation" or the merger.

b. **MBCA 13.01(4):** the MBCA's valuation provision. It says that valuation is as of immediately before the merger, and should use valuation methods that are customary for the type of business and type of transaction. And their generally shouldn't be any minority marketability discount.

Comment: (4) "Fair value" means the value of the corporation's shares determined:
(i) immediately before the effectuation of the corporate action to which the shareholder objects;
(ii) using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and
(iii) without discounting for lack of marketability or minority status except, if appropriate for amendments to the articles . . . .

ii) **Exclusivity**

a. **Long-form cash-outs**

1) ***Glassman*** **(Delaware):** although *Glassman* concerned a short-form merger, the court reviews the caselaw on exclusivity in mergers, generally, in Delaware. It started with *Stauffer*, which said that appraisal was the exclusive remedy. The courts then retreated, with *Singer* saying there's a fiduciary duty breach when a cash-out is used to eliminate minority shareholders. Then, with *Weinberger*, the court went back to appraisal as an exclusive remedy--or so it appeared. But with *Rabkin*, the court said appraisal is exclusive *only* when the complaining shareholders' complaints are limited to "judgmental factors of valuation." Thus, the court has, arguably, returned to an entire fairness review in cases not strictly limited to valuation concerns.

2) ***Stringer v. Car Data Systems, Inc.*** **(MBCA):**

3) ***Weinberger*** **remand**

4) ***Shell Petroleum, Inc.***

b. **Short-form cash-outs:** appraisal is the exclusive remedy, says *Glassman.*

C. **LLCs**

1. **Private ordering**

a) ***Elf Atochem v. Jaffari***

2. **Fiduciary duties**
   a) ***VGS, Inc. v. Castiel***
   b) ***McGee v. Best***
3. **Veil piercing:** the contractarian preferences of the LLC might suggest veil piercing in this world should be a little different. But, actually, we end up with basically the same veil piercing rules here as in the corporate setting.
   a) ***Kaycee Land and Livestock v. Flahive***
4. **Exit**
   a) ***McGee v. Best***

III. Securities

A. Is it a security?

1. ***Landreth Timber Co. v. Landreth*****:** while buying all or substantially all of a business's stock might be a purchase of the business, and not a security transaction, here the court does not employ this "sale of business" doctrine.
2. ***SEC v. Ralston Purina Co.*****:** the court refuses to get hypertechnical with the registration exemption rules. Rather, they note the remedial nature of those rules and enforce them where unsophisticated purchasers will be protected.

B. Anti-fraud provisions

1. **Rule 10b-5**

Comment: Employment of Manipulative and Deceptive Devices

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,

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

in connection with the purchase or sale of any security.

   a) **Elements**
      (1) **Purchase or sale of security:** (note that this element is the source of a jurisprudential controversy wrt. misappropriation, since there the fraud is on the *source* of the information, rather than on a specific market participant.)
      (2) **Means of interstate commerce**
      (3) **Misrepresentation and omission**
      (4) **Materiality**
      (5) **Scienter**
         (a) ***Ernst & Ernst v. Hochfelder*****:** looking at words like "manipulative" in section 10(b), the Court says that negligence is not sufficient in Rule 10b-5 actions for damages. (Later, in *Aaron v. SEC*, the Court says negligence is not sufficient in 10b-5 actions for injunctions.) The Court expressly declines to decide whether recklessness is sufficient, or if intent is required.

(b) **The *Novak v. Kaskas* / PSLRA strong inference pleading requirements:** setting out the pleading requirements wrt. scienter. The court says (especially under the Private Securities Litigation Reform Act (PSLRA)), you have to plead facts that give rise to a "strong inference" of fraudulent intent. And you have to do it with particularity. You can do this by (with particularity):

i) Alleging that the defendants benefited--in a concrete and personal way--from the fraud.

ii) Alleging that the defendants engaged in deliberately illegal behavior.

iii) Alleging that the defendants knew facts or had access to information suggesting that their public statements weren't accurate.

a. Note how this could work out scarily against the defendants when looking in hindsight at what people told them.

iv) Alleging that the defendants failed to check information that they had a duty to monitor.

a. Note how this could work out even scarilier against the defendants when looking in hindsight at what people *could have* told them, if they'd only asked.

(6) Reliance and causation

(a) The *Basic, Inc. v. Levinson* fraud on the market theory: a majority of four out of six participating justices upholds the "fraud on the market" theory, which sets up a presumption in favor of a 10b-5 plaintiff that he relied on the integrity of the market price (when the price was set by a securities exchange). Defendants can rebut this presumption by demonstrating that the market did not actually believe their misrepresentations--that the market instead reacted to analysts opinions, e.g.

2. Non-traders

a) Rule 10b-5: non-traders can break 10b-5, but *only* if they say something. Once they say something, they have a duty to say other things necessary to make what they did say not misleading.

(1) *Basic, Inc. v. Levinson*:

b) Regulation FD: which prohibits issuers from disclosing nonpublic information just to certain people, e.g. analysts. They have to disclose to everybody, or nobody. This closes a loophole where issuers could disclose just to certain analysts without creating non-trader liability (no misleading prior statements), classic insider trading liability (no trading by insiders), *Dirks* tipping liability (no personal gain, arguably), or *Dirks* footnote 14 temporary insider liability (no relationship of trust or confidence, arguably).

(1) *In re Siebel Systems, Inc.*: the corporation had a meeting with certain analysts where the CEO disclosed material, nonpublic information. FD gets them.

3. Traders

a) Classic insider trading

(1) *Texas Gulf*: the court follows a "parity of information" theory.

- **(2)** ***Chiarella*****:** the court abandons the parity of information theory, and adopts in its place the policy-hollow "preexisting duty" requirement.

b) Tipping

- **(1)** ***Dirks*****:** the Court looks, generally, to see whether the insider breached his fiduciary duties by tipping. Specifically, "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure." And without personal gain by the tipper, there's no breach of duty, and so no derivative breach by the tippee.
  - **(a)** <u>Gifts</u>: gifts of tips result in personal benefit to the tipper, the Court says, because it's just like the tipper traded himself and gave the proceeds to the tippee. Also, the gift can provide a reputational benefit to the tipper (but Anderson notes that the tipper in *Dirks*, who gets off, would have gained some reputational benefit from his tip--so this reputational benefit theory is limited in application).

c) Temporary insiders

- **(1) The *Dirks* fn. 14 test:** looking for a relationship of trust or confidence between the insider and the outsider he discloses to. The insider must expect the outsider to keep the disclosed information confidential, and the outsider must know that (either actually know, or know it by implication from the nature of the relationship).

d) Misappropriation

- **(1)** ***O'Hagan*****:**

e) Combinations

- **(1)** ***Carpenter*****:** here, the trader is the roommate of a WSJ reporter. Thus, the connection between the WSJ reporter and the issuer derives from the misappropriation theory. The connection between the WSJ reporter and his roommate derives from the *Dirks* tipping for personal benefit theory. These two theories together create a connection between the roommate and the issuer, making the roommate a 10b-5 rulebreaker.

f) Rule 14e-3: a special rule that applies in tender offer situations.

- **(1)** ***O'Hagan***