Business Associations
LAW-611-002

**COURSE OUTLINE**

# I. Introduction

A. The Subject in General

- Classification by business form naturally breaks into two categories: 1) corporations, and 2) unincorporated associations
- Closely held: whether there are one or a few owners
- Publicly held: hundreds or thousands of owners.
- The dividing line is whether there is a public market for ownership interests.

B. The Statutes (p. 2)

- The Uniform Partnership Act (1914)
- The Uniform Partnership Act (1997)
- The Uniform Limited Liability Company Act (1996)
- The Model Business Corporation Act (amended through Dec. 2001)
- The financial provisions of the MBCA of 1969

C. Introduction to Business Forms

**1. The Proprietorship**

- A business owned by a single individual is called a sole proprietorship.
- The owner of a sole proprietorship is personally liable on all business obligations since there is no legal separation between the owner and the business. (Risks grow as the business grows.)
- one person going into business. From a legal perspective, you don't have to do anything. You can simply "go into business." No formalities. Taxed on personal income, no separate entity—extension of the person. Person is responsible for all associated liabilities that may arise.

**2. The General Partnership**

- A partnership is sometimes called a general partnership so as to distinguish from a limited partnership.
- A partnership is a voluntary agreement entered into by two or more parties to engage in business and to share any attendant profits or losses
- A joint venture is undertaken based on an express or implied agreement between the members, common purpose and interest, and an equal power of control.
- A general partnership is a voluntary agreement entered into by two or more parties to engage in business whereby each of the parties is to share in any profits and losses there from equally and each is to participate equally in the management of the enterprise.
- There is no need for a written agreement and no public filing of any document (other than any name certificate). A handshake is sufficient.
- Under the 1914 Act, a partner may dissolve a partnership at any time.
- *[class notes]* Every partner is jointly and severally liable for all the responsibilities (claims against the enterprise) of the business. All tax responsibilities flow through to the partners.

**3. The Limited Liability Partnership (LLP)**

- An LLP is a general partnership in all respects except that partners generally have no personal liability for firm obligations that exceed the assets of the general partnership
- Partnership type taxation for federal income tax purposes and limited liability for investors.

**4. The Traditional Limited Partnership**

- A limited partnership is formed by the filing of a certificate in some public office.
- Limited partnerships differ from general partnerships in that they have two classes of partners, one or more **general partners**, and one or more **limited partners**, who are not personally liable for the debts of the partnership and who are not expected to participate in it's daily affairs.
- Limited partners are passive investors who stand to lose what they have invested and no more.
- Partnership-type taxation for federal income tax

**5. The Limited Partnership with a Corporate General Partner**

- The limited partnership with a corporate general partner is adaptable to both publicly held and closely held enterprises. Corporations may act as partners to the same extent that individuals can.
- The use of a corporate general partner results in a partnership in which no individual may be personally liable for the partnership obligations. Disadvantage is that cash flow and tax situations may be complex.

6. **The Limited Liability Limited Partnership (LLLP)**
    - The LLLP is a limited partnership that has elected to register under state statutes that provide protection for general partners against liability for actions of other general partners. To creat an LLP a certificate that is renewable annually must be filed with a state official.
    - The general partners elect to become an LLP.
    - The limited partners have no liability for the firm's obligations under the limited partnership statute, and the general partners, among themselves, have personal liability only to the extent provided by the LLP statute.
7. **Limited Liability Companies (LLC)**
    - The LLC combines limited liability for all investors with federal partnership-type taxation, but also avoids technical problems associated with the management roles of limited partners in a limited partnership.
    - The LLC provides limited liability for all participants, whether or not they are active in the management of the business, and permits total flexibility in internal management. (Provides the benefits of incorporation w/o the limitations and rules applied to corporations.)
    - *[class notes]* Four primary features: 1) Limited liability for members (all members), 2) Pass through entity for tax, 3) Flexible management, 4) Contractual Freedom
8. **The Corporation**
    - Unlike general or limited partnerships, a corporation provides limited liability for all investors and participants, whether active or passive.
    - A corporation is a fictitious legal entity separate from its owners (the shareholders)
    - Created by a public filing with the secretary of state and the payment of a filing fee.
    - If a business is incorporated, the business' assets are owned by the corporation, not by the person who owns the shares in the corporation. The shares are property, but they are not corporate assets.
    - Unlike the limited partnership, the persons with limited liability in a corporation may participate freely in it management and control so long as they stay in their proper role as agents of a fictitious entity.

## II. The Partnership

A. Formation and Management

1. The Role of Agency Law in Business Associations (p. 4-10)
    - Agency is the fiduciary relationship that arises when one person (the "principal") manifests consent to another person (the "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent consents so to act.
2. The Need for a Written Agreement (p. 30)
    - Although there is no requirement that a partnership agreement be in writing, there are several advantages: 1) it may avoid future disagreements, 2) readily proved in court, 3) may point out potential trouble spots, 4) facilitates allocation of tax burdens among themselves, 5) resolves death or retirement issues, 6) clarifies whether investments are lent rather than contributed, 7) satisfies the statute of frauds where real estate is involved
3. Sharing Profits and Losses
    - Partners may share profits and losses in any way they agree, and they may agree to share losses in a different way than they share profits.
    - In absence of an agreement the UPA/RUPA default rule is that partners share profits equally, and that losses are shared in the same proportion as profits are shared.
    - A personal creditor of a partner cannot attach or seize partnership assets.
    - Any partner may be called on by a creditor at any time to pay a specific partnership debt.

    **Richert v. Handley** (p. 35)
    Facts: Together, Richert (P) and Handley (D) engaged in a logging enterprise. When the venture lost money, a dispute arose as to how the venture's receipts and losses were to be allocated.
    Rule: The respective rights and duties of partners or joint venturers cannot be determined until the terms of all agreements between them have been ascertained.
    Richert v. Handley (p. 38)
    Facts: Richert (P) and Handly (D) were associates in a logging venture. Richert had contributed all of the capital which was invested in the enterprise. The business ultimately lost money, and a dispute arose concerning the proper allocation of the receipts and losses.
    Rule: In absence of an express agreement to the contrary, each partner is liable for a partnership's losses in an amount proportionate to his share of its profits.
4. Management

- Absent an agreement to the contrary, partners in a partnership have equal rights to participate in the management of the business.
- The default rule is that if there is a vote taken on specific matters, each partner has one vote and the majority decision controls in the absence of an agreement to the contrary.
- The partnership agreement may create classes of partners with different voting and financial rights.
- Partners have apparent and actual authority to bind the partnership to obligations relating to the business of the partnership. Thus, a partner may bind the partnership on obligations he or she was not authorized to create.

**National Biscuit Co. v. Stroud** (p. 62)
Facts: Stroud (D) advised National Biscuit (P) that he would not be responsible for an y bread which the company (P) sold to his partner. Nevertheless, National Biscuit continued to make deliveries.
Rule: The acts of a partner, if performed on behalf of the partnership and within the scope of its business, are binding upon all copartners.
- UPA §15—all partners are jointly and severely liable for the acts and obligations of the partnership.

**Smith v. Dixon** (p. 64)
Facts: Smith (D), manager of a partnership consisting of his family members (D), agreed to sell land to Dixon (P). The other members of the partnership later refused to convey the property.
Rule: The acts of a partner are binding upon the partnership if he acted within the scope, or apparent scope, of his authority.

**Rouse v. Pollard** (p. 67)
Facts: Fitzsimmons (D), a partner in a prestigious law firm promised to invest Mrs. Rouse's (P) money for her but in fact converted it to his own use.
Rule: Partners are liable for the acts of their copartners onl if those acts are within the scope of the partnership's business.

**Roach v. Mead** (p. 71)
Facts: Berentson (D) contended he was not vicariously liable for the negligent acts of his partner, Mead (D), because such acts were outside the scope of the partnership's business.
Rule: Each partner is responsible to third parties for the acts of the other partner when such could reasonably have been thought by the third party to fall within the purpose of the partnership.

**B.** Partnership Duties, Property Rights; Accounting for Interests

1. Duties of Partners to Each Other (p. 76)
   - The UPA (1997) approaches the fiduciary duty issue very differently from the UPA (1914). Attempts to diminish vague, broad statements and uncertainty.

   **Meinhard v. Salmon** (p. 76)
   Facts: Meinhard (P) and Salmon (D) were co-adventurers in a lease on a hotel, but prior to the expiration of that lease, Salmon alone, without Meinhard's knowledge, agreed to lease the same and adjacent property.
   Rule: Joint adventurers owe to one another, while their enterprise continues, the duty of finest loyalty, a standard of behavior most sensitive.
2. Partnership Property
   Subdivisions (1) and (2-B) of §25 of the Uniform Partnership Act (p. 84)
   - On the death of a partner, the other partners and not the executors of the decease partner should have a right to wind up the partnership affairs. Subdivision (1) UPA (1914) §25(d)
   - Subdivision (2-b). Clause (b) asserts that the right of a partner as co-owner in specific partnership property is not separately assignable.
   - Partnership is a voluntary relation. B cannot have a partner thrust upon him by A w/o his consent.
   - The ability of a *partnership* creditor to proceed against the individual property of a partner is dependent only on naming and serving the partner as a defendant in the suit.
   - However, the ability of an *individual* creditor to proceed against *partnership property* is sharply circumscribed.
3. Partnership Accounting (p. 89-90)
   - A capital account essentially sets forth the partner's ownership interest in the partnership.
   - A partner's capital account equals the capital contributed by the partner less the amount of any distributions to the partner plus the partner's share of the profits les the partner's share of the losses.
   - The standard set of accounting principles that forms the norm for financial reporting in the United States is known as generally accepted accounting principles (GAAP).
   - These principles must be followed by most publicly held corporations in publicly reporting results.
   - Accounting in large business involves two basic functions: the entering of records of transactions as they occur and the subsequent determination and reporting of results of operations on a periodic basis (quarterly or annually)

- Equity = Assets – Liabilities. This means that the net worth of a business is equal to its assets – its liabilities.
- There are **four fundamental premises** underlying financial accounting: 1) financial accounting assumes that the business that is the subject of the financial statements is an entity, 2) all entries have to be in terms of dollars, 3) a balance sheet has to balance, 4) every transaction entered into by a business must be recorded in at least two ways if the balance sheet is to continue to balance.

The Balance Sheet

- Assets = Liabilities + Equity. (Balance sheet equation.)
- The asset side of a balance sheet is sometimes referred to as the left-hand side.
- The liability/equity side is sometimes called the right-hand side.
- A balance sheet must balance and must be in terms of dollars. Transactions must be recorded in at least two ways.
- Left hand side (assets) may be divided into two categories: Current assets and Non-current assets.
    - **Current assets** consist of cash plus other assets that normally may be expected to turned into cash w/in a year, including *cash* (and cash equivalents—certificates of deposit, Treasury bills, etc.), *marketable securities, accounts receivable*, and *inventories* (raw materials, partially finished goods, finished goods).
    - **Non-current assets** consist of all assets that are not classified as current and include a variety of different items, including fixed assets (property, buildings, equipment). Because these things depreciate, accumulated depreciation appears as an offset.
- Current liabilities (right hand side) include: accounts payable, notes payable, accrued expenses payable
- Long-term liabilities include: mortgages and debentures
- Stockholders' equity is the balancing factor between assets and liabilities on the balancing sheet.
- *[class notes]* Balance sheets do not say much to the true value of the business—do not include intangible assets. Any item of intellectual property is an intangible asset.

Accounting for Profits and Losses

- Income = Revenues – Expenses
- Profit and loss items are reflected on the balance sheet as changes in owner's equity.
- *[class notes]* Income Statement: measures what a company burns or gains from day to day over a period of time.

Journal Entries

- Debit means left-hand; credit means right-hand.

Ledger or T Accounts

- All debits go on the left side, all credits go on the right side.
- Usually there is a separate T account for each item on the balance sheet, and as entries are made in the journal they are also entered on the appropriate T account.

4. Partnership Dissolution (p. 95)

- In § 29 of UPA (1914), "dissolution" is defined as a change in legal relationship "caused by any partner ceasing to be associated in the carrying on of the business."
- Here, dissolution refers to a change in personal relationships among partners within the partnership and has nothing to do with the disposition of assets or closing down or selling of the business.
- UPA (1997) consistently uses the word "dissociation" to refer to an event that causes a partner to cease being a participant in the partnership; it is therefore very close to the technical concept of "dissolution" that was used in the UPA (1914) § 29.
- In UPA (1997), "dissolution" is used only when referring to an event that leads to the termination of a partnership.
- The unique feature of partnership law that distinguishes it from corporation law is that each partner has the power to dissolve the relationship at any time.
- **Dissolution** refers to the winding up of the business
- *[class notes]* §29 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 down of the business. State of affairs when a partner ceases to be a part of a partnership.
- Winding down: Stage during which partnership affairs are settled, accounts are paid, obligations met.
- **Dissociation** refers to the termination of the legal relationship

**<u>Collins v. Lewis</u>** (p. 96)

Facts: Lewis (D) persuaded Collins (P) to enter into a partnership for the operation of a cafeteria. The venture failed to make money, allegedly because of Collins' lack of cooperation.

Rule: A partner who has not fully performed the obligations imposed on him by the partnership agreement may not obtain an order dissolving the partnership.

**<u>Cauble v. Handler</u>** (p. 100)

Facts: Cauble and Handler (D) were business partners until Cauble died. The administratix (P) of his estate thereafter sought Cauble's share of the partnership assets.
Rule: If a partnership continues to do business after it has been formally dissolved, the non-continuing partner or his representative may elect to receive his share of the profits earned by the firm after the date of its dissolution.
- U.P.A. §42 gives the representative of the estate of a deceased partner a right to share in profits if the other partner continues the business.

**Adams v. Jarvis** (p. 104)
Facts: Adams (P), Jarvis (D), and a third doctor (D) entered into a partnership for the practice of medicine. Adams (P) later withdrew and claimed a right to share in the partnership's existing accounts receivable.
Rule: A partnership agreement which provides for the contribution of the firm's business despite the withdrawal of one partner and which specifies the formula according to which partnership assets are to be distributed to the retiring partner is valid and enforceable.

**8182 Maryland Associates, LP v. Sheehan** (p. 110)

**Meehan v. Shaughnessy** (p. 116)
Facts: Shaughnessy (P) contended that Meehan (D) and his new partners violated the partnership agreement while they were leaving their old law firm and attempting to set up their new firm.
Rule: Partners owe a fiduciary duty of the utmost good faith and loyalty and may not act or fail to act for purely private gain.

**Bohatch v. Butler & Binion** (p. 134)
- The fiduciary duty that partners owe one another does not encompass a duty to remain partners.
- Many courts have held that a partnership can expel a partner without breaching any duty in order to resolve a "fundamental schism."
- The threat of tort liability for expulsion would tend to force partners to remain in untenable circumstance—suspicious of and angry with each other—to their own detriment and that of their clients.

5. Inadvertent Partnerships; Limited Partnerships
   1. Inadvertent Partnerships
      - A recurring issue in partnership law is whether an arrangement between persons may unintentionally constitute a partnership so that a creditor who dealt with A may force B to pay its claim.
      - At common law, a sharing of profits was often deemed conclusive of the existence of a partnership.
      - UPA (1914) states that profit sharing is "prima facie evidence" of a partnership
      - UPA (1997) states that a person who receives a share of the profits of a business "is presumed to be a partner."

      **Martin v. Peyton** (p. 147)
      Facts: Peyton (D) and others (D) loaned a partnership money so that it could carry on its brokerage business.
      Rule: While words are not determinative, where a transaction bears all of the aspects of a loan, no partnership arrangement will be found.

      **Smith v. Kelly** (p. 151)
      Facts: Smith (P) was hired by Kelly (D) and Galloway (D), partners in an accounting firm. Smith later claimed to be a partner in the firm, with a right to share in its profits.
      Rule: Unless the rights of third parties are involved, a partnership cannot exist in the absence of an intention to create it.

      **Young v. Jones** (p. 152)
      Facts: Investors claim that they lost $550,000 in capital as a result of Price Waterhouse-Bahamas' (D) negligent conducting of an audit and related documents upon which the investors (P) relied to their detriment.
      Rule: Persons who represent themselves, or allow others to represent them to third parties as a partner in either an existing partnership or with other parties who are not their true partners, are liable to any third persons who relied to their detriment on the existence of that apparent partnership.
      - UPA § 7: Persons who are not partners as to each other are not partners as to third persons.
      - UPA § 16: Persons who represent themselves to anyone as a partner is liable to that person.
   2. Limited Partnerships with Corporate General Partners (p. 169)
      - In the late 70s/early 80s, the typical limited partnership was a federal income tax driven business in which there were hundreds of limited partners and one general partner that was a corporation or another limited partnership.
      - **The acceptance of three basic principles were critical to the major change in limited partnerships:**
        1) The potential liability of limited partners and their agents taking part in the control of the business had to be significantly restricted

2) It must be clear that limited partners did not have the power to withdraw from a limited partnership during the term of the partnership agreement
3) Corporations and other limited liability entities had to be eligible to serve as the sole general partner of a limited partnership.

a. ULPA 1976 (p. 170)
- § 303 Liability to Third Parties. (a) Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business.
- However, if the limited partner participates in the control of the business, he is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.

b. Hamilton
- Reason for rise of corporate general partners: A business form was needed that assured that taxes could be passed through to the investors, that investors had no personal responsibility for losses, and that the promoters of the tax shelter could run things w/o personal responsibility for debts and losses arising when the business ultimately collapsed.
- If the general partner is only marginally capitalized, the limited partnership becomes a limited liability entity not unlike a corporation. No individual is personally liable for the firm's debts.
- Control of that entity may be vested exclusively in the persons who organize the venture, but provide only a small fraction of the capital needed by the enterprise.
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**c. <u>In re USACafes, L.P</u>.** Litigation (p. 175)

d. Limited Partnerships in the 21st Century (p. 184)
- The development of the limited liability company (LLC) has sharply reduced the popularity of limited partnerships.
- There are two groups of modern economic entities that typically are organized as limited partnerships: venture capital firms and leveraged buyout companies.
- Family Limited Partnerships—created by affluent individuals primarily to minimize gift and estate taxes upon distribution of wealth to relatives, principally children and grandchildren.

## III. Limited Liability Companies

### A. Introduction (p. 188)

### B. The Uniform Limited Liability Company Act (ULLCA) (p. 195)

- ULLCA has had limited acceptance since it's promulgation in part b/c it embodies more partnership concepts than most existing state LLC statutes.

Partnership Characteristics
- An operating agreement may be oral
- Partnership concepts of "dissociation" and "dissolution" are applicable to LLCs.
- Membership interests are patterned after interests in a partnership.
- LLCs may be manager managed rather than member managed, but an affirmative election to be manager-managed must be made in the articles of organization. (In most states the default rule is the opposite: corporate man. is default
- Voting in a member-managed LLC is on a per capita basis as in a general partnership.

Corporate Characteristics
- An LLC is formed by filing "articles of organization" in a government office.
- Restrictions on distributions are based on the corporate model

Differs from Corporate Model
- ULLCA provides extreme flexibility with respect to internal organization and financing.
- In a corporation, the articles of incorporation control over bylaws in case of conflict; ULLCA provides that the operating agreement controls over the articles of organization in case of conflict.

Article 3—Relations of Members and Managers to Persons Dealing with Limited Liability Company

Article 4—Relations of Members to Each Other and to Limited Liability Company

Article 8—Winding Up Company' Business

Article 9—Conversions and Mergers

### C. Contractual Aspects of Limited Liability Companies (p. 197)

- The LLC is an attractive form of business entity b/c it combines corporate-type limited liability with partnership-type flexibility and tax advantages.

- Section 18-101(7) defines the limited liability company agreement as "any agreement, written or oral, of the member or members as to the affairs of a limited liability and the conduct of its business."

**D. Characteristics of an LLC** (p. 203)

- A partnership may represent itself in court; a corporation must be represented by legal counsel.
- Structured as a partnership for federal income tax purposes, like a corporation for limited liability.
- A member or manager of an LLC cannot be held liable for the company's debts beyond her contribution to the LLC.
- In Delaware, an LLC must be represented by legal counsel in court, not by a member or manger.
- Rule: The formation of an LLC creates a separate legal entity that must be represented by legal counsel in court.

**E. Limited Liability Companies and "Check the Box"** (p. 207)

- New regulations popularly know as "check the box" made the election of tax regimes voluntary for unincorporated business forms, while limiting corporations to the traditional S Corporation and C Corporation rules.
- An entity that is not classified as a corporation and has at least two members can elect to be classified for tax purposes either as a corporation (Subchapters S and C) or as a partnership (Subchapter K) by making an election at the time it files its first tax return.
- If the entity does not formally elect to be taxed as a corporation, it will be taxed as a partnership.
- An entity that has only one member may elect to be taxed as a corporation or it will be taxed as a "nothing," i.e. as though it had no existence separate from its owner.
- Conversion from a partnership or LLC to a corporation is usually free, though converting a corporation to a partnership or LLC is treated as a dissolution and can be costly.

**F. LLCS as Asset Protection Devices** (p. 208)

- Both general and limited partnerships are "business" entities that must be organized for profit. Not so for LLCs.

**IV. Development of Corporation Law in the U.S.** (p. 212)

- Following the intense industrial development that began about 1825, the corporation proved to be an ideal instrument since it could raise large amounts of capital from numerous investors and yet provide centralized direction of large industrial concerns.
- The formation of business corporations in the United States is firmly in the hands of the states.
- The corporation proved to be an ideal vehicle for the development of large business entities since it combined firm, centralized direction with limited financial commitment by a theoretically limitless number of passive investors.

**<u>Louis K Liggett Co. v. Lee</u>** (p. 213)

Douglas Branson (p. 227)

Robert Hamilton (p. 229)

Triton Energy Corporation Proxy Statement (p. 232)

- Reasons for changing the state of incorporation from Texas to Delaware: 1) DE corporation law is recognized as one of the most comprehensive and progressive, addresses matters of corporate concern more thoroughly and is more reflective of current trends and developments. 2) There is a more substantial body of case law concerning corporate matters.

Bayless Manning (p. 236)

**A. The Formation of a Closely Held Corporation** (p. 243)

1. **Where to Incorporate**
   - Deciding where to incorporate depends on 1) a cost analysis of the relative costs of incorporation, and 2) consideration of the advantages and disadvantages of the states under consideration.
   - If the corporation is closely held and its business is to be conducted largely or entirely w/in a single state, local incorporation is almost always preferred.
2. **How to Incorporate**
   - The modern trend is to limit the articles of incorporation to provisions that are required by law to appear in that public document while all other substantive provision are placed in documents that are not filed of public record.
   - Formal requirements for filing of documents are set out in MBCA, Chapter 1.
3. **The Decline of the Doctrine of Ultra Vires** (p. 262)
   - Ultra Vires: An act undertaken by a corporation that is beyond the scope of its authority pursuant to law or its articles of incorporation. Beyond the scope of power granted.
   - The doctrine of ultra vires is declining in importance and should not be applied to purposes clauses of articles of incorporation.

   **<u>711 Kings Hwy. Corp. v. F.I.M.'s Marine Repair Serv., Inc</u>.** (p. 263)

   Facts: 711 (P) leased premises to FIM (D) to use as a movie theatre, but then sought to declare the lease invalid on the grount that the intended use was outside the scope of business activities allowed in the charter.

Rule: No act of a corporation and no transfer of property to or by a corporation shall be held invalid by reason that the corporation was without capacity or power to do such act except in an action brought by a shareholder.

**Theodora Holding Corp. v. Henderson** (p. 266)

Rule: A majority stockholder may cause a charitable contribution to be made out of corporate funds if such charitable gift is within reasonable limits as to amount and purpose.

- The question is whether the gift is "reasonably necessary" to furthering a valid corporate objective.

4. **Premature Commencement of Business** (p. 271)

   a. Promoters (p. 271)

   - The term "promoter" includes a "person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer."
   - Promoters make the necessary arrangements prior to the start of the business, such as raising capital, negotiating employment contracts, securing a site or building, etc. (Main function of a promoter is to secure 1) necessary capital, and 2) necessary assets and personnel)
   - The promoter owes a significant **fiduciary duty** to other participants in the venture and to the to-be-formed corporation, he therefore may not pursue his own profit at the corporation's ultimate expense.
   - The corporation itself may bring suit against its promoters after it has come under the control of subsequent investors or other persons.
   - Contractual problems are avoided if the corporation is formed first, so that the necessary steps may be carried out in the name of the corporation, thus avoiding chance of confusion between the corporation and the promoter's individual liability. Promoters *may be* held personally liable for debts he contracts.

   Contracts Executed in the name of the Promoter

   - If the promoter enters into a contract in his or her own name w/o referring to the corporation with the thought of subsequently assigning the contract to the corporation, personal liability clearly exists on the part of the promoter.
   - The subsequent assignment of the contract to the corporation does not relieve the promoter of personal liability unless the creditor agrees to release the promoter (called a *novation*).

   Contracts Entered in the Name of the Corporation

   - If the promoter enters into a contract with a third person in the name of the corporation without disclosing that it is not in existence, the promoter is personally liable on the contract .
   - If the corporation is thereafter created and takes over the contract, the promoter has a chance of being relieved of liability but there is a substantial chance that a court will conclude that no novation was intended and the promoter remains personally liable.

   Contracts Referring to the Fact that the Corporation is not Yet Formed

   - If the contract entered into by the promoter on behalf of the corporation recites that the corporation has not yet been formed, the liability of the promoter depends on what the court finds to be the parties' intent.
   - If the corporation is never formed, or is formed but then immediately defaults, the promoter will probably be liable.
   - If the corporation is formed, and then shows its intent to take over the contract, then the court may find that both parties intended that the promoter be released from liability.

   Liability of Corporations for Promoter's Contracts

   - The corporation is not automatically liable on obligations incurred by its promoters before it is formed.
   - The reason usually cited is that the promoter cannot be the corporation's agent since the corporation is not yet in existence.
   - However, if a corporation takes the benefits of a contract mad by its promoter, it will usually be concluded that is has assented to the burdens of the contract.
   - The corporation becomes liable only when it adopts the contract. Adoption may be implied.

     **Stanley J. How & Assoc., v. Boss** (p. 274)

     Facts: Boss (D) signed a contract, on behalf of a corporation not yet formed, with How (P).

     Rule: A promoter will be liable on a contract he entered into on behalf of a corporation yet to be formed unless the other party agree to look to some other person or fund for payment.

     **McArthur v. Times Printing Co.** (p. 280)

     Rule: Formal adoption or acceptance of a contract by a corporation is not a requirement, but acceptance may be inferred from acts or acquiescence on the part of the corporation or its authorized agents.

   b. **Defective Incorporation** (p. 283)

      **De Facto Corporation**—a corporation arising from the good faith attempt to comply with the statutory requirements of establishing a corporation.

- The usual test was threefold: 1) there must be a statute under which incorporation was permitted, 2) there must have been a "good faith" or "colorable" attempt to comply with the statute, 3) there must have been actual user of the corporate privilege.
- At common law, this would be sufficient to shelter the would-be incorporator from personal liability.
- Today, most states have abolished the de facto doctrine and impose personal liability.

**De Jure Corporation**—A corporation that results from the incorporators full satisfaction of the statutory requirements of establishing a corporation. A fully formed corporation.

**Corporations by Estoppel**—a creditor who deals with the business as a corporation, and who agrees to look to the corporation's assets rather than the shareholder's assets will be estopped from denying the corporation's existence.

**Robertson v. Levy** (p. 283)

- The corporation comes into existence only when the certificate has been issued. Before the certificate issues, there is no corporation de jure, de facto, or by estoppel
- Under § 139, if an individual or group of individuals assumes to act as a corporation before the certificate of incorporation has been issued, joint and several liability attaches.
- Rule: Officers and directors who attempt to act for a defectively formed corporation or prior to its formation are jointly and severally liable for those acts.

**Cranson v. International Business Machines Corp.** (p. 288)

- An officer of a defectively incorporated association was not subjected to personal liability.
- Rule: Two doctrines have been used by the courts to clothe an officer of a defectively incorporated association with the corporate attribute of limited liability: 1) the Doctrine of De Facto Corporations, where there is evidence showing (a) the existence of law authorizing incorporation, (b) an effort in good faith to incorporate under that existing law, and (c) actual exercise of corporate powers and 2) The doctrine of estoppel where the person seeking to hold the officer personally liable has contracted or otherwise dealt with the association as a corporation.

**B. Piercing the Corporate Veil** (p. 298)

- The term "corporate veil" refers to the shielding from personal liability of a corporation's officers, directors or shareholders for unlawful conduct engaged in by the corporation.
- If the corporate veil is pierced, some or all of the shareholders may be personally liable for the corporations debts.

Individual shareholders.

- If the corporation's shares are held by individuals, the following are factors that the court looks to in deciding whether the veil should be pierced:
  1) Tort v. contract—Courts are more likely to pierce the veil in a tort case where the creditor is "involuntary," than in a contract case, where the creditor is "voluntary."
  2) Fraud—veil piercing is more likely where there has been grievous fraud or wrongdoing by the shareholders.
  3) Inadequate capitalization—veil piercing is most likely if the corporation is inadequately capitalized, though most courts do not make inadequate capitalization *alone* enough for veil piercing. (zero capital or siphoning)
  4) Failure to observe corporate formalities—shareholder meetings, keeping books, etc.

Parent/subsidiary

- If shares are held by a parent corporation, the court may pierce the veil and make the parent company liable for the debts of the subsidiary
- Factors considered are 1) failure to follow separate corporate formalities (ex. same board and no separate directors meetings), 2) the subsidiary and parent are operating pieces of the same business, and the subsidiary is undercapitalized, 3) the public is misled about which entity is operating which business, 4) assets are intermingled as between parent and subsidiary, 5) the subsidiary is forced to operate in an unfair manner (i.e. forced to sell at cost to parent.)

1. Disregard of the Corporate Entity
   b. The Common Law Doctrine of Piercing the Corporate Veil

**Bartle v. Home Owners Coop**. (p. 298)

- Westerlea was a wholly owned subsidiary of Home Owner's Coop.
- Appellate court agreed with the trial court that the corporate veil of Westerlea should not be pierced.
- "The law permits the incorporation of a business for the very purpose of escaping personal liability."
- There is no requirement that a corporation make a profit.
- Strong dissent: the business was run in such a way that it was impossible to make a profit. The objective of Westerlea was to benefit stockholders of Home Owner's Coop.
- RULE: Where there has been neither fraud, misrepresentation, nor illegality, the doctrine of "piercing the corporate veil" will not be invoked to hold a corporation liable for the debts of a wholly owned subsidiary.

**DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.** (p. 300)

- A corporation is an entity, separate and distinct from its officers and stockholders, and that its debts are not the individual indebtedness of its stockholders.
- "This power to pierce the corporate veil is to be exercised "reluctantly" and "cautiously" and the burden of establishing a basis for the disregard of the corporate fiction rests on the party asserting such claim."
- Factors to look at in piercing: undercapitalization, failure to observe corporate formalities, non-payment of dividends, insolvency of the debtor corporation at the time, siphoning of funds of the corporation by the dominant stockholder, non-functioning of other officers or directors, absence of corporate records, the fact that the corporation is merely a façade for the operations of the dominant stockholder
- RULE: The conclusion to disregard the corporate entity may not rest on a single factor, but must involve a number of such factors; in addition, it must present an element of injustice or fundamental unfairness.

**Baatz v. Arrow Bar** (p. 308)

- Parties injured by a drunk sued the bar that served him.
- Factors that indicate injustices and inequitable consequences and allow a court to pierce a corporate veil are: 1) fraudulent representation by corporation directors, 2) undercapitalization, 3) failure to observe corporate formalities, 4) absence of corporate records, 5) payment by the corporation of individual obligations, 6) use of the corporation to promote fraud, injustice or illegalities.

**Radaszewski v. Telecom Corp** (p. 316)

- The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke.
- We think the doctrine would largely be destroyed if a parent corporation could be held liable simply on the basis of errors in business judgment.
- Under Missouri law, a P must show 1) complete domination of finances, policy and business practices, 2) that control must be used to commit fraud or wrong, 3) the aforesaid control and breach of duty must be the proximate cause of the injury or unjust loss complained of.

**Fletcher v. Atex, Inc.** (p. 323)

Facts: Fletcher (P) brought suit against Atex (D) and Eastman Kodak (D), its parent company, to recover for injuries incurred from the utilization of computer keyboards procured by Atex.

Rule: Under applicable state law, the court may pierce the corporate veil of a company and hold its shareholders personally liable only in cases involving fraud, or where the company is a mere instrumentality or alter ego of its parent company.

c. Should the Piercing Doctrine be Abolished?

d. The Piercing Doctrine in Federal / State Relations (p. 337)

**United States v. Bestfoods** (p. 337)

- …bedrock principle
- There is an equally fundamental principal of corporate law, applicable to the parent-subsidiary relationship as well as generally, that the corporate veil may be pierce and the shareholder held liable for the corporation's conduct when, inter alia, the corporate form would otherwise be misused to accomplish certain wrongful purposes, most notably fraud, on the shareholder's behalf.

## V. Financial Matters and the Closely Held Corporation (p. 356)

- Authorized Shares—number of shares that a corporation is actually authorized to issue.
- Issued Shares—number of shares that a corporation has actually issued.
- Treasury Shares—Stock issued by a company, but then reacquired and either cancelled or held.

### A. Dept and Equity Capital (p. 356)

- Capital may be obtained from a variety of different sources: 1) borrowing funds, 2) capital contributions from owners, 3) capital contributions from outside investors, 4) retaining earnings of the business rather than distributing them.
- Raising capital may be with funds that are in the form of "equity capital" or "debt".
- Debt usually must be repaid at some time, usually with interest.
- Equity capital is composed of contributions by the original entrepreneurs in the firm, capital contributed by other investors usually in exchange for ownership interests in the business, and retained earnings of the enterprise.
- The Securities Act of 1933 imposes substantial disclosure requirements on the public sale of securities

### B. Types of Equity Securities (p. 357)

1. Shares generally
   - Shares are the "units into which the proprietary interests in a corporation are divided."
   - All shares within a single class must have the same rights.

- If a corporation issues only one class of shares, they may be referred to as common shares, capital shares, or simply shares or stock.
- MBCA §6.01(b) sets forth **two fundamental rights of shareholders**: 1) right to vote for the election of directors and other matters, and 2) they are entitled to the net assets of the corporation when distributions are made.

2. Common and Preferred Shares
   - ***Common shares*** are a class or classes of share that have the fundamental rights of voting and receive the net assets.
   - Holders of common shares have non-financial rights too: right to sue, right to inspect books, right to finan. info.
   - ***Preferred shares*** are typically classes of share with preferential but limited rights. Usually non-voting.
   - Holders of preferred shares are entitled to a specified distribution before anything can be paid on common shares.
   - A ***dividend*** is a distribution form current or retained earnings; payments to shareholders out of capital are called distributions.
3. Special Rights of Publicly Traded Preferred Shares
   - ***Cumulative Dividend Rights***—A dividend that grows from year to year when not paid. Unlike interest on a debt, dividends on preferred shares may be paid only from funds that are legally available for making distributions.
   - *Voting*—Preferred shares are usually nonvoting shares.
   - ***Liquidation Preferences***—Preferred shares usually also have a liquidation preference.
   - ***Redemption Rights***—Preferred shares may be made redeemable at the option of the *corporation*. A right to "redeem" shares means that the corporation has the power to buy back the redeemable shares at any time at the fixed price, and the shareholder has no choice but to accept that price.
   - ***Conversion Rights***—Preferred shares may be made convertible at the option of the *holder* into common shares at a fixed ratio.
   - ***Protective Provisions***—Preferred shares may also have certain financial safeguards, such a sinking fund provisions, which require the corporation to set aside a certain amount each year to redeem a specified portion of the preferred stock issue.
   - ***Participating Preferred***—These shares are entitled to the specified dividend and, after the common shares receive a specified amount, they share with the common in additional distributions on some predetermined basis.
4. Classes of Common Shares
   - Section §6.01 of the MBCA authorizes the creation of classes of common shares by appropriate provision in the articles of incorporation; such classes may vary in terms of management, financial or voting rights.

**C. Issuance of Shares: Herein of Subscriptions, Par Value and Watered Stock** (p. 364)

- **Watered Shares**—are par value shares issued for property that has been overvalued and is not worth the aggregate par value of the issued shares.
- **Par Value**—(or stated value) of shares is a nominal value assigned to each share. At one time par value represented the selling or issuing price of shares, but in modern corporate practice, par value has little or no significance.

1. Share Subscriptions and Agreements to Purchase Securities
   - Historically, the traditional method of raising capital for a new corporation was by public subscriptions pursuant to which persons agreed to purchase a specified number of shares contingent upon a specified amount of capital being raised.
   - Modern practice is to use simple contractual agreements to purchase securities rather than a formal subscription agreement.
2. Authorization and Issuance of Common Shares Under the MBCA
   - The price must be the same if shareholders are to be equally treated.
   - The number of authorized shares must be at least equal the number the corporation plans to issue
3. Par Value and Stated Capital
   - In 22 states, the articles of incorporation must stat the "par value" of the shares of each class.
   - The remaining states, like the MBCA, have eliminated or made optional the concept of par value, and the current trend is toward the elimination of this concept as an historical anomaly.

   **<u>Hanewald v. Bryan's Inc.</u>** (p. 370)
   - "It is the shareholder's initial capital investments which protects their personal assets from further liability in the corporate enterprise." Notion of limited liability.

   Facts: After Bryan's Inc. (D) went out of business without paying off a promissory note or the lease on his store, Hanewald (P) filed suit against the corporation and the Bryan (D) family members, to whom the corporate stock had been issued, seeking to hold them personally liable.

   Rule: A shareholder is liable to corporate creditors to the extent his stock has not been paid for. A corporation that issues its stock as a gratuity commits fraud upon creditors who deal with it on the faith of its capital stock. The Bryan's had a statutory duty to pay for the stock issued to them by Bryan's Inc.

4. Eligible and Ineligible Consideration for Shares (p. 373)
    - MBCA (1969) § 19 shares issued for a promissory note are prohibited
5. Par Value in Modern Practice (p. 375)
    - To avoid watered stock liability the issuance price for shares of stock with par value must always be equal to or greater than par value.
    - Under current practice, par value serves only a minor function and is in no way an indication of the price at which the shares are issued.
    - Today the practice most often followed is to use "nominal" par value, that is one cent, ten cents, or one dollar per share when the shares are issued for several dollars or more per share.
    - Par value relates only to the initial issuance of shares, and has no application whatever to subsequent transactions in the shares themselves, which may be bought or sold at any mutually acceptable price.

      Ted Fiflis, Homer Kripke, Accounting for Business Lawyers (p. 379)

**D. Dept Financing** (p. 380)

- "Bonds" and "debentures are evidences of long term indebtedness that are usually referred to ad "debt securities."
- Technically, a debenture is an unsecured corporate obligation while a bond is secured by a lien or mortgage or corporate property.
- Zero coupon bonds, often called "zeroes," pay no interest at all; they sell at a substantial discount from face value and upon maturity the holder receive the face value.
- It is usually advantageous to engage to some extent in debt financing. The notion that the best business is a debt-free business, while sounding attractive, is not consistent with either the minimization of income taxes or with the maximization of profits.

1. The Concept of Leverage (p. 382)
    - Leverage is favorable to the borrower when the borrower is able to earn more on the borrowed capital than the cost of the borrowing.
    - Debt financing is attractive during periods of high inflation because the loans will ultimately be repaid with inflated dollars. Loan competition and high interest rates may offset this, however.
2. Tax Treatment of Debt (p. 383)
    - Interest payments on debt are deductible by the borrower whereas dividend payments on equity securities are not.
    - There are tax advantages of loans by individual shareholders to C Corporations.
3. Debt as a Planning Device (p. 385)

**E. Planning the Capital Structure for the Closely Held Corporation**

**F. Public Offerings**

- A *public offering* is the sale of securities by an issuer or a person controlling the issuer to members of the public. Normally registration of a public offering under the Securities Act of 1933 is required, though in some instances exemptions from registration may be available.

**G. Preemptive Rights** (p. 414)

- Preemptive rights give an existing shareholder the opportunity to purchase or subscribe for a proportionate part of a new issue of share before it is offered to other persons.
- A preemptive right protects shareholders from dilution of value and control when new shares are issued.
- In modern practice, preemptive rights are often limited or denied by provisions in the governing corporate documents.

  **<u>Stokes v. Continental Trust Co. of City of New York</u>** (p. 414)

  Facts: Stokes (P), a shareholder of Continental Trust (D), demanded that they sell him an equivalent number of newly issued shares of stock to the proportion he now holds.

  Rule: A corporation must allow a shareholder to purchase newly issued stock at the fixed price to allow him to keep his proportionate share of the stock.

  **<u>Katzowitz v. Sidler</u>** (p. 418)

  Facts: Two of three directors of a close corporation voted an additional issuance of stock which they opted to purchase and which the third director refused. When the corporate assets were sold, the proceeds were distributed in proportion to the stock owned, and the third director sought to have this distribution set aside.

  Rule: Where new shares are offered in a close corporation, existing shareholders who do not want to or are able to purchase their share of the issuance are not estopped from bringing an action based on a fraudulent dilution of their interest where the price for the shares is inadequate.

**C. Distributions by a Closely Held Corporation**

- A *distribution* is a payment to shareholders by a corporation. If out of present or past earnings, it is a *dividend*.

  **<u>Gottfried v. Gottfried</u>** (p. 424)

Facts: Minority stockholders (P) sought to compel the board of directors (D) to declare dividends on the common stock, alleging that such dividends had not been paid upon consideration other than the best welfare of the corporation or its stockholders.
Rule: If an adequate corporate surplus is available for the purpose, directors may not withhold a declaration of dividends in bad faith.

**Dodge v. Ford Motor Co.** (p. 428)
Facts: Ostensibly to lower the price of its autos and increase jobs, the Ford Motor Co. (D) decided to discontinue the payment of dividends.
Rule: Ordinarily, the directors of a corporation alone have the power to declare a dividend, but the courts will intervene to require that a dividend be paid if it is discovered that the refusal of the directors to do so is based in fraud or an intention to conduct the affairs of the corporation not for the shareholders.

**Wilderman v. Wilderman** (p. 431)
Facts: Joseph Wilderman (D), as president of a family-owned business, paid himself large sums w/o the approval of his wife, Eleanor (P), who was the company's only other director, officer and shareholder
Rule: In the absence of a specific authorization by the company's board of directors, a corporate executive may receive only compensation that is reasonably commensurate with his functions and duties.

**Donahue v. Rodd Electrotype Co.** (p. 438)
Facts: Donahue (P), a minority stockholder in a close corporation, sought to rescind a corporate purchase of shares of the controlling shareholder.
Rule: A controlling stockholder (or group) in a close corporation who causes the corporation to purchase his stock breaches his fiduciary duty to the minority stockholders if he does not cause the corporation to offer each stockholder an equal opportunity to sell a ratable number of shares to the corporation at an identical price.

Equity Insolvency Test (p. 455)
- Older statutes prohibited payments of dividends if the corporation was, or as a result of the payment would be, insolvent in the equity sense. This test is retained, appearing in §6.40(c)(1)
- In determining whether the equity insolvency test has been met, certain judgments or assumptions as to the future course of the corporation's business are customarily justified.
- *Equity*—(or equity interest) in general refers to the extent of an ownership interest in a venture. In this context, ownership interest refers to the economic concept that an owner's equity in a business is equal to that business's assets minus its liabilities and amounts allocable to senior securities.
- *Equity financing* is raising money by the sale of common or preferred shares.
- *Insolvency* may be either "equity insolvency" or "insolvency in the bankruptcy sense." Equity insolvency means the business is unable to pay its debts as they mature while bankruptcy insolvency means the aggregate liabilities of the business exceeds its assets.

Balance Sheet Test (p. 456)
- §6.40(c)(2) requires that, after giving effect to any distribution, the corporation's assets equal or exceed its liabilities plus the dissolution preferences of senior equity securities.

Pure Insolvency Test (p. 459)
- Liability is imposed on directors if the distribution renders the corporation insolvent. (applied in Mass.)

## VI. Management and Control of Corporation (p. 463)

### A. The Traditional Roles of Shareholders and Directors

**McQuade v. Stoneham** (p. 463)
Facts: After McQuade (P) was removed as an officer and director of the New York Giants Baseball Club, he alleged that his removal violated an agreement between the parties to use best efforts to keep the parties as officers and directors of the club.
Rule: A contract is illegal and void so far as it precludes the board of directors, at the risk of incurring legal liability, from changing officers, salaries, or policies or retaining individuals in office.

**Galler v. Galler** (p. 469)
Facts: Suit by Emma Galler (P) to compel specific performance of a shareholder agreement made between her deceased husband, Benjamin Galler, and Isadore Galler (D), his brother and business partner. The agreement bound the shareholders to vote for specific individuals and directors and called for mandatory dividends.
Rule: Close corporations will not be held to the same standards of corporate conduct as publicly held corporations in the absence of a showing of fraud or prejudice toward minority shareholders or creditors.

### B. Shareholder and Voting Agreements (p. 492)

- The person in whose name shares are registered is called the “record holder” and may or may not be the person who is the actual owner of the shares, usually referred to as the “beneficial owner.”
- ***Cumulative Voting***—method of voting that allows substantial minority shareholders to obtain representation on the board of directors. When voting cumulatively, a shareholder may multiply the number of shares he owns by the number of director positions to be filled at that election, and cast that number of votes for any one candidate or spread that number among two or more candidates.
- ***Straight Voting***—(or non-cumulative voting) limits the number of votes a shareholder may cast for a single candidate to the number of shares he owns.

  **Salgo v. Matthews** (p. 492)
  Facts: A corporate election inspector (D) appointed by Salgo (D) refused to accept several proxies, which, if accepted, would have enabled Matthews (P) to win his proxy fight against Salgo (D).
  Rule: Shares of stock may be voted only by an authorized representative of the party designated in the corporate records as legal owner of the shares.

  **Ringling Bros. –Barnum and Bailey Combined Shows v. Ringling** (p. 506)
  Facts: Ringling (P) and Haley (D) entered into a stock pooling agreement by which they agreed to always vote their shares together, but when Haley refused to agree on a vote for director or vote as directed by the arbitrator, who was provided for in the agreement, Ringling sought to enforce the arbitrator’s decision.
  Rule: A group of shareholders may lawfully contract with each other to vote in such a way as they determine.
  New York v. McKinney’s Bus.Corp.Law (p. 513)

  **Lehrman v. Cohen** (p. 527)
  Facts: Dispute between rival factions, Lehrman (P) and Cohen (D) over issuance of class AD stock and its voting power.
  Rule: The creation of a new class of voting stock does not divest and separate the voting rights, which remain vested in the stockholders who created it, for the other attributes of the ownership of that stock.
  *Voting trust*—An agreement establishing a trust, whereby shareholders transfer their title to share to a trustee who is authorized to exercise their voting powers.

**C. Deadlocks** (p. 545)

Deadlock in a closely held corporation arise when a control structure permits one or more factions of shareholders to block corporate action if they disagree with some aspect of corporate policy.

- It occurs when a closely held corporation finds itself on dead center and unable to act.
- Deadlocks may be avoided by careful planning.
- Situations where deadlocks may arise: two shareholders or factions, even number of directors
- A deadlock usually arises with respect to the election of director by an equal division of shares between two factions.
- A deadlock may also arise at the level of the board of directors if there is an even number of directors and no single faction of shareholders has power to elect a majority of the board.

  **Gearing v. Kelly**
  Facts: When Mrs. Meacham (P) refused to attend a directors’ meeting, the Kellys (D) elected Hemphill, and the Meacham-Gearing faction objected.
  Rule: Where a shareholder-director deliberately causes a lack of quorum required for a directors’ meeting by refusing to attend, equity will refuse to set aside a board decision held at such a meeting for lack of quorum.

  **In Re Random & Neidorff, Inc.** (p. 547)
  Facts: Radom (P) and his sister Neidorf (D) were the sole shareholders in a music publishing corporation. Due to a mutual dislike and distrust, they were deadlocked as to the election of directors and the declaration of dividends
  Rule: Where corporate dissolution is authorized by statute in the case of deadlock or other specified circumstances, the existence of the specified circumstances does not mandate the dissolution. The court will exercise its discretion, taking into account benefits to the shareholders as well as injury to the public.

**D. Modern Remedies for Oppression, Dissension or Deadlock** (p. 553)

**Dissention** in a closely held corporation refers to personal quarrels or disputes among shareholders that may make business relations unpleasant and interfere with the successful operation of the business.

- Dissention may occur w/o constituting oppression or causing a deadlock or adversely affecting the corporation’s business.

**Oppression** in a close corporation involves conduct by controlling shareholders that deprive a minority shareholder of legitimate expectations concerning roles in the corporation, including participation in management and earnings.

- Oppressive conduct is the most common violation for which a “buy-out” was found to be an appropriate remedy in other jurisdictions.
- Oppressive conduct has been described as an expansive term that is used to cover a multitude of situations dealing with improper conduct.

- Oppression, freeze-outs, and squeeze-outs are abusive tactics by majority shareholders that limit or exclude minority shareholders. Oppression may include non pro-rata (proportional) distributions of corporate assets.
- A **freeze-out** involves the use of control to deprive the minority of all participation rights and benefits of share ownership in an effort to persuade the minority to sell their shares to the controlling shareholders at an unfavorable price.
- A **squeeze-out** is a transaction that involves the issuance of additional shares by the corporation on a non-proportionate basis that dilutes the interest of minority shareholders.

1. Buyouts
   - In the event of an unreasonable agreement, one solution is for one shareholder to buyout the other.
   - Courts have turned to this remedy (court-ordered buyouts) where it is unfavorable to dissolve a deadlocked company.
   - The court may mandate a buyout of the interest of a minority shareholder at a judicially determined price.
   - If the majority shareholder is unwilling to purchase the interest, the court may then order involuntary dissolution.
   - § 14.34 of the MBCA outlines a buyout remedy in deadlock or oppression cases. It is less flexible than remedies devised by the courts. It is triggered only if a suit is brought for involuntary dissolution.
2. Arbitration
   - Mandatory arbitration may be used as a device to resolve internal corporate disputes and deadlocks.
   - Requires either a current willingness or a pre-existing agreement to submit to arbitration.
   - Advantages of arbitration include speed, cheapness, informality (compared to court), and the prospect of the decision being made by a person knowledgeable of business, permits the corporation to continue.
   - Disadvantages are that in close-corporations, many disputes are personal and arbitration is impossible.

   **Davis v. Sheerin** (p. 554)
   Facts: Davis (D) contended that the trial court erred in imposing a forced buy-out of Sheerin's (P) shares in the corporation for Davis' oppressive conduct toward the minority shareholder.
   Rule: Courts, in appropriate cases, may order a buy-out of stock as a remedy for oppressive conduct on the part of majority shareholders, true interest in the viability and advancement of the corporation as an entity.
3. Provisional Director
   - In evaluating candidates for provisional director, the court may consider: degree and quality of past involvement in the corporation, an understanding of the corporation's history and current situation, experience and abilities, degree of impartiality

   **Abreu v. Unica Indus. Sales, Inc.** (p. 562) – Alternative Remedies to Dissolution
   Facts: After Abreau (P) filed a shareholder's derivative action for a usurping of a corporate opportunity by one of the directors of Ebro Foods, Inc., the court removed one of Ebro's directors, appointing a provisional director to stabilize the two hostile factions.
   Rule: As an alternative to judicial dissolution of a corporation, the court may retain jurisdiction and, in it's discretion, appoint a provisional director.
   **Shareholder Derivative Action:** Action asserted by a shareholder in order to enforce a cause of action on behalf of the corporation.

**D. Action by Directors and Officers** (p. 568)

- RMBCA (1984) suggests the following:
- President: principal executive officer of the corporation, and subject to the control of the board of directors, shall in general supervise and control all of the business affairs of the corporation.
- Secretary: keeps minutes of proceedings, sees that all notices are duly given in accordance of the bylaws, acts as custodian of corporate records, authenticates records of the corporation
- Treasurer: has charge and custody of all funds and securities of the corporation, receives and gives receipts for monies due.

See MBCA §8.21 – Action without Meeting. Designed to prevent informal board practices.
See MBCA § 8.41 Duties of Officers
**In the Matter of Drive-in Corp.** (p. 568)
**Black v. Harrison Home Co.** (p. 570)
Facts: Black (P) purchased property which the Harrison Home Co. (D) had, through its president, agreed to sell. A company (D) resolution required joint action by the president and secretary whenever property was to be sold.
Rule: The president of a corporation has no authority to execute contracts on behalf of the company in the absence of a bylaw or a resolution of the board of directors permitting him to do so.
- Common Law rule regulating authority of management to execute contracts or commit property, in the absence of some approval of the board, is very very strict.

**Lee v. Jenkins Bros.** (p. 575)

Facts: Lee (P) sought to enforce a promise made by Jenkins' (D) president in 1920, when Lee (P) was hired, that Jenkins would pay Lee a $1500 pension at age 60, "regardless of what happens."
Rule: A president has authority only to bind his company by acts arising in the usual and regular course of business but not for contract of an extraordinary nature.

**F. Controlling Interests**

**Perlman v. Feldmann** (p. 591)
Facts: Feldmann (D), a director and dominant stockholder of Newport Steel, sold, along with others, the controlling interest of that steel manufacturer, to steel users, along with the right to control distribution.
Rule: A corporate director who is also a dominant shareholder stands, in both situation, in a fiduciary relationship to both the corporation and the minority stockholders if selling controlling interest in the corporation, its accountable to it (and the minority shareholders) to the extent that the sales price represents payment for the right to control.
**Petition of Caplan** (p. 601)

**VII. Duty of Care and the Business Judgment Rule** (p. 747)

**Litwin v. Allen** (747)
Facts: Stockholders (P) brought a derivative action against Trust Co. (D), its subsidiary, Guaranty Trust (D), and J.P. Morgan (D) for a loss resulting out of a bond transaction.
Rule: A director is not liable for loss or damage other than what was proximately caused by his own acts or omissions in breach of his duty.
- A director owes to his corporation a loyalty that is undivided and an allegiance uninfluenced by no consideration other than the welfare of the company.

**Smith v. Van Gorkom** (p. 767)
Facts: The trial court held that because Van Gorkom (D) and the other Trans Union directors had three opportunities to reject the merger proposal, they acted with due deliberation and their conduct fell within the business judgment rule.
Rule: Directors are bound to exercise good faith informed judgment in making decisions on behalf of the corporation.
**Business Judgment Rule**: Doctrine relieving corporate directors and/or officers from liability for decisions honestly and rationally made in the corporation's best interest.
Del. Gen. Corp. Law (p. 781)

**In re Caremark Intern. Inc. Derivative Litigation** (p. 784)
- Where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention.
- Absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.

**Malone v. Brincat** (p. 792)

**Gall v. Exxon Corp.** (p. 801)
Facts: At trial of Gall's (P) shareholder derivative suit against Exxon (D), claiming illegal bribes by the corporation, Exxon moved for summary judgment, claiming that it was in the corporation's sound business judgment and to refuse to sue on Gall's complaint.
Rule: The decision of corporate directors, whether or not to assert a cause of action held by the corporation, rest within the sound business judgment of management.

**Zapata Corp. v. Maldonado** (p. 807)
Facts: Maldonado (P) initiated a derivative suit charging officers and directors of Zapata (D) with breaches of fiduciary duty, but four years later an "Independent Investigation Committee" of two disinterested directors recommended dismissing the action.
Rule: Where the making of a prior demand upon the directors of a corporation to sue is excused and a stockholder initiates a derivative suit on behalf of the corporation, the board of directors or an independent committee appointed by the board can move to dismiss the derivative suit as detrimental to the corporation's best interests, and the court should apply a two-step test to the motion: 1) has the corporation proved independence, good faith, and a reasonable investigation, and 2) does the court feel, applying its own independent business judgment, that the motion be granted?

**Aronson v. Lewis** (p. 816)
Facts: The trial court dismissed theis derivative suit for failure to meet the prerequisite of making a demand on the Board of Directors to bring the suit.
Rule: A prior demand can be excused only where facts are alleged with particularity which create a reasonable doubt that the director's action was entitled to the protections of the business judgment rule.

**Cuker v. Mikalauskas** (p. 829)

Facts: PECO Energy Company's board of directors (D) sought to quash tow derivative actions initiated by its minority shareholders.
Rule: Under PA law, application of the business judgment rule permits a corporation's board of directors to terminate a derivative suit initiated by the company's minority shareholders.

**VIII. Duty of Loyalty and Conflict of Interest** (p. 848)

**A. Self-Dealing** (p. 848)

- ***Self dealing***—transaction in which a fiduciary uses property of another, held by virtue of the confidential relationship, for personal gain.
- Intrinsic fairness standard—A defense to a claim that a director engaged in an interested director transaction by showing the transaction's fairness to the corporation.
- Duty of Loyalty—A director's duty to refrain from self-dealing or to take a position that is adverse to the corporation's best interests.

**<u>Marciano v. Nakash</u>** (p. 848)
Facts: A loan to Gasoline, Ltd. by certain board members was validated as a fair transaction.
Rule: A transaction by a corporation with its insiders will be valid if intrinsically fair.

**<u>Heller v. Boylan</u>** (p. 857)
Facts: Heller (P) and six other stockholders in American Tobacco Company claimed that the bonuses paid top executive officers bore no relation to the services for which they were given.
Rule: If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority.

**<u>Sinclair Oil Corp. v. Levien</u>** (p. 869)
Facts: A minority stockholder in Sinven, Levien (P) accused Sinclair (D), the parent company, of using Sinven assets to finance its operations.
Rule: Where a parent company controls all transactions of a subsidiary, receiving a benefit at the expense of the subsidiary's minority stockholders, the intrinsic fairness test will be applied, placing the burden on the parent company to prove the transactions were based on reasonable business objectives.

**<u>Weinberger v. UOP, Inc</u>.** (p. 874)
Rule: When seeking to secure minority shareholder approval for a proposed cash-out merger, the corporations involved must comply with the fairness test, which has two basic interrelated aspects: 1) fair dealings—which imposes a duty on the corporations to completely disclose to the shareholders all information germane to the merger, and 2) fair price—which require that the price being offered for the outstanding stock be equivalent to a price determined by an appraisal where "all relevant non-speculative factors" were considered.

**B. Corporate Opportunity**

The Corporate Opportunity Doctrine—a fiduciary concept that limits the power of officers, directors, and employees to take personal advantage of opportunities that belong to the corporation.

- It is an opportunity that a fiduciary to a corporation has to take advantage of information acquired by virtue of his or her position for the individual's benefit.

**<u>Northeast Harbor Golf Club, Inc. v. Harris</u>** (p. 890)
Rule: Prior to availing herself of an opportunity property belonging to the corporation, an officer or director must first fully disclose the opportunity to the corporation, and allow the board of directors the opportunity to reject it by a majority vote of the disinterested directors.

**C. Duties to Other Constituencies / Other Fiduciary Duties to Officers and Directors** (p. 902)

- Preferred shareholders. Delaware courts have also recognized fiduciary duties running to preferred shareholders on questions such as whether the proceeds of a merger were being fairly divided between preferred and common shareholders.
- Holders of Convertible Securities. Where convertible securities are called for redemption, holders have the option of converting into common shares or to be redeemed. The corporation has a duty to provide holders with accurate information about the desirability of each alternative.
- Creditors. As a general rule, directors do not owe fiduciary duties to creditors—whether they be short-term trade creditors, long-term bondholders, or holders of debt securities convertible into common shares.

**IX. Indemnification and Insurance** (p. 1049)

**<u>Merritt-Chapman & Scott Corp. v. Wolfson</u>** (p. 1049)
Rule: Corporate agents, criminally charged for their conduct in regards to the corporation, are entitled to indemnification for the costs of their legal defense only on those indictment counts on which they are successful.

Diane Mazur

**McCullough v. Fidelity & Deposit Co.** (p. 1063)

Rule: An insurer must provide coverage for claims made after a policy expires, so long as the insured band notifies the insurer of any specified wrongful act, error, or omission that may later give rise to a claim being made against its directors or officers.

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