

## BUSINESS ASSOCIATIONS

### INTRODUCTION

#### ASPECTS OF BUSINESS ASSOCIATIONS

1. Formation
2. Control and Management
3. Financing
4. Purchase and Sale

#### I. CHOICE OF ORGANIZATIONAL FORM

##### A. SOLE PROPRIETORSHIP

1. Structure: single owner, unincorporated, simplest form
2. Liability: unlimited liability, agency law controls
3. Control: sole control
4. Profit: pass through = does not pay a tax as a separate entity; sole proprietor pays tax on business through personal tax
5. Formalities: easiest form; limited formalities

##### A. GENERAL PROPRIETORSHIP/PARTNERSHIP

1. Structure: partners, joint ownership, unincorporated, two or more persons who are co-owners for profit; possible creation even if not intended (Uniform Partnership Act § 202(a))
2. Liability: unlimited liability; agency principles; joint and several liability among all partners
3. Control: partners control; either equal votes or in accordance with capital contributions
4. Profit: partners agreement
5. Tax: pass through to partners themselves
6. Formalities: few or none
7. **Revised Uniform Partnership Act (1997) (supp. pg. 62)**

- a. § 101(6) Partnership: as association of two or more persons who carry on as co-owners of a business for profit
- b. § 306 Partner's Liability: joint and several liability for all obligations of the partnership unless otherwise agreed by the claimant or provided by law

#### 1. *Young v. Jones* (page 115)

- *Estoppel liability*
- *two or more persons can be carrying on business as partners though they are not aware of it, nor intend it*
- *pls are investors who relied on letterhead stating that the company was price waterhouse when depositing \$1/2 million in bank*
- *PWB gave SAFIG an unqualified audit statement which pls relied on*
- *PWB does not have sufficient contacts to be hailed into US court so pls sue PWUS*
- *Court finds that partners of PWUS had nothing to do with the documents relied on by pls nor with the investment and so no liability of PWUS partners by estoppel*

##### A. LIMITED PARTNERSHIP

1. Structure: at least one partner and at least one limited partner
2. Liability: general partner = unlimited / limited partner = limited
3. Control: general partner = exercises control / limited partner = none
4. Profit: partner agreement
5. Tax: pass through b/c a partnership by agreement; files Information Return but does not pay tax as entity; if one cannot pay, others not liable
6. Formalities: must file under state statute to be recognized as limited
7. Used as financing means for speculative or risky ventures: real estate, oil and gas, cable television
8. **Uniform Limited Partnership Act § 303 Liability to Third Parties**
  - a. *Limited partner liability*
  - b. *deals with liability of limited partners who were acting as general partners by participating in control of the business*
  - c. *if limited partner participates in the control of the business, he is liable only to those person who transacted business with him, reasonably believing that he was a general partner*
  - d. *things limited partners can do without giving up limited liability: being an employee, attending meetings, acting as a surety, consulting and advising general partners, etc.*

#### 1. *Continental Waste v. Zoso Partners*

- *claimed that limited partner exercised control of business*
- *some acts should not disqualify a limited partner from not being liable*

- A. LIMITED LIABILITY PARTNERSHIP (LLPS)
  - 1. used by professional organizations: law firms, doctors, accountants
  - 2. general partnerships which states have amended to allow partners to limit their personal liability in some way or another (all states are different)
    - a. sometimes liability committed to another partner A that has nothing to do with the work B does
    - b. "Full Shield Liability" = relief for partners who did not commit actual deeds; partnership with all advantages but insulated from liability of other partners; liable for own malpractice and those you supervise

- A. CORPORATION
  - 1. Structure: directors make policy, officers implement policy, and shareholders as owners share in ultimate power
  - 2. Liability: limited (ultimate limited liability vehicle)
    - a. Direct Participation: direct participation in the crime will make a partner liable even though the company is a corporation; when the officer or director is merely supervising, the case becomes tricky
    - b. Piercing the Corporate Veil: court disregard the fact that the company is a corporation in order to hold the officers liable

- 1. Control: Shareholders and Board of Directors
- 2. Profit: dividends
- 3. Tax: pays corporate tax as an entity; employees pay income tax; shareholders pay tax on dividends
- 4. Formalities: multiple

A. S-CORPORATION (partnership alternative / tax basis)

- 1. Structure: articles of incorporation
- 2. Liability: same as corp.
- 3. Control: same as corp.
- 4. Profit: same as corp.
- 5. Tax: not liable for payment of corporate tax
  - a. feature of pass through taxation typical of partnerships made it popular
  - b. plausible alternative to partnership from tax standpoint

1. Formalities: many

2. **Subsection "S" of Internal Tax Code**

- a. used for qualified small business with less than 75 shareholders
- b. may not have shareholders who are non-resident aliens nor certain artificial entities
- c. may not have issue more than one class of stock

A. LIMITED LIABILITY COMPANY

- 1. Growing use b/c of limited liability for all owners and pass through status
- 2. Not adopted on wide-spread basis:
  - a. relatively new type of company
  - b. don't know under what circumstances you won't have limited liability
  - c. piercing the corporate veil may be carried over from corporate law

1. **Poore v. Fox Hollow Enterprises**

- *campbell believed that although he did not have a license to practice law in DE, he could appear in court there b/c FH was a limited liability company rather than a corporation*
- *court determined that LLC more closely resemble corporations than partnerships*
- *b/c of the limited liability and contractual nature of LLC's, the legislature did not intend that a member or manager of the company could represent itself in court, but rather than they needed DE legal counsel*

1. **Meyer v. OK Alcoholic Beverage Laws Enforcement Commission**

- *can LLC receive and hold a retail package store license*
- *evident purpose was to assign personal responsibility for compliance with liquor laws*
- *business forms that did not insure such personal responsibility were excluded from eligibility from licensing*

1. **Delaware Limited Liability Company Act (supp. 199)**

§ 18-303(a): liability shall be that of the LLC and no member shall be personally obligated for any such debt, obligation or liability of the company solely by being a member of that company

I. DEVELOPMENT OF CORPORATION LAW (Chapter Four)

- A. Corporation is a creature of the state and of the statutory law of that state
- B. Character of corporation and law will change and evolve as a result of larger social, economic, and historic forces - industrial revolution/economic growth
- C. Possibility of revenue for the states sometimes effects the characteristics of corporate law - Delaware phenomenon
- D. Federal law has stepped in to fill a void left in statutory law
- E. Tensions and conflicts found in corporate law will always be there
- 1. management controlled corporation v. protection of vulnerable players

2. respective roles of state and federal government
3. government's role as regulator in the public interest v. prerogative of private parties to contract and make their own agreements

## I. FORMATION OF THE BUSINESS ASSOCIATION

### A. PARTNERSHIP (chapter two)

#### 1. Need for Written Agreement

- a. major advantage: avoid future disagreements
- b. readily proved in court
- c. may focus attention on potential problem spots
- d. IRS permits allocation of tax burdens
- e. What happens in case of partner's death
- f. Lend rather than contribute property to relationship
- g. Required when contributing property for more than one year
- h. Higher fee for attorney and less misunderstanding

#### 1. *Smith v. Kelley*

- *appellant left accounting firm and declared that he was titled to a fixed percentage of its profits*
- *there was no written evidence of a partnership agreement*
- *though appellant was held out to the public as a partner, at no time between themselves did they intend to create partnership relationship*
- *court ruled: must have objective intent (held out to public) and subjective intent of parties concerned*

### A. CLOSELY HELD CORPORATION

#### 1. Where to Incorporate

- a. Appraisal of Two Factors:
  1. analysis of the relative cost of incorporation and
  2. consideration of the advantages and disadvantages of the substantive corporation laws of the states
- a. \*\*\*if corporation is closely held and business is to be conducted largely within a single state, local incorporation is almost always preferred
- b. Delaware Statutes:
  1. negligent without fraud and lose lots of money, shareholders cannot sue to recover monetary damages
  2. corporation can operate with more freedom from shareholders
- a. Corporation Service Companies: assist lawyers in forming and representing corporations in other states for a fee

#### 1. How to Incorporate

- a. Dangers: overlooking an obvious matter and using boiler plate language not suitable for the corporation
- b. Formal Requirements: MBCA Chapter 1
- c. Examples on page 196 (text)

#### 1. Articles of Incorporation (handout)

- a. MBCA authorized electronic filing but most states require physical documents be filed with actual signatures
- b. MBCA limited role of secretary of state to by ministerial role of reviewing documents
- c. Names: corporate name must be distinguishable upon the records from other corporate names
- d. Corporations may generally conduct business under a fictitious name to the extent that an individual may if the purpose is not to defraud
- e. MBCA grants every corporation perpetual duration unless articles of incorporation provide otherwise
- f. Purposes: corp. may list multiple purposes without limitation; changed language to "for the transaction of any lawful business"
- g. Registered office and registered agent: often the attorneys
- h. Some states require three total, or if there are two directors then two incorporators, etc.
- i. Initial Capital: no dollar figure referenced, some states have minimum

#### 1. Attorneys Handle Preparing and Filing Articles of Incorporation:

- a. prepare corporate bylaws
- b. notice calling the initial board meeting, minutes, waivers
- c. corporate seal and minute book
- d. blank certificates for stock
- e. opening of corporate bank account
- f. employment contracts, voting trusts, shareholder agreements, share transfer restrictions
- g. taxpayer identification numbers, occupancy certificates, govt. permits
- h. evaluate whether to file S corporation election

I. ULTRA VIRES DOCTRINE (if corp. conducting acts that were not in its articles of incorporation (purposes), those acts were deemed void)

A. **Revised Model Business Corporation Act §2.02**

- a. articles of incorporation must set forth
  1. corporate name
  2. number of shares
  3. street address and registered agent
  4. name and address of incorporators
- a. articles of incorporation may set forth
  1. initial directors
  2. provisions not inconsistent with law regarding

A. **Ashbury Ry. Carriage & Iron Co. v. Riche (1875)**

- *although a purposes clause may be narrower than the activities actually engaged in by the corporation, the activities themselves were not inherently unlawful or beyond the powers of the corporation generally*
- *this case quite unsettling*
- *justification for doctrine: articles of incorporation are on public file*

A. **MBCA § 3.04 Ultra Vires**

1. provides limited circumstances where ultra vires may be asserted
2. reducing the effect of doctrine has presented standing issues
3. three types of persons having standing to sue at anytime:
  - a. shareholder bringing suit against the corporation
  - b. corporation bringing suit against current or former directors or officers
  - c. attorney general bringing suit against corporation

A. **711 Kings Highway Corp. v. FIM's Marine Repair Serv. Inc. 1966**

- *third party standing*
- *pl lease premises for use as motion picture theatre*
- *alleges that corp was formed for marine activities and so leasing theatre for operation of a theatre falls completely outside the scope of the powers and authority conferred by the charter*
- *third parties (pls) may not sue on the basis of ultra vires and so suit dismissed*

A. **Theodora Holding Corp v. Henderson**

- *Charitable gifts*
- *T holds 1/4 stock and states that her father is giving large charitable donations (apartment in Arizona) which are not approved by her*
- *Court states that contributions are under the limits of the tax code*
- *Corporate charitable or educational gifts must merely be within reasonable limits both as to amount and purpose to be valid*
- *Good way for T to let IRS know def is a crook though she loses the suit*

I. PREMATURE COMMENCEMENT OF BUSINESS (PROMOTERS)

A. General Information

1. promoter owes significant fiduciary duties to other participants in venture
2. corporation has not yet been created
3. carries constructive and destructive power and creates risk for others
4. represents notion of advances planning

A. Relationship to Corporation = **Fiduciary Duty**

1. **Stanley J Howe & Assoc. v. Boss (1963)**

- *RULE: promoter, though he may assume to act on behalf of the projected corporation and not for himself, will be personally liable on his contract unless the other party agreed to look to some other person or fund for payment*
- *Promoter signed "Boss, agent for corporation to be formed and who will be the obligor"*
- *Court held that although he was attempting to sign away his liability, he was still liable for the contract (possibly b/c court felt that someone should pay and the corporation was not formed)*
- *"Corporation would be the obligor" rather than "is the obligor" determined to be ambiguous and so could not be held liable*

1. **Quaker Hill v. Parr (1961)**

- *NY corp selling nursery items, promoters being sued b/c corp. never got off the ground*
- *Sued defs b/c there was no agreement in the contract to look to some other person, corporation, or fund*
- *Court stated that there was no intent for the parties to look to defs for performance or payment → court turned rule on its head*

- Used interpretations of the words in the rule to come to the conclusion it preferred
- Must make sure that signature block is set up correct and clearly so that everyone knows promoters are signing solely on behalf of the corp and will not be liable

#### A. Liability to Third Parties

##### **Mac Arthur v. Times Printing Co. (1892)**

- promoters negotiate employment contract, pl signs contract for one year, pl let go and not paid for work
- **RULE ONE:** after promoter makes contract and employee signs it, and the corp is later formed, the corp. must adopt the contract as its own
- **RULE TWO:** adoption of the contract can be express or implied and does not have to be highly formal
- **HOLDING:** corp adopted the contract when it accepted pl's services

#### I. PREMATURE COMMENCEMENT (DEFECTIVE INCORPORATION)

##### A. Provide for Limited Liability Even if Articles of Incorporation are Not Filed

1. prob generally: when promoter has attempted to incorporation but b/c of technical defect, incorporation did not occur
2. **def facto corporation:** save those acting for a corporation by conferring limited liability as if actually incorporated (colorable attempt); tried but didn't file
3. **de jure corporation:** technically correct corporation
4. **corp by estoppel:** to avoid injury; detrimental reliance upon someone's representation; held out to public as though, but not

##### A. **Robertson v. Levy**

- passive shareholder held personally liable
- **RULE:** directors or officers who act for defectively formed corp prior to filing are jointly and severally liable
- corporate articles had not been filed and the individual shareholder liable

##### A. **Cantor v. Sunshine Greenery, Inc**

- **de facto corporation** was deemed possible
- articles of incorporation were sent, lease was signed and repudiated, then the articles were approved
- def sincerely followed the steps of incorporation but the articles did not get filed until after the legal event
- **de jure** corporate existence would have shielded him from personal liability

##### A. **Cranson v. IBM**

- Corporation by **estoppel** doctrine applies
- at the time of accepting the business machines, the company had not been incorporated b/c the lawyer had forgotten to file the articles of incorporation
- company had not relied on the payment or credit of the individual and acted as though the company was a corporation

#### I. DISREGARD OF THE CORPORATE ENTITY

##### A. Elements

1. Piercing the Corporate Veil - only pierce when corporation goes under
2. Reverse Piercing
3. Subordination

##### A. **Bartle v. Home Owners Coop.**

- Set up corporation to build homes, not for profit but to operate at cost, went into bankruptcy
- Creditors sued and attempted to pierce the corporate veil to get the shareholders of the corporation
- **HOLDING:** no basis for piercing, there were shareholders meetings minutes, stock certificates, etc. and operated as other businesses do even though they were not out to make a profit

##### A. **Dewitt Truck Brothers v. W Ray Flemming Fruit Co.**

- F went to fruit farmers and guaranteed transportation, sales, collection of money, and reimbursement to farmers for cost of produce
- F provided paperwork to farmers stating how much profit was kept for himself and what was paid to the trucking companies
- F kept money allegedly going to truckers and used it for his salary
- Truckers sued, but F's corporation was undercapitalized
- Important elements to determine **whether or not to pierce:**
  1. must be careful when there is one owner although it does not automatically mean the corp will be pierced
  2. whether corporation was grossly undercapitalized for the purposes of its corporate formation
  3. basic injustice (someone has fundamentally been wronged; does not have to actual fraud present)
  4. formalities: keeps records, corporate name on checks used to pay expenses, by-laws, contracts signed in corporate name, usually requirement that is added on to others, does not stand alone

**A. Baatz v. Arrow Bar**

- Def formed corporation to operate a bar, bar served A who was already intoxicated, he left the bar and injured pls
- Rather than get dram shop insurance, decided instead to incorporate to prevent personal liability
- Fundamental result is inequitable justice:
  1. fraudulent representation by corporate directors
  2. undercapitalization
  3. failure to observe corporate formalities
  4. absence of corporate records
  5. payment by corporation of individual obligations
  6. use of corporation to promote fraud, injustice, or illegalities
- **HOLDING:** no personal liability
- Bar owners were not transacting personal business; corporation was not undercapitalized; owners did not serve alcohol; nor did they treat the corp. in any way that would produce injustices and inequitable consequences necessary to justify piercing the corporate veil
- \*different than Flemming where he personally guaranteed the contract
- \*only important to pierce the veil when the corporation goes under

**A. Radeszewski v. Telecom Corp.**

- **Insurance - Parent/Subsidiary**
- insurance can be used to show that there was adequate compensation
- absence of insurance cannot prove that the corp was undercapitalized
- violated trucking law while operating in Missouri and committed tort
- subsidiary was liable but had no money so pl tried to pierce parent veil
- **Tripartite Test:**
  1. control = domination → finance, business policy
  2. how control used → to commit fraud or wrongdoing
  3. proximate cause relationship required
- subsidiary was adequately capitalized by an excess carriage through insurance company
- **HOLDING:** insurance company was broke, parent knew it and kept operating the subsidiary anyway, which caused the accident
- **RULE:** whenever anyone uses the corp to further his own interests, he will be held liable for corporate acts upon principle of **respondeat superior**

**A. Fletcher v. Atex Inc.**

- Whether or not Parent is liable for the Subsidiary
- **Parent or Subsidiary Liability → Delaware Test**
  1. Operated as single economic entity
  2. Overall element of injustice and unfairness (states have own tests)

**A. United States v. Kayer-Roth Corporation**

- SM manufactured textiles and polluted drinking water; SM out of business b/c parent dissolved, parent had complete control over SM
- Parent liable under two theories
  - a. direct participation / controlled the act
  - b. piercing occurs where the subsidiary is so dominated by the parent

**A. Stark v. Flemming**

- When pl forms corp for purposes of securing social security benefits, can those benefits be withheld on the ground that the corp is a sham
- **HELD:** amount of benefits was adjusted, but they could not be withheld
- Motives of incorporation immaterial so long as formalities are observed

**A. Roccogranti v. Unemployment Comp. Bd. Of Review**

- Corp laid off family members who applied for unemployment
- **HOLDING:** Family denied unemployment benefits b/c they were in essence self-employed
- Difference with Stark: here, they were younger people who could get jobs and unlike Stark, they had not paid into society (SS and taxes)

**A. Cargill Inc v. Hedge (1985)**

- **REVERSE PIERCE**
- Set up corp to run a farm, debt created, creditor wanted to sell land
- Used homestead exception: can't sell part of land b/c he lives on it
- **HELD:** corp can't use homestead exceptions; reverse piercing allowed

## A. *Pepper v. Litton*

- Case of *subordination* by sole shareholder of a corporation
- Subordination = court claimed equity jurisdiction and determined that L's debt, in the absence of the ability to go back and investigate DS's records, there were sufficient facts to lower L's claim on the priority list with respect to other person's claims on the company, i.e. P's
- **HOLDING:** shareholders directors are subject to rigorous scrutiny and when a contract for engagement of the corporation is alleged, the burden shifts to the shareholder to prove good faith transactions and to show its inherent fairness from the view of the corp and those interested

## I. FINANCIAL MATTERS

### A. Determinations

1. What you Have = Assets (people, cash, equipment, patents, inventory, good luck)
2. What you Need
3. How to Get What you Need
  - a. Borrow - liabilities
  - b. Sell Ownership - business can finance itself by selling ownership interest in itself through stock - equities
  - c. Make Money - may be successful and finance itself - equities

### A. DEFINITIONS

1. Equity = selling ownership and making money
2. Liability = borrowing (accounts payable = short term / note payable = long term)
3. Capital Accounts → Income Statement

### A. EQUITY SECURITIES

#### 1. Common Shares

- a. Two Characteristics
  1. entitled to vote for election of directors and on other matters coming before the shareholders
  2. entitled to net assets of corp when distributions are made in the form of dividends or liquidating distributions
- a. Common Stock Riskier than Preferred
  1. in bankruptcy, creditors are paid first, preferred holder next and common holders last
  2. profits paid to preferred holders first and common if anything left

#### 1. Preferred Stock

- a. Usefulness: corp needs money but does not want to give up decision-making aspect; sell preferred stock w/ preference but no voting rights
- b. Characteristics
  1. preference to dividends
  2. liquidation preference
  3. cumulative dividend rights (not paid one year then rolls over)
  4. usually do not have voting rights
  5. redemption rights: corp. has power to buy back shares at redeemable value
  6. conversion rights: may be made convertible at the option of the holder into common shares → conversion is forced when shares are called for redemption at a time when the market value of the shares obtainable on conversion exceeds the redemption price
  7. participation preferred: entitled to the specified dividend and after common shares received specified amount, they share with the common stockholders in additional distributions on some predetermined basis
  8. classes of preferred: corporation may issue different classes of preferred shares
  9. series of preferred

### A. ISSUANCE OF SHARES

#### 1. Authorized Stock

- a. number of shares company authorized to issue - don't have to issue all
- b. company will issue number of stock needed to raise necessary capital
- c. number of authorized stock must be stated in articles of incorporation

#### 1. Issued Stock: stock that is possessed

#### 2. Outstanding Stock

- a. stock that the company does not own itself (owned by shareholders)
- b. treasury shares = stocks that have been bought back by the company but which have not been retired (company may re-sell or retire stocks)

### A. SUBSCRIPTIONS

### B. PAR VALUE

1. Model Act has done away with par value concepts but still exists in many jurisdictions

2. Par value must be defined on balance sheets and requires two line to do so; addition of the two line makes up all the stock and the par value
  - a. one line may be either "capital" "common stock" or "preferred stock"
    - stated capital = number of shares outstanding x par value of each share
  - b. second line reflects stock but is labeled "capital surplus" or "capital contributed in excess of par"
    - Capital Surplus = (purchase price - par value) x number of shares
1. Example: If you sell three shares at \$10/share and each has a par value of \$1 → on the balance sheet, stated capital = \$3 and capital surplus = \$27
2. Definition: original value of the stock, stated in articles of incorporation and cannot be changed
3. **Hanewald v. Bryan's Inc**
  1. **CONSIDERATION FOR SHARES**
  2. *RULE: 100 shares of stock were issued at \$1000 par value/share → b/c the par value was \$1000 and the defs paid nothing, they are held liable for the entire \$1000 per share of stock*
  3. *Company did not receive any payment in labor, services, money, or property for the stock which was issued to K and J*
  4. *Upon bankruptcy, corp paid all of its creditors (including \$10,000 loan back to K and J) but did not pay pls*
  5. *MBCA § 24 requires shareholders to pay for their shares as a prerequisite to their limited personal liability*
1. Eligible and Ineligible Consideration for Shares
  - a. money, property, services actually rendered were adequate considerations in the traditional statutes and codes
  - b. all jurisdictions different
  - c. today, most jurisdictions use nominal par values
- A. WATERED STOCK (stock of certain value that is issued for property or service said to be worth the same amount, but is actually overvalued and worth must less)
- B. DEBT FINANCING
  1. LEVERAGE: use of debt or borrowing with the intention of magnifying the profit, achieve profitability greater than the cost of capital; want to make more money without the debt; have to make enough profit to cover your cost of capital so as not to be in the hole

EXAMPLE 1		
	Investment	Profit
Equity:	\$100	\$10
Debt:	\$100 @ 8% interest rate	\$10 - (8% of \$100) = \$2
Total:		\$12

- A. Equity: owner invested \$100 of his own money which will produce \$10 of profit at the end of the year
- B. Debt: owner also borrowed \$100 at the rate of 8% (five years to pay back loan)
  - \$100 is the principle amount of the loan
  - interest is an expense of doing business and must be subtracted from the profit
  - interest must be paid each year
  - principle \$100 will be paid back five years from now

EXAMPLE 2		
	Investment	Profit
Equity:	\$100	\$10
Debt:	\$100 @ 12% interest rate	\$10 - (12% of \$100) = -\$2
Total:		\$8

- losses are magnified here and the cost of capital (interest rate) ate up the profit that would otherwise have been seen

1. INSIDE DEBT
  - a. Inside Debt
    1. corporation borrows money or property from shareholders
    2. belongs under note payable on balance sheet
    3. provides capital with security needs of shareholder-lender
    4. outside creditors will want creditors construed as shareholders so that they have to stand at the back of the line and IRS wants loans characterized as dividend so they can tax principle and interest
  - a. Reasons Shareholder Would Lend
    1. would stand in line with creditors and ahead of shareholders in bankruptcy
    2. creates safer investment in the company
    3. gains a fair amount of control over the flow of capital

4. tax treatment: dividends are taxable and interest is also taxable
    - a. Company Considerations for Inside Debt
      1. company gets more money
      2. company has tax deduction for interest paid - no tax deduction for dividends paid to shareholders
    - a. **Slappy Drive Industrial Part v. US**
      - **INSIDE DEBT DONE WRONG**
      - *when inside debt is done wrong, IRS may recharacterize the entire amount (principle + interest) as a dividend and tax it heavily*
      - *lender/creditor/shareholder did not treat the debt as debt b/c he did not demand repayment though there were schedules which were not adhered to; did not seek postponements*
      - *lender stated that he only intended to be repaid when there was enough cash to do so*
      - *inside creditors will not be permitted to step up in line for repayment upon company liquidation, they will be pushed back in line with the equity holders (not at issue in this case)*
    - a. **Obre v. Alban Tractor Co**
      - *how to do inside debt correctly*
      - *two person started business which soon failed*
      - *O contributed \$65,000 and N contributed \$10,000 with control shared equally between the two*
      - *No showing is undercapitalization, fraud or misrepresentation, so \$35,000 of the unsecured promissory note was treated as a loan*
      - *Loan to the corp by O was either known to the creditors or could easily have been discovered by examining public state tax filings, by requesting a financial statement, or by obtaining a credit report*
1. DEBT/EQUITY RATIO
  - ratio between corporation's liabilities and shareholder's equity
  - ex. corporation with \$10,000 of equity that borrows \$100,000 has a debt/equity ratio of 10:1
  - corp with high debt/equity ratio often referred to as a **thin corporation**
- A. PLANNING CAPITAL STRUCTURE FOR CLOSELY HELD CORPS
  1. Considerations for the Attorney
    - a. will the structure work
    - b. will the structure provide the desired result
    - c. will desired tax treatment be available, probable, or certain
    - d. might structure give rise to unexpected liabilities
    - e. are clients' financial contributions reasonably protected and fairly treated in the event of unexpected occurrences causing sudden and premature termination of the venture
  1. Securities Laws
    - a. administered by SEC; blue skies laws; invoked when security is sold
    - b. **Securities Act of 1933**
      1. heart of act is § 5(c): if will be unlawful for anyone to either offer or sell securities unless a registration statement has been filed
      2. registration statement: disclosure document consists of two parts
        - a. prospectus statement: distributed to potential and actual investors and required to contain the following
          - use of proceeds
          - summary information
          - determination of offering price
          - dilution: control issues
          - selling security holders
          - plan of distribution
          - description of securities to be registered
        - a. additional information that must be publicly available but is not included in the prospectus
- A. PUBLIC OFFERINGS
  1. Securities Act of 1933
    - a. regulated sale and distribution of securities at the federal level
    - b. § 5: procedures, time limits, prohibitions, allowances

- c. many small and medium businesses cannot engage in registration process → where exemptions come into play
1. **Statutory Exemptions**
    - a. Private Sale rather than Public Sale
      - "transactions by an issuer not involving any public offering are exempted"
      - "private placement exemption"
      - rationale: sophisticated investors should have asked the same questions that would have been answered by registering
      - SEC interpretative guidelines decipher many sections of the act
    - a. § 3(a)(11) Intrastate Offering Exemption
      - companies which are incorporated and doing business in a state and sell stocks only to persons within the same state
      - profits made by sale of securities must be kept in the state
      - if you offered in three states but only one purchased, you are not exempt → every offeree must be in the same state
    - a. § 3(b) Small or Limited Offering Exemption
      - ceiling of \$5 million
      - SEC may add exempted categories as necessary, but no sale shall be exempted where the aggregate amount at which such issue is offered to the public exceeds \$5 million
      - Rationale: small and damage done to investors is minimal
    - a. **Securities and Exchange Commission v. Ralston Purina (1953)**
      - *def sold \$2mill. of stock to employees who took the initiative and were interested without registration and made use of the mails*
      - *ISSUE: was the offering to "key employees" public*
      - *"public" distinguishes the populace at large from groups of individuals segregated b/c of some common interest of characteristic*
      - *offering does not have to be made to all the world to be public*
  1. **Regulatory Exemptions** (text pages 342-346)
    - a. Rule 147 based on § 3(a)(11)
    - b. Regulation D - Rule 230.506 based on § 4(2) → must not be more than 35 investors who must be either accredited or sophisticated
    - c. Regulation D - Rule § 230.504 and Rule § 230.505 are based on §3(b)
    - d. Rule § 230.502(c) → if you made an exemption under Regulation D, you may not advertise when making an offering
    - e. If you make several small holdings to create exemptions, SEC may litigate under the integration doctrine
    - f. **Smith v. Gross (1979)**
      - *Howey Test = conditions for an investment contract, whether scheme involves:*
        1. *an investment of money*
        2. *in a common enterprise*
        3. *with profits to come solely (primary) from the efforts of others*
      - *investment contracts are securities and must be registered (selling contracts regarding earthworms)*
  1. **Preemptive Rights**
    - a. right which may be granted or withheld by the articles of incorporation
    - b. MBCA "opt in": no right exists unless provision for is expressly made
    - c. Some state statutes adopt and "opt out" clause
    - d. **Anti-Dilution Concept**: makes sure that more stocks may not be sold which would dilute your percentage of shares and power
    - e. **RULE**: articles of incorporation will give each shareholder 1/3 control of the company and give those persons the right to purchase the amount of stock in the future, which will maintain 1/3 control
    - f. **Katzowitz v. Sidler (1969)**
      - *three owners had equal interest and a falling out*
      - *K did not participate in later issuing of stock and so took cash*
      - *Started out with 5 shares each and other two issued 25 more each*
      - *When company dissolved, two would get 30/65 percent and K would get 5/65*
      - *K could have waived his rights but there was a fiduciary duty to let him know what the consequences of not participating were, and here they did not → K won*

## A. DISTRIBUTIONS IN CLOSELY HELD CORPORATIONS

1. Flow of funds out of the corporation (rather than into)

2. **Dividends:** payment of profits by corporation
    - a. not automatically payable, must be profit, board of directors must declare them and then pay out
    - b. Freeze-Out: minority claims that majority is using power to keep them from receiving basic entitlements

Factors

    1. hostility of controlling faction against the minority
    2. exclusion of minority from employment in the corp. (majority names themselves to Board and hire themselves as employees, they then have the power to declare dividends, salaries & perks while minority gets nothing b/c their only claim is to dividends)
    - a. **Gottfried v. Gottfried**
      - **BAD FAITH EXCEPTION**
      - family feud with 38% v. 62%
      - two types of stock: common stock and preferred stock (classic = paid before common shares and class A = dividends plus \$8 per share before common stock paid + can get paid extra dividends is money left over after paying all classes (further participation earnings))
      - Board of Directors had not declared dividends and 38% mad
      - **RULE:** board has discretion to make business decisions including whether or not to pay dividends unless the discretion is bad faith
      - **HOLDING:** not bad faith, minority loses
    - a. **Dodge v. Ford Motor Co.**
      - Dodge brothers were minority shareholders in Ford who sat on the Board, learned the assembly line, took the dividends being paid from Ford and started pouring them into their own co.
      - Ford became enraged and stopped paying dividends
      - **HOLDING:** Bad faith exception applied to Ford and must pay
    1. **Expenditures:** payments of expenses such as salaries, wages, entertainment (those paid to the benefit of the corp insider)
 

**Wilderman v. Wilderman (1974) Delaware**

      - **EXCESSIVE**
      - guy married into family and took over business
      - couple divorced and wife sued stating that expenditures were waste
      - **RULE:** corp officials who make excessive expenditures may be personally liable for the amount above what is reasonable especially if he benefits personally from the expenditure
      - **HOLDING:** husband must pay back expenditures into corp treasury
      - **Tax Note:** expenditures are business tax deductions and lowers taxable income; govt has interest in preventing excessive expenditures
      1. Repurchase: of ownership interest through stock repurchase
 

**Donahue v. Rodd Electrotypes Co.**

        - R and D took over company and bought controlling interest
        - R had more stock than D, brought in members of family to take over corp., then began making gifts of stock which the corp repurchased for \$800 per share
        - D claimed freeze-out b/c her stock was repurchased at \$20-400/share
        - **HOLDING:** corp violated fiduciary duty by not treating D fairly and ordered to offer repurchase at same price as R
        - **Decision is limited to closely held corp** characterized by: small number of shareholders, limited market for shares, substantial majority participation in management by shareholders
        - **Jurisdiction backed off from bright-line rule to case-by-case approach**
- A. Legal Restrictions on DISTRIBUTIONS (used to limit right of directors to pay dividends or repurchase stock; limits flow of capital out of the company)
- DIVIDEND RESTRICTIONS**
1. Earned Surplus Dividend Statutes: can pay dividends if has earned surplus
    - a. Earned surplus = all aggregate income from income statements
    - b. Corp must remain solvent
  1. Non-Impairment of Capital Dividend Statutes (Balance Sheet)
    - a. capital surplus + earned surplus = ceiling of dividend payouts
    - b. cannot use stated capital of corp to pay dividends
  1. Nimble Dividend (Delaware)
    - a. Out of corp net profits for fiscal year or previous fiscal year
    - b. Make sure company debt has been paid before required or permitted to pay dividends

- c. You can have tons of debt, but one year make a profit and pay it all out in dividends; can shift money into different categories to create the illusion of profit and pay dividends
- 1. Insolvency
  - Must satisfy both tests:
    - 1. equity insolvency test: can business pay its debts as they come due
    - 2. bankruptcy insolvency test: assets - liabilities = ceiling of assets that can be paid out
  - 1. Model Act = Insolvency
  - 2. Revised Model Act (must pass Insolvency and Balance Sheet)
- I. MANAGEMENT AND CONTROL OF CLOSE CORPORATIONS (chapter 8)
  - A. SHAREHOLDER AGREEMENT
    - 1. Introduction
      - a. allows shareholders in small corp to agree on how to run the company, what benefits they intend to receive, and what powers and positions they will have as managers and controllers of the company
      - b. when smaller numbers of people were concerned, they were wasting time playing roles and holding and attending meetings
      - c. today we have legislative provisions allowing for such agreements
    - 1. **McQuade v. Stoneham** 1934 (traditional law)
      - three men set of corp in NY to own and run baseball team; they were directors, officers/managers and shareholders
      - state in articles of incorporation that the shareholders are voting in advance to vote in the future for these three to be directors and officers, and includes salaries for matters of efficiency
      - for those actors which did not have a majority vote (pl), found out that he could not trust the other two completely
      - **HOLDING:** not a valid and legal contract (must hold yearly meeting)
      - **RULE:** duty of officers to protect the interest of corp and shareholders
    - 1. **Clark v. Dodge**
      - court created formula where shareholders' agreements can be valid under certain circumstances where the harm done to the corp and shareholders is slight
      - if there are no complaints from the shareholders or public, the agreement is valid and can stand (board still has ultimate control)
    - 1. **Galler v. Galler** 1964
      - Test to enforce agreement:
        - a. must be no minority interest injured by it
        - b. must be no fraud/injury to public or creditors
        - c. agreement must not violate clear statutory prohibition
      - stressed importance of broad and enforceable shareholders agreements in context of the close corporation
    - 1. **Zion v. Kurtz** 1980
      - **CHOICE OF LAW CASE**
      - legislatures enacted provisions allowing corporations to have shareholders agreements if they included a statement in the articles that the corp was going to engage and operate as a closely-held corp
      - condition precedent was not met here but agreement upheld anyway on public policy grounds
      - business set up only to acquire another business, K expanded the business without Z consent and Z sued → Z won
      - NY business incorporated in Delaware so use Delaware law
  - A. SHAREHOLDER VOTING
    - 1. **Salgo v. Mathews** 1973
      - look at shareholders voting: most decisive control of management
      - sense of annual shareholder meeting = fundamental context in which the vote is exercised
      - role of the proxy vote

### Straight v. Cumulative Voting

1 2 3 1 2 3

X owns 1 share 1 1 1 x=3 3 0 0

Y owns 5 shares 5 5 5 y=15 7 2 6

With cumulative voting, you take the (number of shares you have X number of positions)

#### 1. **Humphrey's Winous**

- shareholder vote exercised at shareholder meeting
- will be elicited to elect/remove officers, & vote on major/trivial issues
- strategic use of cumulative and straight voting

- cumulative voting increases chance of having impact
1. **Ringling Brothers - Barnum & Bailey v. Ringling 1947**
    - battle between family re: exercise of power in the company
    - cumulative voting and pooling agreement used together
    - cumulative voting = set forth in articles of incorporation
    - pooling agreement = shareholders pool their shares and agree in advance to vote the same way to advance their interests
    - pooling agreements are valid, legally enforceable agreements, but they are not a guarantee
- A. VOTING TRUST
1. Introduction
    - a. shareholders remain beneficial owners of the stock and the voting trustee becomes the record owner
    - b. voting trustees have fiduciary duties to act in accordance with the voting trust agreement, in the best interest of the trust and the beneficiaries of the trust
  1. **Brown v. McLanahan**
    - company is in railroad business and enters into reorganization bankruptcy
    - **HOLDING:** court told the preferred and common stock owners that they had to place their stock in a voting trust b/c it was clear from past history that they had no idea how to vote - if they were permitted to continue voting, they would run the company back into bankruptcy
    - 1<sup>st</sup> lien bond holders sold their preferred stock and got money, then wanted to gain control of the company by giving their debentures voting rights and out-voting common stock holders
    - court ruled they had fiduciary duties and their tricks were crooked
    - ordinarily used for beneficial purposes but here to trick and defraud
    - **\*\*\*RULE:** trustees in voting trust may not exercise powers granted that is detrimental to the owner of the voting shares, nor may trustee favor one class of stock at the expense of another
  1. **Lehrman v. Cohen 1966**
    - Giant held by L and C families; later created 3<sup>rd</sup> class of stock in D for the sole purpose of electing a tie breaking director; L claims the arrangement is a voting trust and illegal
    - **HOLDING:** arrangement is a valid creation of a 3<sup>rd</sup> type of stock b/c it did not separate the voting rights of the other two classes from their other ownership rights
    - Fact that new class of stock somewhat diminished the voting power of the other two classes does not make it a voting trust
    - **VOTING TRUST TEST:** voting rights of the stock are separate from the other attributes of ownership; voting rights granted are intended to be irrevocable for a definite period of time; principle purpose of granting voting rights is to acquire voting control of the corp.
  1. **Ling & Co. v. Trinity Savings and Loan**
    - **TRANSFER RESTRICTIONS: IN ARTICLES & CONSPICUOUS**
    - restrictions on transfers of stocks are legal and helped to reinforce the closely held nature of the corporation (cannot be a restriction stating that stock could never be transferred b/c unreasonable)
    - person borrowed money from bank and pledged his stock as collateral - loan was not repaid and bank tried to take the stock - company states that there was a restriction and so bank cannot have stock
    1. Conspicuousness Test:
      - a. Texas Business Corp. Act: passed test b/c it had the restrictions on the back which were referenced on the front of the certificate
      - b. UCC: did not pass test b/c it was not printed in capital letters or in contrasting type or color as to be noticed by the reasonable person → 2<sup>nd</sup> part of test: restriction is effective against the person who had actual knowledge of the restriction, whether or not it was conspicuous → need trial for determination (bank must prove it did not have knowledge)
    1. Reasonableness Test
  1. **Buy-Sell Agreements**
    - a. company may set this up with a transfer restriction
    - b. there is usually not a ready market for the stock, the agreement can bring about some fairness in the price of the stock for someone who wants to retire and sell his stock
- A. DEADLOCKS
1. **Gearing v. Kelley 1962.**
    - 50/50% deadlock and one party refused to attend meetings so that a director could not be elected (no quorum)
    - court ordered new election b/c she stayed away from the meeting with unclear hands to defeat the vote, which will not be condoned

1. ***In re Radom v. Neidorff, Inc***

- **DISSOLUTION OPTION**
- brother and sister fighting each other
- relied on provision for dissolution stating that we are not getting along and do not plan to
- court holds that brother not getting paid a salary is not enough without more to dissolve the company - court has absolute discretion
- court felt that the company was making profits and that the invisible hand of the market would reach in and make the two get along
- **SIDENOTE:** is all parties want dissolution, they can take a vote to do so, file regarding the requirements, divide cash, pay creditors, etc.

Modern Remedies for Oppression, Dissension and Deadlock

1. ***David v. Sheerin***

- deals with a **buyout**: court declares that they can provide the remedy
- court decides proper price and other provisions, one part is left to run the company and the other goes on about his business - would not otherwise happen without insistence of the court

1. ***Abreu v. Unica Industrial Sales***

- Illinois Statute cites remedies available to court:
  - a. appoint provisional director
  - b. appoint custodian or
  - c. order a buyout

A. ACTION BY DIRECTORS (law has something to say about how the director must act in order to bind the corporation)

1. ***Baldwin v. Canfield***

- King was principle shareholder in company and obtained a personal loan from Baldwin with his stock as collateral; stock was based on real estate owned by the corp.; King sold real estate for bonds
- King defaulted on loan, bank brought suit against King b/c they have a claim for the shares (collateral); however, the real estate which stood behind the shares have been sold to Canfield; King and corp were on the run with the bonds
- Had to grasp onto a concept to invalidate the real estate transaction, in this case it was that the directors all signed in different places and at different times

1. ***Mickshaw v. Coca Cola Bottling***

- def would pay difference between what he received from military service and what he would have received had he continued to work for pl
- def stated that it was not a contract b/c did not have proper process and procedures
- court willing to accept less formalistic action than court in Baldwin and upholds the contract by making various assumptions

1. ***Cooke v. Lynn Sand & Stone Company 1994***

- corp resolution empowered president to approve and sign contracts
- president made secret contract and did not tell company until they decided to sell itself and pres tried to make his contract legitimate
- signifies changes in law and legislative reform which allows presidents of companies to sign contracts and make arrangements with much less formalistic requirements involved
- agreement which allowed president to take action was overruled b/c clear breach of fiduciary duty and unfairness (fiduciary duty principle come through and undue something which would otherwise occur)

A. AUTHORITY OF OFFICERS

1. Corporation is Only Bound if there is:

- a. **Actual Authority:** corp has provided authority through resolution, employment contract or some direct order to the agency of the corporation to carry out certain acts; mutual authority
- b. **Apparent Authority:** based upon what someone who does business with the corp reasonably should believe; not based upon specific order given by the corporation to the agent
- c. **Estoppel Power:** similar to apparent authority; legal construct derived from law of equity; tries to say to a principle that if you sent out messages to the world that an agency has the authority to act for the corporation and the world acted in reliance upon those messages
- d. **Inherent Agency Power:** catch-all category which attempts to hold a corporation liable based on the agency relationship itself; makes sense in society that one would need others to act for you, but if you engage in this act, you will be responsible depending on what you do - **respondeat superior**

A. AGENCY LAW

1. Directors are not agents and agency does not apply

2. Mutually consensual relationship
3. If the agent had proper authority, the principle is bound
4. Types of Authority created to hold the principle bound to the agreement created by the agent, when the third party attempts to do so
  - a. Actual Authority
  - b. Apparent Authority
  - c. Estoppel Agency Power
  - d. Inherent Agency Power

## I. CONTROL AND MANAGEMENT OF PUBLIC CORPORATIONS

### A. PROXY REGULATION

1. stockholder is the principle and person seeking proxy (right to exercise the vote of a shareholder) is the agent
2. Situations in which proxies are sought
  - a. directors who are seeking to be re-elected
  - b. directors who have some corp action that need shareholder approval
  - c. someone trying to kick directors out
1. mostly used in large public settlings
2. **Statutory Mandates:** When soliciting proxies, one must:
  - a. provide disclosure in a statement that
  - b. is accurate and not misleading and which is
  - c. written
1. **Securities and Exchange Act of 1934**
  - a. ongoing period and continuous disclosure documents
  - b. **ONLY PUBLIC COMPANIES ARE REGULATED**
    1. § 15(d) - when company has filed 1933 act registration statement to go public and sold stock as public, you are public
    2. § 12(a) - if your stocks are exchanged on any national stock exchange (or regional exchange)
    3. § 12(g)(1) - if you have 500 shareholders and \$10mill in assets

### A. SECURITIES ACT OF 1933

1. Concern is with the offer and sale of securities
2. Registration and prospectus statement
3. § 5 lays out the different phases of business process and creates three periods (pre-filing, registration period, and post-effectuation period)
4. § 3 or 4 → private offerings through one of the exemption sub-sections
5. Balances need of company to raise funds through sale of stock and investors interest in making an informed decision (integrity of market)

### A. SECURITIES AND EXCHANGE ACT OF 1934 (see #5 above)

#### B. *Studebaker v. Gitlin* 1966

- **PROXY SOLICITATION**
- corp would not turn over shareholder's list to Gitlin - NY law stated if 5% of the shareholders requested it, it would be granted
- company sued Gitlin stating that if you are soliciting proxies in a corp that is registered as public, with regard to votes for a corporate meeting, it must be done in a certain regulated manner
- **RULE:** any communication to shareholders that seeks shareholder support in an action that is a continuous plan intended to end with solicitation of shareholders to vote is a proxy solicitation and required to comply with proxy solicitation rules

#### A. *In the Matter of Caterpillar* 1992

- **PROFITS**
- Caterpillar did non comply with SEC rules to provide info about its Brazil subsidiary earnings
- Cat did not disclose the source of the extraordinary profits nor that they would not exist next year b/c of new Brazilian political administration
- **HOLDING:** failure on the part of management to discuss and disclose info that created unclearness on continued profitability of Brazil subsidiary = violation

#### A. *JJ Case v. Borak* 1964

- **PRIVATE RIGHT OF ACTION**
- **ISSUE:** whether a private cause of action existed for 14a-9 violation, YES
- **HOLDING:** there is an implied right of action for private shareholders and that the passage of § 14(a) was intended to prevent management from obtaining authorization for corporate action by deceptive or inadequate disclosures

- Regulation was intended to protect investors and thus not unreasonable to let investors sue for violations where there is fraud by corporation
- Stricter standard for private cause of action exists today but still good law
- A. Elements of **Fraud** to Make Case under § 14(a)
  1. Materiality: substantial likelihood that a reasonable shareholders would consider it important in deciding how to vote
  2. Causation: no need to provide causation link in merger case so long as the misstatement or omission was material, the causal relation between the violation and injuries was sufficiently established
  3. Reliance: look on proxies for standard
- A. **TSC Industries v. Northway**
  - **PROXY STATEMENT OMISSIONS**
  - N complained that they voted for liquidation of TSC without being informed by Natl that they controlled TSC
  - Objective statements and questions or omissions in proxy statements are not material
- A. **Virginia Banskshares v. Sandberg**
  - **IF MINORITY VOTES NOT NEEDED, THEY MAY NOT SUE**
  - outside opinion stated that \$42 was appropriate price for buyback of minority shareholders' stocks; minority shareholders did not give approval but the merger went through anyway; minority holders state that \$60 was fair price
  - **RULE:** there is no private recovery for misstatements to a member of a class of minority shareholders whose votes are not required by law or corporate bylaws to authorize the transaction giving rise to the claim
  - Majority shareholders were not deceived and so minority can't sue
  - Does not matter how deceptive the proxy statement was, there can be no recovery b/c the proxy statement is not what allowed the merger to occur
- A. SHAREHOLDER PROPOSAL
  1. § 240.14A-8 → provides for use of shareholder's position to be addressed or voted on
- A. **Rauchman v. Mobil Corp. 1984**
  - **PROPOSAL EXCLUSIONS**
  - pl owns shares in Mobil and submitted proposal stating that citizens of OPEC countries can't serve on the board; already an OPEC citizen on board who is up for reelection
  - **HOLDING:** proposal is excludable b/c it relates to the election of board members into office
  - Shareholder was not able to vote for pl's proposal and vote to keep the OPEC citizen on the board at the same time

## I. DUTY OF CARE AND THE BUSINESS JUDGEMENT RULE

- A. Introduction
  1. Fiduciary duty owed by director, officer, manager, employees and agents
  2. Violation: who can sue
    - a. insiders can sue but outsiders cannot b/c duty is to shareholders
    - b. 3<sup>rd</sup> parties may sue under piercing the corporate veil, but not for duty
  1. Statement of Duty: must in handling the corporation's affairs, behave with the level of care that a reasonable person in similar circumstances would use
  2. Liability
    - a. director or officer can be held personally liable to pay damages to corp
    - b. usually only find breach with directors engage in self-dealing
    - c. director or officer has failed to comply with reasonable procedures for making decisions or was grossly negligent or reckless
- A. **Litwin v. Allen 1940**
  - **DUTY OF CARE**
  - MP needed to raise money and sold its debentures to A who held them as assets until they needed cash and sought to sell the debentures
  - **DEBINTURES:** could be converted to stocks at a later date; would show up as liabilities on a balance sheet; holders are unsecured creditors
  - Directors were keeping the interest and selling away the profit opportunities
  - **HOLDING:** directors did not meet the standard of care or fiduciary duty to handle stockholder's money
  - If value of bonds was higher at end of option period, seller would buy back into a profit; if bonds had lesser market value, he would not buy them back (any gain would be taken by the seller at the expense of the company buying into a loss)
- A. **Shlensky v. Wrigley 1968**
  - **BUSINESS JUDGMENT RULE**
  - shareholder upset b/c he feels the directors acts to be improper: losing money b/c not playing night games

- *Business Judgment Rule: judges are not business experts; comes into play in duty of care cases and states that you do have to be careful when dealing with other people's money but don't have to be perfect*
- *So long as what the owner did was within reason and within the scope of his authority, it will be upheld*
- *Courts should only intervene when behavior is arbitrary or capricious*

A. **Francis v. United Jersey Bank 1981**

- **DIRECTOR IGNORANCE**
- *upon death of husband, wife became a director but had not become familiar with the business; sons were stealing money*
- *bankruptcy trustee trying to get money into hands of creditors and lists wife as def. - court does not excuse wife's ignorance*
- *wife was already dead → bankruptcy trustee could not find evidence to pin the sons → liability would be placed on wife's estate and would prevent sons from taking money from the estate*

A. **Smith v. VanGorkam**

- **BJR = GROSS NEGLIGENCE (PRICE FOR STOCK)**
- *VG derived \$55 price for stock (\$38 in the market) by asking inside financial persons to run the numbers*
- *Directors duty is to get the best price for the stock in the interest of the corporation and shareholders, not make the deal attractive to the buyers*
- *VG facing mandatory retirement, wanted the deal to go through quickly, owned 75,000 shares, was going to make a fortune, regardless of the price*
- *Directors had not satisfied the business judgement rule with the threshold test of gross negligence*
- *Duty of care is often used to punish cases which are really duty of loyalty case but which cannot be proven with the facts*

ISSUES TO NOTE:

1. *meeting last two hours, merger agreement never presented nor read*
2. *most important decision company could make, made quickly*
3. *how process appears to court after the fact (no documentation)*
4. *no outside fairness opinion*
5. *other offers were not shopped, sought, nor obtained*

A. Legislative Action After *Smith v. Van Gorkam*

1. Delaware legislature provided a basis whereon directors could be excused from liability for monetary damages for certain types of fiduciary duty
2. Many state codes added things permissible in articles of incorporation
  - may eliminate or limit personal liability of the director for monetary damages for director breach of fiduciary duty (limited to duty of care)

A. **Gall v. Exxon New York**

- **derivative suit** = *shareholders sue on behalf of the company to vindicate a right and the directors of the company refuse to sue → shareholder suing on behalf of corp and any proceeds go to the corp*
- **direct suit** = *shareholders sue on behalf of themselves*
- *possible for directors to submit a motion to have the derivative suit knocked out without a determination on the merits*
- *shareholders suing b/c corp was paying money to Italian political parties*
- *court refused to rule on whether or not the company should or should not have been paying the bribes*
- *primary suit was against the directors for paying the bribes and the second suit is against the directors for refusing to sue itself (the corp)*

1. HYPOTHETICAL

- *linen company supplies to children's center which cannot pay their bill*
  - *corp appoint special litigation counsel and decides not to sue center*
  - *Joe initiates a derivative lawsuit:*
    1. *primary cause of action against center for contract breach*
    2. *against the directors for failure to sue the children's center*
  - *strike a balance between rights of directors to manage the corp and the shareholders rights to sue on behalf of the corp*
1. Application of Duty of Care (with regard to derivative suits)
    - a. *shareholder could not sue for breach of contract between a third party and the corp b/c he lacks standing, so he files a derivative suit*
    - b. *allowance by law for limited suits to do for the corp what the directors should have done*
    - c. **derivative suits governed by the business judgment rule**

- d. shareholders must file the suit and plead with particularity the harms that were done (difficult b/c of lack of information from the corp which they will resist giving to shareholders)
- e. rebuttal presumption of innocence on the part of the directors when dealing with the business judgment rule

#### 1. FOOTNOTE 31

- a. factors cited in reaching decision: unfavorable prospectus for success of litigation, cost of conducting litigation, interruption of corporate business affairs, and the undermining of personnel morale
- b. often cited in motions to dismiss derivative suits without proceeding to the merits

#### A. *Zapata Corp v. Maldonado* 1981 - Delaware Case

- **DEMAND EXCUSED = FUTILITY**
- *involved futility b/c suit was against directors who were going to get more money from the deal and would not sue themselves*
- *demand excused*
- *Steps to follow when filing derivative suits:*

\*\*Make a demand of the directors to sue (administrative exhaustion)(demand is required unless you can show that the demand would have been futile)

#### a. demand required

- demand is made
- board accepts the demand and takes over the lawsuit (highly unlikely) or the board sets up a special litigation committee (devised of members of the board) which conducts the investigation and prepares a report making a recommendation to reject the lawsuit and the plaintiff sues
- court uses a test: the business judgment rule → when demand is required, made and refused, the decision of the corporation will be upheld unless wrongful (grossly negligent, violated duty of loyalty, intentionally bad faith behavior)

#### (b) demand excused (due to futility)

- shareholder sues
- special litigation committee set up by corporation
- corporation files motion to dismiss, discovery
- court uses test: business judgment rule II (if the corporation is already tainted, it will not have the benefit of the original business judgment rule) → two steps
- i. court inquires into the independence and good faith of the committee and the bases supporting its conclusions → rebuttable presumption taken away from corporation which now has the burden of proving independence, good faith, and a reasonable investigation, rather than presuming these things
- ii. court should determine, applying its own independent business judgment, whether the motion should be granted → now using the court's business judgment rather than presuming that the corporation's is correct

#### A. *Aronson v. Lewis* Delaware

- **DETERMINING FUTILITY**
- *after business judgment rule II was laid out in Zapata, all cases were being brought forth by pls as demand-excused due to futility*
- *Rule re: the determination that there was no futility:*
  1. *directors are disinterested and independent and*
  2. *the challenged transaction was otherwise the product of a valid exercise of business judgment*

#### A. *Cuker v. Mikalauskas*

- PA case, court does not like Delaware formulation, instead draws upon ALI principles and formulates their own rule

- *Felt that using business judgment rule II contradicted a long line of PA cases and did not have adequate procedural framework*
- *Although Delaware rule influential in country, might not apply in all cases*

### I. DUTY OF LOYALTY AND CONFLICT OF INTEREST (self-dealing)

#### A. Duty of Loyalty

- means that key players (directors, officers, controlling shareholders) may not put their interests ahead of the those of the corporation and shareholders
- when sued, there are two causes of action:
  - a. Breach of Duty of Care
  - b. Breach of Duty of Loyalty (anytime there is duty of loyalty, arguments, throw in duty of care and the business judgment rule)

#### 1. Delaware Test (Safe Harbor)

- a. disclosure of material facts followed by affirmative votes of disinterested directors
- b. shareholder vote and specifically approve in good faith

- c. transaction is fair
  - 1. Transactions that Involve Duty of Loyalty
    - a. **Self-Dealing Transactions**
      - key player and corp are on opposite sides of the transaction and the key players financial interests are involved and different than the corporations interests
      - **RULE** = self dealing transaction that is held by the courts to be fair will be upheld even if it was not approved by a disinterested board
      - Categories of self-dealing
        - 1. fair transactions: will be upheld
        - 2. waste/fraud: will be voided if shareholder complains
        - 3. middle ground: courts response depends on whether there was director approval and/or shareholder ratification
    - a. **Executive Compensation**
      - 1. Categories of Compensation
        - a. current payments, salary and annual bonus
        - b. stock based incentive arrangements (stock options, restricted stock, phantom stock, stock appreciation rights)
        - c. pension and other deferred cash compensation
      - 1. **RULE:** an executive or director compensation scheme is much more likely to be upheld if either
        - a. a majority of disinterested directors have approved it following disclosure of all material facts or
        - b. shareholders have approved it following disclosure
    - 1. **FAIRNESS IS THE KEY**
      - a. **Corporate Opportunity Doctrine**
        - 1. issue is not about fairness - if key player appropriates to himself some business opportunity or property that is found to belong to the corp, it is per se wrongful and the corp may recover
        - 2. Test for Determining:
          - a. Interest or Expectancy Test = looks at whether the corp has an interest or expectance in the opportunity
          - b. Line of Business Test = an opportunity is a corp one if it is closely related to the corp's existing or prospective activities
          - c. Fairness Test = court will measure unfairness on particular facts of a fiduciary taking advantage of an opportunity when the interest of the corp justly called for protection
          - d. Two Step Test (combines business and fairness tests) = even if the opportunity comes within the corporation's line of business, the officer won't be held liable for usurping if he can show that the conduct was fair to the corp
- A. **Marciano v. Nakash**
  - **SELF-DEALING**
  - *two families each own 50% of the stock*
  - *allegation: there was an interested transaction when N made loan of \$2.5 million to the corp b/c the corp needed the infusion of cash*
  - *upon liquidation of the corp, M are trying to state that the loan is not proper and should not be repaid before families split what is left*
  - *(Loans that should be attacked are those that have high interest rates or those made from the company to the shareholders with no interest)*
  - *as business has become more complex and sophisticated, interested transactions were deemed valid so long as they were not unfair to the corp.*
    - a. *disclosure*
    - b. *disinterested approval*
    - c. *fairness*
- A. **Fleigler v. Laurence**
- B. **Sinclair Oil v. Levien**
  - **PARENT / SUBSIDIARY**
  - *question about whether duty of loyalty or duty of care applies*
  - *Sinclair owns 97% of Sinven; Levien owns remaining 3%; parent needed money and forced Sinven to pay dividends*
  - *Court holds that b/c the parent did not get wrongful cash through the dividend payment, the business judgment rule should apply*
  - *Evidence did not show that minority shareholders (Levien) did not also benefit from the dividend payments*

- Parent breached contract with subsidiary and did not pay the money → leans more toward self dealing b/c parent had money for longer period of time, thus duty of loyalty breach and fairness test apply

#### A. **Weinberger v. UOP**

- **FAIRNESS = FAIR DEALING AND FAIR PRICE**
- merger where all shareholder's stocks would be cashed out, even those who voted in opposition to the plan
- pl b/c of procedural rules could not attack the merger and so used the fiduciary duty concepts to get around that (**DELAWARE**)
- there was a breach of the duty of loyalty by the company b/c there was a conflict between the company as the majority shareholder and the minority shareholders
- process of determining the price was not fair nor adequate
- Concept of Fairness has Two Aspects:
  1. fair dealing = when transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and shareholders were obtained
  2. fair price = economic and financial considerations of the merger including assets, market value, earnings, future prospects, and any other element that affect the intrinsic or inherent value of the stock

#### A. **Northeast Harbor Golf Club v. Harris**

- **CORPORATE OPPORTUNITY DOCTRINE**
- Business opportunity that belongs to the corp is taken by the fiduciary who might have an obligation to secure the opportunity for the corp
- Still have problems with self-dealing and conflict of interest
- President of golf club bought parcels of land abutting and surrounding
- Impression was created that pres was not going to pursue development and so directors did not raise a fuss when she originally purchased land
- Court rejects the line of business and fairness tests
- Court adopts the **American Law Institute (ALI) approach**:
  - a. strict requirement of full disclosure prior to taking advantage of any corporate opportunity
  - b. corporation must then formally reject the opportunity
  - c. once the club show that the opportunity is indeed a corporation opportunity (closely related to a business in which the corp is engaged) it must show either that Harris did not offer the opportunity to the club or that the club did not reject it property
    - **\*\*\*may add statement into articles of incorporation allowing directors to pursue activities similar to those of the corp without liability**

### I. TRANSACTIONS IN SHARES

- only area of the law which attempts to police transactions, deals with issuance of stock and later trading of those securities

#### A. **RULE 10b-5**

1. Promulgated based on the authority of §10(b) of the 1934 Exchange Act
2. Applies to Both Public or Private Corporations → *Kardon*
3. Implied Private Right of Action → *Kardon*
4. Purchaser-Seller Rule (Standing) → *Blue Chip*
5. Scienter as an Element (common law fraud elements) → *Ernst & Ernst*
6. Rule 10b-5 is not co-extensive with fiduciary duty → *Sante Fe*
7. Statute of Limitations (one year after discovery or three years after action)
8. Aiding and Abetting claims can be pursued under Rule 10b-5

#### A. **Kardon v. National Gypsum**

- **PUBLIC & PRIVATE SECURITIES - IMPLIED PRIVATE RIGHT OF ACTION**
- 10(b) of the 1934 Act extends beyond the rest of the act which requires corps to be public in order to be regulated by the act - 10(b) applies to both public and private securities
- two directors (of four) made arrangements with NG to sell the stock for \$1.5mill; bought out the other two directors for \$1/2 mill. without telling them of their plans; and proceeded to sell the company and make a \$1mill profit
- determined that 10b-5 could be the basis of a private right of action

#### A. **Blue Chip Stamps v. Manor Drug Stores**

- **MUST BE ACTUAL PURCHASER OR SELLER**
- reorganized public offering required
- claim by person who was offered an opportunity to purchase securities but failed to do so b/c of materially misleading and overly pessimistic prospectus statements

- *RULE: you must have either purchased or sold the security in order to sue - if you would have sold or would have purchased but did not, too bad*
- *Represents the increasingly narrow reading of Rule 10b-5*
- A. **Ernst & Ernst v. Hochfelder**
- **SCIENTER = FRAUD**
- *scienter is an aspect of 10b-5 cases and must be proven*
- *common law fraud elements are part of Rule 10b-5*
- *pres set up arrangements whereby he possessed high-yielding escrow accounts that did not exist, respondents sent money directly to him and everyone in the office was ordered not to touch pres's mail for 22 years; money was gone and pres committed suicide*
- *accountants at Ernst were supposed to be auditing the books and failed to catch this behavior*
- *accountants were definitely negligent but respondents did not prove scienter and negligent conduct alone is simply not enough to sue under Rule 10b-5*

#### E. **Sante Fe Industries v. Green**

- *Rule 10b-5 is not co-extensive with fiduciary duty*

##### A. **Insider Trading**

Must Remember to Also Prove the Basics (materiality, causation, etc.)

##### 1. **SEC v. Texas Gulf Sulphur Co**

- *classic insider trading*
- *knew that more minerals were found in the mine than was released to the public and bought stock based on that insider knowledge*
- *director's began buying shares and call options and eventually got caught for violating Rule 10b-5 along with their fiduciary and loyalty duties*

##### 1. **Chiarella v. United States**

- **PRINTER NOT INSIDER = NO DUTY**
- *Rule 10b-5 violations may be criminal or civil cases*
- *Acquiring co is launching a hostile tender offer for a hostile take over of a target company*
- *Acquiring company took an offer above the market price to the shareholders*
- *Printer decodes deal and buys stock in target company, knowing that a premium price is about to be for it by acquiring company*
- *First known criminal proceeding for insider trading in country*
- *Court deems printer not guilty b/c classical theory of Rule 10b-5 insider trading is that you have to have a duty to the company or the shareholders of the stock which you purchased and printer is not an insider and had no duty*
- *SEC promulgated Rule 14e-3 in response to their disappointment in this decision (could only apply new rule to tender offers b/c could not overrule supreme court's decision here)*

##### 1. SIDENOTE

- a. RULE 10b-5
  1. **Classical Insider Trading:** based on insiders who had a duty
  2. **Misappropriation Theories:** requires duty to the source, would hold those liable under traditional theory plus more, includes insiders and outsiders
- a. RULE 14e-3 Tender Offer Theory (pg 860): No Duty Required at All

##### 1. **United States v. O'Hagen**

- **Misappropriation Theory:** *material information insider or outside the company; if someone fields the information and violates a duty, he would be liable (duty could be inside or outside the company) - if you steal the information from anyone inside or outside the company, you could be liable*
- *Supreme Court accepted both theories of Rule 10b-5*
- *Lawyer with a firm who was helping an acquiring company pull off a hostile take-over used cash from the client trust funds*
- *Lawyer did not have a duty to the shareholders of the company but was liable*

##### 1. **United States v. Chestman**

- **FAMILY**
- *nature of the fiduciary rule under 10b-5 and how the duty does not automatically flow from family relationships*
- *not just any family relationship constitutes a duty*
- *characteristics: dependency, influence, trust, and confidence*
- **RULE:** *family relationship do not impose a per se duty*

- *Affirmed conviction under 14e-3 but reversed under 10b-5*
- *Court was able to affirm under 14e-3 b/c no duty is required*

#### **1. Dirks v. SEC**

- *tippee liability*
- *tippee tipped off investment banker that there was fraud in his company; banker tried to tell others including SEC who would not listen; banker told his clients who sold their equities and avoided losses*
- *HOLDING: investment banker not liable*
- *RULE:*
  1. *Tippee must have a duty but the duty is derivative from the insider (tipper's duty)*
  2. *insider must provide the information to the tippee in breach of his duty &*
  3. *the tipper (insider) must be seeking personal benefit*
- *Tippee was not doing it for personal benefit but b/c he was concerned about the fraud in his company*
- *You go as far down the chain as you have derivative duties*

#### **A. Securities Fraud**

##### **Basic v. Levinson**

- *securities fraud occurred in the context of a merger agreement; when you disclose merger discussions, you can't lie, which the company did when confronted*
- *there was heavy trading after merger talks and when asked about it, the president stated that he had no reason to speculate why it was occurring*
- *after lying again, they were caught and sue*
- *RULE: it is material if there is a substantial likelihood that a reasonable shareholder would consider it when determining which way to vote (PSC Ind)*
- *MATERIALITY RULE: particularized test for contingent and speculative events = balancing between the probability that the event will occur along with the anticipated magnitude of the event (small magnitude will take much greater likelihood of occurrence)*
- *RELIANCE RULE: If you lied to the market about the information, you have defrauded the market, the market has miscalculated the price of the stock, and the investor is considered to have traded in reliance by a statement or omission from those who had a duty to deal truthfully with the market = investor can be derivatively defrauded through defraudment of the market*