

## Corporations Outline

- I. SOLE PROPRIETORSHIPS:** A business structure without a legal structure. The business and its owner are the same actual person and same legal person.
- a. If there are workers, the sole proprietor bears direct liability for their compensation.
  - b. The sole proprietor may also be liable for the acts/omissions of workers.
  - c. **Growth**
    - i. Contribution of capital.
    - ii. Issuing debt
      - 1. Selling bonds/IOUs
      - 2. Drawing on a line of credit
      - 3. Secured v. Unsecured
    - iii. Issuing Equity
      - 1. Selling stock in the company
      - 2. Equity is ownership. Can't issue equity if you wish to sole proprietorship.
    - iv. Issuing convertible debt.
  - d. **Borrowing Options**
    - i. Offer personal or "business" assets as collateral to secure the loan.
    - ii. Agree to a quick maturity date.
    - iii. Give the creditor some degree of control over business decisions.
    - iv. Offer to share some percentage of business profits.
      - 1. Danger of creating partnership relationship.
- II. AGENCY PRINCIPALES:**
- a. Essential Characteristics
    - i. Manifestation of assent by one person (the principal) to another (the agent) that the agent shall act on the principal's behalf and subject to the principal's control, and agent manifests assent or otherwise consents.
    - ii. The agent owes fiduciary duties to the principal in discharging the act.
    - iii. Must be consent by the agent so to act.
  - b. **Actual Authority:** Manifestations from the principal to the agent that the agent reasonably believes creates authority.
    - i. **Restatement 7 Definition:** Actual authority is the power of the agent to affect the legal relations of the principal by acts done in accordance with the principal's manifestations of consent to him. [P → A]
      - 1. EX. The principal simply tells the agent that the agent is empowered to act on the principals behalf in accomplishing some task.
    - ii. **Creation of Actual Authority:**
      - 1. Written words of the principal which, reasonable interpreted, causes the agent to believe that the principal desires him so to act on the principals account.
      - 2. Spoken words of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principals account.
      - 3. Other Conduct of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principals account.
    - iii. **Actual Express Authority:** When the principal expressly gave the agent the power to undertake the act on his/her behalf.
    - iv. **Actual Implied Authority:** An agent has the authority to do what is reasonably necessary to get the assigned job done, even if the principal did not spell it out in detail.
  - c. **Apparent Authority:** Created by manifestations by the principal to a third party. (Does NOT require detrimental reliance by the third party on principal's manifestations).
    - i. Manifestations MUST:

1. Be attributable to the principal.
  2. Get to the third party.
  3. Lead third party to reasonably conclude that the agent is an agent for the principal.
- ii. **Restatement 8 Definition:** Apparent authority is the power to affect the legal relations of another person by transaction with third persons, professedly as agent for the other, arising from and in accordance with the others manifestations to such third persons. [P → 3p]
  - iii. **Creation of Apparent Authority:**
    1. Written words of the principal which, reasonable interpreted, causes the agent to believe that the principal desires him so to act on the principals account.
    2. Spoken words of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principals account.
    3. Other Conduct of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principals account.
    4. **Manifestations of Principal Consent may be:**
      - a. Direct (Words spoken to the 3<sup>rd</sup> person)
      - b. Indirect (public signs, advertisements, continuous employment of the agent, etc.).
- d. **Inherent Authority (Inherent Agency Power):** Agent has inherent power to act on Principals behalf due to Agent's position.
- i. **Restatement 8 Definition:** This power derives not from actual authority, apparent authority or estoppels, but solely from agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent.
- e. **Agency Principles: Employer/Employee Relationship**
- i. **Respondeat Superior:** The principal may be liable through the actions of their agent. The principal's liability is vicarious or secondary and does not depend on the principal being negligent. (**Only applied to Master/Servant relationships, NOT all principal/agent relationships**).
    1. **Servant:** Is employed to perform services for another AND is subject to the others control (or right of control) with respect to the physical conduct in the performance of the services.
    2. Tort must have been committed within the scope of employment.
      - a. **Frolic (Outside the scope):** Action was not motivated in any way to serve the master.
      - b. **Detour (Within the scope):** A slight deviation from master/servant duties.
    3. **Master/Servant Control Factors;**
      - a. Extent and control of Master over Servant over Servants work.
      - b. Employed in distinct occupation/service
      - c. Practice of trade in locality
      - d. Does master provide tools/place of work.
      - e. Length of employment.
      - f. Method of payment.
      - g. Is the work part of the business of the master?
      - h. Subjective belief of parties to create relationship.
  - ii. **\*\*NOTE\*\* Independent contractors can be agents or non-agents FOR CONTRACT LIABILITY PURPOSES.**
- f. **Agency Principles: Attorney/Client and Other Relationships**
- i. Lawyers are agents (*Hayes* case – lawyer apparent auth. to settle)
  - ii. Clients are principals.
  - iii. The relationship is unique given the roles lawyers play in the larger society.
- g. **Franchisor-Franchisee**

- i. The franchisor-franchisee relationship is not always that of principal-agent.
- ii. External facts govern, regardless of the verbalizations of the parties.
- iii. The principal-agent relationship will exist if the franchisor and franchisee satisfy RSA 1.
- iv. Vicarious tort liability exists only if the franchisor has the requisite heightened level of control (ie: control over day-to-day operation).
- v. Court may not use the “master/servant” terminology, but the analysis is similar.

**III. PARTNERSHIPS:** An association of two or more persons to carry on, as co-owners, a business for profit.

**a. Essential Characteristics**

- i. More than one owner, the business is a partnership by legal default.
- ii. A partnership is an entity separate and distinct from its partners.
- iii. Assets – Partnership assets are partnership assets, not the assets of the individual partners. (RUPA §203).
- iv. Liabilities – In general, partners share joint and several liability for partnership liabilities (RUPA § 306(a)).
- v. Taxes – The partnership is a pass-through entity. Thus, income passes through the partnership to the individual partners in the form of distributions. Thus, the **partnership itself has no tax liability**. Rather, partners pay taxes on distribution made to them.

**b. Partnership Law**

- i. State Statute (typically modeled after UPA and RUPA provisions) serve largely as fall-back rules.
- ii. The primary source of partnership law or governance is the Partnership Agreement.
- iii. Partnership Agreement will trump the RUPA based statute regarding rights and obligations of the partnership agreement and its partners.
- iv. If the Partnership Agreement is silent on a given matter, then RUPA based provision will govern (except non-waivables under §103b).

**c. Operations**

- i. Ownership of Partnership Property
  1. Partnerships do own property (in the name of the partnership).
  2. The individual partners do not own partnership.
  3. Partners owe each other the duty of the finest loyalty (*Meinhard v. Salmon*). §404(b3)-must refrain from competing with the partnership before dissolution.
- ii. Decision Making:
  1. Partnership v. Third Parties
    - a. Courts look to the provisions of the relevant partnership statute and then to agency principles such as actual and apparent authority.
  2. Partner v. Partner
    - a. Courts look to the provisions of the partnership first, and then to provisions of the relevant partnership statute and then to common law agency principles.

**iii. Management**

1. Each partner is an agent of partnership for purposes of its business.
2. §401 – Difference re: ordinary biz decisions are decided by majority of partners; decisions outside OCoB must be via amendment to agreement, and require consent of ALL partners.

**iv. Liabilities of Partnership**

1. As separate legal entities, partnerships can sue and be sued (RUPA § 201).
2. Contract Liability?
  - a. Yes, with respect to those entered into by its agents on its behalf.
  - b. A third party can sue the partnership for the contracts entered by its agents.
3. Tort Liability?

- a. Yes, for torts of its agent committed while conducting partnership business.
    - b. A third party can sue the partnership for the torts committed by its agents.
  - 4. A partner can sue the partnership to enforce her rights under the Act or under the partnership agreement (RUPA § 405(b)).
  - 5. Liability order to creditors? *Fenmore* p. 58
- v. **Liabilities of Partners**
  - 1. Partners are jointly and severally liable for all obligations of the partnership (RUPA §§§305, 306, 307).
    - a. **Joint and Several Liability:** Plaintiff is free to sue one or more of the partners.
    - b. **Jointly Liability:** The plaintiff must sue all of the partners together in a single suit.
- vi. **Limited Liability Partnerships (LLPSs):** Partners are not liable for the debts of their partners (in CA, only for accounting and law firms).
  - 1. RUPA § 306(c) provides that an obligation of a partnership while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner.
  - 2. LLPs operate like any other general partnership.
  - 3. With respect to liability, there are two basic LLP statute groups
    - a. Limiting Liability for claims arising from actions of others.
      - i. Limits partner's liability for partnership obligations arising from negligence/conduct of other partners, employees, or representatives of the partnership
      - ii. Most statutes used to take this approach
      - iii. Note: The partnership itself is still on the hook to the extent of its assets. The partner is still on the hook with respect to other obligations not specifically excluded by statute. The partner is still on the hook with respect to his own actions.
      - iv. The actions of those under his direct supervision and control
      - v. The partnership's contractual obligations
      - vi. Possibly, statutory claims (e.g., environmental liabilities) or successful partnership piercing-claims
      - vii. Modern statutes modify contribution and "distribution on dissolution" rules to accommodate the limited liability.
    - b. Limiting all vicarious liability.
      - i. Partner is protected from all partnership liabilities incurred while the partnership was an LLP
      - ii. Notes:
        - 1. Recently, many states have adopted this approach
        - 2. The ABA's Prototype and the NCCUSL's LLP Amendments adopt this approach
        - 3. The partnership itself is still on the hook to the extent of its assets. The partner is still on the hook with respect to his own actions
- 4. **How does a business become an LLP?**
  - a. Partnership must vote to register as an LLP
  - b. Partnership must file statement of registration with the appropriate agency.
    - i. Name of partnership (must include LLP).
    - ii. Street address of partnerships chief executive offices.

- iii. If no office in state, name and address of agent for process service.
    - iv. Statement of election to be an LLP.
    - v. Other state-required disclosures.
  - c. Satisfy/Complete certain other requirements
    - i. Pay necessary fees
    - ii. File periodic/renewal statement
    - iii. Obtain necessary insurance.
  - d. Foreign LLP's must generally register in a given state before conducting business there.
- 5. **What are the legal problems in starting an LLP?**
  - a. Problems may arise with respect to ascertaining the vote requirement
  - b. Some state statutes are silent on the issue
  - c. Other have varying requirements:
    - i. Majority approval
    - ii. Approval at the partnership agreement amendment level (MBCA General)
    - iii. Approval at the contribution amendment level (MBCA conditional).
- 6. **Growth**
  - a. Taking additional capital contributions from existing partners.
  - b. Adding partners (i.e., exchange new partnership interest for capital contribution).
  - c. Putting borrowed money or retained earnings to good use.
- 7. **How do LLP Owners Make Money?**
  - a. Receiving salaries
  - b. Receiving distributions
  - c. Selling partnership interests
- d. **Growth/Making a Business Grow**
  - i. Existing Owners
    - 1. Contribution of capital.
    - 2. Partners themselves agree on capital contributions – by whom, how much and when.
    - 3. Capital Contribution arrangements will typically be found in Partnership Agreement.
      - a. Provisions will state:
        - i. The vote or events that trigger the obligation to contribute
        - ii. The amount of each partners contribution obligation
        - iii. The time in which to make the additional contribution
        - iv. The consequence of a failure to contribute.
  - ii. Outside Lenders
    - 1. Get a loan. Usually secured on collateral.
  - iii. Additional Owners (i.e. Investors)
    - 1. Financial Issues
      - a. Investors, like lenders are going to balance the risk and returns. High risk would need a higher return. Lower risk would need a lower return.
      - b. Selling part of the partnership. In order to compute “return on equity” divide the amount the owner invested with the generated annual cash flow. The higher the amount of debt a business has, the higher the risk t the owner, and the higher the rate of “return on equity” that the investor will look for.
    - 2. Legal Issues

- a. RUPA § 401(i) requires the consent of all existing partners unless the partnership agreement provides otherwise in terms of new investors which would then mean new partners.
    - b. RUPA § 306(b) says a new partner is not personally liable for partnership obligations incurred before the persons admission as a partner.
  - iv. Earnings from Business Operations
    - 1. Partners fund growth by deciding not to take money out of the partnership.
    - 2. Earnings should be distributed unless the partnership has some lucrative use for the funds.
- e. Return on Investment
  - i. Salary
    - 1. A partner is not entitled to wages for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership (RUPA §401(h)).
  - ii. Profits
    - 1. Each partner is entitled to an equal share of the partnership profits and chargeable with a share of the partnership losses in proportion to the partners share of the profits (RUPA § 401(b)). But no absolute right exists as to distributions! §402
  - iii. Sale of Ownership Interest to a Third Party
    - 1. The only transferable interest of a partner in the partnership is the partner's share of profits and losses of the partnership and the partners right to receive distributions (RUPA § 502). Can't sell control.
  - iv. Sale of Ownership Interest Back to the Partnership
    - 1. "Buy-Sell" Agreement—it is common for the partnership agreement or some separate agreement among partners to provide for sale of partnership interests back to the partnership or to other partners.
      - a. Even if there is no "buy-sell" agreement, a partner has the power to compel the partnership to pay for his/her partnership interest by withdrawing from the partnership. What rule?
    - 2. **Withdrawal of a Partner (Disassociation) – Not all dissociations result in dissolution of the partnership.**
      - a. RUPA § 602 states that any partner has the power to dissociate at any time.
      - b. **Wrongful Withdrawal**
        - i. RUPA § 602(b) states that if the withdrawal or dissociation violates the partnership agreement, or occurs before the expiration of the partnership term, or satisfies any other circumstances set out in §602(b), it is 'wrongful'.
        - ii. If the dissociation is wrongful, the partner may be paid less than otherwise for his/her partnership interest and, more importantly, may be paid later. (Refer to RUPA §§602(c), 701(c), and 701(h). Wrongful withdrawal → liable to partnership for damages arising from withdrawal.
        - iii. A partner in a partnership at will can quit at anytime without it being wrongful.
      - c. **Events Causing Partner Dissociation (RUPA § 601)**
        - i. Partnership acquires notice partner's express will to withdraw.
        - ii. Dissociating event (per Partnership Agreement) occurs.
        - iii. Expulsion per Partnership Agreement.
        - iv. Expulsion per unanimous vote of the other partners under certain circumstances. §601(4) Unlawful to continue w/ partner, partner has transferred interest, corporate partner has dissolved.

- v. For an “individual”
  - 1. Death
  - 2. Appointment of guardian/conservator for the partner
  - 3. Judicial determination of incapacity
- f. **End Games:** Under RUPA, the partnership faces two choices when a partner dies or otherwise withdraws from the partnership. Either (1) the remaining partners can purchase the departing partner’s interest and continue the partnership business, or (2) the partnership can dissolve, liquidate, and terminate.
  - i. Dissolution:
    - 1. **Triggered Upon:**
      - a. Disassociation, expiration of term, event agreed in Partnership Agreement, unlawful activity, judicial determination of economic frustration or equitable to dissolve.
    - 2. **Partnership Accounts:**
      - a. On dissolution, the partnership must pay each partner the amount in his partnership account.
      - b. Partnership Account
        - i. Money I put in (+).
        - ii. Value of property I put in (net of liabilities) (+).
        - iii. My share of the profits (+).
        - iv. Money I received (-).
        - v. Property I received (net of liabilities assumed) (-).
        - vi. My share of partnership liabilities/losses (-).
      - c. On dissolution
        - i. Partnership accounts become a partnership liability
        - ii. After liquidation of the partnership assets and payment of partnership debts, net business profit/loss, if any, must be allocated equally to the partners; partners will be paid (or must pay in) according to their final account balance.
  - ii. Winding Up: Winding up the partnership business entails selling its assets, paying its debts, and distributing the net balance, if any, to the partners in cash according to their interest.
  - iii. Termination: On the completion of the winding up, the partnership terminates.
    - 1. The partners can agree to waive their right to a winding up and termination.
    - 2. The agreement must be unanimous, *including* any dissociating partner (other than one wrongfully dissociating).
    - 3. Waiver must occur post-dissolution and before the winding up is completed.
    - 4. Partnership continues as if dissolution never occurred.
  - iv. Expulsion (RUPA §601(3)-(5))
    - 1. Expulsion May Occur:
      - a. Per the Partnership Agreement
        - i. *Bohatch*- can expel for personal disagreements if not blocked by agreement (to maintain trust of partnership), but not in bad faith.
      - b. Per unanimous vote of the other partners
        - i. Non-individual “persons”
      - c. Per judicial determination (on application of the partnership or another partner)
        - i. Naughty partners
  - v. Freeze-Out: The holders of the majority interest force a minority owner to sell or otherwise give up her interest (*Page v. Page*).
    - 1. A partner at will is not bound to remain in a partnership, regardless of whether the business is profitable or unprofitable. A partner may not, however, by use of

adverse pressure “freeze out” a co-partner and appropriate the business to his own use. A partner may not dissolve a partnership to gain the benefits of the business for himself, unless he fully compensates his co-partner for his share of the prospective business opportunity. In this regard his fiduciary duties are at least as great as those of a shareholder of a corporation (*Page v. Page*).

#### IV. CORPORATIONS

##### a. Corporations in General

- i. **The Four Primary Sources of Corporate Law ARE:**
  1. State statutes.
  2. Articles of incorporation (necessary papers), bylaws and other agreements.
  3. Case law.
  4. Federal statutes
- ii. A corporation is a separate legal entity and its owners are called share/stock holders.
- iii. Share/Stock Holders generally not personally liable for debts of the Corporation.
- iv. Corporation is taxed and stockholders are taxed on dividends.
- v. S corporation can have only a certain number of shareholders.
- vi. State of Incorporation
  1. A corporation may incorporate in any state.
  2. Thereafter, the law of that state will govern internal corporate affairs (i.e. internal affairs doctrine).
  3. State law reference to “foreign” corporations refer to corporations incorporated anywhere outside that state.
  4. All states require foreign corporations transacting business in the state to “qualify to do business in the state”.
- vii. **Closely-Held Corporation:** Small corporations. They have relatively few shareholders and there is no public market for buying or selling interest in them.
- viii. **Public Corporation:** Large corporations. Many shareholders and the interests in them are publicly traded.

##### b. Formations

- i. Filing of Articles of Incorporation “necessary papers” (MBCA § 2.03)
  1. A corporation does not exist until the articles of incorporation are properly executed and filed with the appropriate state agent or agency (usually the Secretary of State).
  2. MBCA § 2.02(a) sets out what the articles of incorporation must contain.
    - a. A **corporate name** for the corporation that satisfies the requirements of section 4.01.
    - b. The **number of shares** the corporation is authorized to issue.
    - c. The **street address** of the corporation’s registered office and name of agent.
    - d. The name and address of each incorporator.
  3. MBCA § 2.02 (b)(1)-(5) explains what the articles of incorporation may contain.
    - a. Initial Directors.
    - b. Corporate Purpose.
    - c. Management.
    - d. Powers of Corporation, Board, Shareholders.
    - e. Par value for authorized shares. (& other stock rights)
    - f. Certain Bylaw provisions.
    - g. *Certain limitations on director liability.*
    - h. Certain director indemnification provisions.
  4. If the incorporators comply with all state laws in creating the corporation, a **“de jure”** corporation results.

- ii. **By-Laws (MBCA § 2.06(b)):** The bylaws may contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with laws or the articles of incorporation. Ie: meetings, composition of board, types/duties of officers.
  - 1. NOTE: No state requires the filing of bylaws.
- iii. **“Promoter”:** Someone who is acting on behalf of a corporation that is not yet formed.
  - 1. Promoter is personally liable on a pre-incorporation contract absent a contrary intent.
  - 2. **Corporation Adoption:** The corporation will be liable on the pre-incorporations contract only if it takes some action to adopt it. Can be done in TWO ways:
    - a. **Expressly Adopt:** Expressly adopt the contract.
    - b. **Implied Adopt:** If the corporation acts in accordance with the contract and thus impliedly adopting such contract. (i.e. contracting to lease a building, becoming incorporated, then moving into the building and paying the mortgage on the pre-incorporated contract).
    - c. **Ratification:** The affirmation by a person of a prior act done by another, whereby the act is given effect as if done by an agent acting with actual authority.
- iv. **Organizational Meeting §2.05**
  - 1. Appointment of Initial Directors.
  - 2. Appointment of Officers/Management.
  - 3. Adoption of Initial Bylaws.
    - a. Incorporator OR Board may adopt initial bylaws.
    - b. Bylaws need not be filed.
  - 4. Approve form of stock certificates.
  - 5. Approve corporate seal.
  - 6. Adopt pre-incorporation contracts.
  - 7. Issue stock.
- v. **De Facto Corporation:** If the corporation is not correctly created, one may be created at common law IF:
  - 1. Statutory incorporation was possible.
  - 2. There was a good faith attempt to comply.
  - 3. Business was conducted in the corporate name and with the exercise of corporate privileges.
  - 4. **Limitations:**
    - a. Those purporting to act as or on behalf of a corporation knowing that there was no incorporation may be held liable (i.e. they cannot avoid personal liability by claiming de facto corporation existence).
- vi. **Corporation by Estoppel**
  - 1. Persons previously treating the corporation as a corporation may not claim that no corporation existed.
    - a. Binds third parties interacting with corporation
    - b. Binds corporation interacting with third parties.
- vii. **Issuing Stock:** Shares of stock are the units of ownership in a corporation.
  - 1. MBCA § 6.03(a) provides a corporation may issue the number of shares of each class or series authorized by the articles of incorporation. Shares that are issued are outstanding shares until they are reacquired, converted or canceled.
  - 2. Benefits of Share Ownership
    - a. Right to vote, right to receive declared dividends, and right to residual assets (in order of priority). The rights are governed by the terms set forth in the Articles of Incorporation.
  - 3. **Classes of Shares**
    - a. Preferred Stock

- i. Series A Preferred
        - 1. *Cumulative*: If the board does not declare dividends, the corporation assumes a continuing, accumulating obligation to pay the unpaid dividends before it pays any future dividends.
        - 2. *Non-Cumulative*: Opposite of above.
        - 3. *Participating*: The right to participate with the common stock in any dividends declared on the common. You get your preferred rate as well as the common stock rate.
        - 4. *Non-participating*: Opposite of above.
      - ii. Series B Preferred (e.g. liquidation preference): a fixed price per share that must be paid in dissolution before any amounts are paid on the common stock.
      - iii. Series C Preferred (e.g. redemption preference)
    - b. Common Stock
      - 4. **Par Value**: The minimum price for which a corporation can issue its shares.
      - 5. **Stated Capital**: Aggregate of par value amounts paid for issued shares.
      - 6. **Capital Surplus**: Aggregate of amounts paid in excess of par value for issued shares.
  - viii. A corporation can be a shareholder of another corporation.
    - 1. **Subsidiary**: A corporation whose stock is owned by another corporation.
    - 2. **Parent Corporation**: The owner of the majority or all of the outstanding stock.
- c. Operations
  - i. Entity Liabilities
    - 1. The corporation can be held liable to third parties for contracts, torts, violations of statutes, etc.
    - 2. No personal liability to the shareholders/directors/officers.
    - 3. Piercing the Corporate Veil
      - a. In general, shareholders bear no responsibility for obligations of the corporation.
      - b. Under some circumstances, however, equity dictates that the corporate veil of limited liability be pierced.
      - c. Elements (*Dewitt Truck Brokers v. W. Ray Flemming Fruit Company*):
        - i. Proof of Fraud
        - ii. Substantial ownership of stock in a single individual.
        - iii. Undercapitalization
        - iv. Lack of Corporate Formalities.
        - v. No participation of other stockholders.
        - vi. Failure to pay dividends, while the dominant stockholder receives substantial sum of money.
        - vii. Nonfunctional directors.
    - 4. Corporate Control/Holding Parent Company Liable
      - a. Factors Courts Look to When Establishing Domination (*In Re Silicone Gel Breast Implants Liability Litigation*):
        - i. Common directors or officers
        - ii. Common business departments
        - iii. Joint financial and tax statements
        - iv. Parental financing
        - v. The parent uses the subsidiaries assets as its own
        - vi. Daily operations of the two firms are not kept separate.
        - vii. The subsidiary does not observe basic corporate formalities.
        - viii. Fraud or misconduct not necessary to pierce.

5. **Enterprise Liability:** This is a theory under which corporations that (although technically separate) are commonly-owned and engage in one enterprise should be treated as a single legal entity for purposes of liability. Ie: separate cab companies.
- ii. Management of the Entity
    1. Board of Directors
      - a. Decision-making body
      - b. “Chairman of the Board”
    2. “Management”
      - a. Chief Executive Officer (“CEO”)
      - b. President
      - c. Chief Financial Officer (“CFO”)
      - d. Executive Vice President
    3. Directors ≠ Agents; Officers = Agents of corp.
  - iii. Decision Maker Responsibilities
    1. Board of Directors (MBCA § 8.01): Board of Directors control the Corporation and are entitled to make the Corporations most important decisions.
      - a. **Duties of the Board of Directors:**
        - i. All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32 (MBCA § 8.01(b)).
        - ii. Board of directors have oversight of business performance, plans, major risks, performance and compensation of senior officers, policies and practices that foster Corporation compliance with law, financial statements, effectiveness of internal controls, arrangements for providing adequate and timely information for directors, and composition of the Board of Directors and its committees (MBCA § 8.01(c)).
      - b. Board of Directors is required except as provided in MBCA § 7.32.
      - c. Shareholders own the corporation
      - d. Cumulative vs. straight voting for directors
      - e. The Board of Directors controls the corporation (i.e., it has the power to make certain key decisions)
      - f. “Inside” Director
        - i. For example, a company officer who is also a director
      - g. “Outside” or “Independent” Director
        - i. A non-company person serving as a director
        - ii. No significant professional, financial, or similar relationships
          1. Ditto for family of director relative to company’s senior management
        - iii. Use judgment and prevailing facts and circumstances to determine whether someone is or is not an outside director
      - h. NOTE: A member of the Board of Directors is not an agent of the corporation or its shareholders
    2. Officers/Management
      - a. Management is charged with the day-to-day operations of the corporation
      - b. Officers are, in fact, agents of the corporation

- iv. Derivative Suits:** A shareholder sues to vindicate the corporation's claims. They stand in the shoes of the corporation in asserting the claim. The suit is derivative because the shareholders right to bring it derives from the corporation's right.
1. **Direct Shareholder Suit:** If the injury is one to the plaintiff as a stockholder and to him individually and not to the corporation, the suit is individual in nature.
  2. Standing Requirements MBCA §7.41: Any shareholder may not commence or maintain a derivative proceeding unless the shareholder:
    - a. Was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time; and
    - b. Fairly and adequately represents the interests of the corporation in enforcing the right of the corporation
  3. **Demand On Directors:** Most states require the shareholder who wants to bring a derivative suit to make a *written demand* on the directors that they assert a claim allegedly existing in favor of the corporation and 90 days have expired from the date delivery of the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period. (MBCA § 7.42)
    - a. **Instances Where Demand is Excused:**
      - i. If the directors themselves have harmed the corporation, it appears futile to ask that they have the corporation seek redress against them (*Marx v. Akers*).
    - b. **If Demand is Refused:**
      - i. Shareholder must prove:
        1. Must prove flaw in the decision-making process OR
        2. Must prove that decision was tainted by conflict-of-interest.
    - c. **Business Judgment Rule:**
      - i. Where matter complained of does not involve director wrongdoing, the Board of Directors good faith refusal may bar action if there is no likelihood of recovery or costs outweigh recovery.
    - d. **Special Litigation Committee**
      - i. Rather than having the decision to file a motion to dismiss decided by the full board (which may include self-interested directors), Board hands the case off to a special litigation committee. This committee will decide whether or not to continue with the case.
  4. **Joinder of the Corporation and Alignment of Parties:**
    - a. The corporation is joined as a nominal defendant. Other defendants are the true defendants. This is to get the corporation before the court so that it may reap the judgment.
  5. **California Special Rule (CCC § 800(b)(1)**
    - a. Page 367 in the supplement.
  6. **Right to a Jury Trial?**
    - a. Federal Court
      - i. Yes, if the corporation's claim presents a legal issue
    - b. State Court
      - i. Varies because of the equity flavor of the derivative action
  7. **Settlement or Dismissal?**
    - a. Court must review and approve terms so that interests not present (but affected) are protected
  8. **Recovery**

- a. Basic recovery goes to the corporation
  - b. Shareholder recovers costs from the losing litigant and attorney's fees from the corporation
  - c. Shareholder may be on the hook for attorney's fees of winning litigant if shareholder sued "without reasonable cause"
  - v. Indemnification and Insurance
    - 1. **Indemnification**
      - a. A director is not an agent of the corporation. Legal basis for a corporation's indemnification of a director are found in indemnification statutes, the articles of incorporation, the bylaws of the corporation, and contracts between a corporation and its directors.
      - b. **Required Indemnification (MBCA § 8.52)**
        - i. A corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he was a director of the corporation against reasonable expenses incurred by him in connection with the proceeding.
      - c. **Permitted Indemnification (MBCA § 8.51(a))**
      - d. **Indemnification Prohibited (MBCA § 8.51(d))**
    - 2. **Insurance (MBCA § 8.57)**
      - a. Authorizes a corporation to buy liability insurance for its directors and officers. Insurance covers loss arising from claims made against directors/officers and in some instances against the company or employees for negligent conduct causing economic injury (MBCA § 8.57).
- d. **Shareholder Voting and Rights**
  - i. Shareholders elect and remove directors. In closely-held companies, the shareholders may have substantial influence.
  - ii. **Cumulative Voting (Only available when voting for directors):** With cumulative voting, directors are not elected seat by seat. There is one at-large election in which the shareholders cast votes. Here, each member gets to multiply the number of shares he/she owns times the number of directors to be elected.
    - 1. In some states, cumulative voting exists, unless the articles take it away. In others, cumulative voting does not exist unless the articles affirmatively grant it.
    - 2. **Formula For Cumulative Voting to Determine # of Shares Needed for a Shareholder to Elect Various Numbers of Directors:**
      - a.  $[(N \times S) / (D + 1)] + 1$
      - b. N= number of directors the shareholder wants to elect
      - c. S= Total number of shares voting
      - d. D= Total number of directors to be chosen at the election
  - iii. **Straight Voting:** There is a separate election for each seat on the board. Each shareholder gets to cast his/her number of shares in any way he/she desires for each of these separate elections.
  - iv. **Shareholder Inspection Rights:** Shareholders have a right to access Corporations books and records. Inspection is important for shareholders who want to act responsibly in voting.
    - 1. *Kortum v. Webasto Sunroofs, Inc.:*
      - a. The right of a director of a Delaware corporation to inspect, have access to the books and records of the corporation, as quite broad. It is described as essentially unfettered in nature, but is limited in the sense that the request for information must be for a purpose that is reasonably related to the director's position as a director.

- b. Unlike the case of a director seeking inspection, a stockholder who seeks inspection under Del. Code Ann. tit. 8, § 220(c) must prove by a preponderance of the evidence: (a) its compliance with the form and manner of making a demand specified in the statute, and (b) the propriety of its purpose for seeking inspection i.e. that the purpose is reasonably related to its interest as a stockholder. Once the shareholder demonstrates its entitlement to inspection, it must also show that the scope of the requested inspection is proper, i.e., that the books and records sought are essential and sufficient to the shareholder's stated purpose.
- v. **Responsibility of Corporation's Decision Makers:** Corporation's decision makers have the job of creating profit for the shareholders.
- vi. **Shareholder & Voter Agreements:**
  - 1. Shareholder Voting Agreements (**This is Delaware Law**) (*Ringling Bros.-Barunum & Baily Combined Shows, Incl v. Ringling*)
    - a. Section 18 of the Corporation Law, Del. Rev. Code § 2050 (1935), authorizes, among other things, the deposit or transfer of stock in trust for a specified purpose, namely, "vesting" in the transferee "the right to vote thereon" for a limited period; and prescribes numerous requirements in this connection. But the statute does not purport to deal with agreements whereby shareholders attempt to bind each other as to how they shall vote their shares. Various forms of such pooling agreements, as they are sometimes called, are valid and are distinguished from voting trusts.
    - b. Generally speaking, under Delaware law a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow shareholders. The ownership of voting stock imposes no legal duty to vote at all. A group of shareholders may, without impropriety, vote their respective shares so as to obtain advantages of concerted action. They may lawfully contract with each other to vote in the future in such way as they, or a majority of their group, from time to time determine.
- vii. **When Shareholders Vote:** Shareholders vote for fundamental changes, not just for new directors.
  - 1. **Fundamental Changes:**
    - a. Amendment of the articles of incorporation.
    - b. Dissolution.
    - c. Merger with another corporation
    - d. Sale of all or substantially all of the assets of the corporation.
  - 2. **Votes Differ from Voting for Directors in 3 Respects:**
    - a. Shareholder vote on a fundamental change is approval or disapproval of a board of director's decision and thus a reaction to board of director's action. Shareholder vote on election or removal of directors is a shareholder decision, a shareholder action.
    - b. May be a supermajority approval requirement in either the state's corporation code or the corporations articles for fundamental changes.
    - c. There is no cumulative voting on fundamental corporate changes.
  - 3. Shareholders vote at annual meetings and special meetings.
- viii. **Where Shareholders Vote**
  - 1. **Record Owner:** The person who has the legal right to vote at an annual or special meeting of shareholders.

2. **Record Date:** The date by which only record owners are entitled to a notice of the meeting and a vote at the meeting (MBCA § 7.07(a), (b)). Typically chosen by the corporation to identify holders of record.
    - a. The corporation is required to send notice of annual meetings and special meetings to its record shareholders (MBCA § 7.05, 7.20(a)).
  3. **Holder of Record:** Person legally entitled to vote
    - a. **“Street Name Ownership”:** An investor who is shown as the owner in the brokerage firm’s record has street name ownership.
      - i. Also known as the “beneficial owner”.
- ix. **Who Votes:**
1. A shareholder does not have to be present at the annual or special meeting to vote his/her shares.
  2. **Proxy:** Voting by proxy simply means that the person who is entitled to vote authorizes another person to vote for him/her. It is a form of agency: the owner is the principal and authorizes the proxy-holder to be his/her agent for voting. The shareholder of record is the principal. The person voting is the agent.
    - a. **Revocability of Proxies:**
      - i. **Process for Revoking:**
        1. Written notice to the corporation
        2. Issuing a subsequent-dated proxy
        3. Attending the shareholder meeting and voting in person.
        4. Death.
          - a. Occasionally subject to corporation receiving notice.
      - ii. A proxy can often be revoked even if it states that it is irrevocable.
      - iii. A Proxy is irrevocable if (MBCA § 7.22):
        1. States that it is irrevocable.
        2. AND is coupled with some interest in the stock.
  3. **Federal Proxy Rules:**
    - a. **When they are Applied:**
      - i. When certain “publicly-held” corporations are involved.
        1. Those traded on a national exchange OR,
        2. Those with more than 500 holders of a class of stock and over \$10million in assets.
    - b. **No False/Misleading Statements (Rule 14a-9)**
      - i. No solicitation shall be made by means of proxy statement, form of proxy, notice of meeting, or other communication:
        1. Containing any statement which, at the time and in light of the circumstances, is false or misleading with regard to material fact OR,
        2. Omission of a material fact which is needed to make the statement not misleading OR,
        3. Misleading content with respect to the solicitation of a proxy for the same meeting OR,
        4. Subject matter which has become false or misleading.
      - ii. **Material Fact Defined:** If there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote (*Virginia Bankshares, Inc. v. Sandberg*).
    - c. **Shareholder Proposals (Rule 14a-8)**
      - i. Shareholders may present proposals, which are separate and distinct from shareholders proxy solicitations. The goal is to have

other shareholders vote with respect to a given shareholder's ideas. Proposals must set out the:

1. Proposal
2. Contact information of proposing shareholder
3. Recommendation from the Board of Directors.

ii. **No Action Letter:**

1. Companies seeking to exclude a given proposal altogether may seek a "No Action" letter from the SEC. If the shareholder is aggrieved by the "no action letter" the shareholder could bypass the SEC and challenge the conduct directly in court.

iii. **Grounds for Exclusion (Rule 14-8(i))**

e. **Fiduciary Duties Owed by Directors**

i. **Duty of Care (*Shlensky v. Wrigley*):** The director must discharge his duties with the care that a person in a like position would reasonably believe appropriate under similar circumstance (MBCA § 8.30(b)).

1. Standard applies when the board is "becoming informed" in its decision making function.
  - a. Director must become familiar with the facts and circumstances such that an informed decision can be made.
2. Standard applies when the board is "devoting attention" to its oversight function.
  - a. Director must gain assurances that adequate information and reporting systems are in place and give due regard to ongoing monitoring of such systems.
3. The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve (Davis Standard from *Wrigley Case*).

ii. **Breach of Duty of Care by INACTION (*Barnes v. Andrews*):**

1. To show a director's misprision in office, a plaintiff must go further than to show that the director should have been more active in his duties. This cause of action rests upon a tort, a tort of omission as though it had rested upon a positive act. Thus, the plaintiff must accept the burden of showing that the performance of the defendant's duties would have avoided loss, and what loss it would have avoided. A plaintiff must show that, had defendant done his full duty, the director could have made the company prosper, or at least could have broken its fall. The plaintiff must further show what sum he could have saved the company.
2. An inattentive director or directors cannot be held liable for a corporate loss if it is shown that proper attentiveness to corporate affairs by all the directors would still not have prevented the loss complained of.

iii. **Duty of Good Faith (*In Re Caremark Int'l, Inc. Derivative Litigation*):** Director must act in a manner he believes to be in the best interests of the corporation.

1. **Rule:** Our law presumes that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company (*In Re The Walt Disney Company Derivative Litigation*).
2. **Bad Faith:** An intentional dereliction of duty, a conscious disregard for one's responsibilities.

iv. **Duty of Loyalty:** The duty of loyalty addresses fiduciaries' conflicts of interest and requires fiduciaries to put the corporation's interests ahead of their own – that is, fiduciaries cannot serve two masters. Corporate fiduciaries breach their duty of loyalty when they divert corporate assets, business opportunities, or proprietary information for personal gain.

1. **Duty of Loyalty Generally Arises When:**
  - a. Competes with the company
  - b. Takes for herself a corporate opportunity
  - c. Has some personal pecuniary interest in a corporation's decision.
2. **"Usurping" a Corporate Opportunity**
  - a. Corporate officers and directors bear a duty of loyalty to the corporations they serve.
  - b. *Broz v. Cellular Information Systems, Inc. Test*
    - i. The corporate opportunity doctrine, as delineated by Guth and its progeny, holds that a corporate officer or director may not take a business opportunity for his own if:
      1. The corporation is financially able to exploit the opportunity.
      2. The opportunity is within the corporation's line of business
      3. The Corporation has an interest or expectancy in the opportunity
      4. By taking the opportunity for their own, the corporate fiduciary will thereby be placed in a position adverse to his duties to the corporation.
  - c. ALI Test
    - i. Under the ALI standard, once the Corporation shows that the opportunity is a corporate opportunity, it must either that the director did not offer the opportunity to the Corporation or that the Corporation did not reject it properly. If the corporation shows that the board did not reject the opportunity by a vote of the disinterested directors after full disclosure, then the Director may defend their actions on the basis that the taking of the opportunity was fair to the corporation (*Northeast Harbor Golf Club, Inc. v. Harris*).
      1. It must have been formally rejected according to this case.
  - d. **Questions to ask:**
    - i. Is the opportunity one which the Corporation would normally take advantage of?
    - ii. Could the Corporation afford the Opportunity?
    - iii. Look for full disclosure and rejection by the Corporation.
3. **Interested Director Transactions**
  - a. **Self-Dealing:** exists when a director deals directly with the corporation, or has a stake in or is an officer or director of a firm that deals with the corporation. Traditionally, the term "self-dealing" describes the situation when a corporate fiduciary is on both sides of a transaction. Absent evidence of self-dealing, evidence of any personal or special benefit accruing to a director in an otherwise arms-length transaction does not establish a lack of independence sufficient to rebut the business judgment rule unless the director's self-interest is also found to be material. A plaintiff's burden of proof of a director's self-interest in an arms-length third party transaction should be greater than in a classic self-dealing transaction where a director or directors stand on both sides of a transaction (*HMG/Courtland Properties, Inc. v. Gray*).
  - b. **Entire Fairness**
    - i. **Fair Dealing:** embraces the questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the

directors, and how the approvals of the directors and the stockholders were obtained.

- ii. **Fair Price:** Related to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a companies stock.

v. **Business Judgment Rule (G.M.C.): A court “applying the business judgment rule” is presuming:**

- 1. The Directors acted in Good Faith; AND
- 2. The Directors acted in a Manner he/she reasonably believed to be in the best interest of the corporations; AND
- 3. The Director discharged his duties with the Care that a person in a like position would reasonably believe appropriate under similar circumstances.

vi. **Overcoming Business Judgment Rule (*Smith v. Van Gorkum*)**

- 1. When a board decision is challenged, courts place the burden on the challenger to overcome the business judgment presumption by proving either:
  - a. Fraud, bad faith, illegality, or conflict of interest.
  - b. The lack of a rational business purpose.
  - c. Failure to become informed in decision making (gross negligence)
  - d. *Smith v. Van Gorkom*: Under the Business Judgment Rule, director liability is predicated upon concepts of gross negligence in the decision making function.
  - e. Or; failure to oversee corporations activities.

f. **Growth of the Corporation**

i. **Initial/Additional Capital Contribution.**

ii. **Debt, equity, & Risk.**

- 1. **Debt:** Debt is money that must be paid back.
  - a. Creditors have protection in that they can demand payment of debt. Less risk.
- 2. **Equity:** Equity is money that is invested so that, in exchange for their money, the investors become owners of the firm.
  - a. Investors don't have protection.
- 3. **Borrowing Money**
  - a. Problems may arise when a company borrows money.
    - i. Getting a lender
    - ii. Covenants, representations, and warranties
      - 1. Covenants are basically promises with respect to what a company will or will not do in the future
        - a. No paying dividends
        - b. No large expenditures
        - c. Carry on business in the usual, regular and ordinary course in all material respects
        - d. No amending articles, bylaws, or other governing documents
        - e. No changing method of accounting
      - 2. Representations and Warranties are basically purported assertions of truth regarding the status quo
        - a. Company is duly organized, validly existing, and in good standing under relevant state law
        - b. Company has power and authority to enter into contract
        - c. No hidden lawsuits or other liabilities

- iii. Servicing the debt (when to pay it back).
- iv. Impact of default.
  - 1. Lender would like expansive definitions
    - a. Default = “Whenever [Bank] in good faith believes the prospect of payment or performance is impaired or in good faith believes the collateral is insecure”
  - 2. Borrower would like narrow definitions
    - a. Default = “Debtor’s monthly obligation to [Bank] under this agreement is not paid when due or within 90 business days thereafter.”
  - 3. Note: Acceleration often accompanies default
  - 4. Note: Personal guarantees (from shareholders) may be required in the closely-held context

### iii. Issuing Stock

#### 1. Various Potential Recipients

##### a. Pre-emptive Rights

- i. A shareholder with preemptive rights has the right to purchase that number of shares of any new issuance of shares that will enable the shareholder to maintain their percentage of ownership. Can do this BEFORE other non-shareholders.
- ii. **Whether a shareholder had pre-emptive rights depends on (MBCA § 6.30):**
  - 1. What the state corporation code says about preemptive rights
  - 2. What the articles of incorporation say about preemptive rights
  - 3. What the purpose of the issuance is.

##### b. Requirements for Lawful Amendment Eliminating Pre-emptive Right

- i. If preemptive rights exist in a particular corporation, their elimination by amendment of the articles of incorporation is possible if such amendment is authorized by the laws of the jurisdiction of incorporation, no violation of fiduciary duties is involved, and procedures required to effectuate such amendment are followed (*Bylick v. Vivadelli*).

##### c. Fiduciary Duty

- i. Issuance of shares at favorable prices to directors (but excluding other shareholders) or the issuance of shares on a non-proportional basis for the purpose of affecting control rather than raising capital may violate the fiduciary duty owed. You still owe a fiduciary duty when issuing stock (*Bylick v. Vivadelli*).

#### 2. **Venture Capitalists:** A substantial equity investment in a non-public enterprise that does not involve active control of the firm.

- a. Venture capitalists invest in new/growing companies in the hope that they can cash out at a substantial profit
- b. Example:
  - i. A venture capitalist “buys” a percentage of the stock of a closely-held company
- c. Nourishes the company such that it grows and increases in value
- d. Sells its share to the public in an initial public offering at a substantial profit

#### 3. **Private Placement:** Sale of stock to a venture capitalist or few people.

#### 4. **Public Offering:** Sale of stock to the general public.

- a. Any sale of stock to the general public will require compliance with various state and federal laws.

## 5. **Going Public**

- a. Companies go public to raise money inexpensively
- b. Often difficult to strike just the right balance between fear (not getting enough money in the IPO) and greed (getting money without giving up too much equity)
- c. It may be difficult to get an accurate valuation of the private company, given the (pre-offering) absence of a market for its shares and the speculative nature of its future earnings
- d. Fortunately, various techniques exist to facilitate the pricing of deals

### e. **Mechanics of Going Public**

- i. Marketing of the stock by an underwriter
- ii. Completing the registration process with the Securities and Exchange Commission.

### f. **Underwriter:**

- i. Typically, it's an investment bank
- ii. The underwriter essentially takes the company through the IPO process
  - 1. Participates in the registration process
    - a. Draws up registration statement for SEC to review
    - b. Advises on structuring and pricing the offering, and maintaining a market for the securities after the offering
  - 2. Participates in the marketing of the securities
    - a. This is the "road show"
    - b. Potential purchasers get the prospectus (which is part of the registration statement)
- iii. Once the SEC signs off on the registration statement, the offering/registration is said to be "effective"
- iv. The deal "prices," and the stock hits the market the next day
- v. **Firm Commitment:** Underwriter buys stock from owners/issuer (at the public offering price less a discount) and later sells to the public.
- vi. **Best Efforts:** Underwriter uses its best efforts to help the owners/issuer find buyers of the stock.

### g. **Does it matter who is selling the stock?**

- i. Venture Capitalist Selling
  - 1. The selling is to be expected
- ii. Company Selling
  - 1. Company will end up with cash infusion
- iii. Current Shareholders Selling
  - 1. May or may not be problematic

- h. Must complete the offering registration with the SEC and once they sign off, it is said to be effective.

## 6. Legal Constraints

### g. **Close Corporations**

- i. Business entity typified by a small number of stockholders.
- ii. Absence of a market for the corporation's stock.
- iii. Substantial shareholder participation.
- iv. **Payment of Stockholders**

1. Earnings of a close corporation are distributed in major part in salaries, bonuses, and retirement benefits, not distributions.

v. **Board of Close Corporation**

1. Dominated by the majority. Techniques of threatening minority stockholders known as squeeze out or freeze out. Techniques can be termination of minority shareholders employment, the refusal to declare dividends, removal from management, or the siphoning off of corporate earnings through high compensation for majority stockholder.

vi. **Relief for Minority Stockholder**

1. Amending dissolution statutes to include oppression
2. Courts impose an enhanced fiduciary duty between close corporation shareholders and have allowed an oppressed shareholder to bring direct suit for this duty.

**h. Cashing In (Legally and Not So Legally)**

i. General Commentary: Salary

1. Non-employee shareholders of publicly-held corporations expect no salary from the entity
2. Rather, they expect to get some return on their investment either in the form of dividends or substantial appreciation in the value of their shares
3. If they are unhappy with the rate of dividends or the pace of appreciation, they can (fairly easily) sell their stock
4. Shareholders of a closely-held company cannot sell their shares on an established market
5. Thus, they look to some other form of cash as a return on their investment
6. A salary from the corporation
7. Substantial dividends
8. Of course, they may be patient enough to sell shares, down the road, on the market in an IPO
9. . . . Or, in the near term, to a venture capitalist

10. **Salary**

- a. Receipt of a salary may be critically important to an investor in a closely-held company
- b. But shareholders commonly disagree . . .
  - i. Who should get a salary?
  - ii. How much salary should be paid?
  - iii. Whether salary levels should rise or fall in a given year
- c. Personal disagreements commonly result in those with major shareholdings (and thus control of the board) abusing those with minor shareholdings
  - i. "Oppression" (management/ownership exclusion)
    1. "Squeeze-out"
    2. "Freeze-out"

11. **Minority Shareholder Oppression**

- a. Some jurisdictions have created the "oppression" cause of action, which may lead to . . .
  - i. Involuntary Dissolution
  - ii. Various other forms of relief
- b. In the absence of an oppression cause of action, a shareholder may be able to assert a direct action for breach of a special fiduciary duty (*Cf. Donahue* and related cases)

- ii. **Dividends:** a special type of distribution, a payment to shareholders by the corporation out of its current or retained earnings in proportion to the number of shares owned by the shareholder.

1. The decision whether to pay dividends or reinvest the money in the corporation is a decision to be made by the board of directors.
  2. **Dividend Declaration Restrictions**
    - a. “Modern”/MBCA Approach (MBCA § 6.40):
      - i. Dividends may not be declared and paid if
      - ii. The corporation would not be able to pay its debts as they come due in the usual course of business
      - iii. The corporation would be insolvent after the distribution
    - b. Traditional Approach (including DE)
      - i. Dividends may be declared and paid from . . .
        1. Earned Surplus (i.e., “Retained Earnings”): Consists of money generated by the business itself. It consists of all losses minus distributions previously paid.
        2. Capital Surplus: Any money received from an issuance above par value.
      - ii. Dividends MAY NOT be declared and paid from . . .
        1. Stated Capital: Consists of the par value of a par issuance plus the amount allocated to stated capital on a no-par issuance.
          - a. No-Par: There is no minimum issuance price.
  3. *Zidell v. Zidell*
    - a. Those in control of corporate affairs have fiduciary duties of good faith and fair dealing toward the minority shareholders. Insofar as dividend policy is concerned, however, that duty is discharged if the decision is made in good faith and reflects legitimate business purposes rather than the private interests of those in control. The essential test of bad faith is to determine whether the policy of the directors is dictated by their personal interests rather than the corporate welfare. To justify judicial intervention in cases of this nature, it must, as a general proposition, be shown that the decision not to declare a dividend amounted to fraud, bad faith or an abuse of discretion on the part of the corporate officials authorized to make the determination.
  4. *Sinclair Oil Corporation v. Levien*
    - a. When the situation involves a parent and a subsidiary, with the parent controlling the transaction and fixing the terms, the test of intrinsic fairness, with its shifting of the burden of proof, is applied. The rule applies when the parent has received a benefit to the exclusion and at the expense of the subsidiary. A parent owes a fiduciary duty to its subsidiary when there are parent-subsidary dealings, but this alone will not evoke the intrinsic fairness standard. This standard will be applied only when the fiduciary duty is accompanied by self-dealing, when a parent is on both sides of a transaction with its subsidiary. Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary.
- iii. Buying and Selling or Selling and Buying at a Profit
    1. In General: no issuance of stock is exempt from common law of fraud and misrepresentation.
    2. **Rule 10b-5(b) (Protection from Fraud)**

- a. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce (this gives jurisdiction to feds), or the mails or of any facility of any national securities exchange,
      - i. To employ any device, scheme, or artifice to defraud,
      - ii. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
      - iii. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.
- 3. **Rule 10b-5 (Insider Trading)**
  - a. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce (this gives jurisdiction to feds), or the mails or of any facility of any national securities exchange,
    - i. To employ any device, scheme, or artifice to defraud,
    - ii. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
    - iii. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
  - b. In connection with the purchase or sale of any security.
- 4. **Materiality: Materiality: A misrepresentation or omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to act.** For a misrepresentation or omission to be material there must be a substantial likelihood that the disclosure of the omitted fact or misrepresentation would have been viewed by the reasonable investor as having significantly altered the total mix of information made available. Material representations must be contrasted with statements of subjective analysis or extrapolations, such as opinions, motives and intentions, or general statements of optimism, which constitute no more than puffery and are understood by reasonable investors as such. (*EP Medsystems, Inc. v. Echocath, Inc.*)
  - a. A corporation must disclose a merger once the agreement in principle is reached. The court looks to the probability and magnitude of a particular situation when deciding whether disclosure is necessary (*Basic v. Levinson*)
  - b. **Bespeaks Caution Doctrine:** Cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.
- 5. **Fraud on the Market:** The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.
- 6. **Insider Trading Defined:** It's trading securities with the benefit of material non-public information.
  - a. Who can be Liable?
    - i. **Insiders:**
      1. **Actual Insiders:** Officers, Directors, Controlling Shareholders, Employees.

2. **Constructive Insiders:** Attorney's, CPA's, Bankers Performing Services.

ii. **Tippers/Tippees**

1. **Tipper:** Person breaching fiduciary duty.
2. **Tippee:** Person who knows that tipper is breaching fiduciary duty.

iii. **Misappropriators**

1. Those agreeing to keep info confidential
  2. Those with established history of keeping confidences
  3. Relatives/spouses/etc. (barring countervailing proof)
- b. Anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.
- c. **The Misappropriation Theory** holds that a person commits fraud in connection with a securities transaction, and thereby violates § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C.S. § 78j(b)) and Securities Exchange Commission Rule 10b-5 (17 C.F.R. § 240.10b-5), when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. (Unlikely we need this, same as misappropriators being liable)

7. **Section 16(a)**

- a. Generally requires that certain statements be filed (electronically) with the SEC by directors, officers, and beneficial owners of more than 10% of a company's stock
- b. When?
- c. At the time when securities of the company are registered
  - i. How much do you own?
- d. Within 10 days after becoming a director, officer, or MORE THAN 10% beneficial owner
  - i. How much do you own?
- e. Within 2 business days of a change in security ownership
  - i. What are your current holdings, and what was the change in ownership?

8. **Section 16b and Short-Swing-Profits**

- a. Section 16(b) of the '34 Act allows issuers to recover short swing profits earned (or losses avoided) by
  - i. Directors
  - ii. Officers
  - iii. Beneficial owners of MORE THAN 10% of a corporation's stock
- b. Short swing profits are those earned within a six-month window
- c. Applies to
  - i. Buying then selling
  - ii. Selling then buying
- d. **CAVEAT: Section 16(b) has limited applicability**
  - i. Publicly-held companies traded on national exchanges

- ii. OR
- iii. Corporation with at least 500 shareholders and more than \$10M in assets

9. Common Law Duties of Selling Shareholder

10. Share Sale Restrictions

**i. Corporate End Games**

**i. Fundamental Changes**

1. In general, corporate law statutes require that certain fundamental corporate changes be approved by shareholders
  - a. Certain amendments of the articles of incorporation
  - b. Dissolution
  - c. Merger
  - d. Sale of Substantially All Assets Outside the Regular Course of Business
  - e. Dissolution
    - i. Corporation liquidates its assets
    - ii. Corporation uses proceeds to pay creditors
    - iii. Any remaining proceeds are distributed to shareholders (as the “residual” owners of the corporation)
    - iv. Notice of Dissolution filed with Secretary of State
    - v. Notice of Dissolution provided to “known” and “unknown” claimants
    - vi. Special Notes:
      1. Creditors must be paid in full before shareholders receive anything
      2. Creditors not paid properly may later seek payment from shareholders to the extent the shareholders received payments on dissolution

**ii. Fundamental Change Procedure**

1. Board Approval
2. Shareholder Notification
3. Shareholder Vote at Special Meeting
  - a. Presence of Quorum *and* (depending on state law) Approval of . . .
    - i. Majority of votes cast; *or*
    - ii. Majority of shares present; *or*
    - iii. Majority of shares entitled to vote; *or*
    - iv. Two-thirds of shares entitled to vote
4. Attention to Dissenters’ Rights of Appraisal
5. Filing of Notice with State

**iii. Merger**

1. Two or more business entities combine to form a single business entity
  - a. Merger v. Consolidation
2. The “Acquiring” corporation (Bidder) survives (i.e., it continues to exist)
3. The “Acquired” corporation (Target) ceases to exist as a separate and distinct entity
4. In M&A parlance, the acquired corporation merges “with and into” the acquiring corporation

5. Approving shareholders generally receive some form of continuing equity interest, cash, or some combination of the two
6. Dissenting shareholders essentially get cashed out
7. **Stock Holder Protection (Not Happy about a Merger?)**
  - a. Vote Against the Merger
  - b. Sue Directors for Breach of Duty of Care
  - c. Sue Directors for Breach of Duty of Loyalty
  - d. If all else fails . . .
    - i. Assert Dissenters' Rights of Appraisal
      1. If shareholder complies (to the letter) with statutory requirements,
      2. Shareholder will be entitled to receive the "fair value" of shares held.
8. **Formalities**
  - a. A sale of substantially all of a corporation's assets outside the ordinary course of business constitutes a fundamental change *for the selling corporation*
  - b. Target's Board of Directors must approve the transaction
  - c. Target's shareholders must approve the transaction
    - i. MBCA: Dissenters get appraisal rights
  - d. What about the Board of Bidder?
  - e. What about the shareholders of Bidder?
    - i. MBCA: Must approve if more than 20% dilution
9. **Direct/Statutory Merger**
  - a. Bidder will generally succeed to Target's Assets & Liabilities.
10. **Asset Purchase for Cash**
  - a. Bidder may assume select target liabilities or simply purchase assets and assume no liabilities.
11. **De Facto Merger Doctrine**
  - a. Various parties may argue that various transactions have the same substantive impact (or practical result) as a statutory merger
  - b. They argue that regardless of its form, the substance of the transaction is a direct merger, and accordingly, the surviving corporation succeeds to the liabilities of the acquired corporation
  - c. **Important Points**
    - i. Delaware does not recognize the de facto merger doctrine
    - ii. California DOES RECOGNIZE the de facto merger doctrine
    - iii. THE IMPACT of the recognition is that protections provided to the public under CA law in a "merger" context are to be provided in a transaction having the same substantive impact as a merger, regardless of the form of the transaction.
  - d. **De Facto Merger Red Lights**
    - i. Acquiring corporation uses its own stock as consideration (rather than cash)

- ii. Acquired corporation required to dissolve (as a stand alone corporation)
    - iii. Acquired corporation forced into upstream merger
    - iv. Smaller corporation buying the assets of a larger corporation.
  - iv. Sale of Substantially All Assets
  - v. Hostile Takeover
    - 1. **Formalities**
      - a. Board of Directors of Target need not approve
      - b. Shareholders approve by tendering shares forth or withholding them
      - c. Bidder makes a public offer for the shares of the Target company, typically at a significant premium over current trading price
      - d. Bidder will usually condition acceptance of tendered shares on receipt of a certain number (e.g., enough to ensure control of the company)
      - e. With control, the new shareholder has the power to throw out the old Board and fire current management
      - f. So, a tender offer will likely generate aggressive inside activity directed at preventing consummation of the deal
    - 2. **Typical Responses**
    - 3. **Takeover Defenses**
      - a. Adopting a “Poison Pill”
        - i. Flip in – Current shareholders may buy more Target stock at a discount
        - ii. Flip over - Current shareholders may buy more Bidder stock at a discount after the merger
      - b. Creating “Golden Parachutes”
        - i. Major \$\$\$\$ to top executives in the event of a takeover
      - c. Adopting “Shark Repellent”
        - i. Special bylaw/charter provisions triggered only on presentation of tender offer
      - d. Securing a “White Knight”
        - i. A more agreeable takeover party who can go toe to toe with the hostile bidder
      - e. **Notes**
        - i. Directors owe fiduciary duties to the corporation
        - ii. Fighting off a takeover may, ultimately, not be in the best interests of the corporation
        - iii. . . . Even if it means that the Board itself and current management will be ousted
        - iv. Current shareholders (which will likely include Bidder) can sue for breach of fiduciary duty if the board acts in a manner which arguably violates fiduciary duty

## V. LIMITED PARTNERSHIPS

- a. Tax Benefits
  - i. Flow-through tax treatment
  - ii. That is, one circumvents the entity-level tax
- b. Limited Liability for Limited Partners
  - i. Limited Partners enjoy limited liability
  - ii. The General Partner in the Limited Partnership shoulders personal liability
- c. Notes

- i. The Limited Partnership MUST have at least one General Partner
  - ii. The name and address of the General Partner (which need not be an “individual”) must be provided in the Certificate of Limited Partnership
- d. Operations
  - i. The Limited Partnership Agreement will outline the roles of limited and general partners
  - ii. The default rule, barring a contrary provision in the LP Agreement, is that the general partner makes business decisions
  - iii. The limited partners typically take no part in LP management, but limited partner approval may be required in some instances:
  - iv. Capital contribution modifications
  - v. Distribution modifications
  - vi. General Partner addition or removal
  - vii. Dissolution or Merger
  - viii. Substantial Encumbering of Assets
  - ix. Fundamental Change of Business Nature
- e. Liability
  - i. With respect to third parties, the general partner is liable for obligations of the limited partnership
  - ii. Per § 303 of the ULP, limited partners are not liable to third parties (in contract, tort, or otherwise) for the obligations of the limited partnership
  - iii. The general partner in a limited partnership has liability exposure to the limited partnership and the limited partners for breach of fiduciary duties
- f. Cashing In
  - i. Salary from LP
  - ii. Distributions from LP
  - iii. Sale of LP Interest
    - 1. Buyer gets right to distributions
    - 2. Buyer does not get right to management/control

## **VI. LIMITED LIABILITY COMPANIES**

- a. Liability Limitation
  - i. Members of the LLC are not liable for the obligations of the LLC
- b. Tax Treatment
  - i. The income of the LLC is not taxed at the LLC level
  - ii. Accordingly, there is only one layer of tax (i.e., at the Member level)
- c. Forming an LLC
  - i. One must file articles of organization with the appropriate state agency (e.g., Secretary of State) containing the information required under § 203(a) of the ULLCA. Note that the Delaware form does not call for all of the information required.
  - ii. Note that it is possible to form a single-member LLC under the ULLCA. *See* § 202
  - iii. Thus, a sole proprietor may, depending on the particulars of the jurisdiction’s LLC statute, organize and thereby limit his liability
  - iv. Start-up capital is from contributions of the Members made under the Operating Agreement
- d. Operations
  - i. The Operating Agreement sets forth the specifics of ongoing operations

1. Member-Managed (similar to general partnership)
2. Manager-Managed (similar to Board/Officers)
- ii. The Uniform Limited Liability Company Act provides default/fallback rules
- iii. Note that the Operating Agreement must comply with § 103(b) of the ULLCA
- e. Liability to Third Parties
  - i. Because the LLC is a separate and distinct legal entity, no Member is liable for the obligations of the LLC. *See* § 303 of the ULLCA
  - ii. Veil-piercing is a jurisdiction-specific matter, but note the restrictions of § 303(b)
  - iii. Although there is no “general partner” in the LLC as there is in a limited partnership, some or all of the MEMBERS may consent to liability per § 303(c)
- f. Liability to Company
  - i. Members in member-managed LLCs owe fiduciary duties to the LLC
  - ii. Managers in manager-managed LLCs owe fiduciary duties to the LLC
  - iii. Members in manager-managed LLCs generally owe NO fiduciary duties to the LLC
  - iv. Exact nature of duties will depend on state statute and the language of the operating agreement
- g. Cash In
  - i. Receiving salaries
  - ii. Receiving distributions
  - iii. Selling LLC interest
    1. Potential statutory impediments
    2. Potential Operating Agreement impediments
  - iv. Note: Speaking generally, assignee gets financial rights previously held by assignor but not the right to participate in management or otherwise act as a Member