agency

I. Who is an agent?
   a. Gorton v Doty
      i. Agency is the relationship which results from the manifestation of
         consent by one person to another than the other shall act on his
         behalf and subject to his control, and consent by the other so to act
   b. Gay Jenson Farms Co v Cargill
      i. Financier considered principal for grain dealer
      ii. To act as an agent for a principal, there must be agreement,
          but not necessarily a contract
      iii. Circumstantial proof:
          1. The principal must be show to have consented to the
             agency since one cannot be the agent of another except by
             consent of the latter
          2. A Creditor who assumes control of his debtor’s business
             may become liable as principal for the acts of the debtor in
             connection w/the business
   iv. Used factors:
      1. the sum of them together made for a case of
         agency/principal

II. Liability of Principal to Third Parties in Contract
   a. Authority
      i. Mill Street Church of Christ v Hogan
         1. Implied authority: actual authority circumstantially proven
            which the principal actually intended the agent to possess
            and includes such powers as are practically necessary to
            carry out the duties actually delegated
            a. Based on past conduct w/principal
         2. Apparent authority: not actual, but the authority the agent
            is held out by the principal as possessing. Matter of
            appearances on which 3rd parties come to rely.
            a. Sam believed that Bill had the authority to hire him
         3. Types of authority:
            a. Actual authority
               i. Express-written or spoken, generally
               ii. Implied- whatever else is required to
                   carry out express authority—whatever is
                   necessary
            b. Apparent authority
   b. Apparent Authority
      i. Lind v. Schenley Industries
1. Lind plaintiff sued def company for a 1% commission on all sales men under him which he had been promised
2. Company said Kaufmann did not have authority to offer him the commission
   a. Kaufmann direct supervisor—inhherent/implied authority—that type of agent generally possesses such powers
   b. V-P told Lind that he should go to Kaufmann for salary details
      i. Proven on apparent authority and Lind reasonably relied on this as represented to him
ii. Three-seventy Leasing Corp v Ampex Corp
   1. Joyce only employee of 370—plaintiff
      a. Sued Ampex for breach of contract
      b. Ampex will sell to 370—370 will lease to EDS
      c. Ampex has officials: Mueller and under him, Kays
   2. Appears that Kays as Joyce’s only contact w/the company accepted Joyce’s offer
3. Apparent authority
4. Reasonable reliance
   a. Interoffice memo says that Kays is to deal w/Joyce (memo by Mueller)

OUTLINE:

III. Was there an agency relationship?
   a. Gorton v. Doty
   b. Cargill
IV. If so, did A have authority to bind P?
   a. Actual
      i. Express
      ii. Implied
   b. Apparent (estoppel is probably just a variation on this)
      i. Manifestation by P to 3rd party
      ii. Reasonableness of belief by 3rd party
   c. Inherent
   d. Ratification-proxy for authority

c. Inherent Agency Power
   a. —Policy behind this is protecting third parties:
      i. agent might violate his instructions for whatever reason
      ii. agent might cause losses to the 3rd party
         1. and the third party is the innocent here
   b. Watteau v. Fenwick
      i. Defs were principals for beerhouse in hotel
ii. Agent was manager in whose name everything for the beerhouse was imprinted
   1. Humble remains the front of the operation even though he had already sold to the principal
   2. Agent, Humble, made contracts w/various people for which he was unauthorized
   3. These purchases were not of those outside of the ordinary course of business

iii. Debts accumulated by the agent were due payable by the principal, even though the principal expressly did not authorize them
   1. Even though said agent could not make them

iv. Undisclosed principals are liable for ordinary debts of agents

v. Partnerships are treated the same in this manner

c. Kidd v Thomas A. Eidson
   i. Fuller seemed to have the power b/c most other agents acting to book performers would have had the power to enter in contract
   ii. Thus the performers could then recover from the principal b/c they believed that they had entered into those contracts w/the principal
      1. Doesn’t seem really reasonable b/c no details—but loses b/c she has the burden of proof

I. AGENCY

A. AGENCY GENERALLY

i. “‘Agency’ is the [fiduciary] relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.” Gorton v. Doty (69 P.2d 136 (Id. 1937); p.1) Teacher volunteered her car for use to transport football players to game. Coach drove, car wrecked, player injured. Court held that the coach was the agent of the teacher in driving her car.


iii. “A creditor who assumes control of his debtor’s business may became liable as principal for acts of the debtor in connection with the business.” Jenson Farms v. Cargill (309 NW2d 285 (Minn. 1981); p.7) Cargill lent
extensive credit to Warren, a grain elevator, which was overextended. Cargill got excessively entangled in Warren’s business – decision making, reviewing the books – and when Warren went under, other creditors went after Cargill as Warren’s principal. Court agreed, held that Cargill was entangled enough in Warren’s business that it was acting as Warren’s principal and therefore was liable for Warren’s debts.

iv. If a person contracts to acquire property from a third person and convey it to another, that person is only an agent of the third person if there is an agreement that the person is to act for the benefit of the third person and not himself. Jenson Farms v. Cargill (309 NW2d 285 (Minn. 1981); p.7)

v. Factors indicating a party is a supplier and not an agent are “(1) That he is to receive a fixed price for the property irrespective of the price paid by him. This is the most important. (2) That he acts in his own name and receives the title to the property which he thereafter is to transfer. (3) That he has an independent business in buying and selling similar property.” Jenson Farms v. Cargill (309 NW2d 285 (Minn. 1981); p.7)

B. LIABILITY OF THE PRINCIPAL TO THIRD PARTIES IN CONTRACT

i. “Implied authority is actual authority circumstantially proven which the principal actually intended the agent to possess and includes such powers as are practically necessary to carry out the duties actually delegated.” Mill Street Church v. Hogan (785 SW2d 263 (Ky. 1990); p. 14) Church Board hired Bill Hogan to paint the church; in the past, Bill had been allowed to hire his brother Sam to help. This time, Board encouraged Bill to hire Gary Petty. Bill hired Sam, Sam got hurt and sued. Church argued Bill had no authority to hire anyone and so wasn’t liable. Court found Bill had implied authority to hire Sam.

ii. “Apparent authority […] is not actual authority but is the authority the agent is held out by the principal as possessing.” Mill Street Church v. Hogan (785 SW2d 263 (Ky. 1990); p. 14)

iii. Actual authority is authority that the principal expressly or implicitly gave to the agent. Lind v. Schenley Industries (278 F2d 79 (3d Cir. 1960); p. 16) Lind, working for Schenley, was made assistant to Kaufman, who promised various benefits. Lind sued over benefits promised but never
received; Schenley argued Kaufman didn’t have authority to promise the benefits, nor had Schenley acted to imply that Kaufman did. Court found for Lind on inherent authority theory.

iv. Apparent authority is authority that the principal acts as though the agent has, but in reality he may or may not have it. Lind v. Schenley Industries (278 F2d 79 (3d Cir. 1960); p. 16)

v. Implied authority can be either actual authority implicitly given by the agent, OR authority “arising solely from the designation by the principal of a kind of agent who ordinarily possesses certain powers (AKA inherent authority). Lind v. Schenley Industries (278 F2d 79 (3d Cir. 1960); p. 16)

vi. “An agent has apparent authority to bind the principal when the principal acts in such a manner as would lead a reasonably prudent person to suppose that the agent had the authority he purports to exercise.” 370 Leasing v. Ampex (528 F.2d 993 (5th Cir. 1976); p. 22) 370 negotiated with Ampex to purchase computer hardware; Kays, an Ampex salesman, sent documents to 370, who executed them. Ampex did not. Court found the documents were a solicitation that turned into an offer when 370 signed, but Ampex never accepted that offer; however, found Kays’ later memo about delivery dates was acceptance, and found Kays had apparent authority and therefore bound Ampex to the deal.

vii. “An agent has the apparent authority to do those things which are usual and proper to the conduct of the business which he is employed to conduct.” 370 Leasing v. Ampex (528 F.2d 993 (5th Cir. 1976); p. 22)

viii. Unless a third party to a contract knows of a limitation to the agent’s authority, that actual limitation “will not bar a claim of apparent authority.” 370 Leasing v. Ampex (528 F.2d 993 (5th Cir. 1976); p. 22)

ix. Undisclosed principals are liable for the acts of their agents when those acts are done on the principal’s account and if those actions are usual and necessary, even if the actions are forbidden by the principal. Restatement (Second) of Agency §§ 194, 195.

x. Inherent agency power is a term used “to indicate the power of an agent which is derived not from authority, apparent authority, or estoppel, but solely from the agency relation and exists for the protection of persons harmed by
or dealing with a servant or other agent.” Restatement (Second) of Agency § 8A

xi. A general agent is “an agent authorized to conduct a series of transactions involving a continuity of service.” Restatement (Second) of Agency § 161

xii. “The principal is liable for all the acts of the agent which are within the authority usually confided to an agent of that character, notwithstanding limitations, as between the principal and the agent, put upon that authority.” Watteau v. Fenwick (1 QB 346 (1892); p. 25) Humble sold brewery to Fenwick but remained on as manager. He was supposed to have the power only to buy beer and water for the business, but bought other goods as well. Watteau, the supplier, sued Fenwick as the principal; Court found that even though the principal was undisclosed to the supplier at the time of the contract, and even though Humble went outside his actual authority, he had apparent authority and therefore Fenwick was liable for his actions.

xiii. “The scope of any authority must [...] be measured, not alone by the words in which it is created, but by the whole setting in which those words are used, including the customary powers of such agents.” Kidd v. Thomas Edison Inc. (239 Fed. 405 (SDNY 1917); p. 28) Fuller, employee of TE, contracted with Kidd to perform in singing recitals. TE placed limitations on what Fuller could contract for, but Fuller went outside the limitations, so claimed it wasn’t bound to the contract with Kidd. Court found the limitations on Fuller weren’t customary, Kidd had no reason to expect them, and therefore Fuller’s actions bound TE.

xiv. “It makes no difference that the agent may be disregarding his principal’s directions, secret or otherwise, so long as he continues in that larger field measured by the general scope of the business instructed to his care.” Nogales Service Center v. Atlantic Richfield (126 Ariz. 133 (1980); p. 31) AR lent NSC money to build a truck stop; agreement included terms on gas purchases and what facilities truck stop would have. AR rep promised gas discount, but that didn’t happen; NSC sued. Court held that the rep bound AR on theory of inherent authority.

xv. There are three elements to proving an agency relationship exists: “(1) a manifestation by the principal that the agent will act for him; (2) acceptance by the agent of the undertaking; and (3) an understanding between the
parties that the principal will be in control of the undertaking.” Botticello v. Stefanovicz (177 Conn. 22 (1979); p. 36) Walter and Mary were tenants in common on a piece of property. Walter leased his portion, included option to buy. Mary told Walter she wouldn’t sell for less than a certain price, but was no part of the lease agreement. Walter didn’t tell tenant that he didn’t own property outright, nor did he ever indicate he was acting as his wife’s agent. Tenant tried to exercise option, was refused, and sued for specific performance. Court held that Walter wasn’t acting as Mary’s agent and she didn’t later ratify the lease, specific performance couldn’t be ordered against her.

xvi. Ratification is “the affirmance by a person of a prior act which did not bind him but which was done or professedly done on his account” (quoting Restatement (Second) of Agency, § 82) [and] requires acceptance of the act’s results with intent to ratify and with full knowledge of all the material circumstances.” Botticello v. Stefanovicz (177 Conn. 22 (1979); p. 36)

xvii. “Where a party seeks to impose liability upon an alleged principal on a contract made by an alleged agent [...] the party must assume the obligation of proving the agency relationship. It is not the burden of the alleged principal to disprove it.” Hoddeson v. Koos Bros. (47 NJ Super 224 (App Div 1957); p. 40) Hoddeson ordered furniture from a supposed salesman in a furniture store, paid cash, didn’t get a receipt. When checked back later, no record of order; appeared the salesman was a con artist who walked off with the cash. Court found furniture store liable for the order because it was the proprietor’s duty to protect its customers from such con artists.

xviii. Types of authority: “(1) express or real authority which as been definitely granted; (2) implied authority [...] to do all that is proper, customarily incidental and reasonably appropriate to the exercise of the authority granted; and (3) apparent authority, such as where the principal by words, conduct, or other indicative manifestations has ‘held out’ the person to be the agent.” Hoddeson v. Koos Bros. (47 NJ Super 224 (App Div 1957); p. 40)

xix. If an agent wishes to avoid liability as a party to a contract, it is the agent’s duty to reveal the existence and identity of the principal. If the principal is non- or partially disclosed, the agent is liable as a party to the
contract. It is the agent’s responsibility to reveal the principal, not the third party’s responsibility to discover the existence of the principal. Atlantic Salmon v. Curran (32 Mass App Ct 488 (1992); p. 43) AS sold product to Curran, who was claiming to be an agent of Boston Seafood Exchange, which was actually a “doing business as” for Marketing Designs. Curran never paid AS, and AS sued Curran personally; Court found for AS

C. LIABILITY OF THE PRINCIPAL TO THIRD PARTIES IN TORT

i. Servant versus Independent Contractor

1. Respondeat Superior: a master/employer is liable for the torts of its servants/employees. Master/servant relationship exists when (a) servant agrees to work on behalf of the master, AND (b) servant agrees to be subject to master’s control in the manner in which the job is done and not just the result of the job.

2. Servants are not the same as independent contractors.

   a. Agent-type independent contractor: one who agrees to act on behalf of the principal but is not subject to the principal’s control over how the job is done (e.g. carpenter who, with homeowner’s permission, buys lumber for the contracted job on the homeowner’s credit)

   b. Non-agent independent contractor: one who operates independently and enters into arm’s-length transactions with other (e.g. carpenter who agrees to build a garage for a homeowner)

3. Humble Oil v. Martin (148 Tex 175 (1949); p. 48) Woman left car at Humble, a station operated by Schneider, for repair and it rolled into the street and hit Martin. Martin sued Humble, who argued no liability because Schneider not Humble’s agent. Court disagreed, found master-servant relationship.

4. A franchisor may be held to have actual agency relationship with its franchisee when the franchiser controls, or has the right to control, the franchisee’s business. Hoover v. Sun Oil (58 Del. 553 (1965); p. 50) Sun Oil owned a gas station operated by Barron. Station employee attended a car, which caught fire; Sun Oil was sued for damages. Court found no liability, relationship more like landlord/tenant than master/servant.

5. “When an agreement, considered as a whole,
establishes an agency relationship, the parties cannot effectively disclaim it by formal consent.”
Murphy v. Holiday Inns (216 Va. 490 (1975); p. 53)
Murphy was staying at a Holiday Inn, operated by a franchisee, when she slipped and fell. Sued franchiser. Court held that no master/servant relationship existed.

6. “In determining whether a contract establishes an agency relationship, the critical test is the nature and extent of the control agreed upon.” Murphy v. Holiday Inns (216 Va. 490 (1975); p. 53)

7. A franchise contract “does not insulate the contracting parties from an agency relationship. If a franchise contract so regulates the activities of the franchisee as to vest the franchiser with control within the definition of the agency, the agency relationship arises even though the parties expressly deny it.” Murphy v. Holiday Inns (216 Va. 490 (1975); p. 53)

8. “What is reasonable foreseeable [in the context of respondeat superior] is quite a different thing from the foreseeably unreasonable risk of harm that spells negligence. […] The employer should be held to expect risks […] which arise out of and in the course of his employment and labor.” Ira Bushey & Sons v. US (398 F2d 167 (2d Cir 1968); p. 61)
   Sailor went out on shore leave, got drunk, came back to ship, opened valves, boat slid, dock damaged. Dock owner sued US as principal. Court held that master/servant relationship existed, so gov’t responsible, even though the actions causing damage were outside scope of sailor’s employment, because they were reasonably foreseeable.

9. “Restatement § 228(2) provides that a servant’s use of force against another is within the scope of employment if the use of force is not unexpectable by the master.” Manning v. Grimsley 643 F2d 20 (1st Cir. 1981); p. 66)
   Pitcher at a baseball game was being heckled, threw ball at crowd. Ball went through fence, hit Manning, who sued pitcher and the team (employer). Court held for plaintiff.

10. “To establish an agency relationship between [a franchiser and franchisees], the plaintiffs must show that [the franchiser] has given consent for the
branded stores to act on its behalf and that the branded stores are [subject to franchiser’s control].”

Arguello v. Conoco (207 F3d 803 (5th Cir. 2000); p. 69)

Class action against Conoco for acts of racial discrimination at Conoco-brand gas stations. Court held there was no agency relationship between Conoco Inc. and the branded gas stations.

11. **An employer can’t be found to have ratified an employee’s actions unless employer knew of the act and adopted, confirmed, or failed to repudiate it.**

Arguello v. Conoco (207 F3d 803 (5th Cir. 2000); p. 69)

12. **A principal is not liable for the negligence of the contractor during the performance of the contract unless the principal retains control over the “means and manner” of the work being contracted for, if the principal hires an incompetent contractor, or if the work contracted for constitutes a nuisance.”**

Majestic Realty v. Toti Contracting (30 NJ 425 (1959); p. 76)

Majestic owned buildings adjacent to property owned by Authority, who hired Toti to demolish one of its buildings. In the process, Toti negligently demolished one of Majestic’s buildings. Court found Authority liable for the acts of its independent contractor because the work contracted for was a per se nuisance.

13. **“If a servant takes advantage of his service and violates his duty of honesty and good faith to make a profit for himself […] then he is accountable for it to his master.”**

Reading v. Regem (2 KB 268 (1948); p. 81)

British soldier earned extra money by acting as a security guard for presumably illegal activities; wore his uniform while doing so. Crown discovered the bribery and claimed the money as his principal. Court upheld the seizure.

14. **If an agent violates his duty to his principal and engages in business practices for which he earns a secret profit, he must account to his principal the amount illegally received.**

General Automotive v. Singer (19 Wis.2d 528 (1963); p. 84)

GA employed Singer, who did rainmaking for GA; when he knew GA was booked, would refer clients to competitors and get kickbacks. Court held Singer owed to GA the profits he made because he violated his fiduciary
duty as GA’s agent.

15. “Even where a solicitor of business does not operate fraudulently under the banner of his former employer, he still may not solicit the latter’s customers who are not openly engaged in business in advertised locations or whose availability as patrons cannot readily be ascertained but whose trade and patronage have been secured by years of business effort and advertising, and the expenditure of time and money […].” Town & Country House v. Newbery (3 NY2d 554 (1958); p. 88) Newbery worked for T&C, broke away and started competing business; T&C sued for unfair competition. Court held for T&C.

II. PARTNERSHIPS
A. PARTNERSHIP GENERALLY
i. A partnership is an association of “two or more persons to carry on as co-owners a business for profit.” Uniform Partnership Act (1914) § 7.

ii. Sharing in profits is prima facie evidence of the existence of a partnership, but not if the profits are received by a party as employee wages, as rent, as annuity to the representative of a deceased partner, as interest on a loan, or as consideration for a sale. Uniform Partnership Act (1914) § 7.

iii. Joint tenancy or common ownership does not establish by itself a partnership, whether or not the co-owners share in profits from the property. Uniform Partnership Act (1914) § 7.

iv. Parties who are not partners to each other are not partners as to third parties. Uniform Partnership Act (1914) § 7(1).

v. Partnership by estoppel: A party who represents himself, or permits another to represent him, to a third party as a partner (whether to a partnership or to others who aren’t in a partnership), is liable to the third party who, in reliance on the representation, gives credit to the partnership. Uniform Partnership Act (1914) § 16(1).

vi. Elements relevant to determining if a partnership exists: intent of the parties, right to share in profits, obligation to share in losses, sharing ownership and control of property and business, language in the agreement, conduct towards third parties, and rights upon dissolution. Fenwick v. Unemployment Compensation
Comm. (133 NJL 295 (1945); p. 92) Fenwick and Chesire drew up a contract under which Chesire would work for Fenwick, who retained control of business, but the K called the two partners. Court held the K was an employment agreement, not partnership.

evii. To prove a partnership, parties may introduce as evidence a written agreement, testimony as to an oral agreement, or circumstantial evidence. Martin v. Peyton (246 NY 213 (1927); p. 97) A banker-broker firm, KN&K, was in financial difficulties, and Peyton et al. offered to become partners in the business. That offer was rejected, but a new agreement arose in which Peyton et al. would lend KN&K money, receive speculative stock in return, and also get 40% of profits till loan repaid; Peyton et al. had rights to inspect KN&K’s books and veto any proposals deemed too speculative. Court determined this arrangement was not a partnership.

viii. Because a partnership can be created even in the absence of a partnership contract, the existence or non-existence of a partnership must be evaluated in light of the totality of the circumstances. Southex Exhibitions v. Rhode Island Builders Assn. (279 F3d 94 (1st Cir. 2002); p. 102) Agreement between RIBA and SEM on home shows; each party had rights and obligations, profits were to be shared, and agreement called the parties partners. Southex acquired SEM’s interest, disagreement over terms with RIBA, and RIBA dissolved agreement. Court held agreement was not a partnership.

ix. Partnership by estoppel – see UPA sections quoted above. Young v. Jones (816 F.Supp. 1070 (DSC 1992); p. 107) Plaintiffs made an investment deposit on the basis of a financial statement that was later found to be falsified. The statement had been certified by a Bahamian accounting firm identified in the audit letter as Price Waterhouse. Plaintiffs claimed PW-Bahamas and PW-US operated as a partnership; defendants argued they are separate organizations. Court found no evidence that investment made on belief of a partnership between PW-Bahamas and PW-US, so no partnership by estoppel.

B. FIDUCIARY OBLIGATIONS OF PARTNERS

i. The duty of loyalty a partner owes to the partnership and the partners is limited to (1) accounting to and holding as trustee for the partnership any property, profit, or benefit
derived from partnership business, (2) refraining from dealing with the partnership as or on behalf of a party with interests adverse to the partnership, and (3) refraining from competing with the partnership. Revised Uniform Partnership Act (1994) § 404(b).

ii. “A partner’s duty of care to the partnership and the other partners in the conducting and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law.” Revised Uniform Partnership Act (1994) § 404(c).

iii. “Unless authorized by the other partners, […] one or more but less than all the partners have no authority to do any […] act would would make it impossible to carry on the ordinary business of the partnership.” Uniform Partnership Act (1914) § 9(c)(3).

iv. Dissolution is caused, without violation of the partnership agreement, by the expulsion of any partner from the partnership in accordance with the power to do so granted under the partnership agreement. Uniform Partnership Act (1914) § 38.

v. A partner has an obligation to disclose, upon demand, “true and full information of all things affecting the partnership to any partner.” Uniform Partnership Act (1914) § 20.

vi. “Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty.” Meinhard v. Salmon (249 NY 458 (1928); p. 111) Salmon and Meinhard created joint venture in a business in property leased to Salmon by Gerry; parties agree that Salmon and Meinhard were partners with fiduciary duties to each other. At time of lease renewal, Salmon entered into a new agreement with Gerry without informing Meinhard of the new agreement or including him as a partner in it. Meinhard argued for a piece of the new agreement. Court agreed found Salmon had violated fiduciary duty to Meinhard.

vii. “A partner is a fiduciary of his partners, but not of his former partners, for the withdrawal of a partner terminates the partnership as to him.” Bane v. Ferguson (890 F2d 11 (7th Cir. 1989); p. 117) Bane, a lawyer at ILB when it adopted a retirement plan, retired and received pension benefits under the plan. Later, ILB merged and the merged firm went under, causing cessation of the pension plan. Bane
sued, claiming ILB’s managing council violated its duty to him. Court found no fiduciary duty to a retired partner.

viii. Partners owe each other a fiduciary duty of “the utmost good faith and loyalty [...] As a fiduciary, a partner must consider his or her partners’ welfare, and refrain from acting for purely private gain.” Meehan v. Shaughnessy (404 Mass. 419 (1989); p. 119) Meehan et al. were partners at PCD, left to start their own firm, and then sued PCD, claiming PCD owed them money under the partnership agreement. PCD counterclaimed, claiming breach of fiduciary duty and tortious interference. Court found Meehan et al. had acted improperly in the way they solicited clients from PCD; remanded for further findings.

ix. A fiduciary may plan to compete with the partnership so long as in the planning, he does not otherwise violate his duties to the partnership. Meehan v. Shaughnessy (404 Mass. 419 (1989); p. 119)

x. “Where the remaining partners in a firm deem it necessary to expel a partner under a no cause expulsion clause in a partnership agreement freely negotiated and entered into, the expelling partners act in “good faith” regardless of motivation if that act does not cause a wrongful withholding of money or property legally due the expelled partner at the time he is expelled.” Lawlis v. Kightlinger & Gray (562 NE2d 435 (Ind.App. 1990); p. 127) Lawlis, a partner at K&G, told partners he was an alcoholic. Agreement drafted under which he’d get treatment and retain his partnership position; agreement specified no second chances. He started drinking again and partners did give him a second chance, but then fired him, with severance, two years later. Lawlis sued, claiming breach of fiduciary duty. Court disagreed, found no breach.

C. Partnership Property

i. Co-partners do not own any asset of the partnership; the partnership owns the asset and the partners own interest in the partnership. Their interest is an undivided interest, a pro rata share of the net value of the partnership. Putnam v. Shoaf (620 SW2d 510 (Ct.App.Tenn. 1981); p. 134) Putnam sold her partnership interest in a failing business to Shoaf. Business later recovered a substantial judgment against a thieving employee; Putnam sued, claiming the money paid to partner Shoaf rightfully belonged to Putnam. Court disagreed; holding that she sold her partnership interest and
therefore any rights she had in the business.


d. Rights of Partners in Management

i. “What either partner does with a third person is binding on the partnership.” National Biscuit Co. v. Stroud (249 NC 467 (1959); p. 142) Stroud and Freeman partners in a grocery store. Stroud said he’d no longer be liable for purchases made from NBC, Freeman made purchases anyway, but Stroud wouldn’t pay. Court found Stroud was liable because Freeman’s actions were within the scope of the partnership and Stroud, not being a majority of partners, couldn’t prevent Freeman from acting.

ii. “Every partner is an agent of the partnership […] and all partners are jointly and severally liable for the acts and obligations of the partnership,” unless the partner has no authority to act in that particular matter and the third party knows of the restriction. National Biscuit Co. v. Stroud (249 NC 467 (1959); p. 142) (emphasis added)

iii. Business differences regarding ordinary partnership business may be decided by a majority of partners, and an act in contravention of such an agreement shall not bind the partnership unless the act was agreed to by all partners. National Biscuit Co. v. Stroud (249 NC 467 (1959); starts on p. 142) (emphasis added)

iv. Business differences regarding ordinary partnership business may be decided by a majority of partners, provided that the partners have no other agreement speaking to the issues. Summers v. Dooley (94 Id. 87 (1971); starts on p. 144) Summers and Dooley partners in a garbage removal business and did the work themselves. S wanted to hire a third person, D said no, S did it anyway, and D refused to pay the third guy from partnership funds. S sued. Court found D couldn’t be held liable because a majority of partners hadn’t consented to the action.

1. Note: Summers seems to contradict National Biscuit. Both dealt with two-partner businesses, but National Biscuit upheld liability to the non-consenting partner, and Summers did not. The difference appears to be that in National Biscuit, the non-consenting partner wanted to change the partnership’s pattern of behavior (i.e., stop ordering from NBC) whereas in
Summers the non-consenting partner wanted to keep things as they were (i.e., no employee hired).

v. **Moren ex rel. Moren v JAX Restaurant** -- partner was acting in the ordinary course of business when she went to restaurant with her son after finding out that a cook had called in sick, and the son stuck his hands in the pizza dough roller. The partnership (its insurance) is liable for the partner’s negligence, even though she was also acting in her role as mother.

vi. “The essence of a breach of fiduciary duty between partners is that one partner has advantaged himself at the expense of the firm.” Day v. Sidley & Austin (394 F.Supp. 986 (DDC 1975); p. 146) Day was a partner at S&A. E-board announced merger plans, partners (including Day) voted to approve. After merger, Day’s office location moved and he was made co-chair, rather than chair, of his office. He sued. Court found he had no rights to what he lost under his partnership K, and merger was allowed under the partnership K, so no violation of fiduciary duty.

vii. “The basic fiduciary duties are: 1) a partner must account for any profit acquired in a manner injurious to the interests of the partnership, such as commissions or purchases on the sale of partnership property; 2) a partner cannot without the consent of the other partners, acquire for himself a partnership asset, nor may he divert to his own use a partnership opportunity; and 3) he must not compete with the partnership within the scope of the business.” Day v. Sidley & Austin (394 F.Supp. 986 (DDC 1975); p. 146)

E. **PARTNERSHIP DISSOLUTION**

i. Courts shall decree a partnership dissolved upon application by a partner when it can be shown that a partner “has been guilty of such conduct as tends to affect prejudicially the carrying on of the business,” that a partner willfully or persistently breaches the partnership agreement, or that any other circumstances exist that make dissolution an equitable solution. Uniform Partnership Act (1914) § 32.

ii. When a partnership contract does not specify a definite term or particular undertaking, the partnership may be dissolved at the will of any partner. Uniform Partnership Act (1914).

iii. When a partner or partners dissolve a partnership in a manner not in accord with the partnership agreement,
partners who didn’t cause the wrongful dissolution have the right to damages for breach and the right to continue the partnership business if they wish, provided they pay the dissolving partners for their interest in the partnership at the time of dissolution, less any damages caused by the wrongfully-dissolving partners. Uniform Partnership Act (1914) § 38.

iv. If a partner withdraws in a manner not in accord with the partnership agreement, the partnership isn’t necessarily dissolved. If it isn’t, the remaining partners must buy out the withdrawing partner for his/her interests in the partnership assets, less any damages for wrongful withdrawal. Revised Uniform Partnership Act (1997) § 701.

v. “Each partner is entitled to an equal share of the partnership profits and is chargeable with a share of partnership losses in proportion to the partner’s share of the profits.” Revised Uniform Partnership Act (1997) § 401(b)

vi. Dissolution upon bad acts by a partner – see UPA § 32 above. Owen v. Cohen (19 Cal.2d 147 (1941); p. 154) Partnership in bowling alley; one partner managed and one partner financed. Disagreement over how business to be run; conflicts affected profitability. Owen (financing partner) sued for dissolution. Court found Cohen at fault for the disharmony and ordered dissolution.

vii. “[T]here is no such thing as an indissoluble partnership only in the sense that there always exists the power, as oppose to the right, of dissolution. But the legal right to dissolution rests in equity, as does the right to relief from the provisions of any legal contract.” Collins v. Lewis (283 SW2d 258 (Tex Ct App 1955); p. 157) Partnership agreement to open café; Collins to finance and Lewis to manage. Cost overruns in preparing to open and in running the business; Collins said Lewis mismanaged and Lewis said Collins micromanaged. Collins sued for dissolution. Court found that under the partnership agreement, dissolution proper only if and when Lewis failed to pay Collins back on the agreed-upon terms. Lewis hadn’t breached the terms, so dissolution not granted on those grounds; further, by refusing to make the mortgage payment, Collins was actually in breach.
viii. “A partner at will is not bound to remain in a partnership, regardless of whether the business is profitable or unprofitable.” Exercising the power to dissolve, however, must be exercised pursuant to the fiduciary duty of good faith. Page v. Page (55 Cal.2d 192 (1961); p. 162) Partnership in linen business initially unprofitable. Major creditor a corporation owned by one partner, plaintiff here. Partnership turned profitable, but P still wanted to dissolve. Court found that there was no definite term specified in the partnership K, so P could dissolve at will.

ix. A partnership at will may be dissolved when a partner is frozen out or excludes from the “management and affairs of the partnership.” Prentiss v. Sheffel (20 Ariz. App. 411 (1973); p. 165) Three-person partnership-at-will. Two partners excluded the third from business decisions (as court found, because they couldn’t work well together, not out of bad faith attempt to acquire business). Partnership was declared dissolved by the courts; those two partners then purchased partnership assets from the court-ordered sale. Court held such a purchase was proper.

x. A partner is not prohibited from bidding on partnership assets at a judicially-ordered sale. Prentiss v. Sheffel (20 Ariz. App. 411 (1973); p. 165)

xi. Disotell v. Stiltner- On appeal, the Supreme Court of Alaska, in a case of first impression, declined to require liquidation and upheld the ruling of the trial court to permit Stiltner to buy out Disotell’s partnership interest. The court reasoned that the statute did not compel liquidation and did not forbid buyouts. The court noted that, under appropriate circumstances, a buyout is a justifiable way of winding up a partnership. The court reasoned that a properly conducted buyout guaranteed Disotell a fair value for his partnership interest, whereas liquidation exposed him to the risk that no buyer would offer to pay fair market value for the property.

xii. Dissolution in contravention of partnership agreement – see UPA § 38 above. Pav-Saver v. Vasso (143 IllApp3d 1013 (1986); p. 171) Pav-Saver a partnership formed by Dale (contributing work), PSC (contributing patents and trademarks), and Meersman (contributing money). This agreement dissolved and replaced with identical one between PSC and Vasso. PSC tried to terminate pursuant to agreement, Vasso physically ousted Dale and assumed management, and PSC sued for dissolution and a return of
its patents and trademarks. Court found PSC wrongfully dissolved, Vasso could continue the business and keep the trademarks, and PSC would get liquidated damages.

xiii. Partners are presumed to have intended to share equally in the profit and loss of the partnership business, regardless of any inequality in money fronted by the partners, absent agreement to the contrary. Kovacik v. Reed (49 Cal.2d 166 (1957); p. 177) Contracting partnership, Reed to superintend and share in profits, Kovacik to finance. No specification on what would happen if lost money on the contracting job. Job did lose money and Kovacik sued when Reed refused to pay Kovacik half the loss. Court found Reed not liable for losses.

xiv. When one partner contributes money and another labor, “neither party is liable to the other for contribution for any loss sustained. Thus, upon loss of the money the party who contributed it is not entitled to recover any part of it from the party who contributed only services.” Kovacik v. Reed (49 Cal.2d 166 (1957); p. 177)

1. Note: this holding of Kovacik is specifically rejected by the Revised Uniform Partnership Act § 401(b).

xv. When a partner dies, retires, resigns, or goes insane, the remaining partners may continue the business provided they purchase the interest of the withdrawing partner according to the buyout provision in the Articles of Partnership – the partner’s capital account plus the average of the prior three years’ profits/gains actually paid to the partner. G&S Investments v. Belman (145 Ariz. 258 (1984); p. 181) Partnership in apartment complex. One partner got involved in drugs, rarely worked, and when did, pushed for bad investments. Partners sued to dissolve; while suit was pending, that partner died. Court held that the filing for dissolution was not an effected dissolution, but the partner’s wrongful conduct gave the court power to dissolve, and partners had to buy out the partner’s interest.

xvi. “[A]bsent a contrary agreement, any income generated through the winding up of unfinished business [of a dissolving partnership] is allocated to the former partners according to their respective interests in the partnership.” Jewel v. Boxer (156 Cal.App.3d 171 (1984); p. 185) Law firm dissolved; partners formed new firms. Had no K on what to do with fees incoming from active cases of the old partnership. Court held fees were to be allocated among
former partners based on their partnership interests.

xvii. “[A] partner who separates his or her practice from that of the firm receives (1) the right to his or her capital contribution, (2) the right to a share of the net income to which the dissolved partnership is currently entitled, and (3) the right to a portion of the firm’s unfinished business, and in exchange gives up all other rights in the dissolved firm’s remaining assets.” Meehan v. Shaughnessy (404 Mass. 419 (1989): facts on p.119, this segment starts on p. 190) Partners in a law firm left, formed own firm, solicited clients from old firm. Court held the withdrawing partners violated fiduciary duty, and remaining partners had the right to payment of a fair charge for any case removed from their firm.

F. LIMITED PARTNERSHIPS

i. “A limited partner shall not become liable as a general partner, unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.” Holzman v. De Escamilla (86 Cal.App.2d 858 (1948); starts on p. 196) Limited partnership went into bankruptcy. Limited partners participated in decision-making, wrote checks, had to countersign general partners’ checks. Court held that the limited partners were general partners in fact and thus liable for partnership’s debt.

III. THE NATURE OF THE CORPORATION

A. PROMOTERS AND THE CORPORATE ENTITY

i. “One who contracts with what he acknowledges to be and treats as a corporation, incurring obligations in its favor, is estopped from denying its corporate existence, particularly when the obligations are sought to be enforced.” Southern-Gulf Marine v. Camcraft (410 So.2d 1181 (La.App. 1982); p. 201) Letter of agreement that Camcraft would build a ship for SGM specified that SGM was a US corporation. SGM not actually incorporated at the time of the K, later incorporated in Cayman Islands; SGM informed Camcraft of its Cayman incorporation. Camcraft didn’t deliver the boat, SGM sued, and Camcraft argued K void b/c of the incorporation issue. Court held for SGM, said Camcraft’s substantial rights not affected by the issue.

ii. “[A party], having given its promise [...] should not be permitted to escape performance by raising an issue as to the character of the organization to which it is obligated,
unless its substantial rights might thereby be affected.”
Southern-Gulf Marine v. Camcraft (410 So.2d 1181 (La.App. 1982); p. 201)

B. THE CORPORATE ENTITY AND LIMITED LIABILITY

i. Piercing the corporate veil is allowed whenever necessary “to prevent fraud or to achieve equity. [...] Whenever anyone uses control of the corporation to further his own, rather than the corporation’s business, he will be liable for the corporation’s acts.” Walkovsky v. Carlton (18 NY2d 414 (1966); p. 206) Plaintiff run over by a cab, which was owned by a corporation whose sole stockholder owned ten like corporations, each with a couple cabs. Plaintiff sued stockholder, claiming the fractured corporate entity was an attempt to defraud the public. Court disagreed, said there was no cause of action to pierce veil.

ii. There are two requirements that must be met before the corporate veil can be pierced: such a “unity of interest and ownership” that the corporation and the individual are not separate personalities, and circumstances are such that not piercing the veil would “sanction a fraud or promote injustice.” Sea-Land Services v. Pepper Source (941 F2d 519 (7th Cir. 1991); p. 211) SLS shipped peppers for PS, who didn’t pay its bill and later was dissolved. SLS sued, attempting to pierce corporate veil and get payment from stockholder; SLS was also attempting to reverse-pierce defendant’s other corporations. Court found first part of test satisfied, remanded for findings on the second part.

iii. There are four factors involved in reverse-piercing: “(1) failure to maintain adequate corporate records or to comply with corporate formalities, (2) the commingling of funds or assets, (3) undercapitalization, and (4) one corporation treating the assets of another corporation as its own.” Sea-Land Services v. Pepper Source (941 F2d 519 (7th Cir. 1991); p. 211).

▪ ROMAN CATHOLIC ARCHBISHOP OF SAN FRANCISCO v SHEFFIELD- Tried to hold local subsidiary/archbishop of San Francisco as alter ego
  o The roman catholic church, governed by the pope through the Coede of Canon Laaw—one worldwide corporation
  • Alter ego theory:
    o 1) such a unity of interest and ownership that the individuality of such person and corporation has ceased AND
2) the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the circumstances, sanction a fraud or promote injustice

- May have raised an issue as to whether the Pope is an alter ego, but not the archbishop
  - Makes a parent liable for the actions of a subsidiary which it controls
  - Does not make a subsidiary liable for the other subsidiaries when all are controlled by a parent corporation
  - No respondent superior

1. The purpose of the doctrine is not to protect every unsatisfied creditor, but rather to afford him protection, where some conduct amounting to bad faith makes it inequitable… for the equitable owner of a corporation to hide behind its corporate veil

iv. “[A] parent corporation is expected – indeed, required – to exert some control over its subsidiary. Limited liability is the rule, not the exception. […] However, when a corporation is so controlled as to be the alter ego or mere instrumentality of its stockholder, the corporate form may be disregarded in the interests of justice.” In re Silicone Gel Breast Implants Product Liability Litigation (887 F.Supp. 1447 (NDAla. 1995); p. 221) Bristol bought MEC; they had a parent-subsidiary relationship and Bristol was involved in MEC’s day-to-day business. MEC eventually shut down by Bristol. MEC was sued in tort over breast implants; plaintiffs wanted to pierce veil and go after Bristol. Court found it couldn’t grant summary judgment to Bristol, issue of “alter ego” to be decided by jury.

v. To determine if a subsidiary is merely the alter ego of the parent, the court must evaluate the totality of the circumstances, considering factors like: if they have directors or officers in common, if they file consolidated taxes, if the subsidiary is undercapitalized, if the subsidiary gets all its business from the parent, if the parent uses the subsidiary’s property for its own, if the parent pays expenses or wages for the subsidiary, if their daily operations are commingled. In re Silicone Gel Breast Implants Product Liability Litigation (887 F.Supp. 1447 (Ala. 1995); p. 221)

vi. When determining if veil-piercing is appropriate in a parent-subsidiary situation, no showing of fraud is
required under Delaware law. In re Silicone Gel Breast Implants Product Liability Litigation (887 F.Supp. 1447 (Ala. 1995); p. 221)

vii. “[L]imited partners do not incur general liability for the limited partnership’s obligations simply because they are officers, directors, or shareholders of the corporate general partner.” Frigidaire Sales Corp. v. Union Properties (88 Wash2d 400 (1977); p. 229) Mannon and Baxter limited partners in Commercial and also directors and shareholders of Union. Union was Commercial’s only general partner. Commercial breached contract with Frigidaire, who sued and tried to pierce Commercial’s and Union’s veils. Court refused to pierce veil, found that Mannon and Baxter “scrupulously separated” their actions on behalf of Union from their personal actions, and Frigidaire never had cause to believe Mannon and Baxter were general partners in Commercial.

C. SHAREHOLDER DERIVATIVE ACTIONS

i. “[A] stockholder who brings suit on a cause of action derived from the corporation assumes a position [...] of a fiduciary character. He sues, not for himself alone, but as a representative of a class [...] [The state is not obliged] to place its litigating and adjudicating process at the disposal of such a representative, at least not without imposing standards of responsibility, liability, and accountability which it considers will protect the interests he elects himself to represent.” Cohen v. Beneficial Industrial Loan (337 U.S. 541 (1949); p. 232) Cohen, owner of .0125% of BIL stock, alleged corporate mismanagement, filed shareholder derivative suit. State law required shareholders owning so little stock to post bond for corporation’s defense costs in case shareholders lose; P challenged law. Court found law a reasonable exercise of state power.

ii. “[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 and may take the form of a representative class action.” Eisenberg v. Flying Tiger Lane (451 F2d 267 (2d Cir. 1971); p. 236) Suit to prevent merger and reorganization. Corporation demanded bond for costs, pursuant to state law on shareholder derivative suits. Court held the action was personal, not a shareholder derivative, so no bond required.

iii. When the plaintiff is charging that management is
interfering with the rights and privileges of stockholders and is not challenging management’s acts on behalf of the corporation, securities for costs cannot be required. Eisenberg v. Flying Tiger Lane (451 F2d 267 (2d Cir. 1971); p. 236)

iv. “Directors may not delegate duties which lie at the heart of the management of the corporation.” However, “an informed decision to delegate a task is as much an exercise of business judgment as any other [...] [and] business decisions are not an abdication of directorial authority merely because they limit a board’s freedom of future action.” Grimes v. Donald (673 A.2d 1207 (Del.Sup.Ct. 1996); p. 241) Grimes, shareholder in DSC, believed employment agreement between DSC and Donald, CEO, was bad. Grimes asked Board to abrogate the agreements; Board refused. Grimes attempted shareholder derivative suit and claimed that his suit was excused from legal requirement of asking Board to sue. Court held employment agreement not an abdication of Board’s duty, and Grimes couldn’t argue his suit was excused when he had asked and had been refused.

v. When a claim of harm belongs to the corporation, it is the corporation, through the Board, that must decide whether or not to pursue the claim. Shareholder derivative actions impinge on the Board’s managerial freedom; therefore, when a shareholder files a derivative action, he/she must show either Board rejection of his/her pre-suit demand, or justification why demand wasn’t made (AKA excusal). Grimes v. Donald (673 A.2d 1207 (Del.Sup.Ct. 1996); p. 241)

vi. “The basis for claiming excusal would normally be that: (1) a majority of the board has a material financial or familial interest; (2) a majority of the board is incapable of acting independently [...] or (3) the underlying transaction is not the product of a valid exercise of business judgment.” Grimes v. Donald (673 A.2d 1207 (Del.Sup.Ct. 1996); p. 241)
vii. Demand may be excused for futility when a complaint alleges that a majority of the Board have interests (either self-interest or loss of independence of a non-self-interested director because of control by a self-interested director) in the challenged transaction, or that a majority of the Board wasn’t fully informed of about the transaction, or that the challenged transaction was so egregious as to not be a product of sound business judgment. Marx v. Akers (644 NYS2d 121 (1996); starts on p. 249) Marx filed shareholder derivative suit without pre-suit demand as required by state law; suit alleged waste of corporate assets and self-dealing by directors. Court found demand excused, but complaint dismissed because there was no wrong to corporation.

D. THE ROLE OF SPECIAL COMMITTEES

i. Courts are not equipped to evaluate “what are and must be essentially business judgments.” Auerbach v. Bennett (47 NY2d 619 (1979); p. 256) GTE management conducted internal investigation of contributions to politicians, gave results of investigation to Board. Outside auditor hired, found wrongdoing. Report made to SEC and shareholders. Board created litigation committee to determine what action should be taken on behalf of corporation. After more investigation, committee decided not to litigate. Court found Board and its committee acted properly and its decision not to litigate was protected by business judgment rule.

ii. Stockholders, as a general rule, cannot be allowed “to invade the discretionary field committed to the judgment of the directors and sue in the corporation’s behalf when the managing body refuses.” Zapata Corp v. Maldonado (430 A.2d 779 (Del. 1981); p. 261) Board created investigation committee that recommended action be dismissed. Court remanded for further fact-finding on independence and good faith of the committee.

iii. If the Board wrongfully refuses action, a shareholder may have the right to initiate action and may sue on behalf of the corporation without demand, when it is apparent that demand is futile. Zapata Corp v. Maldonado (430 A.2d 779 (Del. 1981); p. 261)

iv. A Board may legally delegate authority to a committee of disinterested directors when the Board finds that it is tainted by the self-interest of a majority of directors. Zapata Corp v. Maldonado (430 A.2d 779 (Del.
v. An action must be dismissed if a committee of independent and disinterested directors conducted a proper review, considered a variety of factors and reached a good-faith business judgment that the action was not in the best interest of the corporation. *Zapata Corp v. Maldonado* (430 A.2d 779 (Del. 1981); p. 261)

vi. In Re Oracle Corp Derivative Litigation—Independence of “SLC”’s-special litigation committees—In finding that the SLC failed to meet its burden of proving its independence, the Court articulated the following principles. First, and most importantly, it held that "the question of independence turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind." This is a departure from prior Delaware case law which, in some cases, adopted a flexible independence inquiry and, in other cases, used a more rigid approach focused on whether a given director is under the notional or economic "dominion and control" of an interested party. By measuring the SLC's independence contextually, taking into account all the circumstances, the Court articulated an independence test that was stricter and more situation-specific than those expressed in the past.

1. When applying this test to the SLC, the Court was satisfied that neither Garcia-Molina nor Grundfest was compromised by any fear that an unfavourable recommendation would harm his ability to earn a living. Nevertheless, the Court found that the inter-relationships between the SLC and the defendant directors were on the minds of the SLC members in a way that generated an unacceptable risk of bias. The Court also acknowledged that even though its task was to determine whether the SLC members were subjectively or actually biased, its consideration of how a reasonable person in the same position would behave was inescapable. Accordingly, the Court felt there was reason to suspect material considerations, other than the best interests of Oracle, could have influenced the SLC.

2. First, when establishing a special committee, boards of directors should make in-depth inquiries into the background of proposed members. Depending on the context, inquiries may extend into academic background, professional and charitable affiliations of proposed members. Second, the due diligence process should not only focus on the proposed members' direct relationships with interested parties, but on indirect relationships as well.

E. THE ROLE AND PURPOSES OF CORPORATIONS
i. A corporation may participate in the creation and maintenance of community, charitable, and philanthropic funds as the directors deem appropriate and will, in their judgment, contribute to the protection of corporate interests. AP Smith Mfg. v. Barlow (13 NJ 145 (1953); p. 270) Corporation wanted to donate to Princeton University; shareholders objected. Court upheld corporation’s judgment to donate.

ii. Directors have the power to declare the amount and frequencies of dividends, and courts will not interfere in those decisions unless it is clear the directors are guilty of fraud, misappropriation, or that they are refusing to declare a dividend when the corporation has a surplus of net profit and can distribute it to shareholders without detriment to the business AND such a refusal is such an abuse of discretion as to amount to fraud or breach of good faith to shareholders. Dodge v. Ford Motor Co. (204 Mich. 459 (1919); p. 276) Ford was a very profitable car maker; Dodge owned 10%. Ford cancelled its special dividends program in favor of a reinvestment policy. Dodge objected, offered its 10% for sale to Ford, who refused. Dodge sued, alleging the new policies were an abuse of discretion. Court partially agreed, ordering dividend paid but allowing some reinvestment.

iii. It is not the function of the courts to resolve a corporation’s questions of policy and management, and the judgment of directors will be accepted by the courts unless those decisions are shown to be tainted by fraud. Shlensky v. Wrigley (95 Ill.App.2d 173 (1968); p. 281) Wrigley, owner of Chicago Cubs, refused to have night games on Wrigley field. Shlensky, a shareholder, sued, claiming decision was an abuse of discretion, and didn’t initiate demand, claiming Board capture by Wrigley. Court gave deference to Board, dismissed Shlensky’s suit.

IV. LIMITED LIABILITY COMPANY

a. LLCs are desirable b/c combine corporate-type liability with partnership-type flexibility and tax advantages.

b. Formation

i. Water, Waste and Land, Inc D/B/A/ Westec v. Lanham—importance of using the LLC on all firm documents and completing contracts properly. The decision illustrates the courts’ inclination to protect third parties in their dealings with agents of a business

ii. the plaintiff, a development and engineering firm that had performed work for an LLC, successfully sued one of the owners
in his individual capacity. Water, Waste & Land had performed work for the LLC, which was owned by two members, Lanham and Clark. When arranging to have work done, Clark failed to properly fill out a contract and verbally authorized the plaintiff to do the work. Clark gave the plaintiff a business card that showed the initials of the business name but did not include the letters LLC. The business card included the LLC’s address, which happened to be the same as Lanham’s personal address. The Colorado Supreme Court ruled that Clark had acted as an agent of Lanham and ultimately held both Lanham and the LLC liable for the bill.

c. The operating agreement

i. Elf Atochem North America Inc v Jaffari- The statute did not authorize, but also did not expressly prohibit, a limited liability company agreement from providing for the exclusive jurisdiction of the courts of a jurisdiction other than Delaware. In Elf Atochem North America, Inc. v. Jaffari, et al., C.A. No. 16320 (Del. Apr. 6, 1999), affg (Del. Ch. June 9, 1998), the Delaware Supreme Court, applying the provisions of Section 18-109(d), held that a contractual choice of California as the exclusive jurisdiction to maintain a court proceeding in a limited liability company agreement was enforceable.

ii. Essentially, giving premiere emphasis to the provisions of contract to have proper venue only in California and that DE law respects the right of LLC to contract its specific provisions—DE law is only a default provision when the contract does not speak to that subject. Contractual forum selection provisions must govern.

d. Piercing the “LLC” Veil

i. Kaycee Land and Livestock v. Flahive—no reason to treat LLCs differently than corporations in regard to the piercing the corporate veil. Here the WY legislature has not spoken on piercing the veil of an LLC; court says then should treat as common law unchanged, which they interpret to mean that LLCs should be treated the same as corps in this regard. --the district ct must complete a fact intensive inquiry and exercise its equitable powers to determine whether piercing the veil is appropriate

1. If the members and officers of an LLC fail to treat it as a separate entity as contemplated by the statute, they should not enjoy immunity from individual liability for the LLC’s acts that cause damage to 3rd parties.

e. Fiduciary Obligation

i. McConnell v. Hunt Sports Enterprises
1. Sec 3.3 of the operating agreement – members may compete, thus waived the duty of loyalty to the LLC
2. “in any other business venture of any nature, including any venture which might be competitive with the business of the company”
3. Without this agreement, you have the same duties of loyalty and care that you would have in a corporation

f. Dissolution

i. New Horizons Supply Cooperative v. Haack-

1. LLC that dissolved—since the proper dissolution papers were not filed, then the individual members are liable:
2. “if the dissolved limited liability company’s assets have distributed in liquidation, a member of the limited liability company to the extent of the assets of the limited liability company distributed to the member in liquidation, whichever is less, but a member’s total liability for all claims under this section may not exceed the total value of the assets distributed to the member in liquidation.”

V. THE DUTIES OF OFFICERS, DIRECTORS, AND INSIDERS

A. THE DUTY OF CARE

i. “Courts will not interfere with [the business judgment of the Board] unless it first be made to appear that the directors have acted or are about to act in bad faith and for a dishonest purpose. […] More than imprudence or mistaken judgment must be shown.” “Kamin v. American Express Co. (383 NYS2d 807 (1976); p. 316) AE bought shares in DLJ, ended up losing most of its investment. Declared a special dividend to distribute DLJ shares in kind. Shareholder derivative suit arguing that the shares should instead be sold for the tax advantages; AE refused and dividend was paid. Court found for AE, said no bad faith in AE decision.

ii. “The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves, prior to making a business decision, of all material information reasonably available to them. […] the concept of gross negligence is the proper standard for determining whether a business judgment reached by a board of directors was an informed one.” Smith v. Van Gorkom (488 A2d 858 (Del.Sup.Ct. 1985); p.320) Trans Union’s CEO, Van Gorkom, approached Pritzker with proposal to sell Trans Union; CEO didn’t inform Board, just company controller. Pritzker set up deal and CEO took it to
management, who hated it; CEO took it to Board anyway, and merger went through. Shareholders sued; Court found for shareholders, saying Board’s decision wasn’t an informed one.

### III. Brehm v. Eisner

The court stated that "the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions."

1. Nevertheless, the state supreme court upheld the Chancery Court's finding that the business judgment rule shielded the director's decisions, stating that "courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context."
2. Failing to respect decisions made in good faith by disinterested directors would, the court declared, "invite courts to become super-directors."

### iv. Directors must “discharge their duties in good faith and with that degree of diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions.” A lack of knowledge about the business or failure to monitor the corporate affairs is not a defense to this requirement. Francis v. United Jersey Bank (87 NJ 15 (1981); p.349) Pritchard inherited 48% interest in reinsurance company; she and her two sons were directors. She wasn’t involved in day-to-day ops and knew almost nothing about the business. Sons misappropriated millions and corporation went into bankruptcy. Court held Pritchard had duty of care and breached it.

### v. Director liability for breach of duty of care may arise in two contexts: from a Board decision that was ill-advised or negligent, or from “an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.” In re Caremark International Inc. Derivative Litigation (698 A2d 959 (Del.Ch. 1996); p. 355) Caremark, a health care corporation, had contracts that raised spectre of kickbacks, changed policies to avoid kickback problems. Internal audit revealed compliance with policy, but Caremark tightened procedures anyway. Firm and some officers indicted; shareholder derivative suit alleging breach of duty of care. Court approved settlement for reorganizing Caremark’s supervisory system.

### vi. If a director “exercises a good faith effort to be
informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention.”
In re Caremark International Inc. Derivative Litigation (698 A2d 959 (Del.Ch. 1996); p. 355)

vii. “[A]bsent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company’s behalf.” In re Caremark International Inc. Derivative Litigation (698 A2d 959 (Del.Ch. 1996); p. 355)

B. THE DUTY OF LOYALTY

i. A director’s personal dealings with the corporation to which he owed fiduciary duty, which may produce a conflict of interest, “are, when challenged, examined with the most scrupulous care, and if there is any evidence of improvidence or oppression, any indication of unfairness or undue advantage, the transactions will be voided.” Bayer v. Beran (49 NYS2d 2 (Sup.Ct. 1944); p. 368)
Corporation advertised on a radio program; suit alleged that directors bought the advertising in order to support career of a singer on the program, who was also the wife of the company’s president. Court found no evidence the Board knew the wife was on the program until after the advertising was approved, and there was no evidence of breach of duty in the decision to advertise.

ii. A corporate transaction in which directors had an interest other than that of the corporation is voidable unless the directors can show the transaction was fair and reasonable to the corporation. Lewis v. SL&E Inc. (629 F2d 764 (2d Cir. 1980); p. 373) Lewis was principal shareholder in SLE and LGT. LGT leased property from SLE, and when lease expired, no new lease; LGT continued paying same rate of rent. Lewis transferred SLE stock to kids (two of whom were SLE officers and shareholders already) with the agreement that if they weren’t also owners of LGT by a certain date, they’d sell their SLE shares to LGT. When date came, one kid refused to sell, believing SLE’s value was lower than it should’ve been due to disarray in SLE management and the low rent LGT was paying. Shareholder derivative suit alleging corporate waste by grossly undercharging LGT. Court agreed, said kid didn’t have to sell stock without an upward adjustment in SLE value to reflect fair rental value of the property to LGT.
iii. A director may not seize for himself, when it would present a conflict of interest between the director and his corporation, an opportunity which his corporation is financially able to undertake, is in the line of the corporation’s business, is an opportunity in which the corporation has an interest or a reasonable expectancy of interest, and is of practical advantage to the corporation. Broz v. Cellular Information Systems (673 A2d 148 (Del. 1996); p. 377) Broz owned RFBC, a cell phone service company, and was also on the Board of CIS, a competitor. CIS was in financial difficulty and selling its cell service licenses. A cell service license was available for sale from another company, and Broz was interested in it. He talked to CIS CEO, who told him CIS didn’t want that license. PriCellular interested in acquiring CIS. Broz and PriCell both put in bids on service license, and CIS knew PriCell was interested in that license. Broz got the license. PriCell completed acquisition of CIS, then sued Broz for breach of duty. Court found Broz had acted properly toward CIS, making sure it wasn’t interested before bidding, and he had no duty to PriCell.

iv. In Re eBay, Inc. Shareholders Litigation-
Shareholder of eBay filed a lawsuit b/c a director got a lucrative stock option through a company contact
1. Court said should have been a corporate opportunity case in which eBay should have had the option
2. In this case, uses a four-factor test set out in Broz (but actually in Guth)
   a. Financial capability
   b. Line of business
   c. Conflict of opportunity between fiduciary duty and self-interest
   d. Ability of corp to make the choice to engage in this if desired
3. IPO-motives here—price low b/c something to appease your other execs with
4. Shareholders of eBay—corporate opportunity
   a. Should have been able to purchase these IPO shares
5. All companies use their spare cash to invest securities

v. A parent owes fiduciary duty to its subsidiary in parent-subsidiary dealings. When fiduciary duty is combined with self-dealing – when parent is on both sides of transaction – the intrinsic fairness standard and not the business judgment rule applies. This standard involves “a
high degree of fairness and a shift in the burden of proof.” The burden would be on the parent to prove that its dealings with the subsidiary were objectively fair. **Sinclair Oil Corp. v. Levien** (280 A2d 717 (Del. 1971); p. 385) Sinven a partially-owned and not wholly independent subsidiary of Sinclair, an oil exploration company. Shareholder derivative suit alleging Sinclair caused Sinven to pay out such excessive dividends that Sinven was harmed. Court found no self-dealing, so business judgment rule applied, and under that rule, dividends were OK.

vi. “The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors.” **Zahn v. Transamerica Corp.** (162 F.2d 36 (3d Cir. 1947); p. 389) Transamerica acquired majority of Axton-Fisher Class A and B stock. Shareholder derivative suit claimed Transamerica knew A-F was holding assets valued on the books at $6 million but was actually worth around $20 million, and wanted to seize the value itself, so T redeemed Class A stock for $80/share and then liquidated A-F, selling the asset and keeping the profit. If Class A holders had participated in the liquidation, they would’ve gotten $240/share. Court found self-dealing by Transamerica, so transaction voidable.

vii. When a majority of shareholders ratify a transaction and dissenting shareholders initiate suit, the burden shifts to the dissenting shareholders “to demonstrate that the terms are so unequal as to amount to a gift or waste of corporate assets.” **Fliegler v. Lawrence** (361 A.2d 218 (Del. 1976); p. 395) Lawrence, president of Agau, a gold and silver exploration venture, had a leasehold on property. Offered leasehold to Agau, Board decided acquisition not possible at that time, so leasehold transferred to USAC, a closely-held corporation owned by Lawrence. Agau later exercised its option to acquire USAC by delivering shares of Agau in exchange for all issued shares of USAC; this action submitted to shareholders, majority of whom approved. Dissenting shareholders sued. Court found they failed to show the transaction was a waste.

viii. Directors have the fiduciary duty to “disclose fully and fairly all material facts within its control that would have a significant effect upon a stockholder vote.” **In re Wheelabrator Technologies Inc. Shareholders Litigation** (663
A.2d 1194 (Del.Ch. 1995); p. 398) WMI acquired majority interest in WTI; under the merger agreement, WTI shareholders would get shares in both companies. Merger approved by Board and shareholders. Shareholder suit alleged proxy statement about merger was materially misleading. Court disagreed, found no breach of duty.

ix. **Ratification decisions involving the duty of loyalty** are those between a corporation and its directors (“interested” transactions), or between a corporation and its controlling shareholder. In the former, an “interested” transaction will not be voidable if approved in good faith by a majority of disinterested stockholders, and the objecting stockholder has the burden of proving that no businessperson of sound judgment would find that the corporation received adequate consideration. In the latter, “in a parent-subsidiary merger the standard of review is ordinarily entire fairness, with the directors having the burden of proving that the merger was entirely fair. But where the merger is conditioned upon receiving “majority of the minority” stockholder vote, and such approval is granted, the standard of review remains entire fairness, but the burden of demonstrating that the merger was unfair shifts to the plaintiff.” In re Wheelabrator Technologies Inc. Shareholders Litigation (663 A.2d 1194 (Del.Ch. 1995); p. 398)

C. **DISCLOSURE AND FAIRNESS**

i. **Securities Act (1933):** principally concerned with the primary market, that is, the sale of securities from the issuer to investors. The Securities Act has two goals: mandating disclosure of material information to investors, and preventing fraud.

1. **Defines** “security” as “any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, [...] investment contract, voting trust certificate, [...] any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities [...], or in general, any interest or instrument commonly known as a ‘security,’ or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or
purchase, any of the foregoing […]” Securities Act § 2(a)(1)

2. Private placements under Securities Act § 4(2) and Regulation D:
   a. Rule 504: if an issuer raises no more than $1 million through securities, it may sell them to an unlimited number of buyers without registering the securities.
   b. Rule 505: if an issuer raises no more than $5 million, it may sell to no more than 35 buyers
   c. Rule 506: if issuer raises more than $5 million, it may sell to no more than 35 buyers, and each buyer must pass certain tests of financial sophistication

3. Securities Act § 11: principal express cause of action directed at fraud committed in connection with the sale of securities through the use of a registration statement. § 11 cannot be used in connection with an exempt offering because the material misstatement must be in the registration statement. Defendant carries the burden of proving its misconduct did not cause plaintiff’s damages. There is no privity requirement, so potential defendants are everyone who signed the registration statement, every director at the time the statement became effective, and every expert involved in statement’s preparation.

4. Securities Act § 12(a)(1): imposes strict liability on sellers of securities for offers or sales made in violation of § 5, e.g., where seller fails to properly register the security, or where the seller fails to deliver a statutory prospectus. Remedy is recission: buyer recovers consideration paid, plus interest, less income received.

5. Securities Act § 12(a)(2): imposes civil liability on any offeror or seller of a security in interstate commerce, who makes a material misrepresentation or omission, and can’t prove he didn’t know of the misrepresentation or omission. Prima facie case has six elements: sale of security, through mail or interstate commerce, by means of prospectus or oral communication, containing a material misstatement or omission, by the defendant who offered/sold the security, and which the defendant knew or should
have known of the untrue statement.

ii. **Exchange Act (1934)**: principally concerned with the secondary market, that is, sale of securities between investors.

1. Effectively, all publicly traded, and some closely held, corporations are required to file Exchange Act reports.
   a. Form 10: filed once, making disclosures similar to what would be in a Securities Act registration statement
   b. Form 10-K: filed annually, containing audited financial statements and reports of previous year’s activities.
   c. Form 10-Q: filed in first three quarters of each year, containing unaudited financial statements and reports on material recent developments.
   d. Form 8-K: filed within 15 days of certain important events affecting company’s operations or financial condition.

2. **Exchange Act § 10(b)** (see p. 443): “It shall be unlawful for any person, directly or indirectly, by use of [...] interstate commerce or the mails or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale or any security [...] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe [...]”

3. **Exchange Act Rule 10b-5** (see p. 444): promulgated under § 10(b), states, “It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   a. “(a) to employ, any device, scheme, or artifice to defraud,
   b. “(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
   c. “(c) to engage in any act, practice, or course of business which operates or would operate as a
fraud or deceit upon any person,
d. “in connection with the purchase or sale of any
security.”

III. Definition of a Security—Robinson v. Glynn:
1. Robinson couldn’t qualify as someone holding a security
such as an investment contract b/c he was very involved in
the company
   a. Not a passive investor heavily dependant on
      Glynn’s efforts
      i. Sat on board
      ii. Appt board
      iii. Treasurer
      iv. Exec committee, etc
2. Knowledgeable executive actively protecting his interest
   and position in the company
3. Investment contract –investment of $$ in a common
   enterprise w/an expectation of profit derived solely from
   the efforts of others

iv. Four factors are relevant to determining if an
offering is an exempt private placement: the number of
offerees and their relationship to each other and the issuer,
the number of units offered, the size of the offering, and
the manner of the offering. The first factor is the most
critical; the more offerees, the more likely the offering is
public. Doran v. Petroleum Management Corp. (545 F.2d
893 (5th Cir. 1977); p. 417) Investor bought limited
partnership interest in an oil drilling venture and then
wanted to back out. Question was whether the sale was a
private offering exempted from Securities Act registration
requirements, as exemption is described in § 4(2). Court
found that only the last three of the four factors present, so
the offering was not exempt.

v. “It is a prerequisite to liability under § 11 of the Act
that the fact which is falsely stated in a registration
statement, or the fact that is omitted when it should have
been stated to avoid misleading, be ‘material.’ […]
[Material matters are those which] an investor needs to
know before he can make an intelligent, informed decision
whether or not to buy the security.” Escott v. BarChris
Construction Corp. (283 F.Supp. 643 (SDNY 1968); p. 426)
Securities Act § 11 shareholder derivative suit alleging
registration statement of debentures contained material false
statements and omissions. Court agreed, considered and
rejected affirmative defenses, found for plaintiff.

vi. “[T]o fulfill the materiality requirement, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available. [...] Materiality will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.” Basic Inc. v. Levinson (485 US 224 (1988); p. 444) Basic in merger talks in 1976; in 1977 and 1978, Basic publicly denied it was in merger negotiations, but in late ’78, announced merger. Suit a Rule 10b-5 action on behalf of shareholders who sold in ’77 and ’78. Court remanded after determining what rules of reliance and materiality lower courts should apply.

vii. Reliance, an element of a rule 10b-5 cause of action, may be proved by a rebuttable presumption supported by the fraud-on-the-market theory, which states that parties who trade in shares do so based on the reliability of the price set by the market, and the material misstatements or omissions affected the price to plaintiffs’ detriment. Basic Inc. v. Levinson (485 US 224 (1988); p. 444)

viii. Fraud-on-the-market theory to prove reliance does not apply where the false statements are not public and do not reach the market. West v. Prudential Securities (282 F.3d 935 (7th Cir. 2002); p. 457) Rule 10b-5 class action arising out of stock broker’s statements to clients that a bank was going to be acquired when, in fact, it was not; clients bought stock in reliance on his tips. Court held fraud-on-the-market theory inappropriate here because statements not public and therefore didn’t affect the market, and decertified the class.

ix. “A statement is material when there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available.

D. INSIDE INFORMATION

i. A corporation’s directors owe “the strictest good faith” to the corporation “with respect to its property and business,” but do not act as trustees for the individual stockholders. Goodwin v. Agassiz (283 Mass. 358 (1933); p. 477) Agassiz et al., directors of Cliff Mining, knew a geologist thought there were copper deposits under CM land. Exploration had not yet yielded results and had ceased. Directors wanted to buy
options in another company with land adjacent to CM’s, knew options would be more expensive or unavailable if geologist’s opinion was known. Goodwin saw an article about exploration ceasing and sold his CM stock (publicly traded on Boston Stock Exchange). Directors, meanwhile, were buying more CM stock in belief that it would go up if geologist was correct. Goodwin sued, arguing that the keeping secret of the geologists’ report was a breach of duty to stockholders. Court said directors committed no fraud, that they didn’t breach fiduciary duty to corporation, and owed no fiduciary duty to stockholders.

ii. “The essence of [Rule 10b-5] is that anyone who, trading for his own account in the securities of a corporation,” who is privy to information “intended to be available only for a corporate purpose and not for the personal benefit of anyone may not take advantage of such information knowing it is unavailable to those with whom he is dealing, i.e. the investing public.” SEC v. Texas Gulf Sulphur (401 F.2d 833 (2d Cir. 1969); p. 480) Texas Gulf did exploratory drilling, found promising site on land it didn’t own, and ordered employees who knew about the results to keep quiet about them while land purchase was negotiated. Employees began buying TGS stock. Rumors spread that TGS had found a site; TGS issued press release that the company hadn’t found anything definite and more exploration was needed. Land purchased and drilling completed. Major ore strike found. Company directors bought lots of TGS stock, then issued press release disclosing ore discovery. Stock went way up. Court held the trades were 10b-5 insider trading violations, remanded on whether first press release was a 10b-5 material misstatement violation.

iii. “The basic test of [a material misstatement] is whether a reasonable man would attach importance in determining his choice of action in the transaction in question. [...] [This includes] any fact which in reasonable & objective contemplation might affect the value of the corporation’s stock or securities.” SEC v. Texas Gulf Sulphur (401 F.2d 833 (2d Cir. 1969); p. 480)

iv. Dirks v SEC- the Supreme Court reversed the SEC’s censure of a securities analyst who told his clients about the alleged fraud of an issuer he had learned from the inside before he made the facts public. Dirks was significant because it addressed the issue of trading liability of “tippees”: those who receive
information from the insider tipper. *Dirks* held that tippees are liable if they knew or had reason to believe that the tipper had breached a fiduciary duty in disclosing the confidential information and the tipper received a direct or indirect personal benefit from the disclosure. Because the original tipper in *Dirks* disclosed the information for the purpose of exposing a fraud and not for personal gain, his tippee escaped liability.

1. footnote 14." There, Justice Powell formulated the concept of the "constructive insiders" – outside lawyers, consultants, investment bankers or others – who legitimately receive confidential information from a corporation in the course of providing services to the corporation. These constructive insiders acquire the fiduciary duties of the true insider, provided the corporation expected the constructive insider to keep the information confidential.

v. United States v O'Hagan-A person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating §10(b) and Rule 10b-5.—law firm partner who used his information

1. Under Rule 14e-In determining whether Rule 14e-3a’s disclose or abstain from trading requirement is reasonably designed to prevent fraudulent acts, we must accord the Commission’s assessment “controlling weight unless it is arbitrary, capricious, or manifestly contrary to statute” under Chevron deference

e. Short Swing Profits

i. Reliance electric co v Emerson Electric co-

1. Respondent, the owner of more than 10% of Dodge Mfg. Co.’s stock, within six months of the purchase thereof sold enough shares to a broker to reduce its holding to 9.96%, for the purpose of immunizing the disposal of the remainder from liability under 16 (b) of the Securities Exchange Act of 1934. Under that provision a corporation may recover for itself the profits realized by an owner of more than 10% of its shares from a purchase and sale of its stock within any six-month period, provided the owner held more than 10% "both at the time of purchase and sale." Held: Under the terms of 16 (b) respondent is not liable to petitioner (Dodge's successor) for profits derived from the sale of the 9.96% to Dodge within six months of purchase.
ii. Foremost-McKesson Inc v Provident Securities Co-

1. Respondent, a personal holding company contemplating liquidation, sold assets to petitioner corporation. Respondent received from petitioner as part of the purchase price convertible debentures which if converted into petitioner's common stock would make respondent a holder of more than 10% of petitioner's outstanding common stock. A few days later, pursuant to an underwriting agreement, one of the debentures was sold to a group of underwriters for cash in an amount exceeding its face value. After making debenture and cash distributions to its stockholders, respondent dissolved. Under 16 (b) of the Securities Exchange Act of 1934 (Act) a corporation may recover for itself the profits realized by an officer, director, or beneficial owner of more than 10% of its shares from a purchase and sale of its stock within a six-month period. An exemptive provision specifies, however, that 16 (b) shall not be construed to cover any transaction where the beneficial owner was not such both "at the time of" the purchase and sale of the securities involved. Since the amount of petitioner's debentures received by respondent was large enough to make respondent a beneficial owner of petitioner within the meaning of 16, and its disposal of the securities within the six-month period exposed respondent to a suit by petitioner to recover profits realized by respondent on the sale to the underwriters, respondent sought a declaratory judgment of its nonliability under 16 (b). The District Court granted summary judgment to respondent, and the Court of Appeals affirmed, though for different reasons. Held: By virtue of the exemptive provision a beneficial owner is accountable under 16 (b) in a purchase-sale sequence such as was involved here only if he was such an owner "before the purchase." Thus, the fact that respondent was not a beneficial owner before the purchase removed the transaction from the operation of 16 (b).

f. Indemnification and Insurance

i. Waltuch v Conticommodity Services- Good faith requirement in Sec 145 may not be overridden by any agreement

1. employee had contract that said BD agreed to indemnify him in suits; his lawyer made a deal so that he did not plead guilty to any counts, thus doesn't matter why he was not charged—he still must be indemnified under the agreement
2. statute does not permit indemnification of officer who did not act in good faith). In criminal proceedings, the standard is whether the person "had reasonable cause to believe that the person's conduct was unlawful." 8 Del. C. § 145(a)

ii. Citadel Holding Corp v Roven-former director was entitled to indemnification in a suit which his former
corporation brought against him

1. “THE CORPORATION SHALL INDEMNIFY THE AGENT AGAINST ANY EXPENSE OR LIABILITY INCURRED IN CONNECTIN WITH ANY THREATENED, PENDING OR COMPLETED ACTION, SUIT OR PROCEEDING, WHETHER CIVIL OR CRIMINAL, ADMINISTRATIVE OR INVESTIGATIVE, TO WHICH HE IS A PARTY OR THREATED TO BE MADE A PARTY BY REASON OF HIS SERVICE AS A DIRECTOR”

Problems of Control

VI. PROXY FIGHTS

a. Federal Proxy Regulation – To avoid proxy abuse, the regulations require:
   
i. SEC-mandated disclosure – SEC requires that anyone soliciting proxies from public shareholders must file with the SEC and distribute to shareholders specified info. in a stylized proxy statement.

   ii. No open-ended proxies – SEC mandates form of proxy card and scope of proxy holder’s power.

   iii. Shareholder access – SEC requires management to include “proper” proposals by shareholders with management’s proxy materials, though this access is conditioned.


b. Mandatory Disclosure when Proxies Not Solicited

   i. When a majority of a public corporation’s shares are held by a parent corporation, it may be unnecessary to solicit proxies from minority shareholders.

   ii. Proxy rules require the company to file with the SEC and send shareholders, at least 20 days before the meeting, information similar to that required for proxy solicitation.

c. Antifraud Prohibitions – Rule 14a-9

   i. Rule 14a-9 – Any solicitation that is false or misleading with respect to any material fact, or that omits a material fact necessary to make statements in the solicitation not false or misleading is prohibited.

      1. Full disclosure – Proxy stmt must fully disclose all material information about the matters on which the shareholders are to vote.

   ii. Private suit – Although Rule 14a-9 does not specifically authorize suits, federal courts have inferred a private cause of action.

d. Strategic Use of Proxies

   i. Levin v. MGM, Inc. (KRB, 520–23) – In a proxy fight between two groups vying to elect their own slate of directors, the incumbents hired specially retained attorneys, a public relations
firm with the proxy soliciting organization, and used the good-will and business contacts of MGM to secure support. Held: These actions did not constitute illegal or unfair means of communication since the proxy statement filed by MGM stated that MGM would bear all the costs in connection with the management solicitation of proxies.

e. Reimbursement of Costs
   i. Rosenfeld v. Fairchild Engine & Airplane (KRB, 523–27) – In a contest over policy, as compared to a purely personal power contest, corporate directors can be reimbursed for reasonable and proper expenditures from the corporate treasury. This is subject to court scrutiny.
      1. Where it is established that money was spent for personal power and not in the best interests of the stockholders/corporation, such expenses can be disallowed.

f. Private Actions for Proxy-Rule Violations
   i. Nature of Action
      1. Either direct or derivative – Shareholder can bring suit either in her own name (class action) or in a derivative suit on behalf of the corporation
         a. Federal suit advantages – Allows Shareholder-πs to recover litigation expenses, including attorney fees, and to avoid derivative suit procedures.

   ii. Elements of Action
      1. Misrepresentation or omission
      2. Statement of opinions, motives or reasons – Board’s statement of its reasons for approving a merger can be actionable.

   g. J.I. Case Co v Borak-
      i. Respondent, stockholder of petitioner company, brought a civil action in federal court for deprivation of his and other stockholders' pre-emptive rights by reason of a merger involving the company, allegedly effected through use of a false and misleading proxy statement. The complaint has two counts, one based on diversity and claiming a breach of directors' fiduciary duty to stockholders and the other alleging a violation of 14 (a) of the Securities Exchange Act of 1934. The District Court held that, in a private suit, it could grant only declaratory relief under 27 of the Act as to the second count and that a state statute requiring security for expenses in derivative actions applied to everything but that part of Count 2 seeking a declaratory judgment. The Court of Appeals reversed, holding that the state law was inapplicable and that the District Court had power to grant remedial relief. Held:

ii. The power to enforce implies the power to make effective the right of recovery afforded by the Act. And the
power to make the right of recovery effective implies the power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case.

iii. Effects congressional purpose by recognizing a private right

h. Mills v Electric Auto-Lite-
   i. 14a9 case-materiality, causation, and scienter
      1. materiality-whether statement would have been significant in a reasonable shareholder’s deliberation
         a. proxy statement misleading (FN 6)-b/c told A-L shareholders that their board of directors recommended approval of merger w/o telling that A-L’s directors were nominees of Mergenthaler and were under “control and dominion” of such
      2. causation-whether separate element?
         a. Since needed 13% beyond management, these shareholders were indispensable to merger-so causation is an issue
         b. Test on pg 551-Where there has been a finding of materiality, a shareholder has made a sufficient showing of casual relationship between the violation and the injury for which eh seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.
      3. scienter-
         a. how much fault is required?—negligence is sufficient under Sec 14a9

i. Seinfeld v Bartz- plaintiff brings derivative suit b/c proxy statement discussing the amendment did not accurately state the increase in the director’s compensation
   i. Ct: Shareholders would not have considered the Black-Scholes valuation-not material as to a matter of law
   ii. But, SEC can set disclosure standards
      a. Materiality— The challenged misrepresentation must be “with respect to a material fact.”
      b. Culpability – Scienter is not required.
      c. Reliance – Complaining shareholders do not need to show they actually read and relied on the alleged misstatement.
      d. Causation – Federal courts require that the challenged transaction have caused harm to the shareholder. (Virginia Bankshares)
(i) Loss causation: Easy to show if shareholders of the acquired company claim the merger price was less than what their shares were worth.

(ii) Transaction causation – No recovery if the transaction did not depend on the shareholder vote.

e. Prospective or retrospective relief – Federal courts can enjoin the voting of proxies obtained through proxy fraud, enjoin the shareholders’ meeting, rescind the transaction or award damages.

j. Attorney fees – Attorneys’ fees available under Mills (S.Ct.)

k. Shareholder Proposals

i. Rule 14a-8 Procedures

1. Any shareholder who has owned 1% or $2,000 worth of a public company’s shares for at least one year may submit a proposal.

2. The Proposal must be in the form of a resolution that the shareholder intends to introduce at the shareholder’s meeting.

3. If management decides to exclude the submitted proposal, it must give the submitting shareholder a chance to correct deficiencies.

   a. Management must also file its reasons with the SEC for review.

4. NY City Employees’ Retirement Sys. v. Dole Food Co. (KRB, 547–52) (2d Cir ’95) – The SEC can reinterpret the rule without formal rulemaking proceeding, but corporations can only omit shareholder proposals from proxy materials if the proposal falls within an exception listed in Rule 14(a)–8(c).

ii. Proper Proposals

1. Proposals inconsistent with centralized management – Interference with traditional structure of corporate governance.

   a. Not a proper subject – Where a proposal is not a proper subject for shareholder action under state law, it can be excluded. 14a-18(i)(1)

   (i) Not significantly related – Where proposal doesn’t relate to the company’s business. 14a-8(i)(5)

      Lovenheim v. Iroquois Brands, Ltd. (KRB, 542–46) (DDC) – Holding to be “significantly related” a resolution calling for report to shareholders on forced geese feeding even though the company lost money on goose pate sales, which accounted for less than .05% of revenues.

   (ii) Not part of co’s ordinary business operations

      Austin v. Consolidated Edison Co. of NY (KRB,
In attempting to exclude a shareholder proposal from its proxy materials, the burden of proof is on the corporation to demonstrate whether the proposal relates to the ordinary business operations of the company. Since here, there is an SEC stance of no enforcement with respect to exclusion of pension proposals from a company’s proxy materials, summary judgment granted.

(iii) Proposals relating to the specific amt of dividends – Recognizing the fundamental feature of U.S. corporate law that the Board had discretion to declare dividends, without shareholder initiative or approval.

f. **Proposals that interfere with management’s proxy solicitation**

   (i) **Election** – Proposals relating to the election of directors/officers

   (ii) **Direct conflict** – Proposals that “directly conflict” with management proposals

   (iii) **Duplicative** - Proposals that duplicate another shareholder proposal that will be included

   (iv) **Recidivist** – Proposals that are recidivist and failed in the past.

f. **Proposals that are illegal, deceptive, or confused**

   (i) **Violation of law**

   (ii) **Personal grievance**

   (iii) **Out of power** – Proposals dealing with matters beyond corporation’s power to effectuate

l. **Mootness** – If co. is already doing what shareholders want

B. **Shareholder Inspection Rights**
   
   (1) **Crane Co v Anaconda**

   a. Whether a qualified stockholder may inspect the corporation’s stock register to ascertain the identity of fellow stockholders for the avowed purpose of informing them directly of its exchange offer and soliciting tenders of stock.

   b. A shareholder desiring to discuss relevant aspects of tender offer should be granted access to the shareholder list unless it is sought for a purpose inimical to the corporation or its stockholders – and the manner of communication selected should be
within the judgment of the shareholder.

c. This statute should be liberally construed in favor of the stockholder whose welfare as a stockholder or the corporation’s welfare may be affected
d. Burden on corp to prove improper purpose – inspection compelled here

(2) **State Ex Rel. Pillsbury v. Honeywell**-shareholder purchased his shares in the corporation solely to give himself in the voice in Honeywell’s affairs so he could persuade Honeywell to cease producing munitions
   a. Petitioner not interested in long-term wellbeing of Honeywell or the enhancement of the value of his shares
   b. Purpose, as such, then does not allow right to inspect Honeywell’s records

VII. SHAREHOLDER CONTROL-voting
   a. It seems like shareholder voting control does not do much to keep directors in line:
      i. Incentive to monitor-bad directors have minimal financial impact on a SH with a small interest in the corporation
      ii. Ability to discipline-each SH has little voting power, so her ability to oust bad directors is small;
         1. however, b/c corporations who perform badly will have future shareholders to account for-thus this may keep them in line; however, these investors are likely to focus on short-term profits
   b. Limitations on Control based on Stock Class
      i. **Stroh v. Blackhawk Holding Corp.** (KRB, 573–76) (Ill. 1971) – A corporation may prescribe whatever restrictions/limitations it deems necessary in regard to issuance of stock, provided that it not limit or negate the voting power of any share. Under applicable Ill. statute, a corporation may proscribe the relative rights of classes of shares in its articles of incorporation, subject to their absolute right to vote. A corporation has the right to establish classes of stock in regards to preferential distribution of the corporation’s assets. However, the shareholder’s right to vote is **guaranteed**, and must be in proportion to the number of shares possessed. Here, the Class B stock possessed equal voting rights, though it did not possess the right to share in the dividends or assets of the company. The stock is valid.
      ii. **State of Wisconsin Investment Board v. Peerless Systems Corp**
         1. contested proposal sought to expand Peerless’ stock option plan by increasing the number of options available, allow
the Board to reprice the options w/o SH approval, and allow the Board to grant options at less than fair market price
   a. SWIB opposed the proposal and sought proxies against it
   b. the proposal did not pass at the annual meeting
2. The Chairman did not close the polls as to that proposal and adjourned the meeting for 30 days
   a. During the adjournment, Peerless selectively sought SH proxies; meeting resumes; proposal passes; SWIB sues.
3. Plaintiff must prove that the Board acted with the primary purpose of interfering with the free exercise of the SH’s franchise; otherwise, business judgment rule applies.
   a. If plaintiff meets their burden, the Board must demonstrate a compelling justification for its actions.
4. Defenses:
   a. Ratification:
      i. SH vote post adjournment
   b. BJR
   c. Board’s primary purpose
      i. Low turnout at meeting
d. Compelling justification
5. CT: wasn’t decided here on summary jmt issue—denies both, but think that SWIB has strong case

VIII. ABUSE OF CONTROL IN CLOSELY HELD CORPORATIONS
a. Ringling Bros-Barnum and Bailey v Ringling- “the parties will act jointly in exercising such voting rights in accordance with such agreement as they may reach with respect to an matter calling for the exercise of such voting rights”
   i. Binding arbitration to resolve, and he decided one what the vote should be, thus the other’s vote didn’t count
b. McQuade v Stoneham- “the parties hereto will use their best endeavors for the purpose of continuing as directors of said Company and as officers thereof the following”
   i. Defendants didn’t use best effort to continue him as treasurer
   ii. However, directors may not by agreements entered into as stockholders abrogate their independent judgment
      1. the power to unite is, however, limited to the election of directors and is not extended to contracts whereby limitations are placed on the powers of directors to manage the business of the corporation by the selection of agents at defined salaries
c. **Clark v Dodge**-Dodge and Clark the sole owners of two medicine companies, enter into an agreement, which said that Clark should continue in the efficient management and control of Bell and Co so long as he should “remain faithful, efficient, and competent to so manage and control the said business” and Clark should share his knowledge with the son of Dodge—Dodge breached by not continuing Clark in management.

d. **Galler v Galler**-shareholders will cast their votes for the above named persons (I, R, B, E) In the event of a death of either brother his wife shall have the right to nominate a director in place of the decedent; as long as there is a surplus, there shall be $50K dividend declared; upon the death of B or I, the corp shall pay a sum equal to twice the salary of such officer, over a 5-yr period

i. The Supreme Court, Underwood, J., held that where the agreement was not a voting trust but a straight contractual voting control agreement which did not divorce voting rights from ownership of stock in a close corporation, the duration of the agreement, which was interpreted as continuing so long as one of the two majority stockholders lived, did not offend public policy and did not render the agreement unenforceable.

e. **Ramos v Estrada**- two groups were required to vote for the directors upon whom a majority of each respective ground had agreed. The terms of that agreement expressly state that failure to adhere to the agreement constitutes an election by the shareholder to sell his or her shares pursuant to buy/sell provisions of the agreement. The agreement also calls for specific enforcement of such buy/sell provisions.—did not illegally give proxies.

i. **Wilkes v. Springside Nursing Home, Inc.** (KRB, 612–18) (Mass. ’76) – In a closely held corporation, the majority stockholders have a duty to deal with the minority in accordance with a *good faith standard*. The burden of proof is on the majority to show a legitimate purpose for its decision related to the operation of the business.

1. **Note**: Shareholders in a closely held corporation are held to a similar standard as required between partners.

ii. **Ingle v. Glamore Motor Sales, Inc.** (KRB, 619–25) (NY ’89) – A minority shareholder in a closely held corporation, who is also employed by the corporation, is *not* afforded a fiduciary duty on the part of the majority against termination of his employment. A court must distinguish between the fiduciary duties owed by a corporation to a minority shareholder, as such, in contrast to its
duties owed to him as an employee.

f. Squeeze-out Merger
   i. *Sugarman v. Sugarman* (KRB, 625–29) (1st Cir. ’86) – Shareholders in a close corporation owe one another a fiduciary duty of utmost good faith and loyalty. Majority shareholder received excess compensation which was designed to freeze-out the minority shareholders from the co.’s benefits. Further, given the lowball price offered for the minority shares, there was evidence of freeze-out.

g. Control of the corporation
   i. *Smith v. Atlantic Properties, Inc.* (KRB, 629–34) (Mass ’81) – Stockholders in a close corporation owe one another the same fiduciary duty in the operation of the enterprise that partners owe one another.
      1. In Smith, Wilkes applies not to just majority SHs, but to anyone who controls the firm
      2. See *Donahue v. Rodd Electrotype Co*-shareholders in a closely held corporation owe each other the fiduciary duty of “utmost good faith and loyalty”
         a. Widow inherited shares; right to vote directors, to receive dividends, but no claim to set on Board—no claim to his job either; directors might no pay dividends (bus jmt)
         b. No protection from a buyout agreement; low-ball offer to buy her shares
         c. Give the protection here b/c of the difficulty in liquidating your interest
            i. Vulnerable to oppression by majority
         d. Equal opportunity doctrine-if repurchasing from one, then must buy from others at same price
         e. No one knew if this equal opportunity doctrine extended beyond sale of shares

h. Disclosure Rules
   i. *Jordan v. Duff & Phelps, Inc.* (KRB, 635–46) (7th Cir. ’87) – Close corporations buying their own stock have a fiduciary duty to disclose material facts. Where π sold his stock in ignorance of facts that would have established a higher value, failure to disclose an important beneficent event is a violation even if things later go sour. A π must establish that, upon learning of merger negotiations, he would not have changed jobs, stayed for another year, and finally received payment from the leveraged buyout. A jury was entitled to conclude that the π would have stuck around.

IX. COUNTERMEASURES – CONTROL, DURATION & STATUTORY DISSOLUTION
   a. Constructive Dividends as an Equitable Remedy
i. *Alaska Plastics, Inc. v. Coppock* (KRB, 648–54) (Alaska ’80)—Majority shareholders in a closely held corporation owe a fiduciary duty of utmost good faith and loyalty to minority shareholders. Although there is no authority allowing a court to order specific performance based on an unaccepted offer, where payments were made to directors and personal expense paid for wives, they could be characterized as **constructive dividends**.

ii. **Haley. Talcott**—agreement provided for buyout, but left the one leaving the business on the mortgage, so this agreement won’t be specifically followed
   1. not an adequate remedy, thus statutory dissolution instead—either party may still buy through bidding on the property of the former LLC

iii. **Pedro v Pedro**—an employee/shareholder may have an additional and separate claim for wrongful termination based on a reasonable expectation that his or her employment was not terminable at will, or even that there was an agreement to provide lifetime employment—in closely held!!!

iv. **Stuparich v Harbor Furniture**—sisters ask for involuntary dissolution under CA statute: reasonably necessary for the protection of the rights or interests of the complaining (SH).
   1. 3 siblings own equal shares of nonvoting stock; Malcolm owns majority of voting stock; upon mother’s death, find out that Malcolm also owns that voting stock.
   2. sisters ask to buy out Malcolm—he refuses.
      a. Have a profitable mobile home park and unprofitable furniture business and sisters want to separate—Malcolm refuses.
      b. Malcolm, wife, and son all work for the corporation. Altercation between one sister and Malcolm.
         i. Working for the co?
         ii. Bus jmt rule—in separating businesses
         iii. Expectation of control
         iv. Acrimony between SHs
      c. Ct: finds for Malcolm

b. **Statutory Dissolution**
   i. **Meiselman v. Meiselman** (KRB, 655–56) (NC ’83)—Minority brother (π) shareholder sued his brother after he was fired and lost his salary/benefits. π invoked a NC statute allowing a court to order dissolution where such relief is “reasonably necessary” to protect a complaining shareholder, or alternatively order a buy-out
of the π’s shares. Held: At least in close corporations, a complaining shareholder need not establish oppressive or fraudulent conduct by the controlling shareholders. Rights and interests, under the statute, include reasonable expectations, including those that the minority shareholder will participate in the management of the business or be employed obey the company – as long as they were embodied in express or implied understandings among the participants.

X. MARKET FOR CORPORATE CONTROL
a. Transfer of Control
   i. Right of first refusal
      1. Frandsen v. Jensen-Sundquist Agency, Inc. (KRB, 675–80) (7th Cir. ’86) – In a transfer of control of a company, the rights of first refusal to buy shares at the offer price are to be interpreted narrowly. In this cases, there was never an offer within the scope of the stockholder agreement. ∵ π’s right of first refusal was never triggered. The acquiring bank was never interested in becoming a majority shareholder, but just wanted to acquire the bank. A sale of stock was never contemplated.

b. Controlling Stockholders Interests/Obligations
   i. Selling at a Premium Price
      1. Zetlin v. Hanson Holdings, Inc. (KRB, 680) (NY ’79) – When a controlling shareholder sells its interest at a premium price, a minority shareholder brought suit claiming equal entitlement to the premium paid for the controlling interest. Held: Absent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price. Minority interest are protected from abuse, but cannot inhibit the legitimate interests of other stockholders.

   ii. Accounting to minority shareholders
      1. Perlman v. Feldmann (KRB, 683–87) (2d Cir ’55) – Directors and dominant stockholders stand in a fiduciary relationship to the corporation and to the minority shareholders as beneficiaries thereof. But, a majority stockholder can dispose of his controlling block of stock to outsiders without having to account to his corporation for profits. However, since the sale provides unusual profit to the fiduciary who caused the sale, he should account for his gains.

   iii. Transfer of Control Immediately after Sale
      1. Essex Universal Corporation v. Yates (KRB, 693–96) (2d Cir ’62) – A sale of a controlling interest in a corporation
may include immediate transfer of control. It is the law that control of a corporation may not be sold absent the sale of sufficient shares to transfer such control. The right to install a new slate of directors can be assignable upon sale, since transfer of control is inevitable in such a situation.

c. **Takeovers**

   i. **Introduction**

      1. **Williams Act**:  
         a. 5%+ – Requires disclosures of stock accumulations of more than 5% of a target’s equity securities so the stock market can react to the possibility of a change in control;
         b. **Tender offers** – By anyone who makes a tender offer for a company’s equity stock so shareholders can make buy-sell-hold decisions; and
         c. **Structure of tender offers** – Regulates the structure of any tender offer so shareholders are not stampeded into tendering.
         d. **Same price** - Tender offeror must give same price to all shareholders, and that must be the highest price ever offered.

   2. **De GCL § 203 – Directed at 2-stage freeze-outs**

      a. A controlling shareholder of a corporation that has recently acquired an interest in the corporation must wait 3 years from the time he created the interest to the second stage squeeze-out.

         i. **Exceptions**: If the controlling shareholder has over 85% of the co. or without 85%, if 2/3 of the other 49% shareholders vote, the 2d stage squeeze out may proceed.

         ii. **Incumbent waiver** – Incumbents can waive these requirements under §203.

ii. **Greenmail.**

   1. **Cheff v. Mathes** (KRB, 743–51) (Del ’64) – Corporate fiduciaries may not use corporate funds to perpetuate their control of the corporation. Corporate funds must be used for the good of the corporation, although activities undertaken for the good of the corporation that *incidentally* function to maintain directors’ control are permissible. But acts effected for no other reason than to maintain control are invalid.

   d. **Takeover Defenses**

      i. **Dominant Motive Review**

         1. Under this standard, courts readily accepted almost any business justification for defensive tactics. The target
board only had to identify a policy dispute between the bidder and management.  

**ii. Intermediate Due Care Review** – Heightened standards of deliberative care in takeover fights, requiring directors to probe into the business and financial justifications for takeover defenses.


1. **Unocal Corporation v. Mesa Petroleum Co.** (KRB, 755–64) – 2 Prong test:
   a. **Dominant purpose.** Board must reasonably perceive the bidder’s action as a threat to corporate policy – a threshold dominant-purpose inquiry into the board’s investigation; and
   b. **Proportionality.** Any defensive measure the board adopts “must be reasonable in relation” to the threat posed.

A. The De Facto Merger Doctrine

(1) **What is it?** Courts have interpreted the statutory merger provisions as giving shareholders in functionally equivalent asset sales the same protections available in a statutory merger.
   a. If an asset sale has the *effect of a merger*, shareholders receive merger-type voting and appraisal rights.
   b. **Farris v. Glen Alden Corporation** (Pa. 1958) (KRB, 704–09) – Glen Alden acquired the assets of List in a stock-for-assets exchange approved by both co.’s boards and the List shareholders, but not the Glen Alden shareholders. The transaction doubled the assets of Glen Alden, increased its debt 7X, and left its shareholders in a minority position. π, a shareholder, of Glen Alden sued to protect the Glen Alden shareholders’ expectation of “membership in the original corporation.” Held: The court recast the asset acquisition as a merger and enjoined the transaction for failing to give the Glen Alden shareholders the voting and appraisal rights they would have had in a statutory merger.

(2) **Rejection of the doctrine** – Since modern shareholders purchase their shares with the expectation of control transfers, most courts have rejected the de facto merger doctrine and have refused to *imply* merger-type protection for shareholders when the statute doesn’t provide it.
   a. **See Hariton v. Arco Electronics** (KRB, 710–11) (Del. 1963)
      (i) In DE, courts accept that corporate management can structure a combination under *any technique* it chooses. Form trumps substance.
B. Squeeze-Out Mergers

(1) How it works?

a. Parent corporation merges into a wholly owned subsidiary created for the merger. The plan for the merger calls for disparate treatment of the parent and minority shareholders. The parent receives the surviving subsidiary’s stock while the remaining shareholders receive other consideration, e.g. cash or nonvoting debt securities.

b. Mechanics

(i) Squeeze-out merger – Parent and subsidiary agree to merge under which subsidiary’s minority shareholders receive cash or other consideration for their shares.

(ii) Liquidation – Subsidiary sells all of its assets to the parent (or an affiliate) and then dissolves and is liquidated. Minority shareholders receive a pro rata distribution of the sales price.

(iii) Stock split – Subsidiary declares a reverse stock split, e.g. 1 for 2,000, that greatly reduces the number of outstanding shares. If no minority shareholder owns more than 2,000 shares, all minority shareholders come to hold fractional shares, which are subject to mandatory redemption by the subsidiary as permitted under some statutes.

(2) Business Purpose Test

a. Requirement – Some states require that the transaction not only be fair, but that the parent also have some business purpose for the merger, other than eliminating the minority.


b. Delaware – Abandoned the business purpose requirement.

(Weinberger)

(3) “Entire Fairness” Test – DE squeeze-out mergers subject 2-Prong Entire Fairness Test:

a. Fair dealing – Court held that valuation must take into account “all relevant factors,” including discounted cash flow.

(i) Discounted cash flow method – Generally used by the investment community looks at the co.’s anticipated future cash stream and then calculates present cash value.

(ii) Fair dealing – When the transaction was timed, how was it initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained.

☞ Indep. Negotiating Comm. – Court strongly recommended that the subsidiary board form a
committee of outside directors to act as a representative of the minority shareholders.

(iii) *Weinberger v. UOP, Inc.* (KRB, 712–23) – (De. ’83) A freeze-out merger without full disclosure of share value to minority shareholders is invalid. For a freeze-out merger to be valid, the transaction must be fair.

b. *Rabkin v. Philip A. Hunt Chemical Corporation* (KRB, 731–37) – (Del. ’85) Delaying a merger to avoid paying a contractual price may give rise to liability to minority shareholders. While an appraisal is an appropriate remedy in many instances, it is *not the only remedy*. In cases of fraud, self-dealing, manipulation, and the like, any remedy that will make the aggrieved shareholder whole may be considered. In the context of a cash-out merger, timing, structure, negotiation, and disclosure are all factors to be taken into account in ruling upon the fairness of the transaction.

(4) **Remedy in Squeeze-Outs**

a. *No damages, just appraisal* – Even if minority shareholders prove the squeeze-out is unfair, they are not necessarily entitled to recover damages. Appraisal rights are the exclusive remedy when the squeeze-out is challenged on *price*, *Weinberger*, *unless*:

   (i) Fraud, misrepresentation, self-dealing, deliberate waste, or palpable overreach.

C. **De Facto Non-Merger** – Rejected in Delaware.

(1) **Doctrine** – DE: If a transaction takes the form of a merger, but is *in substance* (or *de facto*) a sale of assets followed by redemption, the claimants are *not* entitled to redemption rights.

e. *Rauch v. RCA Corporation* (KRB, 738–40) – When GE acquired RCA, all common and preferred shares of RCA stock were converted to cash. Each share of preferred stock would be converted from $3.50 to $40. π claimed that the merger constituted a *liquidation or dissolution or winding up of RCA and a redemption of the preferred stock*, and under Articles, preferred stock could be redeemed at $100. **Held**: Under DE law, a conversion of shares to cash that is carried out in order to accomplish a merger is *legally distinct* from a redemption of shares by a corporation. RCA was allowed to choose conversion over redemption, and since the $40 conversion rate forPreferred Stock was fair, π had no action.