

BUSINESS ORGANIZATIONS I

Syllabus & Supplementary Materials

Spring Semester 2015

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Room 9107; Office Hours – Tuesday, 4:00-5:00 & Wednesday, 12:00-1:00

Course Materials

Klein, Ramseyer & Bainbridge, Business Associations (8th ed. 2012) (“KR&B”)

Klein, Ramseyer & Bainbridge, Business Associations, Fall 2013 Update (“KR&B Update”)

Klein, Ramseyer & Bainbridge, 2014 Statutory Supplement

Davis Supplementary Materials (“KBD Supp.”)

COMMON LAW AGENCY

Assignment

- #1. Creation of the Agency Relationship – KR&B pp. 1-13; Restatement of Agency 3d (“R3d”) § 1.01; Chez Sinoza & Question (KBD Supp. pp. 1-2 below)
- #2. Liability of Principal to Third Parties in Contract – The Basics of Authority
 - a. Actual & Apparent Authority – KR&B pp. 14-19; R3d §§ 2.01-2.03
 - b. Agent’s Liability – KR&B pp. 31-34; R3d §§ 1.04(2), 6.01, 6.02, 6.04, 6.10, 8.09
 - c. Ratification – KR&B pp. 24-28; R3d §§ 4.01-4.03, 4.06
 - d. Termination of Authority – KBD Supp. pp. 2-5; R3d §§ 3.06 & Comment, 3.07, 3.10, 3.11
- #3. Liability of Principal to Third Parties in Contract – Authority at the Margin
 - a. Improper Purposes – KBD Supp. p. 5; Restatement of Agency 2d (“R2d”) § 165

- b. Inherent Agency Power – KBD Supp. pp. 5-10; R2d §§ 8A, 161; R.3d § 1.03 & Comment
 - c. Estoppel – KR&B pp. 28-31; R3d § 2.05
 - d. Undisclosed Principals – KBD Supp. pp. 10-13; KR&B pp. 20-24; R3d §§ 2.06, 6.03, 6.11(4) & Comment
- #4. Liability for an Agent’s Torts – Respondeat Superior; Scope of Employment – KBD Supp. pp. 13-14; R 3d §§ 2.04, 7.07; R 2d §§ 228, 229; KR&B pp. 52-59
- #5. Liability for an Agent’s Torts – Independent Contractors – KR&B pp. 35-36, 64-68; R 2d § 220
- #6. Liability for an Agent’s Torts – Franchise Relationships – KR&B pp. 36-52; R 2d § 267; KBD Supp. 14-16
- #7. Fiduciary Obligations – KR&B pp. 69-75; KBD Supp. pp. 17-19; R 3d §§ 8.01-8.03, 8.05-8.06
- #8. Post-Employment Competition – KR&B pp. 75-78; KBD Supp. pp. 19-21; R 3d §§ 8.04, 8.05 & Comment

GENERAL PARTNERSHIPS

- #9. Creating the Partnership Relationship
- a. Definition – KR&B pp. 79-83; Uniform Partnership Act (1914) (“UPA”) § 6(1)
 - b. De Facto Partnerships – KR&B pp. 84-93; UPA § 7; *Question*: Does the Chez SinoZa arrangement constitute a general partnership under the UPA? Would it make a difference if Charles structured his investment as a loan rather than a capital contribution?
 - c. Partners by Estoppel – KR&B pp. 93-96; UPA § 16
- #10. Partnership Finance – KR&B pp. 157-160, 164 (footnote); UPA §§ 18(a)-(d), (f), 40(b), (d); Uniform Partnership Act (1997) (“RUPA”) § 401(a), (b) & Comment; Chez SinoZa Problem #1 (KBD Supp. pp. 21-22)
- #11. Fiduciary Duties Among Partners – KR&B pp. 97-108; RUPA §§ 404, 103(b)(3)-(5)
- #12. Characteristics of the Partnership Relationship
- a. Is the Partnership an Aggregate or an Entity? – UPA § 6(1), RUPA § 201
 - b. Personal Liability – UPA § 15; RUPA § 306

- c. Delectus Personae; Transfer of a Partnership Interest – UPA §§ 18(g), 26-28, 32(2)
 - d. Partnership Property – KR&B pp. 123-126; UPA §§ 24, 25; RUPA §§ 203, 501, 502
- #13. Partnership Management – KR&B pp. 127-136; UPA §§ 9, 13, 14, 18(f), (h); RUPA §§ 301, 303, 305, 401(j); Chez SinoZa Problem #2 (KBD Supp. p. 22)
- #14. Partnership Dissolution
- a. Partnerships at Will – The Statutory Framework – KBD Supp. pp. 23-29; UPA §§ 29-31, 36, 38, 41(3), 42; RUPA §§ 601, 603, 701, 801, 802
 - b. Continuation Agreements – KR&B pp. 135 (Note), 161-165; UPA §§ 38(1), 42; RUPA § 103(a), 701(a), (b)
 - c. Partnerships for a Term or Undertaking; Judicial Dissolution – KR&B pp. 137-145, 151-157; UPA §§ 31(2), (6), 38(2), 36; RUPA §§ 602, 701 (c), (h), 801(2), (5)
 - d. Fiduciary Limitations on the Right to Dissolve – KR&B pp. 109-116, 145-151
 - e. Expulsion of a Partner – KR&B pp. 116-122; KR&B Update pp. 4-10; UPA § 31(1)(d); RUPA § 601(3)-(5)
- #15. Review of General Partnerships – Apple Computer Co. Problem (A) (KBD Supp. p. 29)
- #16. Conflicts of Interest – KBD Supp. pp. 29-34; Apple Computer Co. Problem (B)

LIMITED PARTNERSHIPS

- #17. Fundamentals – Chez SinoZa Problem #3 (KBD Supp. p. 34)
- Relevant sections of the Uniform Limited Partnership Act, in its various versions, are set forth at KBD Supp. pp. 35-39
- a. Formation – Uniform Limited Partnership Act (1976, with 1985 amendments) (“RULPA”) §§ 101(7), 201
 - b. Limited Liability; Taking Part in Control – KR&B pp. 166-168, 198-200; Uniform Limited Partnership Act (1916) (“ULPA”) § 7; Uniform Limited Partnership Act (1976) § 303(a); RULPA § 303; Uniform Limited Partnership Act (2001) § 303.
 - c. Centralization of Management – RULPA §§ 302, 403
 - d. Transferability of Interest – RULPA § 704(a)

- e. Continuity of Life – RULPA § 801
- #18. Taxation – KBD Supp. pp. 39-45
- #19. Master Limited Partnerships (“MLPs”); Fiduciary Duty & Contractual Limitations – KBD Supp. pp. 45-55

CORPORATIONS

- #20. Incorporation – KR&B Update pp. 11-12
 - a. Filing the Articles of Incorporation – Model Business corporation Act (“MBCA”) §§ 2.01-2.03; Wisconsin Articles of Incorporation: <https://www.wdfl.org/resources/indexed/site/corporations/Form2R02-2014.pdf>
 - b. Organization Meeting – MBCA § 2.05
 - c. Adoption of Bylaws – MBCA § 2.06 [Compare the requirements for amending the articles and bylaws – MBCA §§ 10.03, 10.20]
 - d. Election of Officers – MBCA §§ 8.40, 8.41
- #21. Promoter’s Fraud – KR&B pp. 169-171; KBD Supp. pp. 55-56
- #22. Authorized Shares; Classes of Shares – Chez SinoZa Problem #4 (KBD Supp. p. 57); KR&B pp. 576-81; MBCA § 6.01
- #23. Legal Capital
 - a. Share Issuance; Treasury Shares – KBD Supp. pp. 57-67; MBCA §§ 6.21, 6.30; Delaware General Corporation Law (“DGCL”) §§ 152-154
 - b. Distributions; Share Buy-Backs – KBD Supp. pp. 68-70; MBCA §§ 6.31, 6.40; DGCL § 160
- #24. Pre-incorporation Transactions & Defective Incorporation – KR&B pp. 171-175; KBD Supp. pp. 71-74; R 2d § 326 & Comment; R 3d § 4.04(1) & Comment; MBCA § 2.04 & Comment
- #25. Limited Liability; Piercing the Corporate Veil – KR&B pp. 176-187; KBD Supp. pp. 74-77; KR&B pp. 190-198
- #26. Corporate Purposes & Powers; Ultra Vires Doctrine – KR&B pp. 251-267; MBCA §§ 3.01, 3.02, 3.04
- #27. Shareholder Agreements & Arrangements for Allocating Control – Chez SinoZa Problem #5A (KBD Supp. p. 77)

- a. Voting Trusts & Agreements; Cumulative Voting; Proxies – KR&B pp. 582-589; MBCA §§ 7.22, 7.28, 7.30, 7.31
 - b. Increased Quorum & Voting Requirements – KBD Supp. pp. 77-79; KR&B pp. 629-633; MBCA §§ 7.25, 7.27, 8.10, 8.24
 - c. Shareholder Agreements – KR&B pp. 589-606; MBCA § 7.32
 - d. Shares Transfer Restrictions; Buy-Sell Agreements – Chez SinoZa Problem #5B (KBD Supp. p.79); KR&B pp. 606-612, 620-625; KBD Supp. pp. 79-80; KR&B pp. 634-645, 675-679; MBCA § 6.27
- #28. Shareholder Disputes & Remedies
- a. Direct versus Derivative Claims – KBD Supp. pp. 80-83; MBCA §§ 7.42, 7.44
 - b. Heightened Fiduciary Duties – KR&B pp. 613-620, 625-629, 633-634 (Notes on *Nixon v. Blackwell*)
 - c. Statutory Dissolution – KR&B pp. 646-655, 663-674; KBD Supp. pp. 83-84; MBCA §§ 14.30, 14.34

LIMITED LIABILITY COMPANIES (“LLCs”)

- #29. Structure of the LLC
- a. Formation – Uniform Limited Liability Company Act (“ULLCA”) §§ 201-203
 - b. Limited Liability & Pre-Incorporation Transactions – KR&B pp. 268-273; KBD Supp. pp. 84-87; ULLCA § 303
 - c. Operating Agreements & LLC Management – KR&B pp. 274-286; ULLCA §§ 103, 301, 404
- #30. Liability for LLC Obligations
- a. Piercing the LLC Veil – KBD Supp. pp. 87-94; KR&B pp.290-291 (Problem); ULLCA § 303(b)
 - b. Distributions – ULLCA §§ 405-406
 - c. Additional Capital – KR&B pp. 298-302; ULLCA § 402
 - d. Dissolution – KR&B pp. 303-307; ULLCA §§ 806-808
- #31. Disputes Among Members
- a. Fiduciary Obligation – KR&B pp. 292-297; KBD Supp. pp. 94-100; ULLCA §§ 103(b); 409(b)-(f)

b. Judicial Dissolution – KR&B pp. 655-663; ULLCA § 801(4)

LIMITED LIABILITY PARTNERSHIPS & PROFESSIONAL CORPORATIONS

#32. KBD Supp. pp. 100-107; UPA § 35; RUPA §§ 1001-1003

SUPPLEMENTARY MATERIALS

CHEZ SINOZA

Arthur, Beverly and Charles have decided to go into business together. Their plan is to open a restaurant that will serve as its principal dish a product the three have dubbed a SinoZa. In essence, a SinoZa is a Chinese pizza. The crust is similar to the skin of an egg roll, and is covered with various types of Chinese food. They have named the restaurant “Chez SinoZa,” and if the concept is successful, the three hope to expand to a chain of restaurants throughout the area, and have also discussed the possibility of developing a frozen version of the SinoZa to be marketed through grocery stores.

The background of these three entrepreneurs, and their objectives for the new business, are as follows:

Arthur is a chef, who has been engaged in a small catering business specializing in Chinese food and novelty items. It is in this capacity that he developed the SinoZa. The plan is for Arthur to quit his catering business and work full-time in the new SinoZa venture. He will supervise the kitchen and continue to develop new menu items. Arthur’s wife is an accountant with a large corporation. While Arthur will definitely miss the income from his catering business, he believes that he and his wife can survive on her income alone until the new venture becomes profitable.

Beverly manages restaurants for a national pizza chain. The plan is for Beverly, like Arthur, to quit her present job and devote her full-time efforts to the SinoZa venture. She will be responsible for managing the business aspects of the restaurant. Beverly’s financial needs are, however, more demanding than Arthur’s. She is a divorced mother of two small children. She has told Arthur and Charles that she can afford to join the venture only if she is guaranteed a monthly “draw” from the business. The two men have been receptive to her position. Beverly does not expect to receive the salary she is presently receiving from the pizza chain (\$120,000) per year, but she figures that she needs a minimum of \$60,000 to \$75,000 per year in order to pay her bills and support her family.

Charles is a practicing surgeon who got to know Arthur and Beverly when their children played on the same soccer team. His surgical practice provides him with more than enough income to meet his family’s present needs, and he is interested in the business venture principally for its potential for long term-growth. After tasting some of Arthur’s SinoZas, Charles agreed to bankroll the venture by contributing \$250,000 in cash. Charles is content to treat this money as “at risk,” but would like to protect himself from any losses in excess of that amount. The plan is for Charles to play no role in the day-to-day management of the business. He is concerned, however, that Arthur and Beverly

might do something rash with his money and would like to have veto power over any major financial decisions that the two might propose.

Question

Assume that the three parties have discussed and reached a general understanding as to the foregoing terms – though no written agreement confirming the terms has been prepared. Arthur and Beverly have begun the preliminary steps to get the business up and running. Has an agency relationship been created? If so, who is the principal and who is the agent? What would you advise Charles to do to limit his risk exposure?

TERMINATION OF AUTHORITY

NOTE ON THE CHINESE CHOP SYSTEM

Consider the following excerpts from an article on the *New York Times* “You’re the Boss” blog, entitled “Mastering the Chinese Chop System.”

Imagine giving away your signature and allowing anyone to use it.

Some American business owners have signature stamps that are shared with a trusted assistant, but that is very different from handing over your signatory authority to everyone in the office.

That’s essentially how China’s chop system works. Documents are rarely ratified in the Western manner with a physical signature. Instead, a printed seal – a chop – is affixed.

Chops date back to 1000 B.C. They have advanced from the dripped-wax seal of the past to modern, preinked stamps, but they still carry the same weight they have for millennia. A document with a company’s chop affixed is a binding commitment on the company’s legal representative, typically the owner.

When I opened my business in China, it was difficult to find information on the chop system. It’s such a common practice that for natives it needs no explanation. That little stamp grants great power, though. Using a company chop, someone could actually change the stock structure of your Chinese company and allow control of it to be “signed over” to another group or individual.

My first Chinese general manager reminded me of that the day I asked for his resignation. Taking my company chop hostage, he told me: “The controller of the chop is the controller of the company – good luck without it.” (In the end, through a great deal of negotiation, I was able to get my chop back.)

....

As a part-time resident of China, I have entrusted my chops to two American managers who are permanently stationed at my firm’s Shanghai office. Every time the chops are

used, they must log in a spreadsheet the date, the purpose, and the name of the person who did the stamping. Consider how many times you sign your name on an ordinary day in the United States and you will get an idea of how often the chops are used.

The chop system has many inherent security risks, but there is one feature that I really like: the “fan chop” used for multipage documents.

When a document is executed, the company chop is used on the final page. Then all of the document’s pages are fanned out so that just a small section of each is showing. The company chop is affixed across all the pages

Later, you can check to make sure all of the chop marks line up. It’s a way to be certain that a page was not substituted.

Suppose, in the author’s anecdote, the terminated general manger had refused to return the chop. Under U.S. law, would he continue to possess actual authority to bind the author? Apparent authority? Would the answers be different if, after returning the author’s chop, he broke into the shop the next night and took it back? Consider Comment *d* to section 3.11 of *Restatement (Third)* below.

Restatement (Third) of Agency

§ 3.06 Termination of Actual Authority—In General

An agent’s actual authority may be terminated by:

- (1) the agent’s death, cessation of existence, or suspension of powers as stated in § 3.07(1) and (3); or
- (2) the principal’s death, cessation of existence, or suspension of powers as stated in § 3.07(2) and (4); or
- (3) the principal’s loss of capacity, as stated in § 3.08(1) and (3); or
- (4) an agreement between the agent and the principal or the occurrence of circumstances on the basis of which the agent should reasonably conclude that the principal no longer would assent to the agent’s taking action on the principal’s behalf, as stated in § 3.09; or
- (5) a manifestation of revocation by the principal to the agent, or of renunciation by the agent to the principal, as stated in § 3.10(1); or
- (6) the occurrence of circumstances specified by statute.

See Comment to § 3.06 in KR&B Statutory Supplement

§ 3.07 Death, Cessation of Existence, And Suspension of Powers

- (1) The death of an individual agent terminates the agent’s actual authority.
- (2) The death of an individual principal terminates the agent’s actual authority. The termination is effective only when the agent has notice of the principal’s death. The termination

is also effective as against a third party with whom the agent deals when the third party has notice of the principal's death.

§ 3.10 *Manifestation Terminating Actual Authority*

(1) Notwithstanding any agreement between principal and agent, an agent's actual authority terminates if the agent renounces it by a manifestation to the principal or if the principal revokes the agent's actual authority by a manifestation to the agent. A revocation or a renunciation is effective when the other party has notice of it.

§ 3.11 *Termination of Apparent Authority*

(1) The termination of actual authority does not by itself end any apparent authority held by an agent.

(2) Apparent authority ends when it is no longer reasonable for the third party with whom an agent deals to believe that the agent continues to act with actual authority.

Comment d. Indicia of authority. A principal may furnish an agent with a writing, such as a power of attorney, that states the extent and nature of the agent's actual authority. Providing the agent with such a writing enables third parties to deal with the agent as to matters within the scope of the stated authority without confirming the agent's authority directly with the principal. When actual authority is terminated, the agent has a duty to return indicia of authority to the principal. If the agent does not return the indicia to the principal, the principal bears the risk that the agent will use them to deceive third parties who do not have notice that the agent's actual authority has been terminated.

A Greek Tragedy

Before his summer sojourn to the Greek islands, Percy Printemps entered into a written contract with the Abner Agency listing Percy's estate, Thornacre, for sale. The contract authorized Abner to sell Thornacre to any eligible buyer at any price above \$1 million, with Abner to receive a commission equal to 6 percent of the purchase price upon closing. The contract was dated May 15 and declared that Abner's authority was to continue until Percy's return on September 1. Unfortunately, Percy's Greek holiday met with disaster. Late on the night of June 15, after several hours of merry-making at the local tavern, Percy chose to walk home along the crest of a steep seaside cliff. He lost his footing and plunged into the Aegean where he promptly drowned.

Meanwhile back in the U.S., negotiations were underway for the sale of Thornacre. On June 25, Abner entered into a contract with Bella Buyer providing for the sale of Thornacre for a price of \$1.2 million. Before signing the contract Bella had insisted upon verification of Abner's authority, and Abner showed her a copy of the May 15 agency contract with Percy's signature.

The local officials did not discover Percy's body for several days after the accident. Because of the limited telecommunications facilities on the island, word of Percy's death did not reach his relatives in the U.S. for several more days, and they informed Abner on July 1. Percy's

heirs want to keep Thornacre in the family and they refuse to honor the contract with Bella. May Bella enforce the contract against Percy's estate? Is the estate liable for Abner's commission?

IMPROPER PURPOSES

Question

Rico is a man of very substantial means. Pobre, his long-time (but ne'er-do-well) friend, recently came up with an idea for a new business venture, and Rico agreed to finance it. Rico had plans to be out of the country for most of the next year, but told Pobre that whenever his investment is needed, Pobre should go to First National Bank, where Rico had a longstanding relationship, borrow up to \$100,000 in Rico's name, and use that money to fulfill Rico's capital commitment. As soon as Rico left the country, Pobre borrowed the full \$100,000, took it to Las Vegas and lost all of it in the casinos. Should Rico be obligated on the First National Bank loan as Pobre's principal?

Did Pobre act with actual authority under section 2.01 of *Restatement (Third)*? Does it matter whether Pobre made the decision to take the money to Vegas before or after he borrowed it? Is it relevant that the *Restatement (Third)* includes no counterpart to section 165 of the *Restatement (Second)* below?

§ 165. *Agent Acts for Improper Purpose*

A disclosed or partially disclosed principal is subject to liability upon a contract purported to be made on his account by an agent authorized to make it for the principal's benefit, although the agent acts for his own or other improper purposes, unless the other party has notice that the agent is not acting for the principal's benefit.

INHERENT AGENCY POWER

ZUMMACH v. POLASEK

227 N.W. 33

Supreme Court of Wisconsin, 1929

Action by William F. Zummach against Vincent Polasek and others. From a judgment dismissing the complaint, plaintiff appeals. Affirmed.

The plaintiff is a manufacturer and dealer in store fronts, paints, oils, etc. One James T. Biersach was in his employ from 1919 to 1926. The plaintiff employed Biersach to call upon contractors and architects and endeavor to make and promote sales of the goods in which the plaintiff dealt. Biersach supervised to some extent the installation of store fronts, but had no authority to make collections for the plaintiff except in the case of overdue accounts. In such

cases statements of accounts overdue were handed to Biersach with directions to endeavor to get the money. This is conceded to be the extent of his authority.

The defendants were contractors, and through the solicitation of Biersach commenced doing business with the plaintiff some time in 1919. It appears that, when the dealings of the parties first began, the defendant John Polasek was at the plaintiff's place of business, and some one took him to Mr. Biersach's office about 100 feet distant from the office of the plaintiff and told him that Mr. Biersach would take care of him. From that time on the defendants transacted all or nearly all of the business done through Biersach. . . .

It appears that Biersach, about 1923, commenced systematically to defraud his employer. He procured orders, took these orders directly to the shop foreman, had the goods manufactured and sent out in regular course, procured the order from the foreman, took the order to the customer, and, upon payment, receipted the order and gave it back to the person from whom he received it. In this way no account of the transaction appeared upon the plaintiff's books in his office. When Biersach had collected the money, he apparently converted it to his own use. This was discovered by the plaintiff when he noticed that in the neighborhood where they were doing the most work more of his store fronts were going up than there were orders for, and an investigation disclosed Biersach's dishonesty. Thereupon plaintiff began this action to recover the value of the goods delivered to the defendants for which they had paid Biersach in cash or by check payable to the order of Biersach, which he claimed Biersach had no authority to receive, and which were therefore as to him not payments of the account.

The issues were submitted to a jury, and the jury found that Biersach, in securing from the defendants their checks made payable to the order of cash for the items set forth in plaintiff's complaint, acted within the scope of his employment with the plaintiff . . .

ROSENBERRY, C. J.

The question presented is whether or not Biersach, the agent, had the power to bind his principal by the acceptance of payments from the plaintiff's customers which he was not authorized to receive. . . . The word "authority" is used in connection with the power of an agent to bind his principal in different senses. As used in some instances, it means the power which the principal has conferred directly upon the agent; in other words, express authority. Power to bind the principal may result also from consent of the principal manifested to third persons by formal or informal writings or by spoken words, or it may result from manifestations of consent on the part of the principal implied from authority to do other acts. This is called apparent authority. . . . [I]f the agent Biersach had authority to accept payment of accounts other than those which were overdue, it was by reason of apparent authority resulting from manifestations made by plaintiff to the defendants.

. . . .

The question here is, Were there such manifestations on the part of the plaintiff made to the defendants as reasonably induced them to believe that the plaintiff had authorized Biersach to receive payment and that they made payment relying upon such apparent authority? The plaintiff put the agent Biersach in a responsible position in his business by virtue of which he

was authorized to enter into contracts, to make prices, to waive liens, to oversee installation of goods sold, to make adjustments where the goods were not as ordered, and to collect accounts where accounts were overdue. In addition to that, the defendants had been advised that Mr. Biersach would take care of them, and for a period of six years during which they had dealt with the plaintiff their dealings were almost entirely through the agent Biersach. Biersach took the orders, pursuant thereto the goods appeared from the shop of the plaintiff, being delivered so far as defendants could see in the regular course of business. It probably never occurred to the defendants and would not occur to very many contractors that an agent could take an order for goods, have the goods manufactured in his principal's shop and delivered by the principal's teamsters in the regular course of business without the knowledge of the principal.

....

Judgment affirmed.

Questions

1. Why were Biersach's actions beyond the scope of his actual authority? Is this case any different from that of Rico and Pobre?
2. Suppose that Biersach had not been on the premises when Polasek visited Zummach's offices? Instead, Biersach later called upon Polasek at the latter's place of business and introduced himself as Zummach's agent. Would the outcome of the case be different? Should it be?

KIDD v. THOMAS A. EDISON, INC.

239 F. 405

U.S. District Court, S.D.N.Y., 1917

Affirmed, 242 F. 923 (2d Cir. 1917)

At Law. Action by Mary Carson Kidd against Thomas A. Edison, Incorporated. On defendant's motion to set aside, on exceptions, a verdict for plaintiff. Motion denied.

This is a motion by the defendant to set aside a verdict for the plaintiff on exceptions. The action was in contract, and depended upon the authority of one Fuller to make a contract with the plaintiff, engaging her without condition to sing for the defendant in a series of "tone test" recitals, designed to show the accuracy with which her voice was reproduced by the defendant's records. The defendant contended that Fuller's only authority was to engage the plaintiff for such recitals as he could later persuade dealers in the records to book her for all over the United States. The dealers, the defendant said, were to agree to pay her for the recitals, and the defendant would then guarantee her the dealers' performance. The plaintiff said the contract was an unconditional engagement for a singing tour, and the jury so found.

LEARNED HAND, District Judge (after stating the facts as above).

The point involved is the scope of Fuller's "apparent authority," as distinct from the actual authority limited by the instructions which Maxwell gave him. The phrase "apparent authority," though it occurs repeatedly in the Reports, has been often criticized (Mechem, Law of Agency, Secs. 720-726), and its use is by no means free from ambiguity. The scope of any authority must, of course, in the first place, 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. . . . In considering what was Fuller's actual implied authority by custom, while it is fair to remember that the "tone test" recitals were new, in the sense that no one had ever before employed singers for just this purpose of comparing their voices with their mechanical reproduction, they were not new merely as musical recitals; for it was, of course, a common thing to engage singers for such recitals. When, therefore, an agent is selected, as was Fuller, to engage singers for musical recitals, the customary implication would seem to have been that his authority was without limitation of the kind here imposed, which was unheard of in the circumstances. The mere fact that the purpose of the recitals was advertisement, instead of entrance fees, gave no intimation to a singer dealing with him that the defendant's promise would be conditional upon so unusual a condition as that actually imposed. Being concerned to sell its records, the venture might rightly be regarded as undertaken on its own account, and, like similar enterprises, at its own cost. The natural surmise would certainly be that such an undertaking was a part of the advertising expenses of the business, and that therefore Fuller might engage singers upon similar terms to those upon which singers for recitals are generally engaged, where the manager expects a profit, direct or indirect.

Therefore it is enough for the decision to say that the customary extent of such an authority as was actually conferred comprised such a contract. If estoppel be, therefore, the basis of all "apparent authority," it existed here. Yet the argument involves a misunderstanding of the true significance of the doctrine, both historically (*Responsibility for Tortious Acts: Its History*, Wigmore, 7 Harv. L. Rev. 315, 383) and actually. The responsibility of a master for his servant's act is not at bottom a matter of consent to the express act, or of an estoppel to deny that consent, but it is a survival from ideas of status, and the imputed responsibility congenial to earlier times, preserved now from motives of policy. . . . It is only a fiction to say that the principal is estopped, when he has not communicated with the third person and thus misled him. There are, indeed, the cases of customary authority, which perhaps come within the range of a true estoppel; but in other cases the principal may properly say that the authority which he delegated must be judged by his directions, taken together, and that it is unfair to charge him with misleading the public, because his agent, in executing that authority, has neither observed, nor communicated, an important part of them. Certainly it begs the question to assume that the principal has authorized his agent to communicate a part of his authority and not to disclose the rest. Hence, even in contract, there are many cases in which the principle of estoppel is a factitious effort to impose the rationale of a later time upon archaic ideas, which, it is true, owe their survival to convenience, but to a very different from the putative convenience attributed to them.

However it may be of contracts, all color of plausibility falls away in the case of torts, where indeed the doctrine first arose, and where it still thrives. 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 intrusted to his care. . . .

The considerations which have made the rule survive are apparent. If a man select another to act for him with some discretion, he has by that fact vouched to some extent for his reliability. While it may not be fair to impose upon him the results of a total departure from the general subject of his confidence, the detailed execution of his mandate stands on a different footing. The very purpose of delegated authority is to avoid constant recourse by third persons to the principal, which would be a corollary of denying the agent any latitude beyond his exact instructions. Once a third person has assured himself widely of the character of the agent's mandate, the very purpose of the relation demands the possibility of the principal's being bound through the agent's minor deviations. Thus, as so often happens, archaic ideas continue to serve good, though novel, purposes.

In the case at bar there was no question of fact for the jury touching the scope of Fuller's authority. His general business covered the whole tone test recitals; upon him was charged the duty of doing everything necessary in the premises, without recourse to Maxwell or any one else. It would certainly have been quite contrary to the expectations of the defendant, if any of the prospective performers at the recitals had insisted upon verifying directly with Maxwell the terms of her contract. It was precisely to delegate such negotiations to a competent substitute that they chose Fuller at all.

The exception is without merit; the motion is denied.

Notes

1. The *Restatement (Second) of Agency* codified Judge Hand's reasoning in *Kidd* under the concept of "inherent agency power." See R.2d §§ 8A, 161. The concept also proved useful in explaining the *Restatement's* treatment of improper purposes discussed above, and the liability of undisclosed principals for unauthorized actions, as reflected in the *Watteau* case, considered later in this assignment.

2. The *Restatement (Third)* abandoned the inherent agency power concept, as explained in the following commentary. Do you agree that the concept of apparent authority under *Restatement (Third)* is now broad enough to address the concerns voiced by Judge Hand in *Kidd*?

Restatement (Third) of Agency

§ 1.03 Manifestation

A person manifests assent or intention through written or spoken words or other conduct.

Comment:

A principal's manifestations of assent or intention to an agent may differ from the principal's manifestations to third parties and carry different legal consequences. If the

principal places a person in a position or office with specific functions or responsibilities, from which third parties will infer that the principal assents to acts by the person requisite to fulfilling the specific functions or responsibilities, the principal has manifested such assent to third parties. . . .

Moreover, an agent is sometimes placed in a position in an industry or setting in which holders of the position customarily have authority of a specific scope. Absent notice to third parties to the contrary, placing the agent in such a position constitutes a manifestation that the principal assents to be bound by actions by the agent that fall within that scope. A third party who interacts with the person, believing the manifestation to be true, need not establish a communication made directly to the third party by the principal to establish the presence of apparent authority as defined in § 2.03.

Reporter's Notes

The definition of manifestation in this section is intended to be broader than that assumed to be operative at points in the *Restatement Second of Agency*. One consequence of this breadth is to eliminate the rationale for a distinct doctrine of inherent-agency power applicable to disclosed principals when an agent disregards instructions or oversteps actual authority. . . . In this *Restatement*, conduct may constitute a manifestation sufficient to create apparent authority even though it does not use the word “authority” and even though it does not consist of words targeted specifically to a third party.

THE UNDISCLOSED PRINCIPAL

Question

The City of Jonesboro hired Willey Real Estate to acquire land on its behalf. Willey entered into a contract to purchase the land from Mr. and Mrs. Miller, without disclosing that the true buyer was the City. Suppose that Willey later refuses to pay the purchase price. The Millers then look into the situation and learn for the first time that the City was behind the transaction, but had later located a less expensive piece of property and instructed Willey not to proceed with the Miller purchase. May the Millers sue the City for breach of contract, even though their contract was with Willey? May they sue Willey? See *Restatement (Third) of Agency* § 6.03.

What if it is the Millers who, upon learning that the City is the true purchaser, refuse to perform?

MILLER v. WILLEY

521 S.W.2d 68

Supreme Court of Arkansas, 1975

HOLT, Justice.

Appellants gave appellee a written option to purchase their property for \$10,000. The option was properly exercised and appellants refused to convey the property. The chancellor ordered specific performance by the appellants. . . .

[We cannot] agree that the trial court erred by not voiding the contract on the ground of the “Undisclosed Principal” doctrine. Appellant refused to deed the property to the City of Jonesboro as instructed by the appellee who was purchasing this and other property for the city. The appellants, it appears, had some animosity toward the city and were unwilling for it to acquire their property. However, the appellants cannot repudiate their contract on this basis since they agreed to “execute and deliver to [appellee], or to any person or persons as we [appellee] . . . shall direct in writing, a good and sufficient Warranty Deed and an up to date Abstract of . . .” their property. Also, appellee testified that he was unaware of any ill feeling of appellants toward the city and that he acquainted appellants with the fact that he was purchasing the property for a client. An agent, without disclosing his principal, can make a valid and enforceable contract in his own name. . . . In the circumstances we cannot say the chancellor’s findings are against the preponderance of the evidence.

Affirmed.

Question

A large entertainment conglomerate plans to build a theme park in a part of central Florida now consisting principally of citrus groves. It hires a local real estate broker to obtain the necessary land and instructs her not to disclose the conglomerate’s interest in the transaction. Among the sellers are two citrus growers, Mickey and Donald, both of whom seek to rescind their sales upon learning the identity of the true buyer. When questioned, Mickey states that he assumed the buyer was another citrus grower and would never have allowed his land to be developed for tourism purposes; Donald says that had he known the true buyer he would have held out for a higher price. Should the two transactions be treated differently?

Restatement (Third) of Agency

§ 6.11 Agent’s Representations

(4) When an agent who makes a contract or conveyance on behalf of an undisclosed principal falsely represents to the third party that the agent does not act on behalf of a principal,

the third party may avoid the contract or conveyance if the principal or agent had notice that the third party would not have dealt with the principal.

Comment

d. Agent for undisclosed principal misrepresents relationship to third party. When an agent deals with a third party on behalf of a principal but does not disclose the principal's existence, the agent does not impliedly represent that the agent does not act on behalf of a principal. This is so because in most cases the principal's involvement is not material to the third party's decisionmaking. That is, most parties decide to commit themselves to transactions on the basis of the price and other substantive terms plus an assessment of the likelihood that the other party will perform duties that the contract creates. An undisclosed principal's involvement ordinarily should not affect the price and other substantive terms of the contract. . .

An undisclosed principal or the agent who acts on the principal's behalf, or both, may know or have reason to know that a third party would not deal with the principal, if the third party knew the principal's identity. Mere doubts or suspicions about the third party's willingness to deal with the principal do not constitute reason to know that the third party would not deal with the principal. It is necessary that the third party manifest its unwillingness to deal with the principal . . .

[T]o ignore an agent's misrepresentation, unless the agent has notice that the third party would not have dealt with the principal, protects an undisclosed principal who purchases property or goods from a third party who regrets the transaction after learning the purchaser's identity. Such regret on the part of a seller is often based on a belief that, had the purchaser's identity been known, the seller would have demanded, and the buyer would have paid, a higher price. The regretful seller may suspect that, for the purchaser, the goods or property had a special and above-market value that would have enabled the seller to bargain for a higher price. Since such negotiations did not take place, it would be difficult to determine how significant a role the purchaser's identity would have assumed in them. Moreover, the seller has manifested assent to be bound at a price then satisfactory to the seller.

If the agent makes no representation to the third party, the third party may avoid the contract only by establishing that the identity of the parties on the other side of the transaction constituted a basic assumption about which the third party was mistaken; and either that the effect of the mistake is such that enforcing the contract would be unconscionable, or that the mistake was known to the agent or principal, and the mistake had a material and adverse effect on the exchange of performances due to the third party.

Illustrations:

10. P, a real-estate developer, engages A to purchase several adjacent lots owned by separate persons so that P may redevelop the property into one large amusement park. P has reason to believe that, were P's interest to become known, some lot owners would demand a higher price and that still higher prices would be demanded by the last lot owners to sell. All lot owners sell their lots to A, who acts on behalf of P but does not disclose P's identity. T, who

owns a lot, asks A why A is interested in buying T's lot. "To build my dream house," replies A. T may not rescind the sale unless T can establish either a mistake in basic assumption or that P or A had notice that T would not have dealt with P.

11. Same facts as Illustration 10, except that A makes no misrepresentation to T. Unless T establishes a mistake in basic assumption, T may not rescind the sale.

12. Same facts as Illustration 11, except that T is P's arch-competitor in real-estate development. P suspects that T would be unwilling to sell the lot to P. T may not rescind the sale unless T establishes a mistake in basic assumption. P's suspicions do not give P notice that T would be unwilling to deal with P.

SCOPE OF EMPLOYMENT

JOEL v MORISON

172 Eng. Rep. 1338

Court of Exchequer, 1834

From the evidence on the part of the plaintiff it appeared that he was in Bishops Gate Street, when he was knocked down by a cart and horse coming in the direction from Shoreditch, which were sworn to have been driven at the time by a person who was the servant of the defendant, another of his servants being in the cart with him. The injury was a fracture of the fibula.

On the part of the defendant witnesses were called, who swore that his cart was for weeks before and after the time sworn to by the plaintiff's witnesses only in the habit of being driven between Burton Crescent Mews and Finchley, and did not go into the City at all.

Thesiger, for the plaintiff, in reply, suggested that either the defendant's servants might in coming from Finchley have gone out of their way for their own purposes, or might have taken the cart at a time when it was not wanted for the purpose of business, and have gone to pay a visit to some friend. He was observing that, under these circumstances, the defendant was liable for the acts of his servants.

Parke, B.—He is not liable if, as you suggest, these young men took the cart without leave; he is liable if they were going extra viam in going from Burton Crescent Mews to Finchley; but if they chose to go of their own accord to see a friend, when they were not on their master's business, he is not liable.

His Lordship afterwards, in summing up, said — This is an action to recover damages for an injury sustained by the plaintiff, in consequence of the negligence of the defendant's servant. There is no doubt that the plaintiff has suffered the injury, and there is no doubt that the driver of the cart was guilty of negligence, and there is no doubt also that the master, if that person was driving the cart on his master's business, is responsible. If the servants, being on their master's

business, took a detour to call upon a friend, the master will be responsible. If you think the servants lent the cart to a person who was driving without the defendant's knowledge, he will not be responsible. Or, if you think that the young man who was driving took the cart surreptitiously, and was not at the time employed on his master's business, the defendant will not be liable. The master is only liable where the servant is acting in the course of his employment. If he was going out of his way, against his master's implied commands, when driving on his master's business, he will make his master liable; but if he was going on a frolic of his own, without being at all on his master's business, the master will not be liable. As to the damages, the master is not guilty of any offence, he is only responsible in law, therefore the amount should be reasonable.

Verdict for the plaintiff—damages, £30.

FRANCHISE RELATIONSHIPS

Restatement (Second) of Agency

§ 267. Reliance Upon Care Or Skill Of Apparent Servant Or Other Agent

One who represents that another is his servant or other agent and thereby causes a third person justifiably to rely upon the care or skill of such apparent agent is subject to liability to the third person for harm caused by the lack of care or skill of the one appearing to be a servant or other agent as if he were such.

WISCONSIN LAW

Dennis Rasmussen, Inc. ("DRI") operated an Arby's restaurant in Madison as an Arby's franchisee. Harvey Pierce was a work-release inmate at the Dane County jail employed by the restaurant. On the afternoon of June 11, 1999, Pierce left his restaurant job without permission, and crossed the street to the Wal-Mart store parking lot, where he waited for Robin Kerl, his former girlfriend, and David Jones, her fiancé, both Wal-Mart employees. When Kerl and Jones appeared, Pierce shot and killed them, then shot himself.

The estates of Kerl and Jones sued DRI and Arby's on grounds that included negligent hiring and negligent supervision. In *Kerl v. Dennis Rasmussen, Inc.*, 682 N.W. 2d 328 (Wis. 2004), the Supreme Court addressed the vicarious liability of Arby's, as franchisor.

Most courts that have addressed the issue of franchisor vicarious liability have assumed that respondeat superior applies in the franchising context and have adapted the traditional master/servant "control or right to control" test to determine whether the relationship between the franchisor and franchisee should give rise to vicarious liability.

As a general matter, however, the usual justifications for vicarious liability lose some force in the franchising context, and the “control or right to control” test for determining the presence of a master/servant agency is not easily transferable to the franchise relationship.

. . . The “control” of a franchisor does not consist of routine, daily supervision and management of the franchisee's business, but, rather, is contained in contractual quality and operational requirements necessary to the integrity of the franchisor's trade or service mark. The perceived fairness of requiring a principal who closely controls the physical conduct of an agent to answer for the harm caused by the agent is diminished in this context.

Similarly, while the rationale of encouraging safety and the exercise of due care is present in the domain of franchising, as elsewhere, it has less strength as a justification for imposing no-fault liability on a franchisor. The typical franchisee is an independent business or entrepreneur, often distant from the franchisor and not subject to day-to-day managerial supervision by the franchisor. The imposition of vicarious liability has less effectiveness as an incentive for enhancing safety and the exercise of care in the absence of the sort of daily managerial supervision and control of the franchise that could actually bring about improvements in safety and the exercise of care.

In light of these considerations, the clear trend in the case law in other jurisdictions is that the quality and operational standards and inspection rights contained in a franchise agreement do not establish a franchisor's control or right of control over the franchisee sufficient to ground a claim for vicarious liability as a general matter or for all purposes. See *Wendy Hong Wu v. Dunkin' Donuts, Inc.*, 105 F. Supp. 2d 83, 87-94 (E.D.N.Y. 2000) (restaurant franchisor not vicariously liable for security lapses associated with rape of franchisee employee because franchise agreement did not give franchisor “considerable control . . . over the specific instrumentality at issue,” *i.e.*, security at franchised restaurant); *Pizza K., Inc. v. Santagata*, 249 Ga. App. 36, 547 S.E. 2d 405, 406-07 (2001) (pizza franchisor not vicariously liable for auto accident caused by franchisee delivery driver because, although franchise agreement “contains specific and even strict requirements concerning operation of franchise,” franchisor was “not authorized under the agreement to exercise supervisory control over the daily activities of [franchisee's] employees”); *Viches v. MLT, Inc.*, 127 F. Supp. 2d 828, 832 (E.D. Mich. 2000) (hotel franchisor not vicariously liable for franchisee's negligent use of pesticides where franchise agreement does no more than insure “uniformity and standardization . . . of services”).

These courts have adapted the traditional master/servant “control or right to control” test to the franchise context by narrowing its focus: the franchisor must control or have the right to control the daily conduct or operation of the particular “instrumentality” or aspect of the franchisee's business that is alleged to have caused the harm before vicarious liability may be imposed on the franchisor for the franchisee's tortious conduct. The quality and operational standards typically found in franchise

agreements do not establish the sort of close supervisory control or right to control necessary to support imposing vicarious liability on a franchisor for the torts of the franchisee for all or general purposes.

....

On the other hand, in *Miller v. McDonald's Corp.*, 150 Or. App. 274, 945 P.2d 1107 (1997), the Oregon Supreme Court reversed a grant of summary judgment on a claim of franchisor vicarious liability where the plaintiff was injured when she bit into a sapphire stone while eating a Big Mac sandwich at a McDonald's franchise. The franchise agreement and an operations manual incorporated into the agreement established that "precise methods" of food handling and preparation were imposed by the franchisor, McDonald's. *Id.* at 1111. Because the plaintiff alleged that the franchisee's "deficiencies in those functions resulted in the sapphire being in the Big Mac," the court concluded that there was an issue of fact for trial on whether the franchisor had the right to control the franchisee "in the precise part of its business that allegedly resulted in plaintiff's injuries." *Id.* *Miller* appears to run contrary to the prevailing rule that quality and operational standards contained in a franchise agreement are generally insufficient to support franchisor vicarious liability. *Miller* is, however, consistent with the current consensus to the extent that it focused on the particular aspect of the franchisee's business that was alleged to have caused the harm.

Consistent with the majority approach in other jurisdictions, we conclude that the standardized provisions commonly included in franchise agreements specifying uniform quality, marketing, and operational requirements and a right of inspection do not establish a franchisor's control or right to control the daily operations of the franchisee sufficient to give rise to vicarious liability for all purposes or as a general matter. We hold that a franchisor may be held vicariously liable for the tortious conduct of its franchisee only if the franchisor has control or a right of control over the daily operation of the specific aspect of the franchisee's business that is alleged to have caused the harm.

682 N.W. 2d 337-41. Applying this test to the relationship between Arby's and DRI, the Court upheld the dismissal of the claims against Arby's.

FIDUCIARY OBLIGATIONS

BECKER v. CAPWELL

270 Or. 200, 527 P.2d 120

Supreme Court of Oregon, 1974

HOWELL, Justice.

Plaintiff filed this action at law to recover alleged “secret profits” from the defendant, who was plaintiff’s agent and a real estate broker. The trial court granted defendant’s motion for a judgment of involuntary nonsuit, and plaintiff appeals.

On June 3, 1969, the defendant purchased certain property known as the Lancaster property. Defendant was an experienced real estate broker who worked as a consultant for clients on an ongoing basis. His services consisted of the purchase, sale and exchange of investment real property on behalf of his clients.

The plaintiff, a medical doctor with no prior land investment experience, became acquainted with an employee of the defendant who explained the defendant’s services. On or about September 15, 1969, the plaintiff was introduced to the defendant. Shortly thereafter the plaintiff and the defendant entered into an agreement whereby the defendant would advise the plaintiff concerning investment real property.

The defendant’s employee told the plaintiff that the Lancaster property was for sale and made a favorable analysis of it. Defendant did not disclose that the property was owned by the defendant, or the price which the defendant had paid for the property in June 1969. The plaintiff purchased the property in early October 1969.

Plaintiff contends that his measure of damages is the “secret profit” made by the defendant – the difference between the amount defendant originally paid for the property and the price at which defendant sold the property to plaintiff. The defendant contends that the proper measure of damages is the difference between the price paid by plaintiff to defendant and the actual value of the property. The plaintiff introduced no evidence of the actual value, and for this reason the trial court granted the motion for a judgment of involuntary nonsuit.

The precise question is: What is the measure of damages when an agent acquires property prior to the creation of the agency relationship and subsequently sells that property to his principal without disclosure of his adverse interest?

It is clear that an agency relationship was created between the plaintiff and the defendant. It is also clear that, by his actions concerning the Lancaster property, the defendant breached his duty to the plaintiff . . .

In support of his contention that he is entitled to recover the difference between the original price paid by the defendant and the sale price to plaintiff, plaintiff cites 2 *Restatement Agency 2d*, at 203, § 388:

Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal.

We agree with this principle. However, the comments to § 388 indicate that the section applies to profits or gratuities received by the agent while acting for his principal. Here we are dealing with real property purchased by the agent before any agency relationship was established with the principal.

When an agent sells his property to his principal without full disclosure of the material facts, the remedies available to the principal depend upon the facts of the case.

The equitable remedy of rescission is available whenever there is a breach of the agent's fiduciary duty by a failure to disclose material facts. . . .

If the principal elects to pursue a legal remedy against his agent, the proper measure of damages also depends upon the facts of the case.

As a general rule, if the agent sells his property to the principal at a price greater than the value of the property and he fails to disclose all material facts, he may be liable in damages for the difference between the sales price and the value of the property. In such a case it is incumbent upon the plaintiff to plead and prove that there was a difference between the price and the market value. . . .

If an agent purchases property for the purpose of reselling it to his principal and fails to make full disclosure of the material facts, he will be liable for any profit he makes on the transaction. The agent is liable for the profits regardless of how fair the transaction may be to the principal.

If an agent purchases property for a purpose other than to resell it to his principal and subsequently does resell it to his principal, the principal may elect to rescind the contract or to recover any difference between the actual value of the property and the sale price to the principal.

The remedy of the principal in such a case is usually the repudiation of the transaction. He cannot, it is held, recover, as a profit made by the agent, the difference between the amount at which the agent sold to him and the price which the agent may have paid for the property before the agency was created, though he may recover the difference between the price paid by the principal and the fair value.

¹ *Mechem on Agency* (2d ed) 880, § 1205 (1914).

The instant case falls within the latter category. The defendant purchased the property before the agency was created and with no intention of selling it to plaintiff because he did not meet plaintiff until three months later. Because of defendant's failure to disclose the material facts of his ownership, the plaintiff was entitled to rescind the transaction or bring an action at law for damages. In the latter event, in order to recover damages the plaintiff would have to show a difference in value between the price he paid for the property and its actual value at the time he purchased do so.

In this case the plaintiff elected to bring an action at law for damages rather than a suit for rescission. He was therefore obligated to prove that there was a difference between the actual value of the property and the sale price. Having failed to do so the trial court properly allowed defendant's motion for a judgment of involuntary nonsuit.

Affirmed.

Notes

1. Suppose Capwell had purchased the Lancaster property after Dr. Becker had become his client and further that he made the purchase (i) because he thought the land was underpriced and (ii) with the expectation that the doctor might be interested in the parcel as an investment. Would Dr. Becker then be entitled to acquire the land from Capwell at the latter's cost?

2. The opinion states that Capwell worked as a consultant for various clients on an ongoing basis. Thus, even though Dr. Becker was not yet Capwell's client at the time he purchased the Lancaster property, he may have had other existing clients for whom the property represented an attractive investment. Don't those clients have cause to complain when Capwell subsequently elected to sell the land to Dr. Becker? At a more general level, how is an agent ever to discharge a fiduciary duty of loyalty to multiple clients whose interests compete?

POST-EMPLOYMENT COMPETITION

Restatement (Third) of Agency

§ 8.05 Use Of Principal's Property; Use Of Confidential Information

Comment

c. Confidential information.

An agent's duties concerning confidential information do not end when the agency relationship terminates. An agent is not free to use or disclose a principal's trade secrets or other confidential information whether the agent retains a physical record of them or retains

them in the agent's memory. If information is otherwise a trade secret or confidential, the means by which an agent appropriates it for later use or disclosure should be irrelevant. Feats of human memory, however commendable and intriguing in many respects, should not be privileged as instruments of disloyal conduct.

Illustrations:

6. P, who owns a commercial cleaning service, maintains a list of customers and prospective customers, noting particulars about each. P's list would be of competitive use to others. P maintains the list on a computer in P's office and restricts access to high-level employees within P's organization. A, P's general manager, who wishes to establish a competing cleaning service, retains a hard copy of the list that P gave to A to use in A's work. A resigns, taking the list and planning to use it to solicit business for A's new competing firm. A has breached A's duty to P.

7. Same facts as Illustration 6, except that A commits the list to memory, memorizing a portion each day and then typing that portion into A's home computer each evening. Same result.

Reporter's Notes

The result stated for Illustration 7 is not consistent with the position taken in *Restatement Second, Agency. Restatement Third, Unfair Competition* § 42, Comment *f*, states that general rules governing trade secrets apply to customer lists. Likewise, under the Uniform Trade Secrets Act, a customer list does not lose protection because it is taken through memorization and not in memorialized form. *See Ed Nowogroski Ins., Inc. v. Rucker*, 971 P.2d 936 (Wash. 1999). In contrast, *Restatement Second, Agency* § 396, Comment *b*, stated a "memory rule": a former agent "is normally privileged to use, in competition with the principal, the names of customers retained in his memory as the result of his work for the principal and also methods of doing business and processes which are but skillful variations of general processes known to the particular trade," although the former employer has kept the information secret from competitors. *Restatement Third, Unfair Competition* § 42, Comments *d* and *f*, characterize intentional memorization by an employee as evidence that information is a trade secret. Most recent cases do not follow the "memory rule," *see Ed Nowogroski Ins.*, 971 P.2d at 946-948. When an employee remembers information only through casual memory, as opposed to a deliberate exercise in memorization, that fact may weigh in a court's analysis of a trade-secret claim against a former employee. *See Leo Silfen, Inc. v. Cream*, 278 N.E.2d 636, 639 (N.Y. 1972). *See also North Atl. Instruments, Inc. v. Haber*, 188 F.3d 38, 46-47 & n.7 (2d Cir.1999) (suggesting that reference to "casual memory" in *Leo Silfen* does not amount to categorical treatment of trade secrets remembered casually and that "such a rule would almost surely prove unworkable in situations where, as here, there is evidence that although the employee may have committed some information to memory, he also physically took other information. The task of crafting an injunction permitting use of casually remembered information, while prohibiting the use of a list that the employee physically pilfered, would be virtually impossible as a practical matter.").

These developments post-*Restatement Second, Agency*, may reflect, among other things, that proficiency in memorization has declined as a trait enjoying cultural and social acclaim. . . .

Question

In *Town & Country*, the company could have sought to limit Newberry's ability to create a rival business through a covenant not to compete. Is it relevant that they failed to do so? To what extent could such a covenant provided greater protection than available under fiduciary law? Consider Wis. Stat. § 103.465:

A covenant by an assistant, servant or agent not to compete with his or her employer or principal during the term of the employment or agency, or after the termination of that employment or agency, within a specified territory and during a specified time is lawful and enforceable only if the restrictions imposed are reasonably necessary for the protection of the employer or principal. Any covenant, described in this subsection, imposing an unreasonable restraint is illegal, void and unenforceable even as to any part of the covenant or performance that would be a reasonable restraint.

In *Streiff v. American Family Mutual Ins. Co.*, 348 N.W.2d 505, 511 n.5 (Wis. 1984), the Supreme Court observed:

The court has indicated that common laws rules are still applicable and our opinions have generally referred to both sec. 103.465 and the common law. Thus this court has said that the common law and sec. 103.465 require this court to make five distinct inquiries in evaluating the enforcement of a covenant not to compete. The covenant must (1) be necessary for the protection of the employer, that is, the employer must have a protectable interest justifying the restriction imposed on the activity of the employee; (2) provide a reasonable time limit; (3) provide a reasonable territorial limit; (4) not be harsh or oppressive as to the employee; and (5) not be contrary to public policy.

PARTNERSHIP FINANCE

Chez SinoZa – Problem #1

Assume the arrangement between Arthur, Beverly and Charles is treated as a general partnership. In the absence of an agreement, how does the UPA resolve the following issues?

1. Are Arthur and Beverly entitled to a salary for the work they perform on behalf of the restaurant?

2. How are profits to be divided? If the business incurs losses, how are they to be allocated?

3. Suppose the business is sold or liquidated and the proceeds are in excess of \$200,000. How are these proceeds to be allocated? What if the proceeds are less than \$200,000?

With those answers in mind, please assume the role of attorney for Arthur, Beverly or Charles and consider whether you should recommend that your client seek an alternative resolution of any of these issues, then negotiate an appropriate agreement with the attorneys for the other parties.

PARTNERSHIP MANAGEMENT

Chez SinoZa – Problem #2

Charles has just learned that Beverly has recently signed a 20-year lease of an expansive restaurant space located in one of the city's most expensive neighborhoods. The lease was signed on behalf of the Arthur, Beverly & Charles partnership. Before signing, Beverly discussed the lease with Arthur, and obtained his approval, but never mentioned it to Charles. Charles now has two questions?

1. Is he personally obligated for the monthly rentals for the next twenty years?

2. If so, can he require Arthur and Beverly to reimburse him for any losses on the lease? For example, assume the restaurant fails after its first year, and is forced to pay the landlord \$20,000 to release the partnership from the lease. Can Charles demand that Arthur and Beverly pay the full amount?

Suppose instead that in forming the partnership, Charles foresees risks such as this, and insists that the partnership agreement address the issue of the partners' management rights and the extent of his responsibility for any decisions by Arthur and Beverly that he fails to approve. You are asked to consult your client and help negotiate an appropriate agreement with the other parties and their attorneys.

PARTNERSHIP DISSOLUTION

IN RE TRUST ESTATE OF SCHAEFER

283 N.W.2d 410

Court of Appeals of Wisconsin, 1979

BROWN, Presiding Judge.

This appeal involves a joint petition brought by Arthur E. Schaefer, co executor of Ben G. Schaefer's estate, and the First National Bank of Kenosha, trustee of the testamentary trust, for a declaration of rights.

Ben Schaefer died testate on October 22, 1969. His will was admitted to probate on December 9, 1969. Under the will his brothers, Arthur E. Schaefer and David E. Schaefer, and his sister, Sadie Stein, were named co executors and co trustees.

Among the assets of the estate at the time of Ben Schaefer's death were thirteen parcels of real estate held in the names of Ben G. Schaefer and Arthur E. Schaefer. During the administration of the estate, a challenge was made by Mrs. Marilynn Schaefer, Ben Schaefer's widow, to the claim that these parcels of real estate were owned by Ben and Arthur Schaefer as a partnership. The Wisconsin Supreme Court held that the real estate in question was partnership property. *In re Estate of Schaefer*, 72 Wis. 2d 600, 241 N.W.2d 607 (1976).

Shortly after the supreme court's decision, by order of the Kenosha county probate court, the First National Bank of Kenosha was appointed trustee of the testamentary trust pursuant to Ben Schaefer's will. All of the remaining estate assets, including Ben Schaefer's partnership interest in the Ben G. Schaefer and Arthur E. Schaefer Real Estate Department (hereinafter referred to as the Schaefer Partnership), were assigned to the trustee.

After the partnership interest was assigned to the trustee, an accounting of the partnership assets, profits and losses was filed with the probate court. No objection was made to the accounting by the trustee. The trustee did, however, dispute the manner in which the present value of Ben Schaefer's partnership interest is to be computed. Consequently, the trustee and Arthur Schaefer brought this action for a declaration of rights. In their petition, Arthur Schaefer contended that Ben Schaefer's interest (now the interest to be transferred to the trust) in the partnership was governed by [UPA § 42]. Thus, he claimed that the estate's interest is 50% of the date of death valuation plus 50% of the profits from the date of death to final settlement. The trust claimed that the deceased's partnership interest is 50% of the valuation of the partnership assets at the time of liquidation or final settlement which has not yet occurred. The partnership assets have substantially appreciated since Ben Schaefer's death. The major issue involved in this case is whether the trust is now entitled to 50% of the appreciated value of the real estate.

[T]he trustee's main claim was that Arthur Schaefer and the estate created a new partnership between themselves and continued to do business as a new partnership. As a result, the trustee, as successor to the estate's interest in the partnership, now has the right to permit the partnership to continue under the present arrangement where the estate and Arthur Schaefer share the expenses, losses and profits, or it may force dissolution and liquidation pursuant to [UPA §§ 31, 37]. Having the right to dissolve the partnership, the trust is entitled to an in cash distribution of 50% of the value of the assets at the time of liquidation pursuant to [UPA § 38(1)].

Alternatively, the trustee claims that if no new partnership existed, there was a slow wind up. Since the wind up has not yet been completed, the trust is entitled to an amount equal to 50% of the surplus after creditors have been paid pursuant to [UPA § 38(1)]. Thus, the trust would be entitled to 50% of the appreciated value.

[The trial court rejected all of the trustee's positions.]

CONTINUATION OF THE BUSINESS

The trial court held that upon the death of a partner, the deceased partner's interest in the partnership is automatically and exclusively controlled by [UPA § 42]. The deceased partner's interest is limited to his share in the value of the assets of the partnership (in this case 50%) as of the date of death, plus interest or profits from the date of death until final settlement. The deceased partner's interest does not include a portion of any appreciation in the assets that has occurred from the date of death to final settlement. Thus, the trustee, as successor in interest, would not be entitled to 50% of the appreciated value of the assets. We think the trial court was in error in holding that [UPA § 42] controls in this case.

When a partner dies, the partnership is dissolved. [UPA § 31(4)] On dissolution, however, the partnership is not terminated; it continues until the wind up of the partnership affairs are completed. [UPA § 30] Winding up is the process of settling partnership affairs after dissolution. Partners, or those claiming through a deceased partner, may agree to settle the partnership affairs without a liquidation of the assets (by agreeing to a cash settlement or in kind distribution). However, absent an agreement, winding up involves reducing the assets to cash (liquidation), paying creditors, and distributing to partners the value of their respective interests. *Dreifuerst v. Dreifuerst*, 90 Wis. 2d 556, 280 N.W.2d 335 (Wis. App. 1979).

Ordinarily, upon dissolution due to death of a partner, it is the duty and responsibility of the surviving partner to wind up the partnership with due diligence and pay the estate of the deceased partner the value of his interest in the partnership. The surviving partner, however, need not wind up the partnership if he has a right to continue the business.

Thus, the first question is whether Arthur Schaefer, as surviving partner, had the right to continue the business. If Arthur Schaefer, as surviving partner, had the right to continue the business and the business was continued, then the trust's interest in the partnership is governed by [UPA § 42]. If Arthur Schaefer had no right to continue the business or decided not to

exercise his right to continue the business, the partnership was in the process of winding up. If the partnership was being wound up, the trustee would be entitled to receive the value of Ben Schaefer's interest at the date of liquidation or final settlement pursuant to [UPA § 38(1)].

Arthur Schaefer's right, as surviving partner, to continue the business is controlled by [UPA § 41]. . . . Under [UPA § 41(3)], the business may be continued by the surviving partner if the legal representative of the deceased partner consents to the continuation without liquidation of the partnership affairs.

. . .

Arthur Schaefer, David Schaefer and Sadie Stein were named as Ben Schaefer's legal representatives. As the legal co-representatives, they had the power to consent to the continuation of the business. Specific consent is not required. Acquiescence by the legal representatives in the continuation of the business is sufficient for consent under [UPA § 41(3)]. *Blumer Brewing Corp. v. Mayer*, 223 Wis. 540, 548, 269 N.W. 693, 696 (1936).

The determination of whether or not the legal representative consented to or acquiesced in the continuation of the business is a fact to be determined by the trier of fact. Since the trial court felt that [UPA § 42] applied whenever a partner died, regardless of whether there was consent to continue the business, no finding of fact was made on consent. Ordinarily, under these circumstances, we would have to remand the case back to the trial court for a finding of fact. However, in this case we do not feel a remand for that purpose is necessary. If consent was given, Arthur Schaefer, as the most active legal representative and as the surviving partner, was the person authorized to give consent. He was the only person who testified at the hearing. Based on his own testimony the record is clear that the legal representatives did not consent to or acquiesce in the continuation of the business.

[Arthur Schaefer] testified that he never discussed with anyone the possibility of the estate becoming a partner, nor did he discuss whether the business would continue. It was apparent from the record that none of these issues were discussed for two reasons. First, Arthur Schaefer did not know that he had to elect, as both surviving partner and legal representative, to either continue the business or liquidate. Second, he never thought about the alternatives because it was his intention from the very beginning to wind up the partnership and pay the estate the deceased partner's interest.

. . . Arthur Schaefer testified that after Ben Schaefer's death he began winding up the partnership affairs and liquidating the assets. Marilyn Schaefer then brought suit challenging the existence of the Schaefer Partnership and, as a consequence, Arthur Schaefer ceased liquidating the assets pending the supreme court's decision on Mrs. Schaefer's suit. Once the supreme court had determined there was a partnership, he began again to wind up the affairs. A trustee was appointed for the testamentary trust and the present petition for a declaration of rights was brought to determine the estate's interest so that wind up could be completed. . . . It was clear that Arthur Schaefer attempted to keep the partnership affairs at a status quo until the existence of the partnership was finally determined and he could safely resume winding up.

...

Therefore, it is clear from the record that the business was not continued pursuant to [UPA § 41(3)], but was instead a slow wind up due to the pending litigation. There was no agreement to continue the business nor was there acquiescence in the continuation of the business. Arthur Schaefer in either capacity (surviving partner and legal representative) did not want to continue the business. He wanted to wind it up. He began to do so when he was *forced*, because of Marilyn Schaefer's suit, to stop the winding up process and keep everything at the status quo until the existence of the partnership was finally determined.

Under these circumstances, the rights of the partners are controlled by [UPA § 38(1)], not [UPA § 42]. Section [42] only applies if the "business is continued under any of the conditions set forth in [UPA §§ 38(2)(b) or 41(1), (2), (3), (5) and (6)]." Here the business was not continued under the conditions set forth in [UPA § 41(3)], the only section applicable. The business was being wound up, albeit slowly, because of the litigation. Thus, [UPA § 38(1)] applies.

Where the business is not continued but is being wound up, the value of the deceased partner's interest is not determined by the date of death value plus interest or profits, as is the case if the business is continued.

If a partnership is seasonably wound up after dissolution, *profits and losses* during the liquidation are shared by the partners in proportion to their predissolution ratios, unless they have agreed otherwise. This is a corollary of the continued existence of the firm during the [winding up] period [in accordance with UPA § 30], and of the partners' representative authority in winding up [in accordance with UPA §§ 33 and 35.]

[Emphasis added.] J. Crane & A. Bromberg, *Law of Partnership* § 86(c), at 495 (1968). Where the business is continued, the value of the deceased partner's interest may be different. Under § 42 of the Uniform Partnership Act, as adopted in Wisconsin . . . , if the business is continued under the conditions set forth in [UPA §§ 38(2)(b), 41(1), (2), (3), (5) or (6)]:

[T]he non-continuing partner (or his representative) has a *first election* between two basic alternatives, either of which can be enforced in an action for an accounting. He can force a liquidation, taking his part of the proceeds and thus sharing in profits and losses after dissolution. Alternatively, he can permit the business to continue (or accept the fact that it has continued) and claim as a creditor (though subordinate to outside creditors) the value of his interest at dissolution. This gives him a participation in all values at dissolution, including asset appreciation and good will, and means he is unaffected by later changes in those values. If he takes the latter route, he has a *second election* to receive in addition either interest (presumably at the local legal rate) or profits from date of dissolution.

[Emphasis in original.] Crane and Bromberg, *supra*, § 86(c), at 495-96. See also *Cauble v. Handler*, 503 S.W.2d 362, 366 (Tex. Civ. App. 1973).

Therefore, where the business is continued pursuant to the sections listed in [UPA § 42], the deceased partner takes as a creditor the value of his interest at the date of death, including asset appreciation and good will up to that date, plus interest or profits from the date of death to final settlement. The “profits,” however, do not include asset appreciation. *Rosen Trust v. Rosen*, 53 A.D.2d 342, 386 N.Y.S.2d 491, 502 (1976). His share is unaffected by changes in values after date of death. If the surviving partner winds up the partnership or the deceased partner’s representative elects to wind it up and liquidate, the estate shares in all profits including appreciation and takes the risk of suffering the losses. By permitting the business to continue and taking as a creditor, the deceased partner’s interest is insulated from losses after dissolution, but he also does not share in asset appreciation after dissolution.

Where the business is wound up, the deceased partner’s interest is not determined until the wind up is complete. After the creditors have been paid, all profits are shared by the surviving partner[s] and the deceased partner, as well as losses based on their predissolution ratios (in this case 50%). Therefore, where the business is wound up rather than continued under the conditions set forth in [UPA § 42], the deceased partner’s interest is the value of his interest at the date of liquidation (when wind up is complete). This value includes assets appreciation during the winding up period and is subject to any losses incurred during that time. . . .

Decree reversed and case remanded for liquidation of all assets and distribution of the surplus, after payment to creditors, to the deceased partner’s estate and the surviving partner, 50% to each, unless otherwise agreed.

NOTE – LIQUIDATION OR CONTINUATION?

In re Trust Estate of Schaefer provides a thorough examination of the two alternative chains of events that follow the dissolution of a partnership at will. The partnership is either liquidated under UPA § 38(1) or continued under UPA §§ 41 and 42. What determines whether the business of the partnership is continued by the remaining partners or is liquidated? Unless there is an agreement to continue, section 38(1) allows any of the partners to elect the liquidation route. Although the statute refers only to the partners themselves, the court in *Schaefer*, and the case law generally, extend the right to this election to the legal representative of a deceased partner. This interpretation not only responds to the practical needs to settle the deceased partner’s estate but also finds support in the wording of section 41(3), which refers to continuation of the business of the dissolved partnership “with the consent of the retired partners or the representative of the deceased partner.”

If the business is continued under section 42, the departing partner (or deceased partner’s estate) has the right to compensation and, as discussed in *Schaefer*, may choose to take that compensation either in the form of interest or a share of the partnership profits. As explained in another Wisconsin case:

Although this election may seem somewhat onesided as the retiring partner is no longer involved in the business, it “serves as ‘a species of compulsion . . . to those continuing the business . . . to hasten its orderly winding up.’ . . . The second election rests partly on the use of the outgoing partner’s assets in the conduct of the business.” Crane and Bromberg, *supra*, § 86(c) at 497.

Lange v. Bartlett, 360 N.W.2d 702, 704 (Wis. Ct. App. 1984)

Must the formal and express consent of each partner (or legal representative) be obtained before the business may be continued under UPA §§ 41 and 42? To the contrary, many decisions take the position rejected in *Schaefer* – that those sections to apply regardless of whether the exiting partner or the deceased partner’s legal representative gave any consent to the continuation of the business. While this might seem a strained reading of the statute, it flows from the court’s understandable desire to avoid a perverse statutory result. Suppose that following the death of partner *D* the surviving partner *S* continues the business without consulting *D*’s personal representative and then runs the business into the ground. Under the common law, *S* would have been strictly liable for the loss. And so long as UPA § 42 is deemed to apply, the estate would likewise be protected, because it is entitled to have “the value of [*D*’s] interest at the date of dissolution ascertained.” But if section 38(1) is instead held to apply, due to the absence of clearcut consent by *D*’s personal representative, all the estate will receive is a one-half share in whatever can now be derived from a liquidation of the distraught business.

Given this quandary, the most practical means of fitting the statutory text to the desired policy outcome would seem to be the approach taken in *Blumer Brewing Corp. v. Mayer*, 223 Wis. 540, 548, 269 N.W. 693, 696 (1936), as discussed in the *Schaefer* case. *Blumer Brewing* held not that consent was unnecessary to trigger UPA § 42, but that the personal representative’s knowledge of and acquiescence in the business’s continuation should be tantamount to consent for that purpose. Then along comes *In re Trust Estate of Schaefer*, presenting the case where the value of the partnership business actually goes up in the wake of dissolution. The court’s response, as we have seen, is to suggest two competing characterizations of what occurs when a business quietly goes on after a partner’s death or other departure: it may represent either an “acquiesced in” continuation or a deferred winding up and liquidation. Obviously, there will often be room to argue over which characterization better describes a particular set of facts.

How does the *Schaefer* case come out under the RUPA? RUPA § 601(7)(i) treats Ben *Schaefer*’s death as a “disassociation.” But what then? According to the official comment to the section:

RUPA dramatically changes the law governing partnership breakups and dissolution. An entirely new concept, “dissociation,” is used in lieu of the UPA term “dissolution” to denote the change in the relationship caused by a partner’s ceasing to be associated in the carrying on of the business. “Dissolution” is retained but with a different meaning. The entity theory of partnership provides a conceptual means of continuing the firm itself despite a partner’s withdrawal from the firm.

Under RUPA, unlike the UPA, the dissociation of a partner does not necessarily cause a dissolution and winding up of the business of the partnership. Section 801 identifies the situations in which the dissociation of a partner causes a winding up of the business. Section 701 provides that in all other situations there is a buyout of the partner's interest in the partnership, rather than a windup of the partnership business. In those situations, the partnership entity continues with the remaining partners, unaffected by the partner's dissociation.

RUPA § 601 official cmt. 1 (1994). Does the deceased partner's personal representative retain the right to elect between having the partnership business continued and having it wound up? See RUPA §§ 701(a), 801(6). What if one of the surviving partners wants the business wound up? See RUPA 801(1).

APPLE COMPUTER CO. PROBLEM (A)

On April 1, 1976, Steve Jobs, Steven Wozniak and Ronald Wayne formed a general partnership, which they named Apple Computer Company. A copy of their original partnership agreement is contained in the first three pages of the Appendix to this Supplement, following page 107. Suppose the three of them asked you to review their agreement and advise them on any changes you would recommend. What would you recommend?

CONFLICTS OF INTEREST

Model Rules of Professional Conduct

Rule 1.7: Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

- (1) the representation of one client will be directly adverse to another client; or
- (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

- (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
- (2) the representation is not prohibited by law;
- (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
- (4) each affected client gives informed consent, confirmed in writing.

Comment

[28] Whether a conflict is consentable depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. Thus, a lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest or arranging a property distribution in settlement of an estate. The lawyer seeks to resolve potentially adverse interests by developing the parties' mutual interests. Otherwise, each party might have to obtain separate representation, with the possibility of incurring additional cost, complication or even litigation. Given these and other relevant factors, the clients may prefer that the lawyer act for all of them.

BRENNAN v. RUFFNER

640 So. 2d 143

District Court of Appeal of Florida, 1994

PARIENTE, Judge.

We affirm a final summary judgment entered in favor of a lawyer and against a disgruntled minority shareholder of a closely held corporation. We find that an attorney/client relationship did not exist between the individual shareholder and the attorney representing the corporation. Consequently, there is no basis for a legal malpractice action. We further reject the other theories of liability asserted by appellant.

In 1976, appellant, Robert J. Brennan, M.D., (Dr. Brennan) along with a Dr. Martell, employed appellee, Charles L. Ruffner, Esq., (lawyer) to incorporate their medical practice as a professional association. In connection with the incorporation, the lawyer prepared a shareholder's agreement. In 1982, a third doctor, Dr. Mirmelli, joined the corporation, and each

doctor became a one third shareholder in the new firm. The lawyer, who was corporate counsel since 1976, was requested to draft a new shareholder's agreement. After approximately 8 months of negotiation, the shareholders executed a new shareholder's agreement. The new agreement included a provision for the involuntary termination of any shareholder by a majority vote of the two other shareholders. It is undisputed that Dr. Brennan was aware of this provision at the time he signed the documents and that he signed the agreement upon reassurances from Dr. Mirmelli that he would not join with Dr. Martell in using the provision against Dr. Brennan.

However, despite the assurances, in 1989 Dr. Martell and Dr. Mirmelli involuntarily terminated Dr. Brennan as a shareholder and employee of the corporation. Dr. Brennan instituted a lawsuit against Dr. Martell and Dr. Mirmelli claiming breach of contract and fraud in the inducement. The verified complaint in that lawsuit specifically alleged that Dr. Brennan was not represented by counsel in the negotiation of the shareholder's agreement. That lawsuit was settled. Dr. Brennan then filed this suit for legal malpractice, breach of contract, breach of fiduciary duty and breach of contract as a third party beneficiary. In contradiction to the sworn allegations of the first lawsuit, Dr. Brennan alleged in this complaint that the lawyer represented him individually, as well as the corporation, in the preparation and drafting of the agreement. The lawyer denied undertaking the representation of Dr. Brennan individually.

Florida courts have uniformly limited attorney's liability for negligence in the performance of their professional duties to clients with whom they share privity of contract. . . . "In a legal context, the term 'privity' is a word of art derived from the common law of contracts and used to describe the relationship of persons who are parties to a contract." *Espinosa v. Sparber, Shevin, Shapo, Rosen & Heilbronner*, 612 So. 2d 1378, 1379 89 (Fla.1993). The only instances in Florida where the rule of privity has been relaxed is where the plaintiff is an intended third party beneficiary of the employment contract. . . .

The material undisputed facts in this case support a legal conclusion that there was no privity of contract between Dr. Brennan and the corporation's lawyer. It is undisputed that the lawyer was representing the corporation. The issue raised by Dr. Brennan's complaint was whether the lawyer was also representing him individually. While Dr. Brennan made the initial contact with the lawyer, there is no evidence in the record to create a credible issue of fact that the lawyer ever represented Dr. Brennan individually. Dr. Brennan's sworn complaint against the other doctors, which preceded the legal malpractice action against the lawyer, states he was unrepresented by counsel in the negotiation of the shareholder's agreement.

Dr. Brennan argues that a separate duty to him as a shareholder arose by virtue of the lawyer's representation of the closely held corporation. Although never squarely decided in this state, we hold that where an attorney represents a closely held corporation, the attorney is not in privity with and therefore owes no separate duty of diligence and care to an individual shareholder absent special circumstances or an agreement to also represent the shareholder individually. While there is no specific ethical prohibition in Florida against dual representation of the corporation and the shareholder if the attorney is convinced that a conflict does not exist, an attorney representing a corporation does not become the attorney for the individual

stockholders merely because the attorney's actions on behalf of the corporation may also benefit the stockholders. The duty of an attorney for the corporation is first and foremost to the corporation, even though legal advice rendered to the corporation may affect the shareholders.

In addition, under the facts of this case, Dr. Brennan cannot claim that he was an intended third party beneficiary of the contract of representation with the corporation. Florida has extended the third party beneficiary exception to the privity requirement in legal malpractice actions to very limited instances, mainly in the area of will drafting, where it can be demonstrated that the intent of the client in engaging the services of the lawyer was to benefit a third party. . . . In this case, there are no facts to support Dr. Brennan's assertion that the primary intent of the corporation in hiring the attorney to draft the shareholder's agreement was to directly benefit Dr. Brennan individually. Dr. Brennan admits that there was an inherent conflict of interest between the rights of the individual shareholder and the corporation. This alone expressly undercuts a third party beneficiary claim. . . . A third party beneficiary theory of recovery has been rejected in other jurisdictions in similar circumstances on the basis that the individual shareholder cannot be an intended third party beneficiary of a shareholder's agreement because the interests of the corporation and the minority shareholder are potentially in opposition.

We also reject the notion that the lawyer in this case could be held liable to one of the minority shareholders for a breach of fiduciary duty. In any closely held corporation, there will be an inherent conflict between the potential rights of the minority shareholder and the rights of the corporation in a shareholder's agreement concerning termination. At the time this agreement was drafted, any one of the three shareholders could have ended up becoming the minority shareholder. While Dr. Brennan claimed in the complaint that the lawyer had a duty to advise him of a conflict of interest and never advised him of a potential conflict, the facts in the record do not support that contention. Dr. Brennan testified in deposition that he simply did not recall any conversations. However, the accountant for the corporation specifically remembered a conversation where the lawyer told the doctors collectively that he represented only the corporation in the drafting of the shareholder agreement. Absent some evidence that the corporation's lawyer conspired or acted with the two shareholders to insert provisions that would work to the detriment of the third shareholder; that the corporation's lawyer concealed his representation of another individual shareholder; or that the attorney agreed to the dual representation, there is no breach of fiduciary duty established in this case.

AFFIRMED.

Notes & Questions

1. Even when, as in *Brennan v. Ruffner*, the attorney-client relationship is with the corporation, special sensitivities may arise when that corporation is closely held. Consider the following observation:

Although, in the ordinary corporate situation, corporate counsel does not necessarily become counsel for the corporation's shareholders and directors, where, as here, the

corporation is a close corporation consisting of only two shareholders with equal interests in the corporation, it is indeed reasonable for each shareholder to believe that the corporate counsel is in effect his own individual attorney.

Rosman v. Shapiro, 653 F. Supp. 1441, 1445 (S.D.N.Y. 1987).

2. *Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C.*, 107 Mich. App. 509, 309 N.W.2d 645 (1981), was another case involving a doctor forced out of his professional corporation. Dr. Fassihi sued Epstein, the attorney who represented the corporation in his termination, and had also formed the corporation and drafted the necessary documents. Like the Florida court in *Brennan v. Ruffner*, the Michigan court held that Epstein's client was the corporation not its individual shareholders. But it added:

Although we conclude that no attorney-client relationship exists between plaintiff and defendant, this does not necessarily mean that defendant had no fiduciary duty to plaintiff. The existence of an attorney-client relationship merely establishes a per se rule that the lawyer owes fiduciary duties to the client.

A fiduciary relationship arises when one reposes faith, confidence, and trust in another's judgment and advice. . . . Based upon the pleadings, we cannot say that plaintiff's claim is clearly unenforceable as a matter of law.

Plaintiff asserts that he reposed in defendant his trust and confidence and believed that, as a 50% shareholder in Livonia Physicians X Ray, defendant would treat him with the same degree of loyalty and impartiality extended to the other shareholder, Dr. Lopez. In his complaint plaintiff states that he was betrayed in this respect. Specifically, plaintiff asserts that he was not advised of defendant's dual representation of the corporate entity and Dr. Lopez personally. Plaintiff also alleges that he was never informed of the contract between Lopez and St. Mary's which gave Lopez sole responsibility in the staffing of the radiology department and, more importantly, that defendant actively participated with Lopez in terminating plaintiff's association with the corporation and using the Lopez St. Mary's contract to his detriment.

In support of his position that he has an attorney client relationship with defendant, plaintiff cites a number of cases standing for the proposition that the corporate veil will be pierced where the corporate identity is being used to further fraud or injustice. . . . These cases are not factually similar to the instant matter as they involve claims against a corporate principal attempting to protect himself from personal liability through the corporate entity. At the same time, these cases are instructive as they point out the difficulties in treating a closely held corporation with few shareholders as an entity distinct from the shareholders. Instances in which the corporation attorneys stand in a fiduciary relationship to individual shareholders are obviously more likely to arise where the number of shareholders is small. In such cases it is not really a matter of the courts piercing the corporate entity. Instead, the corporate attorneys, because of their

close interaction with a shareholder or shareholders, simply stand in confidential relationships in respect to both the corporation and individual shareholders.

Id. at 514-16, 309 N.W.2d at 648-49

APPLE COMPUTER CO. PROBLEM (B)

In the earlier problem, is it permissible for you to collectively advise Jobs, Wozniak and Wayne in connection with their partnership agreement? How might the problem of joint representation be handled? Would your answer be different if the three had formed a corporation rather than a general partnership?

LIMITED PARTNERSHIPS

Chez SinoZa – Problem #3

Suppose Chez SinoZa is organized as a limited partnership with Arthur and Beverly as the general partners and Charles as a limited partner.

a. Who has authority to make decisions on behalf of the limited partnership? Could Charles still have the right to veto any major financial decisions that Arthur and Beverly might make? Would the exercise of that right expose Charles to personal liability?

b. Suppose Charles desires to assign one half of his limited partnership interest to his daughter Carla, who is also a practicing surgeon? May he do so? Does the assignment make Carla a limited partner?

c. Suppose Arthur resigns; does the limited partnership continue? What if it is instead Charles who resigns?

d. Instead of serving as general partners in their individual capacities, what if Arthur and Beverly form a new corporation to serve as the sole general partner? They will serve as its officers and directors as well as owning its shares. Would this jeopardize the business's status as a limited partnership? Do Arthur and Beverly remain personally liable for the business's debts?

e. To what extent do the answers to the above questions depend on which version of ULPA or RULPA the jurisdiction has adopted?

Uniform Limited Partnership Act (1916)

§ 7. Limited Partner Not Liable to Creditors

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.

Uniform Limited Partnership Act (1976)

§ 303. Liability to Third Parties.

(a) Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he or she is also a general partner or, in addition to the exercise of his or her rights and powers as a limited partner, he or she takes part in the control of the business. However, if the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he or she is liable only to persons who transact business with the limited partnership with actual knowledge of his or her participation in control.

Uniform Limited Partnership Act (1976, as amended in 1985)

§ 101. Definitions.

(7) "Limited partnership" and "domestic limited partnership" mean a partnership formed by two or more persons under the laws of this State and having one or more general partners and one or more limited partners.

§ 201. Certificate of Limited Partnership.

(a) In order to form a limited partnership, a certificate of limited partnership must be executed and filed in the office of the Secretary of State. The certificate shall set forth:

- (1) the name of the limited partnership;
- (2) the address of the office and the name and address of the agent for service of process required to be maintained by Section 104;
- (3) the name and the business address of each general partner;
- (4) the latest date upon which the limited partnership is to dissolve; and
- (5) any other matters the general partners determine to include therein.

(b) A limited partnership is formed at the time of the filing of the certificate of limited partnership in the office of the Secretary of State or at any later time specified in the certificate of limited partnership if, in either case, there has been substantial compliance with the requirements of this section.

§ 302. Voting.

Subject to Section 303, the partnership agreement may grant to all or a specified group of the limited partners the right to vote (on a per capita or other basis) upon any matter.

§ 303. Liability to Third Parties.

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

(b) A limited partner does not participate in the control of the business within the meaning of subsection (a) solely by doing one or more of the following:

(1) being a contractor for or an agent or employee of the limited partnership or of a general partner or being an officer, director, or shareholder of a general partner that is a corporation;

(2) consulting with and advising a general partner with respect to the business of the limited partnership;

(3) acting as surety for the limited partnership or guaranteeing or assuming one or more specific obligations of the limited partnership;

(4) taking any action required or permitted by law to bring or pursue a derivative action in the right of the limited partnership;

(5) requesting or attending a meeting of partners;

(6) proposing, approving, or disapproving, by voting or otherwise, one or more of the following matters:

(i) the dissolution and winding up of the limited partnership;

(ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership;

(iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;

(iv) a change in the nature of the business;

(v) the admission or removal of a general partner;

(vi) the admission or removal of a limited partner;

(vii) a transaction involving an actual or potential conflict of interest between a general partner and the limited partnership or the limited partners;

(viii) an amendment to the partnership agreement or certificate of limited partnership; or

(ix) matters related to the business of the limited partnership not otherwise enumerated in this subsection (b), which the partnership agreement states in writing may be subject to the approval or disapproval of limited partners;

(7) winding up the limited partnership pursuant to Section 803; or

(8) exercising any right or power permitted to limited partners under this Act and not specifically enumerated in this subsection (b).

(c) The enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by him or her in the business of the limited partnership.

§ 403. General Powers and Liabilities.

(a) Except as provided in this Act or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners.

(b) Except as provided in this Act, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to persons other than the partnership and the other partners. Except as provided in this Act or in the partnership agreement, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.

§ 704. Right of Assignee to Become Limited Partner.

(a) An assignee of a partnership interest, including an assignee of a general partner, may become a limited partner if and to the extent that (i) the assignor gives the assignee that right in

accordance with authority described in the partnership agreement, or (ii) all other partners consent.

§ 801. Nonjudicial Dissolution.

A limited partnership is dissolved and its affairs shall be wound up upon the happening of the first to occur of the following:

- (1) at the time specified in the certificate of limited partnership;
- (2) upon the happening of events specified in writing in the partnership agreement;
- (3) written consent of all partners;

(4) an event of withdrawal of a general partner unless at the time there is at least one other general partner and the written provisions of the partnership agreement permit the business of the limited partnership to be carried on by the remaining general partner and that partner does so, but the limited partnership is not dissolved and is not required to be wound up by reason of any event of withdrawal if, within 90 days after the withdrawal, all partners agree in writing to continue the business of the limited partnership and to the appointment of one or more additional general partners if necessary or desired; or

- (5) entry of a decree of judicial dissolution under Section 802.

Uniform Limited Partnership Act (2001)

§ 303. No Liability as Limited Partner for Limited Partnership Obligations.

An obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

Comment

This section provides a full, status-based liability shield for each limited partner, “even if the limited partner participates in the management and control of the limited partnership.” The section thus eliminates the so-called “control rule” with respect to personal liability for entity obligations and brings limited partners into parity with LLC members, LLP partners and corporate shareholders.

The “control rule” first appeared in an uniform act in 1916, although the concept is much older. Section 7 of the original Uniform Limited Partnership Act provided that “A limited partner shall not become liable as a general partner [*i.e.*, for the obligations of the limited

partnership] unless . . . he takes part in the control of the business.” The 1976 Uniform Limited Partnership Act (ULPA-1976) “carrie[d] over the basic test from former Section 7,” but recognized “the difficulty of determining when the ‘control’ line has been overstepped.” *Comment* to ULPA-1976, Section 303. Accordingly, ULPA-1976 tried to buttress the limited partner's shield by (i) providing a safe harbor for a lengthy list of activities deemed not to constitute participating in control, ULPA-1976, Section 303(b), and (ii) limiting a limited partner’s “control rule” liability “only to persons who transact business with the limited partnership with actual knowledge of [the limited partner’s] participation in control.” ULPA-1976, Section 303(a). However, these protections were complicated by a countervailing rule which made a limited partner generally liable for the limited partnership’s obligations “if the limited partner's participation in the control of the business is . . . substantially the same as the exercise of the powers of a general partner.” ULPA-1976, Section 303(a).

The 1985 amendments to ULPA-1976 (*i.e.*, RULPA) further buttressed the limited partner’s shield, removing the “substantially the same” rule, expanding the list of safe harbor activities and limiting “control rule” liability “only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.”

In a world with LLPs, LLCs and, most importantly, LLLPs, the control rule has become an anachronism. This Act therefore takes the next logical step in the evolution of the limited partner's liability shield and renders the control rule extinct.

TAXATION

REVIEW of SELECTED ENTITY CLASSIFICATION and PARTNERSHIP TAX ISSUES

JOINT COMMITTEE on TAXATION

(April 8, 1997)

I. EXECUTIVE SUMMARY

In general

Under present law, a corporation generally is treated as an entity separate from its shareholders for Federal tax purposes. The corporation is taxed separately on its income, and shareholders are taxed separately on distributions by the corporation. Corporate income is thus subject to a two-tier Federal income tax regime. Partnerships, by contrast, are not treated as separate taxpayers for Federal income tax purposes. The income of the partnership is taxed to the partners and items of income, gain, loss, deduction and credit generally are allocated to the partners in accordance with the partnership agreement. Partnership income is thus subject to one level of Federal income tax at the partner level.

Historically, owners of business enterprises have chosen to incorporate a business for various non-tax reasons. A primary reason for incorporating in many cases has been the fact that corporate form shields the shareholders of the corporation from liabilities of the business. Pass through treatment is often preferred for Federal income tax purposes, however, to avoid the two levels of tax generally applicable to distributed corporate income. In recent years, the growth of limited liability companies (“LLCs”), which can provide owners with protection from liability and at the same time can be treated as partnerships for Federal tax purposes, has reduced the importance of some non-tax reasons that business owners may choose to operate in corporate form.

Entity clarification

Prior entity classification regulations applied a four-factor test for determining whether an entity was classified as a corporation or a partnership for Federal tax purposes. The new check-the-box entity classification regulations achieve across the board what the Internal Revenue Service (the “Service”) had been moving toward in a series of revenue rulings holding that LLCs established under various States’ laws can be classified as partnerships for Federal income tax purposes. In general, under the check-the-box regulations, pass-through entity status is elective for most domestic unincorporated entities other than those whose interests are publicly traded. Single-member entities may be disregarded, so that sole proprietors pay no entity-level tax and corporate sole owners can use the tax attributes of the entity as if it were a division or branch, while remaining insulated from the entity’s liabilities. Thus, these entity classification rules tend to make it easier for business activities to fall within the “one-level-of-tax” partnership regime rather than the two-tier regime applicable to corporations.

These changes raise a number of issues. An initial issue involves the legal authority for the regulations under the statutory language defining partnerships and corporations, which does not explicitly describe an elective regime. A closely related issue is whether it would be appropriate or necessary for the Congress to legislate specifically to authorize the check-the-box regulations. Other issues relate to whether, on the one hand, the check-the-box regulations have the effect of simplifying but not significantly expanding the availability of pass-through tax treatment under present law, or whether, on the other hand, they have the effect of making significant changes to the business tax base, giving taxpayers many more choices of when or whether to be subject to tax. Another set of issues involves the continued utility of other statutory pass-through regimes, such as subchapter S of the Code (governing S corporations), in light of the ability of taxpayers to elect partnership status or (in the case of single-member entities) to disregard an entity altogether.

Partnerships

Business transactions and tax planning in the partnership area have become more sophisticated since the bulk of the present-law partnership rules were enacted in 1954. Some provisions may be out of date, may give anomalous results, or may have unforeseen problems in application. The tax rules applicable to partners and partnerships merit scrutiny in light of the

possibility that they will be more widely used, given the simple electivity of partnership status under the check-the-box regulations.

II. ENTITY CLASSIFICATION

A Prior and Present Law

1. Tax treatment of corporations, partnerships, and publicly traded partnerships

Corporations

For Federal income tax purposes, a corporation generally is treated as a separate entity apart from its shareholders. Corporations and shareholders generally are each separately subject to tax on distributed corporate income. The shareholders do not calculate their tax liability by reference to the corporation's income; instead, the corporation pays tax on its income. In addition, the shareholders generally include in their income amounts that the corporation distributes to them. The rules governing the relationship of a taxable corporation and its shareholders generally are found in subchapter C of the Internal Revenue Code of 1986 ("Code"), and corporations subject to tax as such are known as "C corporations."

Partnerships

A partnership, on the other hand, generally is not treated as a taxable entity (except for certain publicly traded partnerships), but rather, is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners, and distributions from the partnership generally are tax-free. The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement (or in accordance with the partners' interests in the partnership if the agreement does not provide for an allocation), so long as the allocation has substantial economic effect. The rules governing the treatment of a partnership and its partners generally are found in subchapter K of the Code.

Choosing pass-through tax treatment

Owners of business enterprises may wish to incorporate for non-tax reasons (easier access to capital markets, or to meet regulatory requirements), but may prefer not to have corporate tax treatment. Limited liability for all the owners of the business generally has been provided by operating in corporate form; but now, because limited liability companies generally may be treated as partnerships for Federal tax purposes, and LLCs generally provide limited liability for LLC owners, limited liability is not as compelling a rationale for choosing corporate tax status. With the passage of time, the increased acceptance of LLCs and the resolution of questions of interstate comity may further reduce the importance of some non-tax reasons that taxpayers may have chosen corporate form.⁸

⁸ The classification of LLCs as partnerships is described in more detail in Part II. A. 2., below. The increased use of LLCs may be reflected in the future by a decline in the use of S corporations (passthrough

Pass-through tax treatment often is preferred over corporate tax treatment because owners may not wish business earnings to be subject to two levels of tax (once when earned and again when distributed). Other reasons for preferring pass-through tax treatment to corporate tax treatment are that: (1) the average or marginal tax rates for individual shareholders may be lower than that of the corporation;⁹ (2) owners may wish to use losses generated by the business to offset income from other sources; (3) the corporate tax base may include items not applicable to individuals (*e.g.*, items included under the corporate alternative minimum tax); and (4) favorable tax accounting methods available to individuals may not be available to corporations (*e.g.*, the cash receipts and disbursements method).

2. Prior entity classification regulations

Classification as a corporation or partnership

Prior to the check-the-box regulations, the Treasury regulations governing the classification of entities as partnerships or, alternatively, associations taxable as corporations for Federal income tax purposes were adopted in 1960. These regulations were known as the “Kintner” regulations because they were a response to the decision in *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954). The classification issue arose in that case because of favorable pension plan rules applicable, at that time, to corporate employees but not to partners. The Kintner regulations generally made it more likely than did the previous entity classification rules that a business entity would be classified as a partnership rather than a corporation.

The Kintner regulations provided that whether a business entity was taxed as a corporation depended on which form of enterprise the entity “more nearly” resembled (former Treas. Reg. sec. 301.7701-2(a)). The regulations listed six corporate characteristics, two of which are common to corporations and partnerships: the presence of associates and an objective to carry on business and divide the gains therefrom. Whether an unincorporated organization was classified as a partnership or a corporation depended on whether the entity had more than two of the remaining four corporate characteristics.

The four corporate characteristics identified in the Kintner regulations were (1) continuity of life, (2) centralization of management, (3) liability for entity debts limited to entity property, and (4) free transferability of interests (former Treas. Reg. sec. 301.7701-2). The effect of the regulations generally was to classify an unincorporated entity as a partnership if it lacked any two or more of the four corporate characteristics, without further inquiry as to how strong or weak a particular characteristic was or how the evaluation of the factors might affect overall

corporations), and some have questioned the continuing need for S corporation status for new businesses, discussed below in Part II B. 2.

⁹ The top marginal rate applicable to individuals under present law (39.6 percent) is higher than the top marginal rate applicable to corporations (35 percent). However, the graduation of the corporate and individual rate schedules and the division of entity income among owners may have the effect that the average and marginal tax rates for the individual owners under present law may be lower than the rates applicable to the entity as a corporation.

resemblance to a partnership or a corporation (former Treas. Reg. sees. 301.7701-2 and -3; *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1).

An organization was treated as having continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member did not cause a dissolution of the organization. In the case of a limited partnership, if the death, insanity, bankruptcy, retirement, resignation, expulsion, or other event of withdrawal of a general partner caused a dissolution unless the remaining general partners, or at least a majority in interest of all the remaining partners, agreed to continue the partnership, continuity of life did not exist. The regulations provided that a general or limited partnership subject to a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act lacked continuity of life. Under these rules, continuity of life generally did not exist even if the remaining partners had agreed to continue the partnership.

An organization generally had centralized management under the regulations if any person (or any group of persons which did not include all the members) had continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. A general partnership subject to a statute corresponding to the Uniform Partnership Act could not achieve centralization of management because of the mutual agency relationship between the partners. A limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act generally did not have centralized management unless substantially all the interests in the partnership were owned by the limited partners. However, if all or a specified group of the limited partners could remove a general partner (even with a substantially restricted right of removal), the test for whether there was centralized management was to be based on all the facts and circumstances.

An organization was treated under the regulations as having limited liability if, under local law, there was no member who was personally liable for the debts of, or claims against, the organization. In the case of an organization subject to a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act, personal liability generally existed with respect to each general partner. In the case of a limited partnership, however, personal liability did not exist with respect to a general partner when he had no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he was merely a “dummy” acting as the agent of the limited partners.

The Service’s ruling position was that a corporate general partner in a limited partnership did not have a substantial assets unless its net worth (excluding the partnership interest) was greater than or equal to 10 percent of the total contributions to the partnership (Rev. Proc. 92-88, 1992-2 C.B. 496). For partnerships with more than one general partner, this test could be met on a collective basis. If this test was met, the corporate partner was considered to have substantial assets, and the entity was considered not to have limited liability, for advance ruling purposes. Some taxpayers successfully contended that a limited partnership lacked limited liability under the regulations if the corporate general partner was not a “dummy” acting as the agent of the limited partners (*see Larson, supra*).

An organization was treated as having free transferability of interests, under the regulations, if members owning substantially all the interests had the power, without the consent of other members, to substitute another person as a member and to confer upon the substitute all the attributes of the transferred interest. Although the regulations indicated, in examples, that free transferability did not exist where unanimous consent of the general partners was required for the assignee of a limited partner's interest to become a substitute limited partner, the court in *Larson* found free transferability where the consent of the general partner to substitute limited partners could not be unreasonably withheld.

If an unincorporated organization had no more than two of these four corporate characteristics (in addition to the two factors that corporations and partnerships have in common), then, under the regulations, it was classified as a partnership rather than a corporation for Federal income tax purposes.

3. Tax treatment of limited liability companies

In recent years a form of entity has emerged, the limited liability company (referred to as an LLC), that generally provides corporate treatment for State law purposes and partnership treatment for Federal tax purposes. LLCs are entities organized under State law. Although LLC statutes differ from State to State, common characteristics among most States include limited liability of owners, management vested in owners or managers, lack of free transferability of interests, and often a lack of continuity of life.

In 1988, the Service ruled that an LLC organized under the Wyoming LLC statute could be treated as a partnership for Federal tax purposes, applying the four-factor test of the prior entity classification regulations then in effect. All 50 States have enacted LLC statutes. Over the years following the 1988 revenue ruling, the Service issued a series of revenue rulings on a State by State basis, eventually addressing the issue for many of the States, concluding that LLCs organized under each such State's laws could be classified as a partnership for Federal tax purposes. No further such rulings have been issued since December 17, 1996, when the final check-the-box regulations were issued, because as described below, those regulations generally make classification of an entity as a partnership for Federal tax purposes elective.

4. Final check-the-box regulations

On April 3, 1995, the Service announced in Notice 95-14, 1995-1 C.B. 297, that it was considering repealing the Kintner regulations and replacing them with new regulations that would allow taxpayers to treat domestic unincorporated business entities as partnerships or, alternatively, associations taxable as corporations on an elective basis. The Service also stated that it was considering the possible extension of such treatment to foreign business organizations. Proposed regulations implementing these changes were issued by the Treasury Department on May 13, 1996 and were adopted without fundamental changes as final regulations on December 17, 1996. The final regulations generally are effective January 1, 1997. Because of the elective classification regime they adopt, the regulations are referred to as the "check-the-box" regulations.

The major change made by the check-the-box regulations is to allow tax classification as either a partnership or a corporation to be explicitly elective, subject to minimal restrictions (compared to the prior entity classification regulations), for any domestic non-publicly traded unincorporated entity with two or more members.

In addition, the check-the-box regulations explicitly provide that a single-member unincorporated entity may be disregarded (treated as not separate from its owners). A disregarded entity is treated in the same manner as a sole proprietorship, in the case of an entity owned by individuals, and in the same manner as a branch or division, in the case of an entity owned by a corporation. The check-the-box regulations also differ from title previous regulations in treating certain entities as per se corporations for tax purposes.

The final check-the-box regulations retain the rules of the previous regulations for distinguishing “business entities” from trusts. Under the final check-the-box regulations, certain business entities will be classified automatically as corporations. These generally are domestic entities formed under a State corporation statute that describes the entity as a corporation, joint-stock company or in similar terms. They also include insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, and organizations that are taxable as corporations under other Code provisions, such as the provisions for publicly traded partnerships (sec. 7704).

FIDUCIARY DUTY & CONTRACTUAL LIMITATIONS

With the proliferation of limited partnerships and LLCs following adoption of the “check the box” regulations, new attention has been focused on the extent to which fiduciary duties may be modified by contract, and on the core requirement of good faith.

GERBER v. ENTERPRISE PRODUCTS HOLDINGS, LLC

67 A.3d 400

Supreme Court of Delaware, 2013

JACOBS, Justice.

I. INTRODUCTION

The plaintiff, Joel A. Gerber, held limited partnership units (“LP units”) of Enterprise GP Holdings, L.P., a Delaware limited partnership (“EPE”). . . . Gerber challenged the sale by EPE in 2009 of Texas Eastern Products Pipeline Company, LLC (“Teppco GP”) to Enterprise Products Partners, L.P. (“Enterprise Products LP”) (the “2009 Sale”).

[The Court’s discussion of Gerber’s second claim, challenging the subsequent merger of EPE into a wholly-owned subsidiary of Enterprise Products LP (the “2010 Merger”), is omitted.]

Gerber's complaint asserted claims against Enterprise Products Holdings, LLC ("Enterprise Products GP" or "general partner") – EPE's general partner before the 2010 merger. Other named defendants were Enterprise Products LP; certain members of Enterprise Products GP's Board of Directors (the "Director Defendants"); the Estate of Dan L. Duncan ("Duncan"), who before his death controlled EPE, Enterprise Products LP, and Enterprise Products GP ("Duncan's Estate"); and Enterprise Products Company ("EPCO"), an affiliate of Enterprise Products LP.

The Defendants moved to dismiss the Complaint in its entirety. On January 6, 2012, the Court of Chancery issued an opinion and order granting the motion to dismiss, from which Gerber has appealed to this Court. For the reasons set forth in this Opinion, we affirm in part, reverse in part, and remand.

II. FACTUAL BACKGROUND AND PROCEDURAL HISTORY

A. The Parties

[EPE and Enterprise Products LP are Delaware limited partnerships engaged in the oil and gas business.] Before the 2010 Merger, EPE and Enterprise Products LP were part of a two-tier limited partnership structure. EPE was the 100% owner of Enterprise Products LP's general partner (Enterprise Products GP). Because EPE had no independent operations, the assets of Enterprise Products LP generated cash flows to both Enterprise Products LP and EPE.

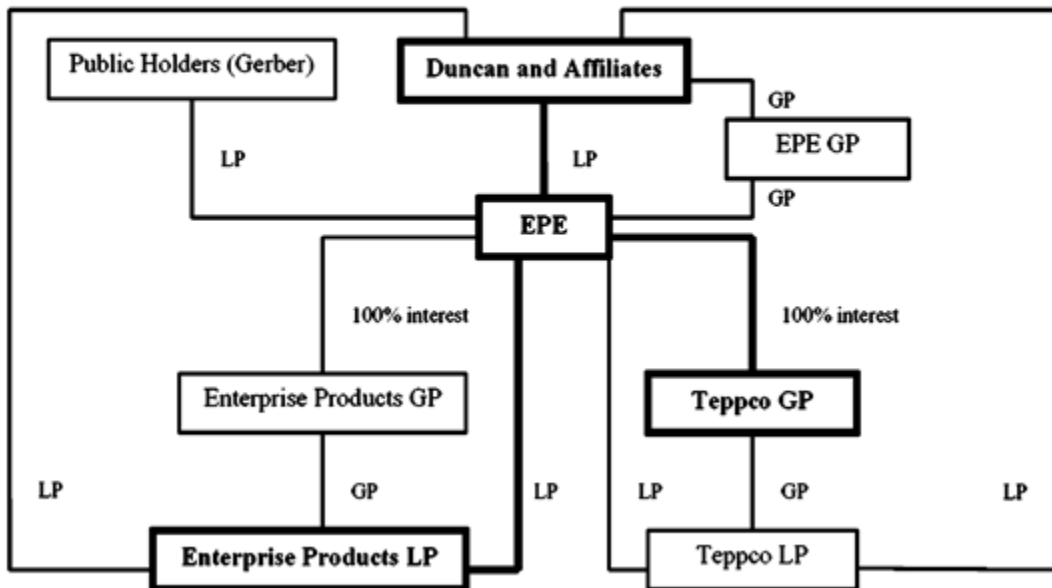
Enterprise Products GP is a privately-held Delaware limited liability company owned by a Duncan affiliate. Before the 2010 Merger, Enterprise Products GP – then named EPE Holdings, LLC ("EPE GP") – was EPE's general partner.

EPCO is a privately-held Texas corporation whose stock was owned, at the time of the 2009 Sale, by Duncan and members of his family. EPCO's principal business was to provide employees, management, and administrative services to Duncan's companies, including Enterprise Products LP, Enterprise Products GP, and (until the 2010 Merger) EPE.

The Director Defendants – Randa Duncan Williams, O.S. ("Dub") Andras, Charles E. McMahan, Edwin E. Smith, Thurmon Andress, Ralph S. Cunningham, Richard H. Bachmann, B.W. Waycaster, and W. Randall Fowler – were at all relevant times directors of Enterprise Products GP (the "Board"). Messrs. McMahan, Smith, and Andress comprised the Board's Audit, Conflict, and Governance Committee (the "ACG Committee").

The somewhat labyrinthine relationships among these affiliated entities and their controllers before the 2009 Sale are shown in the following chart:

Chart A: Before 2009:



B. The Facts

1. The 2009 Sale

In May 2007, EPE purchased Teppco GP from a Duncan affiliate in exchange for EPE LP units worth \$1.1 billion. Teppco GP was the general partner of Teppco Partners, LP, a Delaware oil and gas master limited partnership (“Teppco LP”). In 2009, the Defendants caused EPE to sell Teppco GP to Enterprise Products LP in what became the “2009 Sale.” On the same date that the 2009 Sale closed, the Defendants also caused EPE to sell Teppco LP to Enterprise Products LP in a separate but related transaction (the “Teppco LP Sale”).

In the 2009 Sale, as consideration for selling Teppco GP to Enterprise Products LP, (i) EPE received \$39.95 million worth of Enterprise Products LP’s LP units, and (ii) Enterprise Products GP (then owned by EPE) received an approximately \$60 million increase in the value of its general partner interest in Enterprise Products LP. The claim challenging the 2009 Sale is essentially that EPE acquired Teppco GP for \$1.1 billion in 2007, but two years later was caused by the Defendants to sell Teppco GP to Enterprise Products LP for \$100 million – only 9% of EPE’s original purchase price.

The 2009 Sale was first presented to the ACG Committee of Enterprise Products GP for its approval. That Committee hired the investment bank, Morgan Stanley & Co. (“Morgan Stanley”), to furnish an opinion on whether the transaction was fair from a financial point of view to EPE and the public holders of its LP units. Morgan Stanley opined that, as of the date of its June 28, 2009 fairness opinion (the “Morgan Stanley 2009 opinion”), “the Consideration to be paid pursuant to the [combined 2009 Sale and Teppco LP Sale] is fair from a financial point of view to EPE and accordingly, to the limited partners of EPE (other than Dan Duncan and his

affiliates).” Morgan Stanley cautioned, however, that it expressed “no opinion with respect to . . . the fairness to EPE or its limited partners of any particular component of the Consideration (as opposed to the Consideration, taken as a whole), in each case in connection with the [two Sales].” The ACG Committee approved the 2009 Sale and recommended its approval by the Board, and on June 28, 2009 the Board approved the 2009 Sale.

We pause to focus on the consideration that Morgan Stanley opined was fair in its 2009 opinion. The 2009 Sale closed on October 26, 2009, when EPE sold Teppco GP to Enterprise Products LP. As noted, that same day, EPE sold Teppco LP to Enterprise Products LP in a separate but related transaction – the “Teppco LP Sale.” The 2009 Sale and the Teppco LP Sale were separately negotiated and were the subjects of separate merger agreements. Importantly, in its 2009 opinion, Morgan Stanley opined on the fairness of the *total* consideration paid for both the 2009 Sale *and* the Teppco LP Sale. Morgan Stanley did not opine, however, on the fairness of the portion of the total consideration specifically allocable to the 2009 Sale.

C. The Complaint

Count I alleges that because the 2009 Sale was neither fair nor reasonable to EPE and its LP unitholders, the Defendants breached their express contractual duties as well as the implied covenant of good faith and fair dealing, under EPE’s Limited Partnership Agreement (“LPA”).

D. The Court of Chancery Opinion

1. Relevant Statutory and LPA Provisions

In conducting its legal analysis, the Court of Chancery relied on certain provisions of the Delaware Revised Uniform Limited Partnership Act (“DRULPA”) and EPE’s Limited Partnership Agreement (“LPA”). To facilitate the reader’s understanding of that court’s analysis and the issues presented on this appeal, those statutory and contractual provisions are briefly summarized at this point.

Section 17–1101(d) of the DRULPA provides that a general partner’s duties to a limited partnership or its unitholders, including fiduciary duties, “may be expanded or restricted or eliminated by provision in the [limited] partnership agreement; provided that the [limited] partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”

The Vice Chancellor determined that, under DRULPA § 1101(d), the LPA had supplanted the fiduciary duties to which EPE’s general partner and EPE’s other fiduciaries would otherwise have been subject. Section 7.9(b) of the LPA expressly provided that the conduct of the general partner or any of its “Affiliates” must be in “good faith,” defined as a “belie[f] that the determination or other action is in the best interests of the Partnership”:

Whenever the General Partner makes a determination or takes or declines to take any other action, or any of its Affiliates causes it to do so, . . . then unless another

express standard is provided for in this Agreement, the General Partner, or such Affiliates causing it to do so, shall make such determination or take or decline to take such other action in good faith, and shall not be subject to any other or different standards imposed by this Agreement, any other agreement contemplated hereby or under the Delaware Act or any other law, rule or regulation or at equity. In order for a determination or other action to be in “*good faith*” for purposes of this Agreement, the Person or Persons making such determination or taking or declining to take such other action must *believe that the determination or other action is in the best interests of the Partnership*.

In addition to changing the liability standard, the LPA also created two separate layers of protection designed to insulate the Defendants from judicial review of whether the general partner or its “Affiliates” had satisfied their contractual duty. The first layer of insulation is Section 7.9(a) of the LPA, which covered “conflict of interest” transactions. That provision created four “safe harbors” within which the general partner and its “Affiliates” could effectuate a conflict of interest transaction free of any claim that they breached “any duty stated or implied by law or equity.” Section 7.9(a) relevantly provided:

Unless otherwise expressly provided in this Agreement, whenever a potential *conflict of interest* exists or arises between the General Partner or any of its Affiliates, on the one hand, and the Partnership or any Partner, on the other hand, *any resolution or course of action by the General Partner or its Affiliates* in respect of such conflict of interest shall be permitted and deemed approved by all Partners, and *shall not constitute a breach of this Agreement . . . , or of any duty stated or implied by law or equity, if the resolution or course of action in respect of such conflict of interest is[:]*

(i) *approved by Special Approval,*

(ii) approved by the vote of a majority of the Units excluding Units owned by the General Partner and its Affiliates,

(iii) on terms no less favorable to the Partnership than those generally being provided to or available from unrelated third parties or

(iv) fair and reasonable to the Partnership, taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable or advantageous to the Partnership).

The first of those four enumerated safe harbors – “Special Approval” is implicated in this case. That term is defined in the LPA as “approval by a majority of the members of the [ACG] Committee.” The layer of insulation afforded by Section 7.9(a) precludes judicial review of any conflict transaction that is the subject of “Special Approval,” except for the limited purpose of determining whether the “Special Approval” process itself complied with the implied covenant of good faith and fair dealing (“implied covenant”).

The second layer of insulation from judicial review was afforded by Section 7.10(b) of the LPA, which applied more broadly and was not limited to conflict of interest transactions. Section 7.10(b) created a “conclusive presumption” that the general partner acts in “good faith” where the following condition is satisfied:

The General Partner may consult with . . . [experts or] investment bankers . . . , and any act taken or omitted to be taken in reliance upon the opinion . . . of such Persons as to matters that the General Partner reasonably believes to be within such Person’s professional or expert competence shall be conclusively presumed to have been done or omitted in good faith and in accordance with such opinion.

2. The Applicable Standard of Liability

In addressing the legal sufficiency of the Complaint, the Vice Chancellor determined preliminarily that: (1) the 2009 Sale was a “conflict of interest transaction,” because both the purchaser and seller had a common controller; (2) “a principal purpose of the [2010] Merger was the termination of [EPE’s] 2007 and 2009 Claims;” and (3) absent any contrary LPA provision, Enterprise Products GP (as EPE’s general partner), the Director Defendants (as members of the general partner’s Board), and Duncan (as the general partner’s controller) and EPCO, all owed fiduciary duties to EPE and its LP unitholders. Stated differently, absent contractual modifications, all Defendants would have been subject to default fiduciary duty standards of liability in connection with the two challenged transactions.

The court concluded, however, that the LPA had contractually modified the Defendants’ fiduciary duties, by eliminating and supplanting them with an express contractual duty to act in good faith.

Accordingly, the court focused its analysis primarily on the question of whether the Complaint cognizably alleged that Enterprise Products GP – as EPE’s general partner and the only Defendant that signed the LPA – breached the LPA’s contractual good faith standard or the implied covenant in connection with the two challenged transactions.

IV. ANALYSIS

A. The LPA’s Conclusive Presumption of Good Faith Does Not Bar a Claim Under the Implied Covenant

We begin our analysis by addressing LPA Section 7.10(b)’s conclusive presumption of good faith. We start there because the foundational premise of the Court of Chancery’s analysis is that Section 7.10(b) bars any claim under the implied covenant. With respect to the 2009 Sale, the Vice Chancellor explicitly held that:

The Complaint can fairly be read to allege that Enterprise Products GP acted in bad faith when it chose to use the [Section 7.9(a)] Special Approval Process. . . . According to the Complaint, the 2009 Sale was a grossly unfair transaction that involved

EPE selling an asset for \$100 million that two years previously it had purchased for \$1.1 billion. The Complaint can fairly be read to allege that because the terms of the 2009 Sale were so unfair to EPE, the 2009 Sale would not be able to meet the second, third or fourth standard established by Section 7.9(a). Thus, if Enterprise Products GP was going to be able to get EPE to undertake the 2009 Sale free from challenge, Enterprise Products GP would have to obtain Special Approval of the 2009 Sale. . . . That is an allegation that Enterprise Products GP exercised, in bad faith, the discretion it had to use the Special Approval process to take advantage of the LPA's duty limitations.

The Court of Chancery further concluded that “[a]lthough the well-pled facts of the Complaint may suggest that Enterprise Products GP breached the implied covenant, that claim is precluded by Section 7.10(b) of the LPA.”

We conclude, for the following reasons, that the foundational premise of the court's reasoning is flawed. Specifically, insofar as Section 7.10(b) creates a conclusive presumption of good faith, that provision does not bar a claim under the implied covenant.

The flaw in the court's reasoning stems from a decision by the LPA's drafters to define a contractual fiduciary duty in terms of “good faith” – a term that is also and separately a component of the “implied covenant of good faith and fair dealing.” Although that term is common, the LPA's contractual fiduciary duty describes a concept of “good faith” very different from the good faith concept addressed by the implied covenant. In *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440-42 (Del. Ch. 2012), the Court of Chancery articulated the important differences between the implied covenant and the fiduciary duty concepts of good faith. We adopt this well-reasoned analysis as a correct statement of our law:

The implied covenant seeks to enforce the parties' contractual bargain by implying only those terms that the parties would have agreed to during their original negotiations if they had thought to address them. Under Delaware law, a court confronting an implied covenant claim asks whether it is clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith – had they thought to negotiate with respect to that matter. While this test requires resort to a counterfactual world – what if – it is nevertheless appropriately restrictive and commonsensical.

The temporal focus is critical. Under a fiduciary duty or tort analysis, a court examines the parties as situated at the time of the wrong. The court determines whether the defendant owed the plaintiff a duty, considers the defendant's obligations (if any) in light of that duty, and then evaluates whether the duty was breached. Temporally, each inquiry turns on the parties' relationship as it existed at the time of the wrong. The nature of the parties' relationship may turn on historical events, and past dealings necessarily will inform the court's analysis, but liability depends on the parties'

relationship when the alleged breach occurred, not on the relationship as it existed in the past.

An implied covenant claim, by contrast, looks to the past. It is not a free-floating duty unattached to the underlying legal documents. It does not ask what duty the law should impose on the parties given their relationship at the time of the wrong, but rather what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting. “Fair dealing” is not akin to the fair process component of entire fairness, *i.e.*, whether the fiduciary acted fairly when engaging in the challenged transaction as measured by duties of loyalty and care whose contours are mapped out by Delaware precedents. It is rather a commitment to deal “fairly” in the sense of consistently with the terms of the parties’ agreement and its purpose. *Likewise “good faith” does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties’ contract. Both necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally.*

The retrospective focus applies equally to a party’s discretionary rights. The implied covenant requires that a party refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of its bargain. *When exercising a discretionary right, a party to the contract must exercise its discretion reasonably.* The contract may identify factors that the decision-maker can consider, and it may provide a contractual standard for evaluating the decision. Express contractual provisions always supersede the implied covenant, but even the most carefully drafted agreement will harbor residual nooks and crannies for the implied covenant to fill. In those situations, what is “arbitrary” or “unreasonable” – or conversely “reasonable” – depends on the parties’ original contractual expectations, not a “free-floating” duty applied at the time of the wrong.

Although the court in *ASB Allegiance* was comparing the analysis under the implied covenant to the analysis under common law fiduciary duty precepts, its reasoning applies equally to contractual fiduciary duties, such as the LPA’s “good faith” standard. Under Section 7.9(b), Enterprise Products GP and its Affiliates must make all determinations and take or decline to take any action in “good faith.” The LPA defines “‘good faith’ for purposes of this Agreement” as a “belie[f] that the determination or other action is in the best interests of the Partnership.” Like a common law fiduciary duty, Section 7.9(b)’s contractual fiduciary duty analysis looks to the parties as situated at the time of the wrong, and inquires whether Enterprise Products GP or its Affiliates “believe[d] that the determination or other action [was] in the best interests of the Partnership.” That is different from the standard that is embedded in the implied covenant.

LPA Section 7.10(b)’s conclusive presumption must be read together with Section 7.9(b). Section 7.9(b) imposes a contractual fiduciary duty to act in “good faith,” and defines “good faith” for the “purposes of this [a]greement.” Under Section 7.10(b), Enterprise Products GP and its Affiliates are conclusively presumed to have met this standard if they rely upon the

opinion of a qualified expert advisor. Nothing in Section 7.10(b) pertains to or addresses the implied covenant.

The reasoning in the Vice Chancellor's opinion improperly conflates two distinct concepts – the implied covenant and the LPA's contractual fiduciary duty – and ignores the temporal distinction between them. Section 7.10(b) is a contractual provision that establishes a procedure the general partner may use to conclusively establish that it met its contractual fiduciary duty. But, the implied covenant attaches to Section 7.10(b), as it attaches to the rest of the LPA. Therefore, Enterprise Products GP's attempt to take advantage of Section 7.10(b) may itself be subject to a claim that it was arbitrary and unreasonable and in violation of the implied covenant. The conclusive presumption of "good faith" applies only to the contractual fiduciary duty. It cannot operate retroactively to alter the parties' reasonable expectations at the time of contracting, and it cannot be used to fill every gap in the LPA.

Were we to adopt the Vice Chancellor's construction of Section 7.10(b), that would lead to nonsensical results. Examples readily come to mind of cases where a general partner's actions in obtaining a fairness opinion from a qualified financial advisor themselves would be arbitrary or unreasonable, and "thereby frustrat[e] the fruits of the bargain that the asserting party reasonably expected." To suggest one hypothetical example, a qualified financial advisor may be willing to opine that a transaction is fair even though (unbeknownst to the advisor) the controller has intentionally concealed material information that, if disclosed, would require the advisor to opine that the transaction price is in fact not fair. More extreme would be a case where the controller outright bribes the financial advisor to opine (falsely) that the transaction is fair. In a third example, the financial advisor, eager for future business from the controller, compromises its professional valuation standards to achieve the controller's unfair objective. Although plaintiffs could properly challenge this conduct under the implied covenant, the court's reasoning, if upheld, would preclude those claims. We therefore conclude that the Court of Chancery erred in holding that Section 7.10(b) bars a claim under the implied covenant.

Having so determined, we next analyze whether Gerber has pled facts that, if true, would establish that Enterprise Products GP breached the implied covenant. Applying the implied covenant is a "cautious enterprise" and we will only infer "contractual terms to handle developments or contractual gaps that the asserting party pleads neither party anticipated." Gerber must show that Enterprise Products GP "acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that [Gerber] reasonably expected." "When conducting this analysis, we must assess the parties' reasonable expectations at the time of contracting;" and will not imply terms to "rebalanc[e] economic interests after events that could have been anticipated, but were not, that later adversely affected one party to a contract."

According to the Complaint, the 2009 Sale was a grossly unfair transaction wherein the Defendants caused EPE to sell Teppco GP to Enterprise Products LP for only 9% of EPE's original purchase price. Enterprise Products GP, acting through its ACG Committee, obtained the Morgan Stanley 2009 opinion to trigger Section 7.10(b)'s conclusive presumption that Enterprise Products GP satisfied its contractual duty of good faith. The Complaint pleads that the Morgan Stanley 2009 opinion did not address whether holders of EPE's LP units received

fair consideration for their Teppco GP interest. Instead, Morgan Stanley addressed only the total consideration paid in both the Teppco LP Sale (which did not include any consideration for EPE's LP unitholders) and the 2009 Sale, and explicitly disclaimed to opine as to the fairness of any specific component of the total consideration.

As the Vice Chancellor noted, the LPA's "protections were minimal" and "did not provide EPE's public investors with anything resembling the protections available at common law." But even though Gerber forewent the protections available under common law fiduciary principles, he still retained a reasonable contractual expectation that the Defendants would properly follow the LPA's substitute standards. That requires us to decide whether an implied covenant claim is stated where the defendant allegedly has attempted to satisfy its contractual obligations by relying on a fairness opinion that did not value the consideration that the LP unitholders actually received.

We answer that question in the affirmative. When Gerber purchased EPE LP units, he agreed to be bound by the LPA's provisions, which conclusively deemed Enterprise Products GP's contractual fiduciary duty to be satisfied, if Enterprise Products GP relied upon the opinion of a qualified expert. At the time of contracting, however, Gerber could hardly have anticipated that Enterprise Products GP would rely upon a fairness opinion that did not fulfill its basic function – evaluating the consideration the LP unitholders received for purposes of opining whether the transaction was financially fair. Although Section 7.10(b) does not prescribe specific standards for fairness opinions, we may confidently conclude that, had the parties addressed the issue at the time of contracting, they would have agreed that any fairness opinion must address whether the consideration received for Teppco GP in 2009 was fair, in order to satisfy Section 7.9(b)'s contractual fiduciary duty. Gerber has pled that Enterprise Products GP engaged in a manifestly unfair transaction, and then relied on an unresponsive fairness opinion, to ensure that its contractual fiduciary duty would be conclusively presumed to have been discharged. That is the type of arbitrary, unreasonable conduct that the implied covenant prohibits.

V. CONCLUSION

For the above reasons, the judgment of the Court of Chancery is affirmed in part and reversed in part, and the case is remanded for further proceedings consistent with the rulings in this Opinion. Jurisdiction is not retained.

Notes and Questions

1. The *ASB Allegiance* methodology distinguishes between focusing on one party's duty to the other at the time the alleged wrong occurs, under a traditional fiduciary analysis, and what the parties would have agreed to, under an implied covenant analysis, had they foreseen the allegedly wrongful course of events. As a practical matter, what is the difference between the two?

2. Suppose you were counsel to Gerber, who asked you to review the Limited Partnership Agreement. Given Sections 7.9 and 7.10, how would you advise him to proceed with the investment?

PROMOTER'S FRAUD

FRICK v. HOWARD

23 Wisc. 2d 86, 126 N.W.2d 619

Supreme Court of Wisconsin, 1964

On January 24, 1958, Michael D. Preston, an attorney, entered into a contract to purchase real estate located at 3816 West Wisconsin Avenue, Milwaukee. The purchase price was \$240,000. Preston agreed to pay \$5,000 down, \$65,000 on the date of closing, and the vendor agreed to take back a purchase money mortgage for \$170,000. On April 1, 1958, Preston organized Pan American Motel, Inc. He subscribed to one share of capital stock of the corporation. The stated value of this one share of stock was \$1,000.

After Preston brought an action to compel specific performance of the contract of January 24, 1958, the real estate was conveyed to him by warranty deed on August 29, 1958. On or about that date Preston withdrew at least \$61,000 from the corporation. He testified that the corporation owed him some \$34,000 and stated that the rest of the money was a personal loan to him. On August 29, 1958 the financial statement referred to earlier showed that Mr. Preston owed the corporation slightly less than \$35,000 and that there was a net worth deficit of \$7,000 consisting of accrued officers' salaries.

On September 1, 1958, Pan American Motel, Inc. offered to purchase the real estate in question from Preston and his wife for \$350,000. The terms of the offer were \$70,000 on closing; that the corporation would assume the outstanding mortgage of \$170,000; and that the corporation would execute a note and mortgage in the sum of \$110,000 to make up the balance of the purchase price. The transaction was not to be consummated until April 1, 1959. The offer was accepted and carried out according to its terms. The \$70,000 down payment paid to Preston on closing consisted of wash out of an existing indebtedness of \$35,000 from Preston to the corporation and the issuance to Preston or his nominee of 35 shares of stock.

In order to construct a motel on the premises the corporation negotiated a \$550,000 construction loan with First Federal Savings and Loan Association. A mortgage securing this loan was recorded on July 2, 1959. Preston recorded his mortgage on September 17, 1959.

[In December 1961, Preston and his wife assigned the note and the mortgage to Frick, who brought suit against the corporation to collect on the note. From a judgment for Frick on the note, the corporation appeals.]

BEILFUSS, Justice.

Did Preston, as a promoter, breach a fiduciary duty to the corporation? It appears without dispute that Preston was the organizer and promoter of the Pan American Motel, Inc.

The trial court found that Preston committed a fraud upon the corporation but that the transaction was not secret.

The fact that the transaction was not secret does not in all instances relieve a promoter of his fiduciary obligation to the corporation.

It is clear that at the time of the sale of the land to the corporation, and the execution of the note and mortgage, that the corporation had no independent board of directors. The actions of the corporation were completely dominated by Preston. The transaction to sell the land held for a very short period of time was controlled by Preston both as buyer and seller. This was not an agreement between an independent buyer and seller dealing at arm's length. Preston as an individual selling the property had a personal financial interest to obtain the highest price available; Preston as the alter ego of Pan American Motel, Inc. had a financial interest to purchase the property at the lowest price available. There could be no meeting of the minds.

The fact that the land may or may not have been worth more than \$240,000 cannot override Preston's fiduciary obligation as a promoter of the corporation. In this instance where he completely dominated the corporation at the time of the transaction it was his fiduciary obligation to give the corporation the benefit of his bargain, if it was one. If Preston had provided the corporation with a board of directors who could have acted independently and at arm's length the situation might have been different. For Preston to obtain a profit of \$110,000 for himself under the circumstances herein is unconscionable and a violation of his fiduciary obligation and as such a fraud upon the corporation.

That the transaction constituted a fraud on creditors, existing and subsequent, is all the more apparent when it is considered that Preston attempted to elevate himself to the position of a secured creditor by the note and mortgage of April 1, 1959. If the transaction had been fair and above board the best that Preston could have claimed was a contribution to capital because of the top-heavy debt structure already existing. We, therefore, hold there was no valid consideration for the note and mortgage of April 1, 1959 in the amount of \$110,000 and that the corporation, subsequent stockholders, creditors, or the receiver for their benefit can assert this defense.

Judgment reversed with directions to dismiss the complaint.

AUTHORIZATION & ISSUANCE OF SHARES

Chez SinoZa Problem #4

Arthur, Beverly and Charles have now decided to organize their venture as a corporation. On behalf of your client, negotiate the share capital structure for the new corporation. Among the issues that need to be decided are (1) whether more than one class of shares should be authorized and, if so, what are to be the differences between the classes; (2) how many shares of each class should be authorized; (3) how many shares of each authorized class should be issued – to whom, and for what consideration; and (4) whether any class of shares should include preemptive rights.

Note on Legal Capital

Traditionally, corporate law restricted both the kind and amount of consideration for which shares can permissibly be issued. In particular, some forms of consideration whose value was deemed too speculative or contingent – such as promissory notes or promises of future services – were prohibited. The minimum amount of allowable consideration depended on the “par value” of the shares – an amount designated in the articles of incorporation. That amount, once received, was allocated to the corporation’s stated capital account, and as such served as a fund for the protection of corporate creditors. In addition, corporate statutes permitted shares without par value (so-called “no par”), which gave the corporate greater flexibility as to the amount to be allocated to capital.

In 1980, the Model Business Corporation Act was revised to eliminate the legal capital concept, *see* MBCA § 6.21, and several states have followed that approach. Other states retain the traditional legal capital regimen, although in some cases, such as Delaware, have relaxed some of the requirements. *See* DGCL §§ 152-153. The following case arose under the law of the District of Columbia, which until recently followed the traditional, strict legal capital approach.

PUBLIC INVESTMENT LIMITED v. BANDEIRANTE CORPORATION

740 F.2d 1222

United States Court of Appeals, D.C. Circuit, 1984

WILKEY, Circuit Judge.

The events giving rise to this case apparently began when Philander P. Claxton III became interested in developing gold mining properties located near the town of Tipuani in Bolivia. According to testimony Claxton gave at trial, an initial investigation of gold mining

opportunities led him to one Gilkey, who claimed to hold title to gold mining concessions in Bolivia worth as much as \$100,000,000.

In December 1980 and January 1981 Claxton organized a network of business ventures to exploit the gold mines. The most central of these was Tipuani Limited Partners, which was to serve as the vehicle for the distribution of proceeds from the gold mines. Limited partnerships in Tipuani were sold for cash and notes totaling about \$7,000,000.

Claxton formed Bandeirante Corporation to be the general partner for Tipuani. Bandeirante was authorized to issue 10,000 shares of Class A voting stock and 10,000 shares of Class B nonvoting stock. The 10,000 Class A shares were initially issued for \$15,000 to Mr. and Mrs. Donald Loveridge, wealthy individuals residing in Florida who were interested in the Bolivian venture for tax advantages and investment. This stock was repurchased two months later, however, when the Loveridges indicated that they did not wish directly or indirectly to control the operations of the corporation. The repurchase of the Loveridge's stock apparently left no voting stock outstanding.

....

Claxton completed the network with an off shore corporation, Nilge, Ltda., which apparently was formed while Claxton was imprisoned at Eglin Air Force Base in January of 1981. (Nilge is Eglin spelled backwards.) . . .

A major problem soon befell the gold mining venture – it was learned in the spring of 1981 that the title to the mining property was not clear. A rival group filed a competing claim to the property, and litigation ensued to determine the right owner.

In the wake of the disclosure that the mining claim might prove worthless, certain of the limited partners began in the summer of 1981 to skip payments on promissory notes owing to Tipuani Limited Partners. Claxton explained at trial that he did not press for payment on these notes, because of the problems surrounding the title to the mines.

In September of 1981, Nilge used \$990,000 of the promissory notes it had received from Tipuani to purchase Class A shares in Bandeirante that had been returned by the Loveridges. This transaction shifted effective control of the mining operation to Nilge, by making Bandeirante a Nilge subsidiary. Nilge, in turn, was controlled in its North American operations by Claxton. By this complex series of transactions, as the district court found, "Claxton III without expenditure of any of his funds controlled Bandeirante, controlled the management of the mining venture and from time to time adjusted the interests of the parties to suit his purpose."

....

The appellants seek to undo . . . the sale of the Class A stock to Nilge. They advance two principal theories: that the sale to Nilge is void because promissory notes do not constitute a

valid form of payment for the shares, and that the sale is void because Claxton failed to show “the entire fairness and adequacy of the consideration” for the sale.

II. TREASURY STOCK ISSUE

A. The Developing Concept of Treasury Stock

The term “treasury stock” has arisen to describe shares of a corporation which are sold to investors, then reacquired and held by the corporation. The trial court below found that Nilge, Ltda., acquired treasury stock – and that promissory notes are acceptable consideration for treasury stock. The case in the trial court thus turned on the treasury stock issue.

1. The Common Law View

For generations, the notion of treasury stock has teased lawyers’ minds. Although the concept has been around for more than a hundred years, commentators and courts have continued to debate the legitimacy and wisdom of the device.

One view – still the rule in Britain – considers it a logical necessity that the shares should be extinguished when reacquired by the corporation, and that any subsequent replacement by newly issued shares. Under this view, the power of the corporation to reacquire shares is a function of its power to reduce its capital. The logic underlying this view was ably expressed by Professor Ballantine in his treatise:

Treasury shares are indeed a masterpiece of legal magic, the creation of something out of nothing. They are no longer outstanding shares in the hands of a holder. They are not outstanding because the obligor has become the owner of the obligation

Treasury shares carry no voting rights as to dividends or distributions. Their existence as issued shares is a pure fiction, a figure of speech to explain certain special rules and privileges as to their reissue. A share of stock, as we have seen, is simply a unit of interest in the corporate enterprise arising from a contract. When the holder of a share surrenders his rights to the corporation it is obvious that the contract is in reality terminated.³⁰

Another view – which at the time the D.C. corporation code was drafted was the majority view in America – held that a corporation could own its own shares. This view held that treasury shares were not extinguished, but remained “in suspended animation – existing, but existing only in a kind of Limbo”³¹ The “suspended animation” language reflected the fact

³⁰ H. BALLANTINE, *BALLANTINE ON CORPORATIONS* 615 (1946); *See also* G. Glenn, *Treasury Shares*, 15 VA. L. REV. 625 (1929).

³¹ *Kirschenbaum v. Commissioner*, 155 F.2d 23, 25 (2d Cir.), *cert. denied*, 329 U.S. 726 (1946) (L. Hand, J.). *See also Taylor v. Miami Exporting Co.*, 6 Ohio 176, 219 (1833).

that the corporation was not allowed to exercise certain rights of share ownership, such as the right to vote the shares or receive dividends. For various reasons, the sale of treasury stock also was often free from restrictions attached to the sale of newly issued stock, such as par value requirements and pre-emptive rights of purchase. States varied widely in the treatment of such shares, however; as one commentator concluded, “There seems to be little agreement as to the precise legal status of treasury shares.”³⁴

....

3. The District of Columbia Code

The D.C. Code provisions at issue in this case were derived almost verbatim from the Model Act. “Shares reacquired by the corporation” (the term “treasury stock” was not used) were defined as “issued but not outstanding” shares, the corporation’s directors were allowed by § 29-316(c) to resell the shares for such consideration as they found adequate, but certain forms of payment (including, again, promissory notes) were specifically excluded as valid payment for the sale of shares by § 29-317.⁴⁴ . . .

B. Promissory Notes and Treasury Shares

1. § 29-317

The specific provision of the District of Columbia Code at issue – § 29-317 – is ambiguous in its treatment of the treasury stock issue. The section bans the use of promissory notes as payment for stock. It can be argued that the promissory note restriction applies only to issuances of new stock: it occurs in a provision otherwise devoted to issuances of stock. In support of this approach, it also could be argued that the elimination of the “consideration” requirement for treasury shares in § 29-316 applies not just to the dollar amount of consideration, but to the type of property tendered as consideration.

³⁴ H. OLECK, 3 MODERN CORPORATION LAW 705 (1948).

⁴⁴ *Id.* at § 29-317. That provision reads:

§ 29 317 Same – Payment; Promissory notes and future services excluded

(a) The consideration for the issuance of shares may be paid, in whole or in part, in money, in other property, tangible or intangible, or in labor or services actually performed for the corporation. When payment of the consideration for which shares are to be issued, which, in the case of shares having a par value, shall be not less than the par value thereof, shall have been received by the corporation, such shares shall be deemed to be full paid and nonassessable.

(b) Neither promissory shares nor future services shall constitute payment or part payment for shares of a corporation.

(c) In the absence of fraud in the transaction, the judgment of the board of directors or the shareholders, as the case may be, as to the value of the consideration received for shares shall be conclusive.

Conversely, it can be argued that § 29-317 does not restrict the ban on promissory notes to “issuances,” but applies by its terms to all situations where payment is being made to the corporation for shares. In support of this view, it can be noted that the “such consideration as may be fixed” provision of § 29-316(c) follows two other provisions relating to par value, and thus only codifies the common law rule that treasury shares could be sold by the corporation without regard to the stock’s par value. More generally, it could be argued that § 29-316 as a whole aims at establishing the dollar value of the shares for the purpose of establishing the corporation’s stated capital, while § 29-317 is an anti-fraud provision aimed at ensuring that the corporation actually receive a reliable type of consideration for its shares. Treasury shares appear to be excluded from the Model Act’s treatment of stated capital, while no reason exists to think treasury shares should be excluded from the corporation’s anti-fraud provisions.

....

3. The Structure of the Act

Under those statutes that recognize the concept of stated capital a valid distinction arises between treasury stock and newly issued stock. Most corporation statutes (again, including the one at issue here) forbid corporations to acquire treasury stock when such an acquisition would deplete the stated capital of the corporation. While considerable confusion exists, even today, as to the proper accounting procedures, one point is clear: with rare and minor exceptions, any acquisition must be paid for from either capital surplus or earned surplus. A corporation cannot use its stated capital to trade in shares of its own stock.

Given these facts, it would make little sense to insist on issuing treasury stock for par value. The stated capital of the corporation was established when the stock was first issued. That stated capital was not disturbed when the stock was reacquired. Since the stated capital is not involved in the transaction, there is no need to invoke the concept of par value when the stock is resold.

Because of this distinction, the drafters of the older statutes needed a mechanism to distinguish between authorized but unissued stock – whose sale would affect stated capital – and stock issued but not outstanding – whose sale would not affect stated capital. This distinction was made through the treasury share provisions of the Model Act, and similar provisions in those statutes which followed the Model Act.

Treasury stock, then, is a function of the “stated capital” concept. Significantly, those modern statutes which have abolished the concepts of stated capital and par value have also abolished the treasury stock concept.

The function of treasury stock provides the key to the issue before this court. If § 29-317 exists only to protect the stated capital account, it ought not apply to treasury shares since the trading of treasury shares does not affect the stated capital account. On the other hand, if § 29-317 serves a broader purpose which would be affected by treasury share transactions, it should apply to transactions such as the one at issue here.

4. The Purpose of § 29-317

Protecting the stated capital account is clearly one purpose of § 29-317. Promissory notes often prove uncollectable. If they are counted as part of the stated capital, creditors and shareholders who relied on their collectability would be misled.

At one time – beginning well after the adoption of the statute at issue here – the Model Act would have supported the interpretation that avoiding the watering of new stock was the only purpose of provisions such as § 29-317. A 1960 commentary to the Model Act specified that the Model Act's provision applied only to newly issued stock; a 1969 amendment to the Model Act itself placed this interpretation in the statute.⁵⁷

The district court relied on this subsequent amendment of the Model Act in interpreting the D.C. Code, terming it “legislative history.” The district court erred in treating this later commentary – which was issued far too late to benefit the drafters of the District of Columbia statute as legislative history. This reasoning underlying these subsequent changes can be used, however, much as law review articles are used: as an aid in interpreting an unclear statute. Unfortunately, both the 1960 commentary and the comments explaining the 1969 revision are conclusory in form. No explanation is given as to why the commentators felt treasury stock should be distinguished.

Since then, the Model Act has been revised, and the concepts of both stated capital and treasury stock have been abolished. Under the Model Act as it now stands, all sales of stock would be subject to the ban on promissory notes. A proposed Revised Model Act would permit the sale of stock for promissory notes, but impose special disclosure requirements on such sales that are not applicable to other corporate sales of stock. The California act – which likewise abolishes the concepts of stated capital and treasury shares – bans outright the sale of stock for unsecured first-party promissory notes. Both the Revised Model Act and the California Code suggest that the ban on promissory notes involves interests reaching beyond the sanctity of the stated capital account.

The survival of these provisions reminds that stated capital was never a solitary – or sufficient – bulwark against the dilution of capital. In this century, the nearly universal acceptance of low-par and no-par stocks (and hence the diminishment of “stated capital” as a proportion of the corporation’s economic capital) has eroded its utility as even a partial safeguard; today’s creditors are more likely to look to recent and projected earnings, the total debt-to-equity ratio, the relationship of cash flow to projected income expense, the ratio of current assets (such as short term promissory notes) to current liabilities, and the general reputation of the firm. Holding out a small “cushion of capital” at best provides slim returns to

⁵⁷ Model Bus. Corp. Act Ann. 2d § 19 (1971). While no parallel amendment was made in the D.C. Code, this omission is of limited significance since the Model Act amendment was ostensibly only to clarify, not change, the law. However, the omission of the term “issuance” from the original statute might have been read to imply that the provision's scope reached treasury shares. See Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: II*, 34 CAL. L. REV. 344, 376-77 (1946) (argument that term “sold” implies treasury shares, while term “issued” implies new issues only).

creditors, and nothing to equity holders who had hoped to see their investment grow. In the current marketplace, as the drafters of the proposed Revised Model Act recognized, reliance on stated capital more often proves misleading than helpful.

The gradual erosion of stated capital as a safeguard has highlighted the other safeguards that have been present all along. The most far reaching of these are the fiduciary duties imposed on certain principals of the corporation; the more recent statutes rely ever more heavily on these duties to prevent corporate misconduct.

As a practical matter, however, the deference shown officers and directors under the “business judgment rule” limits the enforceability of fiduciary duties except in the case of self-dealing or other egregious misconduct. These vague fiduciary duties are therefore supplemented with flat bans against specific kinds of behavior, where a predictive judgment can be made that allowing the practice would more often lead to abuses than to economic gains.

The D.C. Code’s ban on the sale of stock for promissory notes is such a prophylactic ban. Little of benefit can be expected from allowing the sale of stock for notes. Those notes which promise to be collectable could readily enough be converted to cash, while a tremendous temptation exists to transform promissory notes without real value – especially third party promissory notes – into a more valuable asset by transferring them to the corporation for stock. Selling shares for promissory notes doomed to default harms the corporation in numerous ways: by diluting the equity of the other shareholders, by deceiving investors and creditors through falsely inflating the value of the corporation’s assets, and (where, as here, all or almost all of the authorized stock is involved) by causing the corporation to forego other sources of capital.

....

This opinion in no way abolishes the distinction drawn by the District of Columbia Code between treasury shares and newly issued shares. It simply refuses to draw additional distinctions not drawn by the Code. The nub of the difference between treasury shares and newly issued shares, as both the majority and the dissent recognize, is that the concepts of par value and stated capital do not apply to treasury shares. Since the prohibition at issue here does not depend on those concepts, it applies to both types of stock when the seller is the corporation.

....

C. Remedy

The plaintiffs sued in both a direct and derivative posture, seeking a declaratory judgment that the sale of stock to Nilge is void. The sale of stock at issue here was illegal. The illegality does not make the sale void from the outset, but merely makes it voidable. The defect in the sale would have been cured had the \$990,000 purchase price been paid in full. While the record suggests strongly that no payment ever was made on any of the notes, the lack of a clear ruling on this point requires us to remand this issue to the district court.

MIKVA, Circuit Judge, concurring in part, dissenting in part.

As the majority aptly observes, this case turns on the purpose of section 29-317. If Congress only envisioned a provision to protect the stated capital account, then the prohibition on promissory notes is inapplicable to the sale of treasury shares since the consideration received for treasury shares does not affect the stated capital account. *See Majority opinion, supra*, at 1230. If, alternatively, Congress envisioned a broad anti-fraud provision, then the statute should not be limited to newly issued shares. I find no support in the statute or in its legislative history, however, for the broad reading that the majority embraces and the novel interpretation that it affixes to section 29-317.

....

Notes and Questions

1. Underlying the differing positions of the majority and dissent is a basic issue: Are the legal capital rules solely for the benefit of the corporation's creditors? Or should they also serve the purpose of protecting minority shareholders from schemes to sell shares to insiders on the cheap?

2. As the court's 2-1 split bears witness, the decisions on the permissible consideration for treasury shares are in conflict. *Compare Place v. P.M. Place Stores Co.*, 857 S.W.2d 291 (Mo. Ct. App. 1993) (corporation may not accept promissory notes as payment for treasury shares) *with Brumfield v. Horn*, 547 So. 2d 415, 417-20 (Ala. 1989) (limits on eligible consideration do not apply to sales of treasury shares). In each case, the decision has turned largely on the wording of the particular state's statute. What result under the Delaware statute? *See* DGCL § 153(c).

3. The treasury share concept has proven to have more lives than many cats. For at least fifty years, commentators have criticized the notion of a corporation holding stock in itself. *See, e.g.*, Henry W. Ballantine, *The Curious Fiction of Treasury Shares*, 34 CAL. L. REV. 536 (1946). When California chose to take a fresh look at the rules governing legal capital in 1976, it concluded that "treasury shares are merely a historical curiosity" and eliminated the concept. CAL. CORP. CODE § 510 Legislative Committee Cmt. (1975) – Assembly. Thus, when a corporation acquires its own shares, they automatically revert to the status of authorized but unissued shares. The drafters of the Model Act followed suit in 1980. *See* MBCA § 6.31(a). But many states, although enacting the Revised Model Act approach to legal capital generally, elected to retain the traditional concept of treasury shares, often reinstating it after having just eliminated it a year or two before. *See, e.g.*, GA. CODE §§ 14-2-140(28), -631(a); ILL. COMP. STAT. ch. 805, §§ 5/1.80(x), 5/9.05(b); WIS. STAT § 180.0631(1).

Various reasons explain the persistence of the treasury share concept, including (1) clarifying the status of the common arrangement in which a shareholder sells his or her stock back to the corporation in exchange for promissory notes, but retains the stock as collateral until the notes are paid; (2) avoiding the preemptive rights and stock exchange listing fees that may

apply to the corporation's issuance of new shares; and (3) avoiding the reduction in retained earnings that may result from the cancellation of acquired shares.

4. Section 152 of the Delaware statute previously required consideration for the issuance of shares to be in the form of "cash, services rendered, personal property, real property, leases of real property or a combination thereof," and was therefore interpreted to prohibit unsecured promissory notes. The statute was amended in 2004, and the present wording adopted, but shares issued prior to that date remain subject to the prohibition. See *Prizm Group, Inc. v. Anderson*, 2010 WL 1850792 (Del. Ch. May 10, 2010) (shares issued for unsecured promissory notes were void or voidable).

U.S. SECURITIES & EXCHANGE COMMISSION
BEGINNERS' GUIDE TO FINANCIAL STATEMENTS
<http://www.sec.gov/investor/pubs/begfinstmtguide.htm>

The Basics

If you can read a nutrition label or a baseball box score, you can learn to read basic financial statements. If you can follow a recipe or apply for a loan, you can learn basic accounting. The basics aren't difficult and they aren't rocket science.

This brochure is designed to help you gain a basic understanding of how to read financial statements. Just as a CPR class teaches you how to perform the basics of cardiac pulmonary resuscitation, this brochure will explain how to read the basic parts of a financial statement. It will not train you to be an accountant (just as a CPR course will not make you a cardiac doctor), but it should give you the confidence to be able to look at a set of financial statements and make sense of them.

Let's begin by looking at what financial statements do.

"Show me the money!"

We all remember Cuba Gooding Jr.'s immortal line from the movie *Jerry Maguire*, "Show me the money!" Well, that's what financial statements do. They show you the money. They show you where a company's money came from, where it went, and where it is now.

There are four main financial statements. They are: (1) balance sheets; (2) income statements; (3) cash flow statements; and (4) statements of shareholders' equity. Balance sheets show what a company owns and what it owes at a fixed point in time. Income statements show how much money a company made and spent over a period of time. Cash flow statements show the exchange of money between a company and the outside world also over a period of time. The

fourth financial statement, called a “statement of shareholders’ equity,” shows changes in the interests of the company’s shareholders over time.

Let’s look at each of the first three financial statements in more detail.

Balance Sheets

A balance sheet provides detailed information about a company’s assets, liabilities and shareholders’ equity.

Assets are things that a company owns that have value. This typically means they can either be sold or used by the company to make products or provide services that can be sold. Assets include physical property, such as plants, trucks, equipment and inventory. It also includes things that can’t be touched but nevertheless exist and have value, such as trademarks and patents. And cash itself is an asset. So are investments a company makes.

Liabilities are amounts of money that a company owes to others. This can include all kinds of obligations, like money borrowed from a bank to launch a new product, rent for use of a building, money owed to suppliers for materials, payroll a company owes to its employees, environmental cleanup costs, or taxes owed to the government. Liabilities also include obligations to provide goods or services to customers in the future.

Shareholders’ equity is sometimes called capital or net worth. It’s the money that would be left if a company sold all of its assets and paid off all of its liabilities. This leftover money belongs to the shareholders, or the owners, of the company.

The following formula summarizes what a balance sheet shows:

$$\text{ASSETS} = \text{LIABILITIES} + \text{SHAREHOLDERS' EQUITY}$$

A company's assets have to equal, or "balance," the sum of its liabilities and shareholders' equity.

A company’s balance sheet is set up like the basic accounting equation shown above. On the left side of the balance sheet, companies list their assets. On the right side, they list their liabilities and shareholders’ equity. Sometimes balance sheets show assets at the top, followed by liabilities, with shareholders’ equity at the bottom.

Assets are generally listed based on how quickly they will be converted into cash. *Current* assets are things a company expects to convert to cash within one year. A good example is inventory. Most companies expect to sell their inventory for cash within one year. *Noncurrent* assets are

things a company does not expect to convert to cash within one year or that would take longer than one year to sell. Noncurrent assets include *fixed* assets. *Fixed* assets are those assets used to operate the business but that are not available for sale, such as trucks, office furniture and other property.

Liabilities are generally listed based on their due dates. Liabilities are said to be either *current* or *long-term*. *Current* liabilities are obligations a company expects to pay off within the year. *Long-term* liabilities are obligations due more than one year away.

Shareholders' equity is the amount owners invested in the company's stock plus or minus the company's earnings or losses since inception. Sometimes companies distribute earnings, instead of retaining them. These distributions are called dividends.

A balance sheet shows a snapshot of a company's assets, liabilities and shareholders' equity at the end of the reporting period. It does not show the flows into and out of the accounts during the period.

PROBLEM

Recall *Frick v. Howard*. In organizing Pan American Motel, Inc., Preston contributed the land, which the corporation valued at \$350,000, and which was still subject to the purchase money mortgage of \$170,000. Preston's interest in the property was therefore valued at \$180,000. In exchange for that interest, Preston received the corporation's note for \$110,000. Assume he took the \$70,000 balance in stock.

(a) How would this transaction be reflected on Pan American's balance sheet? If Pan American was incorporated in Delaware, how would the Stockholders' Equity section of the balance sheet differ if the \$70,000 of stock was (1) 70 shares with a par value of \$1,000, (2) 70 shares with a par value of \$100, or (3) 70 shares without par value? See DGCL § 154.

(b) Suppose that in its first year of operation, Pan American had \$50,000 in net profits and that – for the sake of simplicity – all of its dealings were in cash. How would these results be reflected on Pan American's balance sheet at the end of the year? Consider the Shareholders' Equity section of Apple Inc.'s balance sheet for the year ended September 28, 2013, set forth below. (Dollar amounts are in millions.)

Shareholders' equity:

| | | |
|--|----------------|----------------|
| Common stock, no par value: 1,800,000 shares authorized; 899,213 and 939,208 shares issued and outstanding, respectively | 19,764 | 16,422 |
| Retained earnings | 104,256 | 101,289 |
| Accumulated other comprehensive income/(loss) | (471) | 499 |
| Total shareholders' equity | <u>123,549</u> | <u>118,210</u> |

KLANG v. SMITH'S FOOD & DRUG CENTERS, INC.

702 A.2d 150

Supreme Court of Delaware, 1997

VEASEY, Chief Justice:

This appeal calls into question the actions of a corporate board in carrying out a merger and self-tender offer. Plaintiff in this purported class action alleges that a corporation's repurchase of shares violated the statutory prohibition against the impairment of capital. . . .

Facts

Smith's Food & Drug Centers, Inc. ("SFD") is a Delaware corporation that owns and operates a chain of supermarkets in the Southwestern United States. Slightly more than three years ago, Jeffrey P. Smith, SFD's Chief Executive Officer, began to entertain suitors with an interest in acquiring SFD. At the time, and until the transactions at issue, Mr. Smith and his family held common and preferred stock constituting 62.1% voting control of SFD. Plaintiff and the class he purports to represent are holders of common stock in SFD.

On January 29, 1996, SFD entered into an agreement with The Yucaipa Companies ("Yucaipa"), a California partnership also active in the supermarket industry. Under the agreement, the following would take place:

- (1) Smitty's Supermarkets, Inc. ("Smitty's"), a wholly-owned subsidiary of Yucaipa that operated a supermarket chain in Arizona, was to merge into Cactus Acquisition, Inc. ("Cactus"), a subsidiary of SFD, in exchange for which SFD would deliver to Yucaipa slightly over 3 million newly-issued shares of SFD common stock;
- (2) SFD was to undertake a recapitalization, in the course of which SFD would assume a sizable amount of new debt, retire old debt, and offer to repurchase up to fifty percent of its outstanding shares (other than those issued to Yucaipa) for \$36 per share; and
- (3) SFD was to repurchase 3 million shares of preferred stock from Jeffrey Smith and his family.

SFD hired the investment firm of Houlihan Lokey Howard & Zukin ("Houlihan") to examine the transactions and render a solvency opinion. Houlihan eventually issued a report to the SFD Board replete with assurances that the transactions would not endanger SFD's solvency, and would not impair SFD's capital in violation of 8 Del.C. § 160. On May 17, 1996, in reliance on the Houlihan opinion, SFD's Board determined that there existed sufficient surplus to consummate the transactions, and enacted a resolution proclaiming as much. On May 23, 1996, SFD's stockholders voted to approve the transactions, which closed on that day. The self-tender

offer was over-subscribed, so SFD repurchased fully fifty per-cent of its shares at the offering price of \$36 per share.

....

Plaintiff's Capital-Impairment Claim

A corporation may not repurchase its shares if, in so doing, it would cause an impairment of capital, unless expressly authorized by Section 160. A repurchase impairs capital if the funds used in the repurchase exceed the amount of the corporation's "surplus," defined by 8 Del.C. § 154 to mean the excess of net assets over the par value of the corporation's issued stock.

Plaintiff asked the Court of Chancery to rescind the transactions in question as violative of Section 160. As we understand it, plaintiff's position breaks down into two analytically distinct arguments. First, he contends that SFD's balance sheets constitute conclusive evidence of capital impairment. He argues that the negative net worth that appeared on SFD's books following the repurchase compels us to find a violation of Section 160. Second, he suggests that even allowing the Board to "go behind the balance sheet" to calculate surplus does not save the transactions from violating Section 160. In connection with this claim, he attacks the SFD Board's off-balance-sheet method of calculating surplus on the theory that it does not adequately take into account all of SFD's assets and liabilities. Moreover, he argues that the May 17, 1996 resolution of the SFD Board conclusively refutes the Board's claim that revaluing the corporation's assets gives rise to the required surplus. We hold that each of these claims is without merit.

SFDs balance sheets do not establish a violation of 8 Del.C. § 160

In an April 25, 1996 proxy statement, the SFD Board released a pro forma balance sheet showing that the merger and self-tender offer would result in a deficit to surplus on SFD's books of more than \$100 million. A balance sheet the SFD Board issued shortly after the transactions confirmed this result. Plaintiff asks us to adopt an interpretation of 8 Del.C. § 160 whereby balance-sheet net worth is controlling for purposes of determining compliance with the statute. Defendants do not dispute that SFD's books showed a negative net worth in the wake of its transactions with Yucaipa, but argue that corporations should have the presumptive right to revalue assets and liabilities to comply with Section 160.

Plaintiff advances an erroneous interpretation of Section 160. We understand that the books of a corporation do not necessarily reflect the current values of its assets and liabilities. Among other factors, unrealized appreciation or depreciation can render book numbers inaccurate. It is unrealistic to hold that a corporation is bound by its balance sheets for purposes of determining compliance with Section 160. Accordingly, we adhere to the principles of *Morris v. Standard Gas & Electric Co.*, 63 A.2d 577 (Del. Ch. 1949), allowing corporations to revalue properly its assets and liabilities to show a surplus and thus conform to the statute.

It is helpful to recall the purpose behind Section 160. The General Assembly enacted the statute to prevent boards from draining corporations of assets to the detriment of creditors and the long-term health of the corporation. That a corporation has not yet realized or reflected on its balance sheet the appreciation of assets is irrelevant to this concern. Regardless of what a balance sheet that has not been updated may show, an actual, though unrealized, appreciation reflects real economic value that the corporation may borrow against or that creditors may claim or levy upon. Allowing corporations to revalue assets and liabilities to reflect current realities complies with the statute and serves well the policies behind this statute.

The SFD Board appropriately revalued corporate assets to comply with 8 Del.C. § 160.

On May 17, 1996, Houlihan released its solvency opinion to the SFD Board, expressing its judgment that the merger and self-tender offer would not impair SFD's capital. Houlihan reached this conclusion by comparing SFD's "Total Invested Capital" of \$1.8 billion . . . with SFD's long-term debt of \$1.46 billion. This comparison yielded an approximation of SFD's "concluded equity value" equal to \$346 million, a figure clearly in excess of the outstanding par value of SFD's stock. Thus, Houlihan concluded, the transactions would not violate 8 Del.C. § 160.

Plaintiff contends that Houlihan's analysis relied on inappropriate methods to mask a violation of Section 160. Noting that 8 Del.C. § 154 defines "net assets" as "the amount by which total assets exceeds total liabilities," plaintiff argues that Houlihan's analysis is erroneous as a matter of law because of its failure to calculate "total assets" and "total liabilities" as separate variables. . . .

We are satisfied that the Houlihan opinion adequately took into account all of SFD's assets and liabilities. Plaintiff points out that the \$1.46 billion figure that approximated SFD's long-term debt failed to include \$372 million in current liabilities, and argues that including the latter in the calculations dissipates the surplus. In fact, plaintiff has misunderstood Houlihan's methods. The record shows that Houlihan's calculation of SFD's Total Invested Capital is already net of current liabilities. Thus, subtracting long-term debt from Total Invested Capital does, in fact, yield an accurate measure of a corporation's net assets.

. . . .

The judgment of the Court of Chancery is affirmed.

PRE-INCORPORATION TRANSACTIONS & DEFECTIVE INCORPORATION

Restatement (Second) of Agency

§ 326 Principal Known to be Nonexistent or Incompetent

Unless otherwise agreed, a person who, in dealing with another, purports to act as agent for a principal whom both know to be nonexistent or wholly incompetent, becomes a party to such a contract.

Comment:

b. Promoters. The classic illustration of the rule stated in this Section is the promoter. When a promoter makes an agreement with another on behalf of a corporation to be formed, the following alternatives may represent the intent of the parties:

(1) They may understand that the other party is making a revocable offer to the nonexistent corporation which will result in a contract if the corporation is formed and accepts the offer prior to withdrawal. This is the normal understanding.

(2) They may understand that the other party is making an irrevocable offer for a limited time. Consideration to support the promise to keep the offer open can be found in an express or limited promise by the promoter to organize the corporation and use his best efforts to cause it to accept the offer.

(3) They may agree to a present contract by which the promoter is bound, but with an agreement that his liability terminates if the corporation is formed and manifests its willingness to become a party. There can be no ratification by the newly formed corporation, since it was not in existence when the agreement was made.

(4) They may agree to a present contract on which, even though the corporation becomes a party, the promoter remains liable either primarily or as surety for the performance of the corporation's obligation.

Which one of these possible alternatives, or variants thereof, is intended is a matter of interpretation on the facts of the individual case.

Restatement (Third) of Agency

§ 4.04 Capacity to Ratify

(1) A person may ratify an act if (a) the person existed at the time of the act, and (b) the person had capacity as defined in § 3.04 at the time of ratifying the act.

Comment:

c. Nonexistent principals, including corporations yet to be formed. Under the rule stated in subsection (1)(a), a person not in existence at the time of an act or transaction may not subsequently ratify it. Instead, a person may elect to become bound under such circumstances by adopting what was done prior to the person's existence. Adoption operates analogously to ratification because it requires assent or affirmance on the part of the ratifier. Unlike ratification, adoption does not have a relation-back effect. Additionally, an adoption, unlike a novation, does not itself release obligors from liabilities created by the original transaction.

This limit on ratification has a long lineage in disputes involving transactions made by promoters on behalf of corporations that have not yet been formed. Comparable questions may arise concerning promoters' transactions on behalf of not-yet-formed limited partnerships and limited-liability companies. A corporation should not be bound by the terms of a contract made prior to its existence until its own mechanisms of governance are in place and able to assess the merits of the transaction. A promoter's interests are often not identical to the interests of those who own equity in a corporation once it is formed.

Model Business Corporation Act

Official Comment to Section 2.04

Earlier versions of the Model Act, and the statutes of many states, have long provided that corporate existence begins only with the acceptance of articles of incorporation by the secretary of state. Many states also have statutes that provide expressly that those who prematurely act as or on behalf of a corporation are personally liable on all transactions entered into or liabilities incurred before incorporation. A review of recent case law indicates, however, that even in states with such statutes courts have continued to rely on common law concepts of de facto corporations, de jure corporations, and corporations by estoppel that provide uncertain protection against liability for preincorporation transactions. These cases caused a review of the underlying policies represented in earlier versions of the Model Act and the adoption of a slightly more flexible or relaxed standard.

Incorporation under modern statutes is so simple and inexpensive that a strong argument may be made that nothing short of filing articles of incorporation should create the privilege of limited liability. A number of situations have arisen, however, in which the protection of limited liability arguably should be recognized even though the simple incorporation process established by modern statutes has not been completed.

(1) The strongest factual pattern for immunizing participants from personal liability occurs in cases in which the participant honestly and reasonably but erroneously believed the articles had been filed. In *Cranson v. International Business Machines Corp.*, 234 Md. 477, 200 A.2d 33 (1964), for example, the defendant had been shown executed articles of incorporation some months earlier before investing in the corporation and becoming an officer and director. The defendant was also told by the corporation's attorney that the articles had been filed, but in

fact they had not been filed because of a mix-up in the attorney's office. The defendant was held not liable on the "corporate" obligation.

(2) Another class of cases, which is less compelling but in which the participants sometimes have escaped personal liability, involves the defendant who mails in articles of incorporation and then enters into a transaction in the corporate name; the letter is either delayed or the secretary of state's office refuses to file the articles after receiving them or returns them for correction. *E.g.*, *Cantor v. Sunshine Greenery, Inc.*, 165 N.J. Super. 411, 398 A.2d 571 (1979). Many state filing agencies adopt the practice of treating the date of receipt as the date of issuance of the certificate even though delays and the review process may result in the certificate being backdated. The finding of nonliability in cases of this second type can be considered an extension of this principle by treating the date of original mailing or original filing as the date of incorporation.

(3) A third class of cases in which the participants sometimes have escaped personal liability involves situations where the third person has urged immediate execution of the contract in the corporate name even though knowing that the other party has not taken any steps toward incorporating. *E.g.*, *Quaker Hill, Inc. v. Parr*, 148 Colo. 45, 364 P.2d 1056 (1961).

(4) In another class of cases the defendant has represented that a corporation exists and entered into a contract in the corporate name when the defendant knows that no corporation has been formed, either because no attempt has been made to file articles of incorporation or because he has already received rejected articles of incorporation from the filing agency. In these cases, the third person has dealt solely with the "corporation" and has not relied on the personal assets of the defendant. The imposition of personal liability in this class of case, it has sometimes been argued, gives the plaintiff more than originally bargained for. On the other hand, to recognize limited liability in this situation threatens to undermine the incorporation process, since one then may obtain limited liability by consistently conducting business in the corporate name. Most courts have imposed personal liability in this situation. *E.g.*, *Robertson v. Levy*, 197 A.2d 443 (D.C. App. 1964).

(5) A final class of cases involves inactive investors who provide funds to a promoter with the instruction, "Don't start doing business until you incorporate." After the promoter does start business without incorporating, attempts have been made, sometimes unsuccessfully, to hold the investors liable as partners. *E.g.*, *Frontier Refining Co. v. Kunkels, Inc.*, 407 P.2d 880 (Wyo. 1965). One case held that the language of section 146 of the 1969 Model Act ["persons who assume to act as a corporation are liable for preincorporation transactions"] creates a distinction between active and inactive participants, makes only the former liable as partners, and therefore relieves the latter of personal liability. Nevertheless, "active" participation was defined to include all investors who actively participate in the policy and operational decisions of the organization and is, therefore, a larger group than merely the persons who incurred the obligation in question on behalf of the "corporation." *Timberline Equipment Co. v. Davenport*, 267 Or. 64, 72-76, 514 P.2d 1109, 1113-14 (1973).

After a review of these situations, it seemed appropriate to impose liability only on persons who act as or on behalf of corporations “knowing” that no corporation exists. Analogous protection has long been accorded under the uniform limited partnership acts to limited partners who contribute capital to a partnership in the erroneous belief that a limited partnership certificate has been filed. Uniform Limited Partnership Act § 12 (1916); Revised Uniform Limited Partnership Act § 3.04 (1976). Persons protected under § 3.04 of the latter are persons who “erroneously but in good faith” believe that a limited partnership certificate has been filed. The language of section 2.04 has essentially the same meaning.

While no special provision is made in section 2.04, the section does not foreclose the possibility that persons who urge defendants to execute contracts in the corporate name knowing that no steps to incorporate have been taken may be estopped to impose personal liability on individual defendants. This estoppel may be based on the inequity perceived when persons, unwilling or reluctant to enter into a commitment under their own name, are persuaded to use the name of a nonexistent corporation, and then are sought to be held personally liable under section 2.04 by the party advocating that form of execution. By contrast, persons who knowingly participate in a business under a corporate name are jointly and severally liable on “corporate” obligations under section 2.04 and may not argue that plaintiffs are “estopped” from holding them personally liable because all transactions were conducted on a corporate basis.

LIMITED LIABILITY; PIERCING THE CORPORATE VEIL

WISCONSIN LAW

In Wisconsin, the leading decision on piercing the corporate veil is *Consumer’s Co-Op of Walworth County v. Olsen*, 419 N.W.2d 211 (Wis. 1988). Stressing that “the ‘legal fiction’ of a corporation is not one to be lightly disregarded remains the law in Wisconsin as well as in most other jurisdictions,” *id.* at 213, the court reversed a judgment holding the majority shareholder of ECO of Elkhorn, Inc. liable for corporate debts owed to the Co-op.

The Court’s opinion contains an extensive analysis of two factors in particular – inadequate capitalization and disregard of corporate formalities. In its view, both factors are significant to the determination whether shareholders can claim non-liability for corporate debts, but neither will independently justify piercing the veil. It premised that conclusion on the three-factor test for veil piercing, often referred to as the “instrumentality” test, which requires:

(1) Control, not mere majority or complete stock control, but complete domination, not only of finances but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; and

(2) Such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or dishonest and unjust act in contravention of plaintiff's legal rights; and

(3) The aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.*

Corporate Formalities

The Court saw the failure to follow corporate formalities as a factor bearing on the first prong of the test, even if control and domination could be established, personal liability would not result, absent a separate showing of injustice.

On the facts before it, the Court held that the creditor has failed to show “that corporate formalities were so egregiously ignored, or that control so pervasively exercised,” that the corporation’s separate existence should be disregarded:

In the case at bar, stock was issued, officers were elected, meetings of the board of directors were frequently held, and all business was undertaken in the corporate name. Moreover, there was no indication of improper commingling of personal and corporate assets. Those financial transactions between Chris Olsen and the corporation were approved, though informally, by the board of directors and were under-taken for the purpose of infusing, rather than improperly withdrawing, capital.

Id. at 219.

In concluding that it was of no particular significance that the meetings of ECO’s board of directors were informal, the court relied on Wisconsin’s statutory close corporation law. Wis. Stat. § 180.1835 provides:

Limited liability. The failure of a statutory close corporation to observe usual corporate formalities or requirements relating to the exercise of its corporate powers or the management of its business and affairs is not grounds for imposing personal liability on the shareholders for obligations of the corporation.

Although ECO had not elected to take statutory close corporation status, the Court observed that the purpose of section 180.1835 nonetheless applied. Further, all relevant facts of the case had

* *Id.* at 217-18. Although the court relied on the three-factor test in the text of its opinion, a footnote suggested that it saw no substantive difference between it and the rival two-factor test, often referred to as the “alter ego” doctrine:

A test which is essentially identical has been articulated as a two-prong test requiring: “(1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual [shareholders] no longer exist; and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow.” Barber, *supra* p. 6, at 376 (footnote omitted). This test, as does the instrumentality test articulated herein, entails essentially a “formalities requirement” and a “fairness requirement.” *Id.*

Id. at 218 n.5.

occurred before the law's effective date, so the corporation had no opportunity to amend its articles to take advantage of it.

Inadequate Capitalization

In the Court's analysis, inadequate capitalization was primarily significant under the three-factor test in determining whether control had been exercised in such a manner as to result in injustice. But injustice, taken alone, was insufficient – there must also be a showing of control and domination.

The Court held that inadequate capitalization was an element in the piercing analysis for both contract and tort cases. The shareholder had argued that because the case involved contractual debts, for which the Co-op had the opportunity to investigate ECO's capital structure and could have insisted upon a personal guarantee, undercapitalization should not be a factor absent additional proof of fraud. In response, the Court acknowledged that the volitional nature of contract claims creates a "cognizable distinction" between contract and tort claims. But it believed that the distinction between the two classes of claims was more appropriately addressed through application of the doctrines of estoppel and waiver, rather than a blanket rule that inadequate capitalization has no bearing in a contract case:

Stated otherwise, whether a contractual relationship is truly one in which a creditor had the opportunity to investigate the capital structure of a debtor and knowingly failed to exercise the right to investigate before extending credit, such that the creditor should be precluded from piercing the corporate veil, should be decided with respect to the particular facts of each case rather than by the denial to all contract creditors of resort to this equitable remedy by a presumption of an "assumption of risk."

Id. at 216-17.

The Court likewise rejected the creditor's argument that for purposes of the inadequate capitalization analysis, the corporation is under a continuing requirement to maintain an adequate level of capital. Relying upon *Gelatt v. DeDakis (In re Mader's)*, 254 N.W.2d 171 (Wis. 1977), the Court held that adequacy of capital is to be measured at the time the corporation is formed. So long as its initial capital is adequate, subsequent financial losses do not render the corporation undercapitalized for purposes of piercing the veil. Inquiry into the corporation's post-formation capitalization may be made "only in those circumstances where, as in *In re Mader's*, the corporation distinctly changes the nature or magnitude of its business." *Id.* at 219.

While the trial court had found that ECO was "undercapitalized," it did not indicate whether that finding was based on its initial capital rather than its financial condition at some later point. In the Supreme Court's judgment, ECO's initial capitalization of over \$7,000 "was not, and could not be reasonably viewed as, an obvious inadequacy of capital as measured by the slight size of the initial undertaking." *Id.* at 220-21. Further, the Court held that on the facts of the case, the doctrines of waiver and estoppel foreclosed the Co-op from arguing that any subsequent expansion of ECO's business required the contribution of additional capital. Specifically, the Co-op's willingness to continue extending credit to ECO for at least nine months

after the corporation fell behind in making its monthly payments precluded the Co-op from asserting that any later undercapitalization constituted an “injustice.”

SHAREHOLDER AGREEMENTS & ARRANGEMENTS FOR ALLOCATING CONTROL

Chez SinoZa Problem #5A

Now that they have decided to organize their business as a corporation, Arthur, Beverly and Charles have been discussing what roles each would play. They have agreed that each will serve on the board of directors. Beverly is to be elected President and Arthur Vice President., and both are to receive substantial salaries. But each is concerned that, should a dispute arise, he or she might be outvoted by the other two and removed from office.

They have talked about an arrangement that assures (1) each will remain on the board; (2) Arthur and Beverly continue to receive salaries; (3) Beverly will continue overseeing the business as a whole, but Arthur will retain authority over culinary issues; and (4) Charles retains the right to veto significant expenditures. Each has asked you, as her or his respective attorney, to negotiate a suitable arrangement and a mechanism for implementing it.

GEARING v. KELLY

11 N.Y.2d 201, 182 N.E.2d 391, 227 N.Y.S.2d 897

Court of Appeals of New York, 1962

PER CURIAM.

Appellants, who own 50% of the stock of the Radium Chemical Company, Inc., seek, within the provisions of section 25 of the General Corporation Law, Consol. Laws, c 23, to set aside the election of a director.

In a proceeding under that section, the court sits as a court of equity which may order a new election “as justice may require.” We have concluded, as did the majority of the Appellate Division, that appellants have failed to show that justice requires a new election, in that they may not now complain of an irregularity which they themselves have caused.

Mrs. Meacham stayed away from the meeting of March 6, 1961 for the sole purpose of preventing a quorum from assembling, and intended, in that manner, to paralyze the board. There can be no doubt, and indeed it is not even suggested, that she lacked notice or in any manner found it temporarily inconvenient to present herself at that particular time and place. It is certain, then, that Mrs. Meacham’s absence from the noticed meeting of the board was

intentional and deliberate. Much is said by appellants about a desire to protect their equal ownership of stock through equal representation on the board. It is, however, clear that such balance was voluntarily surrendered in 1955. Whether this was done in reliance on representations of Kelly, Sr., as alleged in the plenary suit, is properly a matter for that litigation, rather than the summary type of action here.

The relief sought by appellants, the ordering of a new election, would, furthermore, be of no avail to them, for Mrs. Meacham would then be required, as evidence of her good faith, to attend. Such a futile act will not be ordered

The identity of interests of the appellants is readily apparent. Mrs. Gearing has fully indorsed and supported all of the demands and actions of her daughter, and has associated herself with the refusal to attend the directors' meeting. A court of equity need not permit Mrs. Gearing to attack actions of the board of directors which were marred through conduct of the director whom she has actively encouraged. To do so would allow a director to refuse to attend meetings, knowing that thereafter an associated stockholder could frustrate corporate action until all of their joint demands were met.

The failure of Mrs. Meacham to attend the directors' meeting, under the present circumstances, bars appellants from invoking an exercise of the equitable powers lodged in the courts under the statute. . . .

The order appealed from should be affirmed, with costs.

FROESSEL, Judge (dissenting).

The by laws of Radium Chemical Company, Inc., provided for a board of four directors, a majority of whom "shall constitute a quorum for the transaction of business." Prior to 1955 the board consisted of appellant Meacham, who had succeeded her father (appellant Gearing's late husband), respondent Kelly, Sr., and Margaret E. Lee. In 1955 Kelly, Jr., was elected to the then vacant directorship. The board continued thus until Margaret Lee offered her resignation in 1961 and, on March 6 of that year, at a meeting of the board of directors at which she and the two Kellys were present, her resignation was accepted. Thereupon the two Kellys elected Julian Hemphill, a son in law of Kelly, Sr., to replace Margaret Lee.

I agree with Justice Eager, who dissented in the Appellate Division, that two members of the board were insufficient to constitute a quorum in this case for the purpose of electing the new director. It necessarily follows that the election of Julian Hemphill is not merely irregular, as the majority hold, but is wholly void and must be set aside.

Section 25 of the General Corporation Law grants to the court two alternatives in a case such as this: (1) to confirm the election, or (2) to order a new election as justice may require As we held in the case just cited, the clause "as justice may require" does not enlarge the court's power nor authorize it to grant different relief from that specified in the statute. There is no basis whatever here for the application of the doctrine of estoppel, and in no event could it reasonably be applied to the non director, appellant Gearing, a substantial stockholder in this corporation. The purported election is, therefore, a nullity.

This is a mere contest for control, and the court should not assist either side, each of which holds an equal interest in the corporation, particularly where, as here, petitioners were willing that director Meacham attend meetings for the purpose of transacting all the necessary business of the board, but were unwilling that she attend a meeting, the purpose of which was to strip them of every vestige of control. Appellant Meacham had surrendered nothing in 1955 when she permitted Kelly, Jr., to become a director as well as his father, Margaret Lee was then a third director.

The statute mandates a new election and that should be ordered. It is no answer to say that the results will probably be the same. If the parties are deadlocked, whether as directors or stockholders, and choose to remain that way, they have other remedies, and I see no reason why we should help one side or the other by disregarding a by law that follows the statute (General Corporation Law, § 27), particularly when it results in giving the Kelly complete control of the corporation.

I would, therefore, reverse the order appealed from, and modify the order of Special Term by ordering a special election and affirming it in all other respects.

Notes and Questions

1. Suppose Radium Chemical Co. had been incorporated in a Model Act jurisdiction. How would MBCA § 8.10 affect the outcome?

Chez SinoZa Problem #5B

Arthur, Beverly and Charles have been thinking about what would happen if Arthur or Beverly were to leave Chez SinoZa for another job, or if any one of the three were to die or wish to sell his or her shares to an outside. They have asked you and the lawyers for the other two shareholders to look into the issue and propose an arrangement that is fair to all.

WISCONSIN LAW

Contrast the result in *Ingle v. Glamore Motor Sales, Inc.*, with *Jensen v. Christensen & Lee Insurance, Inc.*, 460 N.W.2d 441 (Wis. Ct. App. 1990). Jensen was an employee of Christensen & Lee for twenty years and its top insurance salesman. He also had a substantial minority share interest in the company and was a director. In December 1988, the other directors voted to terminate Jensen's employment and removed him from the board one month later, which together triggered the buyout of his shares under the company's stock retirement and deferred compensation agreements.

Jensen alleged that the reason for his termination was to allow the company to pay a lower price for his stock than if his employment had continued until 1991, his normal retirement

age. Although rejecting Jensen's claim for wrongful discharge from his employment, the court held that he had adequately pleaded a claim that the defendants breached their fiduciary duty to him as a minority shareholder. The court added that the "defendants' argument that the agreements provide for discharge as a legitimate triggering mechanism for the company's purchase of stock may be a proper issue in later proceedings," but was "not controlling to whether this complaint states a valid claim for relief under the [Wisconsin Business Corporation Law]." *Id* at 443-44.

SHAREHOLDER DISPUTES & REMEDIES

DIRECT OR DERIVATIVE?

Consider the nature of a minority shareholder's claim that the controlling shareholders have paid themselves excessive salaries or received other benefits not shared by the minority. Who, specifically, is the injured party? Is it the corporation, because corporate funds were wrongfully expended? Or is it the minority shareholder, because he or she did not receive a proportionate share?

If it is the corporation, then only the corporation can bring suit on the claim, and any recovery on the claim belongs to it, not the shareholders. Recognizing that those in control of the corporation are unlikely to bring a corporate suit against themselves, the law allows a minority shareholder, under certain circumstances to file a *derivative* claim on the corporation's behalf. But the minority shareholder suing on a derivative basis faces several procedural obstacles that would not exist if suing on his or her own behalf. The plaintiff must first make a demand on the corporation's board of directors and afford it an opportunity to rectify the wrong. In Delaware, demand may be excused if the shareholder can show it would be futile in light of the directors' conflict of interest. Under the Model Act, in contrast, demand is required in all cases. *See* MBCA § 7.42. Following the demand, the corporation's independent directors can seek dismissal of the suit if they conclude it is not in the corporation's best interests.

For this reason, the determination of whether a claim belongs to the corporation or to the individual shareholder – referred to as a *direct* or *individual* claim to distinguish it from a derivative claim – will often have significant bearing on the minority shareholder's ability to recover. One of the important implications of holding that the shareholders of a closely held corporation owe partner-like fiduciary duties to one another is therefore a procedural one – to facilitate the complaining shareholder's right to sue on an individual basis.

JORGENSEN v. WATER WORKS, INC.

630 N.W.2d 230

Court of Appeals of Wisconsin, 2001

ROGGENSACK, J.

Because we conclude, based on the facts found by the circuit court, that the individual defendants breached their fiduciary duties as directors of Water Works, Inc. by violating the shareholder-rights of Duane and Sharon Jorgensen, which caused an injury that was primarily personal to them, we reverse and remand for further proceedings consistent with this opinion.

BACKGROUND

The plaintiffs, Duane and Sharon Jorgensen, are shareholders in Water Works, a corporation that owns and operates a car washing facility in Wisconsin Rapids. The individual defendants, James Barber, Doreen Barber, Gary Tesch and Mary Tesch, are the remaining shareholders in the corporation. They are also the directors and officers of Water Works. Since its inception in 1988, Water Works has elected to be taxed under subchapter S of the Internal Revenue Code.

Initially, the business venture got off to a good start. Each shareholder was issued an equal number of shares in the corporation, and each was a director and an officer, with Duane being elected president. Each received regular payments from Water Works. Those payments increased in size and frequency as Water Works became profitable. Each year, Water Works filed a federal tax return using IRS form 1120S, which passed through all corporate income and losses to the six shareholders in equal amounts.

Disagreements among the shareholders arose in 1996, causing Duane to resign and Sharon to be removed as officers and directors. The weekly payments they had been receiving from Water Works also ceased, but Doreen, James, Gary and Mary continued to receive their regular payments. Duane and Sharon then sued the other shareholders alleging they had breached the fiduciary duty which they, as directors, owed to the Jorgensens as Water Works shareholders.

[The circuit court] held a two-day trial and found that the defendants had not proved that the fees they were paying themselves from Water Works were reasonable for the services they had rendered to the corporation. The court also found that it was “obvious that the salaries and the payment of salaries is related to profits [of the corporation].” The court found that because there was “no differentiation between directors’ salaries – or, at least, there hasn’t been since 1996 – suggests that salaries aren’t being paid on the basis of work done as compensation for work done.” The court further found that there was no demonstration that Sharon’s removal from the board of directors was based on her conduct, and that her dismissal meant a loss of the

Water Works' fees the Jorgensens had previously received. Based on those findings, the circuit court concluded that "your conduct was in breach of your fiduciary duty."

. . . Because it believed the Jorgensens had no individual right to require the corporation to pay dividends and that the cash flow payments to the defendants could affect the future payment of dividends, the court concluded that the challenge to those payments had to be brought as a derivative action. . . .

DISCUSSION

Breach of Fiduciary Duty.

On appeal, Duane and Sharon claim that the circuit court erred in concluding that their claim for improper distributions from Water Works must be brought as a derivative action rather than as an individual claim. They seek reversal and remand for further proceedings.

A corporation's directors owe individual shareholders a fiduciary duty to act in good faith and to deal fairly with them. That duty requires that directors not "use their position of trust to further their private interests." *Rose v. Schantz*, 56 Wis.2d 222, 228, 201 N.W.2d 593, 597 (1972). Whether a claim must be brought derivatively or may be brought individually depends upon whether the injury alleged is primarily to the complaining shareholder or primarily to the corporation. As the supreme court explained in *Rose*, "[W]here some individual right of a stockholder is being impaired by the improper acts of a director, the stockholder can bring a direct suit on his own behalf because it is his individual right that is being violated." *Rose*, 56 Wis.2d at 228-29, 201 N.W.2d at 597.

As we evaluate whether the Water Works' payments to the defendants after discontinuing payments to the Jorgensens are primarily injuries to Duane and Sharon personally, we note that Water Works is a subchapter S corporation. Subchapter S of the Internal Revenue Code, 26 U.S.C. §§ 1361-1379. A subchapter S corporation uses a pass-through taxation system where, generally, corporate income, losses, deductions and credits are attributed to the individual shareholders on a pro rata basis, similar to the tax treatment of a partnership. Each shareholder is required to report, as taxable income, his or her share of the corporation's pass-through income, even if he or she does not receive corporate payments . . .

The record reflects that Water Works filed IRS forms 1120S as a subchapter S corporation for all the years in question. In 1997 and again in 1998, Water Works paid the four defendants \$16,900 each as "officers' compensation." The circuit court found that these payments were not based on work performed for the corporation but instead were distributions related to profits of Water Works. Neither Duane nor Sharon received officer's or director's compensation or salaries of any type in 1997 and 1998, although both had received them annually before being removed as officers and directors.

Each shareholder has a right to be treated fairly by the directors. . . . An injury due to a director's action is primarily an injury to an individual shareholder if it affects a shareholder's rights in a manner distinct from the effect upon other shareholders.

Here, the circuit court found that the defendants' removal of Sharon from her position as an officer and director was not based on anything she did to cause it. The court also found that her dismissal resulted in the discontinuance of the officer's compensation and fees she had received previously.

Additionally, when they stopped paying Sharon and Duane the *pro rata* distribution from Water Works' cash flow while they continued to pay themselves regular distributions, they treated Duane and Sharon differently, and inequitably, when compared with the treatment accorded all other shareholders. . . . Accordingly, we conclude that the individual defendants breached Duane's and Sharon's right to be treated in the same way as the other shareholders and in so doing they inflicted a harm on them that other shareholders did not suffer. Therefore, we reverse the dismissal of the Jorgensens' claim for breach of fiduciary duty, and we remand for further proceedings consistent with this opinion.

STATUTORY DISSOLUTION IN WISCONSIN

In *Jorgensen v. Water Works, Inc.*, 582 N.W.2d 98, 107 (Wis. Ct. App. 1998), the court discussed the appropriate test for "oppressive conduct" under Wisconsin's version of MBCA § 14.30:

The definition of "oppressive conduct" generally employed for the purpose of such a statute is: "burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of the company to the prejudice of some of its members; or a visual departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely." *Baker v. Commercial Body Builders, Inc.*, 264 Or. 614, 507 P.2d 387, 393, (1973). We adopt this definition, adding the following observations. This definition is intended to be broad and flexible, rather than narrow. *Fix v. Fix Material Co.*, 538 S.W.2d 351, 358 (Mo. Ct. App. 1976). In the context of a close corporation, oppressive conduct of those in control is closely related to breach of the fiduciary duty owed to minority stockholders. *Baker*, 507 P.2d at 394; *Fix*, 538 S.W.2d at 358.¹⁰

¹⁰ "Oppression" has also been analyzed as the "frustration of the reasonable expectations of the shareholders." See *Gimpel v. Bolstein*, 125 Misc. 2d 45, 477 N.Y.S.2d 1014, 1018 (N.Y. Sup. Ct. 1984); *Landstrom v. Shaver*, 561 N.W.2d 1, 8 (S.D. 1997). This test has the virtue of focusing on the particular context, and therefore, on the specific problems of a close corporation relationship, see Robert B. Thompson, *The Shareholders Cause of Action for Oppression*, Vol 48, THE BUSINESS LAWYER 699, 712-13 (1993). However, it is not appropriate in every situation, such as when the shareholders have recently acquired shares in a pre-existing corporation. See *Gimpel*, 477 N.Y.S.2d at 1019.

We view the broad “burdensome, harsh and wrongful conduct” definition we have adopted as including consideration of the frustration of the reasonable expectations of shareholders, when that is appropriate.

LIMITED LIABILITY COMPANIES

DURAY DEVELOPMENT, LLC v. PERRIN

792 N.W.2d 749

Court of Appeals of Michigan, 2010

PER CURIAM.

In this breach of contract action, defendant Carl Perrin appeals . . . judgment following a bench trial in which the trial court found that Perrin was in breach of contract and owed damages to plaintiff, Duray Development, LLC, in the amount of \$96,637.68. The judgment did not find defendants Perrin Excavating, LLC, or Outlaw Excavating, LLC, in breach of contract, so neither of those defendants are parties to this appeal.

We find no plain error in the trial court’s failure to raise sua sponte the issue of corporation by estoppel. However, we reverse the judgment of the trial court that the de facto corporation doctrine cannot apply to limited liability companies Accordingly, we remand for further proceedings in accordance with this opinion.

I. BASIC FACTS AND PROCEDURAL HISTORY

Duray Development is a residential development company whose sole member is Robert Munger. . . . In 2004, Duray Development purchased 40 acres of undeveloped property called “Copper Corners”

On September 30, 2004, Duray Development entered into a contract with Perrin, Perrin Excavating, and KDM Excavating for excavating at Copper Corners. In that contract, Munger signed on Duray Development’s behalf, Perrin signed on behalf of himself and Perrin Excavating, and Dan Vining signed on behalf of KDM Excavating.

On October 27, 2004, Duray Development and Perrin entered into a new contract, intended to supersede the September 30, 2004 contract. The new contract contained the same language and provisions as the earlier contract. However, the new contract was between Duray Development and Outlaw only, and Perrin, Perrin Excavating, and KDM Excavating were not parties. Outlaw was an excavation company that Perrin and Vining had recently formed. Perrin and Vining signed the new contract on behalf of Outlaw, and both held themselves out to Duray Development as the owners and persons in charge of the company. . . .

Two contracts were drafted because Perrin had not yet formed Outlaw at the time of the first contract. However, Duray Development did not want to wait for Perrin to finish forming the company before starting the excavation of Copper Corners. Therefore, the parties entered

into the first contract on September 30, 2004, and then entered into the second contract once the parties thought Outlaw was a valid limited liability company.

Defendants began excavation and grading work pursuant to the contracts, but did not perform satisfactorily or on time. Duray Development then sued defendants for breach of contract. . . . Duray Development later learned through discovery that Outlaw did not obtain a “filed” status as a limited liability company until November 29, 2004, and therefore Outlaw was not a valid limited liability company at the time the parties executed the second contract.

Duray Development filed an amended complaint After trial, the trial court ruled in favor of Duray Development, finding that Perrin was in breach of contract and owed \$96,367.68 in damages to Duray Development.

II. PERRIN’S PERSONAL LIABILITY

B. THE LIMITED LIABILITY COMPANY ACT

The Limited Liability Company Act provides precisely when a limited liability company comes into existence. MCL 450.4202(2) provides that “[t]he existence of the limited liability company begins on the effective date of the articles of organization as provided in [MCL 450.4104].”

Once a limited liability company comes into existence, limited liability applies, and a member or manager is not liable for the acts, debts, or obligations of the company. In contrast, a person who signs a contract on behalf of a company that is not yet in existence generally becomes personally liable on that contract. However, a company can become liable if, (1) after the company comes into existence, it either ratifies or adopts that contract, (2) a court determines that a de facto corporation existed at the time of the contract, or (3) a court orders that corporation by estoppel prevented the opposing party from arguing against the existence of a corporation.

C. DE FACTO CORPORATION AND CORPORATION BY ESTOPPEL

De facto corporation and corporation by estoppel are separate and distinct doctrines that warrant individual treatment. The de facto corporation doctrine provides that a defectively formed corporation – that is, one that fails to meet the technical requirements for forming a de jure corporation – may attain the legal status of a de facto corporation if certain requirements are met, as discussed later in this opinion. The most important aspect of a de facto corporation is that courts perceive and treat it in all respects as if it were a properly formed de jure corporation. For example, it can sue and be sued. Often, as in this case, the status of the company is crucial to determine whether the parties forming the corporation are individually liable.

Corporation by estoppel, on the other hand, is an equitable remedy and does not concern legal status. The general rule is: “Where a body assumes to be a corporation and acts under a particular name, a third party dealing with it under such assumed name is estopped to deny its

corporate existence.” Like the de facto corporation doctrine, corporation by estoppel often arises in the context of assessing individual versus corporate liability. . . .

D. THE DE FACTO CORPORATION DOCTRINE

The Michigan Supreme Court established the four elements for a de facto corporation long ago: “When incorporators have [1] proceeded in good faith, [2] under a valid statute, [3] for an authorized purpose, and [4] have executed and acknowledged articles of association pursuant to that purpose, a corporation de facto instantly comes into being.[24] A de facto corporation is an actual corporation. As to all the world, except the State, it enjoys the status and powers of a de jure corporation.”

The trial court, however, concluded that the de facto corporation doctrine does not apply to limited liability companies and therefore did not apply to Outlaw. It reasoned that the plain reading of the Limited Liability Company Act “clearly and specifically provides for the time that a limited liability company comes into existence and has powers to contract.” The trial court then cited a passage from a legal treatise, which states “[t]he de facto corporation doctrine and, presumably, a possible de facto [limited liability company] doctrine are apparently dead in Michigan, having been replaced by the Business Corporation Act, MCL 450.1221, and the [Limited Liability Company Act], MCL 450.4202.” Thus, the trial court concluded that the Legislature had “clearly spoken on this subject” and did not extend the de facto corporation doctrine to limited liability companies.

Neither this Court nor the Supreme Court has addressed whether the de facto corporation doctrine can be extended or applied to a limited liability company. That is not to say, however, that the doctrine cannot be applied to a limited liability company. The 1911 case of *Newcomb-Endicott Co.* is similar to the facts here and suggests that the plain language of the Limited Liability Company Act and the Business Corporation Act should not supplant the de facto corporation doctrine.

Indeed, the similarities between the Business Corporation Act and the Limited Liability Company Act support the conclusion that the de facto corporation doctrine applies to both. The purposes for forming a limited liability company and a corporation are similar. Notably, the Limited Liability Company Act states, “A limited liability company may be formed under this act for any lawful purpose for which a domestic corporation or a domestic partnership could be formed, except as otherwise provided by law.” Further, both the Limited Liability Company Act and the Business Corporation Act contemplate the moment in time when a limited liability company or corporation comes into existence. Because the Business Corporation Act and the Limited Liability Company Act relate to the common purpose of forming a business and because both statutes contemplate the moment of existence for each, they should be interpreted in a consistent manner.

Accordingly, we conclude that the de facto corporation doctrine applies to Outlaw, a limited liability company. As a result, Outlaw, and not Perrin, individually, is liable for the breach of the October 27, 2004 contract.

E. CORPORATION BY ESTOPPEL

As with the doctrine of de facto corporation, this Court has not addressed whether corporation by estoppel can be applied to limited liability companies. However, corporation by estoppel is an equitable remedy, and its purpose is to prevent one who contracts with a corporation from later denying its existence in order to hold the individual officers or partners liable.

With this in mind, and in light of the purpose of corporation by estoppel, the corporate structure has little impact on the equitable principles at stake. In other words, there is no reason or purpose to draw a distinction on the basis of corporate form. Furthermore, like de facto corporation, because corporation by estoppel coexists with the Business Corporation Act, so too can it coexist with the Limited Liability Company Act.

Moreover, here, the record clearly supports a finding of “limited liability company by estoppel” through the extension of the corporation by estoppel doctrine. Perrin was an individual party to the first contract, as was his limited liability company, Perrin Excavating. However, only Outlaw became a party to the second contract, which superseded the first. And all parties dealt with the second contract as though Outlaw were a party. After the second contract, Duray Development received billings from Outlaw, and not from Perrin. Duray Development also received a certificate of liability insurance for Outlaw. Munger testified that he dealt with Perrin, Perrin Excavating, and KDM Excavating before the second contract and only dealt with Outlaw after. Duray Development continued to assume Outlaw was a valid limited liability company after filing the lawsuit and only learned of the filing and contract discrepancies once litigation began in July 2006.

However, we cannot find plain error requiring reversal on the doctrine of limited liability company by estoppel. Perrin did not raise the issue in the trial court, and the trial court did not err by not raising it for him. . . . Accordingly, we conclude that no plain error occurred requiring reversal on this issue.

LIABILITY FOR LLC OBLIGATIONS

NETJETS AVIATION, INC. v. LHC COMMUNICATIONS, LLC

537 F.3d 168

U.S. Court of Appeals, Second Circuit, 2008

KEARSE, Circuit Judge:

[Plaintiffs NetJets Aviation, Inc., and NetJets Sales, Inc. (collectively “NetJets”), appeal from so that part of a summary judgment that dismissed their claims against defendant LHC Communications, LLC (“LHC”), for breach of contract and their claims against defendant Laurence S. Zimmerman, as LHC’s alter ego, for breach of contract and account stated.]

I. BACKGROUND

NetJets is engaged in the business of leasing fractional interests in airplanes and providing related air-travel services. LHC is a Delaware limited liability company whose sole member-owner is Zimmerman. Most of the facts with respect to the relationship between NetJets and LHC are not in dispute.

A. The Contracts Between NetJets and LHC

On August 1, 1999, LHC entered into two contracts with NetJets. In the first (the “Lease Agreement”), NetJets leased to LHC a 12.5 percent interest in an airplane, for which LHC was to pay NetJets a fixed monthly rental fee. The lease term was five years, with LHC having a qualified right of early termination. The second contract (the “Management Agreement”) required NetJets to manage LHC’s interest in the leased airplane and to provide services such as maintenance and piloting with respect to that airplane The Management Agreement allotted to LHC use of the airplane for an average of 100 hours per year for the five-year term of the lease (“LHC air hours”)

In July 2000, LHC terminated its agreements with NetJets. LHC’s chief financial officer (“CFO”) James P. Whittier sent a letter, addressed to a NetJets vice president, stating, in pertinent part, that “[t]he present outstanding is \$440,840.39 and we are requesting that you apply the deposit of \$100,000 against the outstanding and contact this office to resolve the balance.” (“LHC Termination Letter”).

As requested, NetJets contacted LHC and applied the \$100,000 deposit against LHC’s debt; however, it did not receive payment of the remaining balance of \$340,840.39. In 2001, LHC ceased operations.

B. The Present Action and the Decision of the District Court

NetJets commenced the present diversity action in 2002, asserting claims against LHC and Zimmerman for breach of contract, account stated, and unjust enrichment. In connection with the breach-of-contract claims, NetJets requested an award of attorneys’ fees.

Following a period of discovery, NetJets moved for summary judgment against both defendants on the breach-of-contract and account-stated claims. NetJets contended that Zimmerman should be held liable for the debts of LHC as its alter ego based on evidence, described in greater detail in Part II.B. below, of, inter alia, (a) the frequent use of LHC air hours for personal travel by Zimmerman and his friends and family, (b) the frequent transfers of funds between LHC and Zimmerman’s other companies, (c) Zimmerman’s frequent withdrawal of funds from LHC for his own personal use, and (d) the fact that LHC is no longer in business and has no assets with which to pay its debt to NetJets, a condition that NetJets contends was caused by Zimmerman’s withdrawals.

[In a Memorandum and Order dated June 12, 2006, the district court granted NetJets’s summary judgment motion in part, awarding it \$340,840.39 against LHC on the account-stated claims, but denied NetJets’s motion for summary judgment on its claims against Zimmerman.]

It stated that under Delaware law, in order to recover against Zimmerman for the debts of LHC, NetJets would be required to meet a two-pronged test showing “(1) that the business entity and its owner ‘operated as a single economic entity’ and (2) that [there was] an ‘overall element of injustice or unfairness.’” The court concluded that although NetJets had “shown that Zimmerman and LHC functioned as a single economic unit,” NetJets had not “set forth any facts from which a jury could reasonably conclude that Zimmerman formed LHC with the specific fraudulent intent of evading liability to Plaintiffs.” . . .

II. DISCUSSION

B. NetJets’s Claims Against Zimmerman

1. Limitations on Limited Liability

. . . The shareholders of a corporation and the members of an LLC generally are not liable for the debts of the entity, and a plaintiff seeking to persuade a Delaware court to disregard the corporate structure faces “a difficult task,” *Harco National Insurance Co. v. Green Farms, Inc.*, No. CIV. A. 1331, 1989 WL 110537, at *4 (Del. Ch. Sept. 19, 1989) (“*Harco*”).

Nonetheless, in appropriate circumstances, the distinction between the entity and its owner “may be disregarded” to require an owner to answer for the entity’s debts. In general, with respect to the limited liability of owners of a corporation, Delaware law permits a court to pierce the corporate veil “where there is fraud or where [the corporation] is in fact a mere instrumentality or alter ego of its owner.”

To prevail under the alter-ego theory of piercing the veil, a plaintiff need not prove that there was actual fraud but must show a mingling of the operations of the entity and its owner plus an “overall element of injustice or unfairness.”

[A]n alter ego analysis must start with an examination of factors which reveal how the corporation operates and the particular defendant’s relationship to that operation. These factors include whether the corporation was adequately capitalized for the corporate undertaking; whether the corporation was solvent; whether dividends were paid, corporate records kept, officers and directors functioned properly, and other corporate formalities were observed; whether the dominant shareholder siphoned corporate funds; and whether, in general, the corporation simply functioned as a facade for the dominant shareholder.

Harco, 1989 WL 110537, at *4. . . .

Our Court has stated this as a two-pronged test focusing on (1) whether the entities in question operated as a single economic entity, and (2) whether there was an overall element of injustice or unfairness.

These principles are generally applicable as well where one of the entities in question is an LLC rather than a corporation. In the alter-ego analysis of an LLC, somewhat less emphasis is placed on whether the LLC observed internal formalities because fewer such formalities are legally required. *See, e.g.*, Delaware Limited Liability Company Act, Del.Code Ann. tit. 6, § 18–

101 et seq. (“DLLCA”) (requiring little more than that an LLC execute and file a proper certificate of formation, *see id.* § 18–201(a), maintain a registered office in Delaware, *see id.* § 18–104(a)(1), have a registered agent for service of process in Delaware, *see id.* § 18–104(a)(2), and maintain certain records such as membership lists and tax returns, *see id.* § 18–305(a)). On the other hand, if two entities with common ownership “failed to follow legal formalities when contracting with each other it would be tantamount to declaring that they are indeed one in the same.”

3. The Evidence that LHC and Zimmerman Operated as One

With respect to the question of whether LHC and Zimmerman operated as a single entity, the record contains, *inter alia*, financial records of LHC and deposition testimony from Zimmerman and LHC’s CFO, Whittier. The evidence discussed below, taken in the light most favorable to NetJets, shows, *inter alia*, that LHC, of which Zimmerman is the sole member-owner, was started with a capitalization of no more than \$20,100; that LHC proceeded to invest millions of dollars supplied by Zimmerman, including some \$22 million in an internet technology company eventually called Bazillion, Inc. (“Bazillion”); and that Zimmerman put money into LHC as LHC needed it, and took money out of LHC as Zimmerman needed it.

Zimmerman formed LHC in 1998; for most of its operating life, it shared office space with some of Zimmerman’s other companies; LHC employed no more than five-to-seven people at any given time; and some of its employees worked for both LHC and Zimmerman’s other companies or for LHC and Zimmerman personally. Whittier ran much of LHC’s day-to-day operations based on instructions, general or specific, received from Zimmerman.

Zimmerman formed LHC “to be used as an investment vehicle for Mr. Zimmerman for him to make investments.” “With regards to investments, Mr. Zimmerman reviewed investments. If he decided to go forward after his review, he would make an investment through [LHC] to an investment corporation he wanted to invest in.” Although Zimmerman sought Whittier’s advice as to the best way of accomplishing something he had decided he wanted to do, the ultimate decisions were always made by Zimmerman. “There were no decisions, financial decisions, made with regard to LHC without Mr. Zimmerman’s approval.” [Quotations are from Whittier’s deposition.]

In connection with Zimmerman’s personal business, LHC’s records show numerous transfers of money by Zimmerman to LHC, as well as numerous transfers of money from LHC to Zimmerman. Some of the transfers by Zimmerman to LHC were for the purpose of having LHC make investments, principally in Bazillion. Other transfers by Zimmerman to LHC were made for the purpose of meeting LHC’s operating expenses

Whittier testified that Zimmerman would transfer funds to LHC “as needed.” Often those funds would come from Zimmerman’s personal bank accounts. However, because Zimmerman generally waited until the eleventh hour to provide money to meet LHC’s operating needs, sometimes “shortcuts” were taken by having the money come to LHC directly from one of Zimmerman’s other companies

Whittier testified also that “[m]onies would go ... out of LHC based on the need.” For example, Zimmerman would take money out of LHC to “mak[e] an investment in another entity” [or to make payments to several brokerage firms, at which Zimmerman had personal accounts that were unrelated to LHC’s operations.

LHC also transferred money to Zimmerman, or to third persons on his behalf, in connection with his living expenses. For example, LHC made payments to Fox Lair, a Zimmerman corporation that owned a \$15 million New York apartment on Park Avenue, which was characterized by Zimmerman as “a corporate residence” but was used by no one other than Zimmerman and his family. Fox Lair needed money “to pay phone bills and cleaning people and things of that nature;” according to LHC’s ledgers, from December 5, 2000, through July 2, 2001, Fox Lair received some \$70,000 from LHC. In addition, LHC made periodic payments to the Screen Actors Guild (of which Zimmerman’s wife was a member) for health insurance for Zimmerman and his family; LHC purchased a Bentley automobile at a cost of approximately \$350,000 for Zimmerman’s personal use, placing title in his name (see Zimmerman Dep. I, at 68–69); and LHC made a payment of \$110,000, characterized in its general ledger as “Loan receivable” and in its check register as “Interest Expense,” to a person who had no connection with LHC but who held a mortgage on a property owned by Zimmerman personally.

In addition, many of the air hours to which LHC was entitled under its agreements with NetJets were used by Zimmerman personally. Of the 40-odd LHC flights invoiced by NetJets, Zimmerman acknowledges that “approximately 6” were for vacations for himself and/or his wife. But in addition to those six, there were at least an equal number of flights that apparently had no relation to LHC’s business. These flights included several that transported Zimmerman’s family to and from Europe or to and from one of Zimmerman’s five homes. Zimmerman contends that use of LHC air hours for these purposes was “part of [his compensation] package” and “[o]ne of the perks of being the chairman. That may be; but for purposes of determining whether Zimmerman and LHC were alter egos, it is pertinent that Zimmerman made all of LHC’s financial decisions; Zimmerman alone decided what his perks and package would be.

In LHC’s general ledger, each of the transfers of money between LHC and Zimmerman – in either direction – is labeled “Loan receivable.” They were also so labeled regardless of whether Zimmerman’s payment to LHC was to be used to make an investment or was to be used for operating expenses. Whittier, who had responsibility for LHC’s financial records, testified that the ledger treated Zimmerman’s payments to and withdrawals from LHC as loans and loan repayments in order to allow Zimmerman to make withdrawals as he needed money, without having to pay taxes on the moneys withdrawn. Thus, aside from Zimmerman’s initial capital contribution to LHC (which Whittier thought was \$100), “any monies that Mr. Zimmerman . . . deposited into LHC should have been designated as loans” The decision that those transactions would be labeled loans or loan repayments was made by Zimmerman.

In all, LHC’s financial records for the period January 1, 2000, through June 18, 2002, show – in addition to some two dozen transactions between LHC and Zimmerman’s other companies – approximately 60 transfers of money directly from Zimmerman to LHC and approximately 60 transfers of money out of LHC directly to Zimmerman. In sum, there is evidence that, *inter alia*, Zimmerman created LHC to be one of his personal investment

vehicles; that he was the sole decisionmaker with respect to LHC's financial actions; that Zimmerman frequently put money into LHC as LHC needed it to meet operating expenses; that LHC used some of that money, as well as some moneys it received from selling shares of one of its assets, to pay more than \$4.5 million to third persons for Zimmerman's personal expenses including margin calls, mortgage payments, apartment expenses, and automobiles; and that with no written agreements or documentation or procedures in place, Zimmerman directly, on the average of twice a month for 2 ½ years, took money out of LHC at will in order to make other investments or to meet his other personal expenses. This evidence is ample to permit a reasonable factfinder to find that Zimmerman completely dominated LHC and that he essentially treated LHC's bank account as one of his pockets, into which he reached when he needed or desired funds for his personal use. Accordingly, we reject Zimmerman's contention that the district court should have granted summary judgment in his favor on the ground that he and LHC did not operate as a single economic entity.

4. The Evidence of Fraud, Illegality, or Injustice

The district court ruled that NetJets had not adduced sufficient evidence to show that there was any fraud or unfairness in Zimmerman's operation of LHC because the court believed it could not consider, with regard to that issue, any of the factors that showed that Zimmerman and LHC operated as a single entity. In so ruling, the court stated that "[t]o hold otherwise would render the fraud or injustice element meaningless. . . ." (quoting *Mobil Oil Corp. v. Linear Films, Inc.*, 718 F. Supp. 260, 268 (D. Del. 1989)). *Mobil Oil*, however, did not suggest that there can be no overlap in the proof as to unity of ownership and the proof of unfairness. Rather, it stands for the proposition that the claimed injustice must consist of more than merely the tort or breach of contract that is the basis of the plaintiff's lawsuit. . . . But nothing prevents a court, in determining whether there is sufficient evidence of fraud or unfairness, from taking into account relevant evidence that is also pertinent to the question of whether the two entities in question functioned as one.

Much of the evidence described in Part II.B.3. above, along with other evidence discussed below, reveals that NetJets adduced sufficient evidence of fraud, illegality, or unfairness to warrant a trial on its contract and account-stated claims against Zimmerman as LHC's alter ego. For example, in an effort to parry NetJets's contention that LHC was undercapitalized, Zimmerman submitted an affidavit from LHC's accountant stating that "it was not intended by Zimmerman to treat the monies paid into LHC as loans" and that all of Zimmerman's payments into LHC were in fact capital contributions. Yet, as discussed above, Whittier testified that Zimmerman instructed him that those payments were to be characterized as loans, in order to allow Zimmerman to take money out of LHC at will and to do so without tax consequences.

[It would appear that, if his payments to LHC were capital contributions as the affidavit opines], LHC's payments to Zimmerman would be properly characterized as distributions. Yet the DLLCA provides generally, with some qualifications, that an LLC "shall not make a distribution to a member to the extent that at the time of the distribution, after giving effect to the distribution, all liabilities of the limited liability company . . . exceed the fair value of the assets of the limited liability company." Del. Code tit. 6, § 18-607(a). Given that LHC ceased

operating and was unable to pay its debt to NetJets, if Zimmerman’s withdrawals left LHC in that condition those withdrawals may well have been prohibited by § 18-607(a). A factfinder could infer that Zimmerman’s payments to LHC were deliberately mischaracterized as loans in order to mask the fact that Zimmerman was making withdrawals from LHC that were forbidden by law, and could thereby properly find fraud or an unfair siphoning of LHC’s assets.

The record also includes other evidence from which a reasonable factfinder could find that Zimmerman operated LHC in his own self-interest in a manner that unfairly disregarded the rights of LHC’s creditors. For example, it could find

- that although LHC was apparently unable in 2000 to pay its \$340,840.39 (net of LHC’s deposit) debt to NetJets, in that year LHC bought, and gave Zimmerman title to, a Bentley automobile for \$350,210.95;
- that LHC’s only paying client for its consulting services began paying LHC for those services in July 2000 (the month in which LHC terminated its agreements with NetJets), sending LHC a first payment of approximately \$675,000 on July 9, and that on that day Zimmerman withdrew that amount and more from LHC;
- that from the point at which LHC terminated its relationship with NetJets in July 2000 until the end of 2001 – the year in which NetJets ceased operations – LHC’s records of its transactions directly with Zimmerman indicate that Zimmerman withdrew from LHC approximately \$750,000 more than he put in;
- and that, excluding moneys put into LHC solely for its investments in Bazillion, the total amount of money taken out of LHC by Zimmerman and his other companies appears to exceed the amount that he and those companies put into LHC by some \$3 million.

From this record, a reasonable factfinder could properly find that there was an overall element of injustice in Zimmerman’s operation of LHC. Summary judgment should not have been entered dismissing NetJets’s breach-of-contract and account-stated claims against Zimmerman.

Notes and Questions

1. As a policy matter, should the test for piercing and LLC’s veil be the same as that applicable to corporations? Do you agree with the court’s analysis of this issue?
2. Is the court’s application of the second step of the “alter ego” test consistent with the Seventh Circuit’s decision in *Sea-Land Services*?
3. How do the limitations on a member’s right to withdraw money from an LLC compare to the Model Act and Delaware rules governing distributions to shareholders? In addition to Delaware section 18-607(a), quoted in the opinion, consider ULLCA § 406.

4. What was LHC's initial "capital"? Why did Zimmerman seek to characterize his subsequent transfers of funds to LHC as loans rather than capital contributions?

5. Loans by members or shareholders to an undercapitalized LLC or corporation are vulnerable to challenge through a variety of remedies, especially in bankruptcy proceedings. *Recharacterization* treats the loans as equity rather than debt; *equitable subordination*, in contrast, recognizes the loans as valid debt claims, but allows them to be paid only after all other creditor claims have been satisfied. From the standpoint of the shareholder or LLC member, how do these remedies compare to veil-piercing?

6. What is the reason for ULLCA § 406(d)?

FIDUCIARY OBLIGATION

Delaware Limited Liability Company Act

§ 18-1101. Construction and application of chapter and limited liability company agreement

(a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

(b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

(c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or

eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

GATZ PROPERTIES, LLC v. AURIGA CAPITAL CORP.

59 A.3d 1206

Supreme Court of Delaware, 2012

PER CURIAM:

In resolving this dispute between the controlling member-manager and the minority investors of a Delaware Limited Liability Company (“LLC”), we interpret the LLC’s governing instrument (the “LLC Agreement”) as a contract that adopts the equitable standard of entire fairness in a conflict of interest transaction between the LLC and its manager. We hold that the manager violated that contracted-for fiduciary duty by refusing to negotiate with a third-party bidder and then, by causing the company to be sold to himself at an unfair price in a flawed auction that the manager himself engineered. For that breach of duty the manager is liable. Because the manager acted in bad faith and made willful misrepresentations, the LLC Agreement does not afford him exculpation. We AFFIRM the damages award solely on contractual grounds. We also AFFIRM the court’s award of attorneys’ fees.

I. FACTUAL AND PROCEDURAL HISTORY

In 1997, Gatz Properties, LLC and Auriga Capital Corp., together with other minority investors, formed Peconic Bay, LLC, a Delaware limited liability company (“Peconic Bay”). That entity was formed to hold a long-term lease and to develop a golf course on property located on Long Island that the Gatz family had owned since the 1950s.

The instrument that governed Peconic Bay was the Amended and Restated Limited Liability Company Agreement (the “LLC Agreement”). The Gatz family and their affiliates controlled over 85% of the Class A membership interests, and over 52% of the Class B membership interests of Peconic Bay. The LLC Agreement requires that 95% of all cash distributions first be made to the Class B members until they recoup their investment. Thereafter, the cash distributions are to be made to all members pro rata.

The LLC Agreement designated Gatz Properties as manager. Gatz Properties was managed and controlled by William Gatz (“Gatz”), who also managed, controlled, and partially owned Gatz Properties. The LLC Agreement precluded the manager from making certain major decisions without the prior approval of 66 2/3% of the Class A and 51% of the Class B membership interests. The Gatz family owned the requisite percentages of those membership interests. As a consequence, the family had a veto power over any decision to (among other things) sell Peconic Bay, to enter into a long-term sublease with a golf course operator or permit Peconic Bay to operate the course itself.

Beginning January 1, 1998, Gatz Properties leased the family property to Peconic Bay under a Ground Lease that ran for an initial 40-year term, with an option to renew for two ten-year extensions. The Ground Lease limited the property's use to a high-end, daily fee, public golf course. . . .

On March 31, 1998, Peconic Bay entered into a sublease (the "Sublease") with American Golf Corp., a national golf course operator. The Sublease ran for a term of 35 years, but granted American Golf an early termination right after the tenth year of operation. . . .

The golf course's operations were never profitable. Both sides characterized American Golf as a "demoralized operator" that neglected maintenance items to the extent that the poor condition of the course adversely affected revenue. By at least 2005, Gatz knew that American Golf would elect to terminate the Sublease in 2010. Anticipating that, in 2007 Gatz commissioned an appraisal that valued the land with the golf course improvements at \$10.1 million, but at a value 50% higher – \$15 million – as vacant land available for development. By mid-2009, again in anticipation of the sublease's termination, Gatz Properties had set aside almost \$1.6 million in cash under Section 11 of the LLC Agreement, which authorized the manager to retain distributions reasonably necessary to meet present or future obligations.

In August 2007, Matthew Galvin, on behalf of RDC Golf Group, Inc. ("RDC"), contacted Gatz and expressed an interest in acquiring Peconic Bay's long-term lease. . . .

On January 22, 2008, Galvin proposed a "Forward Lease" whereby RDC would take over the Sublease from American Golf if American Golf exercised its 2010 early termination option. RDC would maintain the Sublease's noneconomic features, but would renegotiate the rent terms. Again, Gatz made no response. The reason is that Gatz himself wanted to acquire the Sublease and Peconic Bay's other assets.

The proof is that one week earlier, on January 14, 2008, Gatz had written to Peconic Bay's minority investors and offered to purchase their interests for a "cash price equal to the amount which would be distributed for those interests as if [Peconic Bay's] assets sold for a cash price of \$5.6 million as of today." . . . What Gatz did not tell the minority investors was that Galvin had expressed an interest in negotiating an offer "north of \$6 million," and that Gatz had never responded. As his "bottom line," Gatz offered the minority members \$734,131, conditioned on their unanimous acceptance.

All but one of the minority members rejected that offer. . . .

On December 8, 2008, Gatz formally proposed to sell Peconic Bay at auction and informed the minority members that Gatz Properties intended to bid. Exercising their majority voting power, the Gatz family and their affiliates approved Gatz's auction proposal. By this point, Peconic Bay had almost \$1.4 million in cash reserves and debt service of about \$520,000 per year.

Assisted by [Blank Rome LLP, his legal counsel], Gatz next hired an auctioneer in February 2009. Although Gatz claimed to have considered three different auction firms, he hired Richard Maltz of Maltz Auctions, Inc. (“Maltz”). Maltz specialized in “debt related” sales and conducted the majority of its work in connection with bankruptcy court proceedings, but had never auctioned off a golf course. . . .

On August 18, 2009, the day of the auction, Maltz informed Gatz that he (Gatz) would be the only bidder. Gatz then proceeded to bid and then to purchase Peconic Bay for \$50,000 cash plus assumption of the LLC’s debt. The minority members collectively received \$20,985. Maltz received \$80,000 for his services. At trial Gatz admitted that “had there been another bidder at the Auction, he ‘might have bid higher’ than \$50,000.”

In 2010, Auriga and the remaining LLC minority members brought this Court of Chancery action for money damages. After a trial, the court ruled in favor of Auriga, holding that Gatz had breached “both his contractual and fiduciary duties” to Peconic Bay’s minority members. The court awarded damages of \$776,515 calculated as of January 1, 2008, plus pre-judgment interest at the statutory rate, compounded monthly. The court also awarded the minority members one half of their requested attorneys’ fees and costs. This appeal by Gatz followed.

III. ANALYSIS

A. Did Gatz Owe Fiduciary Duties To The Other Members Of Peconic Bay?

The pivotal legal issue presented on this appeal is whether Gatz owed contractually-agreed-to fiduciary duties to Peconic Bay and its minority investors. Resolving that issue requires us to interpret Section 15 of the LLC Agreement, which both sides agree is controlling. Section 15 pertinently provides that:

Neither the Manager nor any other Member shall be entitled to cause the Company to enter into any amendment of any of the Initial Affiliate Agreements which would increase the amounts paid by the Company pursuant thereto, or enter into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66-2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).

The Court of Chancery determined that Section 15 imposed fiduciary duties in transactions between the LLC and affiliated persons. We agree. To impose fiduciary standards of conduct as a contractual matter, there is no requirement in Delaware that an LLC agreement use magic words, such as “entire fairness” or “fiduciary duties.” Indeed, Section 15 nowhere expressly uses either of those terms. Even so, we construe its operative language as an explicit contractual assumption by the contracting parties of an obligation subjecting the manager and

other members to obtain a fair price for the LLC in transactions between the LLC and affiliated persons. Viewed functionally, the quoted language is the contractual equivalent of the entire fairness equitable standard of conduct and judicial review.

We conclude that Section 15 of the LLC Agreement, by its plain language, contractually adopts the fiduciary duty standard of entire fairness, and the “fair price” obligation which inheres in that standard. Section 15 imposes that standard in cases where an LLC manager causes the LLC to engage in a conflicted transaction with an affiliate without the approval of a majority of the minority members. There having been no majority-of-the-minority approving vote in this case, the burden of establishing the fairness of the transaction fell upon Gatz. That burden Gatz could easily have avoided. If (counterfactually) Gatz had conditioned the transaction upon the approval of an informed majority of the nonaffiliated members, the sale of Peconic Bay would not have been subject to, or reviewed under, the contracted-for entire fairness standard.

....

We therefore uphold the Court of Chancery’s determination that Gatz breached his contractually adopted fiduciary duties to the minority members of Peconic Bay. Although the trial court reached that conclusion after first having determined that Delaware’s LLC statute imposed “default” fiduciary duties – a conclusion that we address elsewhere in this Opinion – we affirm the court’s holding that Gatz was subject to fiduciary duties and that he breached them. We do that exclusively on contractual grounds, however.

Entire fairness review normally encompasses two prongs, fair dealing and fair price. . . .

The trial judge found facts, solidly grounded in the record, that firmly support his conclusion that Gatz breached his contracted-for duty to the LLC’s minority members. Regarding price, the court found that “Peconic Bay was worth more than what Gatz paid.” . . .

The court also found as fact that had “Gatz dealt with Galvin with integrity in 2007, it seems probable that Peconic Bay could have been sold in a way that generated to the Minority Members a full return of their invested capital (\$725,000) plus a 10% aggregate return (\$72,500).” In reaching that result, the court relied on the fact that Gatz had rebuffed Galvin’s interest in discussing a deal “well north of \$6 million.” The court also found persuasive Galvin’s explanation of why, under the circumstances, an over \$6 million price was justifiable.

As for fair dealing, the Court of Chancery did not “view the Auction process as generating a price indicative of what Peconic Bay would fetch in a true arms-length negotiation.” Indeed, the court found, the Auction was a “sham,” “the culmination of Gatz’s bad faith efforts to squeeze out the Minority Members.” . . .

C. Unnecessary Construction Of LLC Statute To Provide Default Fiduciary Duties

At this point, we pause to comment on one issue that the trial court should not have reached or decided. We refer to the court's pronouncement that the Delaware Limited Liability Company Act imposes "default" fiduciary duties upon LLC managers and controllers unless the parties to the LLC Agreement contract that such duties shall not apply. Where, as here, the dispute over whether fiduciary standards apply could be decided solely by reference to the LLC Agreement, it was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default fiduciary duty issue as a matter of statutory construction. The trial court did so despite expressly acknowledging that the existence of fiduciary duties under the LLC Agreement was "no longer contested by the parties." For the reasons next discussed, that court's statutory pronouncements must be regarded as dictum without any precedential value.

First, the Peconic Bay LLC Agreement explicitly and specifically addressed the "fiduciary duty issue" in Section 15, which controls this dispute. . . .

[Also], the merits of the issue whether the LLC statute does – or does not – impose default fiduciary duties is one about which reasonable minds could differ. Indeed, reasonable minds arguably could conclude that the statute – which begins with the phrase, "[t]o the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties)"⁶⁹ – is consciously ambiguous. That possibility suggests that the "organs of the Bar" (to use the trial court's phrase) may be well advised to consider urging the General Assembly to resolve any statutory ambiguity on this issue.⁷⁰

⁶⁹ 6 Del. C. § 18-1101(c) (emphasis added).

⁷⁰ The trial court's statutory view may have been influenced by its misreading of two cases, *Cantor Fitzgerald, L.P. v. Cantor*, 2000 WL 307370 (Del. Ch. Mar. 13, 2000) and *William Penn Partnership v. Saliba*, 13 A.3d 749 (Del. 2011). The trial judge regarded *Cantor Fitzgerald* as supportive of the proposition that the "manager of an LLC has more than an arms-length, contractual relationship with the members of the LLC." *Auriga*, 40 A.3d at 850-51, 851 n. 38. To the extent that reading interprets *Cantor Fitzgerald* as recognizing default statutory fiduciary duties, it is inaccurate. In *Cantor Fitzgerald*, the Court of Chancery found that, based on specific provisions in the partnership agreement, the limited partners could not "credibly argue that they [had] not knowingly and willingly accepted the obligation of a fiduciary duty of loyalty," and that it made sense to conclude that the parties intentionally bargained for that provision in light of the partnership's unique business. *Cantor Fitzgerald*, 2000 WL 307370, at *22. The *Cantor Fitzgerald* court clarified that the duty of loyalty expressly adopted in the partnership agreement required "no dependency upon a default concept to a narrow definition derived from corporate common law," and that in interpreting the partnership agreement, the "scope of the duties owed by the parties must be determined by reference to the nature of this particular business enterprise." *Id.* (emphasis added, citation omitted).

The trial court also interpreted our decision in *Saliba* as holding that traditional fiduciary duties exist unless the contracting parties expressly modify or eliminate them in their operating agreement. *Auriga*, 40 A.3d at 854, 855 n.65 (citing *Saliba*, 13 A.3d at 756). That misreads *Saliba's* holding. In *Saliba* our task was to interpret the intent of the parties as expressed in their operating agreement. There, the parties agreed that under the operating agreement, fiduciary duties applied. *Saliba*, 13 A.3d at 756 ("[T]he parties here agree that the Lingos [as managers] owe fiduciary duties of loyalty and care to the members of Del Bay."). In that circumstance, we do not look behind their in-court representations. See *Stroud v. Grace*, 606 A.2d 75, 87 n. 2 (Del.1992) ("Plaintiffs do not specifically contest this aspect of the Vice Chancellor's ruling on appeal and effectively waive that claim."). Similarly, where, as here, the LLC Agreement expressly imposes a contractual obligation of entire fairness, it is unnecessary to look beyond the contract language to determine whether default fiduciary duties exist as a matter of statutory law.

....

IV. CONCLUSION

For the foregoing reasons, the judgment of the Court of Chancery is AFFIRMED.

Notes & Questions

1. Following the *Gatz* decision, the Delaware legislature amended § 18-1104 of the LLC statute to add the italicized words below.

In any case not provided for in this chapter, the rules of law and equity, including *the rules of law and equity relating to fiduciary duties and* the law merchant, shall govern.

LIMITED LIABILITY PARTNERSHIPS & PROFESSIONAL CORPORATIONS

DOW v. JONES

311 F. Supp. 2d 461

United States District Court, District of Maryland, 2004

BLAKE, District Judge.

Now pending before the court is a motion for summary judgment filed by the defendant, Seals Jones Wilson Garrow & Evans, L.L.P., against the plaintiff, Jeffrey Dow. . . . For the reasons stated below, the motion for summary judgment will be denied.

BACKGROUND

This case involves claims of legal malpractice arising from the representation of the plaintiff, Jeffrey Dow (“Dow”), in a criminal trial in Maryland state court.

On October 3, 1996, Dow was charged with various criminal offenses in the Circuit Court for Wicomico County, Maryland, arising from an alleged sexual assault of a minor. At the time, Dow was a radio disc jockey and a candidate for mayor of Berlin, Maryland. . . . On November 15, 1996, Dow and his wife met at the Washington, D.C. office of the law firm Seals Jones Wilson Garrow & Evans, L.L.P. (“SJWGE”) with two partners, James Benny Jones (“Jones”) and Robert Wilson. Dow states that Jones agreed at that meeting to represent Dow, on behalf of himself and the firm SJWGE. On January 15, 1997, Dow paid a \$1,000.00 retainer to Jones and executed a criminal retainer agreement, agreeing to pay a flat fee of \$12,500.00 for the representation. The retainer agreement is printed on SJWGE letterhead, and states that Dow

agrees “to retain the legal services of Attorney James Benny Jones to provide representation” in his pending criminal case.

. . . Dow states that the defendants “conducted only a cursory, one day investigation” and failed to interview key defense witnesses. According to Dow, Jones . . . also failed to move for a change of venue despite substantial pretrial publicity, did not question potential jurors about this pretrial publicity, did not object to the presentation of inadmissible testimony at his trial, and failed to call available defense witnesses, including alibi witnesses.

Dow was tried before a jury on July 30 and 31, 1997, and was found guilty of second degree sex offense, third degree sex offense, and perverted sexual practice. Dow was sentenced to 15 years of imprisonment, all but seven years suspended, and 36 months of supervised probation. . . . In March 1999, Dow filed a petition for post-conviction relief, alleging ineffective assistance of counsel at his criminal trial. On March 6, 2000, the Circuit Court for Wicomico County vacated Dow's convictions and granted a new trial. On November 26, 2001 the Circuit Court for Wicomico County entered a *nolle prosequi* in the pending criminal case against Dow.

SJWGE was organized as a registered limited liability partnership (“LLP”) in the District of Columbia in May 1994. Dow states that the five named partners of SJWGE held themselves out to the public generally, and to Dow specifically, as partners operating a law firm under the name of Seals Jones Wilson Garrow & Evans, L.L.P. On June 27, 1997, approximately one month before Dow’s criminal trial, SJWGE received a certificate from the District of Columbia government formally canceling the firm’s status as a limited liability partnership. The firm states that SJWGE actually had dissolved as of May 1, 1997. Dow states that he was not notified and was not aware of SJWGE’s dissolution, or that Jones might not have the authority to act for SJWGE, or that Jones might not be a partner of SJWGE.

ANALYSIS

SJWGE denies that the firm was a party to the retainer agreement executed with Dow in March 1997, and argues that the firm never formed an attorney-client relationship with Dow. [SJWGE argues] that the firm cannot be held liable because it had dissolved at the time of the alleged malpractice. Dow responds that general principles of agency and partnership law govern registered LLPs under District of Columbia law, that Jones’s alleged actions are binding on the firm pursuant to these general legal principles, and that the firm’s dissolution did not automatically terminate its liability to Dow.

A.

In general partnerships, all partners are jointly and severally liable for all debts and obligations of the partnership, including any wrongful acts or omissions by another partner. By registering with the state, paying a fee, and carrying a specified amount of liability insurance, registered LLPs are granted a special statutory shield which limits the liability of individual partners for the misconduct of other partners. *See* Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax & Business Law* §§ 15.01(1), 15.02(3)(b),(e) (2004). This does

not relieve partners who are personally culpable of their individual liability to third parties, and partnership assets also remain available to satisfy third-party claims. *See id.* §§ 15.02(1),(3).

SJWGE was formed under the Registered Limited Liability Partnership Amendment Act of 1993 (“RLLPAA”), which was adopted by the District of Columbia to amend provisions of the Uniform Partnership Act of 1962 (“UPA”). The law provides for the registration and naming of LLPs, and requires registered LLPs to carry liability insurance. Importantly, the RLLPAA limits the liability of individual partners in registered LLPs:

A partner in a registered limited liability partnership is not individually liable for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed in the course of the partnership business by a second partner or a representative of the partnership not working under the supervision or direction of the first partner at the time the errors, omissions, negligence, incompetence, or malfeasance occurred.

Exceptions are provided if a partner was directly involved in or had written notice or knowledge of the specific conduct at issue. In addition, these provisions do not limit “the liability of partnership assets for partnership debts and obligations.” The RLLPAA also specifies that the liability of partners in an LLP properly registered in the District of Columbia for the debts and obligations of the LLP “shall at all time be determined solely and exclusively” by the provisions of the District of Columbia's UPA.

B.

The malpractice claims against SJWGE rely on Dow’s subjective belief that an attorney-client relationship had been formed between the firm and himself, based on representations allegedly made by Jones and SJWGE itself. . . . SJWGE admits that a subjective analysis would govern under general partnership law, but argues that general partnership law is inapplicable to registered LLPs, and notes that no provision in the RLLPAA specifically provides for partnership liability for the acts of partners. If SJWGE were correct, then Dow’s subjective beliefs that he was represented by SJWGE would be irrelevant.

This argument fails, however, because general principles of agency and partnership law continue to govern registered LLPs. The RLLPAA provides that, “[u]nless otherwise specifically provided by other provisions of this chapter, the registered limited liability partnership shall be subject to all the provisions of this chapter,” referring to the provisions governing general partnerships under the District of Columbia’s UPA. . . .

Pursuant to the provisions of the UPA, as in effect in the District of Columbia in 1997, every partner of an LLP has the power to bind the partnership as an agent:

[Text of UPA § 9(1)]

. . . Under these provisions and basic principles of agency law, a partner of an LLP who is acting within the actual or apparent authority of the partnership can bind the partnership to an agreement with a third party. . . . For example, if a law firm publicly represents that a person is a partner, and a third party actually and reasonably relies on this representation, then that person has apparent authority to perform all acts that a partner in a law firm ordinarily would.⁷

. . . .

Dow has raised genuine issues of material fact as to whether Jones had apparent authority to enter into a retainer agreement on behalf of SJWGE, as a partner of the firm. SJWGE listed Jones as a partner in its application for a limited liability partnership and included his last name and the designation of “partnership” in the firm’s operating name. SJWGE does not dispute Dow’s assertions that he met with Jones and another partner of SJWGE at the firm’s office in November 1996 “to discuss the firm’s representation of me,” and that Jones agreed at that meeting to represent Dow “on behalf of himself and SJWGE.” . . .

C.

SJWGE next argues that the firm cannot be held liable for Jones’s alleged malpractice, because the firm had dissolved as of May 1, 1997, several months prior to Dow’s criminal trial. Without citing any authority, SJWGE argues that the UPA provisions regarding the dissolution of general partnerships should not apply to registered LLPs. SJWGE’s argument fails for many of the reasons stated above. SJWGE’s premise that the UPA provisions governing dissolution of general partnerships do not apply to registered LLPs is incorrect.

Under the governing UPA provisions, an LLP does not terminate immediately upon dissolution, but instead “continues until the winding up of partnership affairs is completed.” After dissolution a partner still can bind the partnership “by any act appropriate for winding up partnership affairs or completing transactions unfinished at dissolution.” [UPA § 35(1)(a)] A partner also can bind the partnership after dissolution:

[Text of UPA § 35(1)(b)(II)]

In some cases, it may be appropriate to impose liability for legal malpractice claims arising after dissolution because the conduct at issue is appropriate for winding up the law partnership. A number of courts have held that cases that are pending at the time of a law firm’s dissolution are matters that must be wound up. Applying this reasoning and the UPA provisions regarding partnership liability during the winding-up period, a former partner’s malpractice which occurs after dissolution but in a case that was pending prior to dissolution still can bind a dissolved law firm partnership, because the former partner’s conduct is appropriate for winding

⁷ This does not require a showing that Dow was familiar with the extent of powers that a partner in a law firm ordinarily would possess. *See* Restatement (Second) of Agency § 27 cmt. d. (“Thus, a manager has apparent authority to do those things which managers in that business at that time and place customarily do, as to persons who know that he is a manager, although they do not know what powers managers in such businesses have.”).

up partnership affairs. In other cases, courts may apply the UPA rule cited above on notice of dissolution to impose liability for post-dissolution malpractice by a former partner, if the client previously had dealt with the partnership and had no knowledge of the partnership's dissolution.

SJWGE correctly states that the partnership's liability for Jones's malpractice depends on the state of partnership affairs at the time of the alleged malpractice, in July 1997. Even if the partnership had dissolved as of July 1997, SJWGE nonetheless may be liable for Jones's malpractice under two different theories. First, Dow can argue that his representation was a pending client matter that had to be wound up following the dissolution of the partnership. Jones's conduct in representing Dow in July 1997 thus would be appropriate for winding up partnership affairs, and binding on the partnership under [UPA § 35(1)(a)]. Second, Dow can argue that Jones's power to bind the partnership under ordinary agency and partnership law, as described *supra*, continued after the firm's dissolution with respect to Dow, because Dow did not receive proper notice of SJWGE's dissolution. Dow alleges that he never received notice or otherwise became aware of SJWGE's dissolution, and there is no evidence in the record that SJWGE provided any public notice of its dissolution. Jones's conduct in representing Dow, which would have bound the partnership if dissolution had not taken place, thus continued to bind the partnership under [UPA § 35(1)(b)(II)]. Dow has presented sufficient evidence to raise genuine factual issues under either of these two theories as to SJWGE's continuing liability after the firm's dissolution for Jones's alleged malpractice.

D.

Finally, SJWGE argues that Dow's lawsuit is a thinly-disguised attempt to circumvent the statutory shield under the RLLPAA and hold the individual partners of SJWGE liable for another partner's misconduct. SJWGE asserts, and Dow apparently does not dispute, that the firm has no assets that can be attached or levied to satisfy any judgment against the firm. SJWGE argues that the only purpose that could be served by winning a judgment against the firm would be to provide grounds for piercing the veil of the former LLP and pursuing the assets of the individual partners. However, the parties' filings suggest an alternative and legitimate purpose that may be served by winning a judgment against SJWGE. Under the RLLPAA, the firm was required to maintain a liability insurance policy of at least \$100,000 to cover "the kind of errors, omissions, negligence, incompetence, or malfeasance" for which the liability of the individual partners is limited. Although SJWGE states that its insurance policy did not cover matters handled by Jones outside of the scope of the LLP, which SJWGE asserts would include Dow's case, this argument assumes the answer to the issues in dispute. Dow is entitled to pursue a judgment against SJWGE and then to pursue any available relief under the firm's insurance policy.

ORDER

For the reasons stated in the accompanying Memorandum, it is hereby Ordered that:

1. defendant Seals Jones Wilson Garrow & Evans, L.L.P.'s motion for summary judgment is DENIED; and

2. copies of this Order and the accompanying Memorandum shall be sent to counsel of record.

Wisconsin Rules of Professional Conduct for Attorneys

Rule 5.7 Limited Liability Legal Practice

(a)(1) A lawyer may be a member of a law firm that is organized as a limited liability organization solely to render professional legal services under the laws of this state, including chs. 178 and 183 and subch. XIX of ch. 180. The lawyer may practice in or as a limited liability organization if the lawyer is otherwise licensed to practice law in this state and the organization is registered under sub. (b).

(2) Nothing in this rule or the laws under which the lawyer or law firm is organized shall relieve a lawyer from personal liability for any acts, errors or omissions of the lawyer arising out of the performance of professional services.

(b) A lawyer or law firm that is organized as a limited liability organization shall file an annual registration with the state bar of Wisconsin in a form and with a filing fee that shall be determined by the state bar. The annual registration shall be signed by a lawyer who is licensed to practice law in this state and who holds an ownership interest in the organization seeking to register under this rule. The annual registration shall include all of the following:

....

(4) A certificate of insurance issued by an insurance carrier certifying that it has issued to the organization a professional liability policy to the organization as provided in sub. (bm).

(bm) The professional liability policy under sub. (b)(4) shall identify the name of the professional liability carrier, the policy number, the expiration date and the limits and deductible. Such professional liability insurance shall provide not less than the following limits of liability:

(1) For a firm composed of 1 to 3 lawyers, \$100,000 of combined indemnity and defense cost coverage per claim, with a \$300,000 aggregate combined indemnity and defense cost coverage amount per policy period.

(2) For a firm composed of 4 to 6 lawyers, \$250,000 of combined indemnity and defense cost coverage per claim, with \$750,000 aggregate combined indemnity and defense cost coverage amount per policy period.

(3) For a firm composed of 7 to 14 lawyers, \$500,000 of combined indemnity and defense cost coverage per claim, with \$1,000,000 aggregate combined indemnity and defense cost coverage amount per policy period.

(4) For a firm composed of 15 to 30 lawyers, \$1,000,000 of combined indemnity and defense cost coverage per claim, with \$2,000,000 aggregate combined indemnity and defense cost coverage amount per policy period.

(5) For a firm composed of 31 to 50 lawyers, \$4,000,000 of combined indemnity and defense cost coverage per claim, with \$4,000,000 aggregate combined indemnity and defense cost coverage amount per policy period.

(6) For a firm composed of 51 or more lawyers, \$10,000,000 of combined indemnity and defense cost coverage per claim, with \$10,000,000 aggregate combined indemnity and defense cost coverage amount per policy period.

(c) Nothing in this rule or the laws under which a lawyer or law firm is organized shall diminish a lawyer's or law firm's obligations or responsibilities under any provisions of this chapter.

Wisconsin Business Corporation Law

180.1903 Formation of service corporation.

(1) Except as provided in sub. (1m), one or more natural persons licensed, certified, or registered pursuant to any provisions of the statutes, if all have the same license, certificate, or registration or if all are health care professionals, may organize and own shares in a service corporation. A service corporation may own, operate, and maintain an establishment and otherwise serve the convenience of its shareholders in carrying on the particular profession, calling, or trade for which the licensure, certification, or registration of its organizers is required.

(1m) A service corporation for carrying on the profession of certified public accounting may be organized under sub. (1) if more than 50% of the shareholders are certified public accountants.

(2) Professional or other personal services, consultation or advice in any form may be rendered only by directors, officers, agents or employees of the service corporation who are licensed, certified or registered pursuant to statute in the field of endeavor designated in the articles of incorporation of the service corporation.

180.1915 Professional relationships and liability.

Except as provided in this section, ss. 180.1901 to 180.1921 do not alter any contract, tort or other legal relationship between a person receiving professional services and one or more persons who are licensed, certified or registered to render those professional services and who are shareholders, directors, officers or employees in the same service corporation. A shareholder, director, officer or employee of a service corporation is not personally liable for the debts or other contractual obligations of the service corporation nor for the omissions, negligence, wrongful acts, misconduct and malpractice of any person who is not under his or her actual supervision and control in the specific activity in which the omissions, negligence, wrongful acts, misconduct and malpractice occurred. A service corporation may charge for the services of its shareholders, directors, officers, employees or agents, may collect such charges and may compensate those who render such personal services. Nothing in this section shall affect any of the following:

(1) The liability of a service corporation for the omissions, negligence, wrongful acts, misconduct and malpractice of a shareholder, director, officer or employee while the person, on behalf of the service corporation, provides professional services.

(2) The personal liability of a shareholder, director, officer or employee of a service corporation for his or her own omissions, negligence, wrongful acts, misconduct and malpractice and for the omissions, negligence, wrongful acts, misconduct and malpractice of any person acting under his or her actual supervision and control in the specific activity in which the omissions, negligence, wrongful acts, misconduct and malpractice occurred.

APPENDIX

PARTNERSHIP AGREEMENT

APPLE COMPUTER COMPANY

APPLE COMPUTER COMPANY
PARTNERSHIP AGREEMENT

TO WHOM IT MAY CONCERN:

WHEREAS, Mr. Stephen G. Wozniak (hereinafter referred to as WOZNIAK), Mr. Steven P. Jobs (hereinafter referred to as JOBS), and Mr. Ronald G. Wayne (hereinafter referred to as WAYNE), all residents of the County of Santa Clara, State of California, have mutually agreed to the formation of a company to be specifically organized for the manufacture and marketing of computer devices, components, and related material, said company to be organized under the fictitious name of APPLE COMPUTER COMPANY (hereinafter referred to as COMPANY), then

BE IT NOTED HEREWITH, that the COMPANY has been formally established in the County of Santa Clara, State of California, in conformance with all laws, statutes, and regulations of said County and State, as of the 1ST day of April 1976, and

BE IT FURTHER NOTED HEREWITH, that by virtue of their respective contributions and commitments to the formation, maintenance, and progress of the COMPANY, the total of all rights, title, and interest in and to the COMPANY, and all assets therein contained, is herewith proportioned among all of the parties to this agreement, WOZNIAK, JOBS, and WAYNE, as follows: WOZNIAK is herewith assigned a total of forty-five percent (45%) of all rights, title, and interest in and to the COMPANY, and all assets therein contained; JOBS is herewith assigned a total of forty-five percent (45%) of all rights, title, and interest in and to the COMPANY, and all assets therein contained; and WAYNE is herewith assigned the remaining ten percent (10%) of all rights, title, and interest in and to the COMPANY, and all assets therein contained.

NOW THEREFORE, in consideration of the respective assignments of interest, as defined in the paragraph above, it is generally understood that the responsibilities of the various parties to this agreement, WOZNIAK, JOBS, and WAYNE, are to be nominally divided into the following categories: WOZNIAK shall assume both general and major responsibility for the conduct of Electrical Engineering; JOBS shall assume general responsibility for Electrical Engineering and Marketing, and WAYNE shall assume major responsibility for Mechanical Engineering and Documentation. All other functions and responsibilities, both primary and secondary, shall be apportioned among the parties to this agreement by mutual accord and by exercise of the various appropriate Articles of this agreement as defined in the following paragraphs.

NOW THEREFORE, it is mutually agreed by WOZNIAK, JOBS, and WAYNE, as current holders of a combined total of one hundred percent (100%) of all rights, title, and interest, in and to the COMPANY, and all assets therein contained, that the conduct of the business of the COMPANY, with regard to all activities of growth and development, distribution of any and all profits, disposition of shares of interest, and all other future operations, shall be performed in accordance with the following Articles:

ARTICLE I:

With regard to the conduct of any business activity, involving the development of COMPANY policy, procurement of capital equipment, development of marketing and assets, or any similar activity, a majority vote of not less than fifty-one percent (51%) of voting shares shall prevail, with not less than seventy-five percent (75%) of the total COMPANY shares in attendance or duly represented, and this Article shall specifically apply in any action involving an expenditure of any sum of money in excess of one hundred dollars (\$100.00); said amount to be subject to change, at any future date, by similar majority vote.

ARTICLE II:

With regard to the distribution of any and all profits, in the form of dividends to the various partners, no dividend shall be voted, except in equal proportion to all share holders, in accordance with the procedures of Article I, above, and then only in equal proportion to their respective share holdings at the time of the distribution. In the event of exceptional action, or extraordinary activity on the part of one of the parties to this contract, however, an exceptional dividend or "bonus", may be voted to that party, by a vote of one hundred percent (100%) of all shares other than those of the subject party.

ARTICLE III:

With regard to the shares of interest held by the various share holders it is herewith, and mutually, agreed that no current share holder shall dispose of, by sale, any portion of his holdings of interest in and to the COMPANY, for any sum of money or equivalent property of value, without first having offered the shares of interest to be so disposed of, to each of the other partners; thus allowing the current partners the right of first option to procure such shares at the price which might subsequently be paid by the outside party. Further, it shall be the responsibility of the seller of such shares to outside purchasers, to convey the understanding to said outside purchaser, that said purchaser shall be bound by all of the Articles, terms, and conditions of this contract, and shall agree in writing to such obligation, prior to the re-registration of the subject shares in the COMPANY records.

ARTICLE IV:

In the event that it shall become necessary to accumulate a fund of free shares for future promotion, reward, or acquisition of new capital, such a fund of shares shall be established from the holdings of the parties to this contract, in direct

proportion to the total percentage of each of their respective holdings, to such an extent as shall be mutually agreed, and voted to, in accordance with the terms of Article I, above.

NOW THEREFORE, it is mutually agreed and understood, that this contract contains and embodies all understandings, representations, and agreements of the parties hereto, that this agreement shall represent a potential of both risk and profit, in direct proportion to each participant's percentage of holdings, and that this contract shall be binding upon, and inure to the benefit of, each of the parties herein named, their respective heirs, assigns, executors, and successors in interest.

IN WITNESS WHEREOF, this instrument has been executed by each of the parties hereto, on this 1ST day of APRIL 1976.

Stephen G. Wozniak
Mr. Stephen G. Wozniak (WOZNIAK)

Steven P. Jobs
Mr. Steven P. Jobs (JOBS)

Ronald G. Wayne
Mr. Ronald G. Wayne (WAYNE)

COUNTY OF SANTA CLARA

STATEMENT OF WITHDRAWAL OF GENERAL PARTNER

FILING FEE \$5.00

April 12, 1976

1 NO: _____ DATE OF WITHDRAWAL

THE UNDERSIGNED HEREBY CERTIFIES THAT HE HAS WITHDRAWN ON THE ABOVE DATE AS A GENERAL PARTNER FROM THE CONDUCT OF BUSINESS UNDER THE FICTITIOUS BUSINESS.

NAME OF:

APPLE COMPUTER COMPANY

NAME

20443

CERTIFICATE NUMBER

April 2, 1976

DATE FILED

Santa Clara

COUNTY WHERE FILED

294-28-9592

SS OR TAX I.D. NUMBER

Ronald G. Wayne

NAME OF WITHDRAWING PARTNER

1900 California Street

RESIDENCE ADDRESS

4

APT. NO.

Mountain View

CITY

Santa Clara

COUNTY

94040

ZIP CODE

7 EXECUTED, AT **Mountain View** CALIFORNIA ON **April 12, 1976**

8 
SIGNATURE

NOTE: UNLESS NOTICE OF DISSOLUTION OF PARTNERSHIP HAS BEEN PUBLISHED PURSUANT TO SECTION 15035.5, CORPORATIONS CODE, THIS STATEMENT OF WITHDRAWAL SHALL BE PUBLISHED IN THE SAME MANNER AS THE FICTITIOUS BUSINESS NAME STATEMENT. (SECTION 17923, BUSINESS AND PROFESSIONS CODE.)

APPLE COMPUTER COMPANY
PARTNERSHIP AGREEMENT

TO WHOM IT MAY CONCERN:

AMENDMENT

By virtue of a re-assessment of understandings by and between all parties to the Agreement of April 1, 1976, WOZNIAK, JOBS, and WAYNE, the following modifications and amendments are herewith appended to the said Agreement, and made a part thereof. These modifications and amendments, having been concluded on this 12th day of April, 1976, hereby supercede, and render void, all contrary understandings given in the Agreement of April 1, 1976.

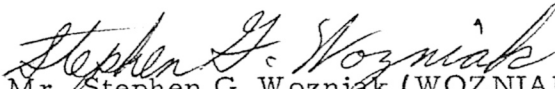
ARTICLE A:

As of the date of this amendment, WAYNE shall hereinafter cease to function in the status of "Partner" to the aforementioned Agreement, and all obligations, responsibilities, agreements, and understandings of the Agreement of April 1, 1976, are herewith terminated. It is specifically understood, and agreed to, by all of the parties to the original agreement, and the amendments hereto appended, WOZNIAK, JOBS, and WAYNE, that that portibn of all financial obligations incurred by WAYNE, on the part of the COMPANY, prior to the date of this amendment, is herewith terminated, and that WAYNE's portion of obligations (10%) to the creditors of the COMPANY are herewith assumed, jointly and equally, by the remaining partners to the original agreement, namely, WOZNIAK and JOBS. It is further mutually understood, and agreed, that WAYNE shall incur no obligations or responsibilities in, or for, the COMPANY, nor shall WAYNE be held liable in any litigation, initiated by or instituted against, the COMPANY, with regard to the conduct of the COMPANY's business with any creditor, vendor, customer, or any other party, nor with reference to or arising from any product of the COMPANY, as of the first day of April, 1976.

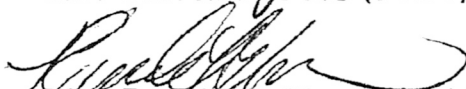
ARTICLE B:

In consideration of the relinquishment of WAYNE's former percentage of ownership, and for all efforts thusfar conducted in honor of the aforementioned agreement during its term of activity, the remaining parties to the partnership, WOZNIAK, and JOBS, agree to pay and deliver to WAYNE, as their sole obligations under the terms of this amendment, the sum of eight hundred dollars (\$800.00).

IN WITNESS WHEREOF: These amendments have been appended to the original Agreement and made a part thereof, and have been executed by each of the parties hereto, on this 12th day of April, 1976.


Mr. Stephen G. Wozniak (WOZNIAK)


Mr. Steven P. Jobs (JOBS)


Mr. Ronald G. Wayne (WAYNE)