BUSINESS ORGANIZATIONS
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Casebook Supplement

5. FEDERAL TAX CONSEQUENCES

Under Subchapter K of the Internal Revenue Code, a partnership is taxed on a "pass-through" basis. *See* 26 U.S.C. §§ 701 *et seq.* A partnership is required to file a separate tax return reflecting the receipts and expenditures of the business. However, no tax is paid with this return. Instead, the net income or loss from partnership operations is allocated among the partners and then carried over to each partner's individual return. The major advantages of pass-through taxation are: (a) partnership profits are not subject to double taxation (*i.e.,* the partnership's profits are taxed only at the owner (partner) level, rather than also taxed at the business (partnership) level); and (b) if the partnership has losses rather than gains, the partners may use the losses to shield other income on their individual returns. There is one major disadvantage. Partners must pay tax on their share of the partnership's income for the year whether or not the partnership distributes cash to the partners.

By way of example, assume that Acme Property Management Associates ("APMA") is a partnership engaged in the business of managing residential apartment complexes. APMA has five partners, each of whom owns an equal share of the partnership and is entitled to 20% of the profits and chargeable with 20% of the losses. APMA does not pay any federal income tax. Rather, each year it calculates its profit or loss for the year, by determining its gross receipts from fees for property management and any other income it received, and subtracting from that amount its costs of doing business—salaries paid, depreciation of equipment, rental payments for its office, other overhead expenses, etc. Assume that in 2012, APMA made a profit of $250,000. APMA does not pay any income tax on that amount. Instead, twenty percent of that amount, $50,000, is allocated to each of the partners. Each partner reports that $50,000 on his or her personal income tax return as income, along with any other income the partner made that year from salaries, investment income, and so forth. Obviously, this increases each partner's tax bill for the year. However, unless the partnership agreement provides otherwise, there is no requirement that the partnership distribute any of its income to the partners. Unless a majority (or all) of the partners decide that the partnership will make a distribution, each partner will have to pay his increased tax bill out of his own pocket.

Conversely, if APMA loses money, the amount of that loss is allocated to the partners. Assume that APMA suffered a $100,000 loss in 2012—the expenses of operating the business exceeded the revenue it earned. Each partner is allocated $20,000 of that loss, and each reports that loss on his or her personal income tax return, subtracting it from the income the partner earned from other sources. The effect is to reduce the partner's taxable income and thus his or her tax bill for the year.

In 1997, the IRS' so-called "check-the-box" regulations became effective. *See* 26 C.F.R. §§ 301.7701–1 *et seq.* These regulations permit noncorporate entities to elect to be taxed like a corporation. If no election is made, partnership taxation is the default rule. Although it would be unusual for a partnership to elect to be taxed like a corporation, the check-the-box regulations make this possible.

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Supreme Court of California

359 P.2d 41 (1961)

TRAYNOR, JUSTICE.

Plaintiff and defendant are partners in a linen supply business in Santa Maria, California. Plaintiff appeals from a judgment declaring the partnership to be for a term rather than at will.

The partners entered into an oral partnership agreement in 1949. Within the first two years each partner contributed approximately $43,000 for the purchase of land, machinery, and linen needed to begin the business. From 1949 to 1957 the enterprise was unprofitable, losing approximately $62,000. The partnership's major creditor is a corporation, wholly owned by plaintiff, that supplies the linen and machinery necessary for the day-to-day operation of the business. This corporation holds a $47,000 demand note of the partnership. The partnership operations began to improve in 1958. The partnership earned $3,824.41 in that year and $2,282.30 in the first three months of 1959. Despite this improvement plaintiff wishes to terminate the partnership.

The Uniform Partnership Act provides that a partnership may be dissolved "By the express will of any partner when no definite term or particular undertaking is specified." Corp.Code, § 15031, subd. (1)(b). The trial court found that the partnership is for a term, namely, "such reasonable time as is necessary to enable said partnership to repay from partnership profits, indebtedness incurred for the purchase of land, buildings, laundry and delivery equipment and linen for the operation of such business. . . ." Plaintiff correctly contends that this finding is without support in the evidence.

Defendant testified that the terms of the partnership were to be similar to former partnerships of plaintiff and defendant, and that the understanding of these partnerships was that "we went into partnership to start the business and let the business operation pay for itself—put in so much money, and let the business pay itself out." There was also testimony that one of the former partnership agreements provided in writing that the profits were to be retained until all obligations were paid.

Upon cross-examination defendant admitted that the former partnership in which the earnings were to be retained until the obligations were repaid was substantially different from the present partnership. The former partnership was a limited partnership and provided for a definite term of five years and a partnership at will thereafter. Defendant insists, however, that the method of operation of the former partnership showed an understanding that all obligations were to be repaid from profits. He nevertheless concedes that there was no understanding as to the term of the present partnership in the event of losses. He was asked: "[W]as there any discussion with reference to the continuation of the business in the event of losses?" He replied, "Not that I can remember." He was then asked, "Did you have any understanding with Mr. Page, your brother, the plaintiff in this action, as to how the obligations were to be paid if there were losses?" He replied, "Not that I can remember. I can't remember discussing that at all. We never figured on losing, I guess."

Viewing this evidence most favorably for defendant, it proves only that the partners expected to meet current expenses from current income and to recoup their investment if the business were successful.

Defendant contends that such an expectation is sufficient to create a partnership for a term under the rule of Owen v. Cohen, 19 Cal.2d 147, 150, 119 P.2d 713. In that case we held that when a partner advances a sum of money to a partnership with the understanding that the amount contributed was to be a loan to the partnership and was

to be repaid as soon as feasible from the prospective profits of the business, the partnership is for the term reasonably required to repay the loan. It is true that Owen v. Cohen, supra, and other cases hold that partners may impliedly agree to continue in business until a certain sum of money is earned, or one or more partners recoup their investments, or until certain debts are paid, or until certain property could be disposed of on favorable terms. In each of these cases, however, the implied agreement found support in the evidence.

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In the instant case, however, defendant failed to prove any facts from which an agreement to continue the partnership for a term may be implied. The understanding to which defendant testified was no more than a common hope that the partnership earnings would pay for all the necessary expenses. Such a hope does not establish even by implication a "definite term or particular undertaking" as required by section 15031, subdivision (1)(b) of the Corporation's Code. All partnerships are ordinarily entered into with the hope that they will be profitable, but that alone does not make them all partnerships for a term and obligate the partners to continue in the partnerships until all of the losses over a period of many years have been recovered.

Defendant contends that plaintiff is acting in bad faith and is attempting to use his superior financial position to appropriate the now profitable business of the partnership. Defendant has invested $43,000 in the firm, and owing to the long period of losses his interest in the partnership assets is very small. The fact that plaintiff's wholly owned corporation holds a $47,000 demand note of the partnership may make it difficult to sell the business as a going concern. Defendant fears that upon dissolution he will receive very little and that plaintiff, who is the managing partner and knows how to conduct the operations of the partnership, will receive a business that has become very profitable because of the establishment of Vandenberg Air Force Base in its vicinity. Defendant charges that plaintiff has been content to share the losses but now that the business has become profitable he wishes to keep all the gains.

There is no showing in the record of bad faith or that the improved profit situation is more than temporary. In any event these contentions are irrelevant to the issue whether the partnership is for a term or at will. Since, however, this action is for a declaratory judgment and will be the basis for future action by the parties, it is appropriate to point out that defendant is amply protected by the fiduciary duties of copartners.

Even though the Uniform Partnership Act provides that a partnership at will may be dissolved by the express will of any partner (Corp.Code, § 15031, subd. (1)(b)), this power, like any other power held by a fiduciary, must be exercised in good faith.

. . . .

A partner at will is not bound to remain in a partnership, regardless of whether the business is profitable or unprofitable. A partner may not, however, by use of adverse pressure "freeze out" a copartner and appropriate the business to his own use. A partner may not dissolve a partnership to gain the benefits of the business for himself, unless he fully compensates his copartner for his share of the prospective business opportunity. In this regard his fiduciary duties are at least as great as those of a shareholder of a corporation.

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. . . [I]n the instant case, plaintiff has the power to dissolve the partnership by express notice to defendant. If, however, it is proved that plaintiff acted in bad faith and violated his fiduciary duties by attempting to appropriate to his own use the new prosperity of the partnership without adequate compensation to his copartner, the dissolution would be

wrongful and the plaintiff would be liable as provided by subdivision (2)(a) of Corporations Code, § 15038 (rights of partners upon wrongful dissolution) for violation of the implied agreement not to exclude defendant wrongfully from the partnership business opportunity.

The judgment is reversed.

DRASHNER V. SORENSON

Supreme Court of South Dakota

63 N.W.2d 255 (1954)

SMITH, PRESIDING JUDGE.

In January 1951 the plaintiff, C. H. Drashner, and defendants, A. D. Sorenson and Jacob P. Deis, associated themselves as co-owners in the real estate, loan and insurance business at Rapid City. For a consideration of $7500 they purchased the real estate and insurance agency known as J. Schumacher Co. located in an office room on the ground floor of the Alex Johnson Hotel building. The entire purchase price was advanced for the partnership by the defendants, but at the time of trial $3,000 of that sum had been repaid to them by the partnership. Although, as will appear from facts presently to be outlined, their operations were not unsuccessful, differences arose and on June 15, 1951 plaintiff commenced this action in which he sought an accounting, dissolution and winding up of the partnership. The answer and counterclaim of defendants prayed for like relief.

The cause came on for trial September 4, 1951. The court among others made the following findings. VII. "That thereafter the plaintiff violated the terms of said partnership agreement, in that he demanded a larger share of the income of the said partnership than he was entitled to receive under the terms of said partnership agreement; that the plaintiff was arrested for reckless driving and served a term in jail for said offense; that the plaintiff demanded that the defendants permit him to draw money for his own personal use out of the moneys held in escrow by the partnership; that the plaintiff spent a large amount of time during business hours in the Brass Rail Bar in Rapid City, South Dakota, and other bars, and neglected his duties in connection with the business of the said partnership. . . . That the plaintiff, by his actions hereinbefore set forth, has made it impossible to carry on the partnership." The conclusions adopted read as follows: I "That the defendants are entitled to continue the partnership and have the value of the plaintiff's interest in the partnership business determined, upon the filing and approval of a good and sufficient bond, conditioned upon the release of the plaintiff from any liability arising out of the said partnership, and further conditioned upon the payment by the defendants to the plaintiff of the value of plaintiffs' interest in the partnership as determined by the Court." II "That in computing the value of the plaintiff's interest in the said partnership, the value of the good will of the business shall not be considered." III "That the value of the partnership shall be finally determined upon a hearing before this Court, . . ." and IV "That the plaintiff shall be entitled to receive one-third of the value of the partnership property owned by the partnership on the 12th day of September, 1951, not including the good will of the business, after the payment of the liabilities of the partnership and the payment to the defendants of the invested capital in the sum of $4,500.00." Judgment was accordingly entered dissolving the partnership as of September 12, 1951.

After hearing at a later date the court found: I "That the value of the said partnership property on the 12th day of September, 1951, was the sum of Four Thousand Four Hundred Ninety-eight and 90/100 Dollars ($4498.90), and on said date there was due and owing by the partnership for accountant's services the sum of Four Hundred Eighty Dollars ($480.00), and that on said date the sum of Four Thousand Five Hundred Dollars ($4500.00) of the capital invested by the defendants had not been returned to the defendants." and II "That there is not sufficient partnership property to reimburse the defendants for their invested capital." Thereupon the court decreed "that the plaintiff had no interest in the property of the said partnership," and that the defendants were the sole owners thereof.

The assignments of error are predicated upon insufficiency of the evidence to support the findings and conclusions. Of these assignments, only those which question whether the court was warranted in finding that (a) the plaintiff caused the dissolution wrongfully, and (b) the value of the partnership property, exclusive of good will, was $4498.90 on the 12th day of September, 1951, merit discussion. A preliminary statement is necessary to place these issues in their framework.

The agreement of the parties contemplated an association which would continue at least until the $7500 advance of defendants had been repaid from the gross earnings of the business. Hence, it was not a partnership at will. In apparent recognition of that fact, both plaintiff and defendants sought dissolution in contravention of the partnership agreement . . . on the ground that the adverse party had caused the dissolution wrongfully by willfully and persistently committing a breach of the partnership agreement, and by so conducting himself in matters relating to the partnership business as to render impracticable the carrying on of the business in partnership with him.

By SDC 49.0610(2) of the Uniform Partnership Act it is provided:

> "When dissolution is caused in contravention of the partnership agreement the rights of the partners shall be as follows:
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> "(a) . . .
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> "(b) The partners who have not caused the dissolution wrongfully, if they all desire to continue the business in the same name, either by themselves or jointly with others, may do so, during the agreed term for the partnership and for that purpose may possess the partnership property, provided they secure the payment by bond approved by the Court, or pay to any partner who has caused the dissolution wrongfully, the value of his interest in the partnership at the dissolution less any damages recoverable under clause (2)(a)(2) of this section and in like manner indemnify him against all present or future partnership liabilities.
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> "(c) A partner who has caused the dissolution wrongfully shall have:
>
> "(1) . . .
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> "(2) If the business is continued under paragraph (2)(b) of this section the right as against his copartners and all claiming through them in respect of their interests in the partnership, to have the value of his interest in the partnership, less any damages caused to his copartners by the dissolution, ascertained and paid to him in cash, or the payment secured by bond approved by the Court, and to be released from all existing liabilities of the partnership; but in ascertaining the value of the partner's interest the value of the good will of the business shall not be considered."

. . . .

From this background we turn to a consideration of the evidence from which the trial court inferred that plaintiff caused the dissolution wrongfully.

The breach between the parties resulted from a continuing controversy over the right of plaintiff to withdraw sufficient money from the partnership to defray his living expenses. Plaintiff was dependent upon his earnings for the support of his family. The defendants had other resources. Plaintiff claimed that he was to be permitted to draw from the earnings of the partnership a sufficient amount to support himself and [his] family. The defendants asserted that there was a definite arrangement for the allocation of the income of the partnership and there was no agreement for withdrawal by plaintiff of more than his allotment under that plan. Defendants' version of the facts was

corroborated by a written admission of plaintiff offered in evidence. From evidence thus sharply in conflict, the trial court made a finding, reading as follows: "That the oral partnership agreement between the parties provided that each of the three partners were to draw as compensation one-third of one-half of the commissions earned upon sales made by the partners; that the other one-half of the commissions earned on sales made by the partners and one-half of the commissions earned upon sales made by salesmen employed by the partnership, together with the earnings from the insurance business carried on by the partnership, was to be placed in a fund to be used for the payment of the operating expenses of the partnership, and after the payment of such operating expenses to be used to reimburse the defendants for the capital advanced in the purchase of the Julius Schumacher business and the capital advanced in the sum of Eight Hundred Dollars ($800.00) for the operating expenses of the business."

As an outgrowth of this crucial difference, there was evidence from which a court could reasonably believe that plaintiff neglected the business and spent too much time in a nearby bar during business hours. At a time when plaintiff had overdrawn his partners and was also indebted to one of [the] defendants for personal advances, he requested $100 and his request was refused. In substance he then said, according to the testimony of the defendant Deis, that he would see that he "gets some money to run on," if they "didn't give it to him he was going to dissolve the partnership and see that he got it." Thereafter plaintiff pressed his claims through counsel, and eventually brought this action to dissolve the partnership. The claim so persistently asserted was contrary to the partnership agreement found by the court.

The foregoing picture of the widening breach between the parties is drawn almost entirely from the evidence of defendants. Of course, plaintiff's version of the agreement of the parties, and of the ensuing differences, if believed, would have supported findings of a different order by the trier of the fact. It cannot be said, we think, that the trial court acted unreasonably in believing defendants, and we think it equally clear the court could reasonably conclude that the insistent and continuing demands of the plaintiff and his attendant conduct rendered it reasonably impracticable to carry on the business in partnership with him. It follows, we are of the opinion, the evidence supports the finding that plaintiff caused the dissolution wrongfully.

This brings us to a consideration of the sufficiency of the evidence to support the finding of the court that the property of the partnership was of the value of $4498.90 as of the date of dissolution.

Bitter complaint is made because the trial court refused to consider the good will of this business in arriving at its conclusion. The feeling of plaintiff is understandable. These partners must have placed a very high estimate upon the value of the good will of this agency because they paid Mr. Schumacher $7500 to turn over that office with its very moderate fixtures and its listing of property, together with an agreement that he would not engage in the business in Rapid City for at least two years. No doubt they attached some of this good will value to the location of the business which was under only a month to month letting. Their estimate of value was borne out by the subsequent history of the business. Its real estate commissions, earned but only partly received, grossed $21,528.25 and its insurance commissions grossed $661.21 in the period January 15 to August 31, 1951. In that period the received commissions paid all expenses, including the commissions of salesmen, retired $3,000 of the $7500 purchase price advanced by defendants, and all of $800 of working capital so advanced, allowed the parties to withdraw $1453.02 each, and accumulated a cash balance of $2221.43. In addition the partnership has commissions due which we shall presently discuss. Notwithstanding this indication of the great value of the good will of this business, the statute does not require the court to take it into consideration in valuing the property of the business in these

circumstances. The statute provides such a sanction for causing the dissolution of a partnership wrongfully. SDC 49.0610(2)(c)(2) quoted supra. The court applied the statute.

With the most valuable asset of the business eliminated, what remained? It is agreed that a group of bills receivable were of the value of $777.47. There was cash in the amount of $2221.43. Subtracting these two amounts from $4498.90, the overall value fixed by the finding, it appears that the court estimated the remaining assets to be of a value of $1500. . . .

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That the $1500 value placed on all of these described assets was conservative we do not question. However, after mature study and reflection we have concluded that the court's finding is not against the clear weight of the evidence appearing in this record. Hence we are not at liberty to disturb it.

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The judgment of the trial court is affirmed.

A. INTRODUCTION

1. COMPARING THE PARTNERSHIP AND THE CORPORATION

A partnership may be created informally—*i.e.*, without any written agreement and without filing any documents with the state. A corporation, by contrast, is a more formal creature. It may only be created by filing a certificate of incorporation with the state in accordance with statutory criteria. Thus, incorporation requires a conscious decision. In deciding whether to incorporate, investors must consider the basic characteristics of the corporate form and the extent to which the default rules may be modified by contract.

a. *Entity Status*. Under UPA, a partnership is not an entity distinct from its owners. Under RUPA, a partnership is an entity. A corporation is an entity distinct from its owners in all jurisdictions.

b. *Continuity of Existence*. Partnerships are relatively easy to dissolve. Unless the partnership is for a term or an undertaking, any partner may dissolve the partnership at will. By contrast, unless a corporation explicitly chooses to have a limited duration, it has perpetual existence until and unless it is dissolved. Dissolution requires approval by the corporation's board of directors and shareholders.

Perpetual existence is a beneficial quality for most publicly held corporations. Shareholders who are dissatisfied with management's performance may follow the "Wall Street rule" and sell their shares. In this way, they may obtain a return of invested capital without the consent of the board of directors or the other shareholders. By contrast, the lack of easy dissolution presents dangers for shareholders in closely held corporations (*i.e.*, corporations with a small number of shareholders and no public market for the sale of shares). The lack of an exit right increases the danger that a majority shareholder or group may oppress a minority. The majority may appropriate a disproportionate share of the corporation's income stream to itself, and the minority may have little choice but to sell to the majority at a bargain price. The minority, however, may protect itself through contractual methods. In addition, in most jurisdictions judicial doctrines exist that protect the minority from oppressive conduct by the majority.

c. *Centralized Management*. Partnerships are often managed informally. Every partner has a right to participate in the management of the business, and a majority vote of the partners decides ordinary matters. By contrast, the ultimate decision-making power in a corporation traditionally resides in the board of directors. The directors may or may not be shareholders. Moreover, formal rules govern meetings of the board. Shareholders elect the directors, but the shareholders otherwise vote only on fundamental transactions (*e.g.*, mergers or dissolutions).

Most publicly held corporations adhere to the traditional model. In closely held corporations, shareholders often expect to operate the business as if it were a partnership. [Later materials discuss] contractual methods by which shareholders may agree to displace the board of directors or to participate in the management of the corporation's business.

d. *Limited Liability*. Perhaps the most important difference between partnerships and corporations involves liability to the outside world for the obligations of the business. All partners are personally liable for a general partnership's obligations. Shareholders of a corporation enjoy limited liability—*i.e.*, a shareholder's losses are limited to the value of his investment. Corporate creditors may seize the corporation's property to satisfy any debts. If the corporation's assets are insufficient to satisfy its obligations, however, creditors usually have no recourse against the shareholders individually. This feature of

corporate existence is an unqualified good for all corporations. It is the chief reason that investors select the corporation over the partnership form.

e. *Free Transferability of Ownership Interests.* Although a partner may freely assign his interest in the profits of the enterprise, new partners may be admitted only by unanimous consent. In a corporation, shares are freely transferable. This rule makes it easier for the corporation to acquire new investors and needed capital. The ability to gain access to the capital markets is a major benefit to publicly held corporations. However, shareholders in many closely held corporations prefer to limit the ability to admit new shareholders into the venture. The legality of such attempts is discussed in [later materials].

f. *Tax Status.* A partnership is taxed on a "pass-through" basis. The partnership allocates its net income or loss to the partners pro rata, and the partners pay individual tax, or take individual deductions, based on their share of the income or loss. A corporation is taxed as a separate legal person. The corporation pays its own taxes based on its income for the year. *See* 26 U.S.C. § 11. When a corporation pays dividends to shareholders, the shareholders are taxed on the income they receive from the corporation. *See id.* § 301. When shareholders sell their shares, they pay a capital gains tax on the income derived from the sale. *See id.* § 61(3). Thus, corporate income is subject to double taxation. Currently, this result is ameliorated by the fact that most dividends and long-term capital gains (gains derived from selling securities held for more than one year) are taxed at a 15% rate, which is lower than the highest rates applicable to ordinary income. *See id.* § 1(h).

Shareholders in publicly held corporations cannot avoid double taxation. However, under Subchapter S of the Internal Revenue Code, shareholders in closely held corporations may elect to be taxed in a partnership-like manner. To qualify for Subchapter S status, a corporation may not have: (a) more than 100 shareholders; (b) any non-individual shareholders (with certain exceptions); (c) any nonresident-alien shareholders; or (d) more than one class of stock. *See id.* § 1361(b)(1). The benefits of Subchapter S status are that the corporation and its shareholders are not subject to double taxation, and if the corporation has losses, shareholders may use their pro rata share to offset income on their individual returns. The major disadvantage is that shareholders must pay tax on their pro rata share of the corporation's income whether or not the corporation distributes dividends to the shareholders.

2. CHOOSING A STATE OF INCORPORATION

The internal affairs of a corporation are normally governed by the jurisdiction of incorporation. *See* CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 89 (1987). A publicly held corporation chooses to incorporate, or reincorporate, in the jurisdiction whose laws best fit the corporation's needs. Delaware is the domicile of choice for large, publicly held corporations. Indeed, a majority of Fortune 500 corporations are chartered in Delaware. A number of factors explain Delaware's preeminent status. Delaware has a liberal corporation statute, the Delaware General Corporation Law ("DGCL"), that seeks to facilitate rather than regulate corporate transactions. This enabling philosophy is attractive to corporate managers. In addition, Delaware has an extensive body of corporate case law that many states lack. As a consequence, corporate planning is more certain in Delaware. Finally, Delaware has a talented bench and bar that specialize in corporate transactions. In an attempt to compete with Delaware for incorporation business, many states have copied the liberal, enabling approach of the DGCL. Whether the states are racing to the top or the bottom in copying Delaware is the subject of academic dispute. *Compare* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 222 (1991) (arguing that "competition creates

a powerful tendency for states to enact laws that operate to the benefit of investors"), *with* Lucien A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1509–10 (1992) (concluding that state competition is undesirable when the interests of managers and controlling shareholders diverge from the interests of public shareholders or the public at large).

A corporation chartered in Delaware must pay the Delaware franchise tax. If the corporation does business in another state, it must qualify as a foreign corporation and pay a tax to that state that is the same as, or similar to, the local franchise tax. This tax burden is relatively insignificant to publicly held corporations. Closely held corporations, by contrast, usually incorporate in the state in which they do most of their business. This approach allows them to avoid paying a separate franchise tax to a jurisdiction like Delaware in which the corporation does little or no business. Moreover, as other states have copied aspects of Delaware law, it is possible to enjoy the benefits of Delaware's liberal, enabling approach without incorporating in Delaware.

Corporate law is a national subject. If a local corporation statute is ambiguous or does not cover a particular matter, and if the local jurisdiction has no cases on point, it is common practice to examine statutes and cases from other jurisdictions. This book will focus on the law of Delaware because of Delaware's status as a leader in the field of corporate law. The book will also focus on the Model Business Corporation Act ("MBCA") because the corporation statutes of many states are based on the MBCA. The MBCA is promulgated by the Committee on Corporate Laws of the Business Law Section of the American Bar Association. The MBCA was extensively revised in 1984 and is continuously updated.

B. FORMATION

1. INCORPORATION AND ITS AFTERMATH

DGCL §§ 102–103, 107–109, 141, 151, 165, 211

MBCA §§ 2.01–2.07, 6.01–6.02, 6.20, 7.03, 8.06

The first step in forming a corporation involves filing a "certificate of incorporation" with a state official, usually the Secretary of State. Under the MBCA, this formal document is called the "articles of incorporation." The corporation's existence commences upon filing the certificate. *See* DGCL § 106; MBCA § 2.03. There is a statutory list of items that the certificate must include. *See* DGCL § 102(a); MBCA § 2.02(a). This list of required items is skeletal and tells one relatively little about the corporation or its business. Perhaps the most important item is the requirement that the certificate contain the number of shares that the corporation is authorized to issue. If the corporation is authorized to issue more than one class or series of shares, the certificate must contain the number of shares of each class or series that the corporation is authorized to issue, along with the terms of each class or series (or a statement that the board may fix the terms at the time of issuance). *See* DGCL §§ 102(a)(4), 151(a); MBCA §§ 2.02(a)(2), 6.01(a), 6.02. It is illegal for the corporation to issue shares that are not authorized by the certificate. Indeed, this mistake is so significant that it cannot be ratified. *See, e.g.*, STAAR Surgical Co. v. Waggoner, 588 A.2d 1130, 1136 (Del. 1991) (noting that "stock issued without authority of law is void and a nullity"). Aside from the required items, the certificate may include any provision concerning the management of the corporation's business or the conduct of the corporation's affairs that is not otherwise contrary to law. *See* DGCL § 102(b)(1); MBCA § 2.02(b)(2).

After the certificate of incorporation is filed, the incorporators, or the initial directors if they are named in the certificate, call an organizational meeting. *See* DGCL § 108;

MBCA § 2.05. If the incorporators call the meeting, they elect the initial board of directors. At the organizational meeting, the initial directors typically approve the following: the certificate of incorporation; the corporation's minute book (in which the minutes of directors' and shareholders' meetings will be placed); the form of stock certificate that will represent ownership of the corporation's shares; and the corporate seal. The initial directors usually reimburse those who expended funds in connection with the organizational process, and they adopt contracts made for the corporation's benefit prior to incorporation. So that the corporation may commence its business, the initial directors often elect officers and fix their salaries, accept offers to purchase shares for a consideration fixed by the board, and authorize the opening of a corporate bank account.

The initial directors usually adopt bylaws at the corporation's organizational meeting. The bylaws may contain any provision not inconsistent with the certificate of incorporation or the law generally. *See* DGCL § 109(b); MBCA § 2.06. Bylaws are typically a complete code for the conduct of corporate affairs. They address such matters as: (a) the rules for calling and conducting shareholders' meetings; (b) the number of directors; (c) the methods of electing and removing directors; (d) the manner in which board vacancies are filled; (e) committees of the board; (f) the rules for calling and conducting directors' meetings; (g) the identification of officers and the duties of each officer; (h) the methods of electing and removing officers; (i) the indemnification of directors and officers to the extent permitted by statute; (j) the advancement of expenses to directors and officers who are sued as a consequence of their positions; (k) the purchase of directors' and officers' insurance; (1) share certificates; (m) the corporation's fiscal year; and (n) the manner in which the bylaws may be amended.

The first annual meeting of shareholders is often held directly after the organizational meeting. The primary purpose of this meeting is to elect directors to replace the initial directors. The directors elected at this meeting hold office for one year (or longer if the corporation has a staggered board). *See* DGCL §§ 141(d), 211(c); MBCA §§ 8.03, 8.06.

2. FINANCING THE CORPORATION

A newly formed corporation may issue shares in exchange for cash or property. In some cases, promoters may line up capital prior to the corporation's formation via subscription agreements. These "agreements" are really offers to purchase the corporation's shares when issued by the board of directors after formation. Such offers are irrevocable for six months from the time they are made. *See* DGCL § 165; MBCA § 6.20(a).

As noted above, the only statutory requirement for the issuance of shares is that their authorized number and terms appear in the certificate of incorporation. Beyond that, the corporation may place whatever labels it likes on particular classes and series of shares and define the terms in any manner it likes. The labels by themselves determine nothing. Nevertheless, a typical financing scheme for publicly held corporations involves common shares, preferred shares, and debt. In closely held corporations, by contrast, there is usually just one class of common shares.

Common shares represent the residual or ultimate ownership of a corporation. After all others (*e.g.,* creditors and preferred shareholders) receive their contract rights, whatever value is left belongs to the common shares. This fact does not mean that the corporation is required to distribute net earnings to common shareholders by way of dividends. Whether to declare a dividend lies within the sound discretion of the board of directors. However, if the corporation earns undistributed profits, this result should increase the value of the common shares. Typically, common shareholders possess voting rights and elect the board of directors.

Preferred shares come in many varieties. They typically have a preference over common shares with respect to dividends. For example, assume that preferred shares are issued for $100 each, the annual dividend rate is 8%, and the dividend is payable quarterly. The dividend to the preferred shareholders may be mandatory or discretionary. If the dividend is mandatory, the board of directors must declare a $2 dividend on the preferred shares each quarter if it is financially and legally able to do so. If the dividend is discretionary, the board may choose whether to declare a dividend on the preferred shares. However, if the board does not pay the preferred dividend, it may not declare any dividend on the common shares. Preferred dividends may also be cumulative or noncumulative. Assume that the board refuses, or is unable, to declare a preferred dividend for two consecutive quarters. If the dividend is cumulative, the board may not declare a dividend on the common shares in the third quarter unless it declares a $6 preferred dividend. If the dividend is noncumulative, the board need only declare a $2 preferred dividend in the third quarter to be able to declare a common dividend. Finally, preferred dividends may be participating or nonparticipating. If the dividend is participating, after the preferred shares receive their quarterly dividend, the preferred shares are allowed to join in any further dividend with the common shares on some specified basis (*e.g.,* 1–1 or 1–2). If the dividend is nonparticipating, all dividends accrue to the common shares once the preferred dividend is satisfied.

Preferred shares normally have a preference on liquidation. They take before the common shares on liquidation and usually receive either the issue price or the issue price plus a small premium. If the preferred dividend is cumulative, any arrearages are usually added to the liquidation price. Returning to our example, the certificate might provide that each preferred share is entitled to $105 on liquidation (which reflects a 5% premium) plus accrued but unpaid dividends.

Preferred shares are often convertible into common shares at some predetermined ratio. Conversion allows preferred shares to participate in the corporation's upside potential. To protect the common shares, preferred shares are often redeemable at some predetermined price. For example, if the corporation may redeem preferred shares for $150 each, the preferred's portion of the corporation's total value should be capped at $150 per share.

Preferred shares usually carry no voting rights unless some number of dividend payments is missed. A typical arrangement would be that, if the board misses two quarterly payments, the preferred shares receive the right to elect some or all of the directors. Preferred voting rights normally continue until the corporation pays all accrued dividends.

In addition to raising capital from shareholders, a corporation may borrow money from a bank. Alternatively, it may borrow money directly from investors. The corporation agrees to pay interest on the loan at some predetermined rate (*e.g.*, 7% annually) and to repay the principal at some date in the future (*e.g.*, 30 years). If the loan is secured by the corporation's assets, the investors have purchased a "bond." If the loan is unsecured, they have purchased a "debenture." Like preferred shares, bonds and debentures are often convertible into common shares.

Bonds and debentures are long-term obligations that are sold in accordance with an "indenture." An indenture is a contract between the corporation and an indenture trustee (usually a bank) that represents the bondholders or debentureholders. Among other items, the indenture describes the terms of the bonds or debentures and provides for enforcement by the trustee in cases of default. The indenture trustee also collects principal and interest payments and distributes them to the bondholders or debentureholders. A corporation may also borrow money by selling "notes." There is no legal distinction between notes and

bonds or debentures. Notes typically mature over a shorter period of time (*e.g.*, ten years or fewer) than bonds or debentures and may or may not be sold pursuant to an indenture.

Preferred shares and debt instruments are often compared. Unlike preferred shareholders, debtholders have an absolute contract right to receive principal and interest payments. If a corporation does not make its required payments, debtholders may place the corporation in bankruptcy. In bankruptcy, debtholders have preference over all shareholders, including preferred shareholders. Thus, preferred shares are riskier investments than debt. However, this fact does not mean that preferred shares are inferior investments. Because preferred shares are riskier than debt, they typically carry higher interest rates. If the increased interest rate is sufficient to compensate for the increased risk, the market as a whole should be indifferent as to which investment to purchase. Individual investors may choose between preferred shares and debt based upon their appetite for assuming risk and the manner in which the investment fits into the rest of their portfolio.

In addition to the investment vehicles described above, there are numerous derivative securities whose value depends on the value of an underlying security. One type of derivative security has already been mentioned. Convertible securities are derivative securities because their value depends in part on the value of the security into which they may be converted. A corporation may also issue "rights" or "warrants" to purchase an underlying security. For example, a corporation may sell rights or warrants that give a purchaser the option to buy a specified number of common shares at a specified price (the "exercise price") for some period of time. If the common shares rise in value above the exercise price, the rights or warrants are "in the money" and have become profitable. If the value of the common shares stays below the exercise price, the rights or warrants are "underwater" and are, therefore, worthless. Rights and warrants permit investors to share in the upside potential of a corporation while limiting the downside risk. The most an investor can lose is the purchase price of the right or warrant.

These are but a few of the derivative instruments sold in the market. The market has become increasingly imaginative in disaggregating and reassembling the investment properties of particular investments. On the positive side, the explosion of derivatives makes it possible for investors to find the perfect mix of risk and return to fit their portfolios. On the negative side, the complexity of these instruments can be bewildering. Indeed, sophisticated professional investors have sued brokerage firms for recommending unsuitable investments even though the contract accurately described the technical terms of the investment. *See, e.g.*, Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1032 (4th Cir. 1997) (upholding a grant of summary judgment for a brokerage firm on a Rule 10b–5 claim because the plaintiff, a bank, "had sufficient information concerning the risks of [collateralized mortgage obligations] to render unjustified any reliance on a recommendation that the securities were suitable investments").

3. PREEMPTIVE RIGHTS

DGCL § 102(b)(3)

MBCA § 6.30

"Preemptive rights" give existing shareholders the ability to subscribe proportionately to any new issuance of shares. Preemptive rights enable shareholders to preserve their proportionate stake in the corporation's assets, earnings, and voting power. In most states, preemptive rights do not exist unless they are granted by the certificate of incorporation. *See, e.g.*, DGCL § 102(b)(3); MBCA § 6.30(a).

Preemptive rights rarely serve much purpose in publicly held corporations. The dilutive effect of issuing shares is apt to be considered less important than the fairness of

the terms on which the new shares are issued. Preemptive rights may restrict the freedom of the corporation in arranging new financing or in making acquisitions. As a consequence, the certificates of most publicly held corporations do not provide for preemptive rights. However, the absence of preemptive rights does not mean that the board may issue new shares for an illegitimate purpose. *See, e.g.,* Condec Corp. v. Lunkenheimer Co., 230 A.2d 769 (Del. Ch. 1967) (invalidating an issuance of shares that was designed to preserve the board's control by diluting the voting power of an insurgent shareholder who was on the verge of acquiring a majority of the corporation's shares).

By contrast, in closely held corporations, protection against dilution is often important, and preemptive rights may serve a real purpose. The protection given by such rights, however, should not be overstated. In order to preserve a shareholder's relative position through the exercise of preemptive rights, the shareholder must make a further cash contribution to the corporation. A minority shareholder may be unwilling or unable to make such a contribution. The majority may take advantage of this state of affairs by issuing new shares at a bargain price. This strategy puts the minority to a difficult choice—either make an additional investment or see a decline in the per-share value of his investment. In Katzowitz v. Sidler, 249 N.E.2d 359 (N.Y. 1969), the court invalidated such a strategy:

> A stockholder's right not to purchase is seriously undermined if the stock offered is worth substantially more than the offering price. Any purchase at this price dilutes his interest and impairs the value of his original holding. . . .
>
> Here the obvious disparity in selling price and book value was calculated to force the dissident stockholder into investing additional sums. No valid business justification was advanced for the disparity in price, and the only beneficiaries of the disparity were the two director-stockholders who were eager to have additional capital in the business.
>
> It is no answer [that the minority stockholder] . . . was also given a chance to purchase additional shares at this bargain rate. The price was not so much a bargain as it was a tactic, conscious or unconscious on the part of the directors, to place [the minority stockholder] in a compromising situation. The price was so fixed to make the failure to invest costly. . . .
>
> No reason exists at this time to permit [the majority stockholders] to benefit from their course of conduct. . . .

Id. at 364–65. *Katzowitz* is consistent with cases protecting minority shareholders in closely held corporations from oppressive conduct by the majority.

5. DEFECTIVE INCORPORATION

DGCL §§ 105–106, 329

MBCA §§ 2.03–2.04

One of the most important benefits of corporate status is limited liability for shareholders. The following cases consider whether failure to incorporate properly will cause shareholders to lose their limited liability.

CANTOR V. SUNSHINE GREENERY, INC.

Superior Court of New Jersey, Appellate Division

398 A.2d 571 (1979)

LARNER, J. A. D.

This appeal involves the propriety of a personal judgment against defendant William J. Brunetti for the breach of a lease between plaintiffs and a corporate entity known as Sunshine Greenery, Inc., and more particularly whether there was a *de facto* corporation in existence at the time of the execution of the lease.

Plaintiffs brought suit for damages for the breach of the lease against Sunshine Greenery, Inc. and Brunetti. Default judgment was entered against the corporation and a nonjury trial was held as to the liability of the individual. The trial judge in a letter opinion determined that plaintiffs were entitled to judgment against Brunetti individually on the theory that as of the time of the creation of the contract he was acting as a promoter and that his corporation, Sunshine Greenery, Inc., was not a legal or *de facto* corporation.

The undisputed facts reveal the following: Plaintiffs prepared the lease naming Sunshine Greenery, Inc. as the tenant, and it was signed by Brunetti as president of that named entity. Mr. Cantor, acting for plaintiffs, knew that Brunetti was starting a new venture as a newly formed corporation known as Sunshine Greenery, Inc. Although Cantor had considerable experience in ownership and leasing of commercial property to individuals and corporations, he did not request a personal guarantee from Brunetti, nor did he make inquiry as to his financial status or background. Without question, he knew and expected that the lease agreement was undertaken by the corporation and not by Brunetti individually, and that the corporation would be responsible thereunder.

At the time of the signing of the lease on December 16, 1974 in Cantor's office, Brunetti was requested by Cantor to give him a check covering the first month's rent and the security deposit. When Brunetti stated that he was not prepared to do so because he had no checks with him, Cantor furnished a blank check which was filled out for $1,200, with the name of Brunetti's bank and signed by him as president of Sunshine Greenery, Inc. The lease was repudiated by a letter from counsel for Sunshine Greenery, Inc. dated December 17, 1974, which in turn was followed by a response from Cantor to the effect that he would hold the "client" responsible for all losses. The check was not honored because Brunetti stopped payment, and in any event because Sunshine Greenery, Inc. did not have an account in the bank.

The evidence is clear that on November 21, 1974 the corporate name of Sunshine Greenery, Inc. had been reserved for Brunetti by the Secretary of State, and that on December 3, 1974 a certificate of incorporation for that company was signed by Brunetti and Sharyn N. Sansoni as incorporators. The certificate was forwarded by mail to the Secretary of State on that same date with a check for the filing fee, but for some

unexplained reason it was not officially filed until December 18, 1974, two days after the execution of the lease.[1]

In view of the late filing, Sunshine Greenery, Inc. was not a *de jure* corporation on December 16, 1974 when the lease was signed. Nevertheless, there is ample evidence of the fact that it was a *de facto* corporation in that there was a bona fide attempt to organize the corporation some time before the consummation of the contract and there was an actual exercise of the corporate powers by the negotiations with plaintiffs and the execution of the contract involved in this litigation. When this is considered in the light of the concession that plaintiffs knew that they were dealing with that corporate entity and not with Brunetti individually, it becomes evident that the *de facto* status of the corporation suffices to absolve Brunetti from individual liability. Plaintiffs in effect are estopped from attacking the legal existence of the corporation collaterally because of the nonfiling in order to impose liability on the individual when they have admittedly contracted with a corporate entity which had *de facto* status. In fact, their prosecution of the claim against the corporation to default judgment is indicative of their recognition of the corporation as the true obligor and theoretically inconsistent with the assertion of the claim against the individual.

The trial judge's finding that Sunshine Greenery, Inc. was not a *de facto* corporation is unwarranted under the record facts herein. The mere fact that there were no formal meetings or resolutions or issuance of stock is not determinative of the legal or *de facto* existence of the corporate entity, particularly under the simplified New Jersey Business Corporation Act of 1969, which eliminates the necessity of a meeting of incorporators. The act of executing the certificate of incorporation, the bona fide effort to file it and the dealings with plaintiffs in the name of that corporation fully satisfy the requisite proof of the existence of a *de facto* corporation. To deny such existence because of a mere technicality caused by administrative delay in filing runs counter to the purpose of the *de facto* concept, and would accomplish an unjust and inequitable result in favor of plaintiffs contrary to their own contractual expectations.

. . . .

Since the trial judge erred in negating the *de facto* existence of the corporation herein, the consequent imposition of individual liability on the thesis that Brunetti was a "promoter" is also unwarranted. Since plaintiffs looked to the corporation for liability on the lease, and since we find that Sunshine Greenery, Inc. had a *de facto* existence, there can be no personal liability of Brunetti on the theory that he was a "promoter."

In view of the foregoing, the judgment entered against defendant William J. Brunetti is reversed and set aside, and the matter is remanded to the Law Division to enter judgment on the complaint in favor of William J. Brunetti.

NOTES & QUESTIONS

1. De facto status allows the shareholders to retain their limited liability in suits by third parties. However, a state Attorney General may bring a quo warranto (which is Latin for "by what right") action to dissolve a de facto corporation. This type of suit is a relic of the nineteenth-century view that it is the state's job to make certain that corporations do not exceed their lawful powers. Today, quo warranto actions are rare.

2. A de jure corporation preserves the limited liability of its shareholders and prevails against the Attorney General in a quo warranto proceeding. It is possible for incorporators to make an insubstantial mistake in the incorporation process and still attain de jure status. For

[1] We note that the letter enclosing the certificate of incorporation is addressed to "Mortimer G. Newman, Jr., Secretary of State, State House Annex, Trenton, New Jersey." Whether this misidentification of the person holding the office of Secretary of State accounts for the filing delay we are unable to say from the record.

example, in People v. Ford, 128 N.E. 479 (Ill. 1920), Illinois law required that a certificate of incorporation bear the corporate seal. The incorporators filed a certificate that did not contain a seal but complied with state law in all other respects. The court held that the requirement of a seal was directory rather than mandatory and that the corporation had de jure status.

3. Why wasn't Sunshine Greenery a de jure corporation on December 16, 1974?

4. The de facto corporation doctrine has three elements. There must be: (a) a statute that permits incorporation; (b) a bona fide attempt to incorporate; and (c) some actual use or exercise of corporate privileges. The first element requires some explanation. In the nineteenth century, incorporation required a special act of the legislature. In Louis K. Liggett Co. v. Lee, 288 U.S. 517 (1933), the Supreme Court discussed the reasons for the "special incorporation" regime and its eventual demise:

> [I]ncorporation for business was commonly denied long after it had been freely granted for religious, education, and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjection of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain. There was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations. So at first the corporate privilege was granted sparingly; and only when the grant seemed necessary in order to procure for the community some specific benefit otherwise unattainable. The later enactment of general incorporation laws does not signify that the apprehension of corporate domination had been overcome. The desire for business expansion created an irresistible demand for more charters; and it was believed that under general laws embodying safeguards of universal application the scandals and favoritism incident to special incorporation could be avoided. The general laws, which long embodied severe restrictions upon size and upon the scope of corporate activity, were, in part, an expression of the desire for equality of opportunity.

Id. at 548–49. Today, general incorporation is permitted in every jurisdiction. *See, e.g.*, DGCL § 101(a); MBCA §§ 2.01–2.03. Therefore, the first element of the de facto corporation test is easily met. Did Sunshine Greenery meet the second and third elements of the test?

5. Is the result in *Cantor* fair? Should Cantor's loss go uncompensated? Should Brunetti retain his limited liability?

6. How might Cantor have protected himself against the possibility that Sunshine Greenery would be insolvent?

NOTE ON CORPORATIONS BY ESTOPPEL

The *Cantor* case illustrates another doctrine that alleviates the consequences of defective incorporation: the corporation by estoppel doctrine. Part of the difficulty with this concept is that it is really three doctrines rather than one.

First, a corporation may not avoid a contract based on defective incorporation. Thus, Sunshine Greenery was not able to avoid its contract with Cantor. This branch of the doctrine involves a true estoppel: those purporting to act for the corporation have represented to a third party that the corporation has been lawfully formed; the third party changes his position based upon this representation; and the corporation is not able to deny its corporate status at a later time.

Second, a third party may not avoid a contract with a corporation based on defective incorporation. Thus, Cantor could not have avoided his contract with Sunshine Greenery. This branch of the doctrine is actually a principle of corporate law rather than an application of traditional estoppel doctrine. After all, Cantor did not make any representations to Sunshine Greenery regarding its corporate status. Cantor was the recipient of such representations. However, Cantor dealt with Sunshine Greenery as if it were a corporation. Sunshine Greenery

became a corporation two days after the lease was signed. Therefore, holding Cantor to the contract allows him to receive everything for which he bargained.

Third, the corporation by estoppel doctrine allows shareholders of a defective corporation to retain their limited liability when a third party understands his contract to be with the purported corporation. Thus, Cantor could not sue Brunetti for Sunshine Greenery's debts. The *Cantor* court alludes to this doctrine as an alternative basis for its result:

> [I]n . . . light of the concession that plaintiffs knew that they were dealing with [a] corporate entity and not with Brunetti individually, it becomes evident that the *de facto* status of the corporation suffices to absolve Brunetti from individual liability. Plaintiffs in effect are estopped from attacking the legal existence of the corporation collaterally because of the nonfiling in order to impose liability on the individual when they have admittedly contracted with a corporate entity. . . .
>
> . . . [To hold otherwise] would accomplish an unjust and inequitable result in favor of plaintiffs contrary to their own contractual expectations.

Like the second branch of the corporation by estoppel doctrine, the third branch is a principle of corporate law rather than an application of traditional estoppel doctrine. Its rationale is similar to that of the second branch. When a third party looks to a corporate entity as the sole obligor on a contract, he receives that for which he bargained when only the corporation is liable.

What distinguishes the third branch of the corporation by estoppel doctrine from the de facto corporation doctrine? Both doctrines protect the shareholders' limited liability. However, the corporation by estoppel doctrine is narrower in one respect and broader in another than the de facto corporation doctrine. By its nature, the third branch of the corporation by estoppel doctrine applies only to contract liability. A tort victim does not make a conscious decision to deal with a purported corporation. Thus, a tort victim cannot be said to have accepted the risk that the corporation will fail to satisfy his claim. In tort cases, only the de facto corporation doctrine can preserve the shareholders' limited liability. On the other hand, it presumably takes less to satisfy the third branch of the corporation by estoppel doctrine than the de facto corporation doctrine. The de facto corporation doctrine requires a colorable attempt to incorporate and some actual exercise of corporate privileges. The third branch of the corporation by estoppel doctrine requires only that a third party consciously decide to deal with a purported corporation.

6. THE ULTRA VIRES DOCTRINE

DGCL §§ 102, 122, 124

MBCA §§ 2.02, 3.02, 3.04

In the nineteenth century, every certificate of incorporation was required to include the specific purpose or purposes for which the corporation was organized. A transaction beyond the purposes specified in the corporation's certificate was "ultra vires." The nineteenth-century view was that ultra vires transactions were void. These rules were occasioned by the nineteenth century's suspicious attitude towards corporations. In the famous case of Ashbury Railway Carriage & Iron Co. v. Riche, 33 L.T.R. 450 (1875), a corporation's charter authorized it to construct and sell railway carriages, wagons, and other railway materials, and to sell materials such as timber, coal, and metal. The charter also authorized the corporation to "carry on the business of mechanical engineers and general contractors." The corporation purchased a concession to construct and operate a railway line in Belgium. The corporation contracted with Riche to construct the railway line. After Riche had done part of the work, the corporation repudiated the contract on the ground that it was ultra vires. Riche sued the corporation. The House of Lords held that

the corporation did not have the power to build a railroad and, therefore, that the corporation lacked the power to contract with Riche.

The nineteenth-century approach led to unfair results, as the *Ashbury* case demonstrates. It also implied that a corporation could rescind completed transactions. As a consequence, land titles were not secure if a corporation was the seller. There was always the possibility that the sale might turn out to be ultra vires. In addition, corporations might avoid responsibility for torts committed during the conduct of ultra vires activities. To prevent these results, courts began to construe purpose clauses broadly. For example, the House of Lords in *Ashbury* might have said that the corporation's ability to "carry on the business of . . . general contractors" gave it the right to construct a railroad. Courts also relied on the doctrines of ratification, estoppel, unjust enrichment, quasi-contract, and waiver to permit ultra vires acts to stand.

Under modern law, the ultra vires problem is far less prevalent. Modern statutes permit a corporation to state that it is created to perform any lawful act, *see, e.g.*, DGCL § 102(a)(3), or make a declaration of purposes optional. *See, e.g.*, MBCA §§ 2.02(b)(2)(i), 3.01(a). As a consequence, the ultra vires doctrine tends to be an issue only when conduct does not benefit the corporation in any manner. In addition, as the following case demonstrates, modern law has sharply restricted the ability to challenge ultra vires conduct.

C. MANAGEMENT AND OPERATION

1. ALLOCATION OF POWER

DGCL §§ 109, 141–142, 211, 220, 223, 225, 228, 242

MBCA §§ 7.02–7.04, 8.01, 8.06, 8.08–8.10, 8.40, 10.03, 10.20, 16.05

According to the traditional model of corporate governance, the board of directors appoints the officers and supervises the management of the corporation's business. The officers run the corporation's day-to-day affairs. The shareholders elect the board and vote on extraordinary matters, such as amending the certificate of incorporation, mergers, sales of substantially all of the corporation's assets, and dissolutions. Otherwise, shareholders, unlike partners, have little role in running the corporation's business. The following materials consider the traditional model and attempts by shareholders to vary it. In closely held corporations, shareholders will often prefer to have a more active role in the management of the corporation's business.

CHARLESTOWN BOOT & SHOE CO. V. DUNSMORE

Supreme Court of New Hampshire

60 N.H. 85 (1880)

Demurrer to the declaration in which the following facts were alleged:—The plaintiffs are a manufacturing corporation having for its object a dividend of profits, and commenced business in 1871. Dunsmore was elected director in 1871 and Willard in 1873, and entered upon the discharge of their duties, and have continued so to act by virtue of successive elections until the present time. December 10, 1874, the corporation[a] voted to choose a committee to act with the directors to close up its affairs, and chose one Osgood for such committee. Osgood tendered his services, but the defendants refused to act with him, and contracted new debts to a larger extent than allowed by law. By their negligence, debts due to the corporation to the amount of $2,161.23 have been wholly lost. By their negligence in disposing of the goods of the corporation, a loss has accrued of $3,300.40. By their neglect to sell the buildings and machinery of the corporation when they might and ought, and were urged by Osgood to sell, the same depreciated in value to the extent of $20,000.

Also for that the plaintiffs owned and possessed a certain shop of the value of $10,000, and a large amount of machinery and fixtures of the value of $10,000; "and whereas it was the duty of said defendants, directors as aforesaid, to procure sufficient and proper insurance against fire to be made on said property, and keep the same so sufficiently insured, of all which the said defendants had notice, yet they did not and would not keep the said property so insured, and afterwards, to wit, on the 28th day of April, 1878, while the said property was so remaining without insurance, the same was wholly consumed by fire and wholly lost to the plaintiff, whereby the plaintiff suffered great loss and damage, to wit, $20,000."

SMITH, J. (after stating the facts).

The provision of the statute is, that the business of a dividend paying corporation shall be managed by the directors. The statute reads, "The business of every such corporation shall be managed by the directors thereof, subject to the by-laws and votes of the corporation, and under their direction by such officers and agents as shall be duly appointed by the directors or by the corporation." G. L., c. 148, s. 3; Gen. Stats., c. 134, s.

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[a] In this instance (and in some others), the court seems to use "corporation" to refer to the collective body of shareholders.

3. The only limitation upon the judgment or discretion of the directors is such as the corporation by its by-laws and votes shall impose. It may define its business, its nature and extent, prescribe rules and regulations for the government of its officers and members, and determine whether its business shall be wound up or continued; but when it has thus acted, the business as thus defined and limited is to be managed by its directors, and by such officers and agents under their direction as the directors or the corporation shall appoint. The statute does not authorize a corporation to join another officer with the directors, nor compel the directors to act with one who is not a director. They are bound to use ordinary care and diligence in the care and management of the business of the corporation, and are answerable for ordinary negligence. There is no difference in this respect between the agents of corporations and those of natural persons, unless expressly made by the charter or by-laws. It would be unreasonable to hold them responsible for the management of the affairs of the corporation if compelled to act with one who to a greater or less extent could control their acts. The statute not only entrusts the management of the business of the corporation to the directors, but places its other officers and agents under their direction. When a statute provides that powers granted to a corporation shall be exercised by any set of officers or any particular agents, such powers can be exercised only by such officers or agents, although they are required to be chosen by the whole corporation; and if the whole corporation attempts to exercise powers which by the charter are lodged elsewhere, its action upon the subject is void. The vote choosing Osgood a committee to act with the directors in closing up the affairs of the plaintiff corporation was inoperative and void. . . .

Demurrer sustained.

NOTES & QUESTIONS

1. Directors are true fiduciaries in that they have a duty to act solely in the best interests of the corporation. Although they manage corporate property on behalf of shareholders, directors are not agents of the shareholders. As the *Charlestown* case demonstrates, directors do not act subject to the shareholders' control. In People *ex rel.* Manice v. Powell, 94 N.E. 634 (N.Y. 1911), the court observed:

> "The board of directors of a corporation do not stand in the same relation to the corporate body which a private agent holds towards his principal. . . . In corporate bodies the powers of the board of directors are, in a very important sense, original and undelegated." (*Hoyt v. Thompson's Executors,* 19 N.Y. 207, 216; *Beveridge v. N. Y. E. R. R. Co.*, 112 N.Y. 1, 22, 23.)
>
> While the ordinary rules of law relating to an agent are applicable in considering the acts of a board of directors in behalf of a corporation when dealing with third persons, the individual directors making up the board are not mere employees, but a part of an elected body of officers constituting the executive agents of the corporation. They hold such office charged with the duty to act for the corporation according to their best judgment, and in so doing they cannot be controlled in the reasonable exercise and performance of such duty. As a general rule the stockholders cannot act in relation to the ordinary business of the corporation, nor can they control the directors in the exercise of the judgment vested in them by virtue of their office.

Id. at 637.

2. Directors have greater informational rights than shareholders. Directors have a right to inspect the corporation's books and records as long as they do not have a purpose detrimental to the corporation (*e.g.*, providing the information to a competitor). *See* DGCL § 220(d); MBCA § 16.05(a). As described in [later materials], the shareholder's right of inspection is more limited.

3. The traditional remedy for shareholders who are displeased with the performance of the board is to elect new directors. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985) (noting that "[i]f the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out"). Would removing Dunsmore and Willard at the next election of directors have solved the shareholders' problem? *See* DGCL § 211(c); MBCA § 7.03.

4. Of course, the shareholders in *Charlestown* did not desire to remove Dunsmore and Willard. They desired to force Dunsmore and Willard to work with Osgood in winding up the corporation's affairs. Under modern law, is it possible to give the shareholders 100% of what they wanted?

5. In *Charlestown*, do the shareholders have any recourse against Dunsmore and Willard for the harm caused to the corporation?

PROBLEM

The shareholders are unhappy with the performance of the corporation's president. At the annual meeting of shareholders, the shareholders seek to vote on a resolution directing the board to replace the president. Is this an appropriate question for shareholder action? *See* DGCL § 142(b); MBCA § 8.40(a).

NOTE ON THE REMOVAL OF DIRECTORS

Unless the certificate or bylaws provide to the contrary, any director, or the entire board, may be removed by the shareholders with or without cause. See DGCL § 141(k); *see also* MBCA § 8.08(a) (allowing for removal without cause unless the articles provide to the contrary). There are, however, three important restrictions on the shareholders' ability to remove directors without cause. First, if a corporation has a classified or staggered board, directors may be removed only for cause. *See* DGCL § 141(k)(1). *But see* MBCA § 8.08 (placing no impediment on removing directors from a classified board). A classified board is usually divided into three groups with one group of directors standing for election each year. Each director is elected to a three-year term. *See* DGCL § 141(d); MBCA § 8.06. One purpose of a classified board is to provide the board with continuity and experience. Perhaps a more important practical purpose is to force a hostile takeover bidder to wait at least two annual meetings before seizing a majority of the board seats. Second, in a corporation that permits cumulative voting, if less than the entire board is to be removed, no single director may be removed if the votes cast against his removal would be sufficient to elect him. *See* DGCL § 141(k)(2); MBCA § 8.08(c). Cumulative voting provides roughly proportional board representation for minority shareholders. This restriction prevents the majority from circumventing the minority's right to cumulative voting. Third, whenever a particular class or series of stock has the right to elect one or more directors, only the shareholders eligible to vote for such directors are permitted to vote on the removal of such directors. *See* DGCL § 141(k); MBCA § 8.08(b).

When directors may be removed only for cause, what constitutes "cause" may be a difficult question. *Compare* Eckhaus v. Ma, 635 F.Supp. 873 (S.D.N.Y. 1986) (holding that acceptance of employment with a direct competitor of the corporation constituted cause), *and* Fells v. Katz, 175 N.E. 516, 517 (N.Y. 1931) (holding that engaging in a competing business constituted cause), *with In re* Korff, 190 N.Y.S. 664, 668 (App. Div. 1921) (holding that a director's temporary financial difficulties in an independent business and his temporary absence from the state did not constitute cause), *and* Fox v. Cody, 252 N.Y.S. 395, 397–98 (Sup. Ct. 1930) (noting that removal must be based on substantial grounds showing a breach of trust rather than on whim, caprice, mistake, or misunderstanding). A director threatened with removal for cause is entitled to notice of the charges against him, an opportunity to be heard, and a hearing—in short, some minimal elements of due process. *See* Campbell v. Loew's, Inc., 134 A.2d 852 (Del. Ch. 1957); Auer v. Dressel, 118 N.E.2d 590 (N.Y. 1954). Of course, in a corporation with shares widely held by the general public, a "trial" of a director by the

shareholders is unwieldy and impractical. Instead, a decision is made by the granting or withholding of a proxy—a fact that has been recognized by the courts when they have insisted that the imperiled director be given access to the proxy machinery to conduct his defense. *See* Campbell v. Loew's, Inc., 134 A.2d 852, 862–63 (Del. Ch. 1957).

In the absence of a statute authorizing judicial removal of directors, *see* DGCL § 225(c); MBCA § 8.09, there is a split of authority on whether a court has the power to remove a director for cause. *Compare* Webber v. Webber Oil Co., 495 A.2d 1215 (Me. 1985) (holding that courts lack the power to remove directors), *with* Ross v. 311 N. Cent. Ave. Bldg. Corp., 264 N.E.2d 406 (Ill. App. Ct. 1970) (holding that courts have the power to remove directors for misconduct). It is generally settled that the board itself lacks the power to remove a director. There is some question as to whether the certificate can change this rule and permit the board to remove one of its members. *See, e.g.*, Dillon v. Berg, 326 F. Supp. 1214 (D. Del.), *aff'd,* 453 F.2d 876 (3d Cir. 1971); Bruch v. National Guar. Credit Corp., 116 A. 738 (Del. Ch. 1922).

2. FORMALITIES REQUIRED FOR BOARD ACTION

DGCL §§ 141, 229

MBCA §§ 8.20–8.25, 14.30

"The general rule is that a board of directors may exercise its power only as a body at a meeting duly assembled." American Bank & Trust Co. v. Freeman, 560 S.W.2d 444, 446 (Tex. Civ. App. 1977). The underlying theory is that the shareholders are entitled to a decision reached only after group discussion and deliberation. Views may be changed as a result of discussion, and the sharpening of minds as a result of joint deliberation improves the decisional process. Several corollaries arise from this theory: (a) the independent approval of an act by each of the individual directors is not effective board action; (b) directors may not vote by proxy; and (c) formalities as to notice, quorum, and voting must be fully adhered to. Three statutory provisions ameliorate these rules. First, directors may act by unanimous written consent in lieu of having a meeting. *See* DGCL § 141(f); MBCA § 8.21. Second, directors may participate in a board meeting by any method that allows all of the participants to hear each other, such as a conference telephone call. *See* DGCL § 141(i); MBCA § 8.20(b). Third, the board may delegate most matters to committees. A committee may be comprised of one or more directors. *See* DGCL § 141(c); MBCA § 8.25.

Delaware does not have statutory provisions dealing with the required notice for board meetings. This question is usually addressed in the bylaws. The Model Act states that, unless the articles or bylaws provide otherwise, regular meetings of the board may be held "without notice of the date, time, place or purpose of the meeting." Special meetings require at least two days' notice of the date, time, and place, but do not require notice of the purpose of the meeting. *See* MBCA § 8.22. A director may waive any notice requirement in writing. He may also waive notice by attending the meeting without objection. *See* DGCL § 229; MBCA § 8.23.

A quorum of directors is a majority of the total number of authorized directors. Thus, if a board has nine authorized seats and two are vacant, five directors constitute a quorum. The certificate or bylaws may specify that any percentage greater or lesser than a majority constitutes a quorum, but they may not specify a percentage less than one-third of the total number of authorized directors. *See* DGCL § 141(b); *see also* MBCA § 8.24(a), (b). If a quorum exists, it takes a majority vote of the directors present to approve a matter. The certificate or bylaws may specify that a supermajority board vote is required. *See* DGCL § 141(b); MBCA § 8.24(c). In Delaware, the certificate of incorporation may provide that certain directors have more or less than one vote per director. In this instance, board action must be approved by a majority of the votes that directors present at a meeting are entitled to cast. *See* DGCL § 141(d).

The requirements for formal board action often make little sense in the context of closely held corporations. When all of the shareholders are directors and participate in the management of the business, the requirement of a directors' meeting is often considered a meaningless formality. Further, rigid application of the formal requirements for board action often permits a corporation to use its internal procedural defects as a sword to avoid undesired transactions. This basic injustice is heightened because the person dealing with the corporation may have no way of verifying that the formalities were followed.

In closely held corporations, unanimous assent or acquiescence by directors is normally viewed as the equivalent of formal board action. *See, e.g.*, Winchell v. Plywood Corp., 85 N.E.2d 313 (Mass. 1949) (upholding conduct in which a majority of the board participated and the remaining director acquiesced). However, informal assent or acquiescence by less than all of the directors should be insufficient to constitute valid board action. *See, e.g.*, Hurley v. Ornsteen, 42 N.E.2d 273 (Mass. 1942) (holding that a

majority of directors could not bind the corporation when the other directors lacked knowledge of the transaction and did not subsequently adopt it). In this circumstance, the requirement of a board meeting has some effect. After full discussion at a meeting, the dissenting directors might convince their colleagues to have a change of heart. Moreover, the dissenting directors are entitled to be informed of the action before it is taken. Finally, when all of the shareholders of a closely held corporation approve a transaction, courts often ignore the fact that the board, rather than the shareholders, was the body required to make the decision. *See, e.g.*, Burger v. Western Sand & Gravel Co., 237 S.W.2d 725, 730 (Tex. Civ. App. 1950) (noting that "the law is well-settled that, where all of the stockholders of a corporation enter into a contract with another party, it is binding upon the corporation even though no action is taken by its board of directors, when the corporation owes no debts and the rights of creditors are not affected").

In addition . . . the law of agency may validate informal corporate conduct. Even though the directors' failure to have a proper board meeting may prevent the conferral of actual authority, a corporate agent may still have apparent authority to consummate a transaction with third parties.

GEARING V. KELLY

Court of Appeals of New York

182 N.E.2d 391 (1962)

PER CURIAM.

Appellants, who own 50% of the stock of the Radium Chemical Company, Inc., seek . . . 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. . . .

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.

. . . 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, for 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 particularly when it results in giving the Kellys complete control of the corporation. . . .

NOTES & QUESTIONS

1. Why were the two Kellys insufficient to constitute a quorum?

2. What is the purpose of the quorum requirement? Is it to require a sufficient number of directors for the purpose of conducting business or protect the rights of minority shareholders?

3. If Meacham is permitted to avoid board meetings to prevent action of which she disapproves, the board might become paralyzed. What remedies are available if the board is unable to operate? *See* MBCA § 14.30(a)(2).

4. In Tomlinson v. Loew's Inc., 134 A.2d 518 (Del. Ch.), *aff'd*, 135 A.2d 136 (Del. 1957), a board consisted of thirteen directors. After four directors resigned, the Tomlinson faction controlled five board seats and the Vogel faction controlled four board seats. The Vogel faction refused to attend a board meeting at which the Tomlinson faction purported to fill two of the board vacancies. The Delaware Court of Chancery held:

> [S]even directors had to be in attendance in order to properly elect the individual defendants as directors unless, as the Tomlinson group contends, the four so-called Vogel directors who stayed away from the meeting to prevent the creation of a quorum should be considered as estopped from raising the question or should be considered as though they had resigned insofar as the meeting was concerned. . . . [N]o authority for either proposition is cited in the brief and I know of no legal reason why such consequences should flow from the action of the Vogel group here, particularly where they felt that the principal business noticed for the directors' meeting should be a matter for stockholder action. . . . I conclude that there was no estoppel or temporary resignations by the Vogel group.

Id. at 530. Do you agree with *Gearing* or *Tomlinson*?

3. THE AUTHORITY OF OFFICERS

DGCL § 142

MBCA §§ 8.40–8.44

A corporation has such offices as are stated in its bylaws or in a board resolution that is not inconsistent with its bylaws. Officers are chosen in a manner prescribed by the bylaws or the board of directors. *See* DGCL § 142; MBCA § 8.40. The usual practice is for the board of directors to appoint officers. The extent to which officers have authority to bind the corporation is governed by the law of agency.

4. SHAREHOLDER ACTION

a. Formalities Required for Shareholder Action

DGCL §§ 211, 213, 216, 219, 228–229

MBCA §§ 7.01–7.02, 7.04–7.07, 7.20, 7.25, 7.27–7.28

The corporation is required to hold an annual meeting of shareholders at which directors are elected. *See* DGCL § 211(b); MBCA § 7.01(a). Any other business may be conducted at an annual meeting. In Delaware, unless otherwise provided in the certificate or bylaws, only the board of directors may call a special meeting of shareholders. *See* DGCL § 211(d). Under the Model Act, owners of at least 10% of the shares entitled to vote may call a special meeting. The articles may alter this percentage but may not raise it above 25%. *See* MBCA § 7.02. The shareholders must be sent notice of an annual or special meeting that specifies the date, time, and place of the meeting. A notice of a special meeting must also specify the purpose or purposes for which the meeting is called. The notice of meeting must be mailed at least ten days and not more than sixty days before the meeting. *See* DGCL § 222; MBCA § 7.05. Shareholders may waive defects in the notice in writing or by attending the meeting without objection. *See* DGCL § 229; MBCA § 7.06.

In Delaware, to determine which shareholders are allowed to vote at a meeting, the board establishes a "record date" that is at least ten and not more than sixty days before the meeting. If the board does not establish a record date, the record date is the day before notice is given. If no notice is given, the record date is the day prior to the meeting. *See* DGCL § 213(a). Under the Model Act, unless otherwise provided in the bylaws, the board may set a record date that is not more than seventy days before the meeting. *See* MBCA § 7.07. Those purchasing shares after the record date do not have the right to vote at the meeting. In such situations, it is typical for the seller to grant the purchaser a proxy allowing the purchaser to vote the shares.

In Delaware, the corporation is required to make a shareholder list available for inspection beginning ten days prior to the meeting and continuing through the meeting itself. *See* DGCL § 219(a). Under the Model Act, the corporation is required to make the list available beginning two business days after the notice of meeting is given. *See* MBCA § 7.20(b).

To constitute a quorum, a majority of shares entitled to vote on a matter must be represented in person or by proxy at the meeting. *See* DGCL § 216(1); MBCA § 7.25(a). In Delaware, the certificate or bylaws may prescribe any lower or higher percentage, but may not allow a percentage lower than one-third of the shares entitled to vote. *See* DGCL § 216. Under the Model Act, the articles may provide that a percentage greater than a majority is required to constitute a quorum. *See* MBCA § 7.27(a).

In Delaware, for ordinary matters other than the election of directors, it takes a majority of shares present at the meeting and entitled to vote to approve the matter. *See* DGCL § 216(2). Thus, shareholders who are present but abstain effectively vote "no." Shareholder voting on extraordinary matters is discussed in [later materials]. Under the Model Act, for ordinary matters other than the election of directors, the matter is approved if the "yes" votes exceed the "no" votes. *See* MBCA § 7.25(c). Thus, abstentions are effectively ignored. Directors are elected by a plurality vote. *See* DGCL § 216(3); MBCA § 7.28(a). In Delaware, supermajority voting requirements may be imposed by the certificate or bylaws. *See* DGCL § 216. Under the Model Act, such requirements must appear in the articles. *See* MBCA § 7.27(a).

Although the usual practice is to allocate one vote per share, the Delaware courts have approved weighted voting schemes. *See* Williams v. Geier, 671 A.2d 1368 (Del. 1996)

(approving a recapitalization plan that granted current stockholders 10 votes per share and limited transferees to one vote per share until they held the stock for three years); Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. 1977) (approving a scheme that allowed a shareholder one vote per share for the first fifty shares and one vote for every twenty shares in excess of fifty; this scheme limited a 28% shareholder to approximately 3% of the corporation's voting power); *see also* DGCL § 212(a) (stating that "unless otherwise provided in the certificate of incorporation . . ., each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder"). However, public corporations with disproportionate voting structures may have difficulty getting their stock listed for trading on the major exchanges. *See, e.g.*, NYSE Euronext, Inc., NYSE Listed Company Manual § 313(a) (providing that voting rights in publicly traded companies "cannot be disparately reduced or restricted" through such mechanisms as "the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock, or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer").

Delaware permits shareholder meetings to be held by "remote communication." For example, a meeting might be held over the Internet. If a meeting is not held at a physical location, there are three caveats: (a) the corporation must be able to verify that each person deemed present and desiring to vote is a shareholder or proxyholder; (b) shareholders and proxyholders must have a reasonable opportunity to participate in the meeting, including the opportunity to read or hear the proceedings substantially as they occur; and (c) the corporation must maintain a record of actions taken at the meeting by shareholders or proxyholders. *See* DGCL § 211(a)(2)(b).

In Delaware, those owning enough shares to approve a particular matter may act by written consent in lieu of a meeting. A telegram, cablegram, or other electronic transmission (*e.g.*, an e-mail) counts as a writing so long as the corporation can verify the identity of the sender and the date on which it was sent. *See* DGCL § 228(a), (d)(1). Under the Model Act, it takes unanimous written consent to approve a matter without a meeting. *See* MBCA § 7.04(a).

b. Straight vs. Cumulative Voting

DGCL § 214

MBCA § 7.28

In a straight voting election of directors, every shareholder votes the entire number of shares that he owns for as many directors as there are seats up for election. For example, assume that a corporation has 1000 shares issued and outstanding. Able owns 600 shares and Baker owns 400. The board consists of three seats and all directors are up for election. Able votes his shares for candidates A, B, and C. Baker votes his shares for candidates D, E, and F. The final tally is: A = 600 votes; B = 600 votes; C = 600 votes; D = 400 votes; E = 400 votes; F = 400 votes. As a consequence, A, B, and C are elected. Thus, in a straight voting election, anyone owning 51% of the shares elects 100% of the board.

In a cumulative voting election of directors, every shareholder has a number of votes equal to the number of shares he owns multiplied by the number of board seats up for election. He may distribute these votes among the candidates in any manner that he chooses. In our example, Able would have 1800 votes and Baker would have 1200 votes. If Able casts 900 votes for A and 900 votes for B, these directors will both be elected because Baker cannot split 1200 votes two ways in a manner that beats 900 votes. On the other hand, if Baker casts 1200 votes for D, his election is also certain because Able cannot split 1800 votes three ways in a manner that beats 1200 votes. As a consequence,

cumulative voting provides minority shareholders with roughly proportional board representation. Baker owns 40% of the votes and receives 33% of the board seats.

What is the value to Baker of receiving one-third of the board seats? Able's representatives may still outvote him on any matter that comes before the board. Nevertheless, directors have greater rights to information than shareholders. Baker's director will be able to attend and participate at board meetings. The participation of Baker's director makes it less likely that the majority will engage in illegal conduct due to fear of discovery. If the majority does engage in illegal conduct, Baker will be able to mount a legal challenge more quickly. The chief disadvantage of cumulative voting is that, if Able and Baker become enemies, their animosity will infect the board.

Two formulas are useful in determining the practical impact of cumulative voting. Given the total number of shares voting (S) and the total number of directors up for election (D), we can determine the number of shares needed (X) to elect a certain number of directors (N):

$$X = \frac{S \times N}{D + 1} + 1 \text{ (Vote)}$$

More precisely, (S × N) ÷ (D + 1) is the maximum number of votes that would be insufficient to elect N directors. Thus, rounding this fraction up to the next nearest whole number gives the exact minimum number of votes necessary to elect N directors (where the corporation does not have fractional shares). If the corporation has fractional shares, any number of shares greater than (S × N) ÷ (D + 1) will be sufficient to elect N directors.

Thus, in our example, Able needs at least 501 shares to elect two directors:

$$X = \frac{1000 \times 2}{3 + 1} + 1 = \frac{2000}{4} + 1 = 501$$

Because Able owns 600 shares, he can elect two directors. Applying the same formula indicates that Baker needs at least 251 shares to elect one director. Because Baker owns 400 shares, he can elect one director. There is one technicality to keep in mind. If the formula results in a fraction, round down to the nearest whole number to determine the minimum number of shares necessary to elect the desired number of directors.

The following formula provides the number of directors (N) that a shareholder has the power to elect at the same election, given the total number of shares owned by that shareholder (X):

$$N = \frac{X (D + 1)}{S}$$

If we ask how many directors Able has the power to elect, the formula yields the following:

$$N = \frac{600(3+1)}{1000} = \frac{2400}{1000} = 2.4$$

Because one cannot elect 4/10ths of a director, we round this number down to the nearest whole number. Thus, Able can elect two directors. If we ask how many directors Baker has the power to elect, the formula produces a result of 1.6, which means that Baker can elect one director.

There is one legal matter that these formulas are helpful in resolving. As discussed in [prior materials], unless the entire board is removed, shareholders may not remove a director elected by cumulative voting without cause if the votes cast against his removal would be sufficient to elect him. Suppose that Able attempts to remove Director D, Baker's director, without cause. If Baker votes his 400 shares against removal, Director D may not be removed because it takes only 251 shares to elect him.

Most states have straight voting for the election of directors unless the certificate of incorporation provides for cumulative voting. *See* DGCL § 214; MBCA § 7.28(b). As a general matter, classifying or staggering the board reduces the number of directors that the minority can elect through cumulative voting. A recent Delaware case holds that a certificate amendment providing for a staggered board is not improper even if the effect is to reduce or eliminate the impact of cumulative voting previously authorized by the certificate. *See* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1 (Del. Ch. 2010).

In states that have mandatory cumulative voting, is it permissible to classify or stagger the board? *Compare* Wolfson v. Avery, 126 N.E.2d 701 (Ill. 1955) (holding that classification of the board was contrary to the mandatory cumulative voting requirement that was once contained in the Illinois constitution), *with* Bohannan v. Corporation Comm'n, 313 P.2d 379 (Ariz. 1957) (holding that an Arizona constitutional provision that once required cumulative voting did not preclude classification of the board as long as the minority retained some board representation). Two supreme courts have held that staggering was permissible regardless of the impact on cumulative voting because the mandatory cumulative voting provisions once present in those states did not explicitly restrict the ability to stagger the board. *See* Humphrys v. Winous Co., 133 N.E.2d 780 (Ohio 1956); Janney v. Philadelphia Transp. Co., 128 A.2d 76 (Pa. 1956).

PROBLEM 4–6

Able owns 700 shares of ABC Corporation and Baker owns 300 shares. The corporation's six directors are elected through cumulative voting, as required by the relevant state's constitution. How many directors does Baker have the power to elect? Assume that Able uses his board and shareholder voting power to amend the corporation's certificate to provide that ABC's board will be classified, with two directors elected each year to three-year terms. At each election of directors, how many directors does Baker have the power to elect? Should Able be permitted to amend the certificate to provide for a classified board?

NOTE ON SELF–ENFORCING VOTING MECHANISMS

The problem with cases like *Ringling* is that the parties must rely on a court to give appropriate relief if a voting agreement is breached. This Note considers three methods of making voting agreements self-enforcing: irrevocable proxies, voting trusts, and classified voting.

a. *Irrevocable Proxies.* A proxy involves an agency relationship. One person gives another the power to vote shares on his behalf. For example, in *Ringling*, Mrs. Haley gave her husband the power to act on her behalf in voting her shares. The Delaware statute provides a simple method for conveying a proxy: the owner of the shares conveys a signed authorization to the proxyholder. Conveying authorization by telegram, cablegram, or other electronic transmission (*e.g.*, e-mail) is also permissible as long as it can be verified that the shareholder sent, or authorized the sending of, the transmission. A proxy is valid for three years unless the proxy itself provides for a longer period. *See* DGCL § 212(b), (c); *see also* MBCA § 7.22(b), (c) (stating that a proxy is valid for eleven months unless the authorization provides for a longer period). Like all agency relationships, a proxy is normally revocable at will.

A voting agreement may be enforced through the conveyance of an irrevocable proxy. Otherwise, the party that desired to breach the agreement would simply revoke his proxy. To create an irrevocable proxy, the proxy must state that it is irrevocable and the proxy must be "coupled with an interest." *See* DGCL § 212(e); MBCA § 7.22(d). The requirement that the proxy be "coupled with an interest" has caused great confusion.

Initially, one may fairly ask why grantors may not simply designate proxies as irrevocable. Why is there an additional requirement that the proxy be "coupled with an interest?" Let us compare two cases. Assume that a shareholder grants a proxy in exchange for a cash payment. Although consideration exists for the granting of the proxy, such a transaction almost certainly would be held to be against public policy and unenforceable. By contrast, if a person lends a shareholder money and takes a lien on the shares as security, an irrevocable proxy granted to the creditor would be enforceable. What is the difference between these two situations? A person who purchases a vote presumably intends to recoup his investment by exercising the power to vote in some way. This power may very well be exercised in a manner adverse to the corporation: the proxyholder's interest is in recouping a personal payment, and in a sense this interest is antagonistic to the corporation. The creditor's interest in the vote, on the other hand, is to preserve or increase the value of the shares that constitute his security. He has a financial interest consistent with that of the corporation whereas the vote purchaser arguably does not. The effect of recognizing an irrevocable proxy is to separate ownership from voting power. Because of the possibility of injury to the corporation through abuse of the voting power, the courts have generally refused to recognize the irrevocability of a proxy except when there appears to be little likelihood that the power to vote will be abused. This is the core of the "coupled with an interest" concept.

The Delaware statute does not specify the circumstances under which a proxy is "coupled with an interest." It does, however, provide that "[a] proxy may be made irrevocable regardless of whether the interest with which it is coupled is an interest in the stock itself or an interest in the corporation generally." DGCL § 212(e). For example, a person who purchases shares after the record date for a meeting will normally demand an irrevocable proxy to vote the shares. This kind of proxy involves an interest in the shares themselves. By contrast, a creditor may lend money to a corporation and require a stockholder to grant him an irrevocable proxy until the loan is repaid. In this case, the creditor has an interest in the corporation, because the corporation's prosperity will determine whether his loan is repaid, but the creditor has no interest in the shares themselves. The Delaware statute resolves a longstanding dispute in the case law and makes clear that an interest in the corporation is sufficient for a proxy to be "coupled with an interest." *See* Haft v. Haft, 671 A.2d 413 (Del. Ch. 1995) (enforcing an irrevocable proxy granted by a son to his father, the corporation's CEO, upon the son's

purchase of the father's controlling block of shares; the father's corporate position gave him a sufficient stake in the corporation to allow the proxy to be "coupled with an interest").

The difficulty with applying this body of law to cases like *Ringling* involves the identity of the proxyholder. Given their agreement, Mrs. Ringling and Mrs. Haley would probably prefer to designate Mr. Loos as the irrevocable proxyholder if they decided to make their agreement self-enforcing. However, Mr. Loos was merely a lawyer who had represented Mrs. Ringling and Mrs. Haley. He had neither an interest in the shares subject to the agreement nor an interest in the corporation. As a consequence, it would seem that Mrs. Ringling and Mrs. Haley would have to provide that each appointed the other (or someone else with an interest in the corporation—*e.g.*, an officer) to act as a proxy on an irrevocable basis in the event that a dispute required Mr. Loos' arbitration and one party refused to follow Mr. Loos' direction. Thus, if Mrs. Haley or her husband refused to follow Mr. Loos' direction, Mrs. Haley would be deemed to confer an irrevocable proxy on Mrs. Ringling. This was essentially the result reached by the Chancery Court in *Ringling*. However, what if Mrs. Ringling failed to exercise the proxy as Mr. Loos directed? This result would pose great confusion for the chairman of the meeting. It might still require a court to untangle the situation.

The Model Act is more helpful. It specifies that proxies are "coupled with an interest" when given in favor of: (a) a pledgee; (b) one who has purchased or agreed to purchase shares; (c) a corporate creditor who extends credit under a contract requiring the proxy; (d) a corporate employee whose employment contract requires the proxy; or (e) a party to a voting agreement. *See* MBCA § 7.22(d). This list is nonexclusive. Presumably, any proxyholder with an interest in the shares or the corporation will have a proxy "coupled with an interest." Moreover, in the *Ringling* case, one would assume that the parties could have conferred an irrevocable proxy on Mr. Loos by making him a party to the agreement for nominal consideration.

b. *Voting Trusts*. A voting trust differs from a voting agreement primarily in that legal title to the shares is vested in one or more trustees. In Delaware, there are three requirements for the creation of a voting trust: (a) the trust agreement must be in writing; (b) a copy of the trust agreement must be deposited with the corporation at its registered office, where it must be available for inspection; and (c) the shares subject to the trust must be transferred to the trustee or trustees. The corporation then cancels the shares transferred to the trustee and issues new shares in the name of the trustee or trustees. If there is more than one trustee, the stock is voted as the trust agreement directs. If the trust agreement is silent, the stock is voted as a majority of the trustees direct. If the trustees are equally divided, the vote of the stock is divided equally among the trustees. *See* DGCL § 218(a). The Model Act has a similar procedure. *See* MBCA § 7.30(a). There is no time limit on voting trusts in Delaware. Under the Model Act, however, a voting trust expires in ten years unless it is extended for an additional ten-year period. *See id.* § 7.30(b).

Voting trust agreements usually provide that all dividends or other corporate distributions are to be passed through to the equitable owners of the shares. The trustees may also issue transferable voting trust certificates representing the equitable interests in the shares. Voting trust agreements may limit the power of trustees to vote on certain matters or to transfer the shares without the consent of the equitable owners.

A voting trust would certainly be one way to make the agreement in *Ringling* self-enforcing. Mrs. Ringling and Mrs. Haley could create a voting trust with Mr. Loos as the trustee. The trust agreement could provide that Mr. Loos would vote as Mrs. Ringling and Mrs. Haley directed, if they agreed, and according to his own best judgment, if they disagreed. There would then be no problem for the chairman of the meeting or the courts because Mr. Loos would be the record owner of the shares and his votes would be the only ones counted. One difficulty is that Mrs. Ringling and Mrs. Haley would have to be willing to divorce the voting rights of their shares from the beneficial interests. They would also have to trust Mr. Loos to vote in accordance with the trust agreement. Of course, Mr. Loos could be sued for breach of contract and breach of fiduciary duty if he failed to comply with the trust agreement. However, such a suit would defeat the purpose of making the agreement self-enforcing.

A difficult legal question surrounding voting trusts is whether failure to comply with the statutory formalities renders a voting trust illegal. The traditional view is that it does. *See* Christopher v. Richardson, 147 A.2d 375 (Pa. 1959) (holding that a voting trust agreement whose duration might exceed the statutory maximum was void in its entirety). Some courts have been more lenient. *See* Holmes v. Sharretts, 180 A.2d 302 (Md. 1962) (enforcing a voting trust agreement whose duration might exceed the statutory maximum because the agreement also stated that it was to be construed in accordance with applicable law).

Another problem is what types of arrangements should be characterized as voting trusts. In Abercrombie v. Davies, 130 A.2d 338 (Del. 1957), six shareholders controlling 54.5% of a corporation's stock desired to form a voting coalition. In a corporation that permitted cumulative voting, these shareholders had the power to elect eight of fifteen directors. They agreed to appoint the eight directors as agents to vote their shares in concert. All shares subject to the agreement would be voted as seven of the eight agents directed. If seven of the eight agents did not agree, there were provisions for arbitration. The shareholders granted irrevocable proxies to the agents to vote the shares for a ten-year term. They also endorsed their shares in blank and delivered the shares to the agents, who placed them in escrow. The agreement permitted seven of the eight agents to withdraw the shares from escrow and to create a voting trust. In form, the shareholders had executed a voting agreement enforced by irrevocable proxies, with the potential to create a voting trust in the future. The Delaware Supreme Court held that, in substance, they had inadvertently created a voting trust:

> A review of the Delaware decisions upon the subject of voting trusts shows that our courts have indicated that one essential feature that characterizes a voting trust is the separation of the voting rights of the stock from the other attributes of ownership. . . .
>
> When we apply [this test] to the Agents' Agreement we find: (1) that the voting rights of the pooled stock have been divorced from the beneficial ownership, which is retained by the stockholders; (2) that the voting rights have been transferred to fiduciaries denominated Agents; (3) that the transfer of such rights is through the medium of irrevocable proxies, effective for a period of ten years; (4) that all voting rights in respect of all the stock are pooled in the Agents as a group, through the device of proxies running to the agents jointly and severally, and no stockholder retains the right to vote his or its shares; and (5) that on its face the agreement has for its principal object voting control of [the corporation].
>
> These elements, under our decisions, are the elements of a voting trust.

Id. at 344–45. Because the shareholders had not followed Delaware's statutory requirements for creating a voting trust (which is hardly surprising given that the parties believed that they had a different form of arrangement), the court held that their voting trust was illegal and declined to enforce it. This result has been reversed by statute in Delaware. *See* DGCL § 218(d); *see also* MBCA § 7.31(a). However, *Abercrombie* still presents a trap for the unwary in states that do not have a similar statutory provision.

By contrast, in Oceanic Exploration Co. v. Grynberg, 428 A.2d 1 (Del. 1981), the Delaware Supreme Court held that an arrangement described as a voting trust was not actually a voting trust. In *Oceanic*, the Grynberg family owned 76% of Oceanic's stock. As part of an accommodation with creditors, the Grynberg family placed their stock in a voting trust and gave the corporation an option to purchase the stock. The Grynberg family later challenged the legality of the voting trust agreement and sought to reacquire the shares. They alleged that the voting trust agreement was invalid because: (a) the agreement was extended more than two years' prior to its scheduled expiration (a prohibition since eliminated from the statute); and (b) all of the shares subject to the agreement could not be transferred to the trustees because some were pledged as security for the corporation's debts. The court noted that "the main purpose of a voting trust statute is 'to avoid secret, uncontrolled combinations of stockholders formed to acquire control of the corporation to the possible detriment of non-

participating shareholders.' " *Id.* at 7 (quoting Lehrman v. Cohen, 222 A.2d 800, 807 (Del. 1966)). The arrangement in *Oceanic* was not secret. In fact, it was described in one of the corporation's annual reports and one of its proxy statements. Moreover, the agreement was designed principally to satisfy creditors and to enforce the corporation's purchase option. It was not designed to enhance shareholder voting power. As a consequence, the court held that the agreement, despite its label, did not constitute a voting trust that had to comply with DGCL § 218.

c. *Classified Voting*. Dividing shares into classes is a method of disaggregating voting rights from the other incidents of stock ownership. For example, suppose that Able contributes 80% of a corporation's capital and Baker contributes 20%. The parties desire to have equal voting power, but Able insists upon receiving 80% of the financial benefits of stock ownership. One easy way to solve this problem is to create two classes of stock, Class A and Class B. The shares of both classes are identical except that Class A has voting rights and Class B does not. The corporation sells 20 shares of Class A stock and 60 shares of Class B stock to Able. The corporation sells 20 shares of Class A stock to Baker. The parties will have equal voting rights, but Able will receive 80% of the dividends and 80% of any distributions upon liquidation. What the parties might have achieved in a partnership by agreement, they have achieved in a corporation by a clever manipulation of classes of stock.

Dividing shares into classes is also useful for apportioning control of the board of directors. Suppose that the Smith family contributes 60% of a corporation's capital and the Thompson family contributes 40%. The parties desire to distribute four board seats equally among the families. Otherwise, the Smith family is to receive 60% of the voting power and 60% of the financial benefits of stock ownership. One way to achieve this result is to provide that the Class A shares may elect two directors and the Class B shares may elect two directors. For all other purposes, Class A shares have identical rights to Class B shares. The corporation sells 60 Class A shares to the Smith family and 40 Class B shares to the Thompson family. With a single class of stock, the shareholders might have achieved the same result by executing an agreement that required all shareholders to vote for two directors nominated by Mr. Smith and for two directors nominated by Mr. Thompson. However, as *Ringling* demonstrates, this agreement would not be self-enforcing. Apportioning the board among classes of shares is self-enforcing. If the voting is classified in this manner, only shareholders who may vote to elect a director may vote to remove that director. *See* DGCL § 141(k); MBCA § 8.08(b).

Finally, dividing shares into classes may be used to prevent a deadlock on the board. In Lehrman v. Cohen, 222 A.2d 800 (Del. 1966), the Cohen family held Class AC stock and the Lehrman family held Class AL stock. Originally, each class of stock was entitled to elect two members of the corporation's four-person board. To prevent the possibility of deadlock, the corporation added a fifth director to the board and created Class AD stock with the power to elect the fifth director. Class AD stock had no economic rights. The corporation issued one share of Class AD stock to the corporation's counsel. The court held that it was legal to create voting stock with no economic rights. The court also rejected the argument that the arrangement amounted to an illegal voting trust:

> [T]he plaintiff says . . . that the AD arrangement provides for a divorcement of voting rights from beneficial ownership of the AC and AL stock; that the creation and issuance of the share of AD stock is tantamount to a pooling by the AC and AL stockholders of a portion of their voting stock and giving it to a trustee, in the person of the AD stockholder, to vote for the election of the fifth director; that after the creation of the AD stock, the AC and AL stockholders each hold but 40% of the voting power, and the AD stockholder holds the controlling balance of 20%; that the AD stock has no property rights except the right to a return of the $10 paid as the par value; and that, therefore, there has been a transfer of the voting rights devoid of any participating property rights. . . .
>
> The contention is unacceptable. The AD arrangement did not separate the voting rights of the AC or the AL stock from the other attributes of ownership of those

classes of stock. Each AC and AL stockholder retains complete control over the voting of his stock; each can vote his stock directly; no AL or AC stockholder is divested of his right to vote his stock as he sees fit; no AL or AC stock can be voted against the shareholder's wishes; and the AL and AC stock continued to elect two directors each.

. . . .

We are told that if the AD stock arrangement is allowed thus to stand, our Voting Trust Statute will become a "dead letter" because it will be possible to evade and circumvent its purpose simply by issuing a class of non-participating voting stock, as was done here. We have three negative reactions to this argument:

First, it presupposes a divestiture of the voting rights of the AC and AL stock—an untenable supposition as has been stated. Secondly, it fails to take into account the main purpose of a Voting Trust Statute: to avoid secret, uncontrolled combinations of stockholders formed to acquire voting control of the corporation to the possible detriment of non-participating shareholders. It may not be said that the AD stock arrangement contravenes that purpose. Finally on this point, if we misconceive the legislative intent, and if the AD stock arrangement in this case reveals a loophole in § 218 which should be plugged, it is for the General Assembly to accomplish—not for us to attempt by interstitial judicial legislation.

Id. at 805, 807.

3. SHARE TRANSFER RESTRICTIONS

DGCL § 202

MBCA § 6.27

ALLEN V. BILTMORE TISSUE CORP.

Court of Appeals of New York

141 N.E.2d 812 (1957)

FULD, JUDGE.

The by-laws of defendant corporation give it an option to purchase, in case of the death of a stockholder, his shares of the corporate stock. The enforceability of this option is one of the questions for decision.

Biltmore Tissue Corporation was organized under the Stock Corporation Law in 1932, with an authorized capitalization of 1,000 shares without par value, to manufacture and deal in paper and paper products. The by-laws, adopted by the incorporators-directors, contain provisions limiting the number of shares (originally 5, later 20) available to each stockholder (§ 28) and restricting stock transfers both during the life of the stockholder and in case of his death (§§ 29, 30). Whenever a stockholder desires to sell or transfer his shares, he must, according to one by-law (§ 29), give the corporation or other stockholders "an opportunity to repurchase the stock at the price that was paid for the same to the Corporation at the time the Corporation issued the stock"; if, however, the option is not exercised, "then, after the lapse of sixty days, the stock may be sold by the holder to such person and under such circumstances as he sees fit." The by-law, dealing with the transfer of stock upon the death of a stockholder (§ 30)—the provision with which we are here concerned—is almost identical. It recites that the corporation is to have the right to purchase its late stockholder's shares for the price it originally received for them:

> "Stock Transfer in Case of Death. In case of the death of any stockholder, the Corporation shall have the right to purchase the stock from the legal representative of the deceased for the same price that the Corporation received therefor originally. If the Corporation does not, or cannot, purchase such stock, the Board of Directors shall have the right to empower such of its existing stockholders as it sees fit to make such purchase from such legal representative at the same price. Should the option provided for in this section not be exercised, then, after the lapse of ninety days, the legal representative may dispose of said stock as he sees fit."

Harry Kaplan, a paper jobber, was one of Biltmore's customers and some months after its incorporation purchased 5 shares of stock from the corporation at $5 a share. In 1936, Kaplan received a stock dividend of 5 more shares, and two years later purchased an additional 10 shares for $100. On the face of each of the three certificates, running vertically along the left-hand margin, appeared the legend,

"Issued subject to restrictions in sections 28, 29, and 30 of the By-laws."

On October 20, 1953, Kaplan wrote to the corporation stating that he was "interested in selling" his 20 shares of stock and requesting that he be given the "price" which the board of directors "will consider, so that I may come to a decision." He died five days later. Some months thereafter, in February, 1954, his son, who was also one of his executors, addressed a letter to Biltmore, inquiring whether it was "still interested in acquiring shares and at what price." By another letter, dated the same day, the attorney for the executors sent to the corporation the three stock certificates, representing the 20 shares, and requested that a new certificate be issued in the name of the estate or the executors.

Within 30 days, on March 4, 1954, Biltmore's board of directors voted to exercise its option to purchase the stock, pursuant to section 30 of the by-laws, and about three weeks later the executors' attorney was advised of the corporation's action. He was also informed that, although the by-law provision permitted purchase at "the same price that the company received therefor from the stockholder originally," the corporation had, nevertheless, decided to pay $20 a share, "considerably more than the original purchase price," based on the prices at which it had acquired shares from other stockholders.

Kaplan's executors declined to sell to the corporation, insisting that the stock which had been in the decedent's name be transferred to them. When their demand was refused, they brought this action to compel Biltmore to accept surrender of the decedent's stock certificate and to issue a new certificate for 20 shares to them. They contended . . . that the by-law is void as an unreasonable restraint. The corporation interposed a counterclaim for specific performance based on the exercise of its option to purchase the shares under by-law section 30. The court at Special Term granted judgment to the corporation on its counterclaim and dismissed the complaint. The Appellate Division reversed, rendered judgment directing the transfer of the stock to the plaintiffs and dismissed the defendant's counterclaim upon the ground that the by-law in question is void.

. . . .

The validity of qualifications on the ownership of corporate shares through restrictions on the right to transfer has long been a source of confusion in the law. The difficulties arise primarily from the clash between the concept of the shares as "creatures of the company's constitution and therefore . . . essentially contractual choses in action" (Gower, Some Contrasts between British and American Corporation Law, 69 Harv. L. Rev. 1369, 1377) and the concept of the shares as personal property represented so far as possible by the certificate itself and, therefore, subject to the time-honored rule that there be no unreasonable restraint upon alienation. While the courts of this state and of many other jurisdictions, as opposed to those of England and of Massachusetts, have favored the "property" concept, the tendency is . . . to sustain a restriction imposed on the transfer of stock if "reasonable" and if the stockholder acquired such stock with requisite notice of the restriction.

The question posed, therefore, is whether the provision, according the corporation a right or first option to purchase the stock at the price which it originally received for it, amounts to an unreasonable restraint. In our judgment, it does not.

The courts have almost uniformly held valid and enforceable the first option provision, in charter or by-law, whereby a shareholder desirous of selling his stock is required to afford the corporation, his fellow stockholders or both an opportunity to buy it before he is free to offer it to outsiders. The courts have often said that this first option provision is "in the nature of a contract" between the corporation and its stockholders and, as such, binding upon them. (Hassel v. Pohle, 214 App. Div. 654, 658). . . .

[W]hat the law condemns is, not a restriction on transfer, a provision merely postponing sale during the option period, but an effective prohibition against transferability itself. Accordingly, if the by-law under consideration were to be construed as rendering the sale of the stock impossible to anyone except to the corporation at whatever price it wished to pay, we would, of course, strike it down as illegal. But that is not the meaning of the provision before us. The corporation had its option only for a 90–day period. If it did not exercise its privilege within that time, the deceased stockholder's legal representative was at liberty to "dispose of said stock as he [saw] fit" (§ 30), and, once so disposed of, it would thereafter be free of the restriction. In a very real sense, therefore, the primary purpose of the by-laws was to enable a particular party, the corporation, to buy the shares, not to prevent the other party, the stockholder, from selling them.

The Appellate Division, however, was impressed with what it deemed the "unreasonableness," that is, "unfairness," of the price specified in the by-law, namely, a price at which the shares had originally been purchased from the corporation. Carried to its logical conclusion, such a rationale would permit, indeed, would encourage, expensive litigation in every case where the price specified in the restriction, or the formula for fixing the price, was other than a recognized and easily ascertainable fair market value. This would destroy part of the social utility of the first option type of restriction which, when imposed, is intended to operate in futuro and must, therefore, include some formula for future determination of the option price.

Generally speaking, these restrictions are employed by the so-called "close corporation" as part of the attempt to equate the corporate structure to a partnership by giving the original stockholders a sort of pre-emptive right through which they may, if they choose, veto the admission of a new participant. Obviously, the case where there is an easily ascertainable market value for the shares of a closely held corporate enterprise is the exception, not the rule, and, consequently, various methods or formulae for fixing the option price are employed in practice—e.g., book or appraisal value, often exclusive of good will, or a fixed price or the par value of the stock.

In sum, then, the validity of the restriction on transfer does not rest on any abstract notion of intrinsic fairness of price. To be invalid, more than mere disparity between option price and current value of the stock must be shown. Since the parties have in effect agreed on a price formula which suited them, and provision is made freeing the stock for outside sale should the corporation not make, or provide for, the purchase, the restriction is reasonable and valid.

. . . .

The judgment of the Appellate Division dismissing the defendant's counterclaim and sustaining the plaintiff's complaint should be reversed, and that of Special Term reinstated. . . .

NOTES & QUESTIONS

1. What is the purpose of Sections 29 and 30 of Biltmore's bylaws?

2. Suppose that Section 29 had prohibited a shareholder from selling his shares? Would such a bylaw be legal?

3. At the time of Kaplan's death, Biltmore's shares appear to have been worth substantially more than the price Kaplan paid for them. Prior to his death, Kaplan desired to sell his shares. Was sale a realistic possibility in light of Section 29 of Biltmore's bylaws?

4. Why not provide that, if a shareholder desires to sell his shares, he must first offer the shares to the corporation, or to the other shareholders, at fair value?

5. Why not provide that, if a shareholder desires to sell his shares, he must first find a willing purchaser and then offer the shares to the corporation, or to the other shareholders, at the same price and on the same terms offered by the purchaser?

6. Section 30 of Biltmore's bylaws placed less of a burden on the liquidity of Kaplan's shares than Section 29. However, Section 30 was also considerably harsher as an economic matter. Do you see why?

7. As the court notes, the law in the area of share transfer restrictions is something of a contest between the law of contracts and the law of property. Given the result in *Allen,* which branch of the law is predominant?

NOTE ON THE OPERATION AND LEGALITY OF SHARE TRANSFER RESTRICTIONS

The most common types of share transfer restrictions are: (a) an obligation to offer the shares to the corporation or the other shareholders at a specified price prior to selling to a third party (a first-option agreement); (b) an obligation to offer the shares to the corporation or the other shareholders at the same price, and on the same terms, offered by a third party (a first-refusal agreement); (c) an obligation to obtain the consent of the corporation or the shareholders prior to selling to a third party (a consent agreement); (d) an agreement that gives a shareholder the opportunity or obligation to sell, and the corporation or other shareholders the opportunity or obligation to purchase, shares at a specified price upon the happening of certain events, such as death or termination of employment (a buy-sell agreement); and (e) a provision prohibiting transfer to designated classes of persons. These major types of share transfer restrictions are permitted by statute, and the categories are nonexclusive. *See* DGCL § 202(c); MBCA § 6.27(d).

Share transfer restrictions are strictly construed. *See, e.g.,* Estate of Riggs v. Midwest Steel & Iron Works, 540 P.2d 361 (Colo. Ct. App. 1975) (refusing to apply a restraint on alienation to a testamentary transfer); Casteel v. Gunning, 402 S.W.2d 529 (Tex. Civ. App. 1966) (holding that a restriction on the sale of shares by an officer-shareholder did not apply to a sale by a corporation owned by the officer-shareholder). It is important to specify clearly and unambiguously the essential attributes of the restriction. This specification should include whether the purchase is optional or mandatory, the persons who may or must purchase the shares, the sequence in which they may purchase, the manner in which the price is to be determined, the time periods during which persons may decide whether or not to purchase (if an option), and the events that are to be covered by the restriction (*e.g.*, proposed sale, death, bankruptcy, family gift).

A share transfer restriction must be "reasonable" to be enforced. This limitation is an extension of the property rule that unreasonable restraints on alienation are invalid. Because society has an interest in maintaining the reasonable liquidity of property, a limitation on the right of contract is thought to be justified. A share transfer restriction is per se reasonable if designed to preserve a tax advantage (*e.g.,* Subchapter S status) or any other regulatory advantage (*e.g.,* prohibit transfers to out-of-state purchasers that would destroy an intrastate offering exemption under the Securities Act of 1933). *See* DGCL § 202(d); MBCA § 6.27(c). Otherwise, any evaluation of reasonableness depends on the particular type of restriction involved.

a. *First–Option Agreements.* A first-option agreement requires a shareholder to offer his shares to the corporation or the other shareholders at an option price prior to selling the shares to a third party. Since closely held shares have no market price, it is usually desirable to provide some definite method of valuation. The following are the principal methods for setting an option price: (a) a stated price (*e.g.,* par value, purchase price, or a negotiated price); (b) book value (total shareholders' equity on the balance sheet divided by the total number of shares); (c) capitalization of earnings; or (d) appraisal or arbitration. Each method has advantages and disadvantages.

The difficulty with the first two methods is that, over time, they often result in an option price that is significantly below the fair value of the shares. A stated price may approximate fair value at the time a shareholder purchases his shares. If the corporation does well, however, the option price will usually become increasingly burdensome to a shareholder who wishes to sell. Book value often underestimates the true value of a business because assets are carried on the balance sheet at cost and no account is taken of the goodwill or going concern value of the business. Nevertheless, as *Allen* demonstrates, courts have generally enforced first-option agreements even though the sale price is well below the fair value of the shares at the time the option is triggered. *See* Palmer v. Chamberlin, 191 F.2d 532, 541 (5th Cir. 1951) (noting

that a court will enforce a first-option agreement unless the difference between the option price and fair value is " 'so great as to lead to a reasonable conclusion of fraud, mistake, or concealment in the nature of fraud, and to render it plainly inequitable and against conscience that the contract should be enforced' ") (quoting New England Trust Co. v. Abbott, 38 N.E. 432, 434 (Mass. 1894)).

The courts' leniency in allowing a large disparity between the option price and fair value demonstrates that contract imperatives have significantly more weight than property imperatives. Requiring a shareholder to give an option to the corporation or the other shareholders at a price that is significantly below fair value constitutes something close to an absolute prohibition on sale. Who will want to sell his shares if they must first be offered to the corporation or the other shareholders for a fraction of their true worth? Nevertheless, enforcing the bargain agreed to by the parties, and providing certainty with respect to the validity of transfer restrictions, is thought to outweigh the property interest in providing for liquid personal property.

To avoid the problems caused by using a stated price or book value, the option price may be based on a capitalization of the company's earnings. According to the most popular form of this method, an average of the company's historical earnings for some specified period of time (*e.g.,* three or five years) is multiplied by an appropriate number to arrive at a value for the company. If one class of shares exists, one divides the company value by the total number of outstanding shares to arrive at a per-share value. The agreement should specify as many details as possible. For what period are earnings to be calculated? What multiplier fairly captures the risk level of the company? Should special adjustments to historical earnings be made before applying the multiplier? Should salaries paid to shareholders be restored to earnings for purposes of the value calculation?

The chief advantage of the capitalization of earnings method is that it is more likely to approximate fair value at the time the option is triggered. As a consequence, the courts should have little difficulty upholding transfer restrictions whose option prices are calculated in this manner. The chief disadvantage of the capitalization of earnings method involves significantly increased complexity. Using this method makes the drafting task harder. For example, extraordinary gains and losses are normally excluded from historical earnings for purposes of the value calculation. How are these to be specified in advance? In addition, because the very purpose of the capitalization of earnings method is to set an option price that will remain fair over time, this method has the disadvantage of increasing the optionholders' uncertainty as to how much money must be set aside to exercise the option. If the corporation or the other shareholders have insufficient funds to exercise the option, they may be unable to prevent an undesirable shareholder from joining their ranks—a result that defeats one of the most important purposes for which transfer restrictions are adopted.

To provide for an option price likely to approximate fair value at the time the option is triggered, but to avoid some of the drafting problems caused by the capitalization of earnings method, it may be desirable to specify some form of appraisal or arbitration to determine the option price. Like the capitalization of earnings method, these mechanisms should receive little difficulty from the courts. However, here too choices must be made. Should standards of valuation be agreed upon in advance? If so, appraisal and arbitration have many of the drawbacks of the capitalization of earnings method and can result in unpleasant surprises. By contrast, should the appraiser or arbitrator be given free rein? For example, should the appraiser or arbitrator be free to employ a direct appraisal of assets, the capitalization of earnings method, or any other valuation method? The parties may not desire to give the appraiser or arbitrator this much power. As a separate matter, any form of appraisal or arbitration involves the transaction costs attendant to the process. Finally, as with the capitalization of earnings method, using appraisal or arbitration to set the option price means that the optionholders will not know in advance how much money must be set aside to exercise the option.

b. *First–Refusal Agreements.* In light of the above problems, it may be desirable to give the corporation or the other shareholders a right of first refusal rather than a first option. According to this scheme, a shareholder may negotiate any sale that he likes with a third party. Prior to effecting the sale, he is required to offer the shares to the corporation or the other shareholders at the same price, and on the same terms, agreed to by the third party. This method has the advantage of allowing the market to determine the option price with no advance planning requirements and a minimum of transaction costs. First-refusal agreements are routinely upheld by the courts. *See, e.g.*, Groves v. Prickett, 420 F.2d 1119 (9th Cir. 1970).

Even with a first-refusal agreement, a selling shareholder may not receive fair value for his shares. The mere existence of the restriction is likely to chill the interest of outsiders so that quoted offers are unlikely to reflect accurately the value of the shares. Conversely, if collusion is involved, a shareholder may arrange with an outsider to make a "deal" for his shares at an artificially inflated price to put pressure on the corporation or the other shareholders to purchase his shares at that price. Although such a collusive arrangement would surely be invalidated by the courts, illegal conduct is not always easy to discover and prove. In addition, as with other flexible methods, the first-refusal approach has the significant disadvantage of keeping the optionholders in the dark as to what funds must be available to exercise the option.

c. *Consent Agreements.* Consent agreements have often been viewed with hostility by the courts because of fears that such agreements would be exercised arbitrarily and would function to prevent any transfer of shares. Presumably, consent to transfer may not be unreasonably or arbitrarily withheld. *See* Rafe v. Hindin, 288 N.Y.S.2d 662, 665 (App. Div.) (invalidating a consent restriction because "[t]he legend on the stock certificate at bar contain[ed] no provision that the individual defendant's consent may not be unreasonably withheld"), *aff'd*, 244 N.E.2d 469 (N.Y. 1968). However, reasonableness and arbitrariness are often in the eye of the beholder. It may, therefore, be difficult to know in advance whether a court will share the nonconsenting party's view of what is or is not appropriate in given circumstances. The courts have had no difficulty in approving consent agreements that preclude the sale of shares to competitors, *see* Mason v. Mallard Tel. Co., 240 N.W. 671 (Iowa 1932), or are designed to maintain ownership within a family unit, *see* F.B.I. Farms, Inc. v. Moore, 798 N.E.2d 440 (Ind. 2003). By contrast, the courts have invalidated consent restrictions where the withholding of consent was inconsistent with the purpose underlying the restriction. *See, e.g.*, Fayard v. Fayard, 293 So. 2d 421 (Miss. 1974) (viewing a consent restriction as designed to prevent non-family members from obtaining shares and invalidating the use of the restriction to preclude intra-family sales).

d. *Buy–Sell Agreements.* The above agreements require a shareholder to offer shares to the corporation or the other shareholders only if he intends to sell them. In contrast, buy-sell agreements are mandatory agreements where the corporation or the other shareholders have an absolute right (or an obligation) to purchase shares under stated circumstances (*e.g.*, upon a shareholder's death or termination of employment), and/or the shareholder has an absolute right (or an obligation) to sell his shares to the corporation (*e.g.*, to provide an estate with liquidity to pay estate taxes or simply to allow heirs a return of the deceased's capital). Such agreements pose the same valuation problems as noted above, and the methods discussed in connection with first-option agreements can be used to specify a purchase or sale price.

Buy-sell agreements may seem harsh because, at the time they are triggered, the parties have no choice but to comply with the contract. However, in some ways, buy-sell agreements pose less of a problem for public policy than first-option or first-refusal agreements. When one party has an absolute obligation to purchase or sell, there is no danger that personal property will be tied up for an undue period of time. The shares will recover their liquidity as soon as ownership changes hands. The only real issue involves the reasonableness of the contract price. As *Allen* demonstrates, the courts have little difficulty in upholding buy-sell agreements. *See, e.g.*, Evangelista v. Holland, 537 N.E.2d 589 (Mass. App. Ct. 1989) (allowing a corporation to exercise its right to buy a deceased shareholder's shares for $75,000 despite evidence that

the shares were worth $191,000); Renberg v. Zarrow, 667 P.2d 465 (Okla. 1983) (permitting a corporation to buy shares for $3,500 per share even though the book value of the shares was between $9,000 and $10,000 at the time the price was fixed); *In re* Mather's Estate, 189 A.2d 586 (Pa. 1963) (enforcing an agreement to sell shares in a family business for $1 despite evidence that the shares were worth at least $1,060).

e. *Prohibiting Transfers to Designated Persons*. A shareholder agreement may prohibit transfers to designated persons or groups as long as such provisions are not "manifestly unreasonable." DGCL § 202(c)(5); MBCA § 6.27(d)(4). As with consent agreements, it will be difficult to know in advance how the courts will define the parameters of reasonableness. However, prohibitions to protect legitimate business interests would seem to be envisioned by the statute. For example, one might bar sales to anyone associated with competing firms.

f. *Preserving a Legal Advantage*. Transfer restrictions are often designed to preserve some legal advantage. For example, a corporation may forfeit its status as a statutory closely held corporation if transfers impermissibly increase the number of shareholders. *See* DGCL § 342(a)(1) (providing that a statutory close corporation may not have more than 30 shareholders of record). A corporation will lose its Subchapter S status (and the benefit of pass-through taxation) if shares are transferred to certain types of entities or nonresident aliens. *See* 26 U.S.C. § 1361(b)(1). A corporation may lose its intrastate offering exemption from registration under the Securities Act of 1933 if shares are sold to residents of another state. *See* 15 U.S.C. § 77c(a)(11). Many states have statutes explicitly endorsing the use of share transfer restrictions to preserve a legal advantage. *See, e.g.,* DGCL § 202(d); *see also* MBCA § 6.27(c)(1), (2). In states that do not have such statutes, such restrictions should easily be enforced as reasonable transfer restrictions.

E. LIMITED LIABILITY AND PIERCING THE CORPORATE VEIL

DGCL § 102(b)(6)

MBCA § 6.22(b)

WALKOVSZKY V. CARLTON

Court of Appeals of New York

223 N.E.2d 6 (1966)

FULD, JUDGE.

This case involves what appears to be a rather common practice in the taxicab industry of vesting the ownership of a taxi fleet in many corporations, each owning only one or two cabs.

The complaint alleges that the plaintiff was severely injured four years ago in New York City when he was run down by a taxicab owned by the defendant Seon Cab Corporation and negligently operated at the time by the defendant Marchese. The individual defendant, Carlton, is claimed to be a stockholder of 10 corporations, including Seon, each of which has but two cabs registered in its name, and it is implied that only the minimum automobile liability insurance required by law (in the amount of $10,000) is carried on any one cab. Although seemingly independent of one another, these corporations are alleged to be "operated . . . as a single entity, unit and enterprise" with regard to financing, supplies, repairs, employees and garaging, and all are named as defendants. The plaintiff asserts that he is also entitled to hold their stockholders personally liable for the damages sought because the multiple corporate structure constitutes an unlawful attempt "to defraud members of the general public" who might be injured by the cabs.

The defendant Carlton has moved . . . to dismiss the complaint on the ground that as to him it "fails to state a cause of action." The court at Special Term granted the motion but the Appellate Division, by a divided vote, reversed, holding that a valid cause of action was sufficiently stated. The defendant Carlton appeals to us, from the nonfinal order, by leave of the Appellate Division on a certified question.

The law permits the incorporation of a business for the very purpose of enabling its proprietors to escape personal liability but, manifestly, the privilege is not without its limits. Broadly speaking, the courts will disregard the corporate form, or, to use accepted terminology, "pierce the corporate veil," whenever necessary "to prevent fraud or to achieve equity." (International Aircraft Trading Co. v. Manufacturers Trust Co., 297 N.Y. 285, 292.) In determining whether liability should be extended to reach assets beyond those belonging to the corporation, we are guided, as Judge Cardozo noted, by "general rules of agency." (Berkey v. Third Ave. Ry. Co., 244 N. Y. 84, 95.) In other words, whenever anyone uses control of the corporation to further his own rather than the corporation's business, he will be liable for the corporation's acts "upon the principle of *respondeat superior* applicable even where the agent is a natural person." (Rapid Tr. Subway Constr. Co. v. City of New York, 259 N.Y. 472, 488.) Such liability, moreover, extends not only to the corporation's commercial dealings but to its negligent acts as well.

. . . .

In the case before us, the plaintiff has explicitly alleged that none of the corporations "had a separate existence of their own" and, as indicated above, all are named as

defendants. However, it is one thing to assert that a corporation is a fragment of a larger corporate combine which actually conducts the business. It is quite another to claim that the corporation is a "dummy" for its individual stockholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends. Either circumstance would justify treating the corporation as an agent and piercing the corporate veil to reach the principal but a different result would follow in each case. In the first, only a larger corporate entity would be held financially responsible while, in the other, the stockholder would be personally liable. Either the stockholder is conducting the business in his individual capacity or he is not. If he is, he will be liable; if he is not, then, it does not matter—insofar as his personal liability is concerned—that the enterprise is actually being carried on by a larger "enterprise entity."

At this stage in the present litigation, we are concerned only with the pleadings. . . . Reading the complaint in this case most favorably and liberally, we do not believe that there can be gathered from its averments the allegations required to spell out a valid cause of action against the defendant Carlton.

The individual defendant is charged with having "organized, managed, dominated and controlled" a fragmented corporate entity but there are no allegations that he was conducting business in his individual capacity. Had the taxicab fleet been owned by a single corporation, it would be readily apparent that the plaintiff would face formidable barriers in attempting to establish personal liability on the part of the corporation's stockholders. The fact that the fleet ownership has been deliberately split up among many corporations does not ease the plaintiff's burden in that respect. The corporate form may not be disregarded merely because the assets of the corporation, together with the mandatory insurance coverage of the vehicle which struck the plaintiff, are insufficient to assure him the recovery sought. If Carlton were to be held individually liable on those facts alone, the decision would apply equally to the thousands of cabs which are owned by their individual drivers who conduct their businesses through corporations organized pursuant to . . . the Business Corporation Law and carry the minimum insurance required by subdivision 1 (par. [a]) of section 370 of the Vehicle and Traffic Law. These taxi owner-operators are entitled to form such corporations and we agree with the court at Special Term that, if the insurance coverage required by statute "is inadequate for the protection of the public, the remedy lies not with the courts but with the Legislature." It may very well be sound policy to require that certain corporations must take out liability insurance which will afford adequate compensation to their potential tort victims. However, the responsibility for imposing conditions on the privilege of incorporation has been committed by the Constitution to the Legislature and it may not be fairly implied, from any statute, that the Legislature intended, without the slightest discussion or debate, to require of taxi corporations that they carry automobile liability insurance over and above that mandated by the Vehicle and Traffic Law.

This is not to say that it is impossible for the plaintiff to state a valid cause of action against the defendant Carlton. However, the simple fact is that the plaintiff has just not done so here. While the complaint alleges that the separate corporations were undercapitalized and that their assets have been intermingled, it is barren of any "sufficiently [particularized] statements" (CPLR 3013) that the defendant Carlton and his associates are actually doing business in their individual capacities, shuttling their personal funds in and out of the corporations "without regard to formality and to suit their immediate convenience." (Weisser v. Mursam Shoe Corp., 127 F.2d 344, 345) Such a "perversion of the privilege to do business in a corporate form" (Berkey v. Third Ave. Ry. Co., 244 N.Y. 84, 95) would justify imposing personal liability on the individual stockholders. Nothing of the sort has in fact been charged, and it cannot reasonably or logically be inferred from the happenstance that the business of Seon Cab Corporation

may actually be carried on by a larger corporate entity composed of many corporations which, under general principles of agency, would be liable to each other's creditors in contract and in tort.[3]

In point of fact, the principle relied upon in the complaint to sustain the imposition of personal liability is not agency but fraud. Such a cause of action cannot withstand analysis. If it is not fraudulent for the owner-operator of a single cab corporation to take out only the minimum required liability insurance, the enterprise does not become either illicit or fraudulent merely because it consists of many such corporations. The plaintiff's injuries are the same regardless of whether the cab which strikes him is owned by a single corporation or part of a fleet with ownership fragmented among many corporations. Whatever rights he may be able to assert against parties other than the registered owner of the vehicle come into being not because he has been defrauded but because, under the principle of *respondeat superior*, he is entitled to hold the whole enterprise responsible for the acts of its agents.

In sum, then, the complaint falls short of adequately stating a cause of action against the defendant Carlton in his individual capacity.

The order of the Appellate Division should be reversed . . . with leave to serve an amended complaint.

KEATING, JUDGE (dissenting).

The defendant Carlton, the shareholder here sought to be held for the negligence of the driver of a taxicab, was a principal shareholder and organizer of the defendant corporation which owned the taxicab. The corporation was one of 10 organized by the defendant, each containing two cabs and each cab having the "minimum liability" insurance coverage mandated by section 370 of the Vehicle and Traffic Law. The sole assets of these operating corporations are the vehicles themselves and they are apparently subject to mortgages.

From their inception these corporations were intentionally undercapitalized for the purpose of avoiding responsibility for acts which were bound to arise as a result of the operation of a large taxi fleet having cars out on the street 24 hours a day and engaged in public transportation. And during the course of the corporations' existence all income was continually drained out of the corporations for the same purpose.

The issue presented by this action is whether the policy of this State, which affords those desiring to engage in a business enterprise the privilege of limited liability through the use of the corporate device, is so strong that it will permit that privilege to continue no matter how much it is abused, no matter how irresponsibly the corporation is operated, no matter what the cost to the public. I do not believe that it is.

Under the circumstances of this case the shareholders should all be held individually liable to this plaintiff for the injuries he suffered. At least, the matter should not be disposed of on the pleadings by a dismissal of the complaint. "If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts. It is coming to be recognized as the policy

[3] In his affidavit in opposition to the motion to dismiss, the plaintiff's counsel claimed that corporate assets had been "milked out" of, and "siphoned off" from the enterprise. Quite apart from the fact that these allegations are far too vague and conclusory, the charge is premature. If the plaintiff succeeds in his action and becomes a judgment creditor of the corporation, he may then sue and attempt to hold the individual defendants accountable for any dividends and property that were wrongfully distributed.

of law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege." (Ballantine, Corporations [rev. ed., 1946], § 129, pp. 302–303).

. . . .

The policy of this State has always been to provide and facilitate recovery for those injured through the negligence of others. The automobile, by its very nature, is capable of causing severe and costly injuries when not operated in a proper manner. . . .

. . . .

The defendant Carlton claims that, because the minimum amount of insurance required by the statute was obtained, the corporate veil cannot and should not be pierced despite the fact that the assets of the corporation which owned the cab were "trifling compared with the business to be done and the risks of loss" which were certain to be encountered. I do not agree.

The Legislature in requiring minimum liability insurance of $10,000, no doubt, intended to provide at least some small fund for recovery against those individuals and corporations who just did not have and were not able to raise or accumulate assets sufficient to satisfy the claims of those who were injured as a result of their negligence. It certainly could not have intended to shield those individuals who organized corporations, with the specific intent of avoiding responsibility to the public, where the operation of the corporate enterprise yielded profits sufficient to purchase additional insurance. Moreover, it is reasonable to assume that the Legislature believed that those individuals and corporations having substantial assets would take out insurance far in excess of the minimum in order to protect those assets from depletion. . . .

. . . .

The defendant contends that a decision holding him personally liable would discourage people from engaging in corporate enterprise.

What I would merely hold is that a participating shareholder of a corporation vested with a public interest, organized with capital insufficient to meet liabilities which are certain to arise in the ordinary course of the corporation's business, may be held personally responsible for such liabilities. Where corporate income is not sufficient to cover the cost of insurance premiums above the statutory minimum or where initially adequate finances dwindle under the pressure of competition, bad times or extraordinary and unexpected liability, obviously the shareholder will not be held liable.

The only types of corporate enterprises that will be discouraged as a result of a decision allowing the individual shareholder to be sued will be those such as the one in question, designed solely to abuse the corporate privilege at the expense of the public interest.

For these reasons I would vote to affirm the order of the Appellate Division.

DESMOND, C.J., and VAN VOORHIS, BURKE, and SCILEPPI, JJ., concur with FULD, J.

KEATING, J., dissents and votes to affirm in an opinion in which BERGAN, J., concurs.

NOTES & QUESTIONS

1. The court granted the plaintiff leave to file an amended complaint. He took advantage of this option. The Supreme Court denied the defendant's motion to dismiss the amended complaint and the Appellate Division affirmed: "In our opinion, the amended complaint

sufficiently alleges a cause of action against [the defendant], i.e., that he and the other individual defendants were conducting the business of the taxicab fleet in their individual capacities." Walkovszky v. Carlton, 287 N.Y.S.2d 546, 547 (App. Div. 1968) (per curiam). The Court of Appeals also affirmed: "The complaint before us—amended following our decision when the case was previously here—now meets the pleading requirements set forth in the court's opinion and states a valid cause of action." Walkovszky v. Carlton, 244 N.E.2d 55, 55 (N.Y. 1968) (per curiam). Neither opinion explains how the amended complaint differed from the original complaint. What do you think Walkovszky alleged to survive a motion to dismiss for failure to state a claim?

2. Note that Walkovszky sought to pierce the corporate veil in two different ways. First, he sought to make all ten corporations in Carlton's fleet liable for the debts of any one corporation. This type of veil piercing is called horizontal veil piercing. Second, Walkovszky sought to make Carlton liable for the debts of his corporations. This type of veil piercing is called vertical veil piercing. Which type of veil piercing involves a greater intrusion on the concept of limited liability?

3. Does the DGCL or the MBCA have any minimum capital requirements? Should the law impose minimum capital requirements for starting a business?

4. Section 370 of New York's Vehicle and Traffic Law required that each cab carry $10,000 worth of insurance. Did Carlton do anything wrong by creating corporations that carried the minimum insurance required by law but had little other capital? *See* Radaszewski v. Telecom Corp., 981 F.2d 305 (8th Cir. 1992) (refusing to pierce the corporate veil where a corporation had sufficient liability insurance to be considered financially responsible under regulations governing motor carriers even though the corporation was otherwise undercapitalized and the insurance company became insolvent after the plaintiff was injured).

5. Walkovszky claimed that corporate assets had been "milked out" of, and "siphoned off" from, the enterprise. How does a shareholder milk assets out of, or siphon off assets from, a corporation? Suppose that Walkovszky could prove his allegations. Would Carlton's conduct be improper? Consider Section 4 of the Uniform Fraudulent Transfer Act:

> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
>
> > (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
> >
> > (2) without receiving a reasonably equivalent value in exchange for the transfer or the obligation, and the debtor:
> >
> > > (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
> > >
> > > (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.

6. Suppose that Carlton's conduct constituted a fraudulent transfer. What would Walkovszky's remedy be? Section 7 of the Uniform Fraudulent Transfer Act provides that "[i]n an action for relief against a transfer or obligation under this [Act], a creditor . . . may obtain: . . . avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim."

7. Why does Walkovszky seek to pierce the corporate veil rather than challenge Carlton's conduct on fraudulent transfer grounds? Should Walkovszky be allowed to pierce the corporate veil horizontally? Should he be allowed to pierce the corporate veil vertically?

MINTON V. CAVANEY

Supreme Court of California

364 P.2d 473 (1961)

TRAYNOR, JUSTICE.

The Seminole Hot Springs Corporation, hereinafter referred to as Seminole, was duly incorporated in California on March 8, 1954. It conducted a public swimming pool that it leased from its owner. On June 24, 1954 plaintiffs' daughter drowned in the pool, and plaintiffs recovered a judgment for $10,000 against Seminole for her wrongful death. The judgment remains unsatisfied.

On January 30, 1957, plaintiffs brought the present action to hold defendant Cavaney personally liable for the judgment against Seminole. Cavaney died on May 28, 1958, and his widow, the executrix of his estate, was substituted as defendant. The trial court entered judgment for plaintiffs for $10,000. Defendant appeals.

Plaintiffs introduced evidence that Cavaney was a director and secretary and treasurer of Seminole and that on November 15, 1954, about five months after the drowning, Cavaney as secretary of Seminole and Edwin A. Kraft as president of Seminole applied for permission to issue three shares of Seminole stock, one share to be issued to Kraft, another to F. J. Wettrick and the third to Cavaney. The Commissioner of Corporations refused permission to issue these shares unless additional information was furnished. The application was then abandoned and no shares were ever issued. There was also evidence that for a time Seminole used Cavaney's office to keep records and to receive mail. Before his death Cavaney answered certain interrogatories. He was asked if Seminole "ever had any assets?" He stated that "insofar as my own personal knowledge and belief is concerned said corporation did not have any assets." Cavaney also stated in the return to an attempted execution that "[I]nsofar as I know, this corporation had no assets of any kind or character. The corporation was duly organized but never functioned as a corporation."

Defendant introduced evidence that Cavaney was an attorney at law, that he was approached by Kraft and Wettrick to form Seminole, and that he was the attorney for Seminole. Plaintiffs introduced Cavaney's answer to several interrogatories that he held the post of secretary and treasurer and director in a temporary capacity and as an accommodation to his client.

Defendant contends that the evidence does not support the court's determination that Cavaney is personally liable for Seminole's debts and that the "alter ego" doctrine is inapplicable because plaintiffs failed to show that there was " '(1) . . . such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow.' " Riddle v. Leuschner, 51 Cal.2d 574, 580, 335 P.2d 107, 110; Automotriz Del Golfo De California S. A. De C. V. v. Resnick, 47 Cal.2d 792, 796, 306 P.2d 1, 63 A.L.R.2d 1042; Minifie v. Rowley, 187 Cal. 481, 487, 202 P. 673.

The figurative terminology "alter ego" and "disregard of the corporate entity" is generally used to refer to the various situations that are an abuse of the corporate privilege. The equitable owners of a corporation, for example, are personally liable when they treat the assets of the corporation as their own and add or withdraw capital from the corporation at will; when they hold themselves out as being personally liable for the debts of the corporation; or when they provide inadequate capitalization and actively participate in the conduct of corporate affairs.

In the instant case the evidence is undisputed that there was no attempt to provide adequate capitalization. Seminole never had any substantial assets. It leased the pool that

it operated, and the lease was forfeited for failure to pay the rent. Its capital was " 'trifling compared with the business to be done and the risks of loss. . . .' " Automotriz Del Golfo De California S. A. De C. V. v. Resnick, supra, 47 Cal.2d 792, 797, 306 P.2d 1, 4. The evidence is also undisputed that Cavaney was not only the secretary and treasurer of the corporation but was also a director. The evidence that Cavaney was to receive one-third of the shares to be issued supports an inference that he was an equitable owner and the evidence that for a time the records of the corporation were kept in Cavaney's office supports an inference that he actively participated in the conduct of the business. The trial court was not required to believe his statement that he was only a "temporary" director and officer "for accommodation." In any event it merely raised a conflict in the evidence that was resolved adversely to defendant. Moreover, . . . the Corporations Code provides that ". . . the business and affairs of every corporation shall be controlled by, a board of not less than three directors." Defendant does not claim that Cavaney was a director with specialized duties. It is immaterial whether or not he accepted the office of director as an "accommodation" with the understanding that he would not exercise any of the duties of a director. A person may not in this manner divorce the responsibilities of a director from the statutory duties and powers of that office.

There is no merit in defendant's contentions that the "alter ego" doctrine applies only to contractual debts and not to tort claims; that plaintiffs' cause of action abated when Cavaney died, or that the judgment in the action against the corporation bars plaintiffs from bringing the present action. . . .

In this action to hold defendant personally liable upon the judgment against Seminole, plaintiffs did not allege or present any evidence on the issue of Seminole's negligence or on the amount of damages sustained by plaintiffs. They relied solely on the judgment against Seminole. Defendant correctly contends that Cavaney or his estate cannot be held liable for the debts of Seminole without an opportunity to relitigate these issues. Cavaney was not a party to the action against the corporation, and the judgment in that action is therefore not binding upon him unless he controlled the litigation leading to the judgment. Although Cavaney filed an answer to the complaint against Seminole as its attorney, he withdrew before the trial and did not thereafter participate therein. The filing of an answer without any other participation is not sufficient to bind Cavaney. . . .

The judgment is reversed.

GIBSON, C.J., and PETERS, WHITE, and DOOLING, JJ., concur.

SCHAUER, JUSTICE (concurring and dissenting).

I concur in the judgment of reversal on the ground that . . . "In this action to hold defendant personally liable upon the judgment against Seminole plaintiffs did not allege or present any evidence on the issue of Seminole's negligence or on the amount of damages sustained by plaintiffs. They relied solely on the judgment against Seminole. Defendant correctly contends that Cavaney or his estate cannot be held liable for the debts of Seminole without an opportunity to relitigate these issues. Cavaney was not a party to the action against the corporation, and the judgment in that action is therefore not binding upon him. . . ."

I dissent from any implication that *mere professional activity by an attorney at law, as such*, in the organization of a corporation, can constitute any basis for a finding that the corporation is the attorney's alter ego or that he is otherwise personally liable for *its* debts, whether based on contract or tort. That in such circumstances an attorney does not incur any personal liability for debts of the corporation remains true whether or not the attorney's professional services include the issuance to him of a qualifying share of stock, the attendance at and participation in an organization meeting or meetings, the holding and exercise for such preliminary purposes, in the course of his professional services, of

an office or offices, whether secretary or treasurer or presiding officer or any combination of offices in the corporation.

The acts and services performed in *organizing* a corporation do not constitute the carrying on of business *by a corporation*. . . .

. . . [T]he lawyer who handles the task of determining and directing and participating in the steps appropriate to transforming the idea into a competent legal entity *ready to engage in business* is not an alter ego of the corporation. By his professional acts he has not been engaging in business in the name of the corporation; he has been merely practicing law.

NOTES & QUESTIONS

1. Veil-piercing cases tend to be conclusion-oriented. The court asks whether there has been an "abuse of the corporate privilege," examines various factors, and then holds that veil piercing is or is not justified. The cases provide little in the way of an applicable legal standard. What factor or factors justified veil piercing in *Minton*? Do you agree with the result in *Minton*?

2. The court notes that veil piercing is appropriate "when [shareholders] provide inadequate capitalization and actively participate in the conduct of corporate affairs." Is inadequate capitalization enough by itself to justify veil piercing? *Compare* Associated Vendors, Inc. v. Oakland Meat Co., 26 Cal. Rptr. 806, 816 (Ct. App. 1962) (noting that "[e]vidence of inadequate capitalization is, at best, merely a factor to be considered by the trial court in deciding whether to pierce the corporate veil"), *with* Nilsson, Robbins, Dalgarn, Berliner, Carson & Wurst v. Louisiana Hydrolec, 854 F.2d 1538, 1544 (9th Cir. 1988) (citing *Minton* for the proposition that "the California Supreme Court has held that undercapitalization alone will justify piercing the corporate veil"). Which case is the better reading of *Minton*?

3. Undercapitalization is a factor frequently relied upon by courts in veil-piercing cases. What constitutes undercapitalization? In Laya v. Erin Homes, Inc., 352 S.E.2d 93 (W. Va. 1986), the court provided some guidance on this issue:

> With respect to determining the adequacy of the corporation's capital, in light of the nature and magnitude of the corporate undertaking, there are several tests and factors which can be utilized to analyze the financial data of the corporation. For example, comparison with the capitalization of other corporations in the same or a similar line of business may be made. The capitalization of the corporation in question could be compared with the average industry-wide ratios (current ratio, acid-test ratio, debt/equity ratio, etc.) obtained from published sources (Dunn & Bradstreet, Moody's Manual of Investments, Standard and Poor's Corporation Records, etc.). These average ratios could be buttressed by expert testimony from certified public accountants, securities analysts, investment counselors or other qualified financial analysts. "Grossly inadequate capitalization" for the purpose of piercing the corporate veil would generally be reflected by a substantial deficiency of capital compared with that level of capitalization deemed adequate in the case by the financial analyst experts.

Id. at 101 (citations omitted).

4. Where a corporation has sufficient capital to maintain its business and meet its obligations for a reasonable period of time, courts have normally found that modest amounts of capital were adequate. *See, e.g.*, Snyder Elec. Co. v. Fleming, 305 N.W.2d 863, 866–68 (Minn. 1981) (holding that a heating and ventilating business with $5000 in stated capital that operated profitably for five years was adequately capitalized); Southern Lumber & Coal Co. v. M.P. Olson Real Estate & Constr. Co., 426 N.W.2d 504, 507–510 (Neb. 1988) (finding that a corporation that suffered no losses during the first six years of its existence was adequately capitalized despite the fact that it had $1,000 in cash, a note against its sole shareholder for

$7,500, and donated equipment, furniture, and fixtures of unstated additional value). By contrast, undercapitalization has been found where a corporation was formed with no or minimal assets and never achieved profitability. *See, e.g.*, Jablonsky v. Klemm, 377 N.W.2d 560, 566 (N.D. 1985) (finding that "liabilities exceeded assets almost 100 percent of the time" over a seven-year period); O'Hazza v. Executive Credit Corp., 431 S.E.2d 318, 321 (Va. 1993) (noting that "if, from its inception, a corporation is unable to pay its costs of doing business because of grossly inadequate capitalization, its legitimacy is suspect").

5. [A] question that has divided the courts is the significance of debt owed to shareholders as part of a corporation's capital structure. Some cases have found undercapitalization based in part on the fact that a corporation received a substantial percentage of its operating capital through loans from shareholders. *See, e.g.*, Jablonsky v. Klemm, 377 N.W.2d 560, 566 (N.D. 1985) (affirming a judgment piercing the veil where a corporation with $19,000 in capital built a project that accounted for $1,340,000 in sales "entirely with borrowed money"); Dieter Eng'g Servs. v. Parkland Dev., Inc., 483 S.E.2d 48, 60 (W. Va. 1996) (affirming a judgment piercing the veil where a corporation with $1,000 in capital built a project that required borrowings of $1,220,000). By contrast, other cases recognize that there are tax advantages to using debt instead of equity and refuse to find undercapitalization merely because the corporation has borrowed most of its operating capital from shareholders. *See, e.g.*, O'Hazza v. Executive Credit Corp., 431 S.E.2d 318, 321 (Va. 1993) (noting that "to gain certain tax advantages, small corporations increasingly, and legitimately, choose to initially capitalize the entity with a small portion of the investment represented by stock and with the larger portion of capital set up as loans to the corporation").

6. The shareholder-directors in *Minton* failed to follow many corporate formalities, a factor frequently relied upon by courts in veil-piercing cases. Does the failure to follow corporate formalities justify veil piercing? If the shareholder-directors had followed all required formalities, would the corporation be in any better position to pay the plaintiffs? *See* Transamerica Cash Reserve, Inc. v. Dixie Power & Water, Inc., 789 P.2d 24, 26 (Utah 1990) (requiring a causal link between disregard of corporate norms and harm to creditors as a condition of veil piercing); *cf.* TEX. BUS. ORGS. CODE ANN. § 21.223(a)(3) (providing that a shareholder will not be responsible for a corporate obligation based on "the failure of the corporation to observe any corporate formality").

7. Most courts agree that minor deviations from corporate norms do not justify veil piercing. *See, e.g.*, Riggins v. Dixie Shoring Co., 590 So. 2d 1164, 1169 (La. 1991) (reversing a veil-piercing judgment where "some of the corporate formalities were not strictly followed, such as formal Board of Director's meetings" because "the [shareholders] did follow most of the essential corporate formalities for the twenty-three years of the corporation's existence, such as having corporate bank accounts and filing corporate tax returns"); Consumer's Co-op v. Olsen, 419 N.W.2d 211, 220–21 (Wis. 1988) (refusing to pierce the corporate veil based on the failure to have formal board meetings or approve financial transactions with a majority shareholder where "stock was issued, officers were elected, meetings of the board of directors were frequently held, and all business was undertaken in the corporate name" and "financial transactions between [a majority stockholder] and the corporation were approved, though informally, by the board of directors"). By contrast, where the failure to follow formalities is so extensive that the corporation appears to be a sham, courts have been more willing to pierce the corporate veil. *See, e.g.*, Peschel Family Trust v. Colonna, 75 P.3d 793, 798 (Mont. 2003) (piercing the veil where "[o]nly three meetings were held concerning corporate decisions over a nine-year period; [a corporation's sole shareholder] exercised absolute authority over all corporate activities as the sole director and officer; . . . payments were made directly from corporate accounts to satisfy [the shareholder's] personal obligations under the guise that they were loan repayments; and there are no records indicating that [the shareholder] was an employee of the Corporation or that he received wages"). In this regard, the courts have placed special emphasis on the failure to maintain adequate financial records. *See, e.g.*, Nerox Power Systems, Inc. v. M–B Contracting Co., 54 P.3d 791, 804 (Alaska 2002) (affirming a veil-piercing

judgment where "[t]here was incomplete documentation of loans" and "[t]he financial reports [were] exceedingly vague as to who received shares of stock and in compensation for what").

PROBLEM

Able owns 100% of ABC Corporation, which operates a restaurant. Able founds the corporation with $1,000 in capital. ABC has its own bank account, and Able does not commingle the corporation's funds with his own. ABC has never had a directors' meeting or a shareholders' meeting. ABC does not employ a bookkeeper, and its financial records are incoherent. ABC operates for six months and does not generate a profit. Shortly thereafter, a customer dies of food poisoning due to contaminated ham served by ABC. Can the customer's estate hold Able personally liable for any judgment rendered against ABC?

PERPETUAL REAL ESTATE SERVICES, INC. V. MICHAELSON PROPERTIES, INC.

United States Court of Appeals, Fourth Circuit

974 F.2d 545 (1992)

WILKINSON, CIRCUIT JUDGE.

In this case plaintiff has sought to pierce the corporate veil of its former business partner, Michaelson Properties, Inc. (MPI), and to hold MPI's sole shareholder, Aaron Michaelson, personally responsible for MPI's contractual liability. The jury returned a verdict in plaintiff's favor, and the district court upheld the jury's decision to pierce MPI's corporate veil. We reverse. The jury instructions in this case misstated the applicable standard under Virginia law, and the jury verdict improperly stripped Michaelson of the limited liability to which his business partner had agreed in the course of their negotiations. Virginia law will not permit the corporate veil to be pierced in this case, and we remand for entry of judgment in Michaelson's favor.

I.

In August 1981, defendant Aaron Michaelson formed Michaelson Properties, Inc., for the purpose of entering into joint real estate ventures. MPI was incorporated under the laws of the state of Illinois with initial paid-in capital of $1,000. Michaelson was the president and sole shareholder.

MPI subsequently entered into two joint ventures with Perpetual Real Estate Services, Inc. (PRES), the plaintiff in this case, involving the conversion of apartment buildings into condominiums. The first was formed in October 1981, and was known as Bethesda Apartment Associates (BAA). Under the BAA partnership agreement, each partner was to contribute $100,000 to a working capital fund, and MPI was to put up a $1 million letter of credit. Michaelson and his wife, Barbara, agreed to personally indemnify PRES against any loss on MPI's letter of credit. The BAA partnership sold the last condominium unit in 1983, and distributed about $600,000 in profits to each partner in 1985.

The second partnership, known as Arlington Apartment Associates (AAA), was formed in November 1983. Under the AAA partnership agreement, both PRES and MPI contributed $50,000 in capital, and each agreed to share *pro rata* in satisfying any liabilities of the partnership. The partnership also borrowed $24 million from Perpetual Savings Bank, PRES's parent corporation, but only after Aaron and Barbara Michaelson agreed to personally guarantee repayment of $750,000 of the loan. When an additional $2.1 million was needed to complete the project, MPI could not come up with the money so PRES loaned MPI $1.05 million, again after PRES secured a personal guarantee of repayment from the Michaelsons.

. . . .

In 1987 . . . several condominium purchasers filed suit against AAA, asserting breach of warranty claims in the amount of $5.5 million. Shortly before the case went to trial, counsel for AAA entered into settlement negotiations. The case was ultimately settled for $950,000. PRES paid the full amount on behalf of the partnership; MPI made no contribution toward the settlement. . . .

PRES then filed this diversity action against Michaelson and MPI. The complaint sought indemnity from MPI pursuant to the AAA partnership agreement. . . . PRES also asserted . . . that MPI was Michaelson's "*alter ego* or mere instrumentality" and that MPI's corporate veil should be pierced. Both parties—and the district court—agreed that Virginia law controls.

The district court entered summary judgment on the contractual indemnity claim against MPI. The remaining counts proceeded to trial. At the close of the evidence, Michaelson moved for a directed verdict. . . . On the "veil piercing" count, Michaelson argued that PRES had failed to justify disregarding the corporate form under Virginia law—that PRES had failed as a matter of law to prove that Michaelson had used MPI as a "device or sham" to "disguise wrongs, obscure fraud, or conceal crime," as required by *Cheatle v. Rudd's Swimming Pool Supply Co.*, 234 Va. 207, 360 S.E.2d 828, 831 (Va. 1987). The court denied this motion, and submitted . . . the veil piercing . . . count[] to the jury.

The jury subsequently returned a verdict in favor of PRES on the veil piercing count. . . . Michaelson filed a motion for jnov, which was rejected by the district court. Michaelson appeals.

II.

Michaelson makes two principal arguments on this appeal. He first argues that the district court's jury instruction on veil piercing misstated the standard applicable under Virginia law. Second, he argues that under the appropriate standard he is entitled to judgment as a matter of law. We will address these arguments in turn.

A.

Virginia courts have long recognized the basic proposition that a corporation is a legal entity separate and distinct from its shareholders. A fundamental purpose of incorporation is to "enable a group of persons to limit their liability in a joint venture to the extent of their contributions to the capital stock." *Beale* [*v. Kappa Alpha Order*, 192 Va. 382, 64 S.E.2d 789, 796 (Va. 1951)]. This concept of limited liability "supports a vital economic policy," *Cheatle* [*v. Rudd's Swimming Pool Supply Co.*, 234 Va. 207, 360 S.E.2d 828, 831 (Va. 1987)], a policy on which "large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted." *Anderson v. Abbott*, 321 U.S. 349, 362, 64 S. Ct. 531, 537, 88 L. Ed. 793 (1944).

Virginia courts have assiduously defended this "vital economic policy," lifting the veil of immunity only in "extraordinary" cases. *Beale*, 64 S.E.2d at 797; *Cheatle*, 360 S.E.2d at 831. Under Virginia law, plaintiff bears the burden of convincing the court to disregard the corporate form, and must first establish that "the corporate entity was the *alter ego*, alias, stooge, or dummy of the individuals sought to be charged personally." *Cheatle*, 360 S.E.2d at 831. This element may be established by evidence that the defendant exercised "undue domination and control" over the corporation, *Beale*, 64 S.E.2d at 797, and the jury instruction in this case fairly described this aspect of the test. Under this element of the test, the court properly permitted the jury to consider such factors as whether Michaelson "observed corporate formalities," whether he kept "corporate records," whether he paid dividends, and whether there were "other officers and directors."

The Supreme Court of Virginia has specifically held, however, that proof that some person "may dominate or control" the corporation, or "may treat it as a mere department, instrumentality, agency, etc." is not enough to pierce the veil. *Beale*, 64 S.E.2d at 798. In Virginia, "something more is required to induce the court to disregard the entity of a corporation." *Id.* at 797. Hence, plaintiff must also establish "that the corporation was a device or sham used to disguise wrongs, obscure fraud, or conceal crime." *Cheatle*, 360 S.E.2d at 831.

. . . .

The jury instruction in this case simply failed to communicate the essence of Virginia law in this area. Virginia adheres to a rigorous standard requiring proof that the defendant used the corporation to "disguise" some legal "wrong." This strict standard contrasts starkly with the rather soggy state in which the law was submitted to the jury, which was permitted to impose personal liability on Michaelson if it found that Michaelson dominated MPI and used MPI to perpetrate "an injustice or fundamental unfairness." The fact that limited liability might yield results that seem "unfair" to jurors unfamiliar with the function of the corporate form cannot provide a basis for piercing the veil. Virginia law requires proof of some legal wrong before it undermines this basic assumption of corporate existence.

. . . .

B.

Ordinarily, an erroneous jury instruction would require the case to be remanded for a new trial. Under the correct standard of Virginia law, however, we think for the reasons that follow that PRES is unable to raise a triable issue with respect to piercing the corporate veil in this case.

The district court pointed to several factors established by the evidence that purportedly justify such action. The district court noted that there was evidence from which a jury could find that Michaelson was the sole shareholder of MPI, that he was the sole director of MPI, that corporate formalities were not observed, that corporate capitalization was not adequate, and that corporate records did not indicate payment of any dividends.

. . . Even if we assume that MPI was Michaelson's "alter ego, alias, stooge, or dummy," *Cheatle*, 360 S.E.2d at 831, or that Michaelson exercised "undue domination and control" over MPI, *Beale*, 64 S.E.2d at 797, PRES's attempt to pierce the corporate veil must fail unless Michaelson used MPI to "disguise wrongs, obscure fraud, or conceal crime." *Cheatle*, 360 S.E.2d at 831. The district court found—and PRES appears to concede—that there was no evidence that Michaelson used the corporation to "obscure fraud" or "conceal crime." The only question, then, is whether a reasonable jury could have found that Michaelson somehow used MPI to "disguise wrongs."

PRES has simply failed to show that Michaelson used the corporate form to "disguise wrongs." PRES and MPI had entered into a longstanding contractual relationship, and PRES had full knowledge of the nature of its corporate partner, including its ownership structure and capitalization. PRES even participated in the decisions to distribute money to itself and to MPI after determining that the AAA partnership had sufficient assets to cover its anticipated expenses, and PRES apparently sought no limitations on what MPI did with those funds. PRES has sought on appeal to attack MPI's distributions to Michaelson by labelling them an unfair "siphoning" of funds. It was entirely foreseeable to PRES, however, that MPI would distribute those funds to Michaelson, its sole shareholder. When MPI did distribute the funds, it did so well before any claims were filed

against the partnership and in a manner that PRES has not shown would violate Virginia law.

PRES points out, however, that in a number of contexts PRES did negotiate personal guarantees from Michaelson, and insists that such guarantees weaken MPI's corporate veil. We think, to the contrary, that they fortify it. Courts have been extraordinarily reluctant to lift the veil in contract cases, such as this one, where the "creditor has willingly transacted business" with the corporation. *United States v. Jon–T Chemicals, Inc.*, 768 F.2d 686, 693 (5th Cir. 1985). In other words,

> courts usually apply more stringent standards to piercing the corporate veil in a contract case than they do in tort cases. This is because the party seeking relief in a contract case is presumed to have voluntarily and knowingly entered into an agreement with a corporate entity, and is expected to suffer the consequences of the limited liability associated with the corporate business form, while this is not the situation in tort cases.

1 William M. Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations* § 41.85 at 712 (1990 ed.). Thus, in contract cases, where "each party has a clear and equal obligation to weigh the potential benefits and risks of the agreement," *United Paperworkers Int'l Union v. Penntech Papers, Inc.*, 439 F. Supp. 610, 618 (D. Me. 1977), *aff'd* 583 F.2d 33 (1st Cir. 1978), courts have emphatically discouraged plaintiffs seeking to disregard the corporate form. In such cases, courts have required proof of some form of misrepresentation to the creditor:

> Unless the [corporation] misrepresents its financial condition to the creditor, the creditor should be bound by its decision to deal with the [corporation]; it should not be able to complain later that the [corporation] is unsound.

Jon–T Chemicals, 768 F.2d at 693. Here PRES and MPI were joint venturers in real estate, each familiar with the other. PRES has failed to point to anything that suggests that Michaelson misled PRES as to its financial condition—there is simply no indication that Michaelson used MPI to "disguise" anything. . . .

Absent some evidence of misrepresentation, "courts should not rewrite contracts or disturb the allocation of risk the parties have themselves established." Fletcher, *supra*, § 41.85 at 713. Parties to a commercial transaction must be free to negotiate questions of limited liability and to enforce their agreements by recourse to the law of contracts. PRES surely understood that principle, and thus went to the trouble of securing Michaelson's personal guarantees on several matters. Michaelson and his wife signed documents agreeing to personally indemnify PRES against loss on MPI's letter of credit and to personally guarantee repayment on two loans to MPI. The amounts were very specific: the Michaelsons were to be personally liable for up to $1 million on the letter of credit, and for $750,000 and $1.05 million on the two loans. Significantly, the AAA joint venture agreement included no personal guaranties by Michaelson. . . . As a matter of contract, then, Michaelson was entitled to insulation from personal liability on the claims from the AAA partners, and it is not our place to restructure the parties' agreement.

From the outset, MPI was a limited liability corporation formed for the express purpose of entering joint ventures in real estate. The parties in this case expressly put the issue of limited liability on the bargaining table, and settled on an agreement that required MPI—not Aaron Michaelson—to answer for the debts of the partnership. Exceptions to this rule were plainly spelled out by the parties in writing. The jury verdict stripped Michaelson of the protections against personal liability to which he was entitled under the settled corporate law of Virginia. It awarded to PRES a new contract—one that bestowed on PRES a personal guarantee on the part of Michaelson that PRES had been unable to obtain at the bargaining table—apparently on the ground that the actual

agreement resulted in a "fundamental unfairness." Be that as it may, Virginia law plainly says that fairness is for the parties to the contract to evaluate, not the courts. Our task is rather one of enforcement.

III.

In conclusion, PRES is a disconsolate joint venturer who now wishes it had been doing business with an individual, and not a corporation. That was not the case, however, and, for the foregoing reasons, we reverse and remand with directions that the district court enter judgment for defendant Michaelson.

REVERSED.

NOTES & QUESTIONS

1. Would MPI's veil have been pierced in a tort case?

2. Do you agree with the court that veil piercing should be subject to more stringent standards in contract cases? *Cf.* TEX. BUS. ORGS. CODE ANN. § 21.223(b) (providing that a shareholder is not liable "on any contractual obligation" unless the obligee demonstrates that the shareholder "caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of" the shareholder).

3. PRES was a sophisticated party who knew how to obtain a personal guarantee in connection with the BAA and AAA transactions. It would, therefore, appear fair to say that, when PRES declined to ask for a personal guarantee, it understood that it was looking only to MPI for satisfaction. Suppose that the plaintiff was an unsophisticated party who had never asked for a personal guarantee. Would this fact change the result in *Perpetual*?

REVERSE PIERCING

In a traditional veil-piercing case, a creditor of a corporation seeks to hold a shareholder liable for the corporation's debts. In a reverse veil-piercing case, a creditor of a shareholder seeks to hold the corporation liable for the shareholder's debts. A growing number of courts have now recognized the doctrine. *See, e.g.*, Minich v. Gem State Developers, Inc., 591 P.2d 1078, 1084 (Idaho 1979); Central Nat'l Bank & Trust Co. v. Wagener, 183 N.W.2d 678, 682 (Iowa 1971); LFC Mktg. Group, Inc. v. Loomis, 8 P.3d 841, 846 (Nev. 2000); Winey v. Cutler, 678 A.2d 1261, 1262–63 (Vt. 1996); W. G. Platts, Inc. v. Platts, 298 P.2d 1107, 1111 (Wash. 1956).

Of course, a shareholder's creditor may obtain a judgment and, upon execution of the judgment, seize the shareholder's stock in the corporation. If the debtor-shareholder owns 100% of the corporation's stock, and the creditor receives all of the stock when he executes his judgment, the creditor may dissolve the corporation and obtain access to the corporation's assets. Indeed, in many states, the creditor may achieve dissolution upon receiving a majority of the corporation's shares by removing and replacing the existing directors and voting his shares in favor of dissolution. *See* DGCL §§ 141(k), 275(a), (b).

However, a creditor may prefer to engage in reverse veil piercing and seize assets directly from the debtor-shareholder's corporation. The test for reverse veil piercing is similar to that for traditional veil piercing. As one court phrased the test in Phillips v. Englewood Post No. 322 Veterans of Foreign Wars of the United States, Inc., 139 P.3d 639 (Colo. 2006):

> A court may reverse pierce the corporate veil and obtain the assets of a corporation for the obligations of a controlling shareholder or other corporate insider only upon a clear showing that (1) the controlling insider and the corporation are alter egos of each other (2) justice requires recognizing the

> substance of the relationship over the form because the corporate fiction is utilized to perpetuate a fraud or defeat a rightful claim, and (3) an equitable result is achieved by piercing. Only when a claimant makes a clear showing of each factor may the corporate form be disregarded.

Id. at 646.

The Phillips court also noted that "in determining whether to . . . reverse pierce the corporate veil, a court should review the same factors utilized in determining whether traditional veil piercing is appropriate." *Id*. However, this view would seem to be a mistake. Given the different contexts, the alter ego factors do not have the same impact when reverse veil piercing is the issue. For example, undercapitalization and siphoning off assets are classic reasons for a court to engage in traditional veil piercing. However, it is hard to understand why these factors support reverse veil piercing. To the extent that a shareholder is diverting assets from a corporation to himself, he is more able to satisfy the claims of his individual creditors. Why should these creditors receive the additional benefit of reverse veil piercing?

As with traditional veil piercing, the most important portion of the reverse veil-piercing test is indeterminate. Reverse veil piercing should not occur unless required by "justice" to achieve an "equitable" result. The hard question here is what factors speak to justice and equity in the context of reverse veil piercing. The courts have generally supported reverse veil piercing where a shareholder uses the corporation form to evade preexisting liabilities or otherwise hide assets from creditors. *See* LFC Mktg. Group, Inc. v. Loomis, 8 P.3d 841, 846 (Nev. 2000). By contrast, reverse veil piercing is disfavored where innocent shareholders or creditors of the corporation would be harmed. *See* Stoebner v. Lingenfelter, 115 F.3d 576, 579 (8th Cir. 1997) (noting that courts do not apply reverse veil piercing where "innocent creditors . . . will be harmed"); Scholes v. Lehmann, 56 F.3d 750, 758 (7th Cir. 1995) (noting that "[r]everse piercing is ordinarily possible only in one-man corporations, since if there is more than one shareholder the seizing of the corporation's assets to pay a shareholder's debts would be a wrong to the other shareholders"). In addition, reverse veil piercing should not occur if there is an adequate, less intrusive remedy available. Such remedies include "conversion, fraudulent conveyance of assets, respondeat superior, and agency law." Phillips v. Englewood Post No. 322 Veterans of Foreign Wars of the United States, Inc., 139 P.3d 639, 647 (Colo. 2006).

E. THE TRADITIONAL ROLE OF FIDUCIARY DUTY

We have previously examined the powers possessed by directors and officers of corporations. With power, of course, comes responsibility. Not surprisingly, therefore, directors and officers owe fiduciary duties to the corporations they serve. These duties primarily take two forms: a duty to exercise care in the management and operation of the corporation, and a duty to exercise loyalty by putting the corporation's interests before personal interests.

Historically, fiduciary duty doctrine developed as a product of the common law. MBCA §§ 8.30 and 8.42 now provide some statutory guidance on the duties owed by directors and officers, and a number of states follow the MBCA approach. Although directors and officers traditionally owe the same fiduciary duties to the corporation, *see* Gantler v. Stephens, 965 A.2d 695, 709 n.36 (Del. 2009) ("That officers and directors of Delaware corporations have identical fiduciary duties has long been an articulated principle of Delaware law."), most of the existing case law addresses the duties of directors. Thus, director duties are the focus of this Section.

1. THE DUTY OF CARE

As a general proposition, a person who engages in conduct that creates a risk of harm to others has a duty to act as a reasonably prudent person would act in the circumstances. Although this proposition is usually associated with tort law, the basic concept is important to corporate law as well. Indeed, directors owe a fiduciary duty to their corporation to act carefully in carrying out their responsibilities. This duty of care encompasses two distinct settings in which director responsibilities arise: oversight and decision-making. In the oversight setting, directors are obligated to use care in monitoring the activities of the officers and the general affairs of the corporation as a whole. Disputes falling within this setting tend to involve allegations that the directors were inattentive to what the officers and other employees of the company were doing, and that such inattentiveness resulted in harm to the corporation. In the decision-making setting, directors are obligated to use care in making decisions that affect the corporation's welfare. Disputes falling within this setting tend to involve allegations that the directors were not reasonably informed in making a decision, and/or that the decision itself was substantively unwise. It is important to keep these settings in mind as you read the following materials.

a. The Oversight Context

MBCA §§ 8.30, 8.31, 8.42

A primary responsibility of a director is to monitor the business of the corporation by remaining knowledgeable about, and attentive to, the operation of the company. Not surprisingly, when there is evidence that a director is "asleep at the switch," duty of care issues often arise.

FRANCIS V. UNITED JERSEY BANK

Supreme Court of New Jersey

432 A.2d 814 (1981)

POLLOCK, J.

The primary issue on this appeal is whether a corporate director is personally liable in negligence for the failure to prevent the misappropriation of trust funds by other directors who were also officers and shareholders of the corporation.

Plaintiffs are trustees in bankruptcy[a] of Pritchard & Baird Intermediaries Corp. (Pritchard & Baird), a reinsurance broker or intermediary. Defendant Lillian P. Overcash is the daughter of Lillian G. Pritchard and the executrix of her estate. At the time of her death, Mrs. Pritchard was a director and the largest single shareholder of Pritchard & Baird. Because Mrs. Pritchard died after the institution of suit but before trial, her executrix was substituted as a defendant. United Jersey Bank is joined as the administrator of the estate of Charles Pritchard, Sr., who had been president, director and majority shareholder of Pritchard & Baird.

This litigation focuses on payments made by Pritchard & Baird to Charles Pritchard, Jr. and William Pritchard, who were sons of Mr. and Mrs. Charles Pritchard, Sr., as well as officers, directors and shareholders of the corporation. Claims against Charles, Jr. and William are being pursued in bankruptcy proceedings against them.

The trial court, sitting without a jury, characterized the payments as fraudulent conveyances within *N.J.S.A.* 25:2–10 and entered judgment of $10,355,736.91 plus interest against the estate of Mrs. Pritchard. The judgment includes damages from her negligence in permitting payments from the corporation of $4,391,133.21 to Charles, Jr. and $5,483,799.02 to William. . . .

The Appellate Division affirmed, but found that the payments were a conversion of trust funds, rather than fraudulent conveyances of the assets of the corporation. We granted certification limited to the issue of the liability of Lillian Pritchard as a director.

Although we accept the characterization of the payments as a conversion of trust funds, the critical question is not whether the misconduct of Charles, Jr. and William should be characterized as fraudulent conveyances or acts of conversion. Rather, the initial question is whether Mrs. Pritchard was negligent in not noticing and trying to prevent the misappropriation of funds held by the corporation in an implied trust. A further question is whether her negligence was the proximate cause of the plaintiffs' losses. Both lower courts found that she was liable in negligence for the losses caused by the wrongdoing of Charles, Jr. and William. We affirm.

I

The matrix for our decision is the customs and practices of the reinsurance industry and the role of Pritchard & Baird as a reinsurance broker. Reinsurance involves a contract under which one insurer agrees to indemnify another for loss sustained under the latter's policy of insurance. Insurance companies that insure against losses arising out of fire or other casualty seek at times to minimize their exposure by sharing risks with other insurance companies. Thus, when the face amount of a policy is comparatively large, the company may enlist one or more insurers to participate in that risk. Similarly, an insurance company's loss potential and overall exposure may be reduced by reinsuring a part of an entire class of policies (e.g., 25% of all of its fire insurance policies). The selling insurance company is known as a ceding company. The entity that assumes the obligation is designated as the reinsurer.

The reinsurance broker arranges the contract between the ceding company and the reinsurer. In accordance with industry custom before the Pritchard & Baird bankruptcy, the reinsurance contract or treaty did not specify the rights and duties of the broker. Typically, the ceding company communicates to the broker the details concerning the risk. The broker negotiates the sale of portions of the risk to the reinsurers. In most instances, the ceding company and the reinsurer do not communicate with each other, but rely upon the reinsurance broker. The ceding company pays premiums due a reinsurer to the broker,

[a] A trustee in bankruptcy acts as the representative of a bankruptcy estate. In essence, the trustee represents the interests of creditors of the bankrupt debtor.

who deducts his commission and transmits the balance to the appropriate reinsurer. When a loss occurs, a reinsurer pays money due a ceding company to the broker, who then transmits it to the ceding company.

The reinsurance business was described by an expert at trial as having "a magic aura around it of dignity and quality and integrity." A telephone call which might be confirmed by a handwritten memorandum is sufficient to create a reinsurance obligation. Though separate bank accounts are not maintained for each treaty, the industry practice is to segregate the insurance funds from the broker's general accounts. Thus, the insurance fund accounts would contain the identifiable amounts for transmittal to either the reinsurer or the ceder. . . .

. . . . [Pritchard & Baird was] incorporated under the laws of the State of New York in 1959. . . . [T]he corporation operated as a close family corporation with Mr. and Mrs. Pritchard [Charles, Sr. and Lillian] and their two sons [Charles, Jr. and William] as the only directors. After the death of Charles, Sr. in 1973, only the remaining three directors continued to operate as the board. Lillian Pritchard inherited 72 of her husband's 120 shares in Pritchard & Baird, thereby becoming the largest shareholder in the corporation with 48% of the stock.

. . . .

Charles Pritchard, Sr. was the chief executive and controlled the business in the [early] years. . . . Beginning in 1966, he gradually relinquished control over the operations of the corporation. In 1968, Charles, Jr. became president and William became executive vice president. Charles, Sr. apparently became ill in 1971 and during the last year and a half of his life was not involved in the affairs of the business. He continued, however, to serve as a director until his death on December 10, 1973. Notwithstanding the presence of Charles, Sr. on the board until his death in 1973, Charles, Jr. dominated the management of the corporation and the board from 1968 until the bankruptcy in 1975.

Contrary to the industry custom of segregating funds, Pritchard & Baird commingled the funds of reinsurers and ceding companies with its own funds. All monies (including commissions, premiums and loss monies) were deposited in a single account. Charles, Sr. began the practice of withdrawing funds from the commingled account in transactions identified on the corporate books as "loans." As long as Charles, Sr. controlled the corporation, the "loans" correlated with corporate profits and were repaid at the end of each year. Starting in 1970, however, Charles, Jr. and William begin to siphon ever-increasing sums from the corporation under the guise of loans. . . . At least by January 31, 1973, the annual increase in the loans exceeded annual corporate revenues. By October 1975, the year of bankruptcy, the "shareholders' loans" had metastasized to a total of $12,333,514.47.

The trial court rejected the characterization of the payments as "loans." No corporate resolution authorized the "loans," and no note or other instrument evidenced the debt. Charles, Jr. and William paid no interest on the amounts received. The "loans" were not repaid or reduced from one year to the next; rather, they increased annually.

The designation of "shareholders' loans" on the balance sheet was an entry to account for the distribution of the premium and loss money to Charles, Sr., Charles, Jr. and William. As the trial court found, the entry was part of a "woefully inadequate and highly dangerous bookkeeping system."

The "loans" to Charles, Jr. and William far exceeded their salaries and financial resources. If the payments to Charles, Jr. and William had been treated as dividends or compensation, then the balance sheets would have shown an excess of liabilities over assets. If the "loans" had been eliminated, the balance sheets would have depicted a

corporation not only with a working capital deficit, but also with assets having a fair market value less than its liabilities. The balance sheets for 1970–1975, however, showed an excess of assets over liabilities. This result was achieved by designating the misappropriated funds as "shareholders' loans" and listing them as assets offsetting the deficits. Although the withdrawal of the funds resulted in an obligation of repayment to Pritchard & Baird, the more significant consideration is that the "loans" represented a massive misappropriation of money belonging to the clients of the corporation.

. . . .

The funding of the "loans" left the corporation with insufficient money to operate. Pritchard & Baird could defer payment on accounts payable because its clients allowed a grace period, generally 30 to 90 days, before the payment was due. During this period, Pritchard & Baird used the funds entrusted to it as a "float" to pay current accounts payable. By recourse to the funds of its clients, Pritchard & Baird not only paid its trade debts, but also funded the payments to Charles, Jr. and William. Thus, Pritchard & Baird was able to meet its obligations as they came due only through the use of clients' funds.

The pattern that emerges from these figures is the substantial increase in the monies appropriated by Charles Pritchard, Jr. and William Pritchard after their father's withdrawal from the business and the sharp decline in the profitability of the operation after his death. This led ultimately to the filing in December, 1975, of an involuntary petition in bankruptcy and the appointments of the plaintiffs as trustees in bankruptcy of Pritchard & Baird.

Mrs. Pritchard was not active in the business of Pritchard & Baird and knew virtually nothing of its corporate affairs. She briefly visited the corporate offices in Morristown on only one occasion, and she never read or obtained the annual financial statements. She was unfamiliar with the rudiments of reinsurance and made no effort to assure that the policies and practices of the corporation, particularly pertaining to the withdrawal of funds, complied with industry custom or relevant law. Although her husband had warned her that Charles, Jr. would "take the shirt off my back," Mrs. Pritchard did not pay any attention to her duties as a director or to the affairs of the corporation.

After her husband died in December 1973, Mrs. Pritchard became incapacitated and was bedridden for a six-month period. She became listless at this time and started to drink rather heavily. Her physical condition deteriorated, and in 1978 she died. The trial court rejected testimony seeking to exonerate her because she "was old, was grief-stricken at the loss of her husband, sometimes consumed too much alcohol and was psychologically overborne by her sons." That court found that she was competent to act and that the reason Mrs. Pritchard never knew what her sons "were doing was because she never made the slightest effort to discharge any of her responsibilities as a director of Pritchard & Baird."

II

A preliminary matter is the determination of whether New Jersey law should apply to this case. Although Pritchard & Baird was incorporated in New York, the trial court found that New Jersey had more significant relationships to the parties and the transactions than New York. The shareholder[s], officers and directors were New Jersey residents. The estates of Mr. and Mrs. Pritchard are being administered in New Jersey, and the bankruptcy proceedings involving Charles, Jr., William and Pritchard & Baird are pending in New Jersey. Virtually all transactions took place in New Jersey. Although many of the creditors are located outside the state, all had contacts with Pritchard & Baird in New Jersey. Consequently, the trial court applied New Jersey law. The parties agree that New Jersey law should apply. We are in accord.

III

Individual liability of a corporate director for acts of the corporation is a prickly problem. Generally directors are accorded broad immunity and are not insurers of corporate activities. The problem is particularly nettlesome when a third party asserts that a director, because of nonfeasance, is liable for losses caused by acts of insiders, who in this case were officers, directors and shareholders. Determination of the liability of Mrs. Pritchard requires findings that she had a duty to the clients of Pritchard & Baird, that she breached that duty and that her breach was a proximate cause of their losses.

The New Jersey Business Corporation Act, which took effect on January 1, 1969, was a comprehensive revision of the statutes relating to business corporations. One section, *N.J.S.A.* 14A:6–14, concerning a director's general obligation . . . makes it incumbent upon directors to

> discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

. . . . Before the enactment of *N.J.S.A.* 14A:6–14, there was no express statutory authority requiring directors to act as ordinarily prudent persons under similar circumstances in like positions. Nonetheless, the requirement had been expressed in New Jersey judicial decisions.

. . . .

Because *N.J.S.A.* 14A:6–14 is modeled in part upon section 717 of the New York statute, *N.Y.Bus.Corp. Law* § 717 (McKinney), we consider also the law of New York in interpreting the New Jersey statute.

Prior to the enactment of section 717, the New York courts, like those of New Jersey, had espoused the principle that directors owed that degree of care that a businessman of ordinary prudence would exercise in the management of his own affairs. In addition to requiring that directors act honestly and in good faith, the New York courts recognized that the nature and extent of reasonable care depended upon the type of corporation, its size and financial resources. Thus, a bank director was held to stricter accountability than the director of an ordinary business.[1]

In determining the limits of a director's duty, section 717 continued to recognize the individual characteristics of the corporation involved as well as the particular circumstances and corporate role of the director. Significantly, the legislative comment to section 717 states:

> The adoption of the standard prescribed by this section will allow the court to envisage the director's duty of care as a relative concept, depending on the kind of corporation involved, the particular circumstances and the corporate role of the director.

This approach was consonant with the desire to formulate a standard that could be applied to both publicly and closely held entities. . . .

Underlying the pronouncements in section 717 . . . and *N.J.S.A.* 14A:6–14 is the principle that directors must discharge their duties in good faith and act as ordinarily prudent persons would under similar circumstances in like positions. Although specific duties in a given case can be determined only after consideration of all of the

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[1] The obligations of directors of banks involve some additional consideration because of their relationship to the public generally and depositors in particular. Statutes impose certain requirements on bank directors. For example, directors of national banks must take an oath that they will diligently and honestly administer the affairs of the bank and will not permit violation of the banking laws. Moreover, they must satisfy certain requirements such as residence, citizenship, stockholdings and not serving as an investment banker.

circumstances, the standard of ordinary care is the wellspring from which those more specific duties flow.

As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. Because directors are bound to exercise ordinary care, they cannot set up as a defense lack of the knowledge needed to exercise the requisite degree of care. If one "feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act." [*Campbell v. Watson*, 62 N.J.Eq. 396, 50 A. 120, 128 (Ch.1901)].

Directors are under a continuing obligation to keep informed about the activities of the corporation. Otherwise, they may not be able to participate in the overall management of corporate affairs. *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y.1924) (director guilty of misprision of office for not keeping himself informed about the details of corporate business); *Atherton v. Anderson*, 99 F.2d 883, 889–890 (6 Cir.1938) (ignorance no defense to director liability because of director's "duty to know the facts"); *Campbell*, *supra*, 62 N.J.Eq. at 409, 50 A. 120 (directors "bound to acquaint themselves with . . . extent . . . of supervision exercised by officers"); *Williams v. McKay*, 46 N.J.Eq. 25, 36, 18 A. 824 (Ch.1889) (director under duty to supervise managers and practices to determine whether business methods were safe and proper). Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.

Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies. Accordingly, a director is well advised to attend board meetings regularly. Indeed, a director who is absent from a board meeting is presumed to concur in action taken on a corporate matter, unless he files a "dissent with the secretary of the corporation within a reasonable time after learning of such action." *N.J.S.A.* 14A:6–13 (Supp.1981–1982). Regular attendance does not mean that directors must attend every meeting, but that directors should attend meetings as a matter of practice. A director of a publicly held corporation might be expected to attend regular monthly meetings, but a director of a small, family corporation might be asked to attend only an annual meeting. The point is that one of the responsibilities of a director is to attend meetings of the board of which he or she is a member. . . .

While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements. In some circumstances, directors may be charged with assuring that bookkeeping methods conform to industry custom and usage. The extent of review, as well as the nature and frequency of financial statements, depends not only on the customs of the industry, but also on the nature of the corporation and the business in which it is engaged. Financial statements of some small corporations may be prepared internally and only on an annual basis; in a large publicly held corporation, the statements may be produced monthly or at some other regular interval. Adequate financial review normally would be more informal in a private corporation than in a publicly held corporation.

Of some relevance in this case is the circumstance that the financial records disclose the "shareholders' loans." Generally directors are immune from liability if, in good faith,

> they rely upon the opinion of counsel for the corporation or upon written reports setting forth financial data concerning the corporation and prepared by an independent public accountant or certified public accountant or firm of such

accountants or upon financial statements, books of account or reports of the corporation represented to them to be correct by the president, the officer of the corporation having charge of its books of account, or the person presiding at a meeting of the board. [*N.J.S.A.* 14A:6–14]

The review of financial statements, however, may give rise to a duty to inquire further into matters revealed by those statements. Upon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign.

In certain circumstances, the fulfillment of the duty of a director may call for more than mere objection and resignation. Sometimes a director may be required to seek the advice of counsel. . . . The duty to seek the assistance of counsel can extend to areas other than the interpretation of corporation instruments. Modern corporate practice recognizes that on occasion a director should seek outside advice. A director may require legal advice concerning the propriety of his or her own conduct, the conduct of other officers and directors or the conduct of the corporation. In appropriate circumstances, a director would be "well advised to consult with regular corporate counsel (or his own legal adviser) at any time in which he is doubtful regarding proposed action. . . ." [Section of Corporation, Banking and Business Law, American Bar Association, "Corporate Director's Guidebook," 33 *Bus.Law.* 1595, 1618 (1978)]. Sometimes the duty of a director may require more than consulting with outside counsel. A director may have a duty to take reasonable means to prevent illegal conduct by co-directors; in any appropriate case, this may include threat of suit.

A director is not an ornament, but an essential component of corporate governance. Consequently, a director cannot protect himself behind a paper shield bearing the motto, "dummy director." *Campbell*, *supra*, 62 N.J.Eq. at 443, 50 A. 120. ("The directors were not intended to be mere figure-heads without duty or responsibility"); *Williams v. McKay*, *supra*, 46 N.J.Eq. at 57–58, 18 A. 824 (director voluntarily assuming position also assumes duties of ordinary care, skill and judgment). The New Jersey Business Corporation Act, in imposing a standard of ordinary care on all directors, confirms that dummy, figurehead and accommodation directors are anachronisms with no place in New Jersey law. Similarly, in interpreting section 717, the New York courts have not exonerated a director who acts as an "accommodation." Thus, all directors are responsible for managing the business and affairs of the corporation.

The factors that impel expanded responsibility in the large, publicly held corporation may not be present in a small, close corporation. Nonetheless, a close corporation may, because of the nature of its business, be affected with a public interest. For example, the stock of a bank may be closely held, but because of the nature of banking the directors would be subject to greater liability than those of another close corporation. Even in a small corporation, a director is held to the standard of that degree of care that an ordinarily prudent director would use under the circumstances.

A director's duty of care does not exist in the abstract, but must be considered in relation to specific obligees. In general, the relationship of a corporate director to the corporation and its stockholders is that of a fiduciary. Shareholders have a right to expect that directors will exercise reasonable supervision and control over the policies and practices of a corporation. The institutional integrity of a corporation depends upon the proper discharge by directors of those duties.

While directors may owe a fiduciary duty to creditors also, that obligation generally has not been recognized in the absence of insolvency. With certain corporations, however, directors are seemed to owe a duty to creditors and other third parties even when the corporation is solvent. Although depositors of a bank are considered in some respects to be creditors, courts have recognized that directors may owe them a fiduciary duty.

Directors of nonbanking corporations may owe a similar duty when the corporation holds funds of others in trust.

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. . . . The distinguishing circumstances in regard to banks and other corporations holding trust funds is that the depositor or beneficiary can reasonably expect the director to act with ordinary prudence concerning the funds held in a fiduciary capacity. Thus, recognition of a duty of a director to those for whom a corporation holds funds in trust may be viewed as another application of the general rule that a director's duty is that of an ordinary prudent person under the circumstances.

The most striking circumstances affecting Mrs. Pritchard's duty as a director are the character of the reinsurance industry, the nature of the misappropriated funds and the financial condition of Pritchard & Baird. The hallmark of the reinsurance industry has been the unqualified trust and confidence reposed by ceding companies and reinsurers in reinsurance brokers. Those companies entrust money to reinsurance intermediaries with the justifiable expectation that the funds will be transmitted to the appropriate parties. Consequently, the companies could have assumed rightfully that Mrs. Pritchard, as a director of a reinsurance brokerage corporation, would not sanction the commingling and the conversion of loss and premium funds for the personal use of the principals of Pritchard & Baird.

As a reinsurance broker, Pritchard & Baird received annually as a fiduciary millions of dollars of clients' money which it was under a duty to segregate.[4] To this extent, it resembled a bank rather than a small family business. Accordingly, Mrs. Pritchard's relationship to the clientele of Pritchard & Baird was akin to that of a director of a bank to its depositors. All parties agree that Pritchard & Baird held the misappropriated funds in an implied trust. That trust relationship gave rise to a fiduciary duty to guard the funds with fidelity and good faith.

As a director of a substantial reinsurance brokerage corporation, she should have known that it received annually millions of dollars of loss and premium funds which it held in trust for ceding and reinsurance companies. Mrs. Pritchard should have obtained and read the annual statements of financial condition of Pritchard & Baird. Although she had a right to rely upon financial statements prepared in accordance with *N.J.S.A.* 14A:6–14, such reliance would not excuse her conduct. The reason is that those statements disclosed on their face the misappropriation of trust funds.

From those statements, she should have realized that, as of January 31, 1970, her sons were withdrawing substantial trust funds under the guise of "Shareholders' Loans." The financial statements for each fiscal year commencing with that of January 31, 1970, disclosed that the working capital deficits and the "loans" were escalating in tandem. Detecting a misappropriation of funds would not have required special expertise or extraordinary diligence; a cursory reading of the financial statements would have revealed the pillage. Thus, if Mrs. Pritchard had read the financial statements, she would have known that her sons were converting trust funds. When financial statements demonstrate that insiders are bleeding a corporation to death, a director should notice and try to stanch the flow of blood.

In summary, Mrs. Pritchard was charged with the obligation of basic knowledge and supervision of the business of Pritchard & Baird. Under the circumstances, this obligation included reading and understanding financial statements, and making reasonable attempts at detection and prevention of the illegal conduct of other officers and directors.

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[4] Following the Pritchard & Baird bankruptcy, New York, a reinsurance center, adopted legislation [regulating] reinsurance intermediaries. One statute codified the industry standard by prohibiting reinsurance intermediaries from commingling their funds with funds of their principals.

She had a duty to protect the clients of Pritchard & Baird against policies and practices that would result in the misappropriation of money they had entrusted to the corporation. She breached that duty.

IV

Nonetheless, the negligence of Mrs. Pritchard does not result in liability unless it is a proximate cause of the loss. Analysis of proximate cause requires an initial determination of cause-in-fact. Causation-in-fact calls for a finding that the defendant's act or omission was a necessary antecedent of the loss, i.e., that if the defendant had observed his or her duty of care, the loss would not have occurred. Further, the plaintiff has the burden of establishing the amount of the loss or damages caused by the negligence of the defendant. Thus, the plaintiff must establish not only a breach of duty, "but in addition that the performance by the director of his duty would have avoided loss, and the amount of the resulting loss." [1 *G. Hornstein*, *Corporation Law and Practice* § 446 at 566 (1959)].

Cases involving nonfeasance present a much more difficult causation question than those in which the director has committed an affirmative act of negligence leading to the loss. Analysis in cases of negligent omissions calls for determination of the reasonable steps a director should have taken and whether that course of action would have averted the loss.

Usually a director can absolve himself from liability by informing the other directors of the impropriety and voting for a proper course of action. Conversely, a director who votes for or concurs in certain actions may be "liable to the corporation for the benefit of its creditors or shareholders, to the extent of any injuries suffered by such persons, respectively, as a result of any such action." *N.J.S.A.* 14A:6–12 (Supp.1981–1982). A director who is present at a board meeting is presumed to concur in corporate action taken at the meeting unless his dissent is entered in the minutes of the meeting or filed promptly after adjournment. *N.J.S.A.* 14A:6–13. In many, if not most, instances an objecting director whose dissent is noted in accordance with *N.J.S.A.* 14A:6–13 would be absolved after attempting to persuade fellow directors to follow a different course of action. *Cf. McGlynn [v. Schultz*, 90 N.J.Super. 505, 520–21, 529, 218 A.2d 408 (Ch.Div.1966)] (receiver had no case against director who advised president that certain funds should be escrowed, wrote to executive committee to that effect, and objected at special meeting of board of directors); *Selheimer v. Manganese Corp.*, [423 Pa. 563, 572, 584, 224 A.2d 634, 640, 646 (Sup.Ct.1966)] (dissenting minority director in publicly held corporation absolved because he did all he could to divert majority directors from their course of conduct by complaining to management, threatening to institute suit and organizing a stockholders' committee).

Even accepting the hypothesis that Mrs. Pritchard might not be liable if she had objected and resigned, there are two significant reasons for holding her liable. First, she did not resign until just before the bankruptcy. Consequently, there is no factual basis for the speculation that the losses would have occurred even if she had objected and resigned. Indeed, the trial court reached the opposite conclusion: "The actions of the sons were so blatantly wrongful that it is hard to see how they could have resisted any moderately firm objection to what they were doing." Second, the nature of the reinsurance business distinguishes it from most other commercial activities in that reinsurance brokers are encumbered by fiduciary duties owed to third parties. In other corporations, a director's duty normally does not extend beyond the shareholders to third parties.

In this case, the scope of Mrs. Pritchard's duties was determined by the precarious financial condition of Pritchard & Baird, its fiduciary relationship to its clients and the implied trust in which it held their funds. Thus viewed, the scope of her duties

encompassed all reasonable action to stop the continuing conversion. Her duties extended beyond mere objection and resignation to reasonable attempts to prevent the misappropriation of the trust funds.

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[Some] courts have refused to impose personal liability on negligent directors when the plaintiffs have been unable to prove that diligent execution of the directors' duties would have precluded the losses.

[Some] courts have held directors liable for losses actively perpetrated by others because the negligent omissions of the directors were considered a necessary antecedent to the defalcations.

In assessing whether Mrs. Pritchard's conduct was a legal or proximate cause of the conversion, "[l]egal responsibility must be limited to those causes which are so closely connected with the result and of such significance that the law is justified in imposing liability." [*W. Prosser*, *Law of Torts* § 41 at 237 (4 ed. 1971)]. Such a judicial determination involves not only considerations of causation-in-fact and matters of policy, but also common sense and logic. The act or the failure to act must be a substantial factor in producing the harm. *Prosser*, *supra*, § 41 at 240; *Restatement (Second) of Torts*, §§ 431, 432 (1965).

Within Pritchard & Baird, several factors contributed to the loss of the funds: commingling of corporate and client monies, conversion of funds by Charles, Jr. and William and dereliction of her duties by Mrs. Pritchard. The wrongdoing of her sons, although the immediate cause of the loss, should not excuse Mrs. Pritchard from her negligence which also was a substantial factor contributing to the loss. Her sons knew that she, the only other director, was not reviewing their conduct; they spawned their fraud in the backwater of her neglect. Her neglect of duty contributed to the climate of corruption; her failure to act contributed to the continuation of that corruption. Consequently, her conduct was a substantial factor contributing to the loss.

Analysis of proximate cause is especially difficult in a corporate context where the allegation is that nonfeasance of a director is a proximate cause of damage to a third party. Where a case involves nonfeasance, no one can say "with absolute certainty what would have occurred if the defendant had acted otherwise." *Prosser*, *supra*, § 41 at 242. Nonetheless, where it is reasonable to conclude that the failure to act would produce a particular result and that result has followed, causation may be inferred. We conclude that even if Mrs. Pritchard's mere objection had not stopped the depredations of her sons, her consultation with an attorney and the threat of suit would have deterred them. That conclusion flows as a matter of common sense and logic from the record. Whether in other situations a director has a duty to do more than protest and resign is best left to case-by-case determinations. In this case, we are satisfied that there was a duty to do more than object and resign. Consequently, we find that Mrs. Pritchard's negligence was a proximate cause of the misappropriations.

To conclude, by virtue of her office, Mrs. Pritchard had the power to prevent the losses sustained by the clients of Pritchard & Baird. With power comes responsibility. She had a duty to deter the depredation of the other insiders, her sons. She breached that duty and caused plaintiffs to sustain damages.

. . . .

NOTES & QUESTIONS

1. The internal affairs doctrine is a choice of law rule stating that disputes among shareholders, directors, and officers of a company, or between those parties and the

corporation, shall be governed by the law of the company's state of incorporation. Given that Pritchard & Baird was a New York corporation, why did the court choose to apply New Jersey law? Do you agree with that choice?

2. Who are the plaintiffs in *Francis*? How did they have standing to sue directors for breach of the duty of care?

3. Under what standard was Mrs. Pritchard's conduct reviewed? How did she breach her duty of care?

4. How would *Francis* have been decided under the MBCA? Consider MBCA §§ 8.30 and 8.31.

5. Is the duty of care a strict "objective" standard, or is it "subjectively" tailored to fit the circumstances of the director at issue? There was testimony indicating that Mrs. Pritchard "was old, was grief-stricken at the loss of her husband, sometimes consumed too much alcohol and was psychologically overborne by her sons." Should that be relevant to the duty of care analysis? Suppose that a director has special expertise in accounting and finance. Should that be relevant to the duty of care analysis? *See* MBCA § 8.30(b) & cmt. 2.; ALI PRINCIPLES § 4.01(a) & cmt.

6. Some courts have distinguished between inside and outside directors in determining whether the duty of care was breached. The notion appears to be that inside directors, as officers of the corporation, should have greater knowledge about the company's business and affairs. For example, in the well-known case of Bates v. Dresser, 251 U.S. 524 (1920), Dresser was the president of a bank as well as a member of its board of directors. Dresser was held liable for sums stolen by Coleman, a bookkeeper at the bank, although the other directors avoided liability. As to the non-liability of the other directors, the Court stated the following:

> . . . . This fraud was a novelty in the way of swindling a bank so far as the knowledge of any experience had reached Cambridge before 1910. We are not prepared to reverse the finding of the master and the Circuit Court of Appeals that the directors should not be held answerable for taking the cashier's statement of liabilities to be as correct as the statement of assets always was. . . . Their confidence seemed warranted by the semiannual examinations by the Government examiner and they were encouraged in their belief that all was well by the president, whose responsibility, as executive officer; interest, as large stockholder and depositor; and knowledge, from long daily presence in the bank, were greater than theirs. They were not bound by virtue of the office gratuitously assumed by them to call in the pass books and compare them with the ledger, and until the event showed the possibility they hardly could have seen that their failure to look at the ledger opened a way to fraud.

Id. at 529–30. As to Dresser, however, the Court was far less lenient:

> The position of the president is different. Practically he was the master of the situation. He was daily at the bank for hours, he had the deposit ledger in his hands at times and might have had it at any time. He had had hints and warnings in addition to those that we have mentioned, warnings that should not be magnified unduly, but still that taken with the auditor's report of 1903, the unexplained shortages, the suggestion of the teller, Cutting, in 1905,[a] and the final seeming rapid decline in deposits, would have induced scrutiny but for an invincible repose upon the status quo. In 1908 one Fillmore learned that a package containing $150 left with the bank for safe keeping was not to be found, told Dresser of the loss, wrote to him that he could but conclude that the package had been destroyed or removed by

[a] Cutting was a teller who was asked to resign by Dresser because of shortages in Cutting's account. Before resigning, Cutting "told Dresser that someone had taken the money and that if he might be allowed to stay he would set a trap and catch the man, but Dresser did not care to do that and thought that there was nothing wrong." *Id.* at 527.

someone connected with the bank, and in later conversation said that it was evident that there was a thief in the bank. He added that he would advise the president to look after Coleman, that he believed he was living at a pretty fast pace, and that he had pretty good authority for thinking that he was supporting a woman. In the same year or the year before, Coleman, whose pay was never more than twelve dollars a week, set up an automobile, as was known to Dresser and commented on unfavorably, to him. There was also some evidence of notice to Dresser that Coleman was dealing in copper stocks. In 1909 came the great and inadequately explained seeming shrinkage in the deposits. No doubt plausible explanations of his conduct came from Coleman and the notice as to speculations may have been slight, but taking the whole story of the relations of the parties, we are not ready to say that the two courts below erred in finding that Dresser had been put upon his guard. However little the warnings may have pointed to the specific facts, had they been accepted they would have led to an examination of the depositors' ledger, a discovery of past and a prevention of future thefts.

Id. at 530–31.

7. By analogy to basic negligence law, it is generally accepted that the plaintiff must prove causation to be awarded damages in a duty of care case. *See* MBCA § 8.31(b)(1); ALI PRINCIPLES § 4.01(d). In *Francis*, why did the court conclude that Mrs. Pritchard's breach was a cause of her sons' misappropriations? Was *Francis* correctly decided on this issue? Consider the following excerpt from the well-known decision in Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924), in which Judge Learned Hand held that the failure of a director, Andrews, to engage in adequate oversight did not cause a corporation's economic failure:

The plaintiff must, however, go further than to show that he [Andrews] should have been more active in his duties. This cause of action rests upon a tort, as much though it be a tort of omission as though it had rested upon a positive act. The plaintiff must accept the burden of showing that the performance of the defendant's duties would have avoided loss, and what loss it would have avoided. . . .

When the corporate funds have been illegally lent, it is a fair inference that a protest would have stopped the loan, and that the director's neglect caused the loss. But when a business fails from general mismanagement, business incapacity, or bad judgment, how is it possible to say that a single director could have made the company successful, or how much in dollars he could have saved? Before this cause can go to a master, the plaintiff must show that, had Andrews done his full duty, he could have made the company prosper, or at least could have broken its fall. He must show what sum he could have saved the company. Neither of these has he made any effort to do.

The defendant is not subject to the burden of proving that the loss would have happened, whether he had done his duty or not. If he were, it would come to this: That, if a director were once shown slack in his duties, he would stand charged prima facie with the difference between the corporate treasury as it was, and as it would be, judged by a hypothetical standard of success. How could such a standard be determined? How could any one guess how far a director's skill and judgment would have prevailed upon his fellows, and what would have been the ultimate fate of the business, if they had? How is it possible to set any measure of liability, or to tell what he would have contributed to the event? Men's fortunes may not be subjected to such uncertain and speculative conjectures. It is hard to see how there can be any remedy, except one can put one's finger on a definite loss and say with reasonable assurance that protest would have deterred, or counsel persuaded, the managers who caused it. No men of sense would take the office, if the law imposed upon them a guaranty of the general success of their companies as a penalty for any negligence.

Id. at 616–17.

8. Delaware's view on the importance of proof of causation has changed somewhat over time. In Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993), the Delaware Supreme Court suggested that a plaintiff might recover rescissory damages (*i.e.,* what would the plaintiff's shares have been worth if the challenged transaction had not occurred) even if causation did not exist. *See id.* at 371. *Cede* is questionable as a conceptual matter because it is hard to understand why the plaintiff is entitled to damages if causation is absent. For example, if a board has engaged in a grossly negligent decision-making process but the price terms of a particular transaction are fair, how has the plaintiff been harmed? Moreover, a rescissory damages award may be difficult to calculate, as the buyer in the transaction usually alters the operation of the corporation after purchasing it (*e.g.*, by combining business operations). It is, therefore, often highly speculative to determine what the corporation would have been worth had the transaction not occurred. In any event, the Delaware Supreme Court has now taken the view that rescissory damages are potentially available only in duty of loyalty cases and are not available in duty of care cases. *See In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27, 66 n.109 (Del. 2006).

9. In larger corporations, which are usually publicly held, the directors' duty of oversight may be more complicated than in a smaller company like Pritchard & Baird. The sheer number of employees makes it more difficult for directors to perform the oversight function. A leading Delaware case, *In re* Caremark International, Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996), concluded that directors of a large corporation may not shirk their oversight duties merely because they are difficult. The directors have a duty to maintain adequate systems of internal controls and compliance: "a director's obligation [to be reasonably informed concerning the corporation] includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists. . . ." *Id.* at 970. However, the court noted that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." *Id.* at 971. Although employees of Caremark participated in various forms of illegal conduct, resulting in Caremark having to pay approximately $250 million to various public and private parties, the directors ultimately prevailed because the court found that "the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts." *Id. Caremark* has been adopted by the Delaware Supreme Court. *See* Stone v. Ritter, 911 A.2d 362, 365 (Del. 2006).

10. Keep in mind that officers owe fiduciary duties as well. "Although most precedents and statutory provisions deal solely with directors, it is relatively well settled, through judicial precedents and statutory provisions in at least 18 states, that officers will be held to the same duty of care standards as directors." ALI PRINCIPLES § 4.01 cmt. a.

b. The Decision–Making Context

In the decision-making context, directors and officers consider whether to authorize a particular transaction or activity. Suppose that a decision turns out poorly (*e.g.*, the corporation loses a considerable amount of money). The directors and officers who made the decision may be sued for breach of the duty of care based on the substance of the decision or the process that led to the decision. The following materials consider challenges to the decision making of directors and officers in both contexts.

Notes & Questions

1. Do you think that refusing to play night games was a bad decision for the corporation in *Shlensky*? Did the court care whether it was a bad decision? What did the court care about? Consider the following:

> While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading. Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation. Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labelled the business judgment rule....
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> . . . .
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> Whatever its merit, however, the business judgment rule extends only as far as the reasons which justify its existence. Thus, it does not apply in cases, *e.g.,* in which the corporate decision lacks a business purpose, is tainted by a conflict of interest, is so egregious as to amount to a no-win decision, or results from an obvious and prolonged failure to exercise oversight or supervision. Other examples may occur....

Joy v. North, 692 F.2d 880, 885–86 (2d Cir. 1982).

2. What is the business judgment rule? Articulations vary, but the rule is usually understood to be an especially deferential standard of review that applies to director and officer decisions if three prerequisites are met. If a director or officer decision is made (1) in good faith, (2) with a reasonable decision-making process, and (3) with no conflict of interest, then a court will uphold the decision so long as the decision can be attributed to a rational business purpose. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) ("The business judgment rule has been well formulated by ... other cases. Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available."). Although it functions as a rule of substantive law, the business judgment rule is often phrased as a rebuttable presumption—*i.e.*, a director or officer decision is presumptively valid unless a plaintiff can rebut one or more of the rule's prerequisites or can establish irrationality.

3. Does the business judgment rule apply in the oversight context—*i.e.*, does it apply to "failure to monitor" claims? The question was addressed by the Delaware Supreme Court in Aronson v. Lewis, 473 A.2d 805 (Del. 1984):

> ... [I]t should be noted that the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. But it also

> follows that under applicable principles, a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.

Id. at 813.

4. Is § 8.31 of the MBCA consistent with the business judgment rule?

5. If the prerequisites of the business judgment rule are met, what occurs? If the prerequisites of the business judgment rule are not met, what occurs? Consider the following:

> .... Our law presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." [Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)]. Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.

In re The Walt Disney Co. Derivative Litig., No. 411, 2005, 2006 WL 1562466, at *15 (Del. June 8, 2006). The "entire fairness" standard is a judicial inquiry into whether a transaction involved fair dealing and a fair price.

6. What is "good faith?" In the recent opinion of *In re* The Walt Disney Co. Derivative Litigation, No. Civ. A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005), Chancellor Chandler engaged in an extensive discussion of this question:

> .... Good faith has been said to require an "honesty of purpose," and a genuine care for the fiduciary's constituents, but, at least in the corporate fiduciary context, it is probably easier to define bad faith rather than good faith.... Bad faith has been defined as authorizing a transaction "for some purpose *other than* a genuine attempt to advance corporate welfare or [when the transaction] is *known to constitute* a violation of applicable positive law." [Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996)].... A similar definition was used seven years earlier, when Chancellor Allen wrote that bad faith (or lack of good faith) is when a director acts in a manner "unrelated to a pursuit of the corporation's best interests." [*In re* RJR Nabisco, Inc. S'holders Litig., Civ. A. No. 10389, 1989 WL 7036, at *15 (Del. Ch. Jan. 31, 1989)]. It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation.
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> . . . .
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> To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation.... To create a definitive and categorical definition of the universe of acts that would constitute bad faith would be difficult, if not impossible.... A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard

> for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

Id. at *35–36; *see also In re* The Walt Disney Co. Derivative Litig., No. 411, 2005, 2006 WL 1562466, at *25–27 (Del. June 8, 2006) (observing that "fiduciary conduct motivated by an actual intent to do harm" is "classic, quintessential bad faith"; concluding that "lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent" cannot, without more, constitute bad faith; and indicating that the notion of "intentional dereliction of duty, a conscious disregard for one's responsibilities" is "a legally appropriate, although not the exclusive, definition of fiduciary bad faith").

Some authorities suggest that good faith may have no independent meaning in a particular dispute—*i.e.*, good faith is often redundant with other aspects of the business judgment rule analysis. For example, the absence of a rational business purpose has been associated with bad faith. *See, e.g., In re* RJR Nabisco, Inc. S'holders Litig., 1989 WL 7036, at *13 n.13 (Del. Ch. Jan. 31, 1989) ("As I conceptualize the matter, such limited substantive review as the rule contemplates (*i.e.,* is the judgment under review "egregious" or "irrational" or "so beyond reason," etc.) really is a way of inferring bad faith."). Similarly, although § 8.31(a)(2)(i) of the MBCA requires directors to act in good faith, the Official Comment to the section states that "[i]f a director's conduct can be successfully challenged pursuant to other clauses of subsection (a)(2) [clauses that implicate a director's decision-making process, conflicts of interest, and business purpose], there is a substantial likelihood that the conduct in question will also present an issue of good faith." The Official Comment further states that "[i]f subsection (a)(2) included only clause 2(i) [the clause specifying that director actions must be in good faith], much of the conduct with which the other clauses are concerned could still be considered pursuant to the subsection, on the basis that such conduct evidenced the actor's lack of good faith." Finally, the Official Comment explicitly points out the "broad overlap of the good faith element with the various other subsection (a)(2) clauses."

7. What is a "rational" business purpose? Consider the following:

> .... This rationality standard of review is much easier to satisfy than a prudence or reasonability standard. To see how exceptional a rationality standard is, we need only think about the judgments we make in everyday life. It is common to characterize a person's conduct as imprudent or unreasonable, but it is very uncommon to characterize a person's conduct as irrational. Unlike a subjective-good-faith standard, a rationality standard preserves a minimum and necessary degree of director and officer accountability. Further, a rationality standard allows courts to enjoin directors and officers from taking actions that would waste the corporation's assets.
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> An obvious example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained. For example, in *Selheimer v. Manganese Corp. of America*, [224 A.2d 634 (Pa. 1966)], managers poured a corporation's funds into the development of a single plant even though they knew the plant could not be operated profitably because of various factors, including lack of a railroad siding and proper storage areas. The court imposed liability, because the managers' conduct "defie[d] explanation; in fact, the defendants have failed to give any satisfactory explanation or advance any justification for [the] expenditures." [*Id.* at 646].

Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law,* 62 FORDHAM L. REV. 437, 442–43 (1993). Keep in mind that directors and officers do not necessarily have to prove rationality; instead, courts have stated that a decision must simply be "attributed" to a rational business purpose. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose."). A court can presumably attribute a decision to a rational business purpose on its own without the defendants having to adduce any proof. *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 100 (2004) ("[T]he reference to a rational business purpose requires only the possibility that the decision was actuated by a legitimate business reason, not that directors must prove the existence of such a reason.").

Note on Illegal Conduct and the Business Judgment Rule

Directors and officers have a duty to obey the law. Indeed, the business judgment rule does not protect decisions to engage in knowingly illegal conduct, even if the conduct is in furtherance of the corporation's interests. Some courts, such as *Shlensky*, explicitly refer to illegality as a ground that permits judicial interference into a director's or officer's decision. As mentioned, other courts characterize illegal conduct as "bad faith" action that does not receive business judgment rule protection. The Comment to § 2.01 of the ALI Principles of Corporate Governance provides some insight into this limitation:

> .... It is sometimes maintained that whether a corporation should adhere to a given legal rule may properly depend on a kind of cost-benefit analysis, in which probable corporate gains are weighed against either probable social costs, measured by the dollar liability imposed for engaging in such conduct, or probable corporate losses, measured by potential dollar liability discounted for likelihood of detection.... With few exceptions, dollar liability is not a 'price' that can properly be paid for the privilege of engaging in legally wrongful conduct. Cost-benefit analysis may have a place in the state's determination whether a given type of conduct should be deemed legally wrongful. Once that determination has been made, however, the resulting legal rule normally represents a community decision that the conduct is wrongful as such, so that cost-benefit analysis whether to obey the rule is out of place.

The duty to avoid knowingly illegal conduct is technically distinct from the fiduciary duties of care and loyalty. After all, directors and officers may decide after careful study (*i.e.*, duty of care satisfied) that violating the law is in the best interests of the corporation (*i.e.*, duty of loyalty satisfied). Even in such circumstances, however, engaging in knowingly illegal conduct is prohibited. The decision of Miller v. American Telephone & Telegraph Co., 507 F.2d 759 (3d. Cir. 1974), is illustrative. In *Miller*, shareholders alleged in a derivative suit that AT&T violated federal election law by failing to collect a $1.5 million debt incurred by the Democratic National Committee as part of the 1968 presidential election. *See id.* at 761. The directors of AT&T presumably believed that the potential for political influence outweighed the cost of forgiving the $1.5 million debt. Assuming that the directors were reasonably informed in deciding to forego collection, there was no basis for a duty of care claim. Similarly, assuming that the directors believed that foregoing collection was in the best interests of AT&T, a duty of loyalty claim was inapposite.

Relying on the business judgment rule, the district court dismissed the complaint for failure to state a claim. The Third Circuit reversed, holding that if the plaintiffs could prove that the directors violated federal election law (by effectively making a "contribution" to the Democratic National Convention), they had stated a viable cause of action that was not defeated by the business judgment rule. *See id.* at 761–62.

In the illegality setting, the question of damages poses a difficult issue. Even if AT&T's debt forgiveness was a violation of federal election law, for example, the corporation may not have suffered a net loss, as the benefit of political influence may have exceeded the cost of the debt forgiveness. Indeed, in *Miller*, the court noted that a cause of action could be stated only if "the breach caused independent damage to the corporation." *Id.* at 763 n.5. Nevertheless, the *Miller* court accepted the allegation that the corporation had suffered "actual damage ... from the transaction in the form of the loss of a $1.5 million increment to AT&T's treasury" as sufficient to state a claim and survive a motion to dismiss. *Id.* at 763. To defeat the claim for damages, the *Miller* court would presumably require AT&T to establish that its illegal actions produced a tangible benefit to the corporation—a benefit that exceeded $1.5 million. It is not hard to imagine courts foregoing this cost-benefit analysis completely, however, and holding directors and officers liable regardless of whether the corporation suffers a net loss. After all, the primary justification for allowing suits like *Miller* is to deter illegal conduct, not to compensate the corporation for damages.

It is important to note that directors and officers who knowingly authorize illegal conduct on behalf of a corporation are personally responsible for the violations. *See, e.g.*, MODEL PENAL CODE § 2.07(6)(a) ("A person is legally accountable for any conduct he performs or causes to be performed in the name of the corporation or an unincorporated association or in its behalf to the same extent as if it were performed in his own name or behalf."). The corporation itself may also face legal sanctions. *See id.* § 2.07(1) (stating the circumstances under which a corporation may be convicted of the commission of an offense).

The Justifications for the Business Judgment Rule

JOY v. NORTH

United States Court of Appeals, Second Circuit

692 F.2d 880, 885–86 (1982)

Although the [business judgment] rule has suffered under academic criticism, it is not without rational basis.

First, shareholders to a very real degree voluntarily undertake the risk of bad business judgment. Investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers. Nor need investors buy stock in particular corporations. In the exercise of what is genuinely a free choice, the quality of a firm's management is often decisive and information is available from professional advisors. Since shareholders can and do select among investments partly on the basis of management, the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.

Second, courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

Third, because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. Given mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.

MELVIN A. EISENBERG, THE DIRECTOR'S DUTY OF CARE IN NEGOTIATED DISPOSITIONS

51 U. Miami L. Rev. 579, 585–89 (1997)

To begin with, the application of a reasonableness standard of review to the quality of disinterested decisions by directors could result in the unfair imposition of liability. In paradigm negligence cases involving relatively simple decisions, such as automobile accidents, there is often little difference between decisions that turn out badly and bad decisions. In such cases, typically only one reasonable decision could have been made under a given set of circumstances, and decisions that turn out badly therefore almost inevitably turn out to have been bad decisions.

In contrast, in the case of business decisions it may often be difficult for fact-finders to distinguish between bad decisions and proper decisions that turn out badly. Business judgments are necessarily made on the basis of incomplete information and in the face of obvious risks, so that typically a range of decisions is reasonable. A decisionmaker faced with uncertainty must make a judgment concerning the relevant probability distribution and must act on that judgment. If the decisionmaker makes a reasonable assessment of the probability distribution, and the outcome falls on the unlucky tail, the decisionmaker has not made a bad decision, because in any normal probability distribution some outcomes will inevitably fall on the unlucky tail.

For example, a board faced with a promising but expensive and untried new technology may have to choose between investing in the technology or forgoing such an investment. Each alternative involves certain negative risks. If the board chooses one alternative and the associated negative risk materializes, the decision is "wrong" in the very restricted sense that if the board had it to do all over again it would make a different decision, but the decision is not for that reason a bad decision.

As a result of a systematic defect in cognition known as the hindsight bias, however, under a reasonableness standard of review fact-finders might too often erroneously treat

decisions that turned out badly as bad decisions, and unfairly hold directors liable for such decisions. Experimental psychology has shown that in hindsight people consistently exaggerate the ease with which outcomes could have been anticipated in foresight. People view what has happened as relatively inevitable. (As one historian put this tendency—"Dear Diary, The Hundred Years' War started today.") Accordingly, people who know that a bad outcome resulted from a decision overestimate the extent to which the outcome was predictable and, therefore, the extent to which the decisionmaker was at fault for making a bad decision. Essentially, people find it difficult or even impossible to disregard information they possess about an outcome. That information, in turn, renders the circumstances that pointed to the outcome more salient in their minds, because those circumstances can be integrated into a cohesive story that ends with the actual outcome, while circumstances pointing in other directions cannot:

> Typically, judges are called upon to predict the future and to "make sense" out of the past. Attempting to understand why a particular outcome occurred seems, among other things, to increase the salience of data and reasons which can be integrated into coherent explanatory patterns. Unintegratable data tend to be forgotten, deemphasized, or reinterpreted to fit the dominant explanation.

[Baruch Fischhoff & Ruth Beyth, *"I Knew It Would Happen"—Remembered Probabilities of Once-Future Things*, 13 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 1 (1975)].

The hindsight bias is nicely illustrated by an experiment in which 112 anesthesiologists reviewed the anesthesiological care in 21 paired cases that were based on actual files. Each of the anesthesiologists was presented with only one case from each pair. The patient and the treatments in each of the two paired cases were identical, and the results in all cases were as adverse. However, the files were edited so that in one case in each pair the adverse outcome was described as temporary, while in the other case the outcome was described as permanent. The reviewers were instructed to determine, in each of the 21 cases they reviewed, whether the anesthesiological care was less than appropriate, appropriate, or impossible to judge. When the adverse outcome was described as permanent rather than temporary, the overall distributions of the reviewers' judgments concerning the appropriateness of the care was shifted by 30 percent. Comparable results have been obtained in other experiments, even when the subjects have been explicitly instructed to disregard outcomes in evaluating fault. The hindsight bias is also well-supported by survey evidence concerning the attribution of responsibility, and by casual empiricism.

The business judgment rule protects directors from the unfair imposition of liability as a result of the hindsight bias, by providing them with a large zone of protection when their decisions are attacked. The need for this zone of protection is highlighted by comparing business decisionmakers with other kinds of actors who must make decisions on the basis of incomplete information and in the face of obvious risks. Many such actors—for example, doctors—can often shield themselves from liability for bad outcomes by showing that they arrived at their decisions by following accepted protocols or practices.[26] In contrast, directors can seldom shield themselves in that way, because almost every business decision is unique. In this respect, perhaps the closest analogy to business decisionmakers would be executive officers of governments, who also cannot arrive at their

26 See, e.g., Osborn v. Irwin Memorial Blood Bank, 5 Cal. App. 4th 234, 278 n.13 (Ct. App. 1992) (recognizing that medical practitioners have this defense available because "compliance with accepted practice is generally taken as conclusive evidence of due care.") (quoting Allan H. McCoid, The Care Required of Medical Practitioners, 12 Vand. L. Rev. 549, 560 (1959)).

decisions by applying established protocols and practices, and are also shielded from liability by a qualified immunity. It is also relevant that negligent decisions by directors, unlike most types of negligent decisions, characteristically do not result in either personal injury or economic damages that are catastrophic to an individual. The law may justifiably be less willing to take the risk of erroneously imposing liability in cases where the injury is typically not traumatic to individuals than in cases where it is.

. . . .

Moreover, at least in the case of non-management directors, liability for the losses caused by an unreasonable business decision would often be far out of proportion to the incentives for accepting a directorship. Outside directors of publicly held corporations typically earn approximately $30,000-$40,000 annually in directors' fees. In contrast, liability for an imprudent decision can be in the millions. Therefore, in the absence of some brake on such liability, it might become more difficult to attract qualified candidates as non-management directors, which also would be contrary to the shareholders' own best interests.

DOUGLAS K. MOLL, SHAREHOLDER OPPRESSION AND DIVIDEND POLICY IN THE CLOSE CORPORATION

60 Wash. & Lee L. Rev. 841, 864–66 (2003)

In ... disputes in public corporations, business judgment rule deference is arguably appropriate. A well-functioning market can discipline [managers] for [their] "poor" ... decisions because dissatisfied minority investors can sell. Significant selling will decrease the company's stock price and, at some level, will expose company management to the dangers of displacement through proxy fights or takeovers. Because senior managers generally value their positions, this threat of displacement will curb ... decisions that fail to maximize shareholder value. When a well-functioning market exists, therefore, it provides an effective restraint on [management's] ... decisions and there is a correspondingly diminished need for additional judicial review.

In close corporations, however, the constraints provided by the market are absent. Without meaningful judicial review, there is insufficient oversight of [management's] ... decisions. In the close corporation context, therefore, the judicial deference embodied in the business judgment rule makes less sense....

Notes & Questions

1. Are courts competent to evaluate business decisions, particularly when judges and juries have little to no business experience? Consider the following:

> .... The standard justifications [for the business judgment rule] are that judges lack competence in making business decisions and that the fear of personal liability will cause corporate managers to be more cautious and also result in fewer talented people being willing to serve as directors. These are helpful but not sufficient. They do not explain why the same judges who decide whether engineers have designed the compressors on jet engines properly, whether the farmer delivered pomegranates conforming to the industry's specifications, and whether the prison system adversely affects the mental state of prisoners cannot decide whether a manager negligently failed to sack a subordinate who made improvident loans.

FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 94 (1991).

2. Why do courts apply the business judgment rule? Are the rationales persuasive? What are the dangers of such a deferential rule?

SMITH V. VAN GORKOM

Supreme Court of Delaware

488 A.2d 858 (1985)

HORSEY, JUSTICE (for the majority):

This appeal from the Court of Chancery involves a class action brought by shareholders of the defendant Trans Union Corporation ("Trans Union" or "the Company"), originally seeking rescission of a cash-out merger of Trans Union into the defendant New T Company ("New T"), a wholly-owned subsidiary of the defendant, Marmon Group, Inc. ("Marmon"). Alternate relief in the form of damages is sought against the defendant members of the Board of Directors of Trans Union, New T, and Jay A. Pritzker and Robert A. Pritzker, owners of Marmon.

Following trial, the former Chancellor granted judgment for the defendant directors by unreported letter opinion dated July 6, 1982.[2] Judgment was based on two findings: (1) that the Board of Directors had acted in an informed manner so as to be entitled to protection of the business judgment rule in approving the cash-out merger; and (2) that the shareholder vote approving the merger should not be set aside because the stockholders had been "fairly informed" by the Board of Directors before voting thereon. The plaintiffs appeal.

Speaking for the majority of the Court, we conclude that both rulings of the Court of Chancery are clearly erroneous. Therefore, we reverse and direct that judgment be entered in favor of the plaintiffs and against the defendant directors for the fair value of the plaintiffs' stockholdings in Trans Union, in accordance with *Weinberger v. UOP, Inc.,* Del.Supr., 457 A.2d 701 (1983).[3]

. . . .

I.

The nature of this case requires a detailed factual statement. The following facts are essentially uncontradicted:

-A-

Trans Union was a publicly-traded, diversified holding company, the principal earnings of which were generated by its railcar leasing business. During the period here involved, the Company had a cash flow of hundreds of millions of dollars annually. However, the Company had difficulty in generating sufficient taxable income to offset increasingly large investment tax credits (ITCs). . . .

. . . .

-B-

On August 27, 1980, Van Gorkom met with Senior Management of Trans Union. Van Gorkom reported on . . . his desire to find a solution to the tax credit problem more permanent than a continued program of acquisitions. [Beginning in the late 1960s, and continuing through the 1970s, Trans Union pursued a program of acquiring small companies in order to increase available taxable income]. Various alternatives were suggested and discussed preliminarily, including the sale of Trans Union to a company with a large amount of taxable income.

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[2] Following trial, and before decision by the Trial Court, the parties stipulated to the dismissal, with prejudice, of the Messrs. Pritzker as parties defendant. However, all references to defendants hereinafter are to the defendant directors of Trans Union, unless otherwise noted.

[3] It has been stipulated that plaintiffs sue on behalf of a class consisting of 10,537 shareholders (out of a total of 12,844) and that the class owned 12,734,404 out of 13,357,758 shares of Trans Union outstanding.

Donald Romans, Chief Financial Officer of Trans Union, stated that his department had done a "very brief bit of work on the possibility of a leveraged buy-out." This work had been prompted by a media article which Romans had seen regarding a leveraged buy-out by management. The work consisted of a "preliminary study" of the cash which could be generated by the Company if it participated in a leveraged buy-out. As Romans stated, this analysis "was very first and rough cut at seeing whether a cash flow would support what might be considered a high price for this type of transaction."

On September 5, at another Senior Management meeting which Van Gorkom attended, Romans again brought up the idea of a leveraged buy-out as a "possible strategic alternative" to the Company's acquisition program. Romans and Bruce S. Chelberg, President and Chief Operating Officer of Trans Union, had been working on the matter in preparation for the meeting. According to Romans: They did not "come up" with a price for the Company. They merely "ran the numbers" at $50 a share and at $60 a share with the "rough form" of their cash figures at the time. Their "figures indicated that $50 would be very easy to do but $60 would be very difficult to do under those figures." This work did not purport to establish a fair price for either the Company or 100% of the stock. It was intended to determine the cash flow needed to service the debt that would "probably" be incurred in a leveraged buy-out, based on "rough calculations" without "any benefit of experts to identify what the limits were to that, and so forth." These computations were not considered extensive and no conclusion was reached.

At this meeting, Van Gorkom stated that he would be willing to take $55 per share for his own 75,000 shares. He vetoed the suggestion of a leveraged buy-out by Management, however, as involving a potential conflict of interest for Management. Van Gorkom, a certified public accountant and lawyer, had been an officer of Trans Union for 24 years, its Chief Executive Officer for more than 17 years, and Chairman of its Board for 2 years. It is noteworthy in this connection that he was then approaching 65 years of age and mandatory retirement.

For several days following the September 5 meeting, Van Gorkom pondered the idea of a sale. He had participated in many acquisitions as a manager and director of Trans Union and as a director of other companies. He was familiar with acquisition procedures, valuation methods, and negotiations; and he privately considered the pros and cons of whether Trans Union should seek a privately or publicly-held purchaser.

Van Gorkom decided to meet with Jay A. Pritzker, a well-known corporate takeover specialist and a social acquaintance. However, rather than approaching Pritzker simply to determine his interest in acquiring Trans Union, Van Gorkom assembled a proposed per share price for sale of the Company and a financing structure by which to accomplish the sale. Van Gorkom did so without consulting either his Board or any members of Senior Management except one: Carl Peterson, Trans Union's Controller. Telling Peterson that he wanted no other person on his staff to know what he was doing, but without telling him why, Van Gorkom directed Peterson to calculate the feasibility of a leveraged buy-out at an assumed price per share of $55. Apart from the Company's historic stock market price,[2] and Van Gorkom's long association with Trans Union, the record is devoid of any competent evidence that $55 represented the per share intrinsic value of the Company.

. . . .

Van Gorkom arranged a meeting with Pritzker at the latter's home on Saturday, September 13, 1980. Van Gorkom prefaced his presentation by stating to Pritzker: "Now

[2] The common stock of Trans Union was traded on the New York Stock Exchange. Over the five year period from 1975 through 1979, Trans Union's stock had traded within a range of a high of $39 ½ and a low of $24 1/4. Its high and low range for 1980 through September 19 (the last trading day before announcement of the merger) was $38 1/4–$29 1/2.

as far as you are concerned, I can, I think, show how you can pay a substantial premium over the present stock price and pay off most of the loan in the first five years. * * * If you could pay $55 for this Company, here is a way in which I think it can be financed."

Van Gorkom then reviewed with Pritzker his calculations based upon his proposed price of $55 per share. Although Pritzker mentioned $50 as a more attractive figure, no other price was mentioned. However, Van Gorkom stated that to be sure that $55 was the best price obtainable, Trans Union should be free to accept any better offer. Pritzker demurred, stating that his organization would serve as a "stalking horse" for an "auction contest" only if Trans Union would permit Pritzker to buy 1,750,000 shares of Trans Union stock at market price which Pritzker could then sell to any higher bidder. After further discussion on this point, Pritzker told Van Gorkom that he would give him a more definite reaction soon.

On Monday, September 15, Pritzker advised Van Gorkom that he was interested in the $55 cash-out merger proposal and requested more information on Trans Union. Van Gorkom agreed to meet privately with Pritzker, accompanied by Peterson, Chelberg, and Michael Carpenter, Trans Union's consultant from the Boston Consulting Group. The meetings took place on September 16 and 17. Van Gorkom was "astounded that events were moving with such amazing rapidity."

On Thursday, September 18, Van Gorkom met again with Pritzker. At that time, Van Gorkom knew that Pritzker intended to make a cash-out merger offer at Van Gorkom's proposed $55 per share. Pritzker instructed his attorney, a merger and acquisition specialist, to begin drafting merger documents. There was no further discussion of the $55 price. However, the number of shares of Trans Union's treasury stock to be offered to Pritzker was negotiated down to one million shares; the price was set at $38–75 cents above the per share price at the close of the market on September 19. At this point, Pritzker insisted that the Trans Union Board act on his merger proposal within the next three days, stating to Van Gorkom: "We have to have a decision by no later than Sunday [evening, September 21] before the opening of the English stock exchange on Monday morning." Pritzker's lawyer was then instructed to draft the merger documents, to be reviewed by Van Gorkom's lawyer, "sometimes with discussion and sometimes not, in the haste to get it finished."

. . . .

On Friday, September 19, Van Gorkom called a special meeting of the Trans Union Board for noon the following day. He also called a meeting of the Company's Senior Management to convene at 11:00 a.m., prior to the meeting of the Board. No one, except Chelberg and Peterson, was told the purpose of the meetings. Van Gorkom did not invite Trans Union's investment banker, Salomon Brothers or its Chicago-based partner, to attend.

Of those present at the Senior Management meeting on September 20, only Chelberg and Peterson had prior knowledge of Pritzker's offer. Van Gorkom disclosed the offer and described its terms, but he furnished no copies of the proposed Merger Agreement. Romans announced that his department had done a second study which showed that, for a leveraged buy-out, the price range for Trans Union stock was between $55 and $65 per share. Van Gorkom neither saw the study nor asked Romans to make it available for the Board meeting.

Senior Management's reaction to the Pritzker proposal was completely negative. No member of Management, except Chelberg and Peterson, supported the proposal. Romans

objected to the price as being too low;[3] he was critical of the timing and suggested that consideration should be given to the adverse tax consequences of an all-cash deal for low-basis shareholders; and he took the position that the agreement to sell Pritzker one million newly-issued shares at market price would inhibit other offers, as would the prohibitions against soliciting bids and furnishing inside information to other bidders. Romans argued that the Pritzker proposal was a "lock up" and amounted to "an agreed merger as opposed to an offer." Nevertheless, Van Gorkom proceeded to the Board meeting as scheduled without further delay.

Ten directors served on the Trans Union Board, five inside (defendants Bonser, O'Boyle, Browder, Chelberg, and Van Gorkom) and five outside (defendants Wallis, Johnson, Lanterman, Morgan and Reneker). All directors were present at the meeting, except O'Boyle who was ill. Of the outside directors, four were corporate chief executive officers and one was the former Dean of the University of Chicago Business School. None was an investment banker or trained financial analyst. All members of the Board were well informed about the Company and its operations as a going concern. They were familiar with the current financial condition of the Company, as well as operating and earnings projections. . . . The Board generally received regular and detailed reports and was kept abreast of the accumulated investment tax credit and accelerated depreciation problem.

Van Gorkom began the Special Meeting of the Board with a twenty-minute oral presentation. Copies of the proposed Merger Agreement were delivered too late for study before or during the meeting.[4] He reviewed the Company's ITC and depreciation problems and the efforts theretofore made to solve them. He discussed his initial meeting with Pritzker and his motivation in arranging that meeting. Van Gorkom did not disclose to the Board, however, the methodology by which he alone had arrived at the $55 figure, or the fact that he first proposed the $55 price in his negotiations with Pritzker.

Van Gorkom outlined the terms of the Pritzker offer as follows: Pritzker would pay $55 in cash for all outstanding shares of Trans Union stock upon completion of which Trans Union would be merged into New T Company, a subsidiary wholly-owned by Pritzker and formed to implement the merger; for a period of 90 days, Trans Union could receive, but could not actively solicit, competing offers; the offer had to be acted on by the next evening, Sunday, September 21; Trans Union could only furnish to competing bidders published information, and not proprietary information; the offer was subject to Pritzker obtaining the necessary financing by October 10, 1980; if the financing contingency were met or waived by Pritzker, Trans Union was required to sell to Pritzker one million newly-issued shares of Trans Union at $38 per share.

Van Gorkom took the position that putting Trans Union "up for auction" through a 90–day market test would validate a decision by the Board that $55 was a fair price. He told the Board that the "free market will have an opportunity to judge whether $55 is a fair price." Van Gorkom framed the decision before the Board not as whether $55 per share was the highest price that could be obtained, but as whether the $55 price was a fair price that the stockholders should be given the opportunity to accept or reject.[5]

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[3] Van Gorkom asked Romans to express his opinion as to the $55 price. Romans stated that he "thought the price was too low in relation to what he could derive for the company in a cash sale, particularly one which enabled us to realize the values of certain subsidiaries and independent entities."

[4] The record is not clear as to the terms of the Merger Agreement. The Agreement, as originally presented to the Board on September 20, was never produced by defendants despite demands by the plaintiffs. Nor is it clear that the directors were given an opportunity to study the Merger Agreement before voting on it. . . .

[5] In Van Gorkom's words: The "real decision" is whether to "let the stockholders decide it" which is "all you are being asked to decide today."

Attorney [James Brennan, retained by Van Gorkom to advise Trans Union on the legal aspects of the merger,] advised the members of the Board that they might be sued if they failed to accept the offer and that a fairness opinion was not required as a matter of law.

Romans attended the meeting as chief financial officer of the Company. He told the Board that he had not been involved in the negotiations with Pritzker and knew nothing about the merger proposal until the morning of the meeting; that his studies did not indicate either a fair price for the stock or a valuation of the Company; that he did not see his role as directly addressing the fairness issue; and that he and his people "were trying to search for ways to justify a price in connection with such a [leveraged buyout] transaction, rather than to say what the shares are worth." Romans testified:

> I told the Board that the study ran the numbers at 50 and 60, and then the subsequent study at 55 and 65, and that was not the same thing as saying that I have a valuation of the company at X dollars. But it was a way—a first step towards reaching that conclusion.

Romans told the Board that, in his opinion, $55 was "in the range of a fair price," but "at the beginning of the range."

Chelberg, Trans Union's President, supported Van Gorkom's presentation and representations. . . .

The Board meeting of September 20 lasted about two hours. Based solely upon Van Gorkom's oral presentation, Chelberg's supporting representations, Romans' oral statement, Brennan's legal advice, and their knowledge of the market history of the Company's stock,[6] the directors approved the proposed Merger Agreement. However, the Board later claimed to have attached two conditions to its acceptance: (1) that Trans Union reserved the right to accept any better offer that was made during the market test period; and (2) that Trans Union could share its proprietary information with any other potential bidders. While the Board now claims to have reserved the right to accept any better offer received after the announcement of the Pritzker agreement (even though the minutes of the meeting do not reflect this), it is undisputed that the Board did not reserve the right to actively solicit alternate offers.

The Merger Agreement was executed by Van Gorkom during the evening of September 20 at a formal social event that he hosted for the opening of the Chicago Lyric Opera. Neither he nor any other director read the agreement prior to its signing and delivery to Pritzker.

. . . .

* * *

On Monday, September 22, the Company issued a press release announcing that Trans Union had entered into a "definitive" Merger Agreement with an affiliate of the Marmon Group, Inc., a Pritzker holding company. Within 10 days of the public announcement, dissent among Senior Management over the merger had become widespread. Faced with threatened resignations of key officers, Van Gorkom met with Pritzker who agreed to several modifications of the Agreement. Pritzker was willing to do

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[6] The Trial Court stated the premium relationship of the $55 price to the market history of the Company's stock as follows:

> * * * the merger price offered to the stockholders of Trans Union represented a premium of 62% over the average of the high and low prices at which Trans Union stock had traded in 1980, a premium of 48% over the last closing price, and a premium of 39% over the highest price at which the stock of Trans Union had traded any time during the prior six years.

so provided that Van Gorkom could persuade the dissidents to remain on the Company payroll for at least six months after consummation of the merger.

Van Gorkom reconvened the Board on October 8 and secured the directors' approval of the proposed amendments—sight unseen. . . .

It was not until . . . October 10 . . . that the actual amendments to the Merger Agreement were prepared by Pritzker and delivered to Van Gorkom for execution. As will be seen, the amendments were considerably at variance with Van Gorkom's representations of the amendments to the Board on October 8; and the amendments placed serious constraints on Trans Union's ability to negotiate a better deal and withdraw from the Pritzker agreement. Nevertheless, Van Gorkom proceeded to execute what became the October 10 amendments to the Merger Agreement without conferring further with the Board members and apparently without comprehending the actual implications of the amendments.

. . . .

On February 10, the stockholders of Trans Union approved the Pritzker merger proposal. Of the outstanding shares, 69.9% were voted in favor of the merger; 7.25% were voted against the merger; and 22.85% were not voted.

II.

We turn to the issue of the application of the business judgment rule to the September 20 meeting of the Board.

The Court of Chancery concluded from the evidence that the Board of Directors' approval of the Pritzker merger proposal fell within the protection of the business judgment rule. . . .

. . . .

Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 *Del.C.* § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors. In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders. The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. The rule itself "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." [*Aronson v. Lewis,* 473 A.2d 805, 812 (Del.Supr. 1984)]. Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.

The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves "prior to making a business decision, of all material information reasonably available to them." *Id.*

. . . . A director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.

Thus, a director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty. Here, there were no allegations of fraud, bad faith, or self-dealing, or proof thereof. Hence, it is presumed that the directors reached their business judgment in good faith, and considerations of motive are irrelevant to the issue before us.

The standard of care applicable to a director's duty of care has also been recently restated by this Court. In *Aronson, supra,* we stated:

> While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence. (footnote omitted)

473 A.2d at 812.

We again confirm that view. We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.

In the specific context of a proposed merger of domestic corporations, a director has a duty . . . along with his fellow directors, to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders. Certainly in the merger context, a director may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement. . . .

It is against those standards that the conduct of the directors of Trans Union must be tested, as a matter of law and as a matter of fact, regarding their exercise of an informed business judgment in voting to approve the Pritzker merger proposal.

III.

. . . .

The issue of whether the directors reached an informed decision to "sell" the Company on September 20, 1980 must be determined only upon the basis of the information then reasonably available to the directors and relevant to their decision to accept the Pritzker merger proposal. This is not to say that the directors were precluded from altering their original plan of action, had they done so in an informed manner. What we do say is that the question of whether the directors reached an informed business judgment in agreeing to sell the Company, pursuant to the terms of the September 20 Agreement presents, in reality, two questions: (A) whether the directors reached an informed business judgment on September 20, 1980; and (B) if they did not, whether the directors' actions taken subsequent to September 20 were adequate to cure any infirmity in their action taken on September 20. We first consider the directors' September 20 action in terms of their reaching an informed business judgment.

-A-

On the record before us, we must conclude that the Board of Directors did not reach an informed business judgment on September 20, 1980 in voting to "sell" the Company for $55 per share pursuant to the Pritzker cash-out merger proposal. Our reasons, in summary, are as follows:

The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the

Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.

As has been noted, the Board based its September 20 decision to approve the cash-out merger primarily on Van Gorkom's representations. None of the directors, other than Van Gorkom and Chelberg, had any prior knowledge that the purpose of the meeting was to propose a cash-out merger of Trans Union. No members of Senior Management were present, other than Chelberg, Romans and Peterson; and the latter two had only learned of the proposed sale an hour earlier. Both general counsel [William] Moore and former general counsel [William] Browder attended the meeting, but were equally uninformed as to the purpose of the meeting and the documents to be acted upon.

Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom's 20–minute oral presentation of the proposal. No written summary of the terms of the merger was presented; the directors were given no documentation to support the adequacy of $55 price per share for sale of the Company; and the Board had before it nothing more than Van Gorkom's statement of his understanding of the substance of an agreement which he admittedly had never read, nor which any member of the Board had ever seen.

Under 8 *Del.C.* § 141(e), "directors are fully protected in relying in good faith on reports made by officers." *Michelson v. Duncan,* Del.Ch., 386 A.2d 1144, 1156 (1978); *aff'd in part and rev'd in part on other grounds,* Del.Supr., 407 A.2d 211 (1979). The term "report" has been liberally construed to include reports of informal personal investigations by corporate officers. However, there is no evidence that any "report," as defined under § 141(e), concerning the Pritzker proposal, was presented to the Board on September 20. Van Gorkom's oral presentation of his understanding of the terms of the proposed Merger Agreement, which he had not seen, and Romans' brief oral statement of his preliminary study regarding the feasibility of a leveraged buy-out of Trans Union do not qualify as § 141(e) "reports" for these reasons: The former lacked substance because Van Gorkom was basically uninformed as to the essential provisions of the very document about which he was talking. Romans' statement was irrelevant to the issues before the Board since it did not purport to be a valuation study. At a minimum for a report to enjoy the status conferred by § 141(e), it must be pertinent to the subject matter upon which a board is called to act, and otherwise be entitled to good faith, not blind, reliance. Considering all of the surrounding circumstances—hastily calling the meeting without prior notice of its subject matter, the proposed sale of the Company without any prior consideration of the issue or necessity therefor, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever—the directors were duty bound to make reasonable inquiry of Van Gorkom and Romans, and if they had done so, the inadequacy of that upon which they now claim to have relied would have been apparent.

The defendants rely on the following factors to sustain the Trial Court's finding that the Board's decision was an informed one: (1) the magnitude of the premium or spread between the $55 Pritzker offering price and Trans Union's current market price of $38 per share; (2) the amendment of the Agreement as submitted on September 20 to permit the Board to accept any better offer during the "market test" period; (3) the collective experience and expertise of the Board's "inside" and "outside" directors; and (4) their reliance on Brennan's legal advice that the directors might be sued if they rejected the Pritzker proposal. We discuss each of these grounds *seriatim:*

(1)

A substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, the fact of a premium alone does not provide an adequate basis upon which to assess the fairness of an offering price. Here, the

judgment reached as to the adequacy of the premium was based on a comparison between the historically depressed Trans Union market price and the amount of the Pritzker offer. Using market price as a basis for concluding that the premium adequately reflected the true value of the Company was a clearly faulty, indeed fallacious, premise, as the defendants' own evidence demonstrates.

The record is clear that before September 20, Van Gorkom and other members of Trans Union's Board knew that the market had consistently undervalued the worth of Trans Union's stock, despite steady increases in the Company's operating income in the seven years preceding the merger. The Board related this occurrence in large part to Trans Union's inability to use its ITCs as previously noted. Van Gorkom testified that he did not believe the market price accurately reflected Trans Union's true worth; and several of the directors testified that, as a general rule, most chief executives think that the market undervalues their companies' stock. Yet, on September 20, Trans Union's Board apparently believed that the market stock price accurately reflected the value of the Company for the purpose of determining the adequacy of the premium for its sale.

. . . .

The parties do not dispute that a publicly-traded stock price is solely a measure of the value of a minority position and, thus, market price represents only the value of a single share. Nevertheless, on September 20, the Board assessed the adequacy of the premium over market, offered by Pritzker, solely by comparing it with Trans Union's current and historical stock price.

Indeed, as of September 20, the Board had no other information on which to base a determination of the intrinsic value of Trans Union as a going concern. As of September 20, the Board had made no evaluation of the Company designed to value the entire enterprise, nor had the Board ever previously considered selling the Company or consenting to a buy-out merger. Thus, the adequacy of a premium is indeterminate unless it is assessed in terms of other competent and sound valuation information that reflects the value of the particular business.

Despite the foregoing facts and circumstances, there was no call by the Board, either on September 20 or thereafter, for any valuation study or documentation of the $55 price per share as a measure of the fair value of the Company in a cash-out context. It is undisputed that the major asset of Trans Union was its cash flow. Yet, at no time did the Board call for a valuation study taking into account that highly significant element of the Company's assets.

We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law. Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management. *See* 8 *Del.C.* § 141(e).

Here, the record establishes that the Board did not request its Chief Financial Officer, Romans, to make any valuation study or review of the proposal to determine the adequacy of $55 per share for sale of the Company. On the record before us: The Board rested on Romans' elicited response that the $55 figure was within a "fair price range" within the context of a leveraged buy-out. No director sought any further information from Romans. No director asked him why he put $55 at the bottom of his range. No director asked Romans for any details as to his study, the reason why it had been undertaken or its depth. No director asked to see the study; and no director asked Romans whether Trans Union's finance department could do a fairness study within the remaining 36–hour period available under the Pritzker offer.

Had the Board, or any member, made an inquiry of Romans, he presumably would have responded as he testified: that his calculations were rough and preliminary; and, that the study was not designed to determine the fair value of the Company, but rather to assess the feasibility of a leveraged buyout financed by the Company's projected cash flow, making certain assumptions as to the purchaser's borrowing needs. Romans would have presumably also informed the Board of his view, and the widespread view of Senior Management, that the timing of the offer was wrong and the offer inadequate.

The record also establishes that the Board accepted without scrutiny Van Gorkom's representation as to the fairness of the $55 price per share for sale of the Company—a subject that the Board had never previously considered. The Board thereby failed to discover that Van Gorkom had suggested the $55 price to Pritzker and, most crucially, that Van Gorkom had arrived at the $55 figure based on calculations designed solely to determine the feasibility of a leveraged buy-out.[19] No questions were raised either as to the tax implications of a cash-out merger or how the price for the one million share option granted Pritzker was calculated.

We do not say that the Board of Directors was not entitled to give some credence to Van Gorkom's representation that $55 was an adequate or fair price. Under § 141(e), the directors were entitled to rely upon their chairman's opinion of value and adequacy, provided that such opinion was reached on a sound basis. Here, the issue is whether the directors informed themselves as to all information that was reasonably available to them. Had they done so, they would have learned of the source and derivation of the $55 price and could not reasonably have relied thereupon in good faith.

None of the directors, Management or outside, were investment bankers or financial analysts. Yet the Board did not consider recessing the meeting until a later hour that day (or requesting an extension of Pritzker's Sunday evening deadline) to give it time to elicit more information as to the sufficiency of the offer, either from inside Management (in particular Romans) or from Trans Union's own investment banker, Salomon Brothers, whose Chicago specialist in merger and acquisitions was known to the Board and familiar with Trans Union's affairs.

Thus, the record compels the conclusion that on September 20 the Board lacked valuation information adequate to reach an informed business judgment as to the fairness of $55 per share for sale of the Company.

(2)

This brings us to the post-September 20 "market test" upon which the defendants ultimately rely to confirm the reasonableness of their September 20 decision to accept the Pritzker proposal. In this connection, the directors present a two-part argument: (a) that by making a "market test" of Pritzker's $55 per share offer a condition of their September 20 decision to accept his offer, they cannot be found to have acted impulsively or in an uninformed manner on September 20; and (b) that the adequacy of the $17 premium for sale of the Company was conclusively established over the following 90 to 120 days by the most reliable evidence available—the marketplace. Thus, the defendants impliedly contend that the "market test" eliminated the need for the Board to perform any other form of fairness test either on September 20, or thereafter.

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[19] As of September 20 the directors did not know: that Van Gorkom had arrived at the $55 figure alone, and subjectively, as the figure to be used by Controller Peterson in creating a feasible structure for a leveraged buy-out by a prospective purchaser; that Van Gorkom had not sought advice, information or assistance from either inside or outside Trans Union directors as to the value of the Company as an entity or the fair price per share for 100% of its stock; that Van Gorkom had not consulted with the Company's investment bankers or other financial analysts; that Van Gorkom had not consulted with or confided in any officer or director of the Company except Chelberg; and that Van Gorkom had deliberately chosen to ignore the advice and opinion of the members of his Senior Management group regarding the adequacy of the $55 price.

Again, the facts of record do not support the defendants' argument. There is no evidence: (a) that the Merger Agreement was effectively amended to give the Board freedom to put Trans Union up for auction sale to the highest bidder; or (b) that a public auction was in fact permitted to occur. . . .

(3)

The directors' unfounded reliance on both the premium and the market test as the basis for accepting the Pritzker proposal undermines the defendants' remaining contention that the Board's collective experience and sophistication was a sufficient basis for finding that it reached its September 20 decision with informed, reasonable deliberation.[21] . . .

(4)

. . . .

Several defendants testified that Brennan advised them that Delaware law did not require a fairness opinion or an outside valuation of the Company before the Board could act on the Pritzker proposal. If given, the advice was correct. However, that did not end the matter. Unless the directors had before them adequate information regarding the intrinsic value of the Company, upon which a proper exercise of business judgment could be made, mere advice of this type is meaningless; and, given this record of the defendants' failures, it constitutes no defense here.

. . . .

A second claim is that counsel advised the Board it would be subject to lawsuits if it rejected the $55 per share offer. It is, of course, a fact of corporate life that today when faced with difficult or sensitive issues, directors often are subject to suit, irrespective of the decisions they make. However, counsel's mere acknowledgement of this circumstance cannot be rationally translated into a justification for a board permitting itself to be stampeded into a patently unadvised act. While suit might result from the rejection of a merger or tender offer, Delaware law makes clear that a board acting within the ambit of the business judgment rule faces no ultimate liability. Thus, we cannot conclude that the mere threat of litigation, acknowledged by counsel, constitutes either legal advice or any valid basis upon which to pursue an uninformed course.

. . . .

-B-

We now examine the Board's post-September 20 conduct for the purpose of determining first, whether it was informed and not grossly negligent; and second, if informed, whether it was sufficient to legally rectify and cure the Board's derelictions of September 20.

(1)

First, as to the Board meeting of October 8. . . .

. . . .

[21] Trans Union's five "inside" directors had backgrounds in law and accounting, 116 years of collective employment by the Company and 68 years of combined experience on its Board. Trans Union's five "outside" directors included four chief executives of major corporations and an economist who was a former dean of a major school of business and chancellor of a university. The "outside" directors had 78 years of combined experience as chief executive officers of major corporations and 50 years of cumulative experience as directors of Trans Union. Thus, defendants argue that the Board was eminently qualified to reach an informed judgment on the proposed "sale" of Trans Union notwithstanding their lack of any advance notice of the proposal, the shortness of their deliberation, and their determination not to consult with their investment banker or to obtain a fairness opinion.

. . . [T]he primary purpose of the October 8 Board meeting was to amend the Merger Agreement, in a manner agreeable to Pritzker, to permit Trans Union to conduct a "market test."[24] Van Gorkom understood that the proposed amendments were intended to give the Company an unfettered "right to openly solicit offers down through January 31." Van Gorkom presumably so represented the amendments to Trans Union's Board members on October 8. In a brief session, the directors approved Van Gorkom's oral presentation of the substance of the proposed amendments, the terms of which were not reduced to writing until October 10. But rather than waiting to review the amendments, the Board again approved them sight unseen and adjourned, giving Van Gorkom authority to execute the papers when he received them.[25]

. . . .

[On] October 10, Pritzker delivered to Trans Union the proposed amendments to the September 20 Merger Agreement. Van Gorkom promptly proceeded to countersign all the instruments on behalf of Trans Union without reviewing the instruments to determine if they were consistent with the authority previously granted him by the Board. The amending documents were apparently not approved by Trans Union's Board until a much later date, December 2. The record does not affirmatively establish that Trans Union's directors ever read the October 10 amendments.[26]

The October 10 amendments to the Merger Agreement did authorize Trans Union to solicit competing offers, but the amendments had more far-reaching effects. The most significant change was in the definition of the third-party "offer" available to Trans Union as a possible basis for withdrawal from its Merger Agreement with Pritzker. Under the October 10 amendments, a better *offer* was no longer sufficient to permit Trans Union's withdrawal. Trans Union was now permitted to terminate the Pritzker Agreement and abandon the merger only if, prior to February 10, 1981, Trans Union had either consummated a merger (or sale of assets) with a third party or had entered into a "definitive" merger agreement more favorable than Pritzker's and for a greater consideration—subject only to stockholder approval. Further, the "extension" of the market test period to February 10, 1981 was circumscribed by other amendments which required Trans Union to file its preliminary proxy statement on the Pritzker merger proposal by December 5, 1980 and use its best efforts to mail the statement to its shareholders by January 5, 1981. Thus, the market test period was effectively reduced, not extended.

. . . .

We conclude that the Board acted in a grossly negligent manner on October 8; and that Van Gorkom's representations on which the Board based its actions do not constitute "reports" under § 141(e) on which the directors could reasonably have relied. Further, the amended Merger Agreement imposed on Trans Union's acceptance of a third party offer conditions more onerous than those imposed on Trans Union's acceptance of Pritzker's offer on September 20. . . .

The October 9 press release [announcing (1) that all financing arrangements for Pritzker's acquisition of Trans Union had been completed and (2) Pritzker's purchase of

[24] As previously noted, the Board mistakenly thought that it had amended the September 20 draft agreement to include a market test. . . .

[25] We do not suggest that a board must read *in haec verba* every contract or legal document which it approves, but if it is to successfully absolve itself from charges of the type made here, there must be some credible contemporary evidence demonstrating that the directors knew what they were doing, and ensured that their purported action was given effect. That is the consistent failure which cast this Board upon its unredeemable course.

[26] There is no evidence of record that Trans Union's directors ever raised any objections, procedural or substantive, to the October 10 amendments or that any of them, including Van Gorkom, understood the opposite result of their intended effect—until it was too late.

one million shares of Trans Union's treasury stock at $38 per share], coupled with the October 10 amendments, had the clear effect of locking Trans Union's Board into the Pritzker Agreement. Pritzker had thereby foreclosed Trans Union's Board from negotiating any better "definitive" agreement over the remaining eight weeks before Trans Union was required to clear the Proxy Statement submitting the Pritzker proposal to its shareholders.

(2)

[On December 2, during the market test period, the investment firm Kolberg, Kravis, Roberts & Co. ("KKR") offered to purchase Trans–Union for $60 a share, contingent upon securing financing. Van Gorkom was not in favor of the offer, and the evidence suggested that he was at least indirectly responsible for KKR ultimately withdrawing its offer]. GE Credit Corporation's interest in Trans Union did not develop until November; and it made no written proposal until mid-January. Even then, its proposal was not in the form of an offer. Had there been time to do so, GE Credit was prepared to offer between $2 and $5 per share above the $55 per share price which Pritzker offered. But GE Credit needed an additional 60 to 90 days; and it was unwilling to make a formal offer without a concession from Pritzker extending the February 10 "deadline" for Trans Union's stockholder meeting. . . . Pritzker refused to grant such extension; and on January 21, GE Credit terminated further negotiations with Trans Union. . . .

. . . . Our review of the record compels a finding that confirmation of the appropriateness of the Pritzker offer by an unfettered or free market test was virtually meaningless in the face of the terms and time limitations of Trans Union's Merger Agreement with Pritzker as amended October 10, 1980.

. . . .

. . . [W]e hold that the defendants' post-September conduct did not cure the deficiencies of their September 20 conduct; and that, accordingly, the Trial Court erred in [affording] to the defendants the benefits of the business judgment rule.

. . . .

V.

The defendants ultimately rely on the stockholder vote of February 10 for exoneration. The defendants contend that the stockholders' "overwhelming" vote approving the Pritzker Merger Agreement had the legal effect of curing any failure of the Board to reach an informed business judgment in its approval of the merger.

The parties tacitly agree that a discovered failure of the Board to reach an informed business judgment in approving the merger constitutes a voidable, rather than a void, act. Hence, the merger can be sustained, notwithstanding the infirmity of the Board's action, if its approval by majority vote of the shareholders is found to have been based on an informed electorate. . . .

. . . .

. . . . The question of whether shareholders have been fully informed such that their vote can be said to ratify director action, "turns on the fairness and completeness of the proxy materials submitted by the management to the . . . shareholders." *Michelson v. Duncan, supra* at 220. As this Court stated in *Gottlieb v. Heyden Chemical Corp.,* Del.Supr., 91 A.2d 57, 59 (1952):

> [T]he entire atmosphere is freshened and a new set of rules invoked where a formal approval has been given by a majority of independent, fully informed stockholders. . . .

In [*Lynch v. Vickers Energy Corp.,* 383 A.2d 278 (Del. 1977)], this Court held that corporate directors owe to their stockholders a fiduciary duty to disclose all facts germane to the transaction at issue in an atmosphere of complete candor. We defined "germane" in the tender offer context as all "information such as a reasonable stockholder would consider important in deciding whether to sell or retain stock." *Id.* at 281. In reality, "germane" means material facts.

Applying this standard to the record before us, we find that Trans Union's stockholders were not fully informed of all facts material to their vote on the Pritzker Merger and that the Trial Court's ruling to the contrary is clearly erroneous. [The Court listed several material deficiencies in the proxy materials, including, among other items, the following: (1) the board failed to disclose its lack of valuation information—*i.e.*, "[t]he fact that [it] had no reasonably adequate information indicative of the intrinsic value of the Company, other than a concededly depressed market price"; (2) the board's references to the "substantial" premium offered were misleading in that "the Board did not disclose its failure to assess the premium offered in terms of other relevant valuation techniques, thereby rendering questionable its determination as to the substantiality of the premium over an admittedly depressed stock market price"].

. . . .

The burden must fall on defendants who claim ratification based on shareholder vote to establish that the shareholder approval resulted from a fully informed electorate. On the record before us, it is clear that the Board failed to meet that burden.

* * *

For the foregoing reasons, we conclude that the director defendants breached their fiduciary duty of candor by their failure to make true and correct disclosures of all information they had, or should have had, material to the transaction submitted for stockholder approval.

VI.

To summarize: we hold that the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer.

We hold, therefore, that the Trial Court committed reversible error in applying the business judgment rule in favor of the director defendants in this case.

On remand, the Court of Chancery shall conduct an evidentiary hearing to determine the fair value of the shares represented by the plaintiffs' class, based on the intrinsic value of Trans Union on September 20, 1980. . . . Thereafter, an award of damages may be entered to the extent that the fair value of Trans Union exceeds $55 per share.

* * *

REVERSED and REMANDED for proceedings consistent herewith.

MCNEILLY, JUSTICE, dissenting:

The majority opinion reads like an advocate's closing address to a hostile jury. And I say that not lightly. Throughout the opinion great emphasis is directed only to the negative, with nothing more than lip service granted the positive aspects of this case. . . .

. . . . The first and most important error made is the majority's assessment of the directors' knowledge of the affairs of Trans Union and their combined ability to act in this situation under the protection of the business judgment rule.

Trans Union's Board of Directors consisted of ten men, five of whom were "inside" directors and five of whom were "outside" directors. . . . At the time the merger was proposed the inside five directors had collectively been employed by the Company for 116 years and had 68 years of combined experience as directors. . . . With the exception of Wallis, [the "outside" directors] were all chief executive officers of Chicago based corporations that were at least as large as Trans Union. The five "outside" directors had 78 years of combined experience as chief executive officers, and 53 years cumulative service as Trans Union directors.

. . . .

Directors of this caliber are not ordinarily taken in by a "fast shuffle." I submit they were not taken into this multi-million dollar corporate transaction without being fully informed and aware of the state of the art as it pertained to the entire corporate panorama of Trans Union. True, even directors such as these, with their business acumen, interest and expertise, can go astray. I do not believe that to be the case here. These men knew Trans Union like the back of their hands and were more than well qualified to make on the spot informed business judgments concerning the affairs of Trans Union including a 100% sale of the corporation. Lest we forget, the corporate world of then and now operates on what is so aptly referred to as "the fast track." These men were at the time an integral part of that world, all professional business men, not intellectual figureheads.

. . . .

At the time of the September 20 meeting the 10 members of Trans Union's Board of Directors were highly qualified and well informed about the affairs and prospects of Trans Union. These directors were acutely aware of the historical problems facing Trans Union which were caused by the tax laws. They had discussed these problems *ad nauseam*. . . . [T]his record reveals that the directors acted with the utmost care in informing themselves of the relevant and available facts before passing on the merger. . . .

NOTES & QUESTIONS

1. Why is the court upset with the TransUnion board? Did the court think that the $55 offer was too low?

2. Under what standard was the board's conduct reviewed?

3. Why was Pritzker willing to pay $55 per share for a company with a market price of $38 per share? Why was the board unable to rely on that premium to justify its decision?

4. Assume that you are advising a board of directors after the *Van Gorkom* ruling about the process that should be followed in making a decision. Based on the guidance provided in the *Van Gorkom* opinion itself, what suggestions would you make?

5. The *Van Gorkom* opinion suggests that a fully informed shareholder vote would have eliminated any problems with the board's decision-making process. However, in Gantler v. Stephens, 965 A.2d 695 (Del. 2009), the Delaware Supreme Court held that shareholder ratification only applies to transactions that the shareholders are not otherwise legally required to approve (unlike a merger, which the shareholders are legally required to approve). In these circumstances, "the 'cleansing' effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to 'extinguishing' the claim altogether." *Id.* at 713. The *Gantler* court also noted that "[n]othing herein should be read as altering the well-established principle that void acts such as fraud, gift, waste and ultra vires acts cannot be ratified by a less than unanimous shareholder vote." *Id.* at 713 n.54.

6. In *Van Gorkom*, the plaintiff established that the Trans Union board had breached its duty of care. The Delaware Supreme Court remanded to the trial court with instructions to determine damages. How should those damages be calculated? Interestingly, the *Van Gorkom*

court made no mention of a need to conduct an entire fairness analysis before such damages could be assessed. As the Delaware Supreme Court later explained:

> In *Van Gorkom,* this Court concluded that the board of directors' failure to inform itself before recommending a merger to the stockholders constituted a breach of the fiduciary duty of care and rebutted the presumptive protection of the business judgment rule. In *Van Gorkom,* this Court *also* concluded that the directors had violated the *duty of disclosure.* This Court then held that the directors were liable for damages, since the record after trial reflected that the compound breaches of the duties of care and *disclosure* could not withstand an entire fairness analysis. Consequently, because this Court had decided the *substantive* entire fairness issue adversely to the board in *Van Gorkom,* the only issue to remand was the amount of damages the Court of Chancery should assess. . . .

Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 (Del. 1995).

7. The *Van Gorkom* opinion had a significant impact on the business community. As one commentator observed:

> Whether the result reached by the Delaware Supreme Court in Van Gorkom was correct or incorrect, the immediate consequences of the decision on the business community were deeply disturbing. Many outside directors began to reassess their willingness to serve as directors at all, and isolated instances of resignations were reported. The number of lawyers serving on boards of directors of their clients declined. Even some inside directors began to have qualms about the desirability of their service on the board of directors of the company that employed them. The prestige and financial rewards of serving on boards of directors of publicly held corporations had to be weighed against the remote risk of a crushing liability being imposed on the board members. Many potential outside directors, in particular, decided that this risk outweighed the benefits. It became considerably more difficult to find desirable persons who were willing to become outside directors. On another level, general counsels made recommendations to boards of directors that they hire expensive financial advisers, commission extensive studies, and otherwise improve the paper record of their decisional process in order to reduce the risk of liability in situations similar to Van Gorkom. It was a widely held belief that the cost of this exercise exceeded the benefits to the decisional process.

Robert W. Hamilton, *Reliance and Liability Standards for Outside Directors*, 24 WAKE FOREST L. REV. 5, 28–29 (1989).

8. After the Delaware Supreme Court's decision in *Van Gorkom*, it was reported that a $23.5 million settlement was reached. Of that amount, $10 million (the policy limits) was paid by the liability insurance carrier of Trans Union's directors and officers. Almost all of the remaining $13.5 million was paid by the Pritzker group on behalf of the Trans Union directors. *See* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 1 (1985). Given that the parties stipulated to the dismissal of the Pritzker group as a defendant (see footnote 2 of the opinion), why do you think the Pritzker group was willing to contribute this sum? Consider the following passage from an interview with Robert Pritzker who, at the time of the interview, was the President and Chief Executive Officer of the Marmon Group, Inc.:

> William Carney [a law professor]: The other question that has, I think, fascinated many people is the settlement of this case, which, I believe, was for $23 million, and there was, I think, $10 million worth of directors' and officers' liability insurance, and your family contributed $11 million—
>
> Robert Pritzker: Thirteen.
>
> . . . .

William Carney: Could you tell us what motivated you to make that kind of a contribution?

Robert Pritzker: Well, we didn't think the directors had done anything wrong. They were a very knowledgeable group; as I recall, four of them were CEOs of conglomerates that had been put together by buying companies. They surely knew what they were doing. There was an academic, Allen Wallis, who had been, I think, head of one of the business schools. . . .

. . . .

. . . . He was quite knowledgeable about this. And there was another director who was in the hospital during this entire transaction. In fact, I'm not sure I've ever met him, but he knew nothing about it. Now, let's start with him. For him to pay $1.3 million which he didn't have would have bankrupted him. It just didn't seem quite appropriate. One of the directors had passed away and his widow was the one who was supposed to come up with the $1.3 million. It just didn't seem fair. As a matter of fact, I think it was $13-and-a-half million, as I recall now. So we felt that we were the beneficiaries of the whole event. The directors didn't do anything wrong, why should they bear the responsibility? They had nothing to gain and everything to lose. Our feeling was that morally we owed it to them. So, our deal was we would pay 90 percent of that $1.35 million for each one, and they would pay 10 percent to charity. We felt they ought to have something, but not so gross a number. And, incidentally, Van Gorkom paid three or four of their charity contributions. He was about as high class as you could be. He asked for nothing, he didn't want any final settlement or bonus. He made one request of us, and that was that we give him some office space for the Chicago Public School Finance Authority. A very decent guy—stubborn as hell—but very honorable.

Roundtable Discussion: Corporate Governance, 77 CHI.–KENT L. REV. 235, 237–38 (2001).

2. THE DUTY OF LOYALTY

In general, the duty of loyalty requires directors and officers to put the corporation's interests ahead of their personal interests. This duty may be implicated in a number of circumstances, but it commonly arises in two principal contexts. First, duty of loyalty issues arise when directors or officers enter into contracts or other transactions with the corporation, including contracts for compensation or other remuneration. Claims in this setting typically allege that the interests of the fiduciary and the corporation conflicted, and that the corporation was disadvantaged as a result. Second, duty of loyalty issues arise when directors or officers take potential corporate opportunities for themselves. Claims in this setting usually allege that a fiduciary learned of a business opportunity that could have benefitted the corporation, and that the fiduciary concealed the opportunity in order to personally pursue it.

The traditional remedies for duty of loyalty violations are restitutionary in nature. In an unfair conflict of interest transaction, for example, the remedy is usually rescission—*i.e.*, the corporation gets back what it paid and returns what it received in the transaction. If rescission is not possible, damages for the difference between the contract price and a fair price are awarded. Similarly, in the corporate opportunity context, the usual remedy is to turn the opportunity over to the corporation and to hold the fiduciary liable for any profits that were made. This remedy is often referred to as the imposition of a "constructive trust" in the corporation's favor. The corporation is normally required to reimburse the fiduciary for whatever sums he expended to obtain the opportunity.

The problem with these restitutionary-based remedies is that they may have little deterrent effect, as they simply require the fiduciary to relinquish whatever he has improperly obtained. Courts have sometimes imposed additional sanctions to address this problem, including, among others, the following: (1) awarding punitive damages; (2) ordering the fiduciary to repay any salary received from the corporation during the time of the breach of duty; and (3) ordering the fiduciary to pay the corporation's attorneys' fees and other expenses that were incurred in establishing the breach of duty.

a. Conflict of Interest Transactions

DGCL § 144

MBCA §§ 8.60–8.63

When a director or officer enters into a transaction with the corporation (*e.g.*, buying property from, or selling property to, the corporation), there is cause for concern. There is some worry that the director or officer will place his personal interests before the corporation's interests and will structure the transaction to favor those personal interests. On the other hand, the transaction may be beneficial to the corporation and may be consummated on fair terms.

During the late nineteenth century, the law took the position that all conflict of interest transactions were voidable at the election of the corporation or its shareholders regardless of the fairness of the transaction. It was eventually recognized, however, that such a bright-line rule did not necessarily fit business needs, particularly in closely held corporations. For example, a small corporation with minimal assets and a short operational history might receive better terms when transacting business with its own directors and officers than with outsiders. Those with a stake in the business, in other words, might be willing to take more of a risk with a fledgling company. In light of this recognition that conflict of interest transactions could be helpful to a corporation, the common law ultimately relaxed the rule of per se voidability. These days, conflict of interest transactions are regulated by statutes and case law that seek to ensure that the

transaction is fair to the corporation or, at the very least, that the transaction has been approved or ratified by a majority of disinterested directors or shareholders.

NOTES & QUESTIONS

1. Describe the conflicts of interest involved in *Marciano*. Do they fall within the coverage of DGCL § 144?

2. When a director or officer receives a benefit from the corporation, DGCL § 144 is implicated only where the other shareholders do not receive the same benefit. *See* Pfeffer v. Redstone, 965 A.2d 676, 690 (Del. 2009) (payment of a dividend to an entity controlled by the corporation's chief executive officer did not constitute a conflict of interest transaction because all of the shareholders received the same dividend).

3. Why were none of the "curative steps" under § 144(a) available in *Marciano*? If § 144(a) wasn't available, how did the Nakashes prevail?

4. To establish director authorization or shareholder approval under DGCL § 144(a)(1) or (a)(2), what must be shown?

5. What is the effect of complying with the director authorization or shareholder approval provisions of DGCL § 144(a)(1) or (a)(2)? What is the effect of failing to comply with these provisions?

6. Does shareholder approval under DGCL § 144(a)(2) require a majority vote of the *disinterested* shares? What does the statutory language suggest? Does it make sense to allow interested shares to effectuate the approval? *See, e.g.*, Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976) ("The purported ratification by the Agau shareholders would not affect the burden of proof in this case because the majority of shares voted in favor of exercising the option were cast by defendants in their capacity as Agau shareholders. Only about one-third of the 'disinterested' shareholders voted, and we cannot assume that such non-voting shareholders either approved or disapproved. Under these circumstances, we cannot say that 'the entire atmosphere has been freshened' and that departure from the objective fairness test is permissible. . . . Nor do we believe the Legislature intended a contrary policy and rule to prevail by enacting [DGCL § 144].").

7. How could the Nakashes meet their burden to establish the fairness of the transaction?

8. How does a director or officer establish the fairness of a transaction? Many jurisdictions follow the Delaware standard of "entire fairness" announced in Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983):

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of [the transaction]. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Id. at 711; *see also* MBCA § 8.60(6) & cmt. (discussing fairness with respect to the "terms of the transaction" and the "process of decision").

9. *Marciano* applies to conflict of interest transactions between a corporation and its directors or officers. It is important to note that Delaware courts treat such transactions differently from conflict of interest transactions between a corporation and its controlling shareholder. In the controlling shareholder context, director authorization or shareholder approval shifts the burden of proof from the controlling shareholder to the plaintiff, but the standard of review remains entire fairness. *See, e.g.*, *In re* Wheelabrator Technologies, Inc. S'holders Litig., 663 A.2d 1194, 1203 (Del. Ch. 1995).

10. The importance of disclosure in the conflict of interest setting cannot be overstated. Disclosure is an essential component of director approval, shareholder approval, and the entire fairness inquiry. In discussing the disclosure obligation in the context of conflict of interest transactions, one court stated the following:

> . . . . [I]n its earliest form, the duty of disclosure was the simple requirement that a board seeking shareholder ratification of a self-interested transaction provide shareholders all information material to the transaction. The duty existed and still exists as an essential component of the duty of loyalty in a situation where the board seeks to comply with its fiduciary obligations by obtaining shareholder approval for the board's otherwise potentially conflicted interests.

In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 369 (Del. Ch. 1998), *aff'd in part & rev'd in part on other grounds sub nom.*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000). Significantly, this duty to disclose is not limited to the conflict of interest setting. Delaware courts now recognize a duty of disclosure "whenever the Board seeks shareholder action, regardless of whether the approval sought is for an act or transaction in which the board itself is conflicted." *Id.* at 369; *accord* Zirn v. VLI Corp., 681 A.2d 1050, 1056 (Del. 1996). Moreover, even when no shareholder action is sought, the Delaware Supreme Court has held that directors can be liable for breach of fiduciary duty when they knowingly disseminate false information to shareholders. *See* Malone v. Brincat, 722 A.2d 5, 12 (Del. 1998) ("When the directors disseminate information to stockholders when no stockholder action is sought, the fiduciary duties of care, loyalty and good faith apply. Dissemination of false information could violate one or more of those duties."). Despite confusing language in a number of opinions, Delaware courts maintain that the duty to disclose is not an independent fiduciary duty. Rather, it is simply part of the fiduciary duties of care and loyalty. *See, e.g.,* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 (Del. 1995) (describing the duty to disclose as "an obligation that has been characterized as a derivative of the duties of care and loyalty").

NOTE ON INTERESTED DIRECTORS

Who is an "interested" director? Notice that the question is important not only because the coverage of conflict of interest statutes (such as DGCL § 144) turns on it, but also because director approval requires a prescribed number of "disinterested" directors to authorize the transaction.

The Delaware statute gives little guidance on the question of "interested" directors. On its face, section 144 of the Delaware statute applies only to transactions "between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest." No more specific definition of an "interested" or "disinterested" director is provided. However, what about close relatives, friends, and business associates? The Delaware courts have no per se rule to govern these situations and treat them on a case-by-case basis. For example, in Beam v. Stewart, 845 A.2d 1040 (Del. 2004), a plaintiff alleged that certain directors were not independent because of an extensive network of personal and business relationships with a director-defendant who was also a 94% stockholder. The Delaware Supreme Court disagreed:

> Allegations that [the controlling stockholder] and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as friends, even when coupled with [the controlling stockholder's] 94% voting power, are insufficient, without more, to rebut the presumption of independence. They do not provide a sufficient basis from which reasonably to infer that [three directors] may have been beholden to [the controlling stockholder].

Id. at 1051; *see also* Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988) (finding that the salaries received by outside directors did not compromise their independence in considering an entrenchment claim); Aronson v. Lewis, 473 A.2d 805, 816–17 (Del. 1984) (rejecting the argument that directors lacked independence merely because they owed allegiance to a 47% shareholder). Presumably, the court would have been willing to find that the directors in question were not disinterested if the plaintiff had adduced facts demonstrating that they were beholden to the 94% shareholder. *See, e.g.*, Rales v. Blasband, 634 A.2d 927, 936–37 (Del. 1993) (holding that two executives whose salaries were dependent on the good will of two other director-defendants were not independent); Heineman v. Datapoint Corp., 611 A.2d 950, 956 (Del. 1992) (concluding that "[t]he amended complaint pleads in sufficient particularized detail claims of interlocking directorships, domination by [a controlling shareholder] and shared investments between [the controlling shareholder] and a majority of [the corporation's board] to raise a reasonable doubt concerning the disinterest and independence of the [the corporation's] board").

By contrast, the MBCA is far more detailed. Section 8.60 defines a director's "conflicting interest transaction" with specificity. Moreover, § 1.43 defines "qualified director"—a director who counts as disinterested for purposes of director approval under § 8.61(b)(1) and § 8.62(a).

In Shapiro v. Greenfield, 764 A.2d 270 (Md. App. 2000), the court engaged in an extensive discussion of who counts as an "interested" and "disinterested" director:

> Both the Model Business Corporations Act ("MBCA") and the American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (1994) ("ALI") expressly define interested director. The ALI provides:
>
> (a) A director or officer is "interested" in a transaction or conduct if either:
>
> (1) The director or officer, or an associate of the director or officer, is a party to the transaction or conduct;
>
> (2) The director or officer has a business, financial, or familial relationship with a party to the transaction or conduct, and that relationship would

reasonably be expected to affect the director's or officer's judgment with respect to the transaction or conduct in a manner adverse to the corporation;

(3) The director or officer, an associate of the director or officer, or a person with whom the director or officer has a business, financial, or familial relationship, has a material pecuniary interest in the transaction or conduct (other than usual and customary director's fees and benefits) and that interest and (if present) that relationship would reasonably be expected to affect the director's or officer's judgment in a manner adverse to the corporation; or

(4) The director or officer is subject to a controlling influence by a party to the transaction or conduct or person who has a material pecuniary interest in the transaction or conduct, and that controlling influence could reasonably be expected to affect the director's or officer's judgment with respect to the transaction or conduct in a manner adverse to the corporation.

ALI § 1.23(1).

The MBCA defines "conflicting interest" as

(1) "Conflicting interest" with respect to a corporation means the interest a director of the corporation has respecting a transaction effected or proposed to be effected by the corporation . . . if:

(i) whether or not the transaction is brought before the board of directors of the corporation for action, the director knows at the time of commitment that he or a related person is a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or a related person that the interest would be reasonably expected to exert an influence on the director's judgment if he were called upon to vote on the transaction.

Model Bus.Corp.Act. § 8.60 (1999).

Appellants assert that Maryland rejected the MBCA and ALI definition of "interested director" and thereby rejected the concept that a director who may be related to a party with a material financial interest in the transaction would also be classified as an interested party. The history of [the Maryland conflict of interest statute] suggests that that conclusion is too broad.

The Maryland statute was modeled after statutes of other jurisdictions, including Delaware, New York, and California. . . . The Delaware, New York, and California statutes are all quite alike in the treatment of interested director transactions. Similar to Maryland's statute, none define the term "interested director." . . . All of the cited approaches ultimately focus on a director's ability to exercise independent judgment and the expected influence of a particular relationship on the director. That is the appropriate subject of inquiry in determining whether a director is to be considered an interested director in a particular transaction.

. . . .

The definitions of the MBCA and the ALI related to interested directors and conflicting interests reflect this same consideration. When the director is actually involved in the transaction, determination is easy. When the director has no direct interests in the conflicting transaction, neither model creates a per se rule based on a familial or business relationship because a relationship between the parties does not necessarily destroy an individual's independent judgment. The pivotal provision is the second prong of the analysis, whether the relationship "would reasonably be expected to exert an influence on the director's judgment." MBCA; see also ALI ("and that relationship would reasonably be expected to affect the director's or officer's

judgment with respect to the transaction or conduct in a manner adverse to the corporation"). The adoption of a per se rule would effectively undermine the purpose of the statute. If an otherwise uninterested director were to be adjudged an interested director based solely on his relationship, familial or otherwise, to another director interested in the transaction, directors who may well retain independence and their own business judgment will be precluded from considering the transaction. On the other hand, to conclude that directors are automatically disinterested because they are not directly involved in the transaction would also undermine the goal of a neutral decision making body, as some directors, because of their familial, personal, or financial relationship, may well be influenced by those relationships to the detriment of the corporation.

Therefore, when a director does not personally benefit from the transaction but, because of that director's relationship to a party interested in the transaction, it would reasonably be expected that the director's exercise of independent judgment would be compromised, that director will be deemed an interested director within the meaning of the statute.

Id. at 279–82.

NOTE ON THE USE OF CORPORATE ASSETS AND COMPETITION WITH THE CORPORATION

Corporate opportunity cases often involve allegations that a defendant used corporate property to acquire an opportunity, or that a defendant's pursuit of an opportunity placed him in competition with the corporation. Although related, usurpation of a corporate opportunity, use of corporate property for personal purposes, and competition with the corporation are three distinct wrongs.

The prohibition on the use of corporate assets prevents a corporate fiduciary from using corporate property (including information and company position) for personal purposes. Section 5.04 of the ALI Principles of Corporate Governance captures this notion by prohibiting directors and senior executives from using company property, information, or position for personal benefit in various circumstances. The director or senior executive has a number of defenses, including proof of advance authorization or later ratification, after full disclosure, by disinterested directors or shareholders. The comment to § 5.04 states, in part, the following:

> . . . . A substantial number of cases have prohibited or placed limitations on a director's or senior executive's use of corporate position, corporate property, or material non-public corporate information for personal benefit. These cases involve misuse of position for a variety of purposes, including securing an undisclosed commission, obtaining a tax benefit at the expense of the corporation, manipulating the corporation's dividend policy for personal objectives, precluding the corporation from engaging in a profitable business activity so that the director or senior executive may do so, and securing a benefit in connection with a director's relinquishment of office. Some cases involve misuse of inside information in connection with transactions in the corporation's stock. Some cases involve use of corporate property for personal benefit. Section 5.04 synthesizes the results reached in these cases by stating the principle that a director or senior executive may not utilize corporate property, material non-public corporate information, or corporate position to obtain a personal pecuniary benefit from the corporation or a third party except as provided in § 5.04(a)(1)–(5). The duty of fair dealing set forth in § 5.04 is similar to the duty of fair dealing owed by an agent to a principal under the law of agency, which would be applicable to employees other than directors and senior executives. See Restatement, Second, Agency § 387 et seq.
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> . . . .
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> Section 5.04(a) covers improper pecuniary benefits received for the director's or senior executive's own personal benefit, even if the use is not necessarily contrary to the corporate objective or harmful to the corporation or its shareholders. In order to prove a violation of § 5.04, it is not necessary to show that the corporation was harmed, except in the case of use of nonproprietary corporate information that falls within the terms of § 5.04(a)(3).

Even if a business opportunity does not belong to a corporation, a director or officer may not pursue the opportunity if it involves competing with the corporation in a way that injures the corporation. *See, e.g.*, Lincoln Stores, Inc. v. Grant, 34 N.E.2d 704, 708 (Mass. 1941) (holding in favor of defendants on a corporate opportunity claim but finding that defendants breached their fiduciary duties when they transformed a noncompetitive store into one that was in active competition with their corporation). Some courts have been relatively permissive in allowing directors and officers to compete with their corporation, *see, e.g.*, Regenstein v. J. Regenstein Co., 97 S.E.2d 693, 696–97 (Ga. 1957), while other courts have strictly prohibited such competition, *see, e.g.*, Foley v. D'Agostino, 248 N.Y.S.2d 121, 128–30 (App. Div. 1964). Section 5.06 of the ALI Principles of Corporate Governance strikes a middle ground that, generally speaking, prohibits a director or senior executive from competing with the corporation unless (1) the benefits to the corporation from allowing the competition outweigh

the harm (or there is no harm to the corporation at all), or (2) the competition is authorized or ratified, after full disclosure, by disinterested directors or shareholders.

Of course, a director or officer may resign his position and compete with his former corporation. Whether a director or officer's pre-resignation preparations for setting up a competing business are a breach of fiduciary duty is a much litigated question. In the words of one court (Maryland Metals, Inc. v. Metzner, 382 A.2d 564, 567–71 (Md. 1978)):

> In defining the scope of the right of an employee or corporate officer to enter into competition with his former principal and in delimiting the countervailing right of an employer to restrain his agent's competitive endeavors both before and after termination of employment, the law seeks to harmonize two important and ofttimes conflicting policies. The first of these policy considerations is that commercial competition must be conducted according to basic rules of honesty and fair dealing. . . . Fairness dictates that an employee not be permitted to exploit the trust of his employer so as to obtain an unfair advantage in competing with the employer in a matter concerning the latter's business.
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> . . . .
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> A direct corollary of this general principle of loyalty is that a corporate officer or other high-echelon employee is barred from actively competing with his employer during the tenure of his employment, even in the absence of an express covenant so providing. Thus, prior to his termination, an employee may not solicit for himself business which his position requires him to obtain for his employer. He must refrain from actively and directly competing with his employer for customers and employees, and must continue to exert his best efforts on behalf of his employer.
>
> Once the employment relationship comes to an end, of course, the employee is at liberty to solicit his former employer's business and employees. . . .
>
> The second policy recognized by the courts is that of safeguarding society's interest in fostering free and vigorous competition in the economic sphere. . . .
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> . . . .
>
> This policy in favor of free competition has prompted the recognition of a privilege in favor of employees which enables them to prepare or make arrangements to compete with their employers prior to leaving the employ of their prospective rivals without fear of incurring liability for breach of their fiduciary duty of loyalty. . . .[3]
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> Moreover, while an employee is under an obligation to be candid with his employer in preparing to establish a competing enterprise, he is not bound to reveal the precise nature of his plans to the employer unless he has acted inimically to the employer's interest beyond the mere failure to disclose.
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> The right to make arrangements to compete is by no means absolute and the exercise of the privilege may, in appropriate circumstances, rise to the level of a breach of an employee's fiduciary duty of loyalty. Thus, the privilege has not been applied to immunize employees from liability where the employee has committed some fraudulent, unfair or wrongful act in the course of preparing to compete in the future. Examples of misconduct which will defeat the privilege are: misappropriation of trade secrets; misuse of confidential information; solicitation of employer's customers prior to cessation of employment; conspiracy to bring about mass resignation of employer's key employees; [and] usurpation of [the] employer's business opportunity.

[3] Although the line separating mere preparation from active competition may be difficult to discern in some cases, we have stated, following the position taken by the American Law Institute, that an employee may properly, before leaving his employment, purchase a rival business or he may advise customers with whom he has been in contact of his proposed termination of employment.

c. Executive Compensation and the Waste Doctrine

The compensation arrangement between a corporation and its officers is a critically important and sensitive matter. A proper compensation arrangement motivates the executive to work in the company's best interests. Moreover, as explained below, executive compensation in closely held corporations is often the preferred mechanism for distributing the financial returns of the business. Compensation arrangements can give rise to troublesome issues, however, particularly when the shareholders perceive that the amounts of compensation are excessive. In the closely held corporation, this perception can be especially difficult to shake. Executive compensation is set by the board of directors, and in the typical closely held corporation, all of the directors also serve as officers of the company. When determining executive compensation, therefore, directors of a closely held corporation are often establishing their own compensation as officers.

Compensation arrangements are significantly influenced by tax concerns. For example, reasonable compensation paid to an employee is a deductible expense for a corporation, but a dividend paid to a shareholder is not. *See* 26 U.S.C. § 162(a)(1) (stating that "a reasonable allowance for salaries or other compensation for personal services actually rendered" is deductible). For this reason, many closely held corporations attempt to pay out much (if not all) of their profits as employee compensation, rather than as dividends, to avoid the "double tax" that dividend payments entail. Compensation in a closely held corporation, therefore, may be comprised of (1) sums representing the value of the labor provided by the shareholder-employee, and (2) sums representing a "disguised" or "de facto" dividend—*i.e.*, amounts beyond the value of the shareholder-employee's labor that represent a distribution of profits to the shareholder-employee.

In closely held corporations, executive compensation challenges are raised in a number of contexts. First, because compensation amounts in a closely held corporation may include de facto dividends, a termination of employment can have the effect of excluding an investor from his rightful share of the company's dividend distributions. Although often characterized as excessive compensation claims, these claims are really personal challenges to the de facto dividend policy of the company. These days, such challenges are typically pled as "shareholder oppression" actions, and they will be discussed further in [later materials].

Second, because of the tax incentive for closely held corporations to distribute profits as compensation, rather than as dividends, the Internal Revenue Service often sues to disallow the deduction of "unreasonable" amounts of compensation. When the IRS is successful, the amount of compensation that exceeds a "reasonable" amount is treated as a dividend and is not deductible from the corporation's income.

Finally, actions on behalf of a corporation (either direct or derivative) may be brought in an effort to recover the excess or "unreasonable" amount of compensation paid to executives. These corporate actions can take several forms themselves: (1) a duty of loyalty claim asserting that a director or officer had a conflict of interest in setting executive compensation; (2) a procedural duty of care claim asserting that a board was grossly negligent in the procedures that it used, and the information that it considered, in setting executive compensation; and (3) a substantive duty of care claim asserting that a board committed "waste" in setting executive compensation. *See* Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 Wash. U. L.Q. 569 (2001) (providing empirical data on the success rates of these three claims).

NOTES & QUESTIONS

1. Why did the business judgment rule fail to protect the compensation decisions in *Wilderman*? What standard did the court use to review those decisions?

2. What factors did the *Wilderman* court consider in determining whether the compensation was excessive?

3. Does DGCL § 144 apply to an executive compensation decision in a Delaware corporation?

4. Most of the reported decisions holding that an executive compensation arrangement is excessive involve closely held corporations. What might explain this result?

5. The waste doctrine prohibits "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (internal quotation omitted). In Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997), Chancellor Allen described the waste doctrine as follows:

> Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky.

Id. at 336. Given this extraordinarily high standard, it is perhaps unsurprising that some courts have equated waste with irrationality. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006) ("This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.' ") (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)); *Brehm*, 746 A.2d at 264 (noting that "[i]rrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule"). It should be noted that shareholders may not ratify corporate waste except by a unanimous vote. *See* Gantler v. Stephens, 965 A.2d 695, 713 n.54 (Del. 2009). The justification for this rule "is apparently that a transaction that satisfies the high standard of waste constitutes a *gift* of corporate property and no one should be forced against their will to make a gift of their property." *Vogelstein*, 699 A.2d at 335–36.

6. Executive compensation challenges often include waste claims. In the modern era, such claims are rarely successful. After all, any form of executive compensation (even bonuses, gratuitous severance payments, or other compensation that does not require additional services by the employee) minimally provides the corporate benefit of improved loyalty and employee morale. The only realistic basis for a waste action, therefore, is to assert that a company has irrationally overpaid one or more of its executives. In contrast to a fairness standard of review, which theoretically attempts to assess whether the benefit the corporation received was fair and reasonable in light of the compensation it paid—a waste standard provides far less room for argument. *Cf.* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 892 (Del. Ch. 1999) ("The pleading burden on a plaintiff attacking a corporate transaction as wasteful is necessarily higher than that of a plaintiff challenging a transaction as 'unfair' as a result of the directors' conflicted loyalties or lack of due care. . . . [I]f, under the facts pled in the complaint, any reasonable person might conclude that the deal made sense, then the judicial inquiry ends." (footnotes omitted) (internal quotation omitted)).

7. Assume that a corporation's board establishes a stock option plan that grants options to current directors and officers. Under what standard should a court evaluate the decision to establish the plan? What if the company's stockholders (or the independent directors, if any) properly ratify the plan? How would that affect the standard of review?

8. Some Delaware cases involving board decisions to grant stock options to directors and officers seem to evaluate the grant with more scrutiny than the conventional waste standard. As one court observed:

> The early Delaware cases on option compensation established that, even in the presence of informed [shareholder] ratification, in order for stock option grants to be valid a two part test had to be satisfied. First it was seen as necessary that the court conclude that the grant contemplates that the corporation will receive "sufficient consideration." *E.g., Kerbs,* at 90 A.2d 652, 656 (1952). "Sufficient consideration" as employed in the early cases does not seem like a waste standard: "Sufficient consideration to the corporation may be, *inter alia,* the retention of the services of an employee, or the gaining of the services of a new employee, *provided there is a reasonable relationship between the value of the services . . . and the value of the options*. . . ." *Kerbs* at 656 (emphasis added).
>
> Secondly it was held early on that, in addition, the plan or the circumstances of the grant must include "conditions or the existence of circumstances *which may be expected to insure* that the contemplated consideration will in fact pass to the corporation." *Kerbs* at 656 (emphasis added): Elsewhere the Supreme Court spoke of "circumstances which may reasonably be regarded as *sufficient to insure* that the corporation will receive that which it desires. . . ." *Id.* at 657 (emphasis added).[a]
>
> This (1) weighing of the reasonableness of the relationship between the value of the consideration flowing both ways and (2) evaluating the sufficiency of the circumstances to insure receipt of the benefit sought, seem rather distant from the substance of a waste standard of judicial review.

Lewis v. Vogelstein, 699 A.2d 327, 336–37 (Del. Ch. 1997). More modern stock option cases seem to reject this two-part test in favor of the conventional waste standard. *See, e.g.,* Michelson v. Duncan, 407 A.2d 211, 223 (Del. 1979); *Volgelstein*, 699 A.2d at 337–38.

PROBLEM 4–12

ABC Corporation has a three-member board of directors comprised of Able, Baker, and Carter. Able, Baker, and Carter also serve as executive officers of the company. Compensation for Able, Baker, and Carter as officers is set in the following manner: Able leaves the board meeting and does not participate while Baker and Carter deliberate and then pass a board resolution establishing Able's compensation. Able then rejoins the meeting. Baker then leaves the board meeting and does not participate while Able and Carter deliberate and then pass a resolution establishing Baker's compensation. Baker then rejoins the meeting. The same procedure is followed for the setting of Carter's compensation. Should the business judgment rule apply to the setting of compensation for Able, Baker, and Carter?

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[a] When a stock option plan does not require a recipient to continue in the service of the company for some period of time after receiving the options, this part of the test is often violated. *See, e.g.*, Beard v. Elster, 160 A.2d 731, 738 (Del. 1960) ("Thus, in the *Kerbs* case, the fact that the Directors who voted in favor of the plan were permitted by the plan to leave the company's employ and, yet, have the right to exercise their options for six months thereafter impaled the plan upon the prong of failure to provide reasonable safeguards that the corporation would receive the contemplated benefit, i.e., the retention of the services of the optionee."). An example of a reasonable safeguard would be a provision requiring a recipient to remain as an employee for some specified period of time as a condition to exercising a stock option or similar privilege.

3. DUTIES OF CONTROLLING SHAREHOLDERS

Absent a contractual obligation, a shareholder normally has no duty to the corporation or the other shareholders. In certain situations, however, the common law has imposed duties upon shareholders. For example, some courts have imposed fiduciary duties upon shareholders of closely held corporations. More generally, controlling shareholders in any corporation, closely held or publicly held, have certain duties to the corporation and the minority investors. These controlling shareholder duties typically arise in two contexts: conflict of interest transactions, and sales of the controlling interest.

What is a "controlling shareholder?" Simply stated, a controlling shareholder (or controlling group) is an investor (or group of investors) with the power to direct corporate affairs. Although the traditional model of the corporation posits that the board, rather than the shareholders, directs corporate affairs, this model breaks down when a single shareholder (or group of shareholders) owns a controlling interest. In such circumstances, the board is often just a conduit for the wishes of the controlling person(s).

A controlling shareholder's power to direct corporate affairs generally stems from its ability to elect (and remove) a majority of the board of directors. While this description ordinarily includes an investor (or group) who owns a majority of the corporation's voting shares, ownership of less than a majority may also suffice to establish control. Indeed, when a corporation's shares are widely scattered among a large number of investors, an owner of a sizable (but less than majority) block of stock is usually able to mobilize enough votes to elect a majority of the board. *See, e.g.*, Essex Universal Corp. v. Yates, 305 F.2d 572, 579 (2d Cir. 1962) (noting that a 28.3% owner of a publicly held corporation is "almost certain to have share control as a practical matter"). When a true majority shareholder is absent, the test for control is a functional one that focuses on the shareholder's ability to control the conduct of the corporation. As the Delaware Supreme Court observed, "a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation." Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987).

Why should a controlling shareholder owe any duties at all? The conventional answer is tied to the definition of a controlling shareholder. Under the traditional corporate model, fiduciary obligations are imposed on directors because they are the persons with the power to direct corporate affairs. If that power is actually possessed by a controlling shareholder, however, it is sensible to impose similar obligations on that party. Controlling shareholder duties, in other words, simply recognize that the controlling shareholder has the ultimate power to direct the business. As a related justification, there is always a danger that a controlling shareholder will exercise its control in a manner that allows it to gain disproportionate benefits at the expense of the corporation or the minority shareholders. From this standpoint, one can view the imposition of controlling shareholder duties as a mechanism for protecting these other interests.

Although the duties owed by a controlling shareholder are typically characterized as "fiduciary" in nature, that label is misleading. A true fiduciary, such as a trustee, is obligated to act solely for the benefit of some other party. In contrast, any shareholder—including a controlling shareholder—has legitimate selfish interests as an owner of the business. Unlike true fiduciary duties, therefore, the duties owed by a controlling shareholder focus on fairness rather than selflessness.

NOTES & QUESTIONS

1. The entire fairness standard in the controlling shareholder context is the same standard that is applied to conflict of interest transactions involving directors and officers.

That standard is typically articulated as a unitary inquiry into fair dealing and fair price. *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422, 428–31 (Del. 1997).

2. Does DGCL § 144 apply to a conflict of interest transaction between a corporation and its controlling shareholder?

3. Where a controlling shareholder is involved in a transaction with the corporation, what is the effect of approval by disinterested directors or shareholders? The Delaware view is that such approval shifts the burden of proof to the plaintiff to demonstrate that the challenged transaction is not entirely fair but does not eliminate the fairness inquiry. *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997); Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994); In re Wheelabrator Techs., Inc. S'holders Litigation, 663 A.2d 1194, 1203–04 (Del. Ch. 1995). Why doesn't disinterested director or shareholder approval resuscitate the protection of the business judgment rule, as it does for "interested director" transactions that do not involve a controlling shareholder?

4. Controlling shareholders have disclosure obligations when dealing with the corporation and its minority shareholders. For example, in Lynch v. Vickers Energy Corp., 383 A.2d 278 (Del. 1977), a majority shareholder made a tender offer to acquire the stock of the minority shareholders. The Delaware Supreme Court concluded that "Vickers, as the majority shareholder of TransOcean, owed a fiduciary duty to plaintiff which required complete candor in disclosing fully all of the facts and circumstances surrounding the tender offer." *Id.* at 279 (internal quotation omitted). Moreover, in the entire fairness context, the most common violation of the fair dealing prong involves a failure to disclose matters that affect the minority's interests. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710–12 (Del. 1983) (involving a controlling shareholder's lack of disclosure); *see also* Kahn v. Lynch Communication Sys., Inc., 669 A.2d 79, 88 (Del. 1995) ("A controlling shareholder owes a duty of complete candor when standing on both sides of a transaction and must disclose fully all the material facts and circumstances surrounding the transaction."). *But see* Kahn v. Tremont Corp., 694 A.2d 422, 432 (Del. 1997) ("Under the facts here present, we find [the controlling shareholder] had no duty to disclose information which might be adverse to its interests because the normal standards of arms-length bargaining do not mandate a disclosure of weaknesses.").

G. DISSENSION IN THE CLOSELY HELD CORPORATION

The materials below focus on two problems that often arise when dissension is present in a closely held corporation: deadlock and oppression. Because a court typically has the power to order dissolution (or a less harsh remedy) when deadlock or oppression is established, it is helpful to begin with a brief overview of dissolution.

DGCL §§ 273, 275, 355

MBCA §§ 14.02, 14.20, 14.30

In general terms, the dissolution of a corporation involves the termination of the corporation's existence, the sale of the business (usually as a going concern or on an asset-by-asset basis), the repayment of debt to creditors, and the pro rata distribution of any remaining assets to shareholders. In each state, three types of dissolution are usually possible: (1) voluntary dissolution; (2) involuntary dissolution; and (3) administrative dissolution.

Voluntary dissolution broadly refers to a dissolution that is not ordered or compelled by a court or a state. In most jurisdictions, a right to voluntarily dissolve a corporation is granted only to shareholders who own, individually or collectively, at least a majority of the outstanding voting stock of a corporation. Even then, voluntary dissolution typically requires the agreement of the board of directors as well. *See, e.g.*, DGCL § 275 (requiring the approval of the board and the approval of a majority of all of the outstanding shares entitled to vote); *cf.* MBCA § 14.02 (requiring the approval of the board and "the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast exists"). In many juridsictions, a statute provides that a corporation can also be dissolved upon a specified event or at a specified time if such provisions are included in the articles of incorporation, although the statute may have eligibility requirements for its use. *See, e.g.*, DGCL § 355; N.Y. BUS. CORP. LAW § 1002; MODEL STAT. CLOSE CORP. SUPP. § 33.

Involuntary dissolution refers to a dissolution that is ordered or compelled by a court. Modern involuntary dissolution statutes typically allow a shareholder to petition for court-ordered dissolution on various grounds, including director or shareholder deadlock, misapplication or waste of corporate assets, and fraudulent, illegal, or oppressive actions by directors or those in control. *See, e.g.*, MBCA § 14.30. Delaware, however, has a much more limited involuntary dissolution statute. *See* DGCL § 273 (authorizing shareholders of corporations "having only two stockholders each of which owns 50% of the stock" to petition for involuntary dissolution).

Administrative dissolution refers to a dissolution for noncompliance with certain requirements of the state, such as the failure to pay taxes or fees. Under most statutes, a state official (usually the secretary of state) is empowered to bring a proceeding for dissolution. *See, e.g.*, MBCA § 14.20. Under some statutes, however, the dissolution is automatic. *See, e.g.*, DGCL § 510 ("If any corporation ... neglects or refuses for 1 year to pay the State any franchise tax or taxes ... which it is required to pay under this chapter, the charter of the corporation shall be void, and all powers conferred by law upon the corporation are declared inoperative....").

HOLZMAN v. DE ESCAMILLA
District Court of Appeal of California
195 P.2d 833 (1948)

MARKS, Justice.

This is an appeal by James L. Russell and H. W. Andrews from a judgment decreeing they were general partners in Hacienda Farms, Limited, a limited partnership, from February 27 to December 1, 1943, and as such were liable as general partners to the creditors of the partnership.

Early in 1943, Hacienda Farms, Limited, was organized as a limited partnership with Ricardo de Escamilla as the general partner and James L. Russell and H. W. Andrews as limited partners.

The partnership went into bankruptcy in December, 1943, and Lawrence Holzman was appointed and qualified as trustee of the estate of the bankrupt. On November 13, 1944, he brought this action for the purpose of determining that Russell and Andrews, by taking part in the control of the partnership business, had become liable as general partners to the creditors of the partnership. The trial court found in favor of the plaintiff on this issue and rendered judgment to the effect that the three defendants were liable as general partners.

The findings supporting the judgment are so fully supported by the testimony of certain witnesses, although contradicted by Russell and Andrews, that we need mention but a small part of it. We will not mention conflicting evidence as conflicts in the evidence are settled in the trial court and not here.

De Escamilla was raising beans on farm lands near Escondido at the time the partnership was formed. The partnership continued raising vegetable and truck crops which were marketed principally through a produce concern controlled by Andrews.

The record shows the following testimony of de Escamilla:

"A. We put in some tomatoes.

"Q. Did you have a conversation or conversations with Mr. Andrews or Mr. Russell before planting the tomatoes?

"A. We always conferred and agreed as to what crops we would put in. * * *

"Q. Who determined that it was advisable to plant watermelons?

"A. Mr. Andrews. * * *

"Q. Who determined that string beans should be planted?

"A. All of us. There was never any planting done—except the first crop that was put into the partnership as an asset by myself, there was never any crop that was planted or contemplated in planting that wasn't thoroughly discussed and agreed upon by the three of us; particularly Andrews and myself."

De Escamilla further testified that Russell and Andrews came to the farms about twice a week and consulted about the crops to be planted. He did not want to plant peppers or egg plant because, as he said, "I don't like that country for peppers or egg plant; no, sir," but he was overruled and those crops were planted. The same is true of the watermelons.

Shortly before October 15, 1943, Andrews and Russell requested de Escamilla to resign as manager, which he did, and Harry Miller was appointed in his place.

Hacienda Farms, Limited, maintained two bank accounts, one in a San Diego bank and another in an Escondido bank. It was provided that checks could be drawn on the signatures of any two of the three partners. It is stated in plaintiff's brief, without any contradiction (the checks are not before us) that money was withdrawn on twenty checks signed by Russell and Andrews and that all other checks except three bore the signatures of de Escamilla, the general partner, and one of the other defendants. The general partner had no power to withdraw money without the signature of one of the limited partners.

Section 2483 of the Civil Code [analogous to ULPA § 7] provides as follows:

> "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."

The foregoing illustrations sufficiently show that Russell and Andrews both took "part in the control of the business." The manner of withdrawing money from the bank accounts is particularly illuminating. The two men had absolute power to withdraw all the partnership funds in the banks without the knowledge or consent of the general partner. Either Russell or Andrews could take control of the business from de Escamilla by refusing to sign checks for bills contracted by him and thus limit his activities in the management of the business. They required him to resign as manager and selected his successor. They were active in dictating the crops to be planted, some of them against the wish of [de] Escamilla. This clearly shows they took part in the control of the business of the partnership and thus became liable as general partners.

Judgment affirmed. . . .

Notes & Questions

1. In *Holzman*, how did the limited partners take part in the control of the business?

2. *Holzman* was decided under the 1916 ULPA. Under RULPA (1976) § 303(a), would the limited partners have been liable? Under RULPA (1985) § 303(a)?

3. Why have the control rule? What function(s) does it serve?