

# **CLASS MATERIALS FOR BUSINESS ORGANIZATION**

**By Andrea L. Johnson  
Professor of Law  
Fall of 2010**

**NOTE TO STUDENTS: THIS SUPPLEMENT CONTAINS MATERIAL WHICH WILL BE DISCUSSED IN CLASS. IT IS A STUDENT AID WHEN USING ROBERT W. HAMILTON'S CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS. THIS IS NOT TO BE USED IN LIEU OF THE READING ASSIGNMENTS NOR IS THE MATERIAL ORGANIZED TO BE USED WITHOUT THE CONTEXT OF CLASS LECTURES.**

**©Andrea L. Johnson 1999, 2009**

## TABLE OF CONTENTS

### PART 1: SELECTING THE BUSINESS ENTITY

#### I. AGENCY & PARTNERSHIP

A. Introduction to Agency & Partnerships	
1. Types of Business Entities	1
2. CONTEXT: AB Software Co.	2
3. Other Types of Business Relationships	3
4. Review of AB Software Store.	4
5. Apparent Authority	5
6. ABA Model Rules of Professional Conduct	6-7
B. Partnership Management and Liability	
1. Partner's Liability of Losses	8
2. Partnership Liability	9
3. Summary of Partnership Liability	10
C. Partner's Rights & Duties	
1. Property Rights in Partnerships	11
2. Tax Terms	12
3. Taxation Rules & Formulas Partnership Accounting	13
4. Instructions for the Dealmaker	14-15
D. Dissolution & Dissociation	
1. Events of Dissolution & Dissociation	16-18
2. Comparing Dissolution and Dissociation	19
3. Review of Agency and Partnership	20-21
4. Issues to Address in Partnership Question	22
5. Agency & Partnership Review Questions	22

#### II. TYPES OF BUSINESS ENTITIES

A. Limited Partnerships	
1. Converting Legal Entities	23
2. Partnerships	24
3. Checklist for Partnerships	25
4. Essential Terms of Partnership Agreements	26
5. Review Question: LLP Liability	27-28
B. Limited Liability Companies	
1. Comparisons between LLPs and LLC	29
2. Characteristics of LLCs	30
3. Limited Liability Companies	31

4. Checklist for a Limited Liability Company	32
5. LLCs Under Model Statutes	33
C. Close Corporations	
1. Necessary Terms of Agreement	34
2. Types of Corporations	35
3. Close Corporations	36
4. Checklist for Corporations	37
5. Essential Terms of a Shareholder Agreement	38
6. Bylaws	39
D. Promoter Liability & Disregarding Corporate Entity	
1. Promoter Liability Rules	40
2. Promoter Rules	41
3. Promoter Question	42
E. Disregard of Corporate Entity	
1. Disregard of Corporate Entity	43
2. Test for Alter Ego	43
<b>III. UNDERSTANDING THE DEAL</b>	
A. Financial Matters of Close Corporation	
1. Basic Terms	44
2. Contributions	45
3. Disposition of Investor's Money	46
4. Comparison of Debt and Equity	47
5. Types of Equity Shares	48
6. Distributions, Preferences, & Preemptive Rights	49
7. Disposition of Shares	50
B. Financing a Business:	
1. Sources of Capital & Types of Commercial Paper	51-52
2. Issues in Getting Financing	53
3. Types of Collateral & Credit Information	54
4. Concept of Leverage	55
5. Exercise: Access to Capital	56-57
C. Tax Matters	
1. Tax Implications	58
2. Tax Hypotheticals	59

D. Management and Control	
1. Ways of Exercising Voting Rights	60
2. Proxy Regulation	61
3. Mandatory Ownership Provisions	62
E. Buy-Sell Agreement	
1. Three Points Re Buy-Sell Agreements	63
2. Buy-Sell Agreements	64-65
3. Exercising Rights of Buy-Sell Agreement	66
F. Selecting the Business Entity	
1. Factors in Selecting a Business Entity	67
2. Charts Comparing Business Entities	68
3. Hypotheticals	71-72
G. Dealmaker Negotiation	
1. AB Software- Ownership Interests	73
2. Computing Valuing Equity Interest	74
3. Provisions to Include in Ownership Agreement	75-76
4. Introduction to Yes	78-80
H. Deadlock and Dissension	
1. Review Shareholder Control of Corporation	81
2. Sale of Shares	82



## PART 1: SELECTING THE BUSINESS ENTITY

### TYPES OF FOR PROFIT LEGAL ENTITIES

Sole Proprietor	One person in business to make money.
General Partnerships	Two or more persons in business to make money. Partners owe a duty of care and loyalty to each other. Agency law applies. Partners are personally liable.
Limited Partnerships	Partnership with general and limited partners. Limited partners have limited liability but have limited control. Must register Certificate of Limited Partnership with the Secretary of State.
Limited Liability Partnerships	Registered partnership for certain licensed professionals in CA, attorneys, accountants, architects. All partners have limited liability for malpractice of others, torts and contracts. Must register Certificate of Limited Partnership with the Secretary of State; and maintain malpractice insurance coverage.
Limited Liability Companies	One or more persons who file articles of organization with the Secretary of State, execute an operating agreement, and pay annual franchise tax. Manager-managed or member-managed. Same duties as partnerships. Elect partnership or corporate taxation.
C Corporation	Default corporation if satisfy minimum requirements, i.e., file articles of incorporation, approve bylaws, hold organization meeting.
Close Corporation	Governed by statute, small closely-held with less than 35 shareholders (CA) of all classes, must state in articles, informal organization, usu. with no board of directors
Professional Corp.	Licensed persons, 1 person ok, informal structure where usu. eliminate board. In California, subject to vicarious liability for malpractice of others.
Public Corporation	Shares publicly traded with more than \$5 million in assets. Must register with SEC and subject to filing and reporting requirements
Subchapter S (not a type of corp. but a tax election)	Election for corporations with up to 100 shareholders with 1 class of stock (classes w/ different voting rights ok) that allow partnership taxation, no foreign residents; Must elect by March 15 in the year want treatment; Termination requires 5 years waiting to reelect.

**CONTEXT: AB Software Store**

A and B are going into the business of selling computer software. A will invest \$100,000 and wants veto power over basic decisions, with no increase in his investment. B will make no cash contributions but will provide sweat equity, by maintaining the store's website on a day-to-day basis. B will receive \$5,000/ mo. in salary. After payment of B's salary and other expenses, profits will be divided equally. If they shake hands and go about starting the business, what type of relationship do they have?

1. What type of business relationship does Andrew and Bob have in this enterprise:

\_\_\_\_\_

2. What major provisions would you include in any agreement to achieve the parties' interests?

A:

B:

3. If C is hired to assist in maintaining the website. Her duties will also include software installation, truck driver, and sales person when B is not present. What type of relationship would she have with A and B? \_\_\_\_\_

Would your answer change if C paid her own taxes and was free to work for other persons?

\_\_\_\_\_

4. If C is given the title of office manager, and then buys 10 Microsoft X Boxes from a visiting representative, what is AB's responsibility?

\_\_\_\_\_

5. If you represent a person with a large claim against AB Software Store, who would you sue and

\_\_\_\_\_

## OTHER TYPES OF BUSINESS RELATIONSHIPS

BUSINESS RELATIONSHIPS THAT ARE BASED UPON AGENCY AND PARTNERSHIP PRINCIPLES:

1. EMPLOYMENT
2. INDEPENDENT CONTRACTOR
3. JOINT VENTURE
4. DEBTOR-CREDITOR

Fiduciary Duty: Agents are a fiduciary of principle and owe certain duties: loyalty to do what the principal wishes for his or her benefit. Restatement §1

This means that the agent may not:

- 1) profit from his or her actions (unless agreed upon, and as a practical matter, the agent usually receives some compensation as an inducement to act, which is the extent of their benefit);
- 2) disclose confidential information or use it for his or her own benefit or the benefit of others (include business records, trade secrets, business plans) during and usually after the agency expires; and
- 3) unless agreed upon, compete with the principal on any matter within the scope of the agency. (This includes use of principal facilities and opportunity.)

## REVIEW OF AB Software Store

1. AB formed a general partnership under which
  - a. Each partner is personally and generally liable for the obligations of the business--Andrew puts up the money, Bob provides the labor, and split the profits 50-50.
  - b. Bob also gets a salary (UPA 7 and 18(e) and (f)) so it is a pretty good deal for Bob.
  - c. Andrew wants veto power over day to day decisions (ULPA 18h). The formalities of a writing and filing are not satisfied so Andrew cannot achieve this, nor can he be limited partner and get limited liability (ULPA 303).
  - d. There is no corporation because the formalities have not been satisfied.
  - e. The ownership interest is reflected by a hand shake. Partnerships don't issue stock. Unless they draft a partnership agreement, there is no assurance that they will not be required to invest more money.

2. PARTNER LIABILITY: EACH AND EVERY PARTNER IN A GENERAL PARTNERSHIP IS AN AGENT FOR THE PARTNERSHIP AND CAN BIND THE PARTNERSHIP UNLESS THEY HAVE NO AUTHORITY AND THAT IS KNOWN TO CONTRACTING PARTY. AUTHORITY IS DEFINED BY KNOWLEDGE OF AND CONSENT BY OTHER PARTNERS. (UPA SECT 9) THE ASSUMPTION FOR APPARENT AUTHORITY IS THAT ACTIONS FALL WITHIN SCOPE OF BUSINESS OF PARTNERSHIP.

3. EMPLOYMENT RELATIONSHIP: LOOK TO THE INTENT AND PUBLIC REPRESENTATION OF THE PARTIES TO DETERMINE WHETHER IT IS A SERVANT/EMPLOYEE OR INDEPENDENT CONTRACTOR RELATIONSHIP; FOCUS ON THE EXTENT OF CONTROL BY THE PERSON PERFORMING THE WORK.

4. LIMITED PARTNERSHIP: LP IS FORMED WHEN FORMALITIES ARE SATISFIED: WRITING AND FILING. LP HAS LIMITED LIABILITY IF HE IS NOT IN CONTROL PER STATUTE--CANNOT EXERCISE CONTROL IN DAY-TO-DAY OPERATIONS .

5. DEBTOR-CREDITOR RELATIONSHIP EXISTS IF CONTRIBUTION IS CONSIDERED A LOAN AND THERE IS AN OBLIGATION BY THE DEBTOR TO REPAY THE LOAN WITH INTEREST--TO CREATE AN ARMS LENGTH TRANSACTION.

6. CORPORATION IS CREATED AFTER ARTICLES OF INCORPORATION ARE FILED AND FORMALITIES SATISFIED; INCORPORATING CREATES A SEPARATE LEGAL ENTITY.

## APPARENT AUTHORITY

Manifestation made by Principal that is directly or indirectly, but reasonably relied upon by third party regarding the nature and/or scope of agent; and such reliance is to their detriment. Third party has the burden to show that the reliance is reasonable.

### Estoppel:

A person will be liable (or can no longer assert title) under estoppel if by action or omission he creates a reasonable reliance on a third party to change their legal position or act to their detriment; if he intentionally or carelessly caused such belief, or knowing of such belief, did not take reasonable steps to notify the party of the facts. (Inaction, unless gross, will rarely constitute grounds for estoppels)

Conduct necessary to charge the Principal is lower than in apparent authority, the 3<sup>rd</sup> party must have some detrimental reliance.

Restatement 8 B (1)

Restatement 3<sup>rd</sup> of Agency 2.03

- Based on 3rd party's reliance on Partner's conduct regarding Agent's authority; Agent can't establish authority with 3rd party
- Partner is an agent of the Partnership unless the Partner has no authority and 3rd party knows it.
- Partner's actions in the ordinary course of business will bind Partnership whether authorized or not.

### UPA

- Sect. 9      If actions are outside ordinary business, Partnership is not bound unless authorized by other Partners
- Sect. 14-    If Partner's actions are within scope of apparent authority where a Partner receives money but misapplies it, the Partnership is bound.
- Sect. 21-    Partners must account to the Partnership for partnership opportunities on any profit received without knowledge or consent of other Partners (Business Opportunity Rule)

**ABA Model Rules of Professional Conduct**  
(Selected Provisions)

**Rule 1.6: Attorney- Client Privilege**

“A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent.”

The exceptions to this rule include: 1) To **prevent** reasonably **certain death or substantial bodily injury**; 2) to **prevent** the client from **committing a crime or fraud** that is reasonably certain to result in **substantial injury to the financial interests or property of another**; 3) to **prevent, mitigate or rectify substantial injury** to the financial interests or property of another caused by committing a crime or fraud; 4) to secure legal advice about the **lawyer's compliance with the Code**, and 5) to **establish a claim or defense** on behalf of the lawyer **involved in a controversy with the client.**

**Rule 1.7: Conflict of Interest**

- (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
- (1) the representation of one client will be directly adverse to another client; or
  - (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
- (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
- (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
  - (2) the representation is not prohibited by law;
  - (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
  - (4) each affected client gives informed consent, confirmed in writing.

### **Rule 1.8 Investment with Current Clients**

- (a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:
- (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
  - (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
  - (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

### **Rule 1.9: Duty to Former Clients**

- (a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.
- (b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client
- (1) whose interests are materially adverse to that person; and
  - (2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter; unless the former client gives informed consent, confirmed in writing.
- (c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:
- (1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or
  - (2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

## **PARTNER'S LIABILITY FOR LOSSES**

- UPA 18                    The rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them, by the following rules:
- a) Each partner shall be repaid his contributions, whether by way of capital or advances to the partnership property...and must contribute towards the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits.
  - b) The partnership must indemnify every partner in respect of payments made and personal liabilities reasonably incurred by him in the ordinary and proper conduct of its business....
  - e) All partners have equal rights in the management and conduct of the partnership business.
  - f) No partner is entitled to remuneration for acting as a partner in the partnership business,....
- UPA 40 (d)                The partners shall contribute... the amount necessary to satisfy the liabilities...but if any of the partners refuse to contribute their share of the liabilities...and the additional amount necessary to pay the liabilities, then the others shall pay.
- RUPA 807 (c)            A partner...may recover from the other partners any contribution the partner makes to the extent the amount contributed exceeds the partner's share of the partnership obligations.
- RUPA 307 (c)            A judgment against a partnership is not by itself a judgment against a partner. A judgment against a partnership may not be satisfied from a partner's assets unless there is also a judgment against the partner.

## **PARTNERSHIP LIABILITY**

URNS ON

1. SCOPE OF AGENT'S/PARTNER'S AUTHORITY
2. PUBLIC DISCLOSURE OF AUTHORITY, AND
3. WHETHER 3RD PARTY KNOWS OF SCOPE OF PARTNER'S AUTHORITY, RATIFIES ACTION, OR ACQUIESCES TO IT.

**SUMMARY OF PARTNERSHIP LIABILITY**

Business		Ptrs or Agent Authority	Other Factors	Liability**
w/in scope	+	authorized		= Pship liable
w/in scope	+	unauthorized		= Pship liable
w/in scope	+	unauthorized +	3rd party knows	= Pship not liable*
w/in scope	+	unauth. +	3rd party knows + Ptrs ratify	= Pship liab.
outside scope	+	authorized		= Pship liable
outside scope	+	unauthorized		= Pship not liable*
outside scope	+	unauthorized +	3rd party knows + Ptrs ratify	= Pship liab

Notes:

\* If partnership, by actions, inaction, conduct or words, accepts the benefit of the transaction, then ratification may be presumed and partnership will be held liable. Liability would be based upon Restatement Agency 141, estoppel, restitution or negotiability.

\*\*In every instance where the partnership is liable, in the absence of agreement, individual partners are jointly and severally liable also. UPA 15

Where actions are unauthorized but the partnership is nevertheless liable, the principal or partners may recover through indemnification from the agent or partner who has acted without authority.

## **Property Rights in Partnership**

Property acquired by a partnership is property of the partnership, not the individual partners. RUPA 203, 501 Partner's interest is his share of the profits and surplus, and is considered personal property. The only right that is transferable is the right to the partner's share of profits and losses and to receive distributions.

Partners' rights: RUPA 401

- 1) To possess property for partnership purposes;
- 2) To participate in the management of the business, which right is not transferable (RUPA 502);
- 3) To a pro rata share of profits, which is personal property; and
- 4) To assign partner's interest to another, however, only right assigned is the right to profits received.
  - Assignee can't participate in the management of the business without the consent of the other partners.

## TAX TERMS

- 1) Basis: cost or purchase price of an asset
- 2) Adjusted basis= basis + improvements - deductions on earnings from the property
- 3) Amount realized= Cash received-adjusted basis upon sale or disposition; what is taxable as gain or profit
- 4) Gain= profit or loss (adjusted basis is greater than amount realized)
- 5) Stepped up basis= fmV of property at the death of a person that becomes the basis of the beneficiary
- 6) Capital asset: asset held for more than 1 year, depending upon income, the maximum tax is 15%
- 7) Short term gain: taxed as ordinary income
- 8) Offset: Deduct capital losses from capital gains; and ordinary losses (expenses) from ordinary income. Cap on offset but can carry forward to future years
- 9) Marginal rate is the percentage of tax that is applied at different levels of income
- 10) Effective rate is actual tax by taking appropriate base and then applying marginal rate above the base amount.

## **TAXATION RULES**

Partnership taxation:

- Partners taxed on pro rata share of earnings (profits);
- Partnership does not pay separate tax;
- Allocate according to Partnership agreement re percent of interest; not what actually distributed.

Individual taxation:

- Taxed on income less allowable deductions;
- Based upon Marginal rate or formula in chart.

Corporations are subject to double tax: taxed as an entity, and then distributions are taxed to the individual investor. Salaries and bonuses are only taxed once, because the corporation can take a deduction as a expense for the salary.

## **FORMULAS FOR PARTNERSHIP ACCOUNTING**

1) EQUITY = ASSETS - LIABILITIES

--EQUITY REFLECTS A PARTNER'S OWNERSHIP INTEREST OR NET WORTH IN THE ENTITY

2) ASSETS = LIABILITIES + EQUITY

--BALANCE SHEET SHOWS THE FINANCIAL CONDITION AS OF A CERTAIN DATE AND INCLUDES LONG TERM DEBT AND EQUITY

3) PROFIT/INCOME = REVENUE - EXPENSES

--PROFIT AND LOSS STATEMENT SHOWS THE FINANCIAL CONDITION OVER A PERIOD OF TIME

4) CAPITAL ACCOUNT= AMOUNT CONTRIBUTED - DISTRIBUTIONS + PRO RATA SHARE OF PROFITS - PRO RATA SHARE OF LOSSES

## **INSTRUCTIONS FOR USING THE DEALMAKER PROGRAM**

### **Note: Read carefully before starting the program**

1. GETTING STARTED: Each person should be assigned a password to access the Dealmaker program, located at [www.cyberworkbooks.com](http://www.cyberworkbooks.com) . Click on Subscriber to access the log-in page of the program. There is also a link from the Business Organizations website. You should access the site, log in and begin going through the various lessons within each part. If you do not have a password, contact Professor Johnson. You need to have on your computer Window 98 or higher, Internet Explorer 6.0, or Netscape 4.0. If you use Opera browser, you need to disable your Cache. See instructions in troubleshooting for instructions.

2. GOING THROUGH THE LESSONS AND QUESTIONS: It will take about 6-8 hours to go through the program. You will have about 5 weeks to complete the program. You will go through a series of lessons within each part, followed by multiple choice and short answer questions. **You will have to answer the questions following each lesson in succession beginning with Part 1, Lesson 1**, although you may skip between the lessons at will. You can take your time going through the lessons, can refer back to the lessons, and can exit and resume the lessons.

You should go through the lessons and answer the questions, individually. You will be asked to acknowledge that violation of the instructions will result in an honor code at the beginning of the program. You should insert your responses to short answer questions in the window provided in the program. There may be short answer questions that follow each set of multiple choice questions. Short answer questions are not timed or graded. You should answer short answer questions individually. **Answers should be created in MS Word and then cut and pasted into the answer box provided. Keep a copy of your responses for your records.** The program will automatically send you feedback on your answers, so make sure you identify your name in the box provided before submitting your answer.

**NOTE: Do not answer the questions in a group or share your answers with anyone. Violation of this provision will result in a reduction in grade and may result in disciplinary action being taken.**

The questions are graded and points are given for answering the questions within the time allotted. Your responses will be recorded and graded. You can exit and resume the program after completing a set of questions following each lesson. However, you should plan to go through the set of questions in one sitting. The number of questions will be listed at the end of the lesson.

The program includes company profiles for each type of business in text form, video client interviews, a series of lessons on the substantive points of business law that we have addressed in class, questions and answers to test your comprehension,

and small group discussion questions.

3. GOAL: Your goal is to go through the lessons and answer the questions correctly in the fewest tries possible. You are generally given more than enough time to respond. The time points are much less than the points for the right answer so don't be overly concerned about the timing function. You will be graded on selecting the correct answer within the fewest number of tries and within the time allotted.

4. TECHNICAL ISSUES: The program uses text, graphics, audio and video so optimally, you should use a computer with a sound card. Transcripts of the videotapes are provided. There are minimum technical requirements to access the program: IBM-compatible, Windows 1998 or better, and Internet Explorer 6.0 or Netscape 4.0 **The computers in the lab have been set up so absent network problems, you should be able to access from the Computer Lab at 290.** The computers in the basement of 350 do not have adequate memory to view video clips so you may to avoid using them. There is a Cyber Workbooks Troubleshooting file posted on the class website that will help you initially if you run into any problems.

Please report any technical problems to Professor Johnson by email. While the program has been tested, it as recently been upgraded so there may be some minor bugs in the system. We appreciate your patience and will work to respond promptly. **Avoid making a copy of each screen as that uses up a lot of memory and may cause you to encounter errors such as blank screens.** If you experience any technical problems, such as being kicked out of the system, or the program not accepting your answers or giving you feedback, do the following:

a) Check the Website Tips on Troubleshooting to see if there is solution to the problem you are having with the program.

b) If that does not work, make a copy of the computer screen error message by clicking on PrintScr (usually in the upper right hand corner of the keyboard), and then paste in a MS Word document, and send via email to [alj@cwsl.edu](mailto:alj@cwsl.edu). In the message section, you will need to provide the **type of computer** such as IBM, **operating system** such as Windows 98, or 2000; the **version of the browser** that you are using, such as Internet Explorer 6.0. and a screen shot of the error message (see above). There is an evaluation form at the end that you should complete. The feedback is appreciated.

5. CONTACT: For a User name and password, technical problems contact Professor Johnson at <[alj@cwsl.edu](mailto:alj@cwsl.edu)> or the technical support person identified during class. ***Thank you for participating in this new way of learning.***

## **EVENTS OF DISSOLUTION**

### VOLUNTARY DISSOLUTION: UPA 31

- 1) Death, bankruptcy, disability
- 2) Unanimous consent
- 3) Retirement of a partner
- 4) Termination of term, or express will of any partner
- 5) Event that makes business unlawful

OR

### DISSOCIATION: RUPA 601

- 1) Event agreed upon in the partnership agreement
- 2) Partner's expulsion under some conditions
- 3) Partner's intent to withdraw
- 4) Death, bankruptcy, disability

## INVOLUNTARY DISSOLUTION BY COURT: UPA 32

- 1) Partner is incompetent or unable to perform part of the contract
- 2) Partner acts prejudicial to carrying on business
- 3) Breach of partnership agreement
- 4) Business is operating at a loss
- 5) Where equity warrants
- 6) Willful breach of the partnership agreement

## PARTNER'S TRANSFERABLE INTEREST SUBJECT TO CHARGING ORDER : RUPA 504

1) A creditor has the right to obtain a judgment against a partner and the court may charge the transferable interest of the judgment debtor to satisfy the judgment.

2) A charging order constitutes a "lien" on the partner's interest and may be redeemed before foreclosure by the judgment creditor, with other than partnership property by other partners, or with partnership property if the other partners agree.

### EFFECT OF DISSOLUTION: (UPA33)

- 1) Terminates all authority of partners
- 2) Right of contribution by other partners for debts
- 3) Partners can bind partnership during the winding up of the business and remain liable for debts
- 4) Innocent partners can seek indemnity from partners acting improperly

### EFFECT OF DISSOCIATION (RUPA 603)

- 1) Terminates withdrawing partner's right to participate in management
- 2) Terminates withdrawing partner's duty of loyalty (except on preexisting matters)
- 3) Remaining partners continue

## Comparing Dissolution and Dissociation

Term	UPA-Dissolution	RUPA-Dissociation
Events of dissolution/dissociation	<ul style="list-style-type: none"> <li>-Completion of term</li> <li>-Liquidation of property</li> <li>-W/drawal or expulsion of Ptr</li> <li>-Per K</li> <li>-Change in relation of Ptrs</li> </ul>	<ul style="list-style-type: none"> <li>-Per K to continue</li> <li>-End of term</li> <li>-Event leading to winding up→dissolve</li> <li>-At will, w/draw→dissolve</li> </ul>
Wrongful dissolution/dissociation	<ul style="list-style-type: none"> <li>-Dissolve before term</li> <li>- Breach of Pship K</li> <li>-Illegal action</li> </ul>	<ul style="list-style-type: none"> <li>- Dissociate before term</li> <li>- Breach of Pship K</li> <li>-Expulsion, bankrupt</li> <li>-Express will</li> </ul>
Effect of wrongful dissolution/dissociation	<ul style="list-style-type: none"> <li>-Get Ptr interest, but no goodwill less damages caused by dissolution</li> <li>-Must be released from liability</li> </ul>	<ul style="list-style-type: none"> <li>-Liable for damages</li> <li>-Can waive right to dissolve</li> <li>-Can't waive rt. to dissociate w/o notice</li> <li>-Return Ptr. interest (buyout is liquidation price) less damages, plus indemnify vs liabilities at end of term</li> </ul>
Right to dissolve (38)	<ul style="list-style-type: none"> <li>-Any partner per Pship</li> <li>-Innocent Ptr</li> </ul>	
Right to wind up	<ul style="list-style-type: none"> <li>-If cause unlawful dissolution</li> </ul>	
Right to continue	<ul style="list-style-type: none"> <li>-Innocent Ptr</li> <li>-For balance of term if wrongful</li> <li>-Ok from other partners or by Pship K</li> </ul>	<ul style="list-style-type: none"> <li>- Ok from other partners</li> <li>-Only for winding up</li> </ul>

## **REVIEW OF AGENCY AND PARTNERSHIP**

### 1. HOW IS IT CREATED

### 2. MAJOR TERMS

- 1) term,
- 2) division of profits and losses,
- 3) management division,
- 4) compensation for businesses,
- 5) valuation and treatment of contribution,
- 6) events of dissolution, and
- 7) preferences in distribution.

### 3. NATURE AND SCOPE OF AUTHORITY

a. GENERAL RULE: A partner is an agent of the partnership and acts are binding on the partnership unless the partner has no authority, the 3rd party knows it, and there has been no ratification; absent fraud, notice to 1 partner constitutes notice to partnership.

### 4. EXTENT OF LIABILITY: RUPA 306:

1. A partner is jointly and severally liable for acts binding partnership and obligations and debts, but a partner may enter into a separate contract for performance.
2. A partner is liable if he represents self as a partner to 3rd party and reliance (even if not actual partner).
3. New partners are liable for preexisting debts except that liability is satisfied only out of partnership property (new partners are not personally liable).
4. In a LLP, an obligation of a partnership, whether arising in contract, or tort, is solely the obligation of the partnership.

## 5. PROPERTY RIGHTS

1. Partners have no property rights in partnership property
2. Rights to share equally in profits and losses
3. Right to participate in operation of business
  
4. Assignees of partner's interest have no right to participate in management--only entitled to partnership profits.

## 6. TERM:

1. A partnership exists for a stated period and can be dissolved voluntarily per U.P.A. Sect. 31 (express will of partner when no term, unlawful activity, death, bankruptcy or by decree of court per Sect.32) or may be continued following a dissociation
2. A partnership is given a reasonable time to wind up affairs
3. Distribution of payments in winding up. (U.P.A. Sect. 40)
  - a. Creditors
  - b. Partners' loans plus interest
  - c. Capital contribution
  - d. Partners' profits

## **Issues to Address in Partnership Question**

- 1) Is the partnership agreement oral or written?
  - General partnership vs Limited partnership
- 2) Is action within scope of the partnership business?
- 3) Did the partner act with express or apparent authority?
  - Consent, knowledge of other partners
  - Fiduciary duty or partnership opportunity
- 4) Basis for withdrawal
  - Malfeasance by the partners
  - Agreement or operation of law
- 5) Entitlement of partners for contributions, profits and losses.

### **Agency & Partnership Review Questions:**

- 1) Palmer had a dealership to sell farm machinery. Hired Adams to organize and operate business. Authorized to collect for goods sold, and hire and manage employees, but was forbidden from borrowing any money on Palmer's credit. Bank account set up in Palmer's name but agent could draw upon it. On occasion the account was overdraft, but Palmer had no knowledge or notice. Adams made deposits to cover the overdrafts. Adams was fired and Palmer became aware of the overdrafts. Account was overdrawn by \$2000. Bank brings an action to collect the overdraft. Will the bank recover?
- 2) Merchant sells used stereos as part of ordinary course of business. Buyer buys a stereo and pays the purchase price, and takes delivery. Merchant later learns that the stereo was not his to sell. It was acquired through a) theft; or b) left for repair and unclaimed? Q: Did merchant have authority to transfer ownership?
  - b) Would your answer change if Owner left the stereo with Merchant to be repaired?
  - c) Under what theory of authority would liability attach?
- 3) Alice, Paula and Brenda are partners in a firm for APB Farms in which they agreed to devote full time to business under a Partnership. Connie has a \$100K judgment against Paula individually, and the only asset she has is her interest in APB Farms. To enforce the judgment against Paula, Connie sends the sheriff out to execute on Connie's share of APB's real estate, equipment and cattle. The parties sued Connie and sheriff, seeking a temporary and permanent injunctions against their interference with partnership property. What is the result?

## CONVERTING LEGAL ENTITIES

Most attorneys usu. are confronted with a change in the entity from one type to another:

GP TO LP (for limited liability);

LP with individual GP (disparate liability and control);

LP with corp. GP (limited liability and greater control);

LP to LLP (limited liability for malpractice and liability of other partners);

LLC (member managed-gives limited liability with equal management, and partnership or corporation taxation); or

LLC (manager managed-limited liability and management with partnership or corporate tax);

Corp to Subchapter S for pass-through tax treatment, informal, more formality;

LLP to PC for 1 person in profession

## PARTNERSHIPS

ADVANTAGES	DISADVANTAGES
+ Less formalities and cost than other entities.	- Interests are not freely transferable, assignees only have the right to receive income.
+ Partners earn money according to the profits and losses.	- Death, withdrawal, or bankruptcy terminate the partnership so they do not have perpetual existence.
+ There is no need to qualify to do business in a given state.	- Lines of authority can become hazy and it is more difficult to get rid of a bad partner.
+ Partners can share disproportionately in the profits and losses of the business.	- General partners are personally liable for partnership obligations, although it is possible to create a corporate general partner which will insulate the partners from personal liability.
+ In many states, no consideration is required to be a partner.	There must be at least two persons to form a partnership.

## **CHECKLIST FOR PARTNERSHIPS**

- 1) EXECUTE A PARTNERSHIP AGREEMENT AND FILE FOR A CERTIFICATE OF PARTNERSHIP.
- 2) FILE FOR STATE AND FEDERAL TAX IDENTIFICATION NUMBERS.
- 3) EXECUTE NECESSARY AGREEMENTS WITH VENDORS, SUPPLIERS, CUSTOMERS.
- 4) FILE STATE AND FEDERAL PARTNERSHIP OR FRANCHISE TAX.
- 5) FILE QUARTERLY EMPLOYEE RETURNS, WORKMEN'S COMPENSATION, WITHHOLDING, ETC.

## **ESSENTIAL TERMS OF PARTNERSHIP AGREEMENT**

(See Appendix 2--UPA)

1. Names of parties
2. Effective Date
3. Name of Partnership (names of partners or fictitious)
4. Purpose of Partnership: business-make it general so have some flexibility
5. Place of business: location
6. Term: fixed or by action of partners (Sect 31)
7. Capital contributions (cash, property, past services)
  - assign a value to property and service (fmv)
  - obligations for future contributions
  - Ps have property rights in Pship property
8. Accounting: Types of accounts: capital accounts for each partner; escrow optional, business account
  - rights of partners to withdraw from account
  - fiscal year-calendar-
  - accounting on accrual or cash basis
9. Distribution of profits and losses
  - timing of distribution: after reimburse % of contribution and expenses
10. Compensation: salaries
  - P cannot be paid for P but can for services rendered
11. Liability or indemnification of partners
12. Inventory of Partnership property
13. Management of business
  - day to day operations
  - matter requiring unanimous vote
14. Events of dissolution: death, incapacity, insolvency
  - winding up affairs
  - right to continue and liability
15. Preferences in distribution (Sect 40)
  - creditors, loans plus interest, capital contribution, profits
16. Boilerplate: Notices, entire agreement, severability clause, choice of law binding effect, modification and amendment, construction of agreement (headings), signature, date

## **REVIEW QUESTION: LLP LIABILITY**

In January of 2007, three attorneys, Adrian, Billy, and Charlie execute a written agreement to open a law practice and call themselves ABC Law Firm. They each promise to contribute \$10,000 for start-up expenses and share equally in the profits and losses of the company. They want to remain independent of each other and include the following provisions in the agreement: 1) eliminate the duties of loyalty, care and good faith to each other; 2) they will operate for one year and then convert to a LLP; 3) they will hire contract attorneys for which they will not be personally liable; and 4) they will not be personally liable for any losses resulting from any errors or omissions of the other. Only Adrian and Billy pay their \$10,000 contribution.

The attorneys hire Ethel to be the office manager and oversee the administrative functions. She has check writing authority for up to \$2,000, without the approval of a majority of the lawyers; and submits monthly reports of her activities to the attorneys. She is paid \$3,000 a month, from which the partners deduct her taxes, and she receives medical benefits.

Over the course of the next year, Ethel executes a one year lease for office space at a lease rate of \$12,000 a year, and signs the lease, "ABC, by Ethel, office manager." She gives them a check for \$1,500 representing the first month's rent and security deposit. Lessor calls and speaks to Adrian, who confirms that the law firm wants to lease the space. Billy and Charlie are unaware of the lease terms, but set up their office in the space provided and begin practicing.

Ethel also buys some second hand office furniture for \$1,500 through a third party referred to her by Adrian, who fails to tell Ethel that she owns the furniture and it is only worth \$1,000. Through the collective acts of the lawyers, the firm is doing well and at the end of the second quarter, the lawyers have earned net \$15,000 in income, but do not make any distributions.

On August 1, 2007, Charlie decides that he wants to be a sole practitioner and gives ABC written notice of his intent to withdraw from the firm effective August 31, 2007 and demands that the firm pay him his interest and any monies to which he is entitled. Adrian and Billy refuse. Charlie gathers up his stuff and vacates the office space and then sues ABC, Adrian and Billy for breach of their agreement, seeking damages and his interest.

On January 2, 2008 Adrian and Billy register the firm as AB LLP with the Secretary of State in California and continue to do business under the same terms as originally agreed upon. Adrian acts as the general partner to handle administrative affairs and Billy will oversee client relations. Billy hires Associate to help manage the workload. Working under Billy, Associate forgets to file a complaint on behalf of Client for a personal injury matter, causing the statute of limitations to run out, which

precludes Client from filing an action. Client sues ABC, AB LLP, Adrian, Billy, Associate and Charlie for negligence and malpractice.

### Discussion Questions

- 1) Is the initial agreement between Adrian, Billy and Charlie regarding their rights and obligations valid and enforceable; and, what is the effect of their agreement? Explain your answer fully.
- 2) Under what theories would ABC, Adrian, Billy and/or Charlie be liable for Ethel's actions regarding the lease and purchase of office equipment? Discuss your answer fully.
- 3) Is Charlie's withdrawal effective, and what, if anything, would he be entitled to recover from ABC, Adrian, and/or Billy? Explain your answer fully
- 4) Can Client recover from AB LLP, Adrian, Billy, Associate and/or Charlie for negligence; and if so, on what basis? Explain your answer fully.

## COMPARISONS BETWEEN LLPS AND LLCs

<b>VARIABLES</b>	<b>LIMITED LIABILITY PARTNERSHIPS</b>	<b>LIMITED LIABILITY COMPANIES</b>
ELIGIBILITY (CALIF)	Available only to licensed professional, i.e., attorneys, accountants, and architects	Not available to licensed businesses, e.g. lawyers, accountants
MANAGEMENT	General partnership with some limited liability to partners	Flexible, central or single level member
LIABILITY	Partners are not liable for malpractice of partners; still liable for agents' negligence	Limited liability generally
EXISTENCE	Term	Perpetual or term
TRANSFER OF INTERESTS	Successors have no right to manage, limited to economic rights	Transfer freely but limited to economic rights.
DISSOLUTION	Upon death, resignation, expulsion or bankruptcy unless all or majority elect to continue	Upon death, resignation, expulsion or bankruptcy unless all or majority elect continuation
FORMALITIES	-- File Certificate with Secretary of State w/ applicable fee; -- Register with licensing body annually	--File Articles of Organization and pay the applicable fee; -- Get a registered agent -- Suggest to execute an operational agreement
TAXATION	--One level of taxation -- Pass-through profits and losses.	Profits and losses pass through; May elect corporate tax
DUTY OF CARE	General partnership fiduciary duty	Loyalty and care
COMPENSATION	Flexible but cannot be unreasonable	Flexible (salary plus share)

## **CHARACTERISTICS OF LIMITED LIABILITY COMPANIES**

Characteristics:

### **Eligibility for Membership**

1. In Calif. not available to most professionals, e.g. attorneys; except brokers and insurance agents
2. Considered a separate legal entity
3. Members are not personally liable for co. obligations, except to extent guarantee, or agree. Must file Articles of Organization.
4. In California, new members require consent of majority of members (not all as in Pship or ULLCA)
5. Interests are assignable w/o dissolving the entity, but rights are limited to economic rights, i.e., profits, losses, distribution

### **Contributions**

1. Can include money, promissory notes, services performed, agreements to contribute or contracts for services to be performed
2. Contributions to LLC are tax-free (assuming convert from P-ship)
3. Non cash contributions keep the same basis
4. Interests given to those who render past services are taxable as ordinary income
5. If sell interest at a loss, then it may qualify for capital loss
6. Share of profits and losses is per agreement, or in absence according to contributions
7. Cannot make distributions if it would result in the LLC being unable to cover debts in the ordinary course of business.
8. Cannot retain earnings w/o still being subject to taxation

### **Management**

1. Equal participation in management by members, unless provide for manager managed. Each member can bind LLC in member-managed
2. Managers need not be members
3. Change in management from member to manager managed requires amending articles of organization
4. Managers owe same fiduciary duty of care and loyalty to LLC and other members
5. Except as set forth in agreement, all members must agree to conversion to LLC.

### **Requirements**

1. File articles of organization, but operating agreement can be oral or written (preferably written)
2. Minimum franchise tax imposed of \$800 annually (same for LP and corp)
3. Additional fee for LLC's with income of \$250,000 or more

## LIMITED LIABILITY COMPANIES

### **ADVANTAGES**

No member is personally liable for debts, liabilities and LLC obligations.

Flexibility in allocating responsibilities and accommodating diverse interests.

Can have unlimited number of members.

Elect treatment as a partnership or corporation for tax purposes .

Can have a single layer of taxation.

No formalities after initial set up.

No waiting time to switch tax election from partnership treatment to corporation, but must remain a corporation for 60 months.

More flexibility in accommodating members' interests, e.g. passive investors and active investors.

Can have multiple classes of ownership.

### **DISADVANTAGES**

More complexity in formalities and structure than a partnership.

State statutes exclude professionals, e.g., attorneys and accountants in CA

State must authorize by filing articles of organization.

Minimum state franchise taxes, and corporate rates may be lower.

Most states have default provisions regarding corporate or partnership treatment.

In some states, may dissolve upon death, resignation, withdrawal, and bankruptcy unless members agree to continue.

Not appropriate for large, public companies.

Assignment of interests confers an economic interest without the right to participate in the management.

Some states, e.g. California, impose minimum tax.

## **CHECKLIST FOR A LIMITED LIABILITY COMPANY**

- DRAFT AN OPERATIONAL AGREEMENT.
- FILE ARTICLES OF ORGANIZATION WITH STATE AGENCY.
- TRANSFER BUSINESS INSURANCE, MEMBERSHIPS, LOANS, MORTGAGES, TITLE TO REAL AND PERSONAL PROPERTY AND OTHER CONTRACTUAL OBLIGATIONS AS NEEDED.
- FILE FOR STATE AND FEDERAL TAX IDENTIFICATION NUMBER.
- EXECUTE NECESSARY AGREEMENTS.
- CHANGE LETTERHEAD.
- SET UP BANK ACCOUNTS, ACCOUNTING SYSTEM.
- FILE STATE AND FEDERAL TAX RETURNS.
- FILE QUARTERLY EMPLOYEE TAX RETURNS.

### LLCs UNDER MODEL STATUTES

Term	ULLCA	RULPA-Dissociation
Events of dissolution/dissociation	<ul style="list-style-type: none"> <li>-Completion of term</li> <li>-At-will, at any time</li> <li>-Per K</li> <li>-no individual rt to dissolve unless per K</li> <li>-mgr upon written notice</li> </ul>	<ul style="list-style-type: none"> <li>-GP can w/draw at any time</li> <li>-By K</li> <li>-At will, w/draw→dissolve if no GP or continue by K</li> <li>-LP can w/draw by K or 6 mo. notice</li> </ul>
Wrongful dissolution/dissociation	<ul style="list-style-type: none"> <li>-Dissolve before term</li> <li>- Breach of Operating K</li> <li>-Illegal action</li> </ul>	
Effect of wrongful dissolution/dissociation	<ul style="list-style-type: none"> <li>-Get fair value, but no goodwill and liable for damages</li> <li>-Other members can continue</li> <li>-term co, then get liquidated value</li> <li>-Can't wind up</li> </ul>	
Right to dissolve (38)	-Agreement among parties	
Right to wind up	-innocent members	
Right to continue	-innocent members	-Ok from other partners

**NECESSARY TERMS OF AGREEMENT TO TRANSFER  
ASSETS TO A CORPORATION**

- 1) DATE OF DISSOLUTION OF PARTNERSHIP OR LLC
- 2) INTENT TO ORGANIZE AS A CORPORATION UNDER THE LAWS OF STATE \_\_\_\_\_
- 3) AMOUNT OF STOCK TO BE ISSUED AND CAPITALIZATION OF THE CORPORATION (VALUATION OF CONTRIBUTIONS)
- 4) PAR OR NO-PAR VALUE OF STOCK
- 5) TAX-FREE EXCHANGE OF ASSETS FOR STOCK
- 6) TRANSFER OF ASSETS AND/OR LIABILITIES
- 7) NOTIFICATION OF VENDORS AND CREDITORS

## TYPES OF CORPORATIONS

C Corporation	Default corporation if satisfy minimum requirements, i.e., file articles of incorporation, approve bylaws, hold organization meeting.
Close Corporation	Governed by statute, small closely-held with less than 35 shareholders (CA) of all classes, must state in articles, informal organization, usu. with no board of directors
Professional Corp.	Licensed persons, 1 person ok, informal structure where usu. eliminate board.
Public Corporation	Shares publicly traded with more than \$5 million in assets. Must register with SEC and subject to filing and reporting requirements
Subchapter S (not a type of corp. but a tax election)	Election for corporations with up to 100 shareholders with 1 class of stock (classes w/ different voting rights ok) that allow partnership taxation, no foreign residents; Must elect by March 15 in the year want treatment; Termination requires 5 years waiting to reelect.

## **CLOSE CORPORATIONS**

### **ADVANTAGES**

Limited liability of shareholders for business debts.

Perpetual existence.

Shares are freely transferable.

Easier to raise money by selling shares.

More flexibility in tailoring ownership interests to special needs of the investors.

May be taxed as a partnership with limited liability through Sub S election.

Employee fringe benefits (insurance, sick pay, retirement) are more readily deductible.

### **DISADVANTAGES**

May be subject to double taxation.

More formalities and cost, i.e., filing articles, drafting by-laws, and payment of fees.

Must maintain accurate records and make periodic filings.

Harder to dissolve.

More layers of centralized management.

Higher taxes on business income from \$100,500 and \$335,000.

Maximum tax rate on corporate long term capital gain (35%) is higher than for individual long term capital gain (20%)

## **CHECKLIST FOR CORPORATIONS**

- PRE-INCORPORATION AGREEMENTS TRANSFERRING ASSETS AND LIABILITIES TO THE CORPORATION.
- DRAFT AND FILE ARTICLES OF INCORPORATION AND RESERVE CORPORATE NAME WITH SECRETARY OF STATE.
- ORDER CORPORATE SEAL.
- HOLD ORGANIZATIONAL MEETING TO ELECT OFFICERS, ADOPT BYLAWS AND STOCK CERTIFICATES, AUTHORIZE SHARES, RATIFY PAYMENT OF EXPENSES AND PROFESSIONAL SERVICES.
- TRANSFER TO THE CORPORATION BUSINESS INSURANCE, MEMBERSHIPS, LOANS, MORTGAGES, TITLE TO REAL AND PERSONAL PROPERTY AND OTHER CONTRACTUAL OBLIGATIONS AS NEEDED.
- FILE FOR STATE AND FEDERAL TAX IDENTIFICATION NUMBER.
- EXECUTE NECESSARY AGREEMENTS.
- CHANGE LETTERHEAD.
- SET UP CORPORATE BOOKS, BANK ACCOUNTS, ACCOUNTING SYSTEM.
- HOLD ANNUAL MEETINGS.
- FILE ANNUAL REPORTS WITH SECRETARY OF STATE.
- UPDATE MINUTES TO REFLECT MAJOR DECISIONS OF THE CORPORATION.
- FILE STATE AND FEDERAL CORPORATE TAX RETURNS.
- FILE QUARTERLY EMPLOYEE TAX RETURNS.
- FILE SUBCHAPTER S ELECTION, IF APPROPRIATE.

## **ESSENTIAL TERMS FOR SHAREHOLDER AGREEMENT**

- \* 1. Name of the parties
- \* 2. Corporate name and purposes of the corporation generally and specifically
- \* 3. Number of shares authorized to be issued, number of classes, the designation of each class, the number of shares in each class, and whether the shares are for Par vs. No Par
- \* 4. Capital contributions, allocation of shares, the nature of the contribution received and by whom, for what interest, and value assigned to the interest, distribution of profits and losses, and if it will be a Sect 351 tax-free exchange of stock for assets
- \* 5. Qualifications, preferences, limitations, restrictions and special rights related to each class of shares, e.g., cumulative voting, minimum participation by minority shareholder
- 6. Amount of the initial capitalization (e.g., \$1,000)
- \* 7. Restrictions on the rights of shareholders to purchase additional shares or the rights of the corporation to redeem, repurchase, exercise a right of first refusal or option to reacquire shares. If there is no provision regarding then so state.
- 8. State the provisions regarding the internal management of the corporation
- \* 9. Who will be the initial directors, any restrictions on electing directors, limiting liability
- 10. Who will be the registered agent and provide address
- \* 11. Name of incorporators and any agreement regarding authority of promoters to act or bind corporation.
- \* 12. Liability for interested transactions of shareholders, officers, or directors, e.g. self-dealing;
- 13. Qualifications of directors or officers
- 14. Conduct of meetings and notice requirements, e.g., quorum, what is required to pass an action.
- \* 15. Procedures for approval or ratification of actions by directors and shareholders
- 16. Compensation and benefits of directors and officers
- 17. Inventory of property
- 18. Accounting
- 19. Boilerplate
- 20. Effective date

\*Critical terms that need to be addressed in light of client(s) interests

## **BYLAWS**

- \* 1. PRINCIPAL OFFICE
- \* 2. SHAREHOLDER RIGHTS AND DUTIES
  - a. Meetings of shareholders: regular meetings, proxy, emergency action, notice, place, record date
  - b. Quorum-min. number of people to conduct meeting; usu. from a majority of outstanding shares to up to 2/3
  - c. How shareholders can vote shares: cumulatively (allows each shareholder to determine the aggregate # of votes needed to elect a director or straight (majority shareholders elect directors--one vote per share)
  - d. Informal actions by shareholders
- \* 3. BOARD OF DIRECTORS RIGHTS AND DUTIES
  - a. Powers of Board
  - b. Number, length of term, qualifications of members
  - c. Regular and special meetings
  - d. How fill vacancies, disqualification
  - e. How issues will be voted (committee)
  - f. Compensation, if any
- \* 4. OFFICERS
  - a. Number, election and term
  - b. Removal
  - c. Powers and duties
  - d. Salaries
- \* 5. COMMITTEES
- 6. Transaction of business
- 7. Bank accounts and location of records of corp.
- 8. Fiscal year for accounting purposes
- \* 9. DIVIDENDS-DISTRIBUTION AND ENTITLEMENTS
- 10. Amendments
- 11. Corporate seal
- 12. Waiver of notice

\*Critical terms that need to be carefully thought through

## **PROMOTER LIABILITY RULES**

RULE: PROMOTERS ARE PERSONALLY LIABLE ON A CONTRACT UNLESS THE OTHER PARTY AGREES TO LOOK TO SOMEONE ELSE. CORPORATION CANNOT RATIFY ACTION AFTER THE FACT SINCE IT DID NOT EXIST AT THE TIME THE CONTRACT WAS ENTERED INTO.

RESTATEMENT ON AGENCY SECTION 326 PROVIDES FOUR OPTIONS:

- 1) PRESENT CONTRACT WHERE THE CORPORATION BECOMES LIABLE AND PROMOTER REMAINS LIABLE AS THE SURETY OR GUARANTOR.

Effect: Promoter is personally liable on the contract and is not relieved after or if corporation is formed and adopts the contract (guarantor or surety)

- 2) BINDING PRESENT CONTRACT WITH THE PROMOTER WITH THE AGREEMENT THAT PROMOTERS LIABILITY WILL BE TERMINATED AFTER CORPORATION IS FORMED AND A NOVATION TAKES PLACE. A NOVATION IS A SUBSTITUTION OF PARTIES.

Effect: Promoter is personally liable on the contract until the corporation is formed and a novation, i.e. substitution occurs. (can't ratify)

- 3) REVOCABLE OFFER TO A NONEXISTENT CORPORATE AND WILL BE A CONTRACT IF THE CORPORATION IS FORMED AND ACCEPTS CONTRACT.

Effect: Not personally liable but view transaction as a revocable offer that is binding only after corporation is formed and adopts the contract

- 4) IRREVOCABLE OFFER FOR A LIMITED TIME WITH THE CONSIDERATION AS A PROMISE TO FORM A CORPORATION IF CORPORATION IS FORMED THEN BINDING CONTRACT.

Effect: Not personally liable on the contract but irrevocable offer with promise to form the corporation. (Liable if fail to take steps to incorporation but not liable on the contract.)

## **Promoter Rules**

- 1) Promoters must make full disclosure of the consideration paid for stock if they become shareholders in the new corporation. (Frick)
- 2) If a 3rd party agrees to look to the corporation to be formed for payment and not the promoter, the promoter is not liable. Look to 3rd party's action. (Quaker)
- 3) Shareholders can adopt the contract made by promoter by acquiescence if they know of the contract and fail to object.

MacArthur - Contract is effective on date of adoption, not original date before incorporation.

## **Promoter Question**

- 1) Does exchange between promoter & 3rd party constitute a binding contract or an offer?

Factors:

- Expressions by the parties,
- Manner of signing, and
- Actions of parties impacting the expectations.

Ask:

- a) If it is a contract, will promoter remain liable?
- b) If it is an offer, is there consideration to make offer irrevocable?

- 2) **Does the promoter have an obligation to incorporate as part of the offer?**

- 3) **Is the promoter also going to be a shareholder?**

Ask:

- a) **Has there been full disclosure to other shareholders or promoters?**
- b) **Has a disinterested board approved action?**

## **DISREGARD OF CORPORATE ENTITY**

Arises when a fraud has been perpetrated on a corporation by shareholders for their sole benefit--in such cases the court with disregard the corporation entity and find shareholder liable.

1. Factors leading to disregarding usually are factual issues:
  - a. Undercapitalization or inadequate capital to run the corporate business;
  - b. Failure to observe corporate formalities (elect officers, hold meetings, resolutions, maintain corp. records);
  - c. Nonpayment of dividends;
  - d. Debtor/corporation is insolvent;
  - e. Siphoning funds by dominant shareholder /treating corporate assets as their own and withdrawing them;
  - f. Non-functioning officers and directors;
  - g. Corporation is a facade for the operations of a dominant shareholder; and/or
  - h. Hold yourself out as personally liable for corporate debts.

### **Test for Alter Ego**

Person asserting claim must show unity of interest and ownership between the corporation and shareholder (dominant) such that no separate identities exists; and if the acts are treated as the corporation's alone, it will lead to an inequitable result.

- Applies to contract claims
- In tort claims, must also show individual shareholder was negligent.

## FINANCIAL MATTERS OF CLOSE CORPORATION

### Basic Terms

Debt-Long term obligations

Equity-Ownership interest or net worth

Debt-Equity Ratio - Ratio of long term debt to shareholders equity in the corporation.

- useful in the assessment of whether corporation is adequately capitalized.

Debt Instrument - Unconditional promise to pay specific sum at a date certain in the future, usually with an interest over a term (monthly, quarterly, semi or annually) e.g. promissory note, bond.

Debt Securities - Bonds - long term debt usually secured by mortgage on corporate property.

- Debenture - long term debt, usually unsecured.

Equity Securities - Usually stocks that evidence investment in corporation in the form of shares or unit of interest or ownership.

## CONTRIBUTIONS

### BASIC CONCEPTS

1. Debt vs. equity- Reflects the characterization of the contribution of an investor. Affects priority in getting return, i.e. debt-repaid before return contribution or distribute profits but limited to amount owed plus interest; or equity-return on contribution plus a pro rata share of profits.
2. Retaining control vs. maximizing return via Preferences (priority in distribution), and Preemptive- right of first refusal. Preferences give the investor priority in distribution or first in line, e.g preferred shares. Preemptions allow the investor to restrict rights of other and protect against dilution. E.g. right of first refusal.
3. Leverage- use of other people's money to purchase or invest. Cost of borrowing must be lower than interest earned in investing.
4. Marginal (tax rate from chart) vs. Effective tax (actual rate applied)

### CONTRIBUTION OF CAPITAL

Capital for a corp can be \$, property, past services, debt securities. In Calif. no future services or promissory notes. There must be some consideration. Calif Corp. 409(a)

-Under MBCA 6.21(b) allows bd to authorize shares for cash, promissory note, services performed, contracts for future services.

--Bd. Assigns reasonable value to the noncash contribution.

-Cf not required in partnership.

-LLC-can contribute \$, property, services rendered or binding obligation to contribute these so future services with a contract is OK.

### CHARACTERIZATION OF CONTRIBUTION

Co. has interests different from individual owners:

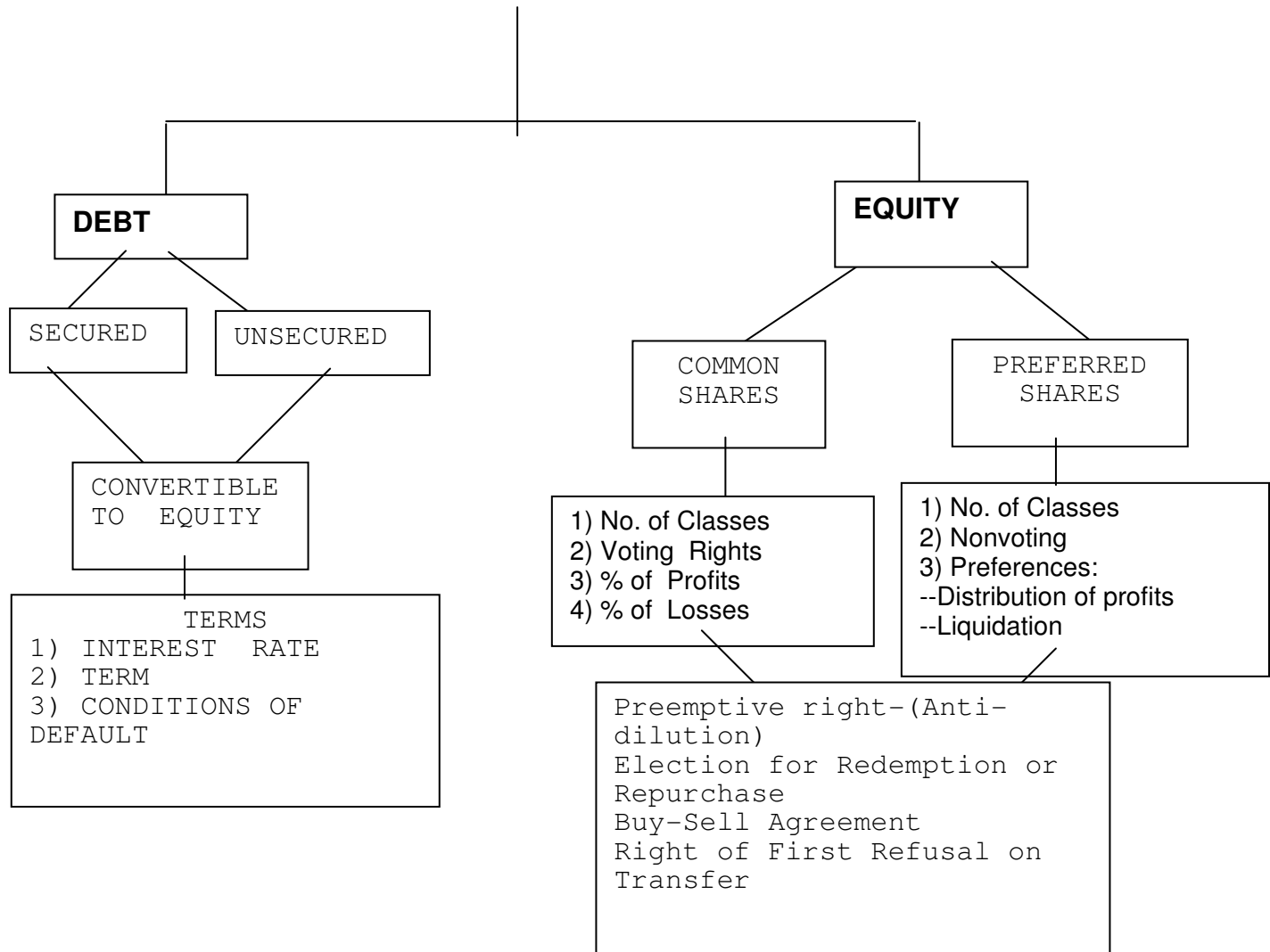
-Prefer more capital and less debt→ no obligation to repay so don't spend your money on debt service; easier to leverage 'cause it is not encumbered; better financial condition for lenders

Individual owners:

-Based upon risk tolerance, need to get money back, tax treatment, so may want more debt than capital 'cause greater assurance for repayment, but low upside.

Priority Rights	Preferences	Preemptive Rights
Preferred shares	Dividends-mandatory or discretionary by Bd	Right of first refusal to acquire additional shares
Debt for interest	Liquidation	Anti-dilution
	Conversion (e.g. options or to common-voting)	Buy-sell agreements -Corp right of redemption
		-Cumulative voting

## DISPOSITION OF INVESTOR'S MONEY



### TIPS IN ALLOCATION OF DEBT AND EQUITY

- High Return + Less Control + High Risk = Preferred Equity**
- High Return + More Control + Low Risk = Hybrid Equity/Debt**
- Moderate Return + More Control + High Risk = Hybrid Equity/Debt**
- Moderate Return + Less Control + High Risk = Preferred Equity**
- Guaranteed Return + Less Control + Low Risk = Secured Debt**

## **COMPARISON OF DEBT AND EQUITY**

	Debt	Equity
Definition	Unconditional promise to repay money over a term with interest	Ownership interest in business
Types	Notes-secured or unsecured Bonds- secured loans Debentures-unsecured	-Preferred stock-usu nonvoting but preferences or priority in distribution -Common stock-usu voting
Evidence	Promissory Note	Stock
Status	Creditor	Shareholder
Pros	-Taxed only on interest earned, not on repayment of the principal -Less risk 'cause get return on front end vs. at end -no involvement in operation of business -Retain control over ultimate disposition of the asset loaned -corporation deducts the interest paid as an expense -possible to write-off losses and bad debts -limited transferability	-Ability to participate in profit sharing of company -Ability to participate in operation and control of company -Freely transferable w/ market interest -Rights of shareholders -Dividends are taxed as capital gain (not ordinary income) -Losses from stock are capital losses
Cons	- Return limited to amount loaned plus interest -Limited rights as a creditor in the business, unless also have equity interest -interest taxed as ordinary income -usu. nonvoting so limited participation in operations.	-Fiduciary duty to other shareholders and creditors -Higher risk 'cause right to profits tied to profitability
Considerations	-Company does not want too much of it -possible to convert to equity but lose advantages.	Priorities, preferences and preemption

## Types of Equity Securities

### I. Common Shares

#### A. Characteristics of Shares

1. Negotiable
2. May be pledged as security or collateral
3. Can appreciate in value

#### B. Rights of Share holders

1. Receive earnings
2. Rt. to sue on behalf of corp.
3. Inspect books
4. Request accounting
5. Vote on matters

### II. Preferred Shares

#### A. Characteristics of Shares

1. Dividends may be cumulative if not paid
2. May be redeemable at option of the corporation, usually above the liquidation preference
3. May be convertible to common at shareholder option

#### B. Rights of Share holders

1. Priority in receiving dividends or distribution upon liquidation
2. Usually non-voting
3. Participating in the profits after the initial distribution

## **DISTRIBUTIONS, PREFERENCES AND PREEMPTIVE RIGHTS**

Distributions: MBCA 6.40 authorizes the Board of Directors to make distributions, subject to any restrictions in the Articles.

- Board can vote on whether or not to make a distribution, which class of shares is entitled to receive it, and how much will be distributed.
- Distributions cannot be made if it renders the corporation insolvent or unable to pay regular debts in the ordinary course of business.
- Distributions can be in the form of shares, cash, or other asset; and can include options

Preferences—Rights attributable to Interests

- Usually relate to entitlements to dividends, liquidation and conversion
- Dividends can be mandatory or discretionary, cumulative or noncumulative.
- Liquidation involves sale or disposition of substantially all of the assets.
- Conversion usually involves conversion from one class of stock to another, e.g. preferred shares to common shares; which has different rights that can be exercised to retain control through voting, or entitlement to distributions

Preferred Interest-Classification of an interest in securities, e.g. Preferred shares (debt or equity)

- Authorization re classes of stock must be in the Articles of Incorporation
- Entitle holder to preferences, conversion rights or preemptive rights that must be spelled out in Articles, and reflected in Shareholder Agreement
- Holders usually give up voting or control for preferences, and are usually passive investors

Preemptive Rights—Rights that enable the holder to retain control by acquiring additional shares

- Governed by MBCA 6.30 Must be included in the Articles of Incorporation.
- Entitles shareholders to acquire proportionate share of corporations' unissued shares.
- Board must vote to issue or reissue shares of a corporation.
- Include right of first refusal, anti-dilution, corporation right of redemption and/or repurchase, buy-sell agreements, cumulative voting

## **DISPOSITION OF SHARES**

1. Shares must be authorized, before they can be issued, but must be for consideration through a stock subscription or stock option. Once shares are issued, they become outstanding until the corporation repurchases or reacquires its shares and either cancel them, reissues them, or keeps them, in which case they become treasury shares. Watered stock usually arises at original issue. If the corporation repurchases shares, then they may cancel or reissue the shares at any price.

Easy way to remember what happens to stock. AIR CROT

Authorized  
Issued  
Repurchased  
Canceled  
Reissue  
Outstanding  
Treasury

2. Shareholders determine by agreement prior to or at the time they file articles what rights corporation, shareholders, board will have regarding disposition of shares, voting, conversion, classes, redemption, preferences, par vs. no par, preemption, distribution, and management. MBCA §§ 7.31, 7.32

3. Above rights must be included in the articles of incorporation, initially or by amendment, including the number of shares that will be authorized. MBCA §§ 6, 6.30, 6.31, 15.

4. Board of directors or shareholders (if they elect to) have the power to establish the value of par value and no par shares which shall be conclusive as an exercise of business judgment; and have the right to declare dividends or distributions, and elect to redeem shares. MBCA §§ 6.21, 6.40, 18, 45

5. Board of directors are liable for voting to declare a dividend or distribution in violation of MBCA and will be liable for excess of what could have been paid. MBCA §§ 8.3, 8.33 48

6. Shareholders have the right to dissent and receive fair value for amendments that will alter or abolish preferential treatment, redemption, and preemptive rights. MBCA §13

## **FINANCING A BUSINESS: SOURCES OF CAPITAL**

Key to financing a closely held corporation is to get the right balance of debt to equity which will allow you to service the debt and to have sufficient income to cover basic operating expenses.

1. Personal funds:
  - a. savings
  - b. securities
  - c. real property
  - d. credit cards and lines of credit
2. Private sources:
  - a. family and friends
  - b. private placements
  - c. private offering
3. Commercial sources
  - a. banks and savings & loan
  - b. venture capital firms
  - c. investment brokers

4. Other sources:
  - a. insurance co and pension funds
  - b. Small Business Administration
5. Internal sources of capital for existing business
  - a. accumulated earnings usually with a cap after which they must be distributed as dividends to the shareholders
  - b. cash reserve accounts: money set aside in an account to pay taxes and other debt service

### **TYPES OF COMMERCIAL PAPER**

1. LOANS: Lump sum obligation secured or unsecured, usu. with interest and repayable at future date.
2. LINES OF CREDIT: An asset that is often used for working capital. Established in advance and may be drawn against by writing checks. Once you draw against it, the amount drawn becomes loan to be repaid with interest-- May be secured or unsecured.
3. LETTER OF CREDIT: An engagement by a bank or another at the request of the customer that the issuer will honor drafts or other demands for payment in compliance w/ certain conditions' may be revocable and irrevocable.

## **ISSUES IN GETTING FINANCING**

1. INTEREST RATE
  - a. Fixed or variable
  - b. Cap
2. POINTS
3. TERM OF NOTE
  - a. Short-term is usually less than 5 years for business, 1 year for a personal financial statement purposes;
  - b. Long-term is usually up to 30 years; maximum long term is 99 years for real estate sale-leaseback provisions
4. SETTLEMENT CHARGES: Include appraisal fees, title report, and credit checks, and is usually imposed for loans and real estate transactions
5. MONTHLY DEBT SERVICE
6. EVENTS OF DEFAULT:
  - a. Explains when a lender can call a note due or escalate payments;
  - b. Includes some forfeiture of collateral in some instances through foreclosure
7. LATE FEES, PREPAYMENT PENALTIES

## **TYPES OF COLLATERAL**

1. Real estate
2. Commercial paper: CD, stocks, bonds
3. Existing contracts: often ok in government contract area

\*subject to==== UCC-1 financing statement

4. Inventory\*
5. Equipment\*
6. Accounts receivables\*

## **CREDIT INFORMATION**

1. Financial statements
  - income/profit and loss statement
  - balance sheet
  - pro forma
2. Guarantees/ insurance policy required
3. Tax returns-usually for 2 years

## CONCEPT OF LEVERAGE

Cost to borrow vs asset should be less than the return on investment to make it attractive. Effect is that end up with greater total assets. Issue turns on acceptable risk tolerance.

1) If you inherited \$100,000 and wanted to buy a piece of property:

Alt 1: Buy a condo for \$100,000 paying cash for it. Have an appreciable asset worth \$100,000.

Alt 2: Buy a condo for \$100,000, putting 20% down (\$20,000) leaving a note of \$80,000 at 5% interest over 30 years. Mortgage is under \$700 (including taxes, etc.) Buy a second rental property for \$250,000, putting \$50,000 down, leaving a note of \$200,000. If you can rent it out for at least \$1300/month, then it is paying for itself. You end up with two assets worth \$350,000 and it has cost you only \$75,000. Still have \$25,000 left.

2) If you inherited \$100,000 and wanted to invest it in a business:

Alt 1: Invest \$100,000 as equity in business- High risk, high return

Alt 2: Invest \$50,000 in equity, \$25,000 in debt, put the \$25,000 in a CD @ 3 percent, pledge it as collateral to secure a \$25,000 line of credit for the business. Moderate-Low risk, higher potential return on equity, and fixed return on debt. Individual collects interest paid on CD and received interest paid on debt. Company repays advances on L/C out of revenues, and indemnifies investor is collateral is ever seized.

3) If you had to \$10,000 to spend, how would you spend or invest it considering the following options:

Stocks pay 4-5% in today's market (average is 6-7%)—High risk

Bonds pay 7% in today's market (average 6-7% depending upon interest rates)----  
Low risk, but lower return

Real estate pay 10% appreciation depending upon market—moderate risk

Debt (credit cards) that charge 14% interest----debt

### Exercise: Access to Capital

Each of the following persons has developed an innovative product or service that has potential to be profitable, BUT they need capital to finance their business. This exercise is designed to focus on the issues they will face, potential solutions for funding sources, and factors that need to be negotiated.

Profile	Issues	Funding Sources & Terms
<p>1) Fifteen year old high school student who has had a newspaper route, worked at a store for minimum wage, and now wants to start their own business. The student has a savings account, savings bonds given by grandparents as part of his inheritance, but no credit.</p>		
<p>2) Twenty-five year old, divorced, single parent with two kids under the age of 10 years, working two jobs during the day and going to community college to get a degree in the evening. Has been using credit cards to finance school and renting an apartment. Not much help from ex-spouse.</p>		
<p>3) Law student who has been working full time for 5 years, saving to finance a portion of tuition plus living expenses, married and spouse has agreed to carry the family for 4 years, through law school and first job. Okay credit, has some cash in bank. Owns their own home.</p>		

<p>4) Professional with good job plus benefits and bonuses. Has an established life style that hesitant to give up. Good credit, single with one child, homeowner, no default on student loans.</p>		
<p>5) Retiree living off pension and is no fixed income. Nest egg of \$60K. House is paid for, but has IRS issues on other failed ventures.</p>		
<p>6) Illegal immigrant in country for 10 years, paying taxes and has two kids in public high school, Ok English. Has a family product that has been handed down through generations. No credit, but has cash. Applied for citizenship, but anticipate it will take 5-10 years for processing.</p>		
<p>7) Convicted felon for drugs while in college, cleaned up life, married and expecting first child, working for same company for 7 years, renting, but saving money for down payment. Willing to work hard to do what is necessary to make this work. Bad credit from previous life, but is paying down debt.</p>		

## **TAX IMPLICATIONS**

1) Goal: What is the tax liability to the individual? What is the tax liability of company? Must compute separately by running the numbers to determine projected.

2) Objective: What are all sources of income? What are deductible expenses and how will they be deductible, e.g. ordinary or capitalized over term? Any carry forward of deductions?

3) Result: At what rate will the investor be taxed? Marginal (schedule rate on income) vs effective rate (based upon computation of actual tax).

4) Impact: How should contribution of capital be characterized? Equity vs. Debt  
What is the optimal return on capital and how should it be characterized? Tax interest as ordinary income vs dividends taxed as capital gain.

### **Tax Consequences**

1) If business makes money and it is distributed:

Pship-taxed once on pro rata interest

Corp-taxed to corporation when earned, to individual when distributed>> double taxation

2) If business makes money, but want to keep it, not distribute it

Pship-no choice but to distribute; taxed under 1)

Corp-taxed when earned, tax is deferred to individuals until it is distributed

3) If business loses money.

Pship-losses pass through to individual to offset vs other income

Corp-deduct losses against income. Max amount deductible each year so carry forward . Shareholders can deduct only by selling stock.

## TAX HYPOTHETICALS-Based upon Tax Rate 2004

1) If Anthony has earned \$80,000 in income, then at the individual rate (married filing joint return), he would pay in taxes \$16,310, i.e., \$5,535 + \$10,775 [ $43,100 \times .25$ ]. While the marginal rate is 25%, the effective rate is 20% ( $16,310/80,000$ ).

2) Anthony is the sole shareholder in a corporation that earns \$80,000 in taxable income without any distributions of dividends. The marginal corporate rate is 34%. The tax is \$15,450. i.e., \$13,750 + \$1,700 [ $5,000 \times .34$ ]. The effective rate is 19% [ $15,450/80,000$ ].

Q: Would it make a significant difference from a tax standpoint, whether the earnings would be taxed individually to Anthony, or to the corporation?

Q: What would be the critical issue from Anthony's standpoint?

3) If Anthony received a salary of \$50,000, then the salary would be deducted by the corporation as a business expense, but would be taxed to Anthony individually as income.

If this was the only income Anthony received with no offsetting deductions, then Anthony would pay a tax on his salary of \$8,810, i.e., \$5,535 + 3,275 [ $13,100 \times .25$ ].

4) If the corporation earned \$50,000 in income, then the corporation would pay \$7,500 ( $50,000 \times .15$ ) in taxes.

5) If A received \$80,000 from the sale of a capital asset that qualified for capital gains treatment, then Anthony would pay \$20,810 i.e., \$8,810 [salary] + \$12,000 [ $80,000 \times .15$ ]

6) If Anthony was the sole shareholder, and the company was planning a major expansion of the business that would result in a \$50,000 loss in the next year, what steps, if any, would you suggest the board consider?

7) If Anthony earned \$300,000 in income, having made the Subchapter S election the previous year, then his individual marginal rate would be 35%. Compute the tax and effective rate?

8) If the business had not elected Subchapter S, then the corporate rate would be 39%. The tax would be \$100,250, i.e., \$22,250 + \$78,000 ( $200,000 \times .39$ ). The effective rate is 33%.

Q: What advice would you give Anthony about the impact of the Subchapter S election?

## WAYS OF EXERCISE VOTING RIGHTS

Cumulative Voting-ensures minority representation

Voting Trusts- Transfer of title to a trust but retain beneficial ownership

Pooling contract-Contract to vote in a block

Proxies-Right of someone else to vote your shares.

### **CUMULATIVE VOTING**

$$\frac{S}{D + 1} + 1 = \text{min. no of shares needed to elect 1 director.}$$

S=total number of shares voting

D=number of directors/slots to be elected

N=number of directors want to elect

If you want to elect more than 1 shareholder, then multiply S x N

Examples: all have 2 shareholders w/ 100 total shares

1) 2 shareholders: 15 shares x 3 slots  
85 shares

2) 2 shareholders: 18 shares x 5 slots  
82 share

3) 2 shareholders: 30 shares x 3 slots  
70 shares

4) 2 shareholders: 10 shares x 10 slots  
90 shares

5) same as 4 but 9 slots

## **PROXY REGULATION**

1. Defined: Person authorized to vote someone else's shares
2. Authorization must be in writing and signed by record owner of shares. Under most statutes, a proxy is valid for 11 months so you need to get a new one for each annual meeting
3. Authorization may be revocable or irrevocable:
  - REVOCABLE- if act inconsistent from instructions
  - IRREVOCABLE- must so state and be coupled with an interest

## MANDATORY OWNERSHIP PROVISIONS

**If the parties seek to depart from the model rules regarding entitlements and rights, such provisions must be contained in Articles of Incorporation or the appropriate organizing document.**

General Rule: Restrictions or entitlements regarding 1) Shares, 2) Authority of Board, 3) Control of Corporation, and 4) Valuations must be included in Articles of Incorporation or other organizational document to be effective.

Provisions include:

1. No. and type of classes of shares
2. Distributions/ dividends
3. Liquidations,
4. Preferences,
5. Right to levy assessment against shares (used in close corporations),
6. Limits in rights or authority of board, e.g. value contribution
7. Conversion rights of shares,
8. Voting rights- or limits on voting
9. Anti-takeover provisions, e.g. supermajority vote for change in control, allow  
minorities to acquire additional shares, conversion rights, limits on repurchasing at a premium
10. Preemptive rights of shareholders
11. Redemption rights of corporation
12. Minimum price or par value of shares

### **THREE POINTS RE BUY-SELL AGREEMENTS**

- 1) Buy-sell agreements, either through cross-purchase contracts, and/or stock redemption contracts enable a close corporation to plan for succession upon the death, disability, or withdrawal of a shareholder. The price should be determined in advance, either through a formula or fixed price with some adjustments for market conditions, and should be tied to earnings, asset valuation and/or industry standards.
- 2) Dissension and deadlock in a close corporation usually occur where there is equal voting or no power to vote cumulatively. In such instances, the only options are to have a buy-sell arrangement in advance to allow one to buy out the other, arbitration, or dissolution.
- 3) Shareholders retain control through rights of redemption, right of first refusal, preemptive rights, proxy agreements, pooling agreements, buy-sell agreements and cumulative voting.

## **BUY-SELL AGREEMENTS**

**PROBLEM:** Tom, Dick and Harry are equal shareholders in a close corporation. Up until now they have reinvested the earnings into the company. Tom dies and the interests of the family become antagonist toward Dick and Harry because the family wants the money. What should the parties do?

### **TYPES OF BUY-SELL AGREEMENTS**

#### **1. CROSS-PURCHASE AGREEMENT**

Each shareholder agrees to sale shares to other the shareholders for a predetermined price or formula.

--Pro: very simple

--Con: shares must be paid for with after tax money and usually falls on the person least able to bear it; it becomes cumbersome with more people .

#### **2. STOCK REDEMPTION AGREEMENT**

Corporation agrees to buy stock.

--Pro: Corporate earnings and profits are used without having a dividend or tax cost; better when have a lot of shareholder.

--Con: Need to have sufficient surplus to do it. See solutions below for how to address issue.

#### **3. HYBRID AGREEMENT**

Combination of both, where the corporation and the shareholders have right to buy back shares.

### **PRICE**

**1. BOOK VALUE**

**2. FIXED PRICE**

**3. APPRAISAL**

**4. FORMULA**

## ISSUES

1. Who is best equipped to buy--shareholder or corporation-- who has the money.
2. Does the corporation have insurance?
3. Consider the tax consequences of the transaction.

## SOLUTIONS

1. Change the capital requirements
2. Shareholders can agree to contribute additional capital
3. Shareholders purchase the balance of stock that the corporation cannot afford
4. Pay the survivor over time
5. Sale and leaseback to the corporation
6. Distribute the noncash assets

**EXERCISING RIGHTS**  
**IN**  
**BUY-SELL AGREEMENTS**

**Triggering Events for Exercising Rights**

1. Death (60 days);
2. Disability or incapacity that continues for more than 180 days;  
and
3. Notice of intent to sell interest.

**Procedure**

1. Establish time frames and triggering events.
2. Written notice with transferee terms.
3. Board meeting and vote within 45 days to consider whether to exercise option.

**Rule of Thumb for Timeframes with Triggering Events**

1. Notice to Board of a triggering event within 10 days
2. Board notice for a meeting to consider whether to exercise---  
usu. 20-30 days.
3. Option to purchase and price exercised within 45-90 days of  
notice.
4. Notice of acceptance or rejection of the option by the  
corporation.
5. Notice to shareholder by corporation to exercise option---usu.  
20-30 days.
6. Notice to shareholder electing to exercise option by corporation  
should include number of shares redeemed, whether it is  
oversubscribed and price.
7. Right to openly solicit by corporation or shareholders for any  
class of stock---offer remains open for 180 days, free of any  
competing offers or agreements.

# **FACTORS IN SELECTING BUSINESS ENTITY**

## STEP ONE: SUBSTANTIVE CONSIDERATIONS

1. TYPE OF BUSINESS:
  - A. GOODS
  - B. SERVICES
  - C. GOODS/SERVICES
  
2. SIZE OF OPERATION:
  - A. LEVELS OF MANAGEMENT NEEDED TO OPERATE
  
3. LIABILITY PROTECTION:
  - A. AGAINST LIABILITY AND MALPRACTICE
  - B. INSURANCE PROTECTION
  - C. REQUIREMENT FOR PERSONAL GUARANTEES
  
4. TAX CONSEQUENCES:
  - A. OTHER SOURCES OF INCOME
  - B. TAX BRACKET AND DESIRE TO SHELTER
  - C. EXPECTATION OF LOSSES
  - D. SUBCHAPTER S STATUS (100 of LESS HOLDERS)
  
5. FUTURE PLANS FOR BUSINESS
  - A. EXPANSION
  - B. DIVERSIFICATION/ACQUISITION
  - C. REORGANIZATION
  - D. MERGER

## STEP TWO: ADMINISTRATIVE CONSIDERATIONS

1. COST TO FORM
  
2. FORMALITIES
  
3. FLEXIBILITY
  
4. TRANSFERABILITY

## COMPARISON OF BUSINESS ENTITIES

VARIABLES	LTD. PARTNERSHIP	C-CORPORATION
MANAGEMENT	Can be shared equally among general partners. Restricted role of limited partners	Centralized in board of directors and officers
LIABILITY	Personal liability for general partners; limited liability for limited partners	No personal liability; limited to corporate assets
EXISTENCE	Limited to fixed term unless agreement among partners	May be perpetual
TRANSFER OF INTEREST	Transferable but successors limited to economic rights	1) Interests are freely transferable but may be limited market; 2) Rights of first refusal
DISSOLUTION	By will of partners, death, incapacity or specified events, unless parties agree to continue.	By resolution by board with approval of shareholders.
FORMALITIES	1) Written agreement preferred; 2) File Articles of Limited Partnership 3) Nothing after formed	File articles of incorporation; draft Bylaws; hold annual meetings; prepare minutes and resolutions.
MEETINGS	Not required	Regular and annual
DUTY OF CARE	Care; General partners act as agents of partnership	Fiduciary duty of care, loyalty, and fair dealing
COMPENSATION	1) Pass-thru profits and losses; can share disproportionately  2) Can't get paid for being a partner, but can be an employee.	Officers can get a salary plus fringe benefits: medical, retirement, life insurance
TAXATION	1) Single layer; profits and losses pass-through, and taxed to partner based upon their interest	1) Double taxation: profits taxed to the corporation;  2) Dividends and applicable salaries taxed to the shareholders

<b>VARIABLES</b>	<b>LIMITED LIABILITY CO.</b>	<b>S-CORPORATION</b>
CLASS OF STOCK	Multiple classes permitted with various interests	Only 1 class permitted
ELIGIBLE MEMBERS	Persons, corporations, partnerships, nonresident aliens, trusts (Excludes attorneys and accountants in California)	no nonresident aliens, no entities
NUMBER OF MEMBERS	1 or more with no limit	Max. 100 persons;
ELECTION	Not required	Required
OWNERSHIP	1) No limitations 2) Can share disproportionately in pro rata share	No limitations
LIABILITY	No personal liability for business debts	No personal liability for business debts
CONTRIBUTION OF SERVICES	Can get interest for past and future services w/ written employment contract.	Can only get shares for past services valued at fair market value.
TERMINATION	Upon death, resignation, expulsion or bankruptcy unless all or majority elect continuation	Must elect to terminate. Cannot make re-election for 5 yrs.
TAXATION	Single layer-pass thru; profit subject to Soc. Sec. tax & Medicare; fringe benefits not deductible	Single layer-pass thru profits and losses; not subject to Soc. Sec. or Medicare
FORMALITIES	1) File Articles and pay applicable fee;  2) Suggest written Operational Agreement	Same as corporation; plus election

<b>VARIABLES</b>	<b>LIMITED LIABILITY COMPANIES</b>	<b>LIMITED LIABILITY PARTNERSHIPS</b>
ELIGIBILITY (CALIF)	Not available to licensed businesses, e.g. lawyers, accountants	Available only to licensed professional, i.e., attorneys, accountants, and architects
MANAGEMENT	Flexible, central or single level member	General partnership with some limited liability to partners
LIABILITY	Limited liability generally	Partners are not liable for malpractice of partners; still liable for agents' negligence
EXISTENCE	Perpetual or term	Term
TRANSFER OF INTERESTS	Transfer freely but limited to economic rights.	Successors have no right to manage, limited to economic rights
DISSOLUTION	Upon death, resignation, expulsion or bankruptcy unless all or majority elect continuation	Upon death, resignation, expulsion or bankruptcy unless all or majority elect to continue
FORMALITIES	--File Articles of Organization and pay the applicable fee; -- Get a registered agent -- Suggest to execute an operational agreement	-- File Certificate with Secretary of State w/ applicable fee; -- Register with licensing body annually
TAXATION	Profits and losses pass through; May elect corporate tax	--One level of taxation -- Pass-through profits and losses.
DUTY OF CARE	Loyalty and care	General partnership fiduciary duty
COMPENSATION	Flexible (salary plus share)	Flexible but cannot be unreasonable

## **HYPOTHETICALS**

1) Prescription Drug Is a manufacturer of PMS and menopause-related treatment. The industry is subject to heavy government regulation by the FDA, including extensive trial tests, documentation and consumer information, and strict liability for negligence in handling or dispensing the drug. Company has 4 departments and a heavy investment in research and development. Investors include individual chemists and scientists who are leading experts in this field of research, university and institutional investors pharmaceutical companies.

2) Group of 5 lawyers who have a varied corporate law practice in related and complementary fields. They propose to divide profits and losses in accordance with valuations assigned to client lists, cash investments. Their practice requires that they issue opinion letters on the feasibility of deals. They will have 4 associates on an independent contract basis based upon billable hours and an hourly rate of \$75.00, and 2 salaried secretaries and 1 office manager.

3) Writer is a writer and producer of programming for television wants to break into computer software and intends to join forces with Programmer, a computer programmer who has the technical skills. Marketer wants to work part-time marketing their programming to studios and publishers. There are rules governing agent fees for commercial programming but not for designs for computer programs. Marketer would like a percentage fee and/or ownership in the production company.

4) A group of four college roommates decide to develop three lots: one for commercial and two residential multi-family dwellings. Only two of the four roommates have any experience in real estate development, one as a marketing agent and the other working for an engineering firm. The other two have experience in banking, and retail sales and \$10,000 each. They do not have enough money to develop all of the lots at the same time, so they will develop and finance them in stages. They propose to sell units to up to 90 passive investors total (30 investors per lot) who are looking to take the initial losses and profits from the business. Some investors want to invest in the commercial, but not the residential development. They are looking for an income stream. Banks will require personal guarantees of all of the roommates. Some of the investors may be foreign aliens. As part of closing, title insurance will be obtained and they intend to use bonded contractors.

5) A computer programmer has started a home-based business developing storing and maintaining secure database files for small companies, and performing administrative support services such as billing and processing purchase orders, employee records, and system support. Most of her work requires her to go to the site or access computer networks remotely, through a dedicated DSL line. She relies upon income from her business and other contract part-time work troubleshooting and administration of system networks for a manufacturing company. There is no conflict of interest in doing both work.

## AB SOFTWARE

**A is contributing \$100,000, no additional contributions, veto power, no salary. B is contributing \$10,000 plus sweat equity, salary of \$5000/mo., no cash contribution, interest for cash, past and future services.**

Debt	A	A	Equity
			Type
Secured			Class
Convertible			% Voting
Trigger			Preference?
Interest Rate			Preemptive Right
Term			Buy-Sell Agreement
Default Conditions			Right of 1 <sup>st</sup> Refusal
Debt	B	B	Equity
			Type
Secured			Class
Convertible			% Voting
Trigger			Preference?
Interest Rate			Preemptive Right
Term			Buy-Sell Agreement
Default Conditions			Right of 1 <sup>st</sup> Refusal

Q: For AB, are these issues that you as the corporate attorney can address for the parties?

## Valuing the Equity Interest

When a company is converting to a new entity and adding additional investors, it is important to value each person's contribution in order to arrive at the starting point for assigning their equity interest.

If the company was dissolving and distributing the assets, the each person's allocable share would reflect their equity interest (stated as a percentage) plus a pro rata share of retained earnings, i.e., money earned but not distributed.

In valuing their interest in the new entity, there are two steps:

Step 1: Assign a value to each contribution,

Step 2: Add the values of all of the contributions together, and then divide the amount of each contribution into the total, which equals the percentage of the interest.

### Launder Care Case Study

Name	Old Percent	Contribution	Earned Distribution	Value of interest upon liquidation
Anna	40%	Past Services* + Sweat equity (\$24K) \$1k x 24=\$24K	40% (\$150K + \$100K) →\$100K	\$124,000+
Christine	40%	\$100K	40% (\$150K + \$100K) →\$100K	\$200,000
Bill	20%	Past Services* + Sweat equity- (\$14,400)	20% (\$150K + \$100K) →\$50K	\$64,400+
TOTAL	100%	\$100,000 cash	\$250,000 retained earnings + net profit	388,400 +

\*Negotiated based upon previous salary, industry standards, or what parties consider reasonable.

Example: If you have 3 persons contributing as follows:

A is contributing \$100,000 in cash

B is contributing \$140,000 in real estate (appreciable asset)

C is contributing \$70,000 in cash

Total amount contributed equals 310,000 plus (because real estate is an appreciable asset)

So, the STARTING POINT in negotiation for assigning interest would be:

A would get about 32% ( $100,000 / 310,000 = .3225$  or 32%)

B would get 45% ( $140,000 / 310,000 = .451$  or 45%) + appreciation

C would get 23% ( $70,000 / 310,000 = .225$  or 23%)

## **PROVISIONS TO INCLUDE IN OWNERSHIP AGREEMENT AB Software Co.**

A and B are going into the business of selling computer software. A will invest \$100,000 and wants veto power over basic decisions, with no increase in his investment. B will make no cash contributions but will provide sweat equity, by maintaining the store's website on a day-to-day basis. B will receive \$3,000/ mo. in salary. After payment of B's salary and other expenses, profits will be divided equally. To the extent that A does not want to contribute additional money, they have begun discussions with E about possibly joining them, but they want to complete setting up the entity first and execute ownership agreement. They have begun operating as a general partnership. They have decided to form either a limited liability company or a close corporation. What should each party include in the agreement.

### **CORPORATION/LIMITED LIABILITY COMPANY**

A: **CONTRIBUTION AND INTEREST**: Contribute \$100,000 with **\$30,000** as debt and **\$70,000** as equity for a **51%** interest. This allows the company to have more equity than debt, but gives A the ability to minimize his exposure by being able to get a fair return on his equity, but still guaranteeing that he receives some money back. The **\$30,000** would have to be repaid over a period of **5 years** at an interest rate of **7%**. **Same whether Corporation or LLC, but easy to keep same percent for profits and losses.**

B: Contribute past services for corporate interest, or employment agreement for future interest of 49%. The only problem is in valuation of B's interest, which would be taxable to him. Is it worth \$100,000. If not then may adjust accordingly.

E: If it is clear that he will be brought in, then A and B can either sell some of their interest to E, which is a taxable event, OR, A and B can only authorize a portion of the total shares and hold back some until E comes in, which is non taxable. His interest should be based upon value of his contribution relative to A, and what he wants to receive in exchange.

**VOTING RIGHTS**: 1) **51% Common stock** with voting rights. This addresses the veto power issue.

2) Alternatively, you can give A a class of stock that gives him veto power on certain types of decisions, e.g. decisions affecting a fundamental change in the business, merger, sale, dissolution, or tied to a minimum monetary value. If you want to give A other preferences not given to him, then can add other elements to the class. NOTE: If you have more than one class, no Sub S election.

3) If it is an LLC, then can make A the sole manager and allow B to be a member with power as an agent in his employment status. B runs day to day but policy issues are decided by A.

## **DISTRIBUTIONS: DESIRABLE FOR CORPORATIONS AND LLC**

1) Per contributions, but need to decide if **mandatory**. N/A if it is an LLC since automatic.

## **LIQUIDATION/DISSOLUTION: OPTIONAL FOR CORPORATION; DESIRABLE FOR LLC**

1) Trigger: **Dissolve if A, B or both die, become incapacitated, bankrupt; OR can decide that it has perpetual term which allows the business to continue notwithstanding what happens to either person.**

2) A gets a liquidation preference on dissolution since he has put in cash. B can get the value of his contribution, which will be valued at **\$50,000**. For any value less than \$100,000, need to justify what is the consideration for 50-50 split., e.g, B is working the business and gets a salary that is below market so the difference between market and actual reflects additional value.

## **PREFERENCES: DESIRABLE FOR CORPORATIONS AND LLC**

1) If you bring in E as an investor, then you may make his interest nonvoting and give him a preference upon distribution, e.g **2 x interest**. Negotiate if there are any conditions under which E's non voting could be made voting, e.g. where there is an offer to buy **51 %** or more of the stock. If so, then may want to add a pooling agreement.

2) Does A want to receive anything other than return on equity.

## **ADDITIONAL CONTRIBUTIONS: DESIRABLE FOR CORPORATIONS AND LLC**

- 1) Obligation for additional contributions is tied to pro rata interest.
- 2) Any additional contributions from A and/or E will be given **50% debt, 50% equity**.
- 3) Any additional contributions from B will be **reflected by a promissory note and paid out of future distributions**.

## **GOVERNANCE: DESIRABLE FOR CORPORATIONS AND LLC**

- 1) LLC: Addressed via voting rights, or specify manager or member managed and who will do what.
- 2) Corporation: Do you want to elect Close corporation and eliminate Board of Directors.
- 3) What percentage is required to pass regular actions: majority, 2/3<sup>rd</sup> or unanimous consent.
- 4) Process for interested transactions: e.g. disinterested voting.

## **PREEMPTIVE RIGHTS**

1) All parties have the right to acquire additional shares to maintain their allocable interest.

## **RIGHT OF FIRST REFUSAL, RIGHT OF REDEMPTION- DESIRABLE FOR CORPORATIONS AND LLC**

1) Corporation: Right to redeem should any shareholder seek to sell to a third party. Price shall **be \$10 below book value** of shares at time of redemption. The remaining shareholder have first right to acquire shares of any withdrawing shareholder at the same price. Corporation may loan money to shareholders for the purposes of acquiring the shares. Terms for repayment will be 3 years @ 7% interest.

2) Assignment in LLC: Assignment of interest requires **unanimous** consent of remaining parties if assignee wishes to participate as a member in the LLC.

## **EMPLOYMENT CONTRACTS- DESIRABLE FOR CORPORATIONS AND LLC**

1) B gets **\$3,000/month** in salary, plus medical, dental and life **benefits that have a total value of \$4,500. Employee vs. an independent contractor. Agreement shall at will or for a term. Required to work a minimum of 40 hours.**

2) A can fire B for **malfeasance, breach of duty, more than 10 unexcused absences**. In the event B is fired, what happens to his interest and voting rights? **Propose a buy-out since relations will likely be bad at that point. What happens if A withdraws, then who has what authority.**

3) Agent of entity and authorized to enter into any contracts for up to **\$5,000. Responsible for executing documents to transfer assets from partnership to corporation.**

4) Any intellectual property developed by B shall belong to the entity and there is an expressed assignment.

**Professor Notes-Read before Class**

- I. Types of Negotiation:
  1. Hard: test of wills;
  2. Soft- Avoid personal conflict
  3. Principled- Issues and merits, win-win and fair to all sides
- II. Purpose of a Negotiation: To produce a wise K, be efficient, and improve but not damage the relationship
  1. Position bargaining may not reach a fair agreement 'cause the parties lock themselves into a position and defend or attack it; Often start with extreme positions and bitter feelings result. The more number of people, the more ineffective 'cause each may have different positions
  2. Principled negotiation- focus on procedure and substance
    - a. The process is often intuitive unless you are from different cultures, then the process needs to be established in advance
- III. Components: People, Interests, Options, Criteria--.>>>Requires analysis, planning and communication/discussion
  1. Separate people from the problem and focus on the merits; remove emotion and human element which is often unpredictable, particularly when dealing with strangers
    - a. In Positioned bargaining, put the relationship and substance in conflict- there is a tradeoff
    - b. Separate perceptions & emotions-focus on the problem and each persons perception of the problem
    - c. Change the other's perception by responding differently than expected
    - d. It is important that you understand the other person's perception, but you do not necessarily have to agree with it.
    - e. Don't blame the other person for the problem-You gain nothing and create antagonism
    - f. Give the other a stake by making them participate in the process, e.g, ask their advice
    - g. The Process is the product so get involved early
    - h. Allow the other person to save face—this reconciles the agreement with the principle with the self-image: E.G. If I said X, and I am wrong, I need to defend X, even if I would be able to agree to Y, but I don't know how to do it without appearing weak
    - i. Express your emotions so that you can work through it, however you feel, it is important that you and the other person acknowledge it
    - j. Learn to listen, not react
    - k. Symbolic gestures can diffuse emotional states
    - l. Avoid talking to 3<sup>rd</sup> party-audience—you act differently
    - m. Listen to what is said and acknowledge it; Remember, understanding is not agreeing

- n. Negotiation is different from a debate where there is a third party decision maker;
  - o. Focus on how it impacts on you and your feelings, which is hard to dispute
2. Interests- focus on mutual interests instead of position; position you decide upon, an interest is the underlying problem. Ask: What do you really want? And Why?
- a. Ask why—look forward for the purpose, not back for the cause
  - b. Agreement is possible because often the interests are different
  - c. Ask for basic decision or position and then why or why not
  - d. Don't assume that persons on the same side have the same interests
  - e. Focus on basic needs: security, economic well-being, belonging, recognition, and control.
  - f. Be specific about intent and give reasons first, then your decision to increase the likelihood that the person will listen to the rationale—if then gives you a point to discuss.
  - g. Be flexible and open-minded; be hard on the problem, not the people.
3. Options- Exercise skill and creativity in developing options
- a. Inhibitions to developing options
    - 1) premature judgments;
    - 2) searching for a single answer;
    - 3) assume the pie is fixed and cannot be expanded; and
    - 4) solving the problem is on them.
  - b. Brainstorm to develop options--Don't judge the options.
  - c. Search for mutual gains.
  - d. Brainstorm somewhere other than where negotiate; sit side-by-side and establish the ground rules which include not judging options.
  - e. Afterwards, select the most promising option and improve on them.
  - f. Be careful in joint brainstorming not to disclose confidential information or give up too much information—talk off the record.
  - g. .Change the scope of the agreement by looking for mutual gains which always exist and create opportunities for compromise.

- h. If there is a stalemate, move from substance to procedure which is from a stronger to a weaker more manageable scenario.

Substance	Procedure
Permanent	Provisional
Comprehensive	Partial
Final	Principle
Unconditional	Contingent
Binding	Non binding

- i. Are you looking for words or performance; if the latter, don't increase the threshold by making it harder to achieve an agreement
- j. Look for some precedent or analogy to argue from

- 4. Objective Criteria- Base it on something that is reasonable
  - a. Frame the issue as a joint search for criteria—Ask for the theory behind the position
  - b. Reason which standards are to be applied –Agree on the principles to be used
  - c. Don't yield to pressure, only principle

#### Exercise: Round Robin

1) You have \$50.00 in your pocket and need to buy a textbook for this class. Another person has the textbook and is looking for \$75 because he promised his spouse that he would buy \$75 worth of groceries for his family. He used up the grocery money gambling. Negotiate the purchase.

2) You want to borrow \$5.00 from a stranger to catch a cab home. You are late for an appointment and have just missed the connection. You are on a bus and have five minutes before your stop. Try to borrow the money.

## **REVIEW SHAREHOLDER CONTROL OF CORPORATION**

**SHAREHOLDER CAN RETAIN CONTROL BY**

**1. LIMITS IN SHAREHOLDER AGREEMENT/ARTICLES**

- RIGHTS OF REDEMPTION**
- RIGHT OF FIRST REFUSAL**
- PREEMPTIVE RIGHTS**

**2. PROXY AGREEMENTS**

**3. BUY-SELL AGREEMENT**

## **SALE OF SHARES**

### **I. GENERAL RULE REGARDING SELF DEALING**

A PERSON WHO ACQUIRES SPECIAL KNOWLEDGE OR INFORMATION BY VIRTUE OF A CONFIDENTIAL OR FIDUCIARY RELATIONSHIP WITH ANOTHER MAY NOT EXPLOIT THAT KNOWLEDGE OR INFORMATION FOR HIS OWN PERSONAL BENEFIT. ANY PROFITS DERIVED FROM USE OF THAT INFORMATION MUST BE ACCOUNTED TO CORPORATION. TO AVOID LIABILITY, THE PERSON WITH THE KNOWLEDGE MUST FIRST DISCLOSE SUCH INFORMATION TO THE OTHER PARTY, OR IF IMPRACTICAL TO DO SO, FORGO THE TRANSACTION.

### **II. SPECIAL FACTS DOCTRINE**

A DIRECTOR OF A CORPORATION MAY BE LIABLE TO A SHAREHOLDER FOR SELF DEALING IN PURCHASING OR SELLING STOCK IF THE DIRECTOR.

- 1) SOLICITS STOCK FROM A SHAREHOLDER WITH KNOWLEDGE THAT HE ONLY RECEIVES BY VIRTUE OF HIS POSITION;
- 2) USES AN INTERMEDIARY TO AVOID DISCLOSING THAT HE OR SHE IS THE BUYER;
- 3) TAKES STEPS TO CONCEAL THE INFORMATION OR MAKES MISREPRESENTATIONS REGARDING MATERIAL FACTS WHICH WOULD AFFECT HIS DECISION.