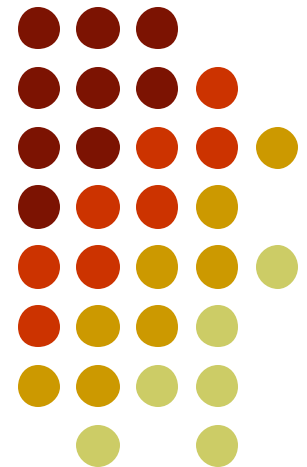


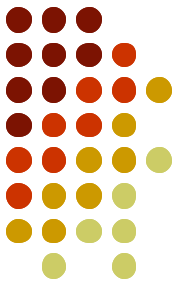
Corporations

Prof. Michael Abramowicz

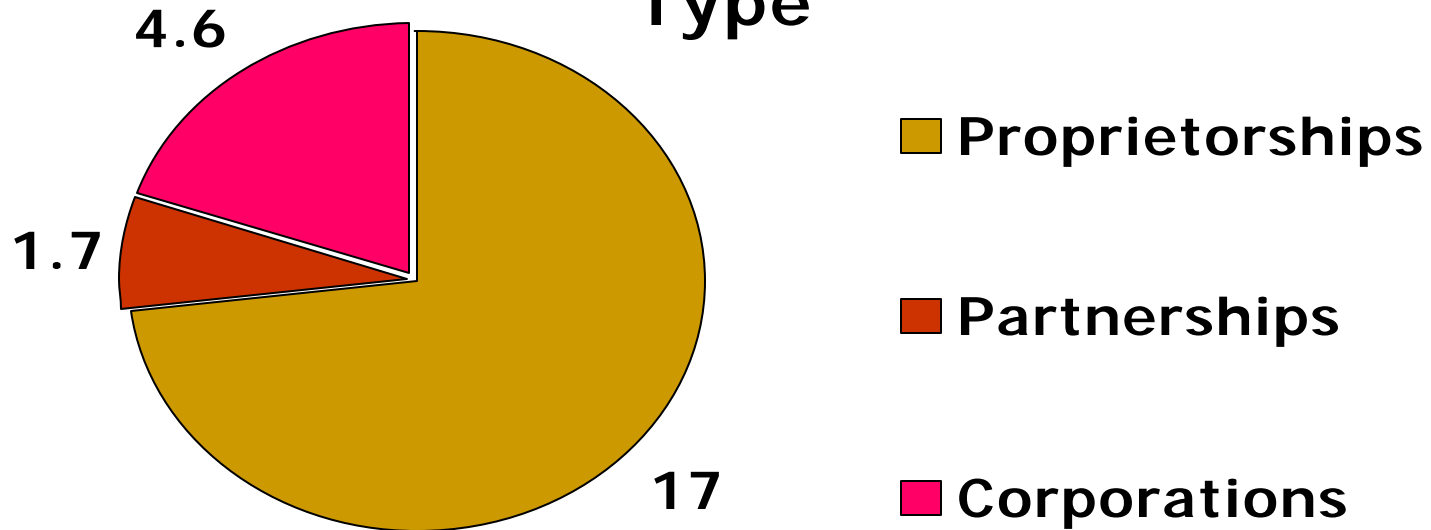
Introduction to the Corporation



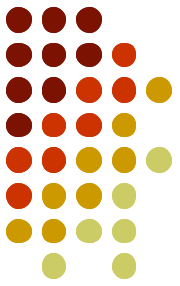
Forms of Business Organizations



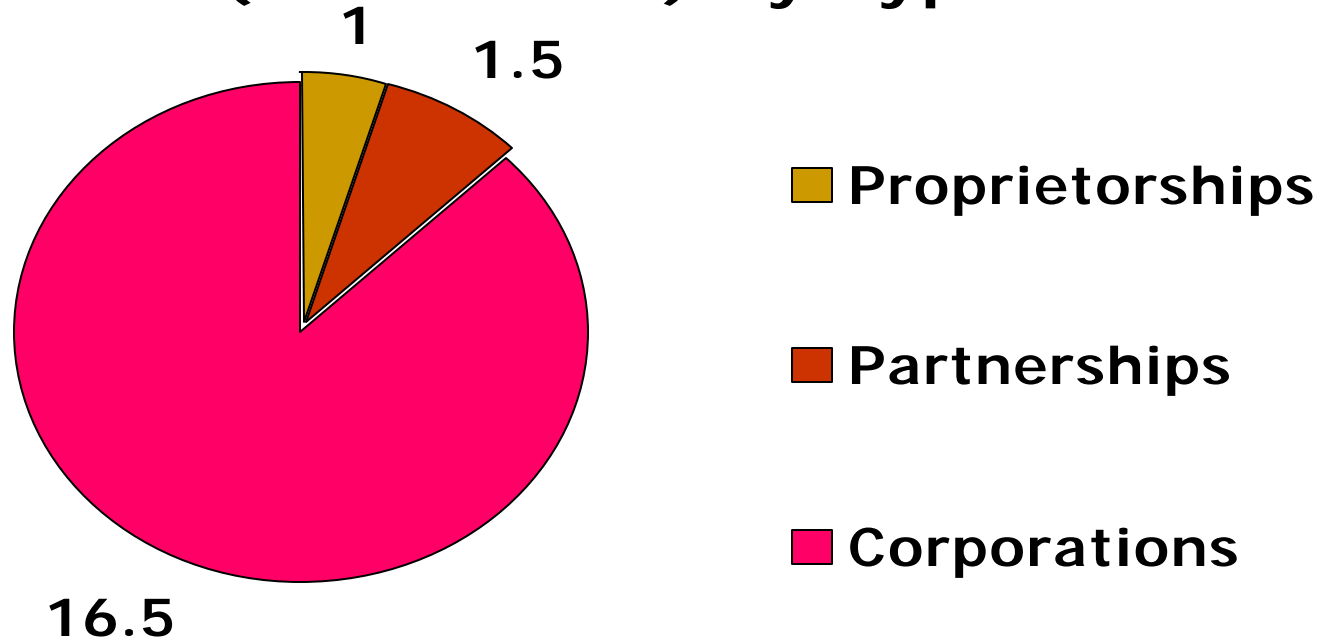
Number of Business Organizations (in millions) by Type



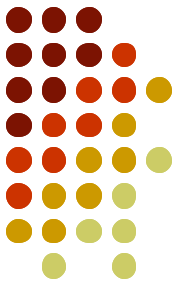
Forms of Business Organizations



**Business Organization Receipts
(in trillion \$) by Type**

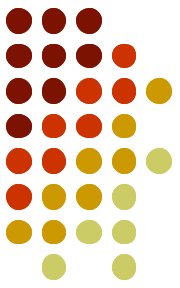


Critical attributes



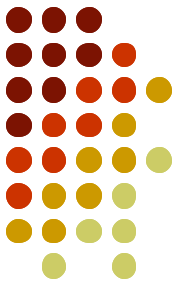
1. Legal personality
2. Limited liability
3. Separation of ownership and control
4. Liquidity
5. Flexible capital structure

Introduction to the Corporation: Overview of Issues



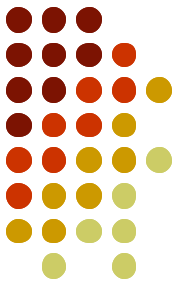
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Delaware's dominance



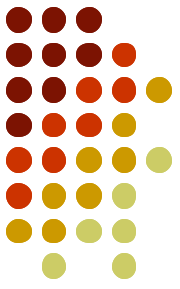
- More than 300,000 companies are incorporated in Delaware including:
 - 60 percent of the Fortune 500
 - 50 percent of the companies listed on the New York Stock Exchange
- Why?
 - Race to the bottom
 - William L. Cary, Federalism and Corporate Law: Reflections on Delaware, 83 Yale L. J. 663 (1974)
 - Race to the Top
 - Ralph K. Winter, State Law, Shareholder Protection and the Theory of Incorporation, 6 J.Leg.Stud 251 (1977)

Comparing Partnerships and Corporations



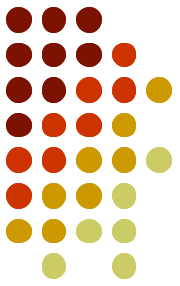
	General Partnership	Corporation
Limited Liability	No, but partners can bargain it from 3 rd party, buy insurance	Yes, but creditors may seek personal guarantees
Free Transferability	Default: No, but may be allowed	Default: Yes, but may be restricted
Longevity	Dissolution at will, unless agreed upon otherwise	Default: Indefinite, but can be limited
Centralized Management	No; each partner an agent. But can use committee & limit authority by agreement/notice.	Yes, but may want to modify to prevent freeze-out.
Formation/Formalities	Informal (no filing)	Formalities required, including: Articles of Incorporation, Bylaws, Board of Directors, Officers, Minutes, Elections, Filings; more costs
Tax	Single taxation – Partnership is not taxed; partners are.	Double on distributed earnings: Corporation taxed, and so are dividends

Introduction to the Corporation: Overview of Issues



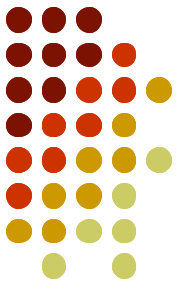
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Liability for Pre-Incorporation Activity



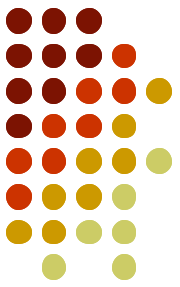
- Promoter: Someone who purports to act as an agent of the business prior to its incorporation
- Legal Issues:
 1. Once the articles are filed, does the corporation become a party to the contract?
 2. Once the articles are filed, is the promoter liable if the corporation breaches the contract?
 3. If the articles are not filed, is the promoter liable on the contract?
 4. If the articles are not filed or are defectively filed, can the defectively formed entity (or individuals) enforce the contract?

“Defective Corporations”



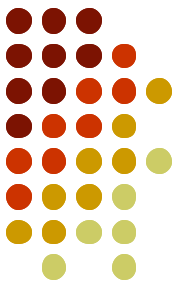
- De facto Corporation: A court may treat an improperly incorporated firm as a corporation if organizers:
 - Acted in good faith to incorporate;
 - Had the legal right to incorporate; and
 - Acted as if they were incorporated.
- Corporation by Estoppel: A court will also treat a firm improperly incorporated as a corporation if third parties:
 - Thought business was a corporation; and
 - Would earn a windfall if it were now allowed to deny that the business was a corporation.
- Significant overlap between doctrines, but not always. E.g.:
 - If firm did not act to incorporate, can't be de facto corporation.
 - If firm incurred liability by doing a tort, the injured party likely did not choose to deal with the firm as a corporation. Still may be de facto corporation.

Southern-Gulf Marine Co. No. 9 v. Camcraft, Inc.



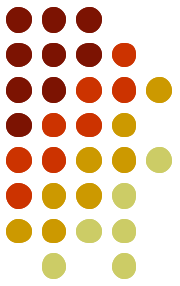
- Facts
 - What was deal?
 - What was problem with SGM?
- Holding
 - Corporation by estoppel?
- Hypos
 - Barrett sues individually
 - Camcraft sues Barrett individually

Introduction to the Corporation: Overview of Issues

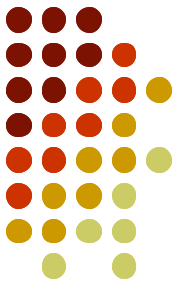


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Limited Liability



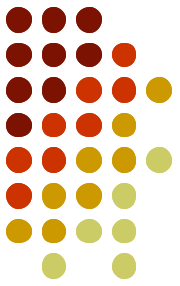
- MBCA § 6.22(b): “Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct”



Walkovszky v. Carlton

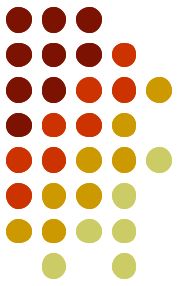
- Facts
 - Corporate setup
 - Accident
- Issues
 - Veil piercing
 - “Alter ego” theory
 - Distinguish agency theory
 - How to protect against veil piercing?
 - Enterprise liability
 - Undercapitalization
- Questions
 - Legitimate uses for multiple corporations?
 - Implications of enterprise liability?

Sea-Land Services



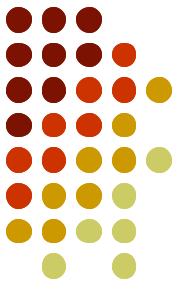
- Facts
 - Transaction
 - Defendants
- “Reverse veil piercing”
- Holding
- Standard for piercing...

Sea-Land Services: Summary of black letter law (in Illinois)



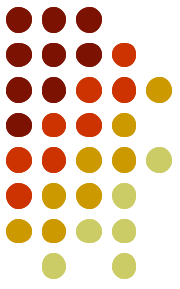
- To pierce the corporate veil, a court must find
 - (a) a unity of interest and ownership, determined by looking at four factors:
 - (w) the lack of corporate formalities,
 - (x) the commingling of funds and assets,
 - (y) under-capitalization,
 - and (z) the use by one corporation of assets of another.
 - and (b) a situation where failing to PCV would either
 - (i) sanction fraud or
 - (ii) promote injustice.

Roman Catholic Archbishop of San Francisco v. Sheffield



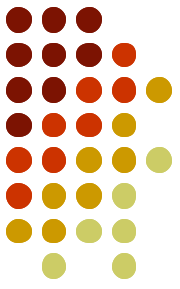
- Facts
- Issue:
 - Alter ego theory
- Holding
- Questions
 - Liability of the Vatican and the Pope?
 - Applicability of enterprise liability theory?
 - Applicability of agency law, including apparent agency theory?

In re Silicone Gel Breast Implants Products Liability Litig.



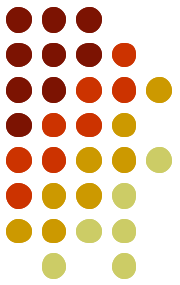
- Facts
- Formalities followed?
- Questions
 - Does justification for veil piercing apply here?
 - Fraud needed?
 - Whom did plaintiffs think they were dealing with?

Introduction to the Corporation: Overview of Issues



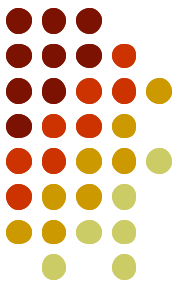
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Derivative Actions

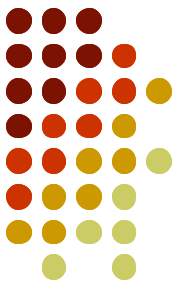


- Questions
 - What are angry shareholder's options?
 - What are the prerequisites for filing a derivative suit?
 - What's the difference between a derivative action and a direct suit?
 - What are the necessary qualifications to be a plaintiff?

Introduction to derivative suits: *Cohen v. Beneficial Industrial*



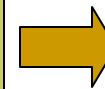
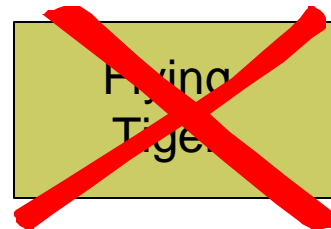
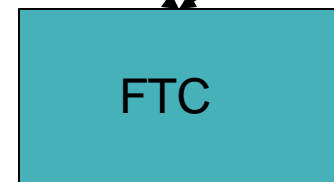
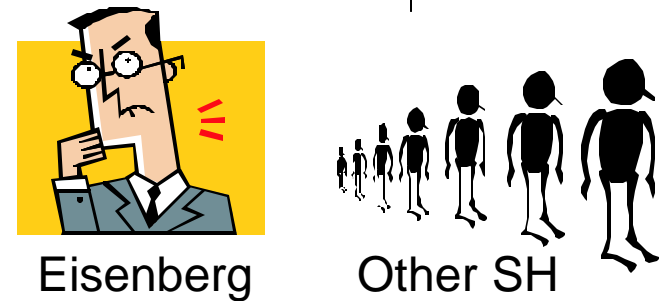
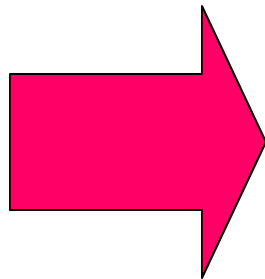
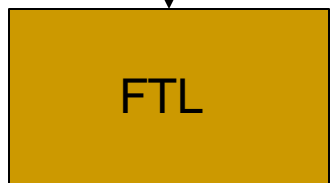
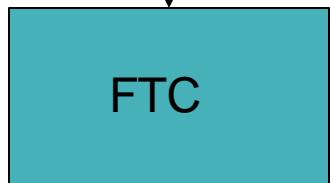
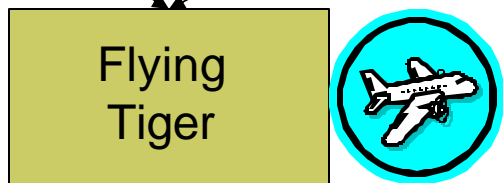
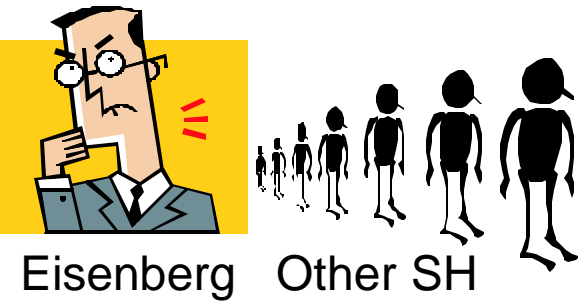
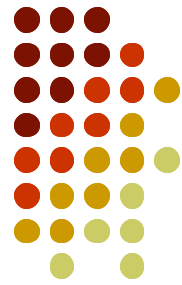
- Facts
 - Who was Cohen, and on whose behalf did he sue?
 - Who were the defendants?
 - What did the corporation demand?
- Holding
 - State law issue
 - Constitutional issues
 - *Erie* issue
- Choice of law in corporations cases
- Derivative suit: Equitable or legal?



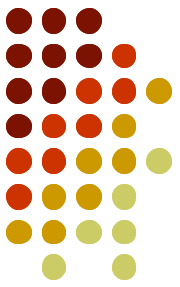
Policy Concerns

- Why should the plaintiff have to pay the defendant's costs if the litigation is unsuccessful? Isn't that un-American?
- Incentives in derivative suits
 - Plaintiff
 - Defendant
 - Strike suits
 - Meritorious suits

Eisenberg v. Flying Tiger



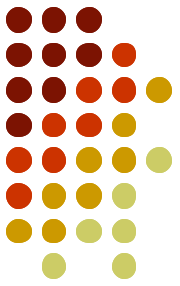
What are possible benefits of this transaction?
What is Eisenberg asking of the court?



Eisenberg v. Flying Tiger

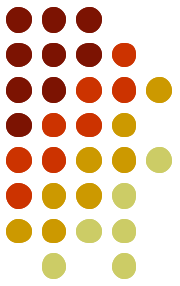
- Questions
 - What are possible benefits of this transaction?
 - What is Eisenberg asking of the court?
 - What is Eisenberg's claim on the merits?
 - How was Eisenberg hurt in practice?
- Possible approaches to direct suit issue
 - Individual injury?
 - Whom does defendant owe a duty?
 - Court's approach: Who would receive benefits?

Shareholders must make “demand” before filing suit

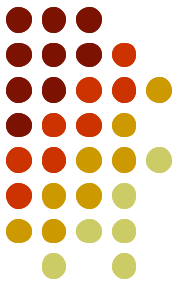


- MBCA § 7.42: “No shareholder may commence a derivative proceeding until ... a written demand has been made ... and 90 days have expired from the date the demand was made ... unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period”
- FRCP 23.1: The complaint shall allege “the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors ... and the reasons for the plaintiff's failure to obtain the action or for not making the effort”

Demand futility (where MBCA does not apply)



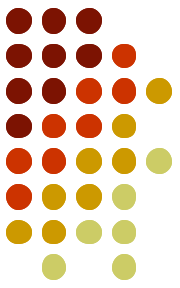
- The demand requirement allows the company to either take over the cause of action (and sue directly) or resist the suit. The decision is up to the business judgment of the directors.
- But where the directors cannot be expected to make a fair decision, demand would be futile and is excused.
- What is standard for demand futility?
 - Del: *Grimes v. Donald*
 - NY: *Marx v. Akers*



Grimes v. Donald

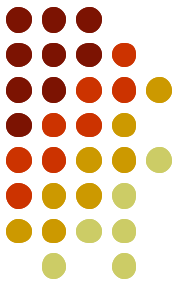
- Facts
 - Employment contract
- Alleged breach of fiduciary duty by BoD
 - Excessive compensation
 - Direct or derivative?
 - Procedural issue?
 - Abdication of board powers to managers
 - Direct or derivative?
 - Merits?

Excusing the Demand Requirement under Delaware Law (*Grimes v. Donald*)



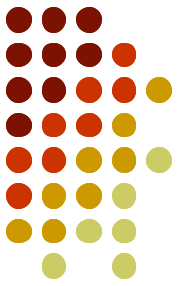
- *Aronson* rule (followed in *Grimes*): The demand requirement is excused if plaintiff shows reasonable doubt that either:
 - A majority of the board has a material financial or familial interest,
 - A majority of the board is incapable of acting independently for some other reason such as domination or control,
 - Or – the underlying transaction is not the product of a valid exercise of business judgment.
- *Grimes* clarifies that this test is *disjunctive*.

The Demand Requirement under New York law: *Marx*



- Two issues
- Purposes of the demand requirement
- Three-prong test

The Demand Requirement as Filter



- **NY standard:**

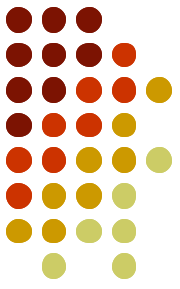
- Majority of directors interested; or
- Directors failed to inform themselves; or
- Challenged transaction could not have been the product of sound business judgment

- **Delaware standard:**

Reasonable doubt as to:

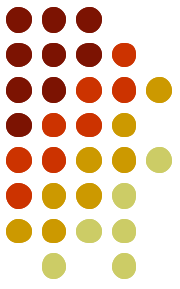
- Majority of board has material interest; or
- Majority of the board lacks independence; or
- Challenged transaction not product of valid exercise of business judgment

Special Litigation Committees: *Auerbach v. Bennett* (N.Y.)



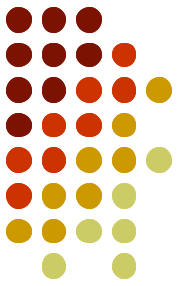
- Facts leading to creation of the SLC
- How disinterested are these directors?
- Outcome of SLC?
- How much deference should court accord SLC recommendation to dismiss suit?

Zapata v. Maldonado (Del.)



- Facts
 - Demand made? Excused?
 - SLC
- Two-step test
 - Step 1
 - Independence
 - Bases
 - Step 2: Court's independent business judgment
- Same as demand refusal case?

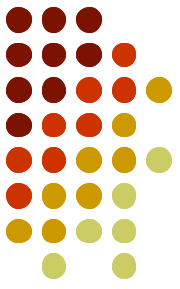
Derivative Action Flowchart



Is suit direct or derivative?

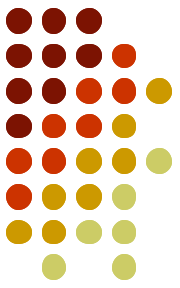
- Direct – SH suit allowed.
- Derivative – Is demand universal?
 - Universal Demand Rule (MBCA §7.42)
 - Did appropriate demand review institution find suit not in corp’s interest?
 - Yes – Dismiss unless institution’s decision not in good faith or based on reasonable investigation.
 - No – SH suit allowed.
 - Non-universal demand rule (Delaware/NY) – Is demand futile and thus excused?
 - Demand excused – SH suit allowed; Corp. may use SLCs to get court to dismiss.
 - Demand not excused – Demand made?
 - No – Suit dismissed/stayed until demand made.
 - Yes – Demand refused?
 - No – Board of Directors takes control of suit.
 - Yes – Refusal wrongful? (BJR applied to decision to refuse demand)
 - Yes – SH suit allowed; No – Suit dismissed.

Introduction to the Corporation: Overview of Issues



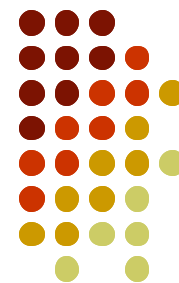
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- One last BA type: The Limited Liability Company

Hierarchy of Legal Sources

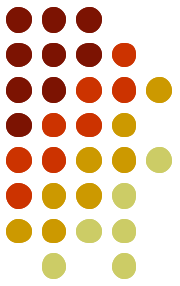


Corporation

Country

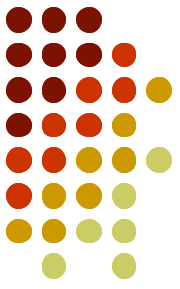
- Applicable Federal/State Laws
 - Articles of Incorporation
 - Bylaws [MBCA §2.06]
 - Board of Directors' Decisions
 - Decisions of Officers
 - Initial Formation
 - Articles of Incorporation: By incorporator [MBCA §2.01, 2.02]
 - Bylaws: By incorporator or Board of Directors [MBCA §2.06(a)]
 - Amendments
 - Articles of Incorporation: By majority vote of shareholders [MBCA §10.03], except for certain technical amendments [MBCA §10.05], or if no stock was issued.
 - Bylaws: SH or BoD, unless Aol or Bylaw amended by SH says otherwise [§10.20]
- Laws of Physics
 - Constitution
 - Laws
 - Regulations
 - Decisions of Gov't employees

Corporate Powers and Purpose



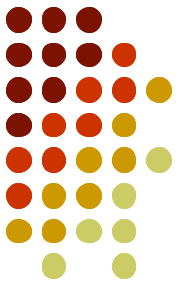
- Corporate powers
 - MBCA §8.01(b): “All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors.” [See also DGCL §141]
 - What are the “corporate powers”?
 - MBCA § 3.02
- Goals of corporations
 - Stakeholders
 - Wealth maximization
- Centralized management

Charitable donations: *A.P. Smith v. Barlow*



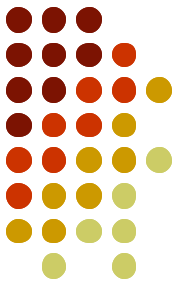
- Facts
 - Gift
 - Defenses of gift
- (A brief) history of corporations
- Holding
 - Statutory limits
 - Date of passage of statutes
 - Caveats
- Controversial charities
- Different states' approaches

Dodge v. Ford Motor Co.



- Facts
- Relief sought
- Holding
 - Dividends
 - General standard of review
 - Application
 - Construction
- Apply MBCA § 8.30(a)

Shlensky v. Wrigley



- Facts
 - Shlensky's position
 - Wrigley's position
- Holding
 - How to reconcile with *Dodge*?
 - Really shareholder benefit here?