MASSACHUSETTS SCHOOL OF LAW

BUSINESS ENTITIES AND OPERATION

FALL 2022

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Introduction:

This course utilizes an electronic casebook, and we will cover three vital (and heavily tested) areas of the law: agency, partnership, and corporations (including LLPs and LLCs). This syllabus will be religiously followed. Prior to most of the cases, there is a short discussion of some of the important points you should think about while reading each case. Thinking about and being ready to discuss these points is crucial to effective classroom learning.

The reading is broken out into 15 weekly assignments. Note that you are responsible for logging in to Westlaw with your password and carefully reviewing the noted sections of the Restatement of Agency, 3rd for the first 6 weeks of class. You are required to read and brief all assigned cases for the week prior to the first class of that week, as the cases may be discussed in no particular order. Students who are unprepared or who are absent without excuse more than twice, will have their final grade lowered.

Grading: There will be 2 quizzes (in Week 4 and Week 13), each worth 5 points. There will be a midterm (in Week 10), worth 15 points. The final exam will be worth 75 points, for a total of 100 points.

Syllabus

Weekly reading assignments:

Week 1: Classifying Agents

Restatement of Agency 3rd: Chapter 1, and 2.04

Demian v. Frank; Tormo v. Yormark; Bucholtz v. Sirotkin; Rowen v. Flushing; Cowan v. Eastern Racing; Miguel v. Linden; Wright v. Kelleher; Commissioner v. Town Taxi; Fortenbacher v. Commonwealth.

Week 2: Rights and Duties of Agents and Principals

Restatement of Agency 3rd: Chapter 2, sections 2.01-2.03

Wing v. Lederer; Elliot v. Great National; Gizzi v. Texaco;
Drummond v. Hilton Hotel; Hoddeson v. Koos Bros; Cullen v. BMW; Barrow v. Dartmouth House Nursing Home; Fergus v. Ross.

Week 3: The Equal Dignities Rule; Ratification

Restatement of Agency 3rd: Chapter 4

Commission v. Roger Gray; Flynn v. Dugas; Bridge v. Futurity; 3A's Towing v. P&A Well Service; Linkage v. Boston University; Colony of Wellfleet v. Harris;

Week 4: Duration and Termination of Agency

Restatement of Agency 3rd: Chapter 3, 3.06-3.16

Thomas v. Ballou-Latimer; Shenn v. Fair-Tex; Pine River v. Mettille; Monge v. Beebe Rubber; Maddoloni v. Western Bus Lines; Siles v. Travenol Labs; Brockmeyer v. Dun & Bradstreet.

Week 5: Notice and Knowledge

Restatement of Agency 3rd: Chapter 5

Farr v. Newman; R & D Muller v. Fontaine's; Southern Farm v. Allen; Sutton Mutual v. Notre Dame; Georgia Pacific v. Great Plains; Bowers v. P. Wiles, Inc.; Mackey v. Rootes Motors.

Week 6: When the Agent Competes Against the Principal

Restatement of Agency 3rd: Chapter 1

Arthur Murray v. Witter; Devoe v. Cheatham; 1st American v. Rezatto; National Recruiters v. Cashman; Maryland Metals v. Metzner; BBF v. Germanium Power.

Week 7: General Liens and Charging Liens

Matter of Heinsheimer Meyer; Upgrade v. Michigan Carton; Williams v. Investors Syndicate; Gormley v. Wilkins; Dudley v. Mass State Police.

Week 8: Partnerships

M.G.L. c. 108A

Kaufman-Brown v. Long; Martin v. Peyton; Frank v. R. A. Pickens; Fenwick v. Unemployment Commission; Jensen Farms v. Cargill; Vohland v. Sweet; Humble Oil v. Martin; Hoover v. Sun Oil; Amory v. Checroune.

Week 9: Partner Rights and Duties; Dissolution

Meinhard v. Salmon; Meehan v. Shaughnessy; Gibbs v. Breed; Nabisco v. Stroud; Roach v. Mead; Prentiss v. Sheffel; Monin v. Monin; Johnson v. Kennedy; Dreifuerst v. Dreifeurst; 8182 Maryland Association.

Week 10: Limited Liability Partnerships and Limited Liability Companies
M.G.L. c.109
M.G.L. c. 156C

Bassan v. Investment Exchange; Puleo v. Topel; Harbison v. Strickland; Knapp v. Neptune Towers; Milliken v. Duro Textiles; Fronk v. Fowler; Pierce v. Morrison, Mahoney; First Bostonview Management, LLC v. Bostonview Corp.

Week 11: Corporations; The Business Judgment Rule

M.G.L. 156D

Smith v. Barlow; Bayer v. Beran; Shlensky v. Wrigley; Menard v. Dage-MTI; Burg v. Horn; Boylan v. Boston Sand & Gravel;

Week 12: Piercing the Corporate Veil

Zempel v. Liberty; Walkovsky v. Carlton; Howie v Ikechukwuka; Sea-Land v. Pepper Source; Kinney Shoe v. Polan; Bratz v. Arrowbar; My Bread Baking v. Cumberland Farms; Gardemal v. Westin Hotel; Philip Alan, Inc. v. Sarcia; Scott v. NG U.S. 1; Nissen Corp. v. Miller; Attorney General v. M. C. K., Inc.

Week 13: Closely Held Corporations

Donahue v. Rodd Electrotype; Wilkes v. Springside Homes; Merola v. Exergen; Sugarman v. Sugarman; Keating v. Keating; Smith v. Atlantic Properties;

Week 14: Mergers; Shareholder Derivative Suits

Coggins v. New England Patriots; Cheff v. Mathes; Beneficial Industrial v. Smith; Heineman v. Datapoint; Alford v. Shaw; Food & Allied v. Wal-Mart; In re Paxton Communications; Cuker v. Mikalauska; Brehm v. Eisner;

Week 15: Securities Law; Insider Trading

Goodwin v. Aggasiz; SEC v. Texas Gulf Sulphur; Carpenter v. U.S.; U.S. v. Chestman; United States v. O'Hagan;

I. Overview of and Introduction to Classifying Agents

You need to know some important rules before delving into the cases that follow. First, many of them are exceedingly complex, but trudge through them as best you can. Nobody ever said the path to Enlightenment is an easy one. Second, you need to understand how cases are decided. Either there is a statute enacted by the state legislature (think of gambling, or what maximum interest rates businesses can charge on loans, to name two), which will govern the issue, or there is what is called judge-made law, or, the common law. And this is exactly what you would expect. If there is no statute governing the issue, the courts still have to decide the issue. And typically, what courts will do is seek guidance, from prior decisions which are closely on point (precedent), or from what is known as the Restatement. And there are lots of Restatements, on lots of common law school subjects. For the first part of this course, we will be focusing on Agency law, and we will rely heavily on the Restatement (Third) of Agency. You can find the whole thing online, either through a search engine or through your Westlaw account, or even in the Library, in hard copy.

In your first year course on Contracts, and in your second year course on Property, you quickly realize that the proper classification of the parties in a dispute governs what rights and duties they have, and how they will be treated. Contract law examples would be third party beneficiaries, or assignees. Property law examples would be fee simple absolute, contingent remainders. To a great extent, the same is true in agency relationships. Once you classify a person or entity, then the rest falls into place. With that as prologue, we can take a look at the cases.

Discussion points for Demian v. Frank

This case presents a typical international contracts business scenario. As you read it, try and classify Frank. Is he an agent, independent contractor, servant? What has he agreed to do? What is his job description? How much responsibility has he agreed to bear, either expressly, or by implication? Is it crucial to classify Sun? Keep in mind that if Sun is a subagent of Frank's, delegation is only allowed if it is 1) authorized, 2) ministerial, 3), customary, or 4) necessary.

DEMIAN, LTD., Plaintiff-Appellant,
v.
CHARLES A. FRANK ASSOCIATES, et. Al.,
Defendants-Appellees.

United States Court of Appeals,
Second Circuit.

Argued Oct. 23, 1981.

MANSFIELD, Circuit Judge:

In this diversity suit for damages for breach of a contract for services in the importation of men's leather and suede garments, plaintiff-appellant, Demian, Ltd. ("Demian"), the purchaser, appeals from a judgment of the Southern District of New York entered by Judge Charles L. Brieant in favor of the defendants, dismissing the complaint after a non-jury trial. We remand the case to the district court for further findings of fact, affirm the dismissal of Frank's counterclaim for commissions, and deny Frank's request for an award of costs, damages, and expenses, including attorneys' fees.

At all pertinent times Demian, a Pennsylvania corporation, was an importer of high grade men's leather garments for sale in the United States and Frank was a service organization with business acquaintances in the Orient. For a commission paid by American importers, Frank would locate manufacturers or sources of supply in the Far East and make arrangements for the manufacture of the goods in the Orient and their importation into the United States. To facilitate importation into the United States of goods made in Korea, Frank entered into an arrangement with K. C. Sun of Da Chong Hong Trading Co., Ltd. ("Sun") in Korea, whereby, for 50% of Frank's commission received for its services, Sun would locate Korean manufacturers and, following Frank's instructions, do anything further required to effectuate the manufacture, sale and importation of goods purchased by Frank's American clients. One of these clients was Demian.

After approving samples of leather jackets to be manufactured in Korea by Koreanna Moulson, Ltd., a manufacturer located by Frank and Sun, who submitted the samples for consideration, Demian placed two orders with Sun for the purchase of two styles meeting the specifications of the samples. Pursuant to arrangements made by Frank, Demian forwarded to Korea letters of credit in favor of Koreanna, to be honored upon presentation of a certificate by Sun that it had inspected the shipment of the leather jackets made by Koreanna and found them to be of merchantable quality, meeting the sample specifications.

Unfortunately Sun did not properly perform its inspection duties, issuing a certificate that released the purchase price to Koreanna against jackets that did not meet the specifications. In June 1980 Demian brought the present suit against Frank for breach of contract, alleging that in return for commission payments Frank had agreed to:

"(A) Assist plaintiff in the designing of leather jackets which were to be manufactured in the Republic of Korea;

"(B) Arrange for the manufacture of said jackets in the Republic of Korea;

"(C) Inspect said jackets upon completion of the manufacturing to insure that they complied with the standards and specifications required by plaintiff, and in accordance with the terms of a Letter of Credit opened by plaintiff.

"(D) Perform all services necessary to accomplish the importation of the jackets into the United States."

Frank entered a general denial and counterclaimed for a 5% commission "for his services."

At trial Michael Driban, President and owner of Demian, testified that, after Charles A. Frank had described his qualifications and his extensive experience in locating Oriental manufacturers, arranging for their manufacture of goods and importing garments into the United States, they entered into an arrangement under which Frank was to "oversee any program we would enter from start to finish." Frank stated:

"Q What do you mean, from start to finish?

"A From the placing of the orders to making sure that the work was done in time, to make sure the garments were packed in time, that every step of the production process was followed through, that the skins arrived in time to be cut, that the cutting was done in time, that the sewing was done in time, that the skins, when they arrived, were first quality, that when all was said and one (sic), the garments were inspected. Evenness of color, quality of skin, sewing details, etc., were packed, the documents were completed in a satisfactory manner, and that it went out on a ship that would ultimately get to us in time to permit us timely deliveries to our customer, which was our responsibility."

With respect to responsibility for inspection of goods in Korea before release of Demian's letter of credit, Driban testified that Frank advised that full responsibility would be assumed by him or, if he was not in Korea at the time of shipment, by his "man in Korea," K. C. Sun, whom Driban had never met. On cross-examination by Mr. Frank, Driban testified:

"Q Did I ever represent to you as a guarantor of the factory-

"THE COURT: He said yes, you sure did. Why do you keep fooling around? Answer the question.

"A You told me you would be personally or someone from your office would be

responsible for the final inspection of those garments. Without a certificate certifying to that effect payment would not be made to the factory."

Frank's defense was that he acted merely as a broker, without assuming responsibility other than to bring the principals together. On his deposition, however, he testified that he entered into a relationship with Mr. Sun whereby Sun would perform numerous services for him in Korea, including location of factories, help in obtaining clients, manufacture of garments, and inspection, and that "(i)f there were requirements that a particular client had that I could not do for the clients because I was not there, he would do it." (App. 45A). Frank testified: "If I gave him instructions, he following them out.... Mr. Sun was to execute what I asked him to execute."

At the close of the trial Judge Brieant, although he found that Frank's "services were totally useless" and he had been a malefactor who had engaged in "unconscionable" conduct, concluded:

"The most the proof shows, an agent was authorized by the principal to delegate a sub-agent and in the absence of some knowledge of it at the time of appointing Sun, that Sun was an improper person to be appointed, there is no liability, no vicarious liability when a sub-agent with the permission of the principal is appointed by an agent to work for the principal, and that is really what happened here with K. C. Sun.

"... there is no joint venture because, in order to have a joint venture, there must be an agreement proved to share losses and profits.

"... When two persons could broker in effect like that, neither one becomes the agent for the other, and Mr. Frank does not, by the facts of this case, become the person vicariously liable for the sins and omissions or defaults or delicts (sic) of K. C. Sun, and that is what is sought to be shown here in this case."

Accordingly the court entered judgment dismissing the complaint. Finding that Frank's services were worthless, he also dismissed its counterclaim for commissions, without costs to either side.

DISCUSSION

We do not question the district court's finding that no joint venture existed between the parties since there is no evidence of profit or loss sharing between them, which is essential to recovery on a joint venture theory.... Under the law of agency Frank's liability to Demian for Sun's improper certification turns on whether Sun was employed as Frank's subagent to perform his duties as Demian's agent or as an independent agent of Demian for which it would assume responsibility. If Sun was Frank's subagent, Frank would be liable to Demian for the subagent's conduct. 2 Restatement (Second) of Agency, s 406.

"s 406. Liability for Conduct of Subagent

"Unless otherwise agreed, an agent is responsible to the principal for the conduct of a subservant or other subagent with reference to the principal's affairs entrusted to the subagent, as the agent is for his own conduct; and as to other matters, as a principal is for the conduct of a servant or other agent." Id. 252.

On the other hand, if Sun was not a subagent but a separate agent acting solely for Demian, Frank would not be liable. Restatement (Second) of Agency, ss 5, 405.

s 405. Liability for Conduct of Other Agents

"(1) Except as stated in Subsections (2) and (3), an agent is not subject to liability to the principal for the conduct of other agents who are not his subagents.

"(2) An agent is subject to liability to the principal if, having a duty to appoint or to supervise other agents, he has violated his duty through lack of care or otherwise in the appointment or supervision, and harm thereby results to the principal in a foreseeable manner. He is also subject to liability if he directs, permits, or otherwise takes part in the improper conduct of other agents.

"(3) An agent is subject to liability to a principal for the failure of another agent to perform a service which he and such other have jointly contracted to perform for the principal." Id. 251.

Here we need not speculate as to the nature of the legal theory asserted by Demian as the basis for its claim against Frank. It does not ask the court to infer from the circumstances that Sun must have been Frank's subagent rather than an independent agent procured by it as a broker. It claims that Frank breached an express agreement with it to inspect the jackets upon completion of the manufacture "to insure that they complied with the standards and specifications required by plaintiff, and in accordance with the terms of the Letter of Credit opened by plaintiff." Under such an agreement Frank would be obligated either personally to inspect the manufactured jackets or to see to it that they were properly inspected by Sun and to issue a certificate or have Sun do so only if they conformed to the samples approved by Demian, which they admittedly did not. If Frank failed to perform these promises and allowed substandard jackets to be certified, he would under elementary principles of contract law be liable in damages to Demian regardless of any joint venture or subagency theory of liability.

The district court does not appear to have considered this issue of whether Frank expressly entered into an agreement with Demian to inspect properly and made no findings with respect to such an agreement. If there were no supporting evidence, we might let stand the dismissal of this claim for breach of an express contract. But here the record contains an abundance of testimony by Driban to the effect that Frank agreed to insure that Sun, whom Frank described as his "man in Korea" who followed Frank's "instructions" and who would "execute what I asked him to execute," would make a proper inspection and issue a certificate only if the jackets conformed to Demian's specifications. Nor does Judge Brieant appear to have discredited Driban as a witness. Indeed at one point he appears to have accepted Driban's testimony that Frank represented himself to be a "guarantor." Judge Brieant's characterization of Mr. Frank, on the other hand, indicates some doubt as to his reliability. The finding that Frank's services were worthless and in violation of his contractual obligations, disentitling him to a commission, is supported by the record and not clearly erroneous.

In view of these circumstances we vacate the judgment dismissing the complaint and remand the case to the district court for further proceedings, findings, and decision.

Discussion points for Tormo v. Yormark

As future lawyers, this case should be of the utmost importance to you, because it focuses on whether an attorney is going to be liable for the torts of someone else. And again, the question comes down to one of classification. What were Devlin's responsibilities for his client? How would you classify Yormark? Subagent? Co-Agent? Does it matter that Devlin performed his services pro bono? Is it true that a scumbag is a scumbag is a scumbag? Is it reasonable to trust a person convicted of tax fraud with the job of babysitting your kids? Is it reasonable to trust a pedophile with delivering packages to your clients? Are attorneys held to a higher standard than other professionals?

Another issue which sometimes arises is the agent's authority to redelegate. The general rule is that there is no authority to redelegate. But within actual authority you have implied authority, so that courts have held that delegation by an agent is acceptable if the delegated task is merely "ministerial," as opposed to discretionary, or if it customary for agents in similar situations to delegate their tasks. So, if you go to a well respected lawyer in a big law firm, whom do you think is going to do the bulk of the work on your case? Can you avoid such a result?

Karen Wendel TORMO and Henry Wendel, Plaintiffs,
v.
Milton YORMARK et al., Defendants.
Plaintiffs,
v.
Edward DEVLIN, Third-Party Defendant.

United States District Court, D. New Jersey.

May 12, 1975.

OPINION

COOLAHAN, District Judge.

This case raises questions concerning a New York attorney's liability for negligence in transferring his clients' personal injury case to a criminally indicted New Jersey lawyer who subsequently embezzled the clients' funds. The questions arise on a motion for summary judgment by third-party defendant Edward Devlin, the New York lawyer, against defendants-third-party plaintiffs Fidelity Union Trust Company (Fidelity) and Keene National Bank

(Keene).

Pertinent procedural history may be briefly summarized. Devlin's clients, plaintiffs Henry Wendel and Karen Wendel Tormo, brought the main action against six defendants to recover $148,997, the face amount of an instrument issued to settle the personal injury suit and wrongfully converted by Milton Yormark, the New Jersey lawyer consulted by Devlin. Against Fidelity, the depository bank, and Keene, a collecting and presenting bank, plaintiffs alleged causes of action for conversion under section 3-419(1) of New Jersey's Uniform Commercial Code, N.J.S.A. 12A:1-101 et seq. In addition, they alleged against Fidelity alone a cause of action for negligence based on its failure to take reasonable measures to discover whether Karen's endorsement on the draft was genuine. The banks in turn filed a third-party complaint for either contribution or indemnity against Devlin based on negligence toward his clients in selecting and failing properly to supervise Yormark. Procedural facts unrelated to the present motion are set forth in the margin.

Facts pertinent to Devlin's role in this case are confused and conflicting. A chronological history must begin on July 5, 1968. On that date Karen Tormo, then an unmarried infant and a citizen of New York, was involved in a boating accident in Dover Township, New Jersey. Shortly afterward, Karen's father, Henry Wendel, consulted Devlin concerning the matter. Devlin, whom Wendel had often consulted concerning his business affairs, visited the Wendel home on July 20 to discuss the incident. Although no retainer agreement was executed, and Devlin's fee was not discussed, Devlin agreed 'to see what could be done with regard to settlement' of Karen's claim. Devlin Deposition at 10; see Wendel Deposition at 8-9.

Devlin initially learned of Yormark several days later through Yormark's telephone call to his office. Representing that he was 'familiar with the accident,' Yormark requested a personal meeting. Devlin Deposition at 18. Devlin agreed. Yormark, accompanied by an associate, met Devlin at the Kings County Courthouse in Brooklyn on July 23, 1968. He informed Devlin that 'he and/or his representatives had discussed (the accident) with the Wendels and they had secured (Devlin's) name.' Id. at 18. Explaining that he was a 'negligence specialist,' id. at 25, Yormark indicated that he was interested in handling the case. Id. at 20. Devlin declined this 'offer,' but promised to 'consult him later if something developed.' Id.

Devlin's testimony indicates that he informed Wendel of the incident several weeks later. Wendel, however, apparently could not recall having met Yormark. His response, according to Devlin, was 'I had a lot of people in the home' after the accident. Id. at 21. Wendel's testimony indicates that he had never conferred with Yormark and that Devlin never informed him of the meeting. Wendel Deposition at 10-11.

By June 1970, Devlin had not settled Tormo's accident claim, and she had married, changed her residence to Spain, and obtained Spanish citizenship. Since New York was no longer a proper venue for the action, see 28 U.S.C. § 1391(a), and since Devlin was not licensed to practice outside New York, he contacted Yormark, requesting that he bring suit in New

Jersey. Whether either Wendel or Tormo actually participated in Devlin's decision is disputed. Devlin testified that he advised Wendel of his action 'when the matter was referred to Yormark.' Devlin Deposition at 23. Wendel's testimony flatly contradicts Devlin. He stated that Devlin failed to advise him of his decision until January 1971. At that time, moreover, Devlin allegedly stated that Yormark was a 'good well-qualified lawyer.' Wendel Deposition at 55-56.

Yormark, meanwhile, had bene indicted in 1969 in Essex County, New Jersey, for conspiring fraudulently to obtain money from an insurance company. He was subsequently convicted in January 1971, sentenced the following month to two consecutive 18-month prison terms, and disbarred in February 1972. The facts concerning Yormark's criminal misadventure received coverage in the New Jersey press, but Devlin never discovered them until after Yormark had fully executed his scheme. Devlin Deposition at 26. Prior to consulting him, Devlin's only independent inquiry into Yormark's reputation consisted of ascertaining that he was listed as a licensed New Jersey attorney in a lawyer's directory. Id. at 25.

Devlin's testimony indicates that he believed his responsibilities terminated as a result of the transfer. He notified Wendel that 'Mr. Yormark was going to handle the case,' id. at 39, but never expressly advised him that he considered his own role to have ended. Id. Wendel's testimony indicates that he never understood that to be true. After the transfer, he testified, he contacted Devlin at least twice monthly concerning the case, Wendel Deposition at 19, and Devlin repeatedly assured him that it was progressing well. Id. at 48. Devlin admitted these conversations, but stated that never was any reference made as to his responsibilities in the matter. Devlin Deposition at 39.

Devlin, at any rate, never consulted Yormark concerning resolution of the case after the transfer. Yormark communicated nearly exclusively with Tormo in Spain. Tormo, in turn, communicated with Wendel, and Wendel with Devlin. In early 1971 Yormark communicated a $150,000 offer of settlement to Tormo. She mailed him a letter indicating her willingness to accept that figure in February 1971. In March, misrepresenting to her that he needed further evidence of her intent, he induced her to sign a release. The release was delivered personally by one James Clare, an attorney for the insurance company whose services Yormark had solicited. Clare acted as a witness to the signing. Tormo neither read the document, see Tormo Deposition at 53-54, nor retained a copy for her records. Id. at 26.

Wendel's testimony indicates that he advised Devlin of her signing this document, which he described as 'needed for Mr. Yormark to prove that he wasn't bluffing.' Wendel Deposition at 43. Wendel could not recall if he described Clare's role in the incident, id. at 50, and there is no indication that Devlin was advised of Tormo's February letter to Yormark. But, Wendel stated, Devlin expressed concern about the nature of the document and indicated that he would investigate the matter. Id. at 50-51. Tormo, further, testified that Devlin telephoned her to obtain a copy of the instrument, but she never complied because she had no copy herself. Tormo Deposition at 25. Devlin's testimony indicates that the call to Tormo never occurred, see Devlin Deposition at 60-61, but that Wendel 'may have' advised him that his

daughter signed a letter evidencing her willingness to settle. Id. at 62.

Shortly after the release was signed, the insurance company delivered two drafts totaling $150,000 to Yormark. Yormark, who was then appealing his conviction, and who had apparently been experiencing financial difficulties for several years,forged Tormo's endorsement on the larger draft for $148,997. After depositing the item in a trustee account which he maintained at Fidelity, he immediately applied a substantial portion of the proceeds to his own use. See Askin Deposition Testimony at 89.

Tormo contacted him five weeks later concerning settlement developments. He assured her that all was well. Tormo Deposition at 29. In July 1971, while visiting her family in New York, she and Wendel met personally with Yormark. Yormark explained that three insurance companies involved in the settlement were debating their respective liabilities. Summer vacations, he warned, would further delay payment. Id. at 32. Wendel's testimony indicates that he communicated the substance of this meeting to Devlin. Wendel Deposition at 70. He purportedly complained of the delay involved, but he conveyed to Devlin no suspicion concerning Yormark. Id. Devlin's testimony indicates that this conversation never occurred. Devlin Deposition at 64-65.

After Tormo returned to Spain, she contacted Yormark nearly monthly. He put her off with similar excuses. In March 1972 she was unable to reach him at his office. Devlin, upon being apprized of this by Wendel, contacted Yormark's office and discovered he had disappeared. His investigation then revealed Yormark's embezzlement scheme.

Devlin's initial contention is that 'it is not at all clear that (he) was involved in an attorney-client relationship with the plaintiffs.' He points out that a formal retainer agreement was never executed and a fee never paid. But the law of New Jersey imposes the duties incident to such a relationship on one who merely 'assumes to give legal advice and counsel.' **** Neither contractual formality nor compensation or expectation of compensation is required. Devlin does not contend that his promise 'to see what could be done with regard to settlement' was an agreement to perform services nonlegal in character. That undertaking was sufficient as a matter of law to impose upon him the duties owed by an attorney to his clients in his relationship with the Wendels.

Devlin next asserts that proof of the fact that Yormark was indicted at the time of the referral is not evidence of negligence because there is no proof that he had actual knowledge of the fact and, being a New York lawyer, the knowledge cannot reasonably be imputed to him. This assertion has merit. Although the Court finds Devlin was under a duty of care in selecting Yormark to prevent harm subsequently caused by Yormark's criminal misconduct, Devlin could not be found negligent, after verifying Yormark's assertion that he was a licensed practitioner, simply for failing to inquire further into Yormark's reputation for honesty.

An actor generally has no duty to use care to prevent harm to another through the criminal acts of third parties not subject to his control. But excepted from this rule is a defendant who

expressly assumes such a duty. An agent who is authorized to employ other agents to handle his principal's affairs, moreover, is under a duty to select competent and otherwise proper agents. Restatement, Agency 2d § 405(2). Thus he might be liable to his principal for loss caused by the other agent's intentional wrongs if the harm were proximately caused by the employing agent's negligence. See id. Prosser, furthermore, has suggested that

there are other situations in which the defendant will be held liable because his affirmative conduct has greatly increased the risk of harm to the plaintiff through the criminal acts of others. The defendant may bring the plaintiff into contact with individuals of known criminal tendencies, as for example, by hiring them, under conditions in which the opportunity for crime is afforded.

Although unaware of New Jersey case law in point, the Court assumes that New Jersey courts would follow these general authorities and apply them to find that Devlin was under a duty to exercise care in retaining Yormark to ensure that he was competent and trustworthy.

A jury which believed Wendel's testimony could find that the duty arose from Devlin's express representations as to Yormark's qualifications. It arose, at any rate, as a matter of law both from Devlin's duties as an agent toward his principal and from his affirmative conduct in bringing his clients into contact with a person of previously unknown character under circumstances affording the opportunity for crime. But in setting a standard of conduct required to fulfill that obligation, a distinction must be drawn between Devlin and an allegedly negligent New Jersey lawyer. Although expressing no opinion as to the latter, the Court believes it would be unfair to require a New York practitioner referring a case to New Jersey counsel to know facts concerning him which are notorious only within New Jersey. Yormark's indictment was reported by the New Jersey press, but there is no evidence that it was given wider coverage. Devlin ought not be deemed negligent for failing to discover that fact absent proof of the latter sort. A contrary conclusion would subject out-of-state lawyers to possible liability for negligence for failure to consult not only a New Jersey lawyer's personal references and the legal ethics committee in the county in which he practices, but also the offices of local prosecutors. Yet a reference may be unaware of an attorney's criminal misadventure, and proceedings before the State's committees on ethics are required to be kept confidential. See N.J.R. 1:20-3(b). Thus the burden of these additional inquiries greatly exceeds the risk that a referring attorney may cause harm to his client by entrusting his affairs to a lawyer who is known to be licensed by the State. And consultation with a prosecutor would, as a practical matter, simply never occur to an actor in Devlin's position. To impose such a burden on a party who neither holds himself out to the public as a referral agent nor, presumably, derives substantial income from transferring his client's business to other counsel would be unfair. Devlin relied, in making the referral, upon the State's judgment that Yormark was fit to practice law. State regulation of the legal profession is extensive, designed both to screen unqualified candidates at the outset, see N.J.R. 1:25 (duties of Committees on Character), and to ferret out the unfit thereafter, see N.J.R. 1:20-2 (powers and duties of committees on ethics). Under the circumstances, he could not be found negligent simply for failing to make further inquiries into Yormark's background.

But even if as a matter of law Devlin was not required to know of Yormark's indictment, that conclusion does not resolve entirely the question whether a jury might find him negligent in retaining the New Jersey lawyer. Devlin's testimony shows that Yormark informed him that he had obtained his name through Wendel. But that testimony raises a question whether Wendel consulted Yormark or his 'representatives,' or whether the opposite was true. As an attorney, Devlin was required to realize that the latter situation would constitute a breach of the Code of Professional Responsibility. See DR 2-103(A), (B). The offense of soliciting legal employment from laymen constitutes a ground for disbarment. It evidences a lawyer's unworthiness of the trust and confidence essential to the attorney-client relationship. An attorney who knowingly entrusted his client's business to a lawyer who he had reason to believe was guilty of that offense would be clearly negligent either in making the referral at all, or in doing so without advising his client of his suspicions.

But there remains a question whether any legal principle precludes Devlin's conduct from being a proximate cause. Generally an actor's negligence, even if creating the opportunity for crime, cannot be a proximate cause of injury sustained by a third party's criminal wrong unless the actor should have realized both that the opportunity would be created, and that a third person might avail himself of it. See Restatement, Torts 2d § 448. The issue here is not whether Devlin should have realized that an opportunity for some crime had been created, for he placed a person of doubtful character in a fiduciary relationship with the plaintiffs; he entrusted him with authority to negotiate their affairs and to receive property on their behalf. The issue, rather, is whether Devlin ought to have realized that Yormark would seize that opportunity to embezzle his clients' funds. Conceivably, Devlin had no reason to believe that, because Yormark had resorted to unethical practices to obtain clients, he might also resort to embezzlement to obtain their property.

But no rule of logic or principle of policy would be served by thus fragmenting the nature of the risk created. If prudence requires an attorney to refrain from entrusting his client's case to another lawyer who may be guilty of 'touting' or employing 'runners,' this is so not because the practice of touting itself presents a particular risk of harm to the client. Rather, it is true because the ethical violation evidences a general lack of trustworthiness. So all conduct amounting to a breach of fiduciary trust-- whether it be embezzlement, fraud, or dealing in the client's property for one's own benefit-- must be considered within the risk making the conduct negligent. Such conduct is both a risk foreseeable to the actor and a consequence for which he may justly be held liable. A different case would be presented if the alleged 'touter' caused injury to his client by a criminal assault. But those facts are not before the Court.

****

Devlin's last contention concerning his own negligence is that, under the facts of the case, all plaintiffs' causes of action against him would be barred by their ratification of his decision to retain Yormark. He rests this sweeping assertion on Wildermann v. Wachtell, 149 Misc. 623, 267 N.Y.S. 840 (Sup.Ct. Trial Term 1933). In Wildermann defendant Wachtell, a New York attorney, was consulted by the plaintiff concerning an unliquidated claim against the

executors of a Pennsylvania estate. The attorney advised the plaintiff that Pennsylvania counsel would have to be retained to bring suit in that State and recommended Gumbes for that purpose The plaintiff agreed that Gumbes should be retained and signed a formal agreement employing both Gumbes and the defendant. Gumbes thereafter negligently failed to file a timely lis pendens in Pennsylvania and plaintiff's judgment, when finally secured, was worthless.

The court found expressly that 'Wachtell himself was not negligent either in retaining Gumbes or in assuming that Gumbes would take care of filing the necessary lis pendens in Pennsylvania.' 267 N.Y.S. at 841. The issue framed for decision was whether an attorney, having retained a Pennsylvania attorney to bring a Pennsylvania suit, 'becomes ipso facto liable for any negligence of the foreign attorney, even though the client has been informed of the necessity and reason for the retainer and has approved the course and choice of attorney.' Id. The court answered this question negatively, reasoning that a contrary conclusion would burden a practicing attorney with 'hazards which he is not qualified either to anticipate or to prevent.'

*****

In accordance with parts I and II of this opinion, Devlin's motion for summary judgment is granted on that portion of third-party plaintiffs' claim alleging negligence in failing to discover the indictment pending against Yormark at the time of the referral. In all other respects, the motion is denied.

Discussion points for Bucholtz v. Sirotkin

We have all at one time or another used travel agents (or other intermediaries) to assist us with our travel plans. What were their responsibilities? How much risk were they taking? How much do they really know about the planes or trains or ships they book us passage on? How much should they know? How much do they get paid for their services? Should that matter? How much should we know? Be honest. What about your dry-cleaning service? Do they do their work on premises, or do they send your clothing out to a big dry-cleaner somewhere else? Should liability for a spot on your collar depend on these facts?

Before continuing please thoroughly acquaint yourself with the Restatement of Agency, 2d, section 3, including the comments and illustrations thereto. The Restatement of Agency 2d is on reserve in the library, and is also available on Westlaw.

Helen BUCHOLTZ, Plaintiff-Respondent,

v.

SIROTKIN TRAVEL, LTD., Defendant-Appellant.

Supreme Court, Appellate Term, Ninth and Tenth Judicial Districts.

Dec. 5, 1974.

PER CURIAM.

Judgment affirmed without costs.

In this Small Claims action, plaintiff seeks to cast defendant travel agency into damages for reservations that went awry. Since it is undisputed that the travel agency had utilized the services of a wholesaler who had put together a 'package tour,' defendant contends on this appeal that the wholesaler alone is liable for any default in performance.

Allocation of responsibility in the case before us should proceed upon the principles of agency law. In our opinion, where, as here, there is no proof of an independent relationship between the retail travel agent and the wholesaler, the travel agent should be considered the agent of the customer. If, in using a wholesaler to make the travel arrangements, the travel agent acts with the consent, express or implied, of the principal-customer, then, if reasonable diligence has been used in its selection, the travel agent will not be responsible for any dereliction of duty on the part of the wholesaler. If, on the other hand, the travel agent acts without such consent, he will be responsible to the customer for any damage sustained as a result of the acts of the wholesaler.

The court below, in applying these principles, found that the plaintiff did not consent to the employment of the wholesaler. Although its opinion did not so state, the record indicates that the court also declined to hold that knowledge of the practice of employing wholesalers should be imputed to the plaintiff. We see no reason to disturb this determination. The record supports a finding that plaintiff was not informed of the existence of the wholesaler until after the reservations were agreed upon and it cannot be said that knowledge of this practice is so pervasive among the public as to compel a finding of implied consent.

We find no merit in defendant's remaining contention.

Discussion points for Rowen v. Flushing

Not all agents are created equal. For the sake of simplicity, there are two types of agents. The first are general agents. These agents have what is known as “continuity of service” for their employer, the principal. Special agents do not have continuity of service. They are hired to conduct a single transaction. Ultimately, whether you can sue the principal for the acts of the agent depends once more on classification. Stated another way, be careful of

special agents, because they possess limited power to bind their principals.

In this case, as in all cases involving contracts between agents and third parties, you have to consider the "reasonable expectations" of the third parties. In short, when dealing with agency law, courts will almost always strive to protect the reasonable expectations of third parties who contract with agents. And this should make sense to you. If agents are to be allowed to act for principals, then third parties should be able to safely rely on the validity and enforceability of their contracts with agents, provided their reliance is based upon "reasonable expectations" (those words again).

So ask yourself, how reasonable was Rowen and Blair, the builder? What assumptions did they make, and should they have made the assumptions they made? Were their assumptions reasonable? Familiarize yourself with the concept of mechanics' liens in Massachusetts. And note that "reasonable expectations" theory does not apply to torts by agents. Stated another way, you can choose with whom you contract, but you don't get to choose the owner of the truck which smashes into your nice new car on Route 495. Finally, note the discussion of "apparent authority" which we discuss in depth later, but is subsumed under "reasonable expectation" theory.

ROWEN & BLAIR ELECTRIC COMPANY, a Michigan Corporation, Plaintiff-Appellant,
v.
FLUSHING OPERATING CORPORATION, a New York Corporation, et al., Defendants-Appellees.

Court of Appeals of Michigan.

Jan. 7, 1976.

KAUFMAN, Judge.

Plaintiff appeals a decision of the Kalamazoo County Circuit Court, which, following a bench trial, refused to impose a mechanics' lien on a building owned by defendant Flushing Operating Corporation (Flushing). We affirm.

The building in question was leased by Flushing to Dutch Treat Bakers, Inc. (Dutch Treat).

Dutch Treat desired to expand its operations by acquiring the property but could not finance the acquisition. As a result, Dutch Treat entered into negotiations with Flushing which decided to purchase the building and its plot of land and lease it to Dutch Treat. Flushing leased the realty to Dutch Treat on July 2, 1969, for a term of ten years, commencing October 1, 1969. During negotiations, Flushing and Dutch Treat determined that approximately $45,000 would be needed to renovate the building to serve as a wholesale bakery. As a result, the lease contained a provision for leasehold improvements:

> 'The landlord has agreed to expend the sum of forty-five thousand dollars ($45,000.00) for improvements to the leased property and for replacement of fixtures as may be required. The alterations, additions and improvements as made with the subject $45,000.00 shall be described in detail by the tenant and a list thereof attached to and made a part of this lease agreement as an exhibit hereto. Any alterations, additions and improvements made, whether from the funds advanced by the landlord or paid for by the tenant, as well as any fixtures, shall immediately become the property of the landlord and at the end or other termination of this lease shall be surrendered to the landlord, with the exception that the moveable personal property and moveable trade fixtures put in by the tenant at the tenant's expense may be removed on or before the expiration or termination of this lease.'

At trial, the testimony presented indicated that, at the time of signing, figures were attached to the lease estimating future repairs to be; structural, $30,000; electrical, $10,000; miscellaneous, $5,000. The list was apparently lost and could not be produced at trial.

Plaintiff, one of a number of contractors hired by Dutch Treat, pursuant to an oral agreement with Dutch Treat, began electrical work on the building early in July, 1969. A letter agreement embodying the oral terms was prepared by plaintiff and sent to Dutch Treat on October 9, 1969. It was not signed until April 6, 1970. In the meantime, Dutch Treat was making progress payments to plaintiff on a 'cost-plus' basis. Dutch Treat sent plaintiff's first invoice to Flushing which issues a check for $7,040.35 payable to plaintiff and Dutch Treat. This check was endorsed by Dutch Treat and turned over to plaintiff.

This was the first time that plaintiff had any knowledge of or contact with Flushing. Plaintiff's employees noted Flushing's check but did not attempt to ascertain Flushing's position. They assumed that Dutch Treat owned the building.

On December 23, 1969, Flushing sent its last check for leasehold improvements to Dutch Treat because the $45,000 contractual limit had been reached through progress payments to plaintiff and the other contractors. At that time, Dutch Treat was behind in its rental payments, and Flushing, by applying the arrears to the rental payment account, used up the remainder of the account. Dutch Treat itself later made two $5,000 payments to plaintiff on March 30 and May 13, 1970.

On May 27, because of a growing indebtedness to plaintiff and the resultant pressure, officers of Dutch Treat signed a 9 per cent demand note for $40,872.48, the amount of the debt. On May 20, plaintiff had also filed a statement of account and lien with the Register of Deeds. Both Flushing and Dutch Treat were named but no notice was served on Flushing

within the 10-day period prescribed by M.C.L.A. s 570.6; M.S.A. s 26.286. Nor had plaintiff served the requisite notice of intention to claim a lien on Flushing within 90 days of the first furnishing of labor, M.C.L.A. s 570.1; M.S.A. s 26.281.

Plaintiff completed work on May 13, 1971, and timely filed the requisite statement with the register of deeds to establish a mechanics' lien against the property occupied by Dutch Treat. Plaintiff claimed that $39,033.50 remained unpaid. A suit to foreclose the lien was begun on May 3, 1971. After this Court reversed a summary judgment for defendant, Rowen and Blair Electric Co. v. Flushing Operating Corp., 49 Mich.App. 89, 211 N.W.2d 527 (1973), a bench trial was held.

The trial court held that plaintiff was entitled to judgment against Dutch Treat for the full amount of the May, 1970, promissory note plus interest. However, after the suit had commenced Dutch Treat had gone bankrupt and had been liquidated. Thus, the crucial issue was the validity of plaintiff's lien against the building, still owned by Flushing. The building was then empty because several creditors had repossessed Dutch Treat's machinery.

The trial court held that the lien was valid against Flushing. It held that plaintiff's failure to give statutory notice to Flushing was not fatal because it found an agency relationship to exist between Dutch Treat and Flushing. Notice to Dutch Treat, the agent, was held to provide notice to Flushing, the undisclosed principal. Merithew v. Bennett, 313 Mich. 189, 193, 20 N.W.2d 860 (1945). The court also held that no apparent authority was present.

However, Flushing's liability was held to be limited to the extent of the authority given to Dutch Treat. The court held that such authority was limited to $10,000. This was the amount allegedly specified for electrical repairs on the Flushing-Dutch Treat lease. Plaintiff had already been paid $17,040.35, an amount in excess of this limit. The court further held that plaintiff had failed to carry the burden of proof which required plaintiff to demonstrate that it was owed money for work other than the electrical job.

On appeal, plaintiff raises two claims of error: ***** Defendant Flushing contends on appeal that the trial court's finding of agency was erroneous. Flushing's claim, however, was not properly raised by a cross-appeal, GCR 1963, 807.1, and we do not consider it.

*****

Although we have held that the trial court was in error in requiring enhancement, we affirm its decision because of our holding on plaintiff's second appellate issue. The trial court found an agency relationship between Flushing and Dutch Treat. It held that Dutch Treat's authority to contract with plaintiff was limited to $10,000.

[6][7] In this case Dutch Treat was acting as a special agent to an undisclosed principal. A special agent is 'an agent authorized to conduct a single transaction or a series of transactions not involving continuity of service'. Restatement of Agency 2d, s 3, p. 15. A special agent can bind an undisclosed principal only with contracts made within the scope of his authority.

The $10,000 figure was the sum estimated by Flushing and Dutch Treat as the amount required for electrical work. We do not agree that this was the correct limitation on Dutch Treat's agency. This sum was only an estimate as to how much electrical work might be done. It was apparently appended to the contract as an exhibit pursuant to a contract clause. That clause, however, required that

> 'The alterations, additions and improvements As made with the subject $45,000 shall be described in detail by the tenant and a list thereof attached to and made a part of this lease agreement as an exhibit hereto.' (Emphasis supplied.)

The $10,000 was only an estimate, not a statement of an amount actually expended or an improvement actually made.

[8][9] We find, instead, that the agency was limited to an expenditure of $45,000 for all improvements, alterations and additions. This was the figure negotiated by the parties to the lease and specifically made part of the lease. Before this amount was reached plaintiff was paid with a check from Flushing. After $45,000 was expended, Dutch Treat itself paid plaintiff $10,000. A mechanics' lien is based entirely on the contract between the parties. As principal and lessor, defendant Flushing's lien liability on the contract between lessee Dutch Treat and plaintiff is limited to the portion made by Dutch Treat within the scope of its agency. The Restatement of Agency 2d, s 195A, provides that:

> 'A special agent for an undisclosed principal has no power to bind his principal by contracts or conveyances which he is not authorized to make unless:
> (a) the agent's only departure from his authority is
> (i) in not disclosing his principal, or
> (ii) in having an improper motive, or
> (iii) in being negligent in determining the facts upon which his authority is based, or
> (iv) in making misrepresentations; or
> (b) the agent is given possession of goods or commercial documents with authority to deal with them.'

[10] In the instant case, Dutch Treat's actions do not fall within either of the exceptions. The agent's departure from authority here would have been exceeding the monetary limit of that authority and not disclosing the principal. Plaintiff cannot bind defendant Flushing beyond the authority granted by Flushing to Dutch Treat. This authority expired on December 23, 1969, when the $45,000 limit was surpassed. The debts claimed by plaintiff in the instant action arose after that date.

We recognize that this is an unfortunate case where, through no fault of its own, either the plaintiff or the defendant will be subject to a monetary loss. Because of Dutch Treat's bankruptcy, plaintiff's sole remedy has become the mechanics' lien. That lien is, however, an extraordinary remedy, one designed as an alternative to a suit for damages and one to be applied narrowly. Additionally, plaintiff had a demand note from Dutch Treat but failed to negotiate it. These facts present an apparent clash between the purposes of the mechanics' lien law and principles of agency law. This is not a case where defendant used an agent in an attempt to circumvent the lien law. If it were, we would have no trouble applying the lien

law.

Because the lien is completely dependent on the underlying contract, plaintiff unfortunately cannot recover from defendant. The contract was a cost-plus agreement, one to be paid as the work progressed. It was not a lump sum payment. Apparently, the other contractors were paid on a similar basis. Defendant carefully restricted Dutch Treat to $45,000 for leasehold improvements. As such, once this figure was surpassed, any liability for paying any of the contractors fell to Dutch Treat.

Affirmed. No costs, neither party having prevailed in full.

Discussion points for Cowan v. Eastern Racing

As I mentioned earlier, you don't look at the reasonable expectations of the third party when it comes to deciding whether to hold the principal (employer) liable for the torts of the agent. Instead, the dreaded "public policy" considerations come into play. And thus we have the doctrine of "respondeat superior." But again, it comes down to classification. If the agent is an employee (servant), the employer (master) will be held liable for the negligent torts of the employee, provided the agent is acting SOHO, not FOHO (more on this later). If the agent is not an employee, then liability of the employer (principal) is much more difficult (but not impossible) to prove.

The question in this case focuses on the issue whether the police officers who beat the living tar out of the plaintiff are "employees" of the racetrack for purposes of pinning liability on the racetrack. Ask yourself how to differentiate between an agent and an employee. How many factors can you come up with? Are any one of them dispositive?

COWAN
v.
EASTERN RACING ASS'N, Inc.

Supreme Judicial Court of Massachusetts, Suffolk.

Decided April 7, 1953.

COUNIHAN, Justice.

This is an action of tort to recover for an assault on the plaintiff by certain persons alleged to be agents or employees of the defendant when the plaintiff was a business invitee of the defendant at Suffolk Downs, a race track in Boston, owned by the defendant. The answer

was a general denial, and by amendments there were special answers in the first of which the defendant denied that the assault was committed by the defendant, its agents or servants or by any one acting in behalf of the defendant, and further set up that if there was any assault on the plaintiff it was committed by two police officers of the city of Boston acting in their own defence and in the public interest; and the second set up that the defendant at the time of the assault was acting as an agent for the National War Fund, Inc., an established charitable organization, in the conduct of the racing meeting on the day of the assault and that all profits derived from such meeting were turned over to the National War Fund, Inc., and other local charitable organizations without any benefit or profit to the defendant.

This action was tried to a jury together with two other actions against the police officers who were involved in the assault. The jury returned verdicts against all three defendants.

This action comes here upon exceptions of the defendant to the denial of its motion for a directed verdict; to the denial of fourteen requests for rulings; to five portions of the judge's charge; and to the admission of evidence.

*****

From evidence disclosed in the bill of exceptions considered in its aspect most favorable to the plaintiff the jury could reasonably have found the following facts: On August 11, 1945, the plaintiff, with his wife and her daughter, was in attendance at Suffolk Downs, a race track owned by the defendant. They all paid the required admission fees. A racing meeting was being held under a license granted by the commission. A license had been originally issued to the defendant to conduct a racing meeting for fifty-four days beginning June 11, 1945, and ending August 11, 1945, except Sundays. Following a written request to it from the National War Fund, Inc., an established charitable organization, the defendant petitioned the commission to transfer that part of the license for the last four days of such meeting to the National War Fund, Inc., with the defendant acting as its agent. These days were from August 8 to August 11, 1945, inclusive. On August 1, 1945, the commission voted to approve the transfer of the license of the defendant for these days to the 'National War Fund, Inc.--Eastern Racing Association, Inc. Agent.' The net proceeds of these four days of racing were substantially paid to the National War Fund, Inc., and certain other local charities.

The plaintiff bought a $10 ticket on a horse called 'Johnny, Jr.,' to win in the seventh race. This horse finished first by a length and the plaintiff noticed nothing wrong in the manner in which the race was run. As he went to collect on his ticket he heard loud 'hollering' and he learned that a foul had been claimed. Subsequently the race was declared official and it appeared that 'Johnny, Jr.,' was placed third so that the win ticket was of no value. The plaintiff became excited and upset, and sought information, without success, at the window where he bought the ticket, as to why his horse was disqualified. He than talked with the clerk of the scales. As 'a result of that conversation' he went across the track to the stewards' stand. To get there he had to climb over an iron fence four and one half feet in height and cross the race track. The stand which was on the other side of the track opposite the grandstand looked as if it was 'on stilts with stairs going around and up.' It was enclosed by

glass. The plaintiff walked up the circular stairway and entered a room about eighteen feet by nine feet in size. He saw there one Almy, one Conway, and one Conkling who is also called Conklin in the bill of exceptions. These three men were the stewards appointed by the defendant under Rule 22 of the rules of the commission and had been acting as such during the earlier days of the meeting as well as from August 8 to August 11, 1945, inclusive. The plaintiff put his ticket on 'Johnny, Jr.,' on a table in front of Almy and asked him why that horse had been disqualified from winning. Almy told him that he would talk with him after he had finished making out a report which he was then writing. The plaintiff waited for two or three minutes and then spoke to Almy again. He made no attempt to strike anybody and there was no loud talk. While he was standing at the table talking to Almy, Conkling walked up to the plaintiff and kicked him in the 'shins.' Conkling then beckoned to the police and two officers came into the room. He said to them, 'Throw the son of a bitch out.' They were the defendants in the actions tried with this action. They grabbed the plaintiff from behind and, as he struggled to get away, they beat him many times on his head and body with their billies. The plaintiff fell to the floor where he was beaten again and kicked by the police officers. The plaintiff was brutally assaulted. He suffered severe injuries, was bleeding profusely from his head, and as a result was taken to the Boston City Hospital for treatment. The police officers were part of a detail of the Boston police department on duty at Suffolk Downs under a Lieutenant O'Brien. The commission did not hire or pay the police although it could have because the commission had such power under the statute but it never exercised it. There was no direct evidence as to who hired the police but it could be fairly inferred that they were hired by the defendant because a check in payment for their services in the sum of $1,368 was drawn to the order of the police commissioner (of Boston) and signed 'Eastern Racing Assn. Inc. Agents for National War Fund, Inc.,' by its officers. This check was indorsed by the police commissioner. The three stewards in the stand were appointed by the defendant or by it at least as agent for the National War Fund, Inc., and were paid by checks of the 'Eastern Racing Assn. Inc. Agents for National War Fund, Inc.' The defendant appointed and paid these stewards and had a right to discharge them.

We first consider the defendant's exception to the denial of its motion for a directed verdict. The disposition of this exception depends largely upon the application of the principle of respondeat superior, and we must therefore determine whether the steward Conkling or the police officers who were involved in the assault were at that time in the control of the defendant and acting as its agent or agents within the scope of their employment.

The principle respondeat superior is not applicable unless it could reasonably be found on the evidence together with all permissible inferences 'that the relation of master and servant existed at the time the plaintiff was injured, whereby the * * * act of the servant was legally imputable to the master. The test of the relationship is the right to control. It is not necessary that there be any actual control by the alleged master to make one his servant or agent, but merely a right of the master to control. If there is no right of control there is no relationship of master and servant. If the power of control rests with the person employed, he is an independent contractor.' Khoury v. Edison Electric Illumination Co., 265 Mass. 236, 238, 164 N.E. 77, 78, 60 A.L.R. 1159.

This is the rule in this Commonwealth and is generally accepted in other jurisdictions. Restatement: Agency, § 220. Meechem on Agency (2d ed.) § 1863. 57 C.J.S., Master & Servant, § 563. 35 Am. Jur., Master & Servant, § 539. This rule is applicable although the choice of persons for the particular work is required to be made from a limited class. Restatement: Agency, § 223.

In the Khoury case it was also said 265 Mass. at page 239, 164 N.E. at page 78, 'Although the conclusive test of the relationship of master and servant is the right to control, other factors may be considered in determining whether the right to control exists, but they are subordinate to this primary test. This court has held that the method of payment is not the decisive test. * * * Neither is the fact that * * * [one] was an employee of the defendant and had no other employment decisive, for a person may be an agent or a servant as to one part of an undertaking, and an independent contractor as to other parts.' To the same effect is Wescott v. Henshaw Motor Co., 275 Mass. 82, at page 87, 175 N.E. 153, at page 155, where it is said, 'It has been frequently decided that one may be the agent or servant of another in some matters and not the agent or servant in other matters.' Likewise 'it is the right to control rather than the exercise of it that is the test. * * * While engaged in the same general work, one may be at certain times and for certain purposes the servant of a party, and at other times or for other purposes an independent contractor or the servant of another.'

In the instant case we are of opinion that one of two conclusions could be found by the jury as matter of fact on the evidence. The first one is that in determining the qualifications of horses and jockeys, corrupt riding, questionable practices such as the artificial stimulation of horses, the weights of jockeys, fouls, and the order in which horses finish, the stewards appointed and paid by the defendant had exclusive jurisdiction, and that when acting upon such matters these stewards could be found to be agents of the commission or independent contractors required to be employed by the defendant under the rules of the commission. On the other hand, on the evidence the jury could reasonably find that at the time of this assault the steward Conkling was acting as an agent for the defendant even though the rules of the commission provide that the stewards appointed by the defendant shall have control over and free access to all stands.

The plaintiff was a business invitee of the defendant, at least in its capacity as an agent for the National War Fund, Inc. Whether he was properly in the stewards' stand to make a complaint is of no consequence for excessive force was used to evict him. While talking to one of the stewards about the complaint, Conkling assaulted him and calling the police, by the use of opprobrious words, told them to throw the plaintiff out of the stand. A struggle ensued and a brutal assault followed. Conkling was appointed and paid by the defendant. The stand where the assault took place was owned by the defendant. Conkling apparently assumed that the plaintiff was an interloper and causing a disturbance. Conkling and the other stewards under the rules had control of the stand and presumably had authority to evict obnoxious persons from it and that was for the purpose of seeing to it that racing was orderly conducted. Proper performance of their duty in this respect could reasonably be expected to enhance the reputation of the defendant with its customers for maintaining order and advance its business which was to conduct racing for a profit. If they failed to perform their duties in

this respect, the defendant could discharge them. To this extent at least it could be found that the defendant had a right to control them.

It is not unreasonable to assume that Conkling believed that to preserve order in the stand he had a right to call upon the police to assist him. Otherwise there was no need of the presence of the police at the stand. It is clear therefore that if Conkling assaulted the plaintiff, or if the police at his instigation were guilty of the assault, the defendant could be found liable. 'An inference of responsibility on the defendant's part was by no means the only permissible inference, but we think that it was a possible one.'

But apart from the question of agency of Conkling and the responsibility of the defendant for his conduct, we are of opinion that the question whether the police officers involved in the assault were acting as agents of the defendant was also for the jury to decide. They were paid by the defendant and they were hired by the defendant for the obvious purpose of preserving and maintaining order on the premises of the defendant during the racing meetings. The maintenance of such order, the prevention of breaches of the peace, with the possibility of ensuing riots, would serve to afford protection to and avoid damage to the physical plant used for racing, which was conceded to be owned by the defendant. In this capacity the police officers were acting not as public officers in a public place but as employees of the defendant for its private purposes on its private premises. It is also reasonable to assume that part of their duty was to prevent annoyance or injury to patrons of the defendant and to that end they could evict from any part of the premises persons who might be causing a disturbance. 'Acts habitually performed by an agent may import acquiescency by the principal and become evidence of his authority.' Hartigan v. Eastern Racing Association, Inc., 311 Mass. 368, 370, 41 N.E.2d 28, 30, and cases cited.

We are of opinion that this action was properly submitted to the jury, and the exception of the defendant to the denial of its motion for a directed verdict must be overruled.

The defendant has argued that it is not responsible for the brutal assault on the plaintiff by Conkling or the police officers because none of them was acting within the scope of his employment when they assaulted the plaintiff. There is no merit in this contention. The case of Perras v. Hi- Hat, Inc., 326 Mass. 78, 93 N.E.2d 219, cited by the defendant, is readily distinguishable. The police officers there involved in an assault were in no sense employees of the defendant. The question of the use of excessive force did not arise for agency alone was considered. The correct rule is stated in Fanciullo v. B. G. & S. Theatre Corp., 297 Mass. 44, at pages 46- 47, 8 N.E.2d 174, at page 176, with cases cited this court said, 'In a place of public amusement where large numbers of people are accustomed to gather, the maintenance of order may incidentally require the use of force. * * * A master not infrequently may be liable for conduct of a servant who uses means not intended or contemplated by the contract of employment.' This rule is recognized in Restatement: Agency, § 245, 'A master who authorizes a servant to perform acts which involve the use of force against persons or things, or which are of such a nature that they are not uncommonly accompanied by the use of force, is subject to liability for a trespass to such persons or things caused by the servant's unprivileged use of force exerted for the purpose of accomplishing a

result within the scope of employment.

Discussion points for Miguel v. Linden Motor Car

The doctrine of respondeat superior rests on two assumptions. First, that the agent was an employee (servant) of the principal (master). And second, that the negligence of the agent occurred within the scope of the agent's duties. There has been some fudging on this second point. Courts have allowed agents to be straying a little (known as a "slight deviation") when the negligence occurs and have still held the principal liable. Does this case support that proposition? What if the negligence occurs after the frolic, but while the agent is still not on the correct route?

MIGUEL
v.
LINDEN MOTOR CAR CO., Inc.

Supreme Judicial Court of Massachusetts, Bristol.

Nov. 30, 1942.

COX, Justice.

The report of the trial judge, who found for the plaintiff, states that at the opening of the trial it was agreed by counsel that the only issue to be decided was whether or not one Rebello, at the time he was operating the motor vehicle that was involved in the collision with the plaintiff's automobile, was the agent or servant of the defendant and acting within the scope of his employment. Upon report, the Appellate Division for the Southern District decided that there was prejudicial error in the denial of the defendant's request for a ruling that Rebello, at the time of the collision, was not acting as the defendant's agent, and ordered the finding for the plaintiff vacated and that a finding for the defendant be entered. It has not been argued that this request does not properly raise the question whether Rebello, at the time of the collision, was acting within the scope of his employment, and the question whether he was is the only one that has been argued.

It could have been found that Rebello was an employee of the defendant, and that part of his work was to 'pick-up' automobiles to be repaired and to deliver automobiles that had been repaired at the defendant's garage. The day before the collision occurred, the daughter of the owner of the automobile that was being operated by Rebello at the time of the collision drove this automobile to the defendant's garage for the purpose of having repairs made. It was impossible to make the repairs that day, and the defendant's manager told another employee

to deliver the automobile to the owner's daughter at her place of employment. This employee, however, turned this task over to Rebello, who delivered the automobile, whereupon he and the owner's daughter arranged that she would pick him up at seven-thirty o'clock the following morning in front of the defendant's garage. She did, then drove him to her place of employment and told him to drive the automobile back to the defendant's garage. But instead of doing this, he went to his home for breakfast, and it was while he was driving from his home to the garage that the collision occurred. Rebello's usual time for commencing work at the garage was eight o'clock in the morning.

The report states that it was agreed by counsel that the most direct and ordinarily travelled route by which an automobile would travel from the daughter's place of employment to the defendant's garage was a distance of one and three-tenths miles 'in a due northerly direction'; that the 'automobile distance' from this place of employment to Rebello's home was one mile in a 'due westerly direction'; and that the 'automobile distance' from Rebello's home to the place where the collision occurred was one-tenth of a mile 'due east'; and therefore that the place of collision was nine-tenths of a mile 'due west' from the place of employment.

The liability of the defendant for the admitted negligence of Rebello depends upon whether he was then acting within the scope of his employment. There was no evidence from which it could be found, by inference or otherwise, that Rebello had any authority to use the automobile for the purpose of getting his breakfast as an incident of his employment and there was no evidence from which it could be found, by inference or otherwise, that after Rebello left the automobile owner's daughter at her place of employment, there was anything for him to do in the scope of his employment except to drive the automobile to the defendant's garage.

We are of opinion that the evidence did not warrant a finding that, at the time of the collision, Rebello was acting within the scope of his employment. The permissible findings do not disclose that this is a case where Rebello chose 'the quickest and best way to reach his destination' or that, at the time of the collision, he had resumed the performance of his duty or this his 'deviation from his employer's business had ended.'

Order of Appellate Division affirmed.

Carlotta WRIGHT, Administratrix et al

v.
David KELLEHER et al

Superior Court of Massachusetts,Worcester County.
April 20, 2007.

Plaintiff Carlotta Wright ("Wright"), brought this action for wrongful death on behalf of her deceased husband, Kenneth E. Wright ("Decedent"), against the defendants, David Kelleher ("Kelleher"), B & G Leasing, Inc. ("B & G"), George Weston Bakeries Distribution, Inc. ("GWBD"), George Weston Bakeries, Inc. ("George Weston"), Arnold Foods Company, Inc. ("Arnold Foods"), and Route Relievers, Inc. ("Route Relievers"). Wright specifically alleges that each of the defendants were directly or indirectly negligent when her husband was fatally injured after Kelleher struck him in a motor vehicle accident while making a delivery. The matter is now before this Court on defendants', GWBD, George Weston, and Arnold Foods (collectively "defendants"), Motion for Summary Judgment. They assert that they are entitled to summary judgment because (1) the defendants cannot be held vicariously liable because at the time of these events Kelleher was an independent contractor and not subject to their control, and (2) the defendants were not negligent because they neither breached a duty owed to the Decedent nor owed a duty to the Decedent. Oppositions to this motion were filed by the plaintiffs and the defendant Kelleher. For the following reasons, the defendants' Motion for Summary Judgment is *DENIED.*

The Summary Judgment Record contains the following undisputed facts and disputed facts viewed in the light most favorable to the nonmoving parties.

On December 15, 1999, Kelleher began work through a temporary employment agency as a shipping clerk at Entenmann's, Inc. and later at Entenmann's Sales Company, Inc. (collectively "Entenmann's"). On April 23, 2000, Kelleher was employed by Entenmann's as a shipping clerk and was required to join a union. While Kelleher was employed at Entenmann's, Entenmann's provided medical and disability benefits, vacation, personal and sick days, a pension plan and withheld taxes. Further, as an employee of Entenmann's, Kelleher punched a time clock and reported to a supervisor on a daily basis.

In June 2001, Bestfoods Baking Distributing Company, Inc., now known as GWBD, advertised the sale of a distributorship business. The distribution rights were for the right to distribute Arnold Foods brand bakery products in the Fitchburg/Leominster area. Kelleher approached Steve Mutascio ("Mutascio"), a district sales manager for Arnold Sales Company, about purchasing the distribution rights. Mutascio interviewed Kelleher, asked employees about Kelleher's work ethic, and informed him that he must have a valid driver's license. Despite the fact that Kelleher was required to have a valid driver's license, the defendants claim that he could "hire anyone to operate his business and deliver product to his customers."

In June 2001, Kelleher voluntarily terminated his employment with Entenmann's. On July 9, 2001 Kelleher executed a Distribution Agreement with GWBD and organized his business as Kelleher Distribution. Numerous other documents were executed at the time Kelleher signed the distribution agreement. Kelleher contends that these documents were all provided to him by the defendants and that he was instructed where to sign in a very rushed fashion. After entering into the distribution agreement, Kelleher no longer paid union dues, no longer received medical, disability or pension benefits, and no longer received vacation or sick time.

Kelleher financed the purchase of the distributorship through loans he received from Banc of America ("BA") and Distribution Services of America, Inc. ("DSA"). The defendants claim that these two financial institutions were independent of GWBD. Kelleher claims that BA and DSA were not independent of GWBD because GWBD presented these two financial institutions to Kelleher. The defendants contend that Kelleher was required to assign his rights in his accounts receivable to the lending institutions in order to secure his loans.

The Distribution Agreement provided that:

> The parties intend to create an independent contractor relationship and it is of the essence of this Agreement that DISTRIBUTOR be an independent contractor for all purposes and DISTRIBUTOR shall only identify himself as such in all third party dealings ... As an independent contractor, DISTRIBUTOR has the right to operate the business as DISTRIBUTOR chooses, and shall bear all risks and costs of operating such business. DISTRIBUTOR has no authority to retain any person on behalf of BBDC [Bestfoods Baking Distribution Company]. It is expressly understood that DISTRIBUTOR has no claim, or right under any circumstances, to any benefits or other compensation currently paid by BBDC to employees, or hereafter declared by BBDC for the benefit of employees.

Kelleher purchased/leased a step-van for the operation of his business from B & G. He contends that the defendants recommended B & G to him and that the necessities of the job dictated that he purchase/lease a van. The defendants contend that Kelleher was free to purchase or lease any vehicle he wanted and that he received the names of leasing companies from other independent contractors. There is some dispute as to whether the defendants or Kelleher paid the sales tax, registration fees, and the excise tax to the van. Although Kelleher selected his own insurance company and purchased personal as well as business insurance, the plaintiffs claim that B & G controlled how much insurance Kelleher was required to purchase. Kelleher paid for all of the gas and maintenance for the van.

The defendants claim that Kelleher was an independent contractor who was free to conduct his business however he chose subject to a few exceptions. Kelleher and the plaintiffs dispute this contention and claim that Kelleher was an employee and that the distribution agreement was created simply to avoid liability. The defendants claim that "Kelleher purchased Arnold brand products from GWBD, took title and owned the product, and then sold the product to his customers."Further, the defendants claim that Kelleher could purchase and sell products other than Arnold Foods products unrelated to GWBD and that Kelleher made his own business decisions and set his own schedule. Kelleher could decide what time he would pick up his product and in what order he would deliver the product to the customers on his route.

Kelleher contends that he did not own the products he delivered and that when he delivered the products they were still owned by GWBD exclusively. Kelleher testified that Mutascio instructed him not to deliver any products other than Arnold Food products. Further, Kelleher claims to have had little control over when he delivered the products. He claims that when he entered into the distribution agreement, each of the stores on his route had a delivery window

in which he could deliver the products. Further, Kelleher claims that GWBD negotiated directly with chain stores with regard to delivery times, space allotment, display locations, and prices. The plaintiffs contend that Kelleher was not free to negotiate his own prices and that he was forced to sell his product at prices dictated by the defendants. Moreover, the motion record supports the fact that Kelleher did not bill the customers; he transmitted information about the transactions to the defendants through a wireless computer provided by the defendants, who in turn billed the customers and credited Kelleher with his commissions earned from those transactions.

The defendants admit that although Kelleher did not receive any formal training from GWBD, he did ride with a former temporary driver, George Senay ("Senay"), who showed Kelleher where the stores on his route were located. The defendants deny that Kelleher received any formal "training regarding proper operation of the truck, proper safety rules regarding a safe number of hours to be driving on the road and the dangers of fatigue."The plaintiffs argue that Mutascio directed Senay [FN4] to take Kelleher with him on his bread deliveries. Further, the plaintiffs contend that Mutascio introduced Kelleher to shipping clerks and managers and trained him how to make stops, where to make deliveries, and how to stock the items on the shelves.

On or about December 15, 2001, defendant Kelleher caused a vehicle he was operating to collide with Decedent's vehicle. The impact of the head-on crash caused Decedent's death and injured the other passenger-plaintiffs, Tiarra Wright, Keshawn Wright, and Kinzaqui Winters. At the time of the accident, the vehicle Kelleher was operating was owned by B & G, which in turn is alleged to have been an agent of George Weston, GWBD, Arnold Foods and/or Route Relievers. Kelleher was in the process of making bread deliveries to specific retail vendors before the accident occurred.

At the time of the accident, Kelleher had finished his deliveries for the day and had consumed enough alcohol to have a blood alcohol level well in excess of the legal limit for the operation a motor vehicle. The defendants contend that this shows that Kelleher was not acting within the "scope of his employment" even if this Court finds that there is a factual dispute as to whether Kelleher was an employee or independent contractor. They assert that Kelleher had completed his deliveries for the day and had finished working before he consumed the alcoholic beverages. Even if he wore still working, the defendants claim that having consumed the amount of alcoholic beverages that the evidence indicates Kelleher had amounted to a break from the proper scope of his duties that would relieve the defendants of any liability for Kelleher's actions. Kelleher contends that he was an employee and was still acting within the scope of his employment and claims that he had not completed his duties for the day until he entered data into the handheld computer that was provided by the defendants.

II. Negligence

To prevail on a claim of negligence in Massachusetts, a plaintiff must prove the following

elements: (1) duty, (2) a breach of that duty, (3) damage to the plaintiff, and (4) a causal relationship between the defendant's breach of duty and the plaintiff's purported damages. In determining whether an employer should be held liable for the negligence of another under a theory of vicarious liability, "[i]t is the right to control, as opposed to the actual control, that is determinative." Even an employer's attenuated right of control over a seemingly very independent employee may give rise to liability. *Id.* As long as the employee's conduct was subject to the employer's control or right of control, vicarious liability may be imposed. *Id.* Proof of "a master-servant relationship is ordinarily a question of fact."

Upon examination of the motion record, summary judgment is not appropriate in this case due to the existence of genuine issues of material fact, including a genuine dispute as to the material issue whether Kelleher was an independent contractor or employee at the time of the accident. This is supported by the following non-exhaustive list of subsidiary factors found within the motion record.

First, it is genuinely disputed as to whether Kelleher took title to the products that he was delivering and whether he was allowed to purchase and sell products other than Arnold Foods brand products. The defendants assert, and the language of the distribution agreement states, that Kelleher was able to sell any product of his choosing. Kelleher contends that the defendants would not have allowed him to sell products other than Arnold Foods brand products and that he was so instructed by Mutascio. This dispute bears upon the issue whether the defendants retained the requisite control over Kelleher so that he should be considered an employee, rather than an independent contractor.[FN5] Second, a genuine issue of material fact exists as to whether Kelleher was actually allowed to make and did make his own business decisions independent from the defendants, including the setting of his own schedule. The defendants claim that Kelleher was free to run his business as he saw fit, could pick up the products to be delivered when he wanted, and could deliver those products in the order he chose. Kelleher contends that he did not have control over when he was to deliver the products because the defendants had negotiated with many of the chain stores and narrow windows of time existed in which the products were to be delivered. Further, Kelleher contends that GWBD negotiated directly with chain stores with regard to space allotment, display locations, and prices. Kelleher asserts that he was not free to negotiate his own prices. Thus, whether Kelleher was free to make his own business decisions such as when to make deliveries and how to stock the products remains at issue. Third, whether Kelleher received training from the defendants and the extent thereof is at issue, with the defendants claiming that Kelleher did not receive any formal training and that Senay merely showed Kelleher where the stores on his route were located, but countered by Kelleher who contends that he received training from Mutascio with regard to how he should make the deliveries, where he should make the deliveries and how he should stock the shelves. Fourth, a disputed material fact exists as to whether Kelleher was actually permitted to allow others to deliver the products for him. The defendants, and the distribution agreement, state that Kelleher was free to hire people to help him with his route. Based upon Kelleher's assertions that he was constantly instructed to do things differently than the distribution agreement stated and the fact that Kelleher was required to have a valid driver's license, whether Kelleher could actually have hired and allowed another person to deliver the products for him, and/or

whether the defendants retained control over that decision is in dispute.

Another genuine issue of material fact exists as to whether Kelleher was free to choose the type of vehicle he would use for his deliveries; Kelleher contends that the defendants referred him to B & G to purchase/lease a van. The defendants claim that Kelleher was free to choose any vehicle to use to deliver the products and that he received leasing information on leasing companies from other independent contractors. Further, there is a dispute as to whether Kelleher or the defendants paid the sales tax, registration fees and excise tax for the van. Further, Kelleher contends that B & G dictated how much insurance he was required to carry on the van. There is a genuine issue of material fact as to whether Kelleher had the discretion to lease or purchase the vehicle of his choosing from the supplier/dealer of his choosing.

As the foregoing issues of fact are genuine and material to the question of the fact and extent of the defendants' control over Kelleher's conduct on the date in question, the defendants have not met their burden of demonstrating the absence of a triable issue and that they are entitled to judgment in their favor as a matter of law, summary judgment is not appropriate.

For the reasons stated herein, it is hereby *ORDERED* that the defendants', George Weston Bakeries Distribution, Inc., George Weston Bakeries, Inc., and Arnold Foods Company, Inc., Motion for Summary Judgment pursuant to Mass.R.Civ.P. 56 be *DENIED.*

COMMISSIONER OF THE DIVISION OF UNEMPLOYMENT ASSISTANCE
v.
TOWN TAXI OF CAPE COD, INC.

No. 06-P-684.

Appeals Court of Massachusetts, Suffolk.

Decided March 12, 2007.

At issue is whether the drivers for Town Taxi of Cape Cod, Inc. (Town Taxi), are independent contractors or employees within the meaning of G.L. c. 151A, § 2, for purposes of requiring Town Taxi to pay unemployment compensation.[FN1] We affirm the judgment of the Boston Municipal Court that the drivers are independent contractors.

Procedural background. A review examiner of the division of unemployment assistance (division) affirmed an initial division determination that taxicab drivers for Town Taxi were employees of Town Taxi within the scope of G.L. c. 151A, § 2. On appeal, the division's board of review (board) remanded the matter to the review examiner for the taking of additional evidence and for further findings. Ultimately, the earlier determination was reversed, and the drivers were held to be independent contractors, Town Taxi having met its burden under the conjunctive three-part test set forth in G.L. c. 151A, § 2, and detailed in

Athol Daily News v. Board of Review of the Div. of Employment & Training, 439 Mass. 171, 175, 786 N.E.2d 365 (2003) (*Athol Daily News*).

The commissioner of the division sought judicial review under G.L. c. 151A, § 42. A judge of the Boston Municipal Court affirmed the decision. After judgment entered and the commissioner's motion for reconsideration was denied, the commissioner appealed.

Facts. The review examiner found that Town Taxi, licensed by the town of Barnstable to operate a taxicab service, required each of its more than thirty drivers to obtain a hackney license from the town,[FN3] had set shifts among which the drivers could choose (but drivers were required to obtain a replacement if unable to work a scheduled shift), and provided taxicabs with full tanks of gas at the beginning of shifts,[FN4] automobile insurance for all cabs, business cards, and all maintenance and repairs on the cabs. At the conclusion of all shifts, Town Taxi required the drivers to return the cabs with full tanks of gas and to submit fifty percent of the money received for passenger fares, with the drivers retaining both the remaining fifty percent and all tips. Town Taxi did not prohibit the drivers from engaging in other employment while driving its cabs.[FN5] Town Taxi used a computerized dispatch system and a global positioning system (GPS) to assist drivers in finding prospective customers,[FN6] but drivers were not required to pick up these customers and were allowed to pick up customers on their own without such assistance. Town Taxi did not provide workers' compensation insurance nor did it provide drivers with W-2 forms or Internal Revenue Service Form 1099s.

FN3. The hackney license permits the prospective driver to open his own taxi service or drive for any other taxi service in the area.

FN4. Town Taxi allowed drivers to use their own vehicles if the vehicles bore the name of Town Taxi on them; however, no drivers did so.

FN5. Some drivers delivered food to the airport for shipment to Martha's Vineyard or Nantucket. In such cases, the drivers were paid a fee for picking up and delivering the food to the airport (not split with Town Taxi), in addition to the taxi fare for the trip (split with Town Taxi). Some drivers engaged in other types of business while driving the cabs, e.g., delivering newspapers, performing collection work, and performing duties as a home health aide.

FN6. The review examiner found that “when the company receives a call from a client requesting service, the company's dispatcher enacts the GPS to determine which of their taxicabs is closest to the client's location. The dispatcher then alerts the driver of that cab, through a computer terminal installed in the cab, of the prospective job offer. If the driver chooses to accept the job, the driver presses a button on the computer signifying such. If the driver does not want to accept the job, they simply ignore the offer and after a few minutes, the dispatcher will offer the job to a driver who is the next closest to the client's location.”

"An employment relationship ... exists, for purposes of G.L. c. 151A, unless it can be demonstrated that the services at issue are performed (a) free from control or direction of the employing enterprise; (b) outside of the usual course of business, or outside of all the places of business, of the enterprise; and (c) as part of an independently established trade, occupation, profession, or business of the worker." *Athol Daily News,* 439 Mass. at 175, 786 N.E.2d 365. See G.L. c. 151A, § 2.[FN8] This three-part test is commonly referred to as the "ABC" test; the failure of the employer to demonstrate any of these three foregoing conditions is sufficient to establish that an employer-employee relationship indeed exists. *Athol Daily News, supra* at 175-176, 786 N.E.2d 365.

FN8. General Laws c. 151A, § 2, as amended by St.1990, c. 177, § 250, provides that:

> "Service performed by an individual, except in such cases as the context of this chapter otherwise requires, shall be deemed to be employment subject to this chapter irrespective of whether the common-law relationship of master and servant exists, unless and until it is shown to the satisfaction of the commissioner that-
>
> "(a) such individual has been and will continue to be free from control and direction in connection with the performance of such services, both under his contract for the performance of service and in fact; and
>
> "(b) such service is performed either outside the usual course of the business for which the service is performed or is performed outside of all the places of business of the enterprise for which the service is performed; and
>
> "(c) such individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed."

Based on our review of the record, we conclude that Town Taxi demonstrated to the board, and the board appropriately concluded, that the drivers were not "employees" as provided for in G.L. c. 151A, § 2.[FN9,FN10] We review each part of the ABC test in turn.

Part (a). "The first part of the test examines the degree of control and direction retained by the employing entity over the services performed." *Athol Daily News,* 439 Mass. at 176-177, 786 N.E.2d 365. The burden is upon the employer to demonstrate that the services at issue are performed free from its control or direction. "[T]he test is not so narrow as to require that a worker be entirely 'free from direction and control from outside forces.' " *Id.* at 178, 786 N.E.2d 365.

Here, the drivers had the freedom of choosing which shifts to work and were not obligated to respond to calls from Town Taxi regarding a prospective customer in the driver's vicinity. Moreover, the drivers were free to engage in other employment and perform personal business during their shifts using the taxis. See *Athol Daily News, supra.* As such, Town Taxi met its burden under part (a) of the test.

Part (b). “The second part of the test involves two separate criteria, and, if the employer demonstrates either, part (b) will be met. The question asked is [1] whether the services are performed outside of the usual course of business of the enterprise or [2] whether the services are performed outside of all the places of business of the enterprise.” *Athol Daily News, supra.*

The board and the judge found that the latter segment of the test was met and we agree. The service performed by the drivers occurred outside the business premises of Town Taxi. Although the taxicabs were stored and the dispatch system was operated at the business premises of Town Taxi, the drivers did not transport customers on those premises. Compare *Athol Daily News,* 439 Mass. at 179, 786 N.E.2d 365 (where carriers picked up newspapers from employer's distribution center and delivered them to individual houses, stores, bundle drops, or vending machines, “all of the carriers ma[d]e deliveries outside of premises owned by the [employer] or which could fairly be deemed its ‘places of business' ”). Further, drivers were free not only to pick up customers not referred from Town Taxi's computerized dispatch system, but also to refuse to pick up a customer referred to them. Drivers were not confined to a specific geographical location and were free to choose locations where they would look for passengers. These factors considered together support the decision made below. *Ibid.*

Part (c). “The third part of the test asks whether the worker is ‘customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.’ ” *Athol Daily News,* 439 Mass. at 179, 786 N.E.2d 365. The main consideration under this section is “whether the service in question could be viewed as an independent trade or business because the worker is capable of performing the service to anyone wishing to avail themselves of the services or, conversely, whether the nature of the business compels the worker to depend on a single employer for the continuation of the services.” *Id.* at 181, 786 N.E.2d 365. See *Boston Bicycle Couriers, Inc. v. Deputy Director of the Div. of Employment & Training,* 56 Mass.App.Ct. 473, 480, 484, 778 N.E.2d 964 (2002) (key is “whether the worker is wearing the hat of an employee of the employing company, or is wearing the hat of his own independent enterprise”; examiner must take into account all relevant facts and circumstances of the working relationship with “[n]o one factor [being] outcome-determinative”).

In *Athol Daily News,* 439 Mass. at 181-182, 786 N.E.2d 365, the Supreme Judicial Court found compelling that (1) “the business of delivering newspapers is not limited to a single employer, and nothing with respect to the carriers' job performance in this case is unique to one certain newspaper publisher”; (2) “the carriers are free to deliver newspapers (or other publications, such as advertising flyers) for anyone who wishes to contract with them, even competitors of the News”; and (3) “the carriers are free to advertise their delivery services, if they so desire, in an attempt [to increase business, which is] ... compelling evidence that a carrier is an entrepreneur and performs his or her newspaper delivery service for the News in that capacity....”

These considerations are at play in the case at bar. Upon obtaining a hackney license, the drivers could open their own taxi service or drive for another service. They were free to find customers on their own and reject prospective customers referred from the dispatcher. Town Taxi permitted them to engage in other employment or generate their own businesses while using the leased taxi, and many did so. This "entrepreneurial" spirit, exhibited by a typical independent contractor, was, as in *Athol Daily News,* 439 Mass. at 182, 786 N.E.2d 365, contemplated by part (c) of the test. *Judgment affirmed.*

Order denying motion for reconsideration affirmed.

Michelle FORTENBACHER

v.

COMMONWEALTH.

Appeals Court of Massachusetts, Bristol.

Decided June 16, 2008.

The plaintiff, Michelle Fortenbacher, individually and in her capacity as the administratrix of the estate of her son, Richard MacCord, brought this wrongful death action, pursuant, in part, to the Massachusetts Tort Claims Act (Act), G.L. c. 258, against the Commonwealth as a result of a fatal motor vehicle accident on a bridge. The Commonwealth's motion for summary judgment, which claimed, among other things, that it was immune from suit pursuant to § 10(*b*) of the Act, was denied by a Superior Court judge.[FN2] In its as-of-right interlocutory appeal of that order, the Commonwealth claims error in the denial of its motion. We agree and reverse.

1. *Background.* a. *The accident.* In the light most favorable to Fortenbacher, the undisputed facts gleaned from the materials submitted on summary judgment reveal the following. On August 29, 1999, MacCord was a passenger in a car being driven by Melissa Hartnett. Hartnett was driving eastbound on Route 6 over the New Bedford-Fairhaven Bridge (bridge), which spans the Acushnet River, when her car collided with another vehicle on the bridge. As a result of the collision, Hartnett's car struck a bridge railing and fell into the river. Both Hartnett and MacCord drowned in the submerged vehicle.

b. *Bridge construction.* At the time of the accident, the bridge was equipped with two railings on each side, but only on the westbound side did both railings extend the entire length of the bridge. The exterior railing was a pedestrian railing, which appeared to be part of the original bridge, constructed in 1901. The second, interior railing separated vehicular traffic from pedestrians on the bridge's sidewalk. The interior railing had been built in two

sections, each at different times, one on top of the other. The bottom section was a concrete parapet curb and the top section was made of aluminum. Beginning in 1972 and ending in 1973, the Massachusetts Highway Department (MHD) installed the aluminum railing, which increased the height of the original interior railing. The plans for this 1972 installation project show the parapet curb as an existing structure on the bridge.

On the day of the accident, Hartnett's car, traveling east, struck the exterior pedestrian railing, which was the only railing that extended the length of eastbound side of the bridge. The interior railing and parapet curb did not extend far enough on the eastbound side of the bridge to offer a barrier to prevent Hartnett's car from plunging into the river.

c. *The complaint and summary judgment.* Pursuant to the Act and G.L. c. 229, § 2,[FN4] Fortenbacher claimed that the MHD breached its duty to properly maintain, repair, and keep safe the bridge, and that those failures caused MacCord's wrongful death. Specifically, she claimed that the MHD failed to follow its own policies when it neglected to install, during the 1972 installation project, a proper guardrail or interior railing that followed the entire eastbound side of the bridge.

Maintaining that the decision whether and how to erect guardrails constituted a discretionary function under § 10(*b*) of the Act, which exempts it from suit, the Commonwealth moved for summary judgment pursuant to Mass.R.Civ.P. 56, 365 Mass. 824 (1974). The judge found no need to resolve this issue because even if § 10(*b*) applied to the 1972 installation project, the Commonwealth might nonetheless be liable for negligence in light of events that occurred after 1972. Specifically, the judge noted that the record revealed that bridge inspection reports from 1993, 1997, and 1999 stated that the bridge was potentially unsafe to the traveling public due to the nature of the eastbound railing, and the chain link fence that was present could not safely redirect an impacting vehicle. There was also an assertion by Fortenbacher that at least four prior accidents occurred on the bridge, some of which were fatal. Given this, the judge found that genuine issues of material fact existed as to whether the Commonwealth was on notice that the bridge was dangerous, and whether it had committed a breach of its duty to remedy that danger. Summary judgment was denied.

b. *The Massachusetts Tort Claims Act.* The Act was enacted in response to the Supreme Judicial Court's decision in *Whitney v. Worcester,* 373 Mass. 208, 366 N.E.2d 1210 (1977), where the court stated its intention to abrogate the doctrine of governmental immunity unless the Legislature took action as to the doctrine. *Id.* at 210, 366 N.E.2d 1210. The next year, the Legislature passed the Act, which provides that public employers, including the Commonwealth, are liable “for injury or loss of property or personal injury or death caused by the negligent or wrongful act or omission of any public employee while acting within the scope of his office or employment.” G.L. c. 258, § 2, inserted by St.1978, c. 512, § 15.

By design, the Act abrogated some of the traditional notions of sovereign immunity and provided consent to suit, but it also retained specified areas where the Commonwealth would remain unamenable to suit. See G.L. c. 258, § 10. One such area, where the Legislature chose not to waive the Commonwealth's immunity from suit, was for acts or omissions that have a

specified discretionary quality. This exemption from the waiver of immunity was codified in § 10(*b*) of the Act. Section 10(*b*) renders the Commonwealth immune from suit for "any claim based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a public employer or public employee, acting within the scope of his office or employment, whether or not the discretion involved is abused." G.L. c. 258, § 10(*b*), inserted by St.1978, c. 512, § 15.

In this case, the judge did not undertake an analysis of the Commonwealth's claim of immunity from suit. Instead, the judge determined that he did not need to resolve the issue because even if the discretionary function applied to the work done on the bridge in 1972 and 1973, the bridge inspection reports from 1993, 1997, and 1999 put the Commonwealth on notice that the bridge was dangerous. Such an approach, however, improperly conflates the questions of the existence of negligence and the availability of immunity. Neither the gravity of the harm alleged nor the substantial merit that may underlie a claim inform the immunity inquiry. Rather, § 10(*b*) immunity is grounded in the public policy notions that certain governmental activities should not be challenged by suit, and that courts are not positioned to officiate policy disputes related to politics and the allocation of public resources. For these reasons, and because § 10 of the Act provides public employers with immunity from suit in specified areas, "a right that is 'lost as litigation proceeds past motion practice,'

c. *The discretionary function exception.* To determine whether the discretionary function exception of § 10(*b*) of the Act applies to injury-causing conduct requires a two-step analysis. The first step is to determine whether the Commonwealth had any discretion at all as to what course of conduct to follow. *Ibid.* If the Commonwealth had no discretion because a course of action was prescribed by a statute, regulation, or established agency practice, then the discretionary function exception does not apply. *Ibid.* The second step is to determine whether the discretion that the Commonwealth had is the type of discretion for which § 10(*b*) provides immunity from suit. *Ibid.* That is, § 10(*b*) provides "immunity only for discretionary conduct that involves policy making or planning." *Ibid.* In other words, we must determine whether the conduct that caused the injury has a "high degree of discretion and judgment involved in weighing alternatives and making choices with respect to public policy and planning," as opposed to conduct that consists of "the carrying out of previously established policies or plans."

Fortenbacher claims that two statutes, G.L. c. 85, §§ 2 and 35, prescribed a course of conduct which eliminated the MHD's discretion relative to bridge construction, repair, and design. However, neither of these statutes does anything of the kind. The first, G.L. c. 85, § 2, authorizes the MHD to install warning signs and traffic signals on State highways when it deems them necessary, and the second, G.L. c. 85, § 35, regulates weight limits on certain types of bridges. Neither statute purports to limit, in any manner, the MHD's discretion regarding bridge construction, repair and design.

Fortenbacher next asserts that the 1966 MHD safety standards established an agency practice relative to the necessity of bridge guardrails. This allegation is supported by an affidavit from Gilbert M. Nelson, a registered professional civil engineer. Nowhere did Nelson document,

assert, or offer any basis from which a reasonable fact finder could conclude that applicable MHD standards existed in 1972, or earlier, or that it was established agency practice to conform to such standards. See *Harry Stoller & Co. v. Lowell, supra* at 141, 587 N.E.2d 780. Instead, what Nelson offered was his opinion that the 1972 reconstruction work on the bridge violated the MHD's construction standards. Nelson neither cited nor appended any actual standards, but rather based his opinion on his claim that he had read the third printing of the "1966 Standards" and "believe[d]" those standards were in place in 1972. Such testimony would not be admissible at trial and, thus, fails to satisfy Mass.R.Civ.P. 56(e), 365 Mass. 825 (1974), requiring that "affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and ... [s]worn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith." Nelson's unsupported and vague opinion does not create a genuine issue of material fact as to the existence of standards in 1972 sufficient to defeat the Act's discretionary function exception.

In contrast, and in support of its summary judgment motion, the Commonwealth provided an affidavit from Alton Ellis, a structures maintenance engineer for MHD. Ellis categorically denied that there were any requirements or standards in existence that required the bridge's railings to have a certain level of crash resistance or required the MHD to rebuild or redesign the bridge's railings. See *Alake v. Boston,* 40 Mass.App.Ct. 610, 612, 666 N.E.2d 1022 (1996) (where the plaintiff was unable to show that a city had a prescribed policy or regulation, the discretionary function exception applied).

Even if we were to assume that the standards Nelson claimed to be familiar with applied to the 1972-1973 work done on the bridge, both Nelson and Ellis agreed that extending the eastbound interior railing on the bridge to protect the area of the accident would affect access to a privately owned driveway. Nelson also stated that all "standards" must be "adapted" to the existing area of the driveway so as to provide traffic safety, and that such "design and construction" measures were "feasible and economical." As Ellis described it, "there was no off-the-shelf solution" to the problem posed by the private driveway, which was unique to any State-owned bridge. According to Ellis, a solution would require "consideration of different alternatives, each of which ha[d] its own strengths and weaknesses."

As described by these expert witnesses, what we are left with is the quintessential type of discretion for which § 10(*b*) of the Act provides immunity. That is, "when the conduct that caused the injury has a 'high degree of discretion and judgment involved in weighing alternatives and making choices with respect to public policy and planning, governmental entities should remain immune from liability.' Fortenbacher's contrary claim invites the judicial "second-guessing" of administrative decisions grounded in social, economic, and political policy that the discretionary function exception was designed to prevent.

d. *Exceptions to immunity under the public duty rule.* Finally, Fortenbacher's argument that § 10(*j*)(3) of the Act precludes the Commonwealth's claim to immunity is based on a misunderstanding of the purpose of that subsection and the operation of immunity under § 10. Section 10(*j*) is the Legislature's codification of the common-law public duty rule.

Pursuant to § 10(*j*), the Commonwealth is immune from suit for "any claim based on an act or failure to act to prevent or diminish the harmful consequences of a condition or situation, including the violent or tortious conduct of a third person, which is not originally caused by the public employer or any other person acting on behalf of the public employer." G.L. c. 258, § 10(*j*), inserted by St.1993, c. 495, § 57. But immunity under § 10(*j*) is not limitless, and does not apply to "any claim based on negligent maintenance of public property." G.L. c. 258, § 10(*j*)(3).

Here, because we have determined that the Commonwealth is immune from suit pursuant to § 10(*b*) of the Act, any exception to immunity based on the public duty rule pursuant to § 10(*j*) is therefore inapplicable in this case. "The immunities provided by § 10 operate in the alternative; even if one immunity contains an exception that would permit a claim to be brought, that claim is barred if any of the other immunities apply." *Brum v. Dartmouth,* 428 Mass. at 697, 704 N.E.2d 1147. In this case, § 10(*b*) provides the Commonwealth with an independent basis for immunity from suit.

3. *Conclusion.*The order dated February 12, 2007, is reversed insofar as it denied the motion for summary judgment. Judgment shall enter in favor of the Commonwealth.

So ordered.

II. Overview of and Introduction to Agent's Powers

We now come to the subject of the powers of agents. Agents might have power, but the real question is whether they have the authority to bind their principals by their acts. The authority of agents flows in two directions. First, they flow from the principal to the agent, either explicitly or implicitly. Hiring a maintenance person for your building, you might give him or her the express power to go into all offices to empty trash, by giving him or her a master set of keys to all of the offices. He or she might also have the implied power to order supplies from the local hardware store to keep the building well maintained. Deciding that issue involves many factors.

The second type of authority is called apparent authority. This does not flow from the principal to the agent. Instead, it flows from the principal to the third party, who, based on the action (or inaction) of the principal, reasonably assumes that the (purported) agent has the actual authority to bind the principal. An example might help illustrate the point I am making. Let's assume that MSL has hired a maintenance worker named Pat. On his first day of work, he goes to the local hardware store to buy nails for the job he's working on (he is an agent, acting for his principal). Let's assume that he has actual authority to buy the nails.

When Pat gets to the hardware store and brings the nails to the counter, he tells the clerk to bill MSL for the price of the nails. At this point, ask yourself what the reasonable expectations of the hardware store should be in a this situation. Pat has actual authority, but

not apparent authority, because MSL has not manifested to the store that Pat is its agent. Would it be reasonable to give him the nails without checking to see whether he really did work for MSL?

Five years go by. Every time Pat goes to the hardware store to purchase items, the bill is sent to MSL, and MSL pays the bill. One day, Pat quits (he now no longer has actual authority to bind MSL as its agent, because he no longer is MSL's agent). And he goes to the hardware store and buys some nails and stuff, which he uses on his house. The hardware store bills MSL, which refuses to pay. Is MSL liable on the theory of apparent authority? Did MSL lead the hardware store (by action or inaction) to believe that Pat possessed the authority to bind MSL? When Pat came in to the store on that fateful morning after he quit, did the hardware store have the reasonable expectation that MSL would pay for the items purchased by Pat?

Discussion points for Wing v. Lederer

What was the extent of Novera's actual authority? Did he have any implied authority? Can Wing win against the homeowner using the theory of apparent authority? Why not? What should Wing have done? Stated differently, was Wing reasonable in assuming that Novera had the actual authority to hire him to work on the grounds? What should Wing's attorney have tried to prove to better his client's chances of winning? Why can't Wing succeed on the theory of ratification? (More on that later.) What should Wing do now?

Jacob E. WING d/b/a Wing's Tree Experts, Appellee,
v.
Philip C. LEDERER, Appellant, and Peter Sonza-Novera.

Appellate Court of Illinois, Second District.

Dec. 29, 1966.

DAVIS, Justice.

Plaintiff, Jacob A. Wing, a licensed tree surgeon, d/b/a Wing's Tree Experts, brought this suit against the defendants, Philip C. Lederer, (herein called Lederer), and Peter Sonza-Novera, (herein called Novera), to recover the sum of $500. for services rendered. The complaint alleged that Novera, who acted as a part time caretaker and yardman for Lederer,

either individually, or as Lederer's agent, hired the plaintiff to do certain work at the Lederer residence.

The case was tried before the court without a jury and judgment was entered for the plaintiff and against Lederer, in the sum of $250; and for the defendant, Novera. Lederer appealed from the judgment against him and no cross appeal was filed.

Lederer contends that the plaintiff did not prove any contractual relationship with him; failed to offer evidence to sustain this action under a quasi- contract theory whereby Lederer would be liable for the work done by plaintiff; and also failed to prove the fair and reasonable value of the services rendered.

Mrs. Lederer testified that in the early spring of 1964 she asked Novera whether a certain maple tree on the Lederer property needed care. He answered that it did, that he knew a man in the business, and that he would send him to her. Novera then contacted the plaintiff, had him come to the property, and showed him this tree, which had some dead branches near its top. Novera testified that he told the plaintiff to talk to the lady of the house about the tree; and that the plaintiff pointed out other tree and shrubbery work which needed to be done.

Plaintiff's version of this conversation is somewhat different. He testified that Novera showed him the maple tree and that he, the plaintiff, told Novera that it, as well as other trees, needed care; that Novera then told him to go ahead and do what was necessary; and that the cost of the work was not discussed.

At the end of June or the first of July, plaintiff sprayed the foliage. Later he came back and pruned the maple tree and root fed several trees. He returned again in the latter part of July and in early September to do more spraying and root feeding. It is undisputed that he neither saw nor talked to either Lederer, Mrs. Lederer or Novera while working on the premises. Sometime during the summer, Novera told Mrs. Lederer that the tree work apparently had been done since the dead branches in the maple tree had been removed. However, the plaintiff did not contact the Lederers and had no conversation with anyone concerning the work, other than that heretofore related between himself and Novera.

No statement was rendered for this work until November of 1964, at which time Lederer received a bill from the plaintiff for $500. Mrs. Lederer did not pay the bill but called the plaintiff on several occasions to discuss it with him. Plaintiff never returned her calls. No further word was received from the plaintiff until October of 1965, at which time another statement was received. At the trial no testimony was offered which specified the work done or the time and materials used on the job, and there was no evidence relative to the fair or reasonable value of the work done.

Lederer had unquestionably constituted Novera his agent to recommend someone to take care of the maple tree. There is no issue as to the existence of an agency between Lederer and Novera, but only as to the latter's authority. The authority of the agent may come only from his principal. There is no dispute as to the actual authority conferred upon Novera. He was

told to recommend someone to take care of the maple tree and to have that person talk to Mrs. Lederer. Both the principal and the agent understood this to be the extent of the agent's authority. It clearly did not include the hiring of a tree man for any purpose, and under no circumstances could it be parlayed to include the hiring of such man to do whatever he thought was necessary.

Nor can it be said that Lederer clothed Novera with apparent authority to hire plaintiff to do the work which was done. Apparent authority in an agent is such authority as the principal knowingly permits the agent to assume or which he holds his agent out as possessing--it is such authority as a reasonably prudent man, exercising diligence and discretion, in view of the principal's conduct, would naturally suppose the agent to possess. The plaintiff had no contact with Lederer either before or during the time in which the work was done, and Lederer neither did nor failed to do anything which would justify the plaintiff in assuming that Novera had authority to hire him.

One dealing with an assumed agent is duty bound to ascertain the extent of the agent's authority. Such circumstance alone, should put the person dealing with such agent on guard in that anyone dealing with such agent must, at his own peril, ascertain not only the fact of the agency, but also the extent of the agent's authority.

Even assuming that the plaintiff's version of his conversation with Novera was correct, he conceded that Novera pointed out to him only the work to be done on the maple tree. It was the plaintiff who mentioned other work which should be done on the trees and shrubbery. Apparently, from the size of the bill, the other work was substantial and, in view of such circumstance, the plaintiff had a duty to confirm that a part time yardman had the authority to direct him to do whatever was necessary.

The plaintiff contends that, absent any original authority on the part of Novera, Lederer, by accepting the work which the plaintiff did, and by retaining the benefit thereof, ratified the acts of his agent in hiring the plaintiff. The rule is that where an agent has acted outside of the scope of his authority, a principal may ratify the act and render it obligatory upon himself; and that subsequent assent and ratification is equivalent to an original authorization and confirms that which originally was an unauthorized act. The ratification may either be express or inferred from the surrounding circumstances, but it must come from the acts or conduct of the principal. However, a principal may not be held to have ratified that which was done unless he acts with full knowledge of all the material facts.

Ratification rests on intention. The mere retention of the benefits of a transaction cannot be held to constitute ratification if the principal does not have the privilege of repudiating the unauthorized act. Absent such choice, the principal's conduct in accepting such benefits does not indicate that he assents to what has been done or intends to confirm it. In all of the cases cited by plaintiff, the ratification by a principal was made when he had full knowledge of the facts and a choice of either accepting or rejecting the benefits of the transaction.

Lederer had no choice! His trees had been pruned and sprayed long before he had

knowledge of what had been done. He could not undo that which had then been done and his acceptance of the work was not by choice but by necessity. The fact that he did not stop the plaintiff from doing the work is no evidence of ratification, since it is undisputed that Lederer did not have knowledge of the services during the time they were being rendered. Lederer cannot be held to have ratified the hiring of plaintiff even if it is assumed that Novera hired him to do whatever was necessary.

The trial court appeared to have rendered judgment in favor of the plaintiff on the theory that the work was done and he should get something for it. The court apparently entered the judgment of $250 on the theory that plaintiff, who offered no evidence which specified the details of the work or the method used in computing the amount charged, was nevertheless entitled to recover something.

If plaintiff predicates his right to recover upon a quasi contractual obligation on the part of Lederer, he must fail since he neither plead sufficient facts to warrant such recovery nor proved the reasonable value of the materials and services rendered. Proof of delivery of a bill in a given amount, standing alone, is not evidence of the reasonable value of services rendered or of materials furnished.

For the reasons we have indicated, the judgment of the trial court is reversed and judgment is hereby entered in favor of the defendant, Lederer.

Discussion points for Elliott v. Great National

What was the extent of Spear's actual authority? How is apparent authority proved in this case? What should the company have done to prevent this type of outcome? Do you think that there is enough evidence of the company's action or inaction to justify a finding of apparent authority?

B. N. ELLIOTT, Petitioner,
v.
GREAT NATIONAL LIFE INSURANCE COMPANY, Respondent.

Supreme Court of Texas.

Jan. 14, 1981.

BARROW, Justice.

B. N. Elliott brought this suit to recover the sum of $12,500 remaining unpaid on an alleged oral agreement of employment for a period of one year. Donald Spear, who was Senior

Vice-President of Marketing for Great National Life Insurance Company, entered into the agreement with Elliott. The question presented is whether Spear was authorized by Great National to make the agreement. The trial court rendered judgment on the jury verdict for Elliott. The court of civil appeals reversed this judgment and rendered a take-nothing judgment for Great National after concluding that there was no evidence to support the jury finding as to Spear's authority. We reverse the judgment of the court of civil appeals and remand the cause to that court for consideration of other points raised by Great National.

Great National was a Texas corporation which was wholly owned by US Life Corporation, a New York-based corporation. Spear's primary responsibility at Great National was to add to the field vice-president staff. Pursuant to this delegated responsibility, Spear, who was located in the Dallas office, contacted Elliott in Atlanta, Georgia, and inquired as to his interest in a field vice-president's position with Great National.

Elliott twice flew to Dallas to interview with Great National. He also flew to New York City to attend a meeting, sponsored by Great National's parent company, of all the marketing people from the parent company's subsidiaries. Elliott believed that he was attending the meeting in order to meet the people who would make the decision as to his selection for a field vice-president's position. Each one of these trips was pursuant to Spear's request and authorization. Great National paid for each of the trips. It also paid Elliott one-twelfth of the agreed annual salary for each of the six months Elliott worked for Great National.

During the series of interviews with Spear, Elliott requested that Great National allow him to remain in Atlanta. Spear testified in this regard as follows:

> "Very early in our conversation, he (Elliott) indicated that he would like to remain there (Atlanta) ... and I spoke to my president about it and we declined to agree that Nick should live there."

Elliott testified that he first knew he would have to relocate to Dallas when he reported to work in the Dallas office on September 16, 1976. He testified as follows:

> "Q. How did you find out, then, on September 16, that you did not have an agreement?
>
> "A. Don (Spear) informed me at that time that we had not had any success at all in talking to New York and getting them to agree to leaving me remain in Atlanta and that I would have to move to Dallas."

The testimony of both Spear and Elliott provides evidence of a chain of communication which facilitated Great National's selection of Elliott as a field vice-president. Spear was expressly delegated to add employees such as Elliott. Spear and Elliott discussed the conditions of employment, and then Spear solicited a decision from the home office. When the decision concerning the conditions of employment was made, Spear communicated the decision to Elliott.

Great National did not limit the use of this chain of communication to a particular time or to a particular condition of employment. In fact, Elliott testified that he did not at any time discuss the terms of his employment with any employee of Great National other than Spear. It was this fact which led Elliott to believe that Spear had the authority to offer Elliott a one year term of employment:

> "Q. As a matter of fact, you testified in your deposition a year ago that you knew during the time of these discussions that Mr. Spear did not have the authority on behalf of Great National to guarantee you a one year term of employment?
> "A. At that time, I didn't think he had the authority, but on September the 16th, I quickly determined that he did have the authority since he was the only person I had had dealings with. I hadn't had any dealings with anyone else and all arrangements were made through him."

In Chastain v. Cooper & Reed, 152 Tex. 322, 257 S.W.2d 422, 427 (Tex.1953), this Court said:

> "The doctrine of apparent authority is based on estoppel, and one seeking to charge a principal through the apparent authority of an agent to bind the principal must prove such conduct on the part of the principal as would lead a reasonably prudent person, using diligence and discretion, to suppose that the agent has the authority he purports to exercise...."

Great National established a chain of communication by which it communicated with Elliott through Spear. In so doing, Great National permitted Spear to hold himself out as having the authority to convey Great National's offer of employment to Elliott, and therefore indicated to Elliott that Spear had the authority to communicate that offer. In this situation, we hold that there was more than a scintilla of evidence that Spear had the apparent authority to hire Elliott on behalf of Great National for a period of one year. Therefore, the holding of the court of civil appeals that there was no evidence to support the jury finding was erroneous.

This error requires a reversal of the judgment of the court of civil appeals. Since Great National's brief in the court of civil appeals contained points not considered by that court, including factual points beyond this Court's jurisdiction, we remand the cause to the court of civil appeals.

The judgment of the court of civil appeals is reversed and the cause is remanded to that court.

Discussion points for Gizzi v. Texaco

We have all seen the ads – “You can trust your car to the man who wears the star.” What does this mean to the ordinary person, whose reasonable expectations we should protect? On a separate piece of paper, line up all of the arguments you believe that you can muster in favor of finding apparent authority in this case. Then do the opposite, writing down all the reasons why your apparent authority arguments fail in this case. Make them legible, because they will be collected and read aloud. What additional facts would you need to succeed under the theory of reasonable expectations/apparent authority, in your estimation? Also, considering that apparent authority is a factual question, are you convinced that this case is

an appropriate one for a directed verdict?

Augustine GIZZI, Appellant, and Anthony Giaccio
v.
TEXACO, INC., Appellee.
Appeal of Anthony GIACCIO.

United States Court of Appeals, Third Circuit.

Decided Jan. 20, 1971, Rehearing Denied March 8, 1971.

GERALD McLAUGHLIN, Circuit Judge.

Appellant Augustine Gizzi was a steady patron of a Texaco service station located on Route 130 and Chestnut Street, Westville, New Jersey. The real estate upon which the station was situated was owned by a third party and was leased to the operator of the station, Russell Hinman. Texaco owned certain pieces of equipment and also supplied the operator with the normal insignia to indicate that Texaco products were being sold there.

In June of 1965, the station operator, Hinman, interested Gizzi in a 1958 Volkswagen van, which Hinman offered to put in good working order and sell for $400. Gizzi agreed to make the purchase and Hinman commenced his work on the vehicle. The work took about two weeks and included the installation of a new master braking cylinder and a complete examination and testing of the entire braking system. On June 18, 1965 Gizzi came to the station and paid the $400. He was given a receipt for the payment and was told that the car would be ready that evening. Gizzi returned at about six o'clock, accompanied by appellant Anthony Giaccio. They took the van and then departed for Philadelphia, Pennsylvania, to pick up and deliver some air-conditioning equipment. While driving on the Schuylkill Expressway, Gizzi attempted to stop the vehicle by applying the brakes. He discovered that the brakes did not work and, as a result, the vehicle collided with the rear end of a tractor trailer causing serious injuries to both Gizzi and Giaccio.

Texaco, Inc. was the only defendant named in the complaint and at trial, the testimony was all directed to the corporation's liability, the court having asked for an offer of proof on that question.

With regard to the sale of this vehicle, no actual agency existed between Texaco and Hinman. Although most of the negotiations involved in the transaction took place at the Texaco station, the record indicates that Hinman was selling the van on his own behalf, and not on behalf of Texaco. Texaco received no portion of the proceeds. The corporation was not designated the seller on the bill of sale, title to the vehicle being listed in the name of a company located in Atlantic City, New Jersey. Gizzi did receive a Texaco credit invoice as a

receipt for the cash he paid. It would seem that this was an available convenience utilized by Hinman to record the transaction.

The repair work performed by Hinman was incidental to the sale of the vehicle. He offered to put the vehicle into good working order to further induce Gizzi to purchase it. Some work was done on the van after the money had been paid on June 18 and all work on the braking system was completed prior to that date.

The theory of liability advanced by appellants below was that Texaco had clothed Hinman with apparent authority to make the necessary repairs and sell the vehicle on its behalf and that Gizzi reasonably assumed that Texaco would be responsible for any defects, especially defects in those portions of the van which were repaired or replaced by Hinman. It was further contended that Gizzi entered into the transaction relying on this apparent authority, thereby creating a situation in which Texaco was estopped from denying that an agency did in fact exist.

The concepts of apparent authority, and agency by estoppel are closely related. Both depend on manifestations by the alleged principal to a third person, and reasonable belief by the third person that the alleged agent is authorized to bind the principal. The manifestations of the principal may be made directly to the third person, or may be made to the community, by signs or advertising. In order for the third person to recover against the principal, he must have relied on the indicia of authority originated by the principal.

In support of their theory of liability, appellants introduced evidence to show that Texaco exercised control over the activities of the service station in question. They showed that Texaco insignia and the slogan 'Trust your car to the man who wears the star' were prominently displayed. It was further established that Texaco engaged in substantial national advertising, the purpose of which was to convey the impression that Texaco dealers are skilled in automotive servicing, as well as to promote Texaco products, and that this advertising was not limited to certain services or products. The record reveals that approximately 30 per cent of the Texaco dealers in the country engage in the selling of used cars and that this activity is known to and acquiesced in by the corporation. Actually Texaco had a regional office located directly opposite the service station in question and Texaco personnel working in this office were aware of the fact that used vehicles were being sold from the station. It was further established that there were signs displayed indicating that an 'Expert foreign car mechanic' was on the premises.

Appellant Gizzi testified that he was aware of the advertising engaged in by Texaco and that it had instilled in him a certain sense of confidence in the corporation and its products.

In granting Texaco's motion for a directed verdict the court stated:

'I am convinced that as a matter of law there could not be any apparent authority on the basis of what I heard so far or what I have had the slightest glimmer that you could show, no apparent authority on the part of this operator to bind Texaco in connection with the sale of

this used Volkswagon bus * * *
'In short, nobody could reasonably interpret any of these slogans or representations or indicia of control as dealing with anything more than the servicing of automobiles, and to the extent of putting gas in them and the ordinary things that are done at service stations.

'That 'Trust your car to the man who wears the star' could not possibly be construed to apply to installing new brake systems or selling used cars.'

We are of the opinion that the court below erred in granting the motion. Questions of apparent authority are questions of fact and are therefore for the jury to determine. While the evidence on behalf of appellants by no means amounted to an overwhelming case of liability, we are of the opinion that reasonable men could differ regarding it and that the issue should have been determined by the jury, after proper instructions from the court.

For the reasons stated herein, the order of the district court will be vacated and the case remanded for further proceedings consistent with this opinion. We do not pass on the merits of any other claims advanced on this appeal, but leave them for the consideration of the district court on the remand.

Discussion points for Drummond v. Hilton Hotel

Before class, find out the difference between a division and a subsidiary, and why the distinction is so important. Is there enough apparent authority in this case to justify a verdict for the plaintiffs? What if the plaintiffs were not hotel patrons, but suppliers of linen who were not paid for their latest delivery? Would the case be decided differently? If so, then why? Why, in Hilton's case, is this a classic case of trying to have your cake and eating it, too?

As mentioned earlier, if an agent is deemed to be an independent contractor, then liability for the negligence of the agent will not be imputed to the principal (respondeat superior does not apply). However, the principal is not always immune from liability, because of public policy concerns. Some exceptions to the general rule that principals are not liable for the negligence of their independent contractor agents include 1) dangerous disrepair, 2) nuisance, 3) inherently dangerous activities, and 4) nondelegable duties (landlords).

James and Verna DRUMMOND
v.
HILTON HOTEL CORPORATION

United States District Court, E. D. Pennsylvania.

July 3, 1980.

GILES, District Judge.

Defendant, Hilton Hotel Corporation ("Hilton"), has moved for summary judgment in this action for damages. Plaintiff, Verna Drummond was injured as the result of a fall in a hotel whose trade name was the Hilton Inn. Hilton asserts that at no time did it maintain, own, control, or operate the hotel and that the record owner was the Creative Development Company ("Creative"), a wholly-owned subsidiary of the Gebco Investment Corporation ("Gebco"). A written agreement which on its face is a license/franchise agreement exists between Hilton and Creative. In that document, Hilton specifically disavows any agency relationship.

Plaintiffs resist Hilton's summary judgment motion asserting the doctrine of apparent agency. They maintain that Hilton held itself out in such a manner as to lead the general public, including hotel guests, to believe they were dealing directly with either Hilton or a servant or employee of Hilton, a hotel corporation of international reputation. Plaintiffs assert that representation of the hotel as a "Hilton Inn" estops Hilton from denying all possessory duties.

Upon careful examination of the controlling authority in this jurisdiction, this court concludes that there are material issues of fact presented regarding the existence of both a real and an apparent agency relationship between Hilton and Creative. Accordingly, for the reasons set forth below, Hilton's motion for summary judgment must be denied.

I.

Plaintiff urges that Hilton should be liable for the alleged negligent acts of Creative based on the doctrine of apparent authority as set forth in the Restatement of Agency s 267. Plaintiffs, opposing the instant motion, reference a signed agreement between Hilton and Creative which purports to be a license and franchise agreement. It has a provision which attempts to deny the existence of an agency relationship and to disclaim all liabilities incurred on behalf of the hotel.

"Under Pennsylvania law, when an injury is done by an 'independent contractor," the person employing him is generally not responsible to the person injured." **** "However, when the relationship between the parties is that of 'master-servant' or 'employer-employee' as distinguished from 'independent contractor-contractee,' the master or employer is vicariously liable for the servant's or employee's negligent acts committed within the scope of his employment." The basic inquiry which the Pennsylvania courts have set forth to determine whether a given person is an employee-servant or an independent contractor is

whether such person is subject to the alleged employer's control or right to control with

> respect to his physical conduct in the performance of the services for which he was engaged.... The hallmark of an employee-employer relationship is that the employer not only controls the result of the work but has the right to direct the manner in which the work shall be accomplished; the hallmark of an independent contractee-contractor relationship is that the person engaged in the work has the exclusive control of the manner of performing it, being responsible only for the result

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In Drexel, the Third Circuit observed that difficulties exist where the parties occupy the status of franchisor and franchisee. The mere existence of a franchise relationship does not necessarily trigger a finding of a master- servant relationship, nor does it automatically insulate the parties from such a relationship. Whether the control retained by the franchisor is also sufficient to establish a master-servant relationship depends in each case upon the nature and extent of such control as defined in the franchise agreement or by the actual practice of the parties. Drexel, 582 F.2d at 786. In Drexel, the defendant occupied the status of franchisor by virtue of a signed agreement. Although the franchise bore the name of the defendant, it denied all ownership and control and thus all liability for any negligence on the part of the franchisee. Notwithstanding a written provision in the agreement which stated that the liability of the defendant was strictly limited, the court concluded that other clauses in the agreement could be construed as reserving to the defendant the right to control certain facets of the franchise. For example, there were clauses requiring the franchisee to operate under the name of the defendant/franchisor, granting the defendant the right of inspection, and requiring that the franchise operate as part of a national organization securing its strength through adherence to defendant's "uniformly high standards of service, appearance, quality of equipment, and proved methods of operation." Id. 787. Such clauses prompted the court to state that it could not hold as a matter of law that a master-servant relationship did not exist.

In the agreement between Hilton and Creative, Hilton has the right to consult with Creative on operating problems concerning the hotel, the right to inspect the hotel to maintain the standards of the Hilton system. Creative is required to feature Hilton's name in all advertising and promotional material. The agreement does have a clause limiting Hilton's liability. Yet, as stated in Drexel, the mere fact that there is express denial of the existence of an agency relationship is not in itself determinative of the matter. Id. 786. Since such a denial of agency is not sufficient to relieve Hilton of all possible liability as a matter of law, the issue of Hilton's right to control any operations of the hotel is an issue for jury determination.

II.

Plaintiff's contention that Hilton should be liable for the alleged negligent acts of Creative, irrespective of an actual agency relationship, is based on the doctrine of apparent agency as set forth by the Restatement (Second) of Agency s 267 (1975), which provides as follows:

> One who represents that another is his servant or other agent and thereby causes a third person justifiably to rely upon the care or skill of such apparent agent is subject to liability

to the third person for harm caused by the lack of care or skill of the one appearing to be a servant or other agent as if he were such. Accord, Restatement of Agency s 267.

Plaintiffs cite Taylor v. Costa Lines, Inc., 441 F.Supp. 783 (E.D.Pa.1977), for the proposition that Pennsylvania law would adopt this section of the Restatement. Hilton asserts that the Pennsylvania courts have traditionally rejected the application of this principle to tort actions. The Third Circuit in Drexel agreed with the decision of the trial court in Taylor, and concluded that the Supreme Court of Pennsylvania would adopt s 267 or some similar principle of apparent agency. Hilton could therefore be liable under this doctrine if the plaintiff makes a showing that Hilton represented Creative to be its servant and that plaintiff justifiably relied on such representation.

In Gizzi v. Texaco, Inc., 437 F.2d 308 (3d Cir.) (applying New Jersey law), cert. denied, 404 U.S. 829, 92 S.Ct. 65, 30 L.Ed.2d 57 (1971) while citing s 267, the court concluded that a question of apparent authority existed where a gas station was neither owned nor operated by Texaco but prominently displayed the Texaco insignia and slogan and where Texaco had engaged in national advertising, the effect of which could be found to instill confidence in Texaco gas stations. In Drexel, the Court also concluded that there were sufficient indicia of authority to raise questions of fact as to whether the elements of apparent agency had been established. Among these indicia were provisions in the franchise agreement which required the franchisee to use the name of the defendant/franchisor in all promotional and advertising materials.

In the instant case, plaintiffs reference to provisions in the license/franchise agreement between Hilton and Creative which require Creative to "disclose in all dealings with suppliers and persons, other than guests, that it is an independent entity and that Licensor (Hilton) has no liability for debts," and "Feature in the Hotel operation, in the guest rooms, public rooms and other public areas of the Hotel, and on the various articles therein as specified in the Operating Manual and in advertising and promotional material, the name 'Hilton'.

Therefore, this court concludes that whether Hilton held itself out to the public as the owner or operator of the Hilton Inn is a proper issue of fact for determination by a jury.

Discussion points for Hoddeson v. Koos Bros.

Read the facts as they are presented very carefully. It seems to me that someone is lying, either the plaintiff or the defendant (how could something like this happen, if it did happen, without the store knowing about it?). Tell me who is lying, and prepare to justify your answer in class.

Why is there no allegation of actual authority in this case? What is missing? If it is apparent authority which is the theory behind the cause of action, what exactly is the plaintiff's case built upon? What are her factual allegations? Can you see any public policy

considerations lurking around in the background of this case which, if not discussed, should at least be considered?

And finally, a hypothetical to consider. Assume your client was injured, she alleges, by slipping on a tomato at the local grocery store which had fallen on the floor. Will you win if you sue? Over and above proving that she slipped on a tomato on the floor of the store, what more will you need to prove? How will you go about proving it?

Robert HODDESON and Joan Hoddeson, Plaintiffs-Respondents,
v.
KOOS BROS., a New Jersey corporation, Defendant-Appellant.

Superior Court of New Jersey.
Decided Oct. 30, 1957.

The occurrence which engages our present attention is a little more than conventionally unconventional in the common course of trade. Old questions appear in new styles. A digest of the story told by Mrs. Hoddeson will be informative and perhaps admonitory to the unwary shopper.

The plaintiff Mrs. Hoddeson was acquainted with the spacious furniture store conducted by the defendant, Koos Bros., a corporation, at No. 1859 St. George Avenue in the City of Rahway. On a previous observational visit, her eyes had fallen upon certain articles of bedroom furniture which she ardently desired to acquire for her home. It has been said that 'the sea hath bounds but deep desire hath none.' Her sympathetic mother liberated her from the grasp of despair and bestowed upon her a gift of $165 with which to consummate the purchase.

It was in the forenoon of August 22, 1956 that Mrs. Hoddeson, accompanied by her aunt and four children, happily journeyed from her home in South River to the defendant's store to attain her objective. Upon entering, she was greeted by a tall man with dark hair frosted at the temples and clad in a light gray suit. He inquired if he could be of assistance, and she informed him specifically of her mission. Whereupon he immediately guided her, her aunt, and the flock to the mirror then on display and priced at $29 which Mrs. Hoddeson identified, and next to the location of the designated bedroom furniture which she had described.

Upon confirming her selections the man withdrew from his pocket a small pad or paper upon which he presumably recorded her order and calculated the total purchase price to be $168.50. Mrs. Hoddeson handed to him the $168.50 in cash. He informed her the articles other than those on display were not in stock, and that reproductions would upon notice be delivered to her in September. Alas, she omitted to request from him a receipt for her cash disbursement. The transaction consumed in time a period from 30 to 40 minutes.

Mrs. Hoddeson impatiently awaited the delivery of the articles of furniture, but a span of time beyond the assured date of delivery elapsed, which motivated her to inquire of the defendant the cause of the unexpected delay. Sorrowful, indeed, was she to learn from the defendant that its records failed to disclose any such sale to her and any such monetary credit in payment.

Such were the essentialities of the narrative imparted to the judge and jury in the Union County District Court, where Mrs. Hoddeson and her husband obtained a final judgment against the defendant in reimbursement of her cash expenditure. The testimony of her aunt was corroborative of that of Mrs. Hoddeson.

It eventuated that Mrs. Hoddeson and her aunt were subsequently unable Positively to recognize among the defendant's regularly employed salesmen the individual with whom Mrs. Hoddeson had arranged for the purchase, although when she and her aunt were afforded the opportunities to gaze intently at one of the five salesmen assigned to that department of the store, both indicated a resemblance of one of them to the purported salesman, but frankly acknowledged the incertitude of their identification. The defendant's records revealed that the salesman bearing the alleged resemblance was on vacation and hence presumably absent from the store during the week of August 22, 1956.

As you will at this point surmise, the insistence of the defendant at the trial was that the person who served Mrs. Hoddeson was an impostor deceitfully impersonating a salesman of the defendant without the latter's knowledge.

It was additionally disclosed by the testimony that a relatively large number of salesmen were employed at the defendant's store, and that since they were remunerated in part on a sales commission basis, there existed considerable rivalry among them to serve incoming customers; hence the improbability of the unnoticed intrusion of an impersonator.

Fortifying the defense, each of the five salesmen, but not every salesman, denied that he had attended Mrs. Hoddeson on the stated occasion, and the defendant's comptroller and credit manager verified the absence in the store records of any notation of the alleged sale and of the receipt of the stated cash payment.

The credibility of the testimony of both Mrs. Hoddeson and her aunt was thus shadowed. The trial judge transmitted to the jury for determination the simple factual issue whether Mrs. Hoddeson and her co-plaintiff had established by a preponderance of the credible evidence that the $168.50 was paid in fact to an employee of the defendant; otherwise, the defendant should be acquitted of liability.

The jury resolved that controversial issue in favor of the plaintiffs. The defendant's application for a new trial was denied by the trial judge who announced:

> 'It is my conclusion that the evidence of the circumstances proved by the plaintiff warranted a finding by the jury that the person who received the money was an employee

of the defendant.'

Does it clearly and unequivocally appear that the action of the trial judge constituted a manifest denial of justice under the law?

The ground now asserted on behalf of the defendant for a reversal of the judgment is that there was a deficit of evidence to support the conclusion that a relationship of master and servant existed between the man who served and received the money from Mrs. Hoddeson and the defendant company.

There can be no doubt that the existence of the alleged relationship, or in the alternative an estoppel by the defendant to deny its existence, was an essential element of the legal right of the plaintiff, Mrs. Hoddeson, to recover her monetary disbursement from the company. Neither is it to be doubted that such a relationship of agency, actual or apparent, can be proved by means of circumstantial evidence.

We do not hastily yield to the temptation immediately to adopt the postulate that the person who waited upon Mrs. Hoddeson was without question a humbugger unassociated with the defendant. We recognize that the jurors, pursuant to the directions of the court, weighed on the scales of reasonable probabilities the inferences anent that issue which were to them derivable from the circumstantial evidence relating on the one hand to the described behavior and deportment of the individual and on the other to the revelatory state of the defendant's records.

Perhaps in reality the jurors did not read the scales mistakenly, and so initially we pause to examine the probative range of the circumstantial evidence. True, in the present case there was evidence that the person whose identity is undisclosed approached Mrs. Hoddeson and her aunt in the store, publicly exhibiting the mannerisms of a salesman; inquired if he could be of service; upon being informed of the type of the articles in which Mrs. Hoddeson was interested, he was not only sufficiently acquainted with their description, but also where in the department they were respectively on display, guiding them without hesitation to the location of the mirror and then to that of the indicated bedroom furniture; he represented that those articles were not then available in stock, which significantly the store records disclosed to be true; his prophetic representation concerning their prospective arrival in stock proved to be prescient, unless he gleaned that information from the price tag; he accurately calculated their true sales prices and openly received the cash. Those activities precisely characteristic of the common experiences and practices in the trade were conspicuously pursued in market overt during a period of 30 to 40 minutes.

In the consideration of the propriety of the defendant's motion for an involuntary dismissal of the action, we are not at liberty to suspect that the verified narrative of Mrs. Hoddeson, corroborated by her aunt, was purely imaginative or artfully inventive, but rather to regard it as a trustworthy revelation of the factual events to the extent of her knowledge. Gentile v. Public Service Coordinated Transport.

In the study of the circumstantial evidence, its perceptible legal deficiency and inadequacy inhere in the limitations of its disclosures. Obviously it confines its information solely to the activities of the supposed salesman. It does not embrace or, indeed, touch any manifestations whatever emanating From the defendant tending to indicate Its conference of authority, actual or apparent, upon the alleged salesman.

Where a party seeks to impose liability upon an alleged principal on a contract made by an alleged agent, as here, the party must assume the obligation of proving the agency relationship. It is not the burden of the alleged principal to disprove it.

Concisely stated, the liability of a principal to third parties for the acts of an agent may be shown by proof disclosing (1) express or real authority which has been definitely granted; (2) implied authority, that is, to do all that is proper, customarily incidental and reasonably appropriate to the exercise of the authority granted; and (3) apparent authority, such as where the principal by words, conduct, or other indicative manifestations has 'held out' the person to be his agent.

Obviously the plaintiffs' evidence in the present action does not substantiate the existence of any basic express authority or project any question implicating implied authority. The point here debated is whether or not the evidence circumstantiates the presence of apparent authority, and it is at this very point we come face to face with the general rule of law that the apparency and appearance of authority must be shown to have been created by the manifestations of the alleged principal, and not alone and solely by proof of those of the supposed agent. Assuredly the law cannot permit apparent authority to be established by the mere proof that a mountebank in fact exercised it.

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Let us hypothesize for the purposes of our present comments that the acting salesman was not in fact an employee of the defendant, yet he behaved and deported himself during the stated period in the business establishment of the defendant in the manner described by the evidence adduced on behalf of the plaintiffs, would the defendant be immune as a matter of law from liability for the plaintiffs' loss? The tincture of estoppel that gives color to instances of apparent authority might in the law operate likewise to preclude a defendant's denial of liability. It matters little whether for immediate purposes we entitle or characterize the principle of law in such cases as 'agency by estoppel' or 'a tortious dereliction of duty owed to an invited customer.' That which we have in mind are the unique occurrences where solely through the lack of the proprietor's reasonable surveillance and supervision an impostor falsely impersonates in the place of business an agent or servant of his. Certainly the proprietor's duty of care and precaution for the safety and security of the customer encompasses more than the diligent observance and removal of banana peels from the aisles. Broadly stated, the duty of the proprietor also encircles the exercise of reasonable care and vigilance to protect the customer from loss occasioned by the deceptions of an apparent salesman. The rule that those who bargain without inquiry with an apparent agent do so at the risk and peril of an absence of the agent's authority has a patently impracticable

application to the customers who patronize our modern department stores. Vide, 2 C.J.S. Agency s 93, p. 1193.

Our concept of the modern law is that where a proprietor of a place of business by his dereliction of duty enables one who is not his agent conspicuously to act as such and ostensibly to transact the proprietor's business with a patron in the establishment, the appearances being of such a character as to lead a person of ordinary prudence and circumspection to to believe that the impostor was in truth the proprietor's agent, in such circumstances the law will not permit the proprietor defensively to avail himself of the impostor's lack of authority and thus escape liability for the consequential loss thereby sustained by the customer.

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Let it not be inferred from our remarks that we have derived from the record before us a conviction that the defendant in the present case was heedless of its duty, that Mrs. Hoddeson acted with ordinary prudence, or that the factual circumstances were as represented at the trial.

In reversing the judgment under review, the interests of justice seem to us to recommend the allowance of a new trial with the privilege accorded the plaintiffs to reconstruct the architecture of their complaint appropriately to project for determination the justiciable issue to which, in view of the inquisitive object of the present appeal, we have alluded. We do not in the exercise of our modern processes of appellate review permit the formalities of a pleading of themselves to defeat the substantial opportunities of the parties.

Reversed and new trial allowed.

Discussion points for Cullen v. BMW

In order to discuss this case, you need to learn a little about franchisors/franchisees. So do some research and be prepared to talk about what you have learned. Understand why actual authority and apparent authority arguments fail for the plaintiff. If the car dealer (Bavarian) is an independent contractor (of sorts), then how can the plaintiff succeed in suing BMW of North America? What are the allegations one must make and prove in order to succeed? When can you go after the principal when the independent contractor is at fault? If your client were run over by a Federal Express truck, could you sue all the companies (the principals) whose packages were being delivered by that Federal Express truck (the independent contractor) when the accident occurred? Why not? What would you have to prove in order to successfully sue those companies?

Thinking back to the Tormo v. Yormark case, do you think that attorneys are held to a higher standard than other professionals (such as hoity-toity foreign car dealers)?

Thomas W. CULLEN, Jr., Plaintiff-Appellee,
v.
BMW OF NORTH AMERICA, INC., Defendant-Appellant.

United States Court of Appeals,
Second Circuit.

Decided Oct. 13, 1982.

Defendant BMW of North America, Inc. ("BMW/NA") appeals from a judgment of the United States District Court for the Eastern District of New York, Honorable Edward R. Neaher, Judge, in favor of Thomas W. Cullen, Jr., in the amount of $18,000 plus interest, and from a judgment of that same court, denying defendant's motion to amend the judgment. BMW/NA is the exclusive importer and distributor in the United States of passenger cars, parts, and products manufactured by Bayerische Motoren Werke, AG. On appeal, BMW/NA claims that the district court erred in finding that it had breached a duty under New York law actively to police the methods of operation of its franchisee, Bavarian Auto Sales, Inc. ("Bavarian"), and had negligently permitted Bavarian to continue as a BMW dealer. We agree with BMW/NA that it did not owe a duty to supervise the operation of Bavarian and to terminate the franchise because of its allegedly precarious financial condition. Accordingly,

we reverse the judgments of the district court.

FACTS

On January 24, 1979, Thomas W. Cullen, Jr., and his wife drove past the showroom of Bavarian and decided to shop for a car. Cullen selected a new 1978 BMW, Model 530i, at a price of $18,245, and placed a deposit of $245 on the vehicle. Although Cullen had originally been told that the car would not be available for seven to ten days, a Bavarian salesman called Cullen five days later, advising that the car had arrived and requesting a check for the balance of the amount of $18,000, which was cashed by Bavarian. However, Cullen never received the automobile or the return of his money. In fact, Hans Eichler, Bavarian's president and owner of a 60 percent interest in the franchise, had stolen and absconded with Cullen's money. At no time relevant to the transaction, however, did Cullen have any contact, in person, by telephone, or by mail, with any representative of BMW/NA.

Cullen subsequently commenced a civil suit against Bavarian in New York State Supreme Court, Nassau County. The suit was stayed after Eichler filed a petition in bankruptcy. Cullen also filed criminal complaints with the Queens County District Attorney and the Attorney General of the State of New York, but no indictments were issued. In addition, Cullen brought this action based on diversity grounds against BMW/NA.

Bavarian was operating as a franchised BMW dealer, with Eichler as its principal, when BMW/NA assumed control over the distribution of BMW automobiles in March, 1975. It continued to operate as a franchised BMW dealer until February 16, 1979 when the dealership ended.

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Pursuant to a standard operating agreement with BMW/NA, Bavarian was responsible for maintaining a prearranged line of credit with a financial institution to be used exclusively for the purchase of BMW vehicles. Bavarian, however, permitted its line of credit to lapse. Prior to August, 1976, Bavarian had a line of credit with the State Bank of Long Island. On August 18, 1976, however, the bank informed BMW/NA that it had terminated its relationship with Bavarian because Eichler had advised the bank that he had arranged to handle Bavarian's credit requirements from personal resources. BMW/NA experienced difficulty, however, in receiving payment for cars and parts and placed Bavarian on a C.O.D. certified check basis, rather than open account status, in the latter part of 1976.

In June, 1977, BMW/NA received a letter from the Israel Discount Bank stating that effective June 16, 1977, Bavarian had established a line of credit for $200,000. From the latter part of 1976 through August 22, 1977, the Israel Discount Bank had paid for approximately eighty-seven vehicles purchased by Bavarian even though no formal letter of credit was in effect for most of this period. The bank also paid BMW/NA for another twenty-six vehicles between September 30, 1977 and December 27, 1977. The Israel Discount Bank continued as Bavarian's credit facility through the summer of 1978. The bank

paid BMW/NA for fifty-three automobiles between January 1, 1978 and August 18, 1978. In the fall of 1978, however, the bank concluded that the dealership was experiencing financial difficulty and decided not to extend further credit. The bank's decision was in part based upon certain tax levies and other legal actions filed against the Bavarian franchise. BMW/NA was unaware, however, of any tax levies filed against Bavarian or the reasons behind the Israel Discount Bank's decision to terminate Bavarian's line of credit.

At approximately the time at which Bavarian lost its line of credit, BMW/NA began receiving an increased number of customer complaints concerning the Bavarian franchise. These complaints ranged from the issuance of checks on accounts with insufficient funds to alleged delays in return of customer deposits. Although an investigation by BMW/NA revealed that all complaints had been satisfactorily resolved and all checks were covered on re-presentation. BMW/NA remained disturbed by Bavarian's continued failure to satisfy certain requirements of its contract with BMW/NA, such as submitting monthly financial statements, and the increased number of checks which Bavarian had issued on accounts with insufficient funds.

Eichler attempted to reassure BMW/NA of Bavarian's financial viability, indicating that he was actively negotiating with a variety of financial institutions to obtain a line of credit. By mid-September, however, Bavarian still had not been able to secure credit funds, and BMW/NA met with Eichler to discuss the future of the franchise. After reviewing the dealership's file, BMW/NA concluded that it would be difficult to terminate the Bavarian franchise at that time, without adequate written documentation certifying the dealer's deficiencies and without providing Bavarian an opportunity to correct those deficiencies. Accordingly, BMW/NA granted Bavarian sixty days to cure all deficiencies, and BMW/NA personnel closely monitored the franchise during this period. BMW/NA continued to operate as a BMW dealer and service facility and maintained the minimum number of vehicles required by its contract with BMW/NA.

At Bavarian's request, the original sixty-day period was extended until November 14, 1978. On the following day, Eichler informed BMW/NA that he had verbal approval from Citibank for credit and that he was awaiting confirmation. Although the Citibank commitment did not materialize, the Lloyd Capital Corporation ("Lloyd") advised BMW/NA by letter dated December 7, 1978, that Bavarian had established a line of credit for $400,000 exclusively for BMW automobiles. Shortly thereafter, BMW/NA allocated seven vehicles to the Bavarian dealership and drew funds pursuant to the Lloyd letter of credit. The cash drafts were refused, however, and Lloyd informed BMW/NA that the letter of credit had been withdrawn. The seven vehicles were then removed from Bavarian and were reallocated to a nearby BMW dealer. Moreover, Friedrich Hanau, vice-president of BMW/NA, immediately wrote to Eichler, setting forth the company's position that unless Bavarian corrected its continuing deficiencies within an additional sixty days, BMW/NA would serve a notice of intent to terminate the franchise. Eichler responded on December 28, 1978, indicating that he was accelerating his efforts to obtain a line of credit, and expressing his desire to continue as a BMW dealer. In early January, 1979, however, Eichler advised BMW/NA that he desired to sell his franchise to another automobile dealer. This prospective purchaser

submitted an application which BMW/NA, in early February, rejected for failing to satisfy BMW/NA's established standards for a new dealership.

On February 13, 1979, BMW/NA officials again met with Eichler to discuss the future of the franchise. At this meeting, BMW/NA officials learned that Eichler had accepted deposits from customers totalling approximately $100,000 and that he had used this money for his own purposes. Three days later, BMW/NA accepted Eichler's voluntary letter of resignation.

DISCUSSION

Cullen alleged at trial two theories of liability: (1) that Bavarian acted as BMW/NA's agent pursuant to principles of either actual agency or agency by estoppel; and (2) that BMW/NA negligently permitted Bavarian to continue as a BMW dealer because it had knowledge of Bavarian's precarious financial condition. The district court rejected the first theory of liability, finding that Cullen failed to prove the essential elements supporting a theory of agency by estoppel. The court held, however, that BMW/NA was liable for damages under the negligence theory, finding that Cullen had met his "burden of proving facts which give rise to a legal duty on the part of BMW/NA, for the protection of its franchisee's customers, to reasonably police the authorized use of the BMW name and supervise the operation of its franchise." Cullen v. BMW of North America, Inc., No. 79 C 970, slip op. at 12 (E.D.N.Y. Oct. 28, 1981). In imposing a duty on BMW/NA, the district court found that BMW/NA "was apprised of Bavarian's propensity for unscrupulous business transactions," Cullen v. BMW of North America, Inc., 531 F.Supp. 555, at 565-66 (E.D.N.Y.1982), and that as a result, "BMW/NA should have reasonably foreseen that Bavarian might have intentionally caused some financial harm to some BMW customer as a result of its original negligence ...." Id. The court thus concluded that where a franchisor, such as BMW/NA, has a "reasonable opportunity to reduce the risk of foreseeable injury" caused by its franchisee, id., but fails to terminate its franchisee or take other appropriate action, the franchisor is negligent and is liable for damages suffered by the ultimate consumer.

> FN6. Cullen's amended complaint alleged four separate theories of liability: (1) that Bavarian was acting as agent for BMW/NA pursuant to principles of either actual agency or agency by estoppel; (2) that BMW/NA was negligent in permitting Bavarian to continue as a dealer because it had knowledge of Bavarian's allegedly precarious financial condition; (3) that BMW/NA entered into a conspiracy with Eichler, and in fact did, defraud customers into doing business with Eichler; and (4) that BMW/NA's conduct constituted a prima facie tort. At the conclusion of discovery, BMW/NA moved for summary judgment dismissing each of Cullen's claims for relief. The district court concluded that an actual agency relationship did not exist between BMW/NA and Bavarian. It also found no evidence to support Cullen's causes of action for conspiracy to commit fraud and prima facie tort, and dismissed those claims as well. Accordingly, only the issues of negligence and agency by estoppel remained to be tried.

> FN7. The court specifically pointed to Cullen's failure "to prove his reliance on

> Bavarian's authority to act for BMW/NA." Cullen v. BMW of North America, Inc., No. 79 C 970, slip op. at 8 (E.D.N.Y. Oct. 28, 1981) (emphasis in original).

We conclude, however, that the district court improperly determined that Cullen's injury was reasonably foreseeable, and thus erred in finding BMW/NA liable for negligent failure to police the methods of operation of its independent franchisee and to terminate the franchise because of Bavarian's precarious financial condition. "The law does not undertake to hold a person who is chargeable with a breach of duty toward another, with all the possible consequences of his wrongful act." Lowery v. Western Union Telegraph Co., 60 N.Y. 198, 201 (1875). It is thus a well-established principle that foreseeability of injury is an indispensable requisite of negligence, and that negligence exists only when there is a reasonable likelihood of danger as the result of the act complained of. Accordingly, an intervening act, tortious or criminal, will ordinarily insulate a negligent defendant from liability when the subsequent act could not have been reasonably anticipated by the defendant.

[3] Applying these principles to the instant action, we decline to hold BMW/NA negligent and liable for damages since it could not reasonably have anticipated the crimes committed by Bavarian's principal, Eichler. Although BMW/NA may have been aware of Bavarian's shaky financial condition, that knowledge alone gave BMW/NA no cause reasonably to anticipate that Eichler would either engage in any criminal activity or that he would abscond with customer funds. In fact, no amount of supervision by BMW/NA would have enabled it to foresee Eichler's thievery. Moreover, even though BMW/NA had notice that Bavarian had been the subject of customer complaints, most complaints were resolved, and the record does not demonstrate that there was any dishonesty or criminal intent associated with these incidents. Furthermore, we note that the district court's finding that Bavarian was an independently owned and operated dealership is sufficient to eliminate any question of control by BMW/NA. BMW/NA had no financial interest in Bavarian, did not participate in the hiring or firing of its officers or employees, or dictate its sales practices. Accordingly, we conclude that BMW/NA, even though it had knowledge of Bavarian's precarious financial condition, was not liable to Cullen for his damages under a negligence theory since it could not have reasonably foreseen Eichler's criminal activity.

Reversed.

III. The Equal Dignities Rule

Nothing much to worry about here, folks. In fact, it is a repeat of a concept you were most likely introduced to in Contracts. The Equal Dignities Rule is just a logical offshoot of the Statute of Frauds, which requires a writing signed by the party to be charged in those Contracts cases it applies to. In these cases, the question does not involve whether a writing exists, which is signed. The question in these cases involves the person who signed – the agent, not the principal. And the question then becomes, is the agent’s signature on the

document enough to bind the principal? And the answer is, it depends. If the jurisdiction follows the Equal Dignities Rule, then you need two writings, one signed by the agent entering into the contract on behalf of the principal, and the other signed by the principal authorizing the agent to enter into the contract on behalf of the principal. If the jurisdiction does not follow the rule, then you need only the writing signed by the agent. But that only takes you half the way there. You still need to bring in the principal under the doctrine of actual or apparent authority.

Scott R. BARROW, executor,[1]
v.
DARTMOUTH HOUSE NURSING HOME, INC.,[2] & others.[3]

Massachusetts Court of Appeals

Decided Aug. 18, 2014.

Background: Executor of nursing-home resident's estate brought wrongful-death action against nursing home, owner of nursing home, and nursing home's employees, asserting that defendants failed to address violent propensities of resident's roommate, who purportedly fatally attacked resident. The Superior Court Department, Essex County, Robert A. Cornetta, J., granted defendants' motion to compel arbitration. Executor appealed.

Holdings: The Appeals Court, Kafker, J., held that:

- executor lacked authority to sign arbitration agreement;

- resident was not third-party beneficiary of the agreement; and

- equitable estoppel did not bar executor from opposing motion to compel arbitration.

Vacated and remanded.

Opinion

KAFKER, J.

***129** The enforceability of arbitration agreements signed on behalf of family members being assisted in the nursing home admission process has been the subject of a recent constellation of cases. See, e.g., *Miller v. Cotter,* 448 Mass. 671, 679–684, 863 N.E.2d 537 (2007); *Johnson v. Kindred Healthcare, Inc.,* 466 Mass. 779, 781–789, 2 N.E.3d 849 (2014), and

Licata v. GGNSC Malden Dexter LLC, 466 Mass. 793, 796–799, 2 N.E.3d 840 (2014). Here, the plaintiff, Scott R. Barrow, signed such an arbitration agreement on behalf of his ninety-six year old mother, Elizabeth Barrow, as he helped her enter the Brandon Woods Long Term Care Facility (nursing home). After she was allegedly beaten and strangled to death by her ninety-seven year old roommate, Scott[4] brought, in his ****321** capacity as executor of his mother's estate, a multicount suit in Superior Court.[5] The Superior Court judge ordered all claims to arbitration. The arbitrator decided all claims in favor of the defendants, and Scott appealed on the grounds that the arbitration agreement was unenforceable.

We agree that the arbitration agreement was not enforceable and reverse the decision of the judge compelling arbitration. Scott did not have a durable power of attorney. Nor was he acting as his mother's guardian or conservator. A health care proxy, as the Supreme Judicial Court has previously held, is insufficient to authorize the health care agent to sign an arbitration agreement. There was no evidence or suggestion that Scott's mother specifically authorized him to sign the arbitration agreement. The agreement, by its express terms, was not a requirement of admission to the nursing home. We also conclude that Scott did not sign the arbitration agreement in his individual capacity and that principles of equitable estoppel do not preclude Scott from bringing suit.

Background. On February 16, 2006, Scott completed the admission authorization process for his mother at the nursing home. Elizabeth had requested that Scott complete this process prior to her arrival at the home, and she had informed the nursing home that Scott would be doing so. The admission process included executing numerous agreements, such as a consent for admission, ***130** a consent for treatment, a physician consent, and various others enumerated on a two-page "admission authorization" form.

In addition to these documents, Scott also signed a "Resident and Facility Arbitration Agreement" (agreement). The agreement provided that "any legal dispute, controversy, demand or claim ... that arises out of or relates to the Resident Admission Agreement or any services or health care provided by the Facility to the Resident, shall be resolved exclusively by binding arbitration." The agreement was not a condition of admission, and clearly stated as much on its face, in bold and capitalized print. It also was not listed on the admission authorization form. Scott signed and dated the agreement on the line for the "Resident Representative Signature," below a paragraph certifying that the signatory was "the Resident, or a person duly authorized by the Resident, which shall include a responsible party, Health Care Proxy, Power of Attorney, or Legal Guardian." Elizabeth did not sign the agreement, and she did not specifically authorize Scott to sign the agreement. According to Scott's affidavit, he never informed his mother that he entered into an arbitration agreement.

Around the same time that Elizabeth was admitted to the nursing home, she signed a health care proxy designating Scott as her health care agent, pursuant to G.L. c. 201D, § 5, in the event of her incapacity to make health care decisions. The proxy was witnessed on February 17, 2006, but was not activated. Aside from the health care proxy, Scott did not hold a power of attorney, and he was not Elizabeth's legal guardian or conservator.

Elizabeth died on September 24, 2009. According to the complaint, Elizabeth's roommate at the nursing home attacked Elizabeth in their room, beating, strangling, and asphyxiating her by putting a plastic bag over her head. Following Elizabeth's death, Scott filed this wrongful death action against the nursing home, its ****322** corporate owner, and various employees of the nursing home (sometimes, collectively, Brandon Woods) in the Superior Court as executor of Elizabeth's estate. The complaint alleged that his mother's roommate demonstrated a propensity for violence on numerous occasions while she was a resident at the nursing home, and that the defendants' failure to address these violent propensities resulted in Elizabeth's death.

Relying on the agreement that Scott had signed during the admission process, Brandon Woods moved to compel arbitration. Scott opposed arbitration based on his claim that he lacked actual or apparent authority to sign the agreement. The judge entered an ***131** order compelling arbitration. After various additional motions, proceedings, and orders—including an order by a single justice of this court denying Scott's interlocutory appeal—the parties proceeded to arbitration, where the arbitrator determined that there had been no wrongdoing by Brandon Woods. The judge confirmed the arbitration decision and denied Scott's postarbitration motions seeking to alter or amend the judgment and to vacate the arbitration decision. This appeal followed.

Discussion. "Adjudication of a motion to compel arbitration, including a challenge to the validity of the arbitration agreement, is governed by G.L. c. 251, § 2(*a*)." *Johnson,* 466 Mass. at 781, 2 N.E.3d 849. "Such motions are treated akin to motions ... for summary judgment." *Chambers v. Gold Medal Bakery, Inc.,* 83 Mass.App.Ct. 234, 241, 982 N.E.2d 1190 (2013). See *Miller v. Cotter,* 448 Mass. at 676, 863 N.E.2d 537. Accordingly, the moving party—here, Brandon Woods—bears the burden of proving that the material facts are established and that it is entitled to arbitration as a matter of law. See *Augat, Inc. v. Liberty Mut. Ins. Co.,* 410 Mass. 117, 120, 571 N.E.2d 357 (1991). In the instant case, the key facts have not been disputed, nor has an evidentiary hearing been requested. We therefore review de novo the judge's legal conclusion regarding the validity of the arbitration agreement. See *Licata,* 466 Mass. at 796, 2 N.E.3d 840; *Chambers, supra* at 241, 982 N.E.2d 1190. Our own legal analysis is guided by the Supreme Judicial Court's most recent decisions in *Johnson* and *Licata.*[6]

1. *Health care proxy and agency.* In *Johnson* and *Licata,* the court defined the standards for authorizing arbitration agreements and distinguished them from other forms of agency authority, including those governing health care proxies and the signing of ordinary nursing home documents. More specifically, the court held that a health care proxy alone is insufficient to provide authorization to sign an arbitration agreement. See *Johnson,* 466 Mass. at 781, 2 N.E.3d 849; *Licata,* 466 Mass. at 797, 2 N.E.3d 840. As the court explained, "the Legislature intended to distinguish between a health care proxy, which limits an agent's decision-making authority on behalf of an incapacitated person to health care decisions, and a durable power of attorney, guardianship, or conservatorship, all of which authorize broad decision-making power on behalf of an incompetent person, including over the person's financial interests and estate." *Johnson, supra* at 784–785, 2 N.E.3d 849. See ***132**

supra at 681–682, 863 N.E.2d 537 (durable power of attorney is sufficient to authorize family member to sign arbitration agreement on behalf of principal). In the instant case, Scott held ****323** at most a health care proxy;[7] he did not have a power of attorney, and he was not a guardian or a conservator.

The court in *Johnson* and *Licata* also distinguished the authority to sign ordinary nursing home documents from arbitration agreements. As the court stated, a "person's designation in a health care proxy may establish the individual's trustworthiness and familiarity with the principal and, therefore, enable the individual to sign many of the documents included in a nursing home's admissions package. But it does not follow that such a person also can sign an arbitration agreement, which requires the power of an authorized fiduciary." *Johnson, supra* at 789, 2 N.E.3d 849.

In addition to the health care proxy, however, we have here Elizabeth's relationship to Scott and her request that Scott complete the admission process prior to her arrival. We agree that her parent-child relationship with Scott, and her request and representation that he act on her behalf in the admission process, further enhances his authority to act as her agent in the nursing home admission process. See *Theos & Sons, Inc. v. Mack Trucks, Inc.,* 431 Mass. 736, 742, 729 N.E.2d 1113 (2000) (*Theos*) (agency relationship is created when there is mutual consent that agent is to act on behalf of principal and subject to principal's control). "Even where an agent-principal relationship exists, however, the principal has liability for the agent's acts toward third parties only if the agent was acting with the actual or apparent authority of the principal *in that transaction.*" *Id.* at 743, 729 N.E.2d 1113 (emphasis added).[8]

In the instant case, Brandon Woods has provided no evidence suggesting that Elizabeth knew Scott was signing an arbitration ***133** agreement as part of her admission into the nursing home or made any representation to Brandon Woods to that effect. She was not in the room when he signed it. See *Licata, supra* at 802, 2 N.E.3d 840. It was not a part of the two-page admission authorization form. The agreement was not a condition of admission. Finally, Scott attested that he did not inform her of his signing of the arbitration agreement. On the factual record before us, Brandon Woods has not met its burden of showing that signing the arbitration agreement was within the scope of Scott's actual or apparent authority to act on her behalf in the nursing home admission process. See *id.* at 801, 2 N.E.3d 840. See also *Theos, supra* at 745, 729 N.E.2d 1113; *Walker v. Collyer,* 85 Mass.App.Ct. 311, 323–325, 9 N.E.3d 854 (2014).

2. *Third-party beneficiary.* Brandon Woods's argument that the arbitration agreement bound Elizabeth as a third-party beneficiary is similarly unavailing. "There can be no third-party beneficiary ****324** ... in the absence of a contract." *Licata, supra* at 803, 2 N.E.3d 840, citing Restatement (Second) of Contracts §§ 304 comment b, 309(1) & comment a (1981). No contract was formed here because no one with authority to do so signed the agreement. See *ibid.* Although Brandon Woods argues that Scott may be deemed to have signed the contract in his individual capacity, this is contradicted by the intent of the parties as manifested by the terms of the agreement itself. See *Constantino v. Frechette,* 73 Mass.App.Ct. 352, 355, 897

N.E.2d 1262 (2008). The agreement is plainly titled "Resident and Facility Arbitration Agreement," and in the first paragraph, the parties to the agreement are listed as "BWD [Brandon Woods Dartmouth]" and "Elizabeth W. Barrow." Scott only purported to sign the arbitration agreement as Elizabeth's "Resident Representative." The contract does not support a reading that either Brandon Woods or Scott intended that he sign the agreement in his individual capacity. See *ibid.* (nurses at care facility were not parties to contract between nursing home and resident where nurses were not named as parties and did not assume obligations under contract).

3. *Equitable estoppel.* Finally, Brandon Woods argues that we should apply equitable estoppel, as the judge did below, to hold that Scott is bound by the agreement. Equitable estoppel may be raised where the defendant can prove that he was harmed because the plaintiff's conduct or representation induced him to do something different from what he otherwise would have done. See *Boston & Albany R.R. Co. v. Reardon,* 226 Mass. 286, 291, 115 N.E. 408 (1917). Nevertheless, "[t]he law does not regard estoppels with ***134** favor," *Licata, supra* at 804, 2 N.E.3d 840, quoting from *Reardon, supra* at 291, 115 N.E. 408, and estoppel is applied only to avoid injustice. See *Reardon, supra* at 291, 115 N.E. 408 ("[T]he doctrine of estoppel is not applied except when to refuse it would be inequitable"). "To establish estoppel, a party must show (1) a representation intended to induce reliance on the part of a person to whom the representation is made; (2) an act or omission by that person in reasonable reliance on the representation; and (3) detriment as a consequence of the act or omission." *Licata, supra* at 804, 2 N.E.3d 840 (quotation omitted). See *Harrington v. Fall River Hous. Authy.,* 27 Mass.App.Ct. 301, 308, 538 N.E.2d 24 (1989) (quotation omitted) (describing the elements of estoppel as follows: "first, a material misrepresentation of a party who had reason to know of its falsity; second, reasonable reliance upon the misrepresentation; and third, some disadvantage to the party seeking to assert estoppel fairly traceable to the misrepresentation"). See also *Walker,* 85 Mass.App.Ct. at 319, 9 N.E.3d 854.

The principles and elements of equitable estoppel neither require nor favor its application here. The flaw in Brandon Woods's argument is that it points only to Scott's purported actions and alleged misrepresentations, and not to any act or omission of its own that was done in response to or in reliance of such actions. Even if we were to accept, for the sake of argument, that the first element is satisfied by any of Scott's purported representations in signing the agreement, the second and third elements cannot be met on these facts. Brandon Woods cannot show that any representations induced it to do something different than it otherwise would have done, as signing the arbitration agreement was not a condition of admission, and Brandon Woods does not argue that it would have treated Elizabeth differently in any other way if the agreement had not been signed. Cf. ****325** *Looney v. Trimount Theatres, Inc.,* 282 Mass. 275, 278–279, 184 N.E. 683 (1933) (lessee who was misled and disadvantaged by lessor's misrepresentation regarding title to property fixtures could assert estoppel where lessee had acted on misrepresentation by acquiring title to fixtures from another). Likewise, Brandon Woods does not attempt to show that it suffered any detriment as a consequence of Scott's purported representation. Cf. *Cellucci v. Sun Oil Co.,* 2 Mass.App.Ct. 722, 729, 320 N.E.2d 919 (1974), *S.C.,* 368 Mass. 811, 331 N.E.2d 813 (1975) (plaintiff detrimentally relied on defendant company's representation that company

would buy plaintiff's land where plaintiff broke off negotiations for land sale with other competitor companies). As such, we cannot say that application of equitable estoppel is necessary to ***135** avoid injustice here.

Conclusion. We conclude that Scott did not have the authority to execute the arbitration agreement on his mother's behalf; he did not sign the agreement in his individual capacity; and equitable estoppel is not warranted on these facts. Therefore, Scott, as executor of his mother's estate, shall be permitted to seek redress in court for Elizabeth's allegedly violent and unnatural death while in the defendants' care. The judgment confirming the arbitration award is vacated, and the matter is remanded to the Superior Court for proceedings consistent with this opinion.

So ordered.

All Citations

86 Mass.App.Ct. 128, 14 N.E.3d 318

Footnotes

1 Of the estate of Elizabeth Barrow. Scott R. Barrow is Elizabeth Barrow's son, and her sole heir and beneficiary.

2 Doing business as Brandon Woods Long Term Care Facility.

3 Scott Picone; Barbara Silva; Samantha Duggan; Susan Plante; Lucy Silveira; Laura Lundquist; and Essex Group Management Corp.

4 We use first names to avoid confusion.

5 He alleged negligence, lack of informed consent, and breach of contractual or implied or express warranties, and sought damages under the wrongful death statute, G.L. c. 229, § 2, as a result of the defendants' care of his mother.

6 We note that neither the judge nor the single justice of this court had the benefit of the *Johnson* or *Licata* decisions, which were issued subsequently.

7 The parties essentially treat the health care proxy as having been signed contemporaneously with the arbitration agreement, as part of the admission process. The timing of when Elizabeth actually signed the health care proxy is uncertain, as it may not have been signed until the day after Scott signed the arbitration agreement. Regardless, even if the proxy were signed prior to the arbitration agreement, it would not have been sufficient.

[8] Actual authority "is the agent's power to affect the principal's relations with third parties as manifested" by the principal to the agent. *Theos, supra* at 743–744, 729 N.E.2d 1113, citing Restatement (Second) of Agency § 7 (1958). Apparent authority arises from "written or spoken words or any other conduct of the principal which, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf by the person purporting to act for him." Restatement (Second) of Agency § 27 (1958).

Joseph FERGUS

v.

Steven A. ROSS.[1]

Massachusetts Appeals Court

Decided June 9, 2016.

Synopsis

Background: Borrower brought negligence claim against private lender for failure of individual who was alleged agent of lender to repay $120,000 side loan to close on property for which alleged agent had signed a purchase and sale agreement. The Superior Court, Suffolk County, Frances A. McIntyre, J., found that individual acted under apparent authority of lender to enter side loan. Lender appealed.

Holdings: The Appeals Court, Wolohojian, J., held that:

- evidence supported finding that individual acted as lender's agent;
- agent's apparent authority extended to "side loan" of real estate transaction and principal was bound by agent's agreement to enter into side loan; and
- knowledge of agent could be imputed to principal in entering into loan transaction.

Affirmed.

Green, J., filed a dissenting opinion.

Procedural Posture(s): On Appeal.

Opinion

WOLOHOJIAN, J.

We consider here a principal's liability to a third party for the conduct and representations of his agent in the context of a private lending transaction. Following a bench trial, a judge of the Superior Court concluded that Steven A. Ross, individually, was bound by promises Bernard Laverty, Jr., made to Joseph Fergus because Laverty was Ross's agent and acted within the scope of his apparent authority. Judgment accordingly entered against Ross, individually. The central issue on appeal is whether the judge erred in concluding Laverty had apparent authority to bind Ross to act as closing agent on a side loan about which Ross did not have actual knowledge. We affirm.

Background. We summarize the judge's findings, which we must accept unless clearly erroneous. See *Weiler v. PortfolioScope, Inc.,* 469 Mass. 75, 81, 12 N.E.3d 354 (2014). "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *J.A. Sullivan Corp. v. Commonwealth,* 397 Mass. 789, 792, 494 N.E.2d 374 (1986), quoting from *United States v. United States Gypsum Co.,* 333 U.S. 364, 395, 68 S.Ct. 525, 92 L.Ed. 746 (1948). Where there are two permissible views of the evidence, a judge's finding adopting one view is not clearly erroneous. See *Pehoviak v. Deutsche Bank Natl. Trust Co.,* 85 Mass.App.Ct. 56, 65, 5 N.E.3d 945 (2014).[2]

Fergus, a middle-aged man with an eighth grade education, is a public insurance adjuster also in the business of rebuilding damaged residential properties he comes across in his insurance work. Fergus is savvy and smart, but he is not sophisticated about financial matters or perfecting security interests. He had previously bought and sold several residential properties, financing them through conventional lenders. Before the facts giving rise to this case, Fergus had never dealt with a private lender.

In the summer of 2007, Fergus required between $75,000 and $100,000 for the cosmetic work needed to complete the rehabilitation of a burned-out property on Ruthven Street in the Dorchester section of Boston. Fergus could not obtain conventional financing on the property and so he contacted his cousin, Catherine Gibbons, a mortgage broker, to ask for her help. Gibbons recommended Bernard Laverty, Jr., who had connections to several "hard money" lenders.[3] One of those connections was Attorney Steven A. Ross, who ran a private lending practice at Gilmartin, Magence and Ross, LLC (GMR). Laverty would bring Ross potential borrowers and if Ross "liked" them, he would make the loan and pay Laverty a referral fee. This arrangement began before the transaction at issue in this case and continued thereafter. In addition, Laverty had himself borrowed money from Ross on five or six occasions in the past.[4]

At the same time, Laverty happened to need money to close on a property in Marshfield for which he had signed a purchase and sale agreement. Therefore, he pressured Fergus to give

him a side loan of $120,000 out of the proceeds of any loan from Ross. To "protect[ ]" Fergus, Laverty offered to give him a "deed-in-lieu" on the Marshfield property. Fergus's notion of the meaning of a deed-in-lieu was vague, but he understood that if Laverty did not repay the side loan, he would be able to sell the Marshfield house. In Fergus's mind, he would be protected "either way." On this basis, Laverty persuaded Fergus to borrow from Ross more money than he (Fergus) needed. The side loan was to be for one month.

Laverty brought Fergus's need for a "hard money" loan to Ross's attention and, thereafter, there was no direct communication between Fergus and Ross. Instead, all discussions with Ross were conducted by Laverty, outside of Fergus's presence. Laverty was the sole conduit of information to and from Ross and, according to Fergus, Laverty "set everything up." Laverty met with Fergus to discuss the loan terms, arranged (and was present for) the inspection of the Ruthven Street property by Ross's wife, delivered the commitment letter to Fergus, obtained Fergus's signature, and returned it to Ross.

As noted above, Ross's wife (who had been told that Fergus needed the loan to complete renovations) inspected the Ruthven Street property for Ross. Based on that inspection, Ross knew or should have known that Fergus needed a loan of only $75,000 to $100,000 to complete the renovations. Nonetheless, Ross set the amount of the loan at $260,000—more than twice what Fergus needed. Fergus never requested a $260,000 loan; in fact, he never requested any specific amount. The amount set by Ross was not a random figure. It represented not only the $75,000 to $100,000 that Fergus needed, but also the $120,000 for Laverty's side loan, and the costs (which included prepaid interest, origination fees, appraisal fee, and legal fee) associated with the loan itself—all of which came out of the loan proceeds at the time of closing. Those facts, together with Ross's knowledge that Laverty was not receiving his customary referral fee, that Laverty could not be expected to expend time and energy without compensation, and that Laverty frequently borrowed money, permitted the judge to ***531** find (as she did) that Ross could have easily deduced that Laverty was to receive a side loan from the proceeds of the loan to Fergus.

All paperwork for the loan was prepared by Ross. Among other things, Ross prepared and signed a commitment letter dated September 7, 2007, containing the terms of the loan. Laverty delivered that letter to Fergus on September 10, 2007, the day before the closing. Fergus signed the letter and gave it to Laverty to return to Ross. On the same day, Fergus handwrote, and signed, a letter to Ross, which Laverty represented he would deliver to Ross together with the signed commitment letter.[5] That letter reads:

"To Steve Ross.

> "Bernard Laverty is getting $120,000 from the closing on Ruthven St. Roxbury.
>
> "I'm authorizing the disbursement from tomorrow's closing on Ruthven St. so that you can write the letter.
>
> "Thank you"

> Fergus's intention in writing this letter was to instruct Ross to prepare the paperwork required for both the loan and the side loan. Laverty told Fergus that Ross "would take care of everything," that Ross would serve as the closing agent with regard to both loans, and that "everything [including the deed-in-lieu] would be prepared at [Ross's] office."

The following day, Laverty, who had assisted in setting up the closing, transported Fergus to Ross's office (to which Laverty had been thirty or forty times before) for the closing.[6] Ross manifested no surprise at Laverty's presence at the closing. Laverty remained throughout the closing, and encouraged Fergus to sign ***532** the closing documents. Those documents made no reference to the side loan, nor did the documents protect Fergus's interest in the side loan.[7]

Fergus timely repaid the $260,000 loan, but Laverty never repaid the $120,000 side loan. Fergus has no practical hope or expectation of repayment from Laverty.[8]

After a bench trial, the judge found in Fergus's favor on his negligence claim against Ross.[9] Judgment entered in the defendants' favor on all other counts.[10] Since Fergus has not cross-appealed, the issues before us relate only to the negligence claim against Ross, individually.

Discussion. Ross argues that the judged erred in concluding that Laverty had authority, as his agent, to bind Ross to serve as closing attorney for the side loan. "An agency relationship is created when there is mutual consent, express or implied, that the agent is to act on behalf and for the benefit of the principal, and subject to the principal's control." *Theos & Sons, Inc. v. Mack Trucks, Inc.,* 431 Mass. 736, 742, 729 N.E.2d 1113 (2000).

Here, ample evidence supported the judge's conclusion that Laverty was Ross's agent with respect to the $260,000 loan. See *Haufler v. Zotos,* 446 Mass. 489, 497–498, 845 N.E.2d 322 (2006). Ross used Laverty as his sole conduit of information to and from Fergus. Laverty arranged and was present for the inspection of the property, which was conducted by Ross's wife for Ross's purposes. Laverty had a prior (and subsequent) history of receiving referral fees for bringing borrowers to Ross for "hard money" loans. Laverty helped arrange the closing and was present at it. Ross's acquiescence to Laverty's presence at the closing is meaningful given Ross's claim that he did not know of the side loan. Accepting that claim as true, Ross should have been puzzled by Laverty's presence at the closing. Ross's lack of surprise therefore buttresses the inference that Laverty was present as Ross's agent.

"Even where an agent-principal relationship exists, however, the principal has liability for the agent's acts toward third parties only if the agent was acting with the actual or apparent authority of the principal in that transaction." See *Theos & Sons, Inc. v. Mack Trucks, Inc., supra* at 743, 729 N.E.2d 1113. A principal imbues his agent with apparent authority by "written or spoken words or any other conduct ... which, reasonably interpreted, causes a third person to believe that the principal consents to have the act done on his behalf by the person purporting to act for him." *Haufler v. Zotos, supra* at 497 n. 22, 845 N.E.2d 322, quoting from *Neilson v. Malcolm Kenneth Co.,* 303 Mass. 437, 441, 22 N.E.2d 20 (1939). See *Kanavos v. Hancock Bank & Trust Co.,* 14 Mass.App.Ct. 326, 331, 439 N.E.2d 311 (1982) (question of apparent authority turns on "how, in the circumstances, a third person ...

would reasonably interpret [the agent's] authority in light of the manifestations of his principal"). Apparent authority may arise from a variety of circumstances, including the manner in which the principal conducts his business. See *Theos & Sons, Inc. v. Mack Trucks, Inc., supra* at 745 n. 15, 729 N.E.2d 1113; *Kanavos v. Hancock Bank & Trust Co., supra* at 332, 439 N.E.2d 311. "Only the words and conduct of the principal, however, and not those of the agent, are considered in determining the existence of apparent authority." *Licata v. GGNSC Malden Dexter LLC,* 466 Mass. 793, 801, 2 N.E.3d 840 (2014).

Here, the judge found that Ross deliberately insulated himself from direct contact with Fergus, choosing instead to communicate solely through Laverty. Ross relied on Laverty to communicate Fergus's requirements for the loan. Similarly, he used Laverty to communicate the lender's requirements and terms to Fergus. Ross appeared to respond to Laverty's communications from Fergus and to acquiesce in Laverty's activities. Ross permitted Laverty to arrange the inspection of the property and to help arrange the closing. In sum, Ross entrusted Laverty to carry out many steps necessary to the successful completion of the $260,000 loan. Ross's conduct was sufficient to support the judge's conclusion that Laverty was acting with apparent authority as Ross's agent with respect to the $260,000 loan.

The record also permitted the judge to conclude that Laverty's apparent authority extended to the side loan. It was Ross who established the amount of the loan—and he knew or should have known, based on his wife's inspection, that it greatly exceeded the amount required by Fergus for renovations on the Ruthven Street property. As the judge found, it would have reasonably appeared to Fergus that Ross increased the amount beyond what Fergus needed in order to accommodate the side loan. Furthermore, Ross knew that Laverty was expending energy in connection with the loan even though Laverty was not receiving his customary referral fee. There was no reason for Ross to think that Laverty would volunteer his services. Furthermore, Ross knew that Laverty frequently needed to borrow money for his various real estate projects.[11]

On these facts, the judge was warranted in concluding that Ross's conduct caused Fergus reasonably to believe that Laverty had authority to bind Ross to act as closing agent on the side loan and to protect Fergus's interest in it. See *DeVaux v. American Home Assur. Co.,* 387 Mass. 814, 819, 444 N.E.2d 355 (1983); *Linkage Corp. v. Trustees of Boston Univ.,* 425 Mass. 1, 16–17, 679 N.E.2d 191, cert. denied, 522 U.S. 1015, 118 S.Ct. 599, 139 L.Ed.2d 488 (1997).

Ross's lack of actual knowledge of the side loan does not compel a different result. Ross admitted that within "two minutes," he should have realized that Laverty, a man he had done business with for several years, was a liability. Nonetheless, Ross placed Laverty, whose "very appearance was a sign of trouble," in a position from which he could and did cause substantial harm to Fergus. Having accepted the benefits provided by Laverty, Ross should bear the loss caused by him. Compare *Kansallis Fin. Ltd. v. Fern,* 421 Mass. 659, 665, 659 N.E.2d 731 (1996) ("A principal who requires an agent to transact his business, and can only get that business done if third parties deal with the agent as if with the principal, cannot complain ****193** if the innocent third party suffers loss by reason of the agent's act").

Ross argues that, even if Laverty acted within the sphere of his apparent authority, Laverty's knowledge should not be imputed to him (Ross) because Laverty "acted fraudulently" and "engaged in an independent fraudulent act from which [Ross did] not benefit." *Sunrise Properties, Inc. v. Bacon, Wilson, Ratner, Cohen, Salvage, Fialky & Fitzgerald, P.C.,* 425 Mass. 63, 67, 679 N.E.2d 540 (1997). See Restatement (Third) of Agency § 5.04 (2006). Ross's argument depends on a finding that Laverty did not intend to repay the side loan. The judge, however, found to the contrary. The judge credited Laverty's testimony that he expected to repay the side loan within thirty days with funds he anticipated receiving in connection with the settlement of an unrelated case. The decision to credit this aspect of Laverty's testimony fell within the judge's purview as the finder of fact.[12] Moreover, the findings that the side loan was not against the interests of Ross and GMR, and in fact benefited them, were not clearly erroneous.[13] See *GTE Prod. Corp. v. Broadway Elec. Supply Co.,* 42 Mass.App.Ct. 293, 299–300, 676 N.E.2d 1151 (1997). Accordingly, Laverty's knowledge of the side loan was chargeable to Ross.

Finally, we note that Fergus was an innocent third party who dealt in good faith with Ross through Laverty. Fergus timely repaid the full amount of the loan, including the side loan, even though he had not been repaid by Laverty and had received no benefit from the side loan. Moreover, the judge found that Fergus reasonably believed Laverty was authorized to act for Ross with respect to both loans. In these circumstances, Laverty's knowledge can be imputed to Ross even if Laverty's actions were unknown to Ross and adversely affected him. See Restatement (Third) of Agency, *supra* at § 5.04(a) ("For purposes of determining a principal's legal relations with a third party, notice of a fact that an agent knows or has reason to know ... is imputed [to the principal] ... when necessary to protect the rights of a third party who dealt with the principal in good faith").

For these reasons, we affirm the judgment in favor of Fergus on his negligence claim against Ross in his individual capacity.

Judgment affirmed.

GREEN, J. (dissenting).

I respectfully dissent from the majority's conclusion that the evidence was sufficient to impose on Steven A. Ross liability for the actions of Bernard Laverty, Jr., regarding the side loan. As the majority acknowledge, the trial judge found (with support in the evidence) that Ross had no direct knowledge of the side loan, and indeed from all appearances it appears that Laverty took great pains to conceal from Ross any information regarding the side loan. To overcome that substantial barrier, the majority (and the trial judge) rely principally on two factors: (i) that the amount of the loan Laverty requested on Fergus's behalf exceeded the

amount required for the renovations Fergus planned, and (ii) that Laverty did not receive from Ross his customary referral fee incident to the loan Ross made to Fergus. In my view, neither factor, alone or in combination, is adequate to support the conclusion that, in transacting the side loan with Fergus, Laverty was acting within the scope of his authority as Ross's agent with respect to the loan from Ross to Fergus. To the extent the trial judge "found" that Ross knew of the side loan (and it is not at all clear that she made any such finding),[1] it was without support in the evidence.

First, it is wholly unremarkable that Fergus borrowed more money than his planned renovations required. Owners of real property commonly borrow funds secured by the property, even when they have no plans to perform renovations of any kind. Fergus was an investor in a variety of properties, and (for all Ross may have known) could have planned to use the additional monies to place a deposit toward purchase of another property, or to perform maintenance or repairs to another property—or even to purchase a new car or take an exotic vacation. The majority cites no authority (and I am aware of none) for the proposition that a lender has a duty to inquire into the purposes to which a borrower plans to direct loan proceeds, or that failure to do so will charge the lender with constructive notice that the borrower has entered into an otherwise undisclosed arrangement with the lender's agent.[2]

Nor, in my view, does the fact that Laverty did not receive from Ross his customary referral fee carry any substantial weight with regard to the question of his authority to bind Ross to the side loan. Again, for all Ross knew, Laverty might have arranged for compensation by Fergus, as a finder's fee, for the services Laverty performed in arranging the loan to Fergus from Ross.

To be sure, Fergus comes before the court in a highly sympathetic posture, having been the victim of a fraud perpetrated by Laverty against him. But the circumstances of the case do not place Laverty's fraudulent conduct within the scope of his agency or authority on Ross's behalf any more than if Laverty instead had persuaded Fergus (without Ross's knowledge) to use $120,000 of the loan proceeds to purchase the Brooklyn Bridge, swamp land in Florida, or stock in an Argentinian silver mine. Had Fergus made any inquiry whatsoever of Ross about the side loan at ****195** the closing, directed either to the documentation of the loan or of the collateral he had been promised to secure it, the case would be entirely different. As things stand, however, the majority concludes that Ross may be held responsible for Laverty's conduct toward Fergus in connection with the side loan, where the only common thread between the loan Ross agreed to extend to Fergus and the side loan Laverty persuaded Fergus to extend to him without Ross's knowledge was that the proceeds of the loan from Ross to Fergus served as the source of the funds Fergus lent to Laverty.

All Citations

89 Mass.App.Ct. 528, 52 N.E.3d 186

Footnotes

[1] Individually and as trustee of the Wisconsin Avenue Lending Trust.

[2] It is primarily because of this well-established principle that we disagree with our dissenting colleague. We recognize that the trial judge could have reached a contrary conclusion about Laverty's apparent authority to act as Ross's agent. But we are not called upon to assess the evidence anew, nor are we to substitute our own views of the witnesses' credibility or thought processes for those of the trial judge. Because the evidence, and the reasonable inferences to be drawn from it, permitted the trial judge to make the findings and reach the conclusions that she did, it matters not that another judge hearing the same evidence might have reached a different conclusion.

[3] A hard money loan is typically a short-term, high-risk, and high-interest loan funded by private investors.

[4] Laverty, a self-described real estate investor whom the judge considered likely to be a "flipper" (i.e., someone engaged in buying houses, rehabilitating them, and then reselling them at a profit), did not make a favorable impression at trial. The judge described him as a man of dissolute and disheveled appearance.

[5] The judge did not believe that Laverty gave Fergus's letter to Ross; instead, she believed that Laverty wanted written documentation of Fergus's intention to make the side loan.

[6] In accordance with his regular practice, Ross created a trust solely to fund the Fergus loan. Ross named Ronald Williams, "an apparent illusion," as the trustee. Ross's use of a straw suggested to the judge that "Ross and GMR sought the huge financial return from hard loans as were made to Fergus without taking on any liability, staying barely within the letter of the law." Ross's general modus operandi, the judge found, was likely designed to protect Ross and GMR from liability under the predatory lending laws. The loan to Fergus was in the amount of $260,000 for three months at an interest rate of 8.25 percent over prime, or 16.5 percent.

[7] Nonetheless, the judge found that Fergus anticipated that Ross would disburse the $120,000 to Laverty and secure a deed-in-lieu from him. Fergus believed that, as in a conventional closing on a conventional mortgage with an institutional lender, the lawyers would use escrows to make filings and disbursements in a fashion that would protect the parties. Fergus anticipated that Ross would hold the funds for Laverty until Ross received the deed-in-lieu from Laverty, and did not recognize the practical impossibility of that idea given that Laverty did not have present title to the Marshfield property. Fergus did not recognize that Laverty could not provide the security interest he promised or that Fergus would be unprotected should Laverty fail to repay the side loan.

[8] Laverty has since gone into bankruptcy, and the Marshfield property that was supposed to secure Fergus's loan to Laverty has been transferred to a third party.

[9] The theory of negligence was that Laverty, acting as Ross's agent, bound Ross to act as closing agent on the side loan such that Ross had a duty to document the side loan in a manner that would protect Fergus's interest in it.

[10] Those were breach of contract, unjust enrichment, fraudulent misrepresentation, violation of G.L. c. 93A, and violation of G.L. c. 183C.

[11] The judge's finding that Ross could easily have deduced that Fergus was lending money to Laverty out of the loan proceeds was amply supported by her subsidiary findings that Ross knew that (1) Laverty, likely a "flipper" of real estate, frequently borrowed money in his line of business and had previously done so from Ross; (2) the amount of the Fergus loan set by Laverty and GMR was "inflated;" (3) he was not paying Laverty a referral fee in connection with the $260,000.00 loan; (4) Laverty was a businessman with no familial or partnership relationship to Fergus or charitable purpose; and (5) Fergus expended much energy to ensure the large loan to Fergus closed. In these circumstances, the judge could have found implied ratification by wilful disregard of the facts within Ross's possession. See *Licata v. GGNSC Malden Dexter LLC, supra* at 802, 2 N.E.3d 840, and cases cited.

[12] It is true, as Ross points out, that Laverty could not have provided Fergus with a deed-in-lieu for the Marshfield property at the closing on the loan to Fergus. This does not mean, however, that Fergus could not have been protected. As a condition to the side loan, Laverty could have been required to ensure that the deed to the Marshfield property would be properly escrowed at the subsequent closing on that property.

[13] The inflated loan amount led to higher interest payments to the beneficiaries of the trust, including Ross's brother-in-law, and higher origination fees payable to GMR.

[1] The trial judge observed that "Ross' actual knowledge of the [side] loan may not be directly proven," and found specifically that at the closing, the side loan to Laverty was not discussed by Ross or in Ross's presence. The closest the trial judge came to finding that Ross actually knew of the side loan is her comment that "I believe [Ross] may well have known that Laverty was borrowing funds from Fergus." Expressed in that fashion, it is less a finding that Ross knew of the loan than speculation regarding the possibility that he may have known of it. Later, the trial judge observed that "Ross could easily have deduced that Fergus was lending money to Laverty out of the proceeds of the loan." For the reasons that follow, to the extent the judge's comment amounts to a finding that a reasonable person in Ross's position, possessed of the information available to him, knew or should have known that Laverty had arranged for Fergus to lend money to him from the proceeds of the loan Ross made to Fergus, I believe it rests on speculation rather than evidence and, accordingly, is clearly erroneous.

[2] Of course, a prudent lender might wish for its own benefit to obtain some explanation of the purpose for which a borrower is borrowing funds. That interest does not equate, however, into a conclusion that an unexplained request for funds, supported by the value of the collateral, is suggestive of an independent financial arrangement between the borrower and the lender's agent.

Discussion points for Commission v. Roger Gray

This jurisdiction follows the Equal Dignities Rule. There is no doubt that the agent (property manager) signed the contract extending the lease. The question becomes whether there is a writing signed by the principal (landlord) authorizing him to do so, as required by the rule. And the funny thing is, there is a writing, so the question then becomes, is the writing specific enough? How would you go about proving to this court that the writing was sufficient? Would the doctrine of apparent authority help? The doctrine of implied agency powers? Who do you think has the better argument, the majority or the dissent? Why don't officers and directors of corporations need writings from their principal (the corporation itself)?

COMMISSION ON ECUMENICAL MISSION AND RELATIONS OF the UNITED PRESBYTERIAN CHURCH IN the UNITED STATES OF AMERICA, Appellant,
v.
ROGER GRAY, LTD., et al., Respondents.

Court of Appeals of New York.

Jan. 14, 1971.

BREITEL, Judge.

The issue is whether the 'managing agent' of plaintiff landlord's predecessor in interest, who purportedly executed a store lease extension agreement by informal letter, was an agent for purposes of subdivision 2 of section 5--703 of the General Obligations Law; and, if so, whether the evidence of his authority to execute the extension agreement satisfies the statute.

Vartan Jinishian, now deceased, had been president and sole stockholder of Madison Avenue Realty Corporation, owner of commercial property at 554 Madison Avenue, its sole asset. Harry Aprahamian was the managing agent of the building from 1948 to 1968. During this period he collected the rents, negotiated leases and the extensions of leases, arranged for bids and contracts with respect to painting, plumbing, and electrical work on the premises. In June, 1964 Jinishian, by letter, extended Aprahamian's employment at the same

monthly salary as managing agent for the corporation's building for a period of six years to be measured from Jinishian's death. By letter, bearing the date of February 14, 1966, Aprahamian purported to extend the lease of defendant Roger Gray, Ltd., a tenant, for a period of three years from January 31, 1971 until January 31, 1974. The letter was signed 'Madison Avenue Realty Corporation By Harry Aprahamian, Manager'. On May 17, 1966, plaintiff landlord acquired all the outstanding shares of Madison by gift from Jinishian. On November 30, 1967, fee title was deeded by the former landlord Madison to the present landlord, plaintiff.

The date of the purported extension is significant; it is February 14, 1966. This is just short of five years before the tenant's lease was to expire by its terms. And it is just short of three months before the entire corporate stock of the former landlord was transferred to the present landlord as a charitable gift.

The landlord's treasurer, Pattison, first learned of the alleged lease extension to Roger Gray in August, 1966. In January, 1969 plaintiff landlord entered into an agreement for the sale of 554 Madison Avenue subject to, among other things, the Roger Gray lease expiring on January 31, 1971. Upon learning of the prospective sale, the tenant, Roger Gray, informed the landlord of the written extension. The landlord then brought this action for a judgment declaring that the purported lease extension was invalid. Special Term granted the landlord's motion for summary judgment, holding the extension letter to be without legal effect.

The Appellate Division reversed, one Justice dissenting. It premised reversal on alternative theories: First, whether the corporation was a signatory to the extension agreement is determined by general corporate law and is not affected by the General Obligations Law; and, second, assuming Aprahamian to be an agent for purposes of the General Obligations Law, the written authorization need not be specific and referable to the particular lease.

The order of the Appellate Division should be reversed, and Special Term's determination granting plaintiff landlord summary judgment should be reinstated.

The statute reads in relevant part that a lease for a period longer than a year must be in writing and 'subscribed by the party to be charged, or by his lawful agent thereunto authorized by writing' (General Obligations Law, Consol.Laws, c. 24--A, 5--703, subd. 2). The mandate that the authority of the putative agent be in writing is not peculiar to New York but is found in the Statute of Frauds provisions of more than a dozen States (1944 Report of N.Y.Law Rev.Comm., pp. 91--102; 2 Williston, Contracts (3d ed.), s 276; Ann., Statute of Frauds--Agent's Authority, 27 A.L.R. 606).

Defendant tenant urges this court to adopt an interpretation of the statute which is not only strained but also without precedential support. It argues that the statute does not apply when the putative agent is also an employee of the corporation. Because a corporation must perforce act through individuals, it contends that if the instrument is executed by an officer or employee on behalf of the corporation, the act of execution is not that of an agent but the act of the corporation itself. The court then, it says, need not reach the question of agency and

the requisite written authorization required by the Statute of Frauds.

This reasoning is unsound.

[1] In the first place, an issue under a Statute of Frauds, such as section 5--703, may not be resolved by reference to rules of agency affecting corporations. If it were otherwise, then the Statute of Frauds would be largely obviated as to corporations and to that extent rendered a virtual nullity. None of the cases in this State or elsewhere have ever taken such a view. The tenant cites none. Indeed, the reasoning urged by the tenant has been expressly rejected as untenable in other jurisdictions. Moreover, the essential premise underlying that reasoning begs the question. The nub of the issue is whether the Statute of Frauds requires that an employee acting as an agent be authorized in writing before he may execute certain kinds of instruments. For that issue it must be assumed that a party can supply parol proof that the actor was both an employee and an agent, and possessed with purported authority. Of course, if by the extraneous proof the purported agent's act was not authorized, or he was not an agent, that is the end of the matter and there is no need to have recourse to the Statute of Frauds. Consequently, the issue tendered on this appeal is, assuming that the purported agent was indeed the agent authorized by parol evidence, does his act of extending the lease fail for lack of compliance with the Statute of Frauds as to his own authorization.

The second problem is whether an employee who is also an agent, or better, an agent who is also an employee, falls within subdivision 2 of section 5--703. Although it has been often stated that a corporate officer or director is not an 'agent' within the meaning of the Statute of Frauds requiring written authorization, the rule has not been applied to employees or agents who are not officers or directors. On the contrary, the authorities relied on by the parties expressly limit the exception to directors and officers. **** A case of marked interest, involving an 'Assistant General Land Agent' for a railroad who lacked any written authorization to execute a contract for the sale of land, arose in Pennsylvania. In Rosenblum v. New York Cent. R.R. Co., 162 Pa.Super. 276, 57 A.2d 690, the court was asked to extend the exception to 'regular employees of the corporation'. It emphatically declined to do so and unequivocally limited the exception to executive officers.

[2] The reason for the exception for officers and directors rests in the view that corporations can only act through individuals. Indeed Fletcher has made the point, with obvious hyperbole, that, 'The officers, as such, are the corporation. An agent is an employee.'

In considering the exception, and any possibility of its extension, it must be kept in mind that the very statute with which this case is concerned deals also with contracts to sell real property and with transfers of real property. Indeed a lease for more than three years is a recordable instrument (Real Property Law, Consol.Laws, c. 50, s 290). The reason why recordable instruments must in turn have their execution supported by documents of rank is self-evident. Otherwise the recorded documents would actually be resting on oral evidence. It is interesting in this context that at common law an agent could execute a sealed instrument only if he himself was authorized to do so under seal (Restatement, Second, Agency, s 28, Comment a). The Law Revision Commission noted that the need for extending the agency

provisions of the Statute of Frauds was created by the need to fill gaps resulting from the abolition of the seal (1944 Report of N.Y.Law Rev.Comm., pp. 124--126).

Notably, the tenant, as already said, cites no authority to sustain the argument that an employee-agent does not come within the agency provision of the statute. It tries only to chip away by tenuous distinctions at the cases relied upon by plaintiff landlord, to show that they involve dicta or could have been decided on narrower Rationes decidendi. From a practical point of view it should be recalled that real property instruments, even when executed by corporate officers, have appended corporate certificates of authorization (e.g., 6C Bender's Forms, Real Property Law, p. 1476).

The last and determinative question is whether the employee-agent in this case had any kind of writing sufficient to comply with the statute. He did not. What defendant relies on is Jinishian's letter to Aprahamian of June 4, 1967 which reads as follows:

June 4, 1964

Mr. Harry Aprahamian,
554 Madison Avenue,
New York 22, New York.

Dear Harry:

In view of the fact that you have been an employee of our Corporation for many years and proved yourself efficient and faithful, we agree to extend the period of your employment for six years from the date of my death; and you are to continue as Managing Agent of the building owned by the Corporation at 554 Madison Avenue, New York City, at the same monthly wage which you may be receiving from us at the time of my death.

Very truly yours,

Madison Avenue Realty Corporation

Vartan H. Jinishian

By Vartan H. Jinishian
President

Accepted:
Harry Aprahamian

Witness:
Robert W. White

A managing agent is not a corporate officer. Moreover, it is an accordion title. Sometimes it is an honorific and refers to a janitor with authority to negotiate leases. At other times it refers to independent corporate enterprises taking over the entire management and control of

buildings, but then, almost invariably under written agreements of considerable length and containing minute detail (see, e.g., the managing agent agreement, dated in 1945 and executed between Jinishian's corporation and Wm. A. White & Sons, including, especially, the typewritten interlining requiring consent in writing by the owner to any new leases or renewals (art. II, par. (c))).

[3] From the foregoing paragraph it is also evident that authority to manage did not imply any authority to execute leases or renewals. At this point it is critical to recognize that two Statutes of Frauds, with independent origins but now embraced in one subdivision of section 5--703 of the General Obligations Law, are applicable: The one, not in issue in this case, which requires leases for terms longer than one year to be in writing; and the other, the issue in this case, requiring an agent, apart from any authority he may be able to establish by parol evidence to execute such a lease, to be authorized to do so in writing. Hence, the issue is not whether the authority to manage embraces, under the second of the mentioned Statutes of Frauds, authority either to negotiate or make leases, but whether the specific authority to execute a lease required to be in writing is itself in writing. The letter to the employee-agent falls far short of satisfying the statute. In thus viewing the letter, it does not mean that a satisfactory written authorization must name the particular transaction, but at the very least it must give express authority to execute documents in a determinate class of transaction; see 37 C.J.S. Frauds, Statute of s 213, p. 709, to the effect that: 'The writing need not be in any special form; but it must contain a sufficient expression of an intent to confer authority, and it must confer authority to execute the very contract which the agent undertakes to execute. The writing must contain express language conferring authority to execute a contract of sale'.

[4] On this analysis plaintiff landlord is entitled to summary judgment as a matter of law, as Special Term concluded. Nor may the frontal issue be avoided by raising attenuated issues of fact. The critical issue of law is whether the statute requires a writing and whether there is one. A writing is required and there is none. To accept the reasoning of the tenant is to blunt the applicable rule of law, open the door to inaccurate if not perjured recollections, and by the inescapable analogy between leases and the other real property instruments covered in the same section 5--703, unsettle the salutary and unvarying interpretations.

A final comment is made necessary on an issue not properly before the court in summary judgment procedure, unless the Statute of Frauds is to be applied only where the court is convinced that the statute is unnecessary because as a matter of law the barred evidence could not be proven. But since reference is made to prior lease extensions arranged by the employee-agent, it is appropriate to show how different they were and thereby demonstrate a salutary consequence of the statute which might otherwise seem harsh in effect.

It is true that Aprahamian had in the past arranged lease extensions. In each case but one the tenant was required to return the extension subscribed with his acceptance, or to give notice of acceptance by registered mail, before the extension became binding. In the exception, the extension was not to become binding until a full formal lease extension was signed by the tenant. In each instance, the language of the letter is that of one to whom the English language is evidently the mother tongue with a suggestion of legal terminology. In this case,

these characteristics are absent. Most important is that Aprahamian's letter does not bind the tenant. It is unilateral in form, requires and carries no acceptance, and was 'missing' from landlord's files. It is a comparison of these letters, if support were relevant, which justifies a Statute of Frauds applicable to agents who purport to execute leases or extensions by informal letter on behalf of their principals, even if alive.

Accordingly, the order of the Appellate Division should be reversed, with costs, and summary judgment granted to plaintiff landlord.

FULD, Chief Judge (dissenting).

The plaintiff landlord seeks a declaration that a lease extension granted to the defendant Roger Gray, Ltd., and signed by one Harry Aprahamian, as Managing Agent for the plaintiff landlord's corporate predecessor, is invalid. The ground relied on to show invalidity is that the extension is not signed by the party to be charged in accordance with the Statute of Frauds.

It is not disputed that on February 14, 1966, Roger Gray was granted a lease extension in writing, as the statute requires. The question here presented is whether that writing can satisfy the Statute of Frauds when signed by Aprahamian, the 'Managing Agent,' rather than by an officer of the corporation which owned the property. That, in turn, depends upon the authority conferred on Aprahamian in the letter--dated June 4, 1964 and signed by the president of the corporation, Vartan Jinishian--which recited that Aprahamian should 'continue as Managing Agent', a job, I note, he had held for 20 years. The letter provided that Aprahamian would hold the position until six years after Jinishian's death.

The Statute of Frauds requires that leases for more than one year must be 'subscribed by the party to be charged, Or by his lawful agent thereunto authorized by writing' (General Obligations Law s 5--703, subd. 2, italics supplied). I agree with the court's conclusion that Aprahamian's signature must be considered, under the statute, as the signature of an agent and not that of the corporation itself. But I cannot agree with the court's ultimate decision that no issue of fact is presented as to whether Aprahamian was sufficiently 'authorized in writing' to execute the lease extension as agent for the corporation. Accordingly, I do not believe that the plaintiff is entitled to summary judgment.

There can be no question that Aprahamian was 'authorized in writing' to undertake certain actions on behalf of the corporate landlord. The issue here is whether those actions included signing lease extensions for the building's tenants. Since, as the court recognizes (opn., p. 732), the written authorization to an agent need not be so specific as to 'name the particular transaction' in question, we must consider whether the papers on this summary judgment motion warrant a decision that an appointment as 'Managing Agent' cannot reasonably furnish the requisite authority.

The court's decision rests on the assumption that 'authority to manage (does) not imply any authority to execute leases or renewals' (opn., p. 732). I dispute this hypothesis, for leasing may well be a central part of the Managing Agent's job. According to the Restatement of

Agency (black letter), authorization to manage property endows one with the 'authority to lease' it (Restatement, Second, Agency, s 67): 'Unless otherwise agreed, authority to lease land or chattels Is inferred from authority to manage the subject matter if leasing is the usual method of dealing with it'. (Emphasis supplied.) If this be so, then, it logically follows that there is authority to arrange and execute extensions, for an extension is nothing more or less than a new lease on the old terms.

The letter designating Aprahamian as Managing Agent, therefore, at least supplies an inference that he could make contracts for lease extensions. As Professor Corbin notes (2 Corbin, Contracts (1963), s 526, p. 782), '(t)he authority to execute a written memorandum (in satisfaction of the Statute of Frauds) may be proved by implication from authority to make the contract.' Thus, it is unimportant that the letter does not specifically state that Aprahamian could execute written lease extensions. His authority to make such contracts is readily inferable from his position. Whether this inference can be substantiated is, of course, a question of fact, and the record before us is more than ample to create an issue sufficient to defeat a motion for summary judgment. Not only does Aprahamian assert in his affidavit that in the 20 years during which he acted as Managing Agent he 'negotiated the leases and the extensions of leases' for tenants in the building but he actually points to at least four lease extensions (March, 1953; March, 1955; April, 1959; March, 1965) which he did sign--three of them prior to the 1964 letter--on behalf of the corporation with Jinishian's full knowledge and approval. These documents, far from deserving the epithet 'inaccurate if not perjured recollections' (opn., p. 732), could be interpreted to establish that, when in 1964 Jinishian 'continued' Aprahamian's employment as Managing Agent, he fully intended to authorize him to sign lease extensions. Be that as it may, as I have already stated, they create a question of fact as to this issue.

The court's discussion in which it compares the prior extensions with the extension to the tenant in this case (opn., p. 732) is quite irrelevant to the issue before us. That the lease extension herein may not be proper in form is a question involving interpretation of that document, not of the letter granting Aprahamian his authority. Moreover, the fact that the other extensions in the record had to be signed by the Tenant and returned by him to the landlord has no bearing whatsoever on Aprahamian's power to bind the Landlord. What the prior extensions do show, I repeat, is that it is reasonable to assume, and thus create an issue of fact, that Aprahamian's authority to act as Managing Agent was understood by Jinishian, his principal, to empower him to sign lease extensions.

The court points to a detailed contract (opn., p. 731), executed in 1945, between Jinishian and a corporate managing agent (Wm. A. White & Sons), to refute the defendant's position that the simple letter to Aprahamian could have conferred the broad authority claimed for it. I believe that this 1945 agreement is irrelevant. In the first place, it dealt with a different building than the one which Aprahamian was authorized to manage. In the second place, and of greater significance, it is manifest that more detail would be required in dealing with an impersonal corporate manager than with a close associate--and presumably a friend--who had been acting as Managing Agent for many years. In the latter case, there would be no need to set out in detail the procedures which the two men knew so well. Exactly what those

procedures were requires further proof.

In sum, and having in mind this court's liberal interpretations of the writing requirements of the Statute of Frauds, we should not approve a grant of summary judgment to the plaintiff. The letter continuing Aprahamian as the 'Managing Agent' raises a question of fact as to whether he was authorized to sign the lease extension. If he was, then, the letter is a written memorandum of such authority as to satisfy the statute.

I would affirm the order appealed from and answer the certified question in the affirmative.

Discussion points for Flynn v. Dugas:

Want to absolve yourself of personal liability in a commercial transaction? Then make absolutely sure you don’t sign the contract in a personal capacity.

Massachusetts Appellate Division, District Court Department, Western District.

Edward A. FLYNN, Jr. d/b/a Flynn's Truck Stop, Plaintiff/Appellee,
v.
Adolph DUGAS, Defendant/Appellant.

Opinion Certified May 24, 2004.

KOENIGS, J.

Adolph Dugas appeals from a finding that he is individually liable as guarantor for the debt of a corporation sued for unpaid fuel deliveries by Edward A. Flynn, Jr., d/b/a Flynn's Truck Stop. The trial court based this finding on a guaranty contract form that Mr. Dugas signed in his corporate capacity after striking out the preprinted words "Personally and Individually" [sic]. The import of this form, and the circumstances of its signing, are the central issues in this appeal.

1. *The sufficiency of the evidence.*

Mr. Dugas contends, in essence, that the evidence, comprising the testimony of Flynn's general manager, Peter Ferraro, and the guaranty form, was not a sufficient basis for finding him individually liable for the corporation's debts to Flynn.

a. *The procedural issue.* Although the defendant did not request a ruling of law regarding the sufficiency of the evidence in compliance with the requirements of Mass. R. Civ. P. 64A (b)(2), the issue is capable of resolution because the trial judge made rule 52(c)-compliant findings; the trial was brief, with only one witness and one exhibit (the contract form); the

entire trial transcript is 22 pages, and the evidence presents a single, simple issue: Did the defendant, by amending the plaintiff's form and then signing it, bind himself in his individual capacity to pay the corporation's debts to the plaintiff?

***

b. The evidence. Mr. Dugas was the chairman and chief operating officer of Automated Products of America, Inc. ("the corporation"). On behalf of the corporation, Mr. Dugas went to Flynn's offices and met with Flynn's general manager, Peter Ferraro, to arrange for fuel deliveries to the corporation.

Mr. Dugas had been provided a combined credit application and payment guaranty form that, as Mr. Ferraro testified, "we have people sign to set up an account to guarantee the account individually." There was no evidence that the form's purpose, i.e., obtaining an individual guaranty for corporate debt as a prerequisite to opening an account, was ever discussed with Mr. Dugas. The form recites no requirement that an individual guaranty be signed as a condition to obtaining a corporate account with Flynn. During the meeting, Mr. Dugas gave the form, which he had signed in his corporate capacity, to Mr. Ferraro.

One side of the form is entitled "Flynn's Truck Plaza--Credit Application." Below the title, in the spaces provided, bank and businesses references for the corporation are supplied in handwriting.

The other side of the form is entitled "Continuing Individual Guaranty." [FN3] There are several paragraphs describing the promise of the "Undersigned" to "guaranty" payments of the "Debtor." The "Debtor" is described by the corporation's name and address; the "Undersigned" is "Adolph Dugas," but the space provided for the residential address of the "Undersigned" was left blank. Although the preprinted words "individual" and "personal" appear in the title and under the signature line, they are not used in the body of the document. The word "guaranty" repeatedly appears in the term language, but is never modified by the words "personally" or "individually."

At the signature line, Mr. Dugas crossed out the preprinted words "Personally and Individually" with two strokes, and wrote "Automated Products of America, Inc." above his signature, to which he added the designation "Chmn/CEO" thus:

Automated Products of America, Inc.
"Signed: [s/]A Dugas Chmn/C.E.O.
"

Mr. Ferraro looked at this signature and asked Mr. Dugas if that were "his signature." Mr. Ferraro did not mention the terms "individual" or "personal." Mr. Dugas said it was. The

plaintiff's agent saw that the defendant had struck out the terms "Personally and Individually", and said nothing to the defendant about the changes. Mr. Ferraro, believing that the changes had no significance, accepted the form with those changes, and, as the plaintiff's agent, signed his name on the line designated "Witness."

Flynn thereafter began fuel deliveries to the corporation, which later went bankrupt.

c. *Discussion.* There was insufficient evidence to find that a contract was formed between Mr. Dugas and Flynn regarding payment for the fuel deliveries. Clearly, Flynn intended that Dugas would become individually liable for the fuel deliveries, if the corporation failed to pay. Mr. Dugas' intention is clear as well: by twice striking out the words "Personally and Individually," placing the corporation's name above his own, signing in his corporate capacity, and refusing to provide his own residential address, Mr. Dugas rejected those proposed terms.

Flynn argues that Mr. Dugas is bound, regardless how he signed the contract, by the rest of the preprinted language on the form, which he did not cross out or alter. The contract form does not have a life of its own; it either reflects a meeting of the minds of the parties as to the essential element of a contract, or it does not.

Flynn's preprinted form is full of language commonly used by lawyers to describe a promise to be liable for the debts of a third party; the word "guaranty" appears throughout the form. However, in the real word, ordinary people often use the word "guaranty" synonymously with "promise."

Flynn's form contract does not state, in plain English, that the "Undersigned" is promising to take on personal and individual liability for paying the debts of another. Flynn's failure to cross out "Individual" in the heading, or change other legalistic language in the form (e.g. "the liability of the Undersigned shall be primary and not secondary") is insufficient to establish that he intended to be individually liable. The signature makes clear that Mr. Dugas intended to act only on behalf of the corporation, not individually.

The instrument relied on must be found to state the essential terms of a contract, by which both parties intended to be bound. Flynn's form, with the critical changes made by Mr. Dugas, does not manifest a meeting of the minds, and cannot be construed as an enforceable contract. It is not a question, therefore, of construing the ambiguous terms of a contract; no contract was ever formed.

2. Remaining issues. In light of this holding, it is unnecessary to reach the other issues raised on appeal.

Judgment reversed; judgment to enter for the defendant.

Discussion points for Bridge Enterprises v. Futurity

This is a Massachusetts case, and Massachusetts generally does not follow the Equal Dignities Rule. See, for example, M.G.L.c 259, section1. But note that the agent signing the document only gets you half way to victory. You still have to prove that the agent was authorized by the principal to enter into this transaction on behalf of the principal under either the actual authority or apparent authority doctrines. Does the court apply the correct doctrine in this case?

BRIDGE ENTERPRISES, INC.
v.
FUTURITY THREAD COMPANY.

Appeals Court of Massachusetts, Middlesex.

Decided May 9, 1974.

This is a bill for specific performance of a written agreement to give the plaintiff a lease of certain premises in Watertown. The defendant appeals from the entry of an interlocutory decree which impliedly overruled his objections to the master's report and expressly confirmed the report, and form the entry of a final decree which ordered the defendant to execute and deliver a written lease, enjoined it from taking certain actions inconsistent with the lease, and determined the amount of rent owed by the plaintiff.

The case was referred to a master. We summarize the facts found by him. The defendant owns a building located at 5 Bridge Street in Watertown. As of February 1, 1972, and for some prior period, the plaintiff occupied the third floor and a portion of the second floor of the defendant's building as a tenant at will. In January of 1972 Benjamin G. Rae, III, the defendant's sales manager, met with George D. Coupounas, the plaintiff's treasurer, to discuss the possible lease of a portion of the building's first floor. Coupunas and Rae did not reach agreement at their first meeting, but on February 1, 1972, they drafted and, in their respective official capacities, signed a memorandum providing, as the master found, for a lease of a portion of the first floor of the building. According to the memorandum, the lease was to commence on the date thereof and tun for five years with an option to renew for another five-year period. The memorandum provided that the defendant would prepare a formal lease document which would be subject to the approval of the plaintiff's attorney.

The defendant drafted a lease, which was signed by Rae, and tendered it to the plaintiff. The draft was rejected by the plaintiff on the ground that it did not conform to the terms of the memorandum (the master found that the draft failed to include an option to renew). Although the plaintiff pointed out the discrepancies between the draft and the memorandum, the defendant refused to prepare another draft. In February of 1972 the plaintiff took possession of a portion of the first floor of the building. It has continued to occupy those

premises.

From the pleadings we find that on April 5, 1972, the defendant sent the plaintiff a letter purporting to revoke its offer to lease; soon afterwards it brought an action of ejectment against the plaintiff in a District Court. On May 16 the plaintiff entered the present bill. The master found, inter alia, that the plaintiff was in lawful possession of the premises which it then occupied and that the defendant was not entitled to possession thereof.

***

The defendant advances the following as grounds for reversing the final decree: (1) the memorandum signed by Coupounas and Rae did not satisfy G.L. c. 259, s 1 (the statute of frauds), (2) Rae had no authority to bind the defendant, (3) the parties never agreed on the terms of the lease and (4) one of the master's findings concerned an issue not raised by the pleadings.

[3][4] 1. The defendant's objection under c. 259 is grounded upon the theory that the memorandum, which provided for a '(l)ease of first floor of building we're presently in, which is approximately 10,653 sq. ft., inside dimensions, according to landlord's measurements,' did not adequately identify the space to be leased. The master's ultimate finding, that the memorandum referred to only a portion of the first floor premises in the Bridge Street building, is supported by subsidiary findings that the plaintiff was a tenant of a portion of that building at the time the memorandum was signed and that the total area of the building's first floor was some 43,500 square feet, approximately four times the amount of space specified in the memorandum. His finding that the memorandum referred to the particular area occupied by the plaintiff is supported by evidence that the space in question had been vacant at the time the memorandum was signed, was separated from the rest of the first floor by a fire wall, and had been inspected by Rae while in the company of Coupounas. There is no suggestion that the defendant had available any other space which conformed to the description in the memorandum

The master also found that the defendant's sales manager, Rae, had actual authority to negotiate the lease in question. The defendant's president had represented to Coupounas that Rae had such authority and Rae had participated in several negotiating sessions with the plaintiff.

The defendant first argues that the finding that Rae had the authority to 'negotiate' for the defendant does not constitute a finding that he possessed the power to bind it to a lease. We reject this interpretation, as there is nothing to indicate that the master intended to make such a distinction or that common usage would support it. See Webster's Third New Intl. Dictionary, p. 1514, which defines 'negotiate' as 'to arrange for or bring about through conference and discussion . . ..'

IV. Ratification

Sometimes an agent enters into a contract for a principal but lacks either the actual or apparent authority to do so, which means that the principal is not on the hook for the damages in the event of a breach. And this is where ratification comes in, to save the third party. If the principal, knowing all the material facts of the contract, subsequently manifests his agreement with the contract, either expressly or impliedly, then the contract is said to be "ratified," and will then be binding on the principal. One other requirement is that the principal must have the capacity to enter into the contract by the agent at two points in time – first, at the time the agent entered into the contract, and second, when the principal ratifies the agent's contract. One issue which tends to arise in ratification cases is whether a principal will be allowed to ratify part of a transaction, and disavow the rest, or whether ratification is an "all or nothing" proposition.

Discussion points for 3A's Towing v. P&A Well Service

As you might expect, there are not going to be too many cases involving ratification, simply because of the fact that if the principal looks at the contract and decided to ratify it, there will be very few problems after that worth talking about. But this case presents two interesting questions. First, how was it that Chevron ratified the contract (actually, in this case, Chevron ratified its agent's repudiation of the contract)? Second, how does this case differ from the result in the prior case of Wing v. Lederer?

3 A's TOWING COMPANY, Plaintiff-Appellee,
v.
P & A WELL SERVICE, INC., etc., Defendant-Third-Party Plaintiff-Appellee,
v.
CHEVRON, U. S. A., INC., Third-Party Defendant-Appellant.

United States Court of Appeals,
Fifth Circuit.

April 13, 1981.

TATE, Circuit Judge:

Chevron appeals from a judgment holding it liable in damages for its cancellation of a

service contract. We find no error in the district court's conclusion that Chevron repudiated its contract with the appellee, P & A, without affording P & A an adequate opportunity to perform. We therefore affirm.

Facts

In December of 1975, Chevron U. S. A., Inc. (Chevron), the third party defendant and appellant in this action, hired P & A Well Service, Inc. (P & A), the third party plaintiff and appellee, to plug and abandon a Chevron well located in the Louisiana coastal waters of Breton Sound. The contract provided that P & A would complete the work within sixty days and would receive $28,900 and the rights to the tubing recovered from the well.

Work commenced in early March of 1976. In late March, equipment problems led the parties to agree to a different method of plugging the well. During the ensuing delay period, rough weather damaged a P & A barge, forcing P & A to withdraw from the well site on April 5, 1976, to obtain repairs.

On April 9, 1976, P & A's president, Edward Estis, telephoned Chevron's Algiers office and was told by an unidentified individual that the Breton Sound contract was cancelled, and that P & A should not return to complete its work at that site. In reliance upon that order, P & A did not return to the Breton Sound well. On June 25, 1976, Chevron sent a letter to P & A cancelling the Breton Sound contract, and in August of 1976, Chevron itself plugged and abandoned that well.

On August 10, 1976, P & A sent an invoice billing Chevron for costs incurred in its attempt to complete the Breton Sound contract, including the salvage value of the unrecovered tubing. This litigation was precipitated when 3 A's Towing Company brought suit against P & A to recover sums due under certain towing contracts. P & A filed a third party demand against Chevron to recover the towing charges incurred in connection with the Breton Sound contract and in addition the lost profit resulting from Chevron's cancellation.

Following a bench trial, the district court concluded that since P & A had not forfeited its right to perform as of June 25, 1976, Chevron's letter cancellation of that date without first putting P & A in default constituted a violation of the contract, and that, in any event, Chevron had attempted to cancel the contract during the telephone conversation on April 9, 1976. Accordingly, the district court held that P & A was entitled to recover the profit it would have made had it been permitted to complete its performance, and entered judgment in favor of P & A in the amount of $77,980, with interest and costs.

I

Chevron does not dispute on this appeal that the April 9 telephone conversation did in fact occur. Chevron argues, rather, that since the unidentified individual who purported to cancel the contract was without authority express, implied, or apparent to act for Chevron in that regard, the cancellation cannot legally be imputed to Chevron, and therefore cannot constitute a violation of the contract entitling P & A to the recovery granted by the district

court. Thus, Chevron challenges as erroneous the district court's conclusion of law that "(i)n any event, ... Chevron did, in fact, attempt to cancel the Breton Sound contract during a telephone conversation on April 9." See Conclusions of Law, no. 7 (italics supplied).

[1][2][3] We find no error in this conclusion of the district court. The law and jurisprudence of Louisiana clearly establish that the unauthorized act of one purporting to bind a corporation may be implicitly ratified by the corporate principal through the knowing acquiescence of those having the authority, so long as the unauthorized act is not violative of the corporate charter, state law, or public policy. **** Such ratification has retroactive effect and is equivalent to prior authority. E. g., Acadian Production Corp. v. Savannah Corp., 63 So.2d at 143. A ratification may be held to have occurred when corporate personnel with the authority to bind the corporation acquire, or are charged with, knowledge of the unauthorized act and fail to repudiate it within a reasonable period of time. Dunham-Pugh Co. v. Stephens, 99 So.2d at 93-94. Although the acceptance of benefits by a corporation may evidence ratification, the cited decisions do not hold such to be a requirement for ratification of an act by a corporate employee repudiating a corporate obligation.

We disagree.

As noted by the Supreme Court of Louisiana in Dunham-Pugh Co. v. Stephens, 234 La. 218, 99 So. 88, 93-94 (1958), the general rule that a ratification occurs when personnel with the authority to bind the corporation acquire knowledge of the unauthorized act and thereafter fail to repudiate it within a reasonable period of time is particularly applicable where the delay in repudiating is a long one, where the failure to repudiate is accompanied by acts indicating approval of the unauthorized act such as receiving and retaining the benefits accruing from it or where the circumstances call for a quick repudiation. There is no requirement that some measurable benefit inure to the corporate principal from the unauthorized act.

To be sure, where the unauthorized act consists of the making of a contract that purports to bind a corporate principal, there is no more telling indication of the principal's ratification or approval of that act than its receipt and retention of the contracted-for benefits. But not all unauthorized acts involve the potential flow of some measurable benefit or consideration from a third party to the principal. In such cases, the principal's ratification or approval of the repudiation must obviously be manifested in terms other than the receipt of contracted-for benefits.

[4] We find sufficient evidence in this record to support a conclusion that Chevron acquiesced in the April 9 telephone cancellation of the Breton Sound contract, thereby implicitly ratifying it and adopting it as an act of the corporation.

The record shows that the Breton Sound contract was negotiated for Chevron by E. J. Morgan, a staff engineer in Chevron's Algiers office. The contract was signed in Morgan's office. All subsequent discussions of that contract were with Morgan, or with his replacements, C. R. Block and Richard Gist. Virtually all of P & A's dealings with Chevron

in connection with the Breton Sound well were conducted over Morgan's telephone. It was Morgan who represented Chevron in altering the procedure to be used in plugging the well and who agreed on Chevron's behalf to supply the mud for the new procedure.

On April 8, 1976, a call was placed to the home of P & A's president, Edward Estis, and a message was left requesting Estis to return the call. The number given was later determined to be that of James Isonhood, E. J. Morgan's immediate inferior, in Chevron's Algiers office. On April 9, 1976, Estis returned the call to the designated number and received no answer. He then called E. J. Morgan's number and spoke to the now-unknown individual who purported to cancel the Breton Sound contract.

Francis R. Daigle, the person who was second in rank at the Algiers office and E. J. Morgan's immediate supervisor, testified in his pretrial deposition, introduced at trial, that he was aware of the fact and the substance of the April 9 telephone conversation. That testimony was at least suggestive of a more general awareness throughout the Algiers office.

Despite that awareness, and despite numerous subsequent contacts between Chevron personnel and P & A personnel, neither Daigle nor any other Chevron employee ever repudiated that conversation, requested P & A to resume its operations on the Breton Sound well, or even inquired into P & A's continued absence from the well site. Chevron took no action in the ensuing weeks that was in any way inconsistent with a cancellation by telephone on April 9. The record shows that telephone cancellation with a follow-up letter of cancellation was an accepted practice in contracts of this sort; and indeed, on June 25, 1976, Chevron notified P & A by letter that it considered the contract cancelled, and thereafter rendered performance by P & A impossible by plugging and abandoning the Breton Sound well with its own resources in August of that year.

Under these facts, we find ample support for a conclusion that Chevron ratified the telephone cancellation by acquiescing in it, and therefore find it unnecessary to determine whether Chevron could likewise be bound by the cancellation under theories of actual or apparent authority. Chevron personnel with the authority to bind the corporation had knowledge of the telephone cancellation and failed to repudiate it within a reasonable period of time. We therefore find no error in the district court's conclusion that Chevron had attempted to cancel the Breton Sound contract by telephone on April 9, 1976.

II

[5] The legal effect of the telephone cancellation, if it is imputable to Chevron, is plain. Under Louisiana law, the active violation of a contract renders the violating party liable in damages from the moment the violation occurs, with no requirement that he first be put in default. La.Civ.C. art. 1932. The unilateral anticipatory repudiation of the contract constitutes just such a violation.

Conclusion

For these reasons, the judgment of the district court is AFFIRMED.

AFFIRMED.

Linkage v. Boston University

LINKAGE CORPORATION
v.
TRUSTEES OF BOSTON UNIVERSITY.

Decided May 15, 1997.

Supreme Judicial Court of Massachusetts

This dispute arises out of an agreement between Linkage Corporation (Linkage) and Boston University that called for Linkage to create and provide educational, training, and other programs of a technical nature at a satellite facility owned by Boston University. Linkage claims that the agreement was renewed by Boston University and then unlawfully terminated; Boston University claims that the agreement was lawfully terminated and never renewed. Linkage stated its case in the Superior Court by means of a ten-count complaint, which asserted theories of contract and tort liability and violations of G.L. c. 93A, §§ 2(*a*) and 11. Boston University's answer contained nine counterclaims stating various theories of wrongdoing on Linkage's part and also included a claim under G.L. c. 93A. A judge in the Superior Court granted summary judgment to Boston University on some of Linkage's claims. That judge thereafter recused himself from the case at Linkage's request because, prior to his appointment to the bench, the judge had practiced law with the law firm representing Boston University. The judge next assigned to the case held pretrial conferences, after which he set aside portions of his predecessor's grant of summary judgment. A twenty-nine day jury trial ensued.[FN1] The jury, in response to a lengthy set of special questions, found Boston University liable for breaches of contract, defamation, wrongful interference with advantageous relations, and violations of G.L. c. 93A. The jury rejected all but one part of Boston University's counterclaims. The judge treated the jury's answers to the special questions on the G.L. c. 93A issues as advisory and subsequently made his own findings of fact and rulings of law on those issues. He also concluded that Boston University had violated G.L. c. 93A, and that Linkage had not. As provided for by G.L. c. 93A, the judge doubled portions of the damages award by the jury and awarded Linkage its attorney's fees and costs. Both before and after his decision on the G.L. c. 93A issues, the judge decided several posttrial motions, eventually allowing judgment not withstanding the verdict on some of Linkage's recovery and denying Boston University a new trial on the remainder. Both parties claimed appeals, and we granted Boston University's application for direct appellate review.

****

We conclude that the jury's findings that the agreement had been renewed were warranted, and the judge should not have granted Boston University judgment notwithstanding the verdict on the renewal claim. Accordingly, we reinstate the jury's finding on that claim and their award of damages. We also conclude that the jury's finding on Linkage's claim for tortious interference with advantageous business relations may not stand. We uphold the jury's finding on defamation, but vacate their award of damages. We determine that Linkage can be given all the relief it is entitled to under the jury's findings that the agreement had been renewed, and the judge's G.L. c. 93A decision. As a result, we need not deal separately with Linkage's claims for promissory estoppel, breach of the covenant of good faith and fair dealing, or breach of contract (as applicable to the original agreement between the parties) or with its tort claims, except to indicate the grounds on which we set aside the jury's finding on the tortious interference claim and their award of damages on the defamation claim.

1. *Background.* We recount at some length the facts that could have been found by the jury. Because of the jury findings in favor of Linkage, we base our recitation on the evidence and inferences most favorable to it.

Linkage was founded in 1988 by Philip Harkins to facilitate the creation of corporate training programs for companies and universities. Harkins, who had a background in both education and computer software for business systems, thought that there was a market for intensive training programs targeted at data processing professionals and software specialists and that, in partnership with a college or university, he could develop a series of educational programs and successfully launch his business.

Boston University became aware of Harkins's plans to start Linkage and expressed an interest in working with Linkage to develop training programs. Boston University had recently acquired the Wang Institute, a facility consisting of an 80,000 square foot building located on 200 acres in Tyngsborough, and had assumed the debt on the facility.[FN2] Harkins met with J. Joseph Meng, Boston University's vice-president for external programs, and discussed his ideas for training offerings with Meng. Meng was looking for a way to produce a revenue stream that would offset Boston University's considerable overhead on the new facility, and Linkage's programs presented a possible solution to this revenue problem.

****

Together with Dennis Hart of Boston University's office of general counsel, Harkins and Meng drafted an agreement that covered the operation of Linkage's training programs at the Wang Institute (base agreement). Under the terms of the base agreement, Linkage's performance was to be measured by revenue produced, and Linkage was to receive bonuses for achieving revenue goals. The base agreement also contained a provision restricting both Linkage and Boston University from hiring each other's employees for a period of one year following the termination of the agreement.

At the time that Linkage and Boston University undertook performance of the base agreement, Meng reported to John Silber, the president of Boston University, and to Jon Westling, executive vice-president and Silber's second in command.[FN3] Silber reviewed the base agreement in draft form and discussed its provisions with Meng, but Meng understood that he had actual authority to negotiate and sign the agreement with Linkage.

****

Meng and Harkins executed the base agreement on August 1, 1988. Harkins signed on behalf of Linkage, and Meng signed on behalf of Boston University. The base agreement was limited to a term of three years, ending August 1, 1991. Under the base agreement, Linkage was to manage and market educational programs and services at the Wang facility, renamed the Boston University Corporate Education Center (BUCEC). Boston University agreed to provide over-all direction and supervision of BUCEC, and Meng was given final authority and decision-making power over the development and content of all educational activities, the recruitment and appointment of instructional personnel, and promotional activities.

Under the arrangement, Linkage initiated a variety of training programs, conferences, seminars, and other offerings for the corporate market. Boston University also transferred some university courses to BUCEC, which Linkage then managed for the university. Linkage's performance under the base agreement was highly successful: Linkage exceeded its revenue targets during each of the three years of the base agreement's operation, earning bonus payments as provided in the base agreement.

Harkins reported on a monthly basis to Meng, who reviewed every activity within BUCEC and approved Linkage proposals for new programs. Although Linkage was responsible for managing BUCEC programs, both credit and noncredit, it did not have total financial responsibility over the operation. All income generated by BUCEC was paid directly to Boston University, and Meng was responsible for all financial reporting. BUCEC's financial office, headed by a Boston University employee, prepared a monthly accounting for Meng's review, tracking revenues and expenses and documenting how much money was owed by each organization to the other.[FN4]

****

Another division of Boston University, the Metropolitan College (MET College), [FN5] ran a training program, professional development seminars (PDS), under contract with another independent training and development company similar to Linkage. When the PDS contract expired at the end of June, 1989, Linkage assumed responsibility for this program. Eventually, Linkage executed a contract with Boston University to run the PDS program (MET College contract). The compensation under the MET College contract differed from Linkage's compensation under the base agreement: under the latter, Boston University received all revenues from the programs and Linkage was paid a fee with incentive bonuses, while under the MET College contract, Linkage received all revenues, paid all expenses, and remitted a 9.15 per cent royalty to Boston University. The MET College contract also

provided for six months' prior notice before either party could terminate the agreement and contained a no-hire provision similar to the one in the base agreement. The MET College contract was executed on February 6, 1990. Kenneth Condon, Boston University's assistant treasurer, signed the agreement on behalf of Boston University.[FN6] As with the programs in operation under the base agreement, Meng supervised Linkage's operation of the PDS programs.

*****

In August, 1990, Harkins and Meng began discussing renewal of the base agreement, scheduled to terminate on August 1, 1991. Harkins wanted to begin negotiations early so that, in the event the base agreement was not renewed, Linkage would have time to replace Boston University as a client. In addition to the renewal of the base agreement, Harkins and Meng negotiated the incorporation of the MET College contract into the base agreement. [FN7]

*****

In March, 1991, Meng and Harkins, under the direction of Hart, agreed to fold the MET College contract into the base agreement, with the result that Linkage would no longer directly incur the expenses for or receive the revenue from the PDS program and instead would receive a fee for management.[FN8] Hart, as Boston University's legal counsel, also expressed concerns that regulations governing Massachusetts Health and Educational Facilities Authority (HEFA) loans (see note 2, *supra*), which prohibited reduced rate loans for profit-making institutions, might be violated by the base agreement's provision that authorized bonus payments to Linkage. Harkins and Meng took these issues into consideration as they proceeded through their negotiations toward renewal of the base agreement.

*****

On March 5, 1991, Boston University instituted a series of changes designed to control costs (March 5 directive). Included in these changes was a requirement that any expenditure greater than $5,000 would require approval of the appropriate dean or vice-president of the university and the provost or senior vice-president. A copy of these new fiscal austerity measures was sent to Harkins and to all vice-presidents, including Meng.

Assuming that the base agreement would be renewed, Harkins and his management team prepared a business plan for the next three years, which was presented at the April meeting of Boston University's trustees in Scottsdale, Arizona. Boston University's chief financial officers attended Harkins's presentation to the trustees. Silber and Westling did not. The Linkage business plan was well received by the assembled senior Boston University officials.

On April 28, 1991, following the presentation of Linkage's business plan at the trustees' meeting, Hart, Meng, and Harkins met, together with Linkage's chief financial officer and the person in charge of financial operations on the Boston University campus. At that meeting, it

was agreed that the MET College contract would be folded into the renewal of the base agreement, and new compensation arrangements were reviewed. On May 21, 1991, Meng and Harkins executed an agreement, which had already gone through several revisions to address concerns expressed by Hart, terminating the MET College contract and making it part of the base agreement (May 21 agreement). The language of the May 21 agreement provided that the base agreement " is being revised and renewed effective July 1, 1991." FN11

Meng promptly sent a confirmatory copy of the May 21 agreement to Westling and Condon. On May 21, 1991, Westling had a copy of the May 21 agreement, together with a copy of the renewal agreement, the terms of which, according to Meng, had been completely finalized. Westling also had a memorandum from Meng directly asking whether anything further was required to secure Boston University's approval. On May 22, Westling met with Harkins and Meng. At that meeting, Harkins reviewed the business plan and told Westling about steps Linkage had taken to expand operations. Westling questioned Harkins regarding conferences and Linkage employees, including program and instructor evaluations. Westling did not raise any concerns about the May 21 agreement or the renewal agreement at this meeting, nor did he object to the fact that Meng had executed the May 21 agreement on behalf of Boston University in apparent contravention of the March 5 directive.

On May 29, 1991, Silber's chief of staff sent a memorandum on behalf of Silber to Westling, Hart, and Condon, asking about the status of the renewal agreement.[FN12] Westling and Meng subsequently joined Silber in Germany. In his discussions with Meng in Europe, Silber raised no concerns about Linkage, the renewal agreement, or BUCEC.[FN13] Silber told Meng that he wanted additional information on Linkage. He and Meng agreed that Harkins would repeat the presentation made by Harkins to the trustees for Silber's benefit after he returned from Europe.

*****

On June 24, 1991, Harkins met with Silber, Westling, and Meng. Silber was rude and confrontational during this meeting, and his actions made it impossible for Harkins to present his business plan. Silber abruptly and angrily left the meeting after only twenty-five minutes.[FN14] Westling reassured Harkins, who was concerned by what appeared to be Silber's open hostility toward him, and told him, " Things will be all right."

*****

Unbeknownst to Harkins or Meng, Silber had been in direct contact with various individuals associated with Linkage's operations at BUCEC. Since his return from Germany, Silber had been in contact with James Devlin, his son-in-law and a part-time instructor in some of the BUCEC programs, and Robert Daniels, a Boston University employee who had originally been hired to work on BUCEC projects by Linkage. In the period of time before and after the June 24 meeting, Daniels had extended telephone conversations with both Silber and Devlin,[FN16] and met personally with Silber.FN17

*****

On July 1, Silber again met with Harkins, Meng, and Westling. During the course of that meeting, Silber contended that he was free to hire Linkage's employees despite the express no-hire provision in the base agreement and asked which employees were the most valuable. Harkins declined to give him this information and insisted that Silber had no right to hire Linkage's employees under the base agreement. Harkins advised Silber that Linkage had turned down opportunities to work with other universities. Silber revealed that he was aware of certain complaints about Linkage. At the close of the meeting, in response to a question by Harkins, Silber told him that the May 21 agreement that Harkins had signed with Meng was ineffective.

Meng, Silber, and Harkins met for the final time on July 3, 1991.[FN18] At this meeting, Silber produced a preliminary audit report, which, he asserted, gave cause to terminate any agreements between the parties. Silber then demanded that Harkins sign a letter, which, in addition to other provisions, waived the no-hire provisions of the base agreement. When Harkins declined, citing his desire to consult with an attorney, Silber withdrew the first letter and handed Harkins a second letter terminating the base agreement between the parties for cause, effective immediately, based on an unfavorable audit and Linkage's failure to cooperate with the auditors. The letter also terminated the MET College contract between the parties.

*****

Prior to the July 3 meeting, Silber had ordered Boston University security personnel and vice-presidents, including Westling, to stand by, ready for immediate action at BUCEC. After the meeting with Meng and Harkins, Silber directed this team to " secure [Boston University's] interests" and authorized them to offer increased salaries, if necessary, to Linkage employees to ensure that BUCEC operations would not be interrupted by the termination of the Linkage contract. By the time Harkins returned to Tyngsborough, Boston University security personnel and officials had occupied BUCEC. Some of the security personnel were armed.

Boston University officials gathered Linkage employees into a room. Westling told the assembled employees that Boston University's contract with Linkage had been terminated " for cause." In response to a question by a Linkage employee, who detected an intimation of wrongdoing in the statement " for cause" and sought clarification, Westling simply repeated that the contract had been terminated " for cause." [FN19] Harkins then met with his employees. Harkins told his employees that he would not seek legal recourse from individual employees if they were offered and accepted employment from Boston University. Harkins indicated that he would seek such recourse from Boston University for violating the no-hire provision of the base agreement.

Boston University officials came to BUCEC with prepared letters offering employment to

selected Linkage employees. While Harkins was gathering his belongings, Boston University conducted interviews with Linkage employees and hired twenty-eight of Linkage's thirty-two employees on the spot. Boston University insisted on review of all documents that Harkins was removing from the facility, refused to allow Harkins to take some of his personal papers, and made copies of everything that Harkins removed from his office.

At 11 p.m., in response to a threat by a Boston University official, Harkins called Tyngsborough police, who sent an officer to stand watch in Harkins's office. At 4:30 a.m., Harkins and his senior management left Linkage. As they left the facility, Westling swore at them and told them never to set foot on Boston University property again.

After Boston University took over operations at BUCEC, Daniels was hired to head the conference programs at BUCEC, reporting directly to the executive director, and received a raise in pay. In conversations with a Linkage employee who had been hired by Boston University, Daniels made disparaging comments about Linkage and its senior management, implying illegal activity had been the reason for the abrupt termination of the contract. Silber also made unfavorable comments about Linkage to a newspaper reporter.

The internal audit of Linkage operations continued after the takeover. Investigations by the Boston University internal audit department and outside auditors employed by Boston University produced evidence of minor errors in Linkage's reporting of financial matters. Boston University alleged after the termination of the base agreement that a Linkage employee had made backup copies of some Linkage files and that these backup copies were missing.

After the takeover, Linkage was unable to replace Boston University as a client, due in part to its reduced staff and to the conditions surrounding the termination of its contractual relationship with Boston University. Although it has rebuilt to some extent in the time since the termination of its contract with Boston University, the company has not been able to regrow its business to the point where it was in July, 1991.

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[6] 3. *Contract claims.* We next examine the jury's responses to a series of special questions concerning Linkage's claims for violations of pertinent agreements. Our inquiry is conducted under the well-established standard that a jury verdict for a plaintiff is sound if any reasonable view of the evidence discloses any combination of circumstances from which a rational inference may be drawn in the plaintiff's favor, even if different circumstances shown by the evidence would sustain a defense verdict.

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(a) *Renewal agreement.* The jury found that Boston University had entered into the renewal agreement with Linkage and had committed a material breach of that agreement. The jury awarded damages to Linkage, in the amount of $2,148,000 for lost profits and $330,358 for

out-of-pocket damages. The judge entered judgment notwithstanding the verdict on these findings, but later partially vacated this order and reinstated the jury's award for out-of-pocket damages. We conclude that the jury's findings on this claim should be upheld in their entirety.[FN23]

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Linkage contended that Boston University became bound to the renewal agreement on May 21, 1991, when Meng and Harkins signed an agreement that (1) terminated the MET College contract effective July 1, 1991, (2) provided that the activities covered by that contract would thereafter be governed by the base agreement, and (3) stated that the " base agreement is being revised and renewed effective July 1, 1991." For Boston University to be bound by Meng's action, the jury had to find, as a fact, that Meng had either actual or apparent authority to enter into the renewal agreement, or that Boston University had acquiesced in, or failed lawfully to disavow, any unauthorized conduct by Meng, and consequently had become bound by that conduct through ratification. The judge carefully instructed the jury on the requirements for establishing a binding agreement under these theories, but the special verdict form submitted to the jury did not include an express question relating to the existence of actual authority. It is not of consequence whether the evidence would have supported a finding of actual authority because the jury found that Boston University was bound by the renewal agreement on the basis of both apparent authority and ratification. There was sufficient evidence to support both of these findings.

[7][8] (i) *Apparent authority.* " Apparent or ostensible authority ' results from conduct by the principal which causes a third person reasonably to believe that a particular person ... has authority to enter into negotiations or to make representations as his agent.' ... If a third person goes on to change his position in reliance on this reasonable belief, the principal is estopped from denying that the agency is authorized." (Citations omitted.) We inquire whether conduct of Boston University's executives warranted a finding that Harkins reasonably believed Meng had authority to enter the renewal agreement.

The jury reasonably could have made the following findings. As Boston University's vice-president for external programs, Meng had virtual autonomy in supervising Linkage's programs at BUCEC. He negotiated and signed the base agreement on behalf of Boston University. Meng was responsible for ensuring Linkage's performance under the base agreement and the MET College contract. When Meng discussed with Silber the renewal of the base agreement in late 1990, Silber gave Meng a green light to proceed, indicating that the arrangement with Linkage had been advantageous to Boston University. Throughout negotiations with Linkage for renewal of the base agreement and the incorporation of the MET College contract therein, Meng was Boston University's primary representative.[FN24] In both the base agreement and in the MET College contract, Meng was named the official representative of Boston University for all legal notice. It was therefore reasonable for Harkins to believe that Meng had the authority to sign the May 21 agreement, thereby binding Boston University to the termination of the MET College contract, the " fold-in" of that contract to the base agreement, and the renewal agreement.

The strongest evidence against the existence of Meng's apparent authority is the March 5 directive requiring approval by Boston University's provost or a senior vice-president for expenditures over $5,000. Harkins had received this directive. Nonetheless, the jury could have found that Boston University's conduct led Harkins to believe that the directive would not apply to the May 21 agreement or to its renewal of the base agreement. Linkage presented evidence that after the issuance of the March 5 directive, payments were authorized involving BUCEC operations without any approval as required by the directive. From his knowledge of the operations of BUCEC, and his observations of the manner in which decisions concerning Linkage's arrangements with Boston University had been reached in the past, Harkins could have reasonably concluded that the March 5 directive expressed a policy that was not always enforced, especially to programs like BUCEC that were headed by someone with direct contact to Silber. After all, it is not uncommon for an employer to issue a mandate concerning financial expenditures, and then to ignore or overlook the mandate in circumstances that suggest benign oversight because the employer's advantages are being advanced.

Based on the evidence, and their assessment of the credibility of the witnesses, the jury properly could have found that Meng had apparent authority to sign the May 21 agreement, and that the execution of that agreement bound Boston University to the renewal of the base agreement on terms that had been agreed to by Meng and Harkins.

(ii) *Ratification.* Where an agent lacks actual authority to agree on behalf of his principal, the principal may still be bound if the principal acquiesces in the agent's action, or fails promptly to disavow the unauthorized conduct after disclosure of material facts. " It is the instant duty of a principal, upon ascertaining the facts, at once to disaffirm an act done in his name by an agent in execution of a power conferred but in a mode not sanctioned by the terms of the agency or in excess or misuse of the authority given."

The jury could have found that any deficiency in Meng's authority to execute the May 21 agreement was obviated by subsequent conduct of Boston University officials, especially Westling in his capacity as provost and executive vice-president, whose approval was ostensibly required by the March 5 directive. Meng sent copies of the May 21 agreement to Condon and Westling immediately on its execution. The draft of the renewal agreement was attached to the May 21 agreement, as was a memorandum from Meng explaining the renewal agreement and explicitly asking whether any further review was needed to secure approval. Harkins and Meng met with Westling on May 22 so that Harkins could present his business plan. Westling did not raise any objections to the renewal agreement, nor did he indicate that the agreement required further approval from him or others before it could take effect. Condon never responded to Meng's query as to whether any further action would be needed. Silber also failed to repudiate Meng's action on behalf of the university. When he met with Meng in Europe in late May, Silber told Meng only that he wanted to " get up to speed" on the Linkage operation, and Silber expressed no objection to the agreement or that Meng had been unauthorized to enter into it without any further approval. Thus, neither Silber nor Westling raised any question about the validity of the renewal agreement until the meeting on

July 1, when Silber finally told Harkins and Meng that, in Silber's opinion, Boston University was not bound by the renewal agreement.

Based on this sequence of events, the jury reasonably could have found that ratification of Meng's execution of the May 21 agreement by Boston University followed from the informed acquiescence of Westling, Silber, and other Boston University officials, and from their failure promptly to disavow Meng's conduct after learning material facts.

[13] There is an additional factor supporting the jury's decision: Boston University clearly benefited from the provisions in the May 21 agreement that folded the MET College contract into the base agreement. " It is settled that one cannot accept the benefits of a transaction purporting to be done in his behalf and afterwards repudiate it." By incorporating the MET College contract into the base agreement, Boston University eliminated the six-month notice for termination in the MET College contract, and the agreement helped to resolve existing problems with the use of the nonprofit postage permit and potential problems with the HEFA financing incurred in connection with the university's acquisition of the BUCEC site. The jury reasonably could have found Harkins credible when he testified that Linkage agreed to terminate the separate MET College contract only as part of a larger arrangement by which the base agreement was to be renewed.[FN25] After the May 21 agreement was executed, the " fold-in" provisions were implemented and the terms of the base agreement were followed for both programs. Boston University's acceptance of the benefits of the May 21 agreement thus furnished a separate, and important, indication of its acquiescence to, and ratification of, the renewal agreement.

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So ordered.

Colony of Wellfleet v. Harris

The **COLONY OF WELLFLEET, INC.**
v.
Edith Keyes HARRIS & others

No. 07-P-287.

Appeals Court of Massachusetts, Suffolk.

Argued Dec. 12, 2007.
Decided April 7, 2008.

The Colony of Wellfleet, Inc. (the Colony), appeals from a judgment of the Land Court denying the Colony's request that the court expunge a 1978 deed transferring title to a cottage and the land upon which it is located (lot 49) to Edith Keyes Harris. The Colony argues that

the Land Court judge (1) had a duty under G.L. c. 185, § 114, to expunge an erroneous registration of a deed in fee where the transferee was not a purchaser in good faith; (2) committed an error of law in ruling that the Colony ratified the 1978 deed in 1983; and (3) erred in finding the Colony guilty of laches. We affirm.

On November 22, 1963, the Colony purchased registered land from the Mayo Hill Colony, Inc. The land housed nine cottages which were rented seasonally. At the time of the purchase, Loris Stefani (Loris) was the sole shareholder of the Colony, although he operated the cottage colony with Eleanor Stefani (Eleanor).

The Colony was often subject to financial problems. As a result, it fell behind on mortgage payments and foreclosure proceedings were commenced. On October 30, 1970, Loris transferred certain real estate and stock to his sons, Marco and Paul Stefani, and to Attorney Charles E. Frazier, Jr., as part of a refinancing to avoid foreclosure. This transaction provided that upon payment of the existing mortgages, title to lot 17 and the stock of the Colony would be returned to Loris. The plan further provided for lot F-10 to be subdivided, with authority for the lots to be sold. On December 9, 1971, a judge of the Land Court approved a partial subdivision plan of lot F-10, resulting in the creation of lots 39-52. On September 30, 1972, the Colony's stockholders and officers voted (the vote) to authorize Frazier to sell the lots for a period of five years from that date. In accordance with his authority as granted by the vote, Frazier sold six lots between October 21, 1972, and December 1, 1975, one of which was the sale of lot 40 to Harris on April 30, 1975.[FN3]

On November 1, 1976, Loris commenced actions in Superior Court (the suit) against his sons and Frazier to recover his stock and lot 17. Loris died on January 26, 1978, and William E. Crowell, Jr., the executor of his estate, was substituted as the plaintiff in the suit. Upon his death, Loris left all of his interest in the Colony to Eleanor.

In the summer of 1978, Harris spoke to Eleanor regarding the purchase of cottage 10B, which stands on lot 49. Eleanor told Harris that there could be no sale of the cottage due to the outstanding court case. After Harris's conversation with Eleanor, Harris approached Frazier and his attorney, Sidney Dockser, and was told that lot 49 was for sale at a price of $40,000.

On August 18, 1978, the Colony and Harris signed a purchase agreement for the sale of lot 49 for the sum of $40,000. Eleanor learned of the sale of lot 49 shortly after the purchase and sale agreement was signed. Lot 49 was conveyed to Harris by deed dated October 7, 1978. The proceeds from the sale were used to pay operating costs of the Colony.

Dockser represented Loris's estate and Eleanor in the suit. In 1978, Dockser advised Eleanor that the sale of lot 49 to Harris was final. As the suit continued, Eleanor hired new counsel, Judith Bowman and Paul Counihan, both of whom were retained during the summer of 1979. Many times during the suit and after the trial in 1979, Eleanor asked Bowman and Counihan if there was anything she could do regarding lot 49, which she asserted Harris had “stolen.” Based on those conversations, Eleanor concluded that the sale of lot 49 was final.

On October 22, 1979, a Superior Court judge decided in favor of Loris's estate, and ordered that the stock in the Colony and lot 17 be held in trust for the benefit of Loris's estate. The ownership of lot 49 was not raised in the suit.

In 1983, a dispute arose between the Colony and Harris over the ownership of lot 49. Eleanor hired Bowman as her counsel, and was again advised that the sale of lot 49 to Harris was final. This dispute never resulted in a court action, and was not otherwise resolved.

Frazier died before this current Land Court action was initiated. Harris was ninety-nine years old when this action was initiated, and died before trial.

The Land Court case. The Colony argued before the Land Court that Frazier lacked corporate authority to execute the deed to Harris, and as a result, the transfer certificate was issued in error and should be subject to the provisions of G.L. c. 185, § 114. Harris argued that Frazier and Dockser told Harris that they had the authority to sell lot 49 and that Frazier was acting with apparent authority when he executed the deed.

The trial judge first noted that the vote authorizing Frazier to sell the lots expired on September 30, 1977; therefore the deed, which was dated October 7, 1978, was not valid because Frazier did not have actual authority to sell lot 49. Frazier's express authority to sell the lots owned by the Colony was limited by the fact that Frazier was only empowered to sell the lots for a duration of five years. Once that five-year window had closed, Frazier lacked actual authority to sell any of the lots owned by the Colony.

Having concluded that Frazier did not have actual authority to sell lot 49, the trial judge addressed the issue of apparent authority and found that Harris could not have held a reasonable belief that Frazier had authority to execute the deed. Harris had spoken with Eleanor about the possibility of purchasing one of the units on lot 49, and had been informed that no land could be sold due to the dispute as to the ownership of the Colony, the subject of a pending action in Superior Court. The trial judge concluded that without a reasonable belief on the part of Harris that Frazier had the authority to sell lot 49, the doctrine of apparent authority did not apply.

The trial judge determined that the Colony qualified as a "person in interest" under G.L. c. 185, § 114, and as such was permitted to bring a petition in the Land Court to correct the error of the recorder in issuing the transfer certificate for the deed despite Frazier's lack of corporate authority to continue to sell lots on behalf of the Colony.

The trial judge found that Harris was not protected from the provisions of § 114 because she was not a "purchaser in good faith." As such, the trial judge concluded that the Land Court was authorized to cancel the certificate.

FN4. The Supreme Judicial Court has held that "the statutory scheme set out in G.L. c. 185 does not protect all purchasers in every circumstance ... [and] anyone who

> seeks the protection of G.L. c. 185 must fulfil his or her obligation to 'investigate further other certificates of title, documents, or plans in the registration system' that are referenced on existing certificates of title for the land to be purchased.... The failure to fulfil that obligation need not be fraudulent for the purchaser to lose his or her claim to certainty of title." *Doyle v. Commonwealth,* 444 Mass. 686, 692-693, 830 N.E.2d 1074 (2005). In the case at bar, Harris did not fulfil this requirement. The authority granted to Frazier by the vote was listed on the memoranda of encumbrances and it would have been clear that Frazier's authority to sell lots on behalf of the Colony had lapsed more than a year prior to the conveyance to Harris. Because Harris at least had constructive knowledge of the error, she was not a purchaser in good faith, and her case falls under the rationale of *Doyle.*

The Land Court judge concluded that the October 7, 1978, deed to Harris was executed by Frazier after his authority under the 1972 vote had expired, and as such, the provisions of G.L. c. 185, § 114, apply. Accordingly, the Land Court had the authority to cancel the certificate; however, while Harris's deed was originally defective because it was not properly executed, the judge concluded that the Colony ratified the deed as of 1983, and that the Colony's claims were barred by laches.

Discussion. 1. *General Laws c. 185, § 114.* Section 114, as amended by St.1996, c. 481, § 20, states in part as follows.

> "A registered owner or other person in interest may apply by motion [for an erasure, alteration or amendment to a certificate of title] to the court upon the ground that ... any error or omission was made in entering a certificate or any memorandum thereon; or ... upon any other reasonable ground; ... and [the court] may order the entry of a new certificate, ... or grant any other relief upon such terms, requiring security if necessary, as it may consider proper; but this section shall not authorize the court to open the original judgment of registration, and nothing shall be done or ordered by the court which shall impair the title or other interest of a purchaser holding a certificate for value and in good faith, or his heirs or assigns, without his or their written consent."

a. The Colony argues that, having concluded that Frazier had no authority to execute the deed to Harris and that Harris was not a purchaser in good faith, the trial judge was required by § 114 to cancel Harris's certificate and restore title to the Colony, and that failure to do so undermines the purpose of the land registration system.

We are not persuaded that permitting a certificate of title to remain with a party who was not a "purchaser in good faith" defeats the purpose of the land registration system. "[T]he underlying purpose of title registration is to protect the transferee of a registered title." *Kozdras v. Land/Vest Properties, Inc.,* 382 Mass. 34, 44, 413 N.E.2d 1105 (1980). This purpose is not defeated by permitting the court to exercise discretion in crafting equitable relief allowing the transferee to maintain possession of a certificate of title where the transferor ratified the deed or where the transferor was guilty of laches.

The argument that the Land Court has no discretion under § 114 is not supported by the language of the statute. A close reading of § 114 leads to the conclusion that this section is intended to be permissive and to provide the court with flexibility in determining relief: the court "*may* order the entry of a new certificate ... or grant any other relief ... as it *may* consider proper" (emphasis added). G.L. c. 185, § 114. Section 114 explicitly says that the court has the authority to grant such relief as it deems proper. Such language leads to the conclusion that § 114 was meant to provide flexibility to the judge in deciding what relief to grant: "By its terms, [G.L. c. 185, § 114,] grants a Land Court judge broad powers to correct errors 'made in entering a certificate.' " *Doyle v. Commonwealth,* 444 Mass. 686, 694, 830 N.E.2d 1074 (2005). Furthermore, the use of the word "may" denotes a discretionary power. Massachusetts law has consistently held that the word "may" in a statute "is a word of permission and not of command." *Cline v. Cline,* 329 Mass. 649, 652, 110 N.E.2d 123 (1953). The trial judge therefore correctly determined that he had the authority to cancel the certificate, but did not have an affirmative mandate to do so.

Although the judge found the rationale of *Doyle* to be controlling in determining that Harris was not a "good faith purchaser," he had discretion within § 114 to consider other factors, such as whether the Colony ratified the deed, or whether there is a laches concern in this case.

b. The final clause of G.L. c. 185, § 114, states that "nothing shall be done or ordered by the court which shall impair the title or other interest of a purchaser holding a certificate for value and in good faith, or his heirs or assigns, without his or their written consent."

The Colony argues that (1) it is a good faith purchaser holding a certificate as a result of its purchase from the Mayo Hill Colony, Inc., in 1963; (2) the Land Court decision impairs its title; and (3) it never gave written consent as required under § 114, thereby requiring reversal of the judge's decision.

The Colony was a purchaser holding a certificate for value and in good faith resulting from the transaction with the Mayo Hill Colony in 1963; however, the protections granted to the Colony through § 114 as a good faith purchaser in 1963 do not extend to the transaction between the Colony and Harris in 1978. Following the 1978 transaction, the Colony no longer held the certificate to lot 49. The Colony is more aptly described as a "person in interest," rather than a "purchaser in good faith" with respect to the transaction in 1978. The Colony's certificate for lot 49 was canceled in 1978, at which time Harris became the new holder of the certificate; Harris, not the Colony, was the "purchaser" for purposes of § 114.

2. *Ratification.*The Colony argues that the Land Court judge committed an error of law in ruling that the Colony ratified the 1978 deed to Harris based on a theory of constructive knowledge. We disagree.

A principal may be bound by an agent's unauthorized acts if the principal expressly or impliedly ratifies the agent's acts. See *Linkage Corp. v. Trustees of Boston Univ.,* 425 Mass. 1, 18, 679 N.E.2d 191,cert. denied, 522 U.S. 1015, 118 S.Ct. 599, 139 L.Ed.2d 488 (1997).

Ratification may be effected by the principal's express declaration or inferred from his actions, including failure to repudiate an act. In order to establish ratification it generally must be shown that the principal had “full knowledge of all material facts.” *Perkins v. Rich,* 11 Mass.App.Ct. 317, 322, 415 N.E.2d 895 (1981), quoting from *Combs v. Scott,* 94 Mass. 493, 12 Allen 493, 496 (1866). However, the law does not allow one to “purposefully shut his eyes to means of information within his own possession and control, having only that knowledge which he cares to have” (citations omitted). *Perkins, supra.* Ratification is essentially a question of fact that will be reversed only if clearly erroneous. *Diep Bui v. Ha Ma,* 62 Mass.App.Ct. 553, 565, 818 N.E.2d 572 (2004).

Although the Land Court judge ultimately decided the issue of ratification with respect to Eleanor, the judge also noted that Marco and Paul were shareholders of the Colony when Frazier conveyed lot 49 to Harris in 1978, and there was no evidence that they objected to the receipt of the proceeds from the sale. This court will affirm a judgment as long as the result is correct on any ground apparent on the record that supports the result reached by the trial court. *Gabbidon v. King,* 414 Mass. 685, 686, 610 N.E.2d 321 (1993).

If the principal benefits from the unauthorized act, “ratification may be implied pretty quickly from the lapse of time.” *Brown v. Henry,* 172 Mass. 559, 567-68, 52 N.E. 1073 (1899). In the case at bar, the money generated from the sale of lot 49 was vitally important to the Colony's financial health since it was used to pay operating expenses. The 1981 appeal from the Superior Court suit concluded that a trust was created in favor of Loris, and that Marco, Paul, and Frazier were the resulting trustees. See *Crowell v. Stefani,* 12 Mass.App.Ct. 966, 428 N.E.2d 334 (1981). As trustees, Marco and Paul were “held to the rule of good faith and due diligence.” *Young v. Tudor,* 323 Mass. 508, 515, 83 N.E.2d 1 (1948). “[A] trustee must use his or her ‘best informed judgment in good faith.’ ” *Fine v. Cohen,* 35 Mass.App.Ct. 610, 617, 623 N.E.2d 1134 (1993), quoting from *Old Colony Trust Co. v. Silliman,* 352 Mass. 6, 10, 223 N.E.2d 504 (1967).

Despite the fact that Marco and Paul were later divested of their positions as the principals of the Colony, the decisions they made at the time as trustees were in good faith, and were binding upon the Colony.[FN7] Furthermore, there is certainly no issue of knowledge about the lapse of authority granted to Frazier through the vote with respect to Paul and Marco. They authorized Frazier to sell the lots for a period of five years and there is no reason to believe they did not know Frazier sold lot 49 to Harris after the expiration of that authority. The Colony ratified the deed in 1978 when Marco and Paul failed to repudiate the transaction and the Colony benefited from the proceeds from the sale.

Even if Marco and Paul were unable to ratify the actions of Frazier in 1978, the Land Court judge correctly determined that Eleanor ratified the deed in 1983. The trial judge found that ratification was implied by Eleanor's acts, including her failure to take any action. Ratification may be implied when a principal makes no effort to repudiate a transaction. See *Kelley v. Newburyport & Amesbury Horse R.R.,* 141 Mass. 496, 499-500, 6 N.E. 745 (1886). “Where an agent lacks actual authority to agree on behalf of his principal, the principal may still be bound if the principal acquiesces in the agent's action, or fails promptly to disavow

the unauthorized conduct after disclosure of material facts." *Linkage Corp. v. Trustees of Boston Univ.,* 425 Mass. at 18, 679 N.E.2d 191. When Eleanor became the principal in 1981, she was aware of the sale of lot 49 to Harris. In fact, she specifically asked her counsel during the suit and again in 1983 whether there was anything she could do with respect to the sale of that lot. After researching the issue, her counsel told her that there was nothing she could do. Even though this information may have been incorrect, Eleanor is not absolved by her agents' erroneous advice and the obligation of her agents to discover that which is clearly reflected in the memoranda of encumbrances filed with the certificate. In making this determination, the judge was not clearly erroneous because Eleanor's agents had knowledge of all of the material facts in this case. "If the purported principal has knowledge of facts which would lead a person of ordinary prudence to investigate further, and he fails to make such investigation, his affirmance without qualification is evidence that he is willing to ratify upon the knowledge which he has." Restatement (Second) of Agency § 91 comment e (1958).

By failing to repudiate the actions of Frazier within a reasonable time after gaining access to all the relevant material facts in 1983, Eleanor ratified the sale of lot 49 to Harris.

3. *Laches.*The Colony argues that the trial judge erred in finding the Colony guilty of laches. We disagree.

Laches is an "unjustified, unreasonable, and prejudicial delay in raising a claim." *Srebnick v. Lo-Law Transit Mgmt., Inc.,* 29 Mass.App.Ct. 45, 49, 557 N.E.2d 81 (1990). "Laches is not mere delay but delay that works disadvantage to another." *Moseley v. Briggs Realty Co.,* 320 Mass. 278, 283, 69 N.E.2d 7 (1946), quoting from *Calkins v. Wire Hardware Co.,* 267 Mass. 52, 69, 165 N.E. 889 (1929). However, there can be no laches where "there is no knowledge of the wrong committed and no refusal to embrace opportunity to ascertain facts." *Moseley, supra* at 284, 69 N.E.2d 7, quoting from *Stewart v. Finkelstone,* 206 Mass. 28, 36, 92 N.E. 37 (1910).

"The operation of laches generally is a question of fact for the judge, and a judge's finding as to laches will not be overturned unless clearly erroneous." *A.W. Chesterton Co. v. Massachusetts Insurers Insolvency Fund,* 445 Mass. 502, 517, 838 N.E.2d 1237 (2005).

In the case at bar, the trial judge found that Eleanor told her attorneys many times that lot 49 was wrongfully taken from her and inquired about the possibility of getting the property back. The judge found that the delay in this case, twenty-three years, was unreasonable given the circumstances. The trial judge's findings were not clearly erroneous in concluding that the delay was unreasonable where Eleanor's attorneys were specifically asked about her rights in lot 49 and the vote was recorded on the memoranda of encumbrances.

The trial judge further found that the defendants were prejudiced by the delay in that the defense's main witness, Harris, died before trial. Frazier, another witness, also died before trial and was unable to add his testimony to the evidence at trial. The fact that several key witnesses died before this case was tried could certainly have prejudiced the defendant.

These findings are not clearly erroneous.

Finally, the trial judge concluded that the Colony, like Harris, knew the facts pertaining to the deed and had access to the records to discover the vote and the limitation of Frazier's authority to execute the deed. The trial judge deemed the Colony to have sufficient knowledge of the material facts to have made the delay in this case unjustified. This conclusion stems from the fact that Eleanor specifically inquired about her rights in lot 49 during the suit, and again in 1983. Her counsel had every opportunity to discover the vote and any rights stemming therefrom. This finding is not clearly erroneous.

For all of these reasons, the trial judge's findings that the Colony ratified the deed as of 1983, and was guilty of laches, were not clearly erroneous. Accordingly, the judgment is affirmed.

So ordered.

V. Termination of Agency

The general rules regarding the duration of an agency relationship are fairly well settled. First, if the agency is for a specific act, the agency terminates when the act is completed. For example, if I hire a real estate broker to sell my house, the agency relationship ends when the house is sold. Second, if the agency is for a specific time period, the agency ends when the time period expires. Third, agency is terminated by operation of law, such as the incapacity or death of either the principal or the agent (but note the exception listed in M.G.L. c. 201B).

There is another general, “American” rule regarding agency (employment) relationships. In the United States, if you are hired for no specific term, then you are an employee “at will,” which means you can quit, or be fired, at any time, without the other party being able to recover for any damages suffered as a result of the quitting (or firing). This general rule has been riddled with exceptions, as you will see.

Discussion points for Thomas v. Ballou-Latimer

First and foremost, this is a case about how important it is that you learn how to draft contracts (employment agreements) which are as clear as possible. Looking at the facts relied upon by the court to find that the contract was for year to year, do you find any of them compelling enough to overcome the American rule? Aren’t some of these facts borderline irrelevant? Did Thomas get shortchanged on the bonus?

Bessie B. THOMAS, Executrix of the Estate of George Winton Thomas, Deceased, Plaintiff-Respondent,
v.
BALLOU-LATIMER DRUG CO., Defendant-Appellant.

Supreme Court of Idaho.

July 8, 1968.

TAYLOR, Justice.

February 16, 1962, George Thomas and the Ballou-Latimer Trust entered into an employment agreement which reads in part:

> 'That Trustees hereby hire and employ party of the second part as General Manager of said drug store belonging to Trustees and General Manager does hereby accept such employment under the compensation, terms and conditions and for the times hereinafter specified, commencing as of the date hereof.
>
> 'The Trustees agree to pay, and the General Manager agrees to accept for the services to be rendered hereunder, a salary of Seven Hundred Twenty-Five (725.00) Dollars per month, payable semi-monthly on the first and 15th day of each month, the first salary payment to be due March 1, 1962. In addition thereto General Manager shall receive a bonus of twenty-five per cent (25%) of the net profit of said Ballou-Latimer Company, before income taxes and before any distribution under provisions of the above mentioned Trust Agreement. Such bonus shall be due as of December 31st of each year or portion of a year this agreement shall be in operation. Said net profit shall be calculated within a reasonable time after the close of the calendar year, and as soon as possible to ascertain the receipts and expenditures and to complete necessary bookkeeping and auditing.
>
> * * *
>
> 'General Manager is charged with and hereby accepts the full responsibility of the management and conduct of the business in general of the Trustees' said drug business in Boise, Idaho, subject only to accountability to, and supervision and direction of the Trustees. General Manager shall not make changes in general policy or discharge key employees without first consulting Trustees.
>
> 'General Manager agrees to so conduct himself, personally and in business, as not to affect adversely the business or the good standing or reputation of himself or the said Ballou-Latimer Co.
>
> 'General Manager agrees that he will not engage in any business or enterprise other than covered by this contract, except with the consent of the Trustees, but this shall not apply to personal investments made by him.

'It shall be the duty of the General Manager to keep full and complete books of account of the business in accordance with recognized accounting procedure and as prescribed by the Trustees or the company auditor; siad books to at all times be available for inspection by the Trustees or said auditor or upon order of any of them. The auditor for the business shall be one to be selected by the Trustees and General Manager.

Said General Manager shall make such statements and reports as a Trustee or Trustees shall require; and shall cause an inventory of such business to be taken as of December 31st and June 30th of each year, commencing with June 30, 1962.

* * *

'This Agreement shall take effect as of February 16, 1962 and shall continue in force until terminated as hereinafter provided.

'It shall terminate upon the death of the said General Manager, or upon the sale or liquidation of the business without provision for a successor to assume the obligations of this Agreement. It is agreed that Trustees shall provide, in case of death of second party, the sum of $5000.00 to the wife of the General Manager, provided she survives him, or in event of her demise, to his children, share and share alike. Said sum to be paid in a lump sum, within 45 calender days of date of death.

'It may be terminated by either party hereto on December 31, 1962. In order for such termination to become effective, a written Notice of such termination shall be delivered to the oter party by the termination party at least thirty days prior to said termination date. In event of such a termination by either party, General Manager agrees that upon request of the Trustees, he will remain in his employment at least sixty (60) days beyond any such termination date and shall in that event share in the profits accordingly during such period. This Agreement shall terminate upon exercise of option of General Manager to purchase in as hereinafter set forth.

* * *

'IT IS UNDERSTOOD AND AGREED, That in event of no termination, that this Agreement shall be reviewed as of each December 31st after date, for the purpose of adjusting and correcting inequities that may develop herein.

'IT IS FURTHER UNDERSTOOD AND AGREED, That at the date of entering into this Agreement, the said drug business is heavily indebted and that the main consideration of entering into this Agreement and the bonus provision hereof, is to provide inducement and encouragement for the General Manager's developing the said drug business to a point where the business will be a strong and going concern, free of debt except for its current monthly bills. It is also agreed, that in the process of liquidating such indebtedness that sufficient funds must be retained to properly maintain and operate said business.'

Thomas was employed by Ballou-Latimer under the terms of the agreement until February 12, 1965, when the agreement was terminated by the defendant.

April 21, 1965, Thomas instituted this action to recover under the terms of the contract his

salary for the remainder of 1965, bonus money for the year 1963, and vacation pay. The case was heard by a jury, and a special verdict was rendered answering three questions submitted to it by the court. Based on the verdict, judgment was entered in favor of Thomas, awarding him $7,612.50 salary for the remainder of 1965, $1,500.00 bonus for the year 1963, and $21.15 in costs. Vacation pay was not awarded. From the judgment, Ballou-Latimer has appealed. No appeal was taken by plaintiff Thomas.

The evidence at the trial showed that, although Thomas signed writings purporting to be resignations, in fact he had been given the choice by the directors of defendant of quitting or being discharged. Defendant attempted to prove that Thomas had been discharged for cause, asserting:

A. He had failed to prepare certain statements as required by the contract of employment.

B. He had accepted employment with a tire distributorship and had done work for the tire company on Ballou-Latimer time, using Ballou-Latimer personnel and equipment without permission of the directors in contravention of the contract of employment. Thomas presented evidence indicating that the directors and their attorney had failed to provide him with certain information necessary for the completion of said statements, though he had requested it from them numerous times. He also contradicted Ballou-Latimer's evidence with regard to the outside employment.

On the issue of the bonus, there is no dispute that Ballou-Latimer failed to show a profit, according to the terms of the employment contract, during the time Thomas held his position. Thomas, however, offered evidence that subsequent to the written contract, he and the directors agreed to an oral modification thereof. By the terms of the oral agreement changes in the method of determining profit and loss were made. Under the oral modification, Thomas contended Ballou-Altimer had a profit before taxes of $6,000.00 in 1963; and that by the terms of the contract, therefore, he was entitled to a bonus of $1,500.00.

The Ballou-Latimer directors admitted that such a modification had been discussed, but testified that it had been rejected by them.

In answer to the questions put to it the jury found:

A. That Thomas had been discharged;
B. That the discharge was without cause;
C. That Thomas and Ballou-Latimer had agreed orally to modify the terms of the wrtten contract as to the method of computing the bonus for 1963.

The trial court then decided that the contract was a contract of employment from year to year, renewable each December 31st. Since Ballou-Latimer failed to produce any evidence that Thomas could have or did mitigate damages by accepting other employment after discharge, the court awarded plaintiff his full salary for the remainder of 1965 ($7,612.50).

On the bonus question, the court accepted Thomas' testimony as to the amount due, Ballou-

Latimer having presented no contrary evidence, and awarded $1,500.00.

Defendant contends that the court erred in concluding that the contract contemplated employment from calendar year to calendar year. it is agreed by all parties that the terms of the agreement were not specific as to duration of employment. The contract gave both parties the option of termination on December 31, 1962. Neither party acted upon that option.

[5][6] There is conflict among the authorities in cases similar to the one before us, when the duration of the contract of employment is not specified. According to the old English Doctrine, since modified, such a general hiring presumes a hiring for one year. Under the American Doctrine, a general hiring not limited to a specified period creates a presumption of a hiring at will under which either party may terminate the employment without cause at any time, assuming any notice requirements are met. As corollaries to the above, jurisdictions following the old English rule have held that a hiring at a named price perweek, month, or year is presumed to be a definite hiring for the period named; while jurisdictions following the American rule hold that such a term, standing by itself, fixes the rate of compensation and not the period of employment. In all jurisdictions, however, the presumptions are rebuttable. The controlling factor is the intention of the parties as evidenced not only by the terms of the contract, but by all the surrounding circumstances. ****

[7][8] The law outlined herein under the term 'American Doctrine' is better suited to the ordinary business practice in our jurisdiction than the old English rules, and consequently is the law followed in Idaho. In the application of the law, whether a contract of employment which does not contain a provision defining duration of employment is of indefinite duration (and thus terminable at will) or of fixed duration for a definite term (and thus not terminable at will) is ultimately a question of fact. See Edwards v. Morrison-Knudsen Company, 61 Wash.2d 593, 379 P.2d 735 (1963); Lasser v. Grunbaum Bros Furniture Co., supra. The trier of the facts as to this issue was the district judge. From his memorandum decision, it is clear that he applied the correct rule of law when he decided that the contract contemplated employment from calendar year to calendar year, after December 31, s962. The facts relied on by the trial court in reaching its conclusion may be summarized as follows:

A. The provision in the contract for an annual bonus as of December 31st of each year;

B. The provision in the contract for inventories as of June 30th and December 31st of each year;

C. The provision in the contract for an annual vacation of fourteen days per calendar year;

D. The provision in the contract to review the agreement as of December 31st each year;

E. The provision in the contract giving plaintiff the option to purchase an interest in the business subsequent to December 31, 1962;

F. The testimony of Thomas that defendant's attorney told him, at the time the contract was negotiated, that the agreement could be terminated only as of December 31st of any given year (except on the occurrence of certain specified events, none of which are relevant here);

G. The fact that the position was of some importance and not the type that would last for only a short period;

H. The fact that Thomas moved from Washington to Idaho to accept the position.

Taken individually, the facts relied on by the trial court do not of themselves show that the contract contemplated employment from calendar year to calendar year. But, taken in their totality (that is, considering all the circumstances) the facts of this case justify the finding of the trial court. As stated before, the question of whether an employment at will or an employment for a definite term was contemplated basically is a factual issue. We do not hold that as a matter of law, the facts in this case show that employment from calendar year to calendar year was contemplated; rather we hold that the trier of the facts did not err in reaching the factual determination under review. Findings of the trial court, supported by substantial, competent, though conflicting, evidence, will not be reversed on appeal.

Discussion points for Shenn v. Fair-Tex

This case is a good counterpoint to the Thomas case, and it shows a fairly typical result. Note that these cases are very fact intensive, but also note that a court can focus on specific facts and inferences (and ignore countervailing ones) to reach the result it desires. Maybe the difference is in the contract language, as this case has a definite ending of the agency relationship, while the Thomas case arguably did not.

Al SHENN, Plaintiff-Respondent,
v.
FAIR-TEX MILLS, INC. and Champagne Knitting Mills, Inc., Defendants-Appellants.

Supreme Court, Appellate Division, First Department.

Oct. 20, 1966.

PER CURIAM.

This appeal is from an order entered January 14, 1966, which denied defendants' motion to dismiss the complaint.

Plaintiff seeks damages for the amount of unpaid salary from April 9, 1965, the date of his alleged wrongful discharge, to October 31, 1965, the date plaintiff claims his contract of employment expired, and an accounting for commissions from November 1, 1964, to and including October 31, 1965.

The complaint alleges that plaintiff and defendant Fair-Tex Mills, Inc. (herein Fair-Tex) entered into a written contract of employment August 22, 1958, whereby plaintiff was employed by Fair-Tex as a salesman for a period up to and including October 31, 1959, at a weekly salary of $200 plus 1% Commission on sales. The agreement is attached to and made a part of the complaint. Plaintiff alleges that at the expiration of the term he continued in the employ of Fair-Tex 'without any new express agreement * * * on the same terms and conditions' and by reason thereof an agreement was created between the parties for plaintiff's employment for one year. The complaint continues that there were like annual renewals in 1961, 1962, 1963 and 1964 except that in 1964 his weekly salary was increased to $300 though the commission remained the same. After plaintiff's discharge on April 9, 1965, he commenced this action. He claims that in each year set forth, including the year involved in this suit, there was an implied renewal of his contract of employment for one year, and that he is entitled to salary from the date of discharge to October 31, 1965, and to commissions as stated.

[1][2] The general rule is that where one enters the employment of another for a fixed period at a stated annual salary, and the employment continues beyond that period, the presumption is continuance of the relationship for another year at the same salary (Adams v. Fitzpatrick, 125 N.Y. 124, 26 N.E. 143; Mason v. New York Produce Exchange, 127 App.Div. 282, 111 N.Y.S. 163, aff'd 196 N.Y. 548, 89 N.E. 1104). In the Adams case, the court quoted with approval from Story on Contracts '(b)ut when wages are payable at a stipulated period, as per week, or month, or half year, such circumstances, standing alone, indicate that the hiring is for such period' (Adams v. Fitzpatrick, supra, 125 N.Y. p. 129, 26 N.E. p. 145). Nor is Carter v. Bradlee, 245 App.Div. 49, 280 N.Y.S. 368, cited by respondent, to the contrary. In that case plaintiff was employed for a fixed period, at a stated annual salary payable monthly.

[3] In the case before us there is no provision for a fixed annual salary, merely a fixed weekly salary. The written agreement upon which plaintiff relies expressly provided that it could not be modified orally, that no oral agreement, understanding, etc., could bind Fair-Tex unless in writing. Such agreement by its terms expired October 31, 1959. The contention that the contract might be considered as 'equivalent to a general hiring, which means from year to year' (see Adams v. Fitzpatrick, supra, p. 127) is rejected both because of the absence of a fixed annual salary and because of the inclusion of a specified weekly salary only, plus commissions. Nothing is shown to warrant an inference of fact or implication of law that there was an annual contract.

The order appealed from should be reversed on the law, the motion to dismiss the complaint

granted, with costs and disbursements to appellants, but with leave to respondent, in the exercise of our discretion, to apply to Special Term for leave to serve an amended complaint if plaintiff is so advised, as to the existence of a contract for one year.

Order, entered on January 14, 1966, unanimously reversed, on the law, with $50 costs and disbursements to the appellants, and defendants' motion to dismiss the complaint granted, with $10 costs, with leave, however, to respondent, in the exercise of discretion, to apply at Special Term for leave to serve an amended complaint if respondent is so advised, as to the existence of a contract for one year.

All concur.

Discussion points for Pine River v. Mettille

This case amply demonstrates how difficult it is to fit traditional contract law doctrine (such as the need for mutual consideration existing at the time of contract modification) into employment agreements. So for now, forget about contract law, and ask yourself, is this result fair? Note how long a promise of "lifetime employment" really is. And consider the logical absurdity of the Court's ruling. What if Mettille were caught embezzling from the company?

PINE RIVER STATE BANK, Appellant,
v.
Richard E. METTILLE, Sr., Respondent.

Supreme Court of Minnesota.

April 29, 1983.

SIMONETT, Justice.

An employee hired for an indefinite, at-will term claims his discharge was in breach of his employment contract as subsequently modified by an employee handbook. A jury awarded the employee damages and the employer appeals from a denial of its post-trial motions. We affirm.

In early 1978 respondent Richard Mettille, then unemployed, nearly 48 years of age, married and living in St. Paul, sent his resume to the appellant Pine River State Bank. After an interview, the bank offered Mettille a job at a salary of $1,000 a month or $12,000 a year. Mettille accepted, moved to Pine River, and started work as a loan officer on April 10, 1978. The employment agreement was entirely oral. Nothing was said as to the position being

permanent or for any specific term. Mettille conceded that he felt free to leave the bank and to take a better job elsewhere if he wished to do so.

Mettille survived his 6-month probationary period and was shortly given the title of loan officer. His duties were to lend, procure insurance on loan collateral, file UCC financing statements, and prepare reports on student loans.

Late in 1978 the bank distributed to its employees, including Mettille, a printed Employee Handbook. The handbook had been drafted by the bank's president, E.A. Griffith, who relied heavily on a model handbook he had received at a recent seminar on employee relations sponsored by the Minnesota Bankers Association. The handbook contained information on the bank's employment policies, including such matters as working hours, time off, vacations, and sick leave. With respect to employee responsibilities, the handbook discussed such matters as punctuality, confidentiality of the work, personal appearance and conduct, and telephone courtesy. The handbook also contained sections on "job security" and "disciplinary policy." According to Griffith, the handbook was intended as a source of information for employees on bank procedures and as a guideline within the bank so that people would know when vacations would be available and how many days the employee would be allowed for vacations. Griffith testified that he never intended the handbook to become part of an employee's employment contract with the bank.

In April 1979 Mettille received his annual performance review and with it a 7% raise. Apparently, about this time he also took out a home improvement loan with the bank. The following September state bank officials conducted an unannounced examination of the Pine River State Bank, and after reviewing the loan portfolio, reported to Griffith that some "technical exceptions" existed, i.e., failures to comply with the applicable law and regulations. Griffith then ordered his own independent review of the 85 files noted in the examiner's report. This investigation disclosed that 58 of the 85 files contained "serious" technical exceptions and that Mettille was responsible for the serious technical exceptions in 57 of these 58 files. Thus, 28 files showed no vehicle certificate of title; 33 files showed no insurance covering the secured collateral; 4 files showed inadequate insurance; 6 files showed failure to record financing statements properly (although here the bank disagreed with the examiner that the financing statement filings had been improper); and 4 files showed expired financing statements. Characterization of these deficiencies as "serious" was made by the bank officers, because those errors created possible loss to the bank. They testified that the defective files involved loans totaling over $600,000.

Mettille was home ill at the time of the audit by the bank examiners and the subsequent review of the files by the bank. On September 28, 1979, Mettille returned to work. The president called Mettille into his office and fired him. The parties at this time did not review the list of technical exceptions. The disciplinary procedures outlined in the handbook were not followed, nor was the handbook even mentioned. Mettille was given 2 months' severance pay.

The reason for Mettille's dismissal and whether that dismissal was for good cause were

sharply contested. The bank claimed that the only reason given for the dismissal was the existence of loan errors, although excessive sick leave and a reduction in force were also factors. Mettille alleged that he was fired because of a personality dispute with his superiors. He argued that no problems were discovered in the course of previous bank examinations, that the exceptions in the 1979 audit were correctable and, in fact, were corrected within a month after he was fired. He disputed that the exceptions were "serious." There was also testimony that Mettille had never received any reprimands or complaints as to his performance prior to September 1979 and that he was loyal and "tried hard." At the time of trial Mettille was still unemployed.

In November 1980 the bank sued Mettille on two notes on which he was in default. Mettille counterclaimed, alleging that the bank had breached his contract of employment by dismissing him without cause and in violation of required disciplinary procedures. The case was tried in January 1982 and the jury found: (1) that the parties had a contract under which the defendant could not be terminated without good cause; (2) that the bank terminated Mettille without good cause; and (3) that Mettille sustained damages of $27,675. The trial judge deducted from the damages award the amount owed on the notes and ordered judgment in favor of Mettille and against the bank for $24,141.07. Both parties moved for a new trial. The bank's main argument was that Mettille's employment contract was at-will and that it was free to terminate him as it did. Mettille argued that he should have been permitted to show mental anguish to recover more damages. The trial judge denied both motions. Only the bank appeals.

The issues may be broadly stated: (1) Can a personnel handbook, distributed after employment begins, become part of an employee's contract of employment? (2) If so, are job security provisions in the handbook enforceable when the contract is of indefinite duration? and (3) In this case, was the employee's summary dismissal without following the job termination procedures of the handbook a breach of contract by the employer? Other issues to be discussed briefly relate to evidentiary rulings and damages.

I.

Whether a handbook can become part of the employment contract raises such issues of contract formation as offer and acceptance and consideration. We need first, however, to describe the Pine River State Bank's handbook. It contains, as we have said, statements on a variety of the bank's employment practices or policies, ranging from vacations and sick leave to personal conduct and appearance. Our inquiry here, however, concerns only the job security provisions. A section entitled "Performance Review" provides for at least an annual review of the employee's work. Another section entitled "Job Security" speaks in general, laudatory terms about the stability of jobs in banking. The key section, central to this case, is entitled "Disciplinary Policy." This section provides for what appears to be a three- stage procedure consisting of reprimands for the first and second "offense" and thereafter

suspension or discharge, but discharge only "for an employee whose conduct does not improve as a result of the previous action taken." The section concludes with the sentence, "In no instance will a person be discharged from employment without a review of the facts by the Executive Officer." [FN3]

> FN3. The section entitled "Disciplinary Policy" reads:
> In the interest of fairness to all employees the Company establishes reasonable standards of conduct for all employees to follow in their employment at Pine River State Bank. These standards are not intended to place unreasonable restrictions on you but are considered necessary for us to conduct our business in an orderly and efficient manner.
> If an employee has violated a company policy, the following procedure will apply:
> 1. An oral reprimand by the immediate supervisor for the first offense, with a written notice sent to the Executive Vice President.
> 2. A written reprimand for the second offense.
> 3. A written reprimand and a meeting with the Executive Vice President and possible suspension from work without pay for five days.
> 4. Discharge from employment for an employee whose conduct does not improve as a result of the previous action taken.
> In no instance will a person be discharged from employment without a review of the facts by the Executive Officer.

[1][2][3] Generally speaking, a promise of employment on particular terms of unspecified duration, if in form an offer, and if accepted by the employee, may create a binding unilateral contract. The offer must be definite in form and must be communicated to the offeree. Whether a proposal is meant to be an offer for a unilateral contract is determined by the outward manifestations of the parties, not by their subjective intentions. Cederstrand v. Lutheran Brotherhood, 263 Minn. 520, 532, 117 N.W.2d 213, 221 (1962). An employer's general statements of policy are no more than that and do not meet the contractual requirements for an offer. Thus, in Degen v. Investors Diversified Services, Inc., 260 Minn. 424, 110 N.W.2d 863 (1961), where the employee was told he had a great future with the company and to consider his job as a "career situation," we said these statements did not constitute an offer for a lifetime employment contract.

[4] If the handbook language constitutes an offer, and the offer has been communicated by dissemination of the handbook to the employee, the next question is whether there has been an acceptance of the offer and consideration furnished for its enforceability. In the case of unilateral contracts for employment, where an at-will employee retains employment with knowledge of new or changed conditions, the new or changed conditions may become a contractual obligation. In this manner, an original employment contract may be modified or replaced by a subsequent unilateral contract. The employee's retention of employment constitutes acceptance of the offer of a unilateral contract; by continuing to stay on the job, although free to leave, the employee supplies the necessary consideration for the offer.

An employer's offer of a unilateral contract may very well appear in a personnel handbook as the employer's response to the practical problem of transactional costs. Given these costs, an employer, such as the bank here, may prefer not to write a separate contract with each individual employee. See Note, Protecting At Will Employees against Wrongful Discharge: The Duty to Terminate Only in Good Faith, 93 Harv.L.Rev. 1816, 1830 (1980). By preparing and distributing its handbook, the employer chooses, in essence, either to implement or modify its existing contracts with all employees covered by the handbook. Further, we do not think that applying the unilateral contract doctrine to personnel handbooks unduly circumscribes the employer's discretion. Unilateral contract modification of the employment contract may be a repetitive process. Language in the handbook itself may reserve discretion to the employer in certain matters or reserve the right to amend or modify the handbook provisions.

[5] We conclude, therefore, that personnel handbook provisions, if they meet the requirements for formation of a unilateral contract, may become enforceable as part of the original employment contract.

II.

The next issue is whether handbook provisions relating to job security require special treatment, i.e., whether they are an exception to the general rule just discussed. Put more precisely, the question is whether, in an at-will hiring, the job security provisions in a subsequently adopted employee handbook are enforceable. On this issue, the courts are split, see Sherman v. St. Barnabas Hospital, 535 F.Supp. 564, 573 (S.D.N.Y.1982) (citing cases), and our own case law is unclear.

[6][7] Where the hiring is for an indefinite term, as in this case, the employment is said to be "at-will." This means that the employer can summarily dismiss the employee for any reason or no reason, and that the employee, on the other hand, is under no obligation to remain on the job. See Cederstrand v. Lutheran Brotherhood, 263 Minn. 520, 532, 117 N.W.2d 213, 221 (1962). Nor will a claim by the employee that he or she was promised "permanent" or "lifetime" employment change the at-will nature of the hiring, Skagerberg v. Blandin Paper Co., 197 Minn. 291, 266 N.W. 872 (1936), at least not in the absence of some kind of additional consideration supplied by the employee which is uncharacteristic of the employment relationship itself. Bussard v. College of St. Thomas, 294 Minn. 215, 200 N.W.2d 155 (1972).

Here the employee does not claim, nor could he, that he was promised "permanent" employment. The law is hesitant to impose this burdensome obligation on an employer in the absence of an explicit promise to that effect. See Degen v. IDS, Inc., 260 Minn. 424, 428-29, 110 N.W.2d 863, 866- 67 (1963). Instead, the respondent employee is claiming that his job termination was wrongful because the job security provisions set out in the employee handbook were not followed. The appellant bank, relying on the "at- will" doctrine as expressed in our cases beginning with Skagerberg, argues that without additional consideration, the job security provisions are not enforceable. Other cases cited by the bank

hold that job termination restrictions, even if part of a contract for an indefinite duration from the outset, can never be enforceable.

This court did say, by way of dictum in Cederstrand, that parties to a contract for an indefinite duration might transform the contract into one where the employee will not be dismissed without cause, and we observed, "This is not to say that such a contract would be unenforceable." 263 Minn. at 536, 117 N.W.2d at 223. We need, therefore, to examine the three reasons given for the unenforceability of job termination restrictions in an employment contract of indefinite duration: (1) the at-will rule takes precedence over any such restrictions; (2) the restrictions ordinarily lack the requisite additional consideration; and (3) mutuality of obligation is missing.

[8][9] The first argument, that because the contract specifies no duration the parties did not intend any job termination restrictions to be binding, is without merit. The argument misconstrues the at-will rule, which is only a rule of contract construction, as a rule imposing substantive limits to the formation of a contract. See Restatement (Second) of Agency, § 442, comment a (inference that employment is at-will may be rebutted by specific terms of the agreement). The general rule is that contracts for a specified duration can nonetheless be terminated during the period of the contract if the employer has good cause. Thomsen v. Independent School District No.91, 309 Minn. 391, 244 N.W.2d 282 (1976). When a contract is for an indefinite duration, the duration is not set, and a corollary is that either party may then terminate it at any time for any reason. Further, if the contract purports to establish "permanent employment," this will be interpreted as a contract for an indefinite period, and hence also at-will. Thus, in Bussard v. College of St. Thomas, 294 Minn. 215, 223, 200 N.W.2d 155, 161 (1972), we said, "[T]he somewhat arbitrary rule of most jurisdictions that a contract for 'permanent employment' will be construed to be terminable at the will of either party * * * is arguably too mechanical an answer to the more basic issue of ascertaining the real intent of the parties" (emphasis added). See also Note, Employment Contracts of Unspecified Duration, 42 Colum.L.Rev. 107, 120-21 (1942).
[10] The cases which reason that the at-will rule takes precedence over even explicit job termination restraints, simply because the contract is of indefinite duration, misapply the at-will rule of construction as a rule of substantive limitation on contract formation. . It should not be necessary for an employee to prove a contract is of "permanent" employment or for a specified term in order to avoid summary dismissal if the parties have agreed otherwise. There is no reason why the at-will presumption needs to be construed as a limit on the parties' freedom to contract. If the parties choose to provide in their employment contract of an indefinite duration for provisions of job security, they should be able to do so.

The second argument against enforceability is, at first glance, more troublesome in view of our case law. The argument is that a provision for job security in a contract of indefinite duration, whether initially promised or subsequently added, is not binding without additional, independent considerations other than services to be performed. In Skagerberg, we noted the general rule that when an employee purchases "permanent" employment with a valuable consideration that is other than and in addition to his services, the employment will be held to be continuous and to extend as long as the employee's work is adequate and there is work to

be done. This rule makes sense as a presumption in construing contracts. Where the "permanent" employment is purchased with additional consideration, we have better reason to believe that the parties, in discussing "permanent" employment, were referring to lifetime employment and were not, instead, simply making a distinction between temporary or seasonal employment and employment which is steady or continuing although nevertheless terminable at will

To say that a job security provision in a contract of indefinite duration is never enforceable without additional consideration is to misconstrue the additional consideration exception recognized in Skagerberg. The requirement of additional consideration, like the at-will rule itself, is more a rule of construction than of substance, and it does not preclude the parties, if they make clear their intent to do so, from agreeing that the employment will not be terminable by the employer except pursuant to their agreement, even though no consideration other than services to be performed is expected by the employer or promised by the employee

. While language in some of our cases may suggest otherwise, our discussion of additional, independent consideration in Skagerberg, Cederstrand, Bussard and Degen was primarily in the context of the employee attempting to avoid a discharge without cause by proving (albeit unsuccessfully in those cases) "lifetime" or "permanent" employment. But none of our cases purport to hold that additional, independent consideration is the exclusive means for creating an enforceable job security provision in a contract of indefinite duration. Handbook provisions relating to such matters as bonuses, severance pay and commission rates are enforced without the need for additional, new consideration beyond the services to be performed. Thus, the consideration here for the job security provision is Mettille's continued performance despite his freedom to leave. As such, the job security provisions are enforceable.

Finally, the third argument is that job security provisions lack enforceability because mutuality of obligation is lacking. Since under a contract of indefinite duration the employee remains free to go elsewhere, why should the employer be bound to its promise not to terminate unless for cause or unless certain procedures are followed? The demand for mutuality of obligation, although appealing in its symmetry, is simply a species of the forbidden inquiry into the adequacy of consideration, an inquiry in which this court has, by and large, refused to engage. See Estrada v. Hanson, 215 Minn. 353, 10 N.W.2d 223 (1943). "If the requirement of consideration is met, there is no additional requirement of * * * equivalence in the values exchanged; or * * * 'mutuality of obligation'." Restatement (Second) of Contracts § 79 (1981). We see no merit in the lack of mutuality argument; as we pointed out in Cardinal Consulting Co. v. Circo Resorts, 297 N.W.2d 260, 266 (Minn.1980), the concept of mutuality in contract law has been widely discredited and the right of one party to terminate a contract at will does not invalidate the contract

To summarize, we do not find the reasons advanced for the unenforceability of job security provisions in an at-will hiring to be persuasive. We hold, therefore, that where an employment contract is for an indefinite duration, such indefiniteness by itself does not

preclude handbook provisions on job security from being enforceable, whether they are proffered at the time of the original hiring or later, when the parties have agreed to be bound thereby.

Not every utterance of an employer is binding. It remains true that "the employer's prerogative to make independent, good faith judgments about employees is important in our free enterprise system." Blades, Employment at Will vs. Individual Freedom: On Limiting the Abusive Exercise of Employer Power, 67 Colum.L.Rev. 1404, 1428 (1967). Properly applied, we think that the unilateral contract modification analysis appropriately accommodates the interests of the employee and the employer.

III.

[11] We now apply the principles discussed in the first two sections to the Pine River State Bank's handbook. First of all, it should be noted that this is a breach of contract case; we are determining if there was a contract, what were its terms, and was it breached. We are not dealing with a discharge that is retaliatory, in bad faith or abusive. Nor do we have before us the question, suggested by the employee here, whether public policy should constrain an "at-will" firing. See generally, Annot., Modern Status of Rule that Employer May Discharge At-will Employee for Any Reason, 12 A.L.R. 4th 544 (1982).

We do not think that the language in the handbook section entitled "Job Security" constitutes any offer. It is no more than a general statement of policy. Cf. Degen v. IDS, supra (invitation to consider job as a "career situation" not an offer). The provisions of the handbook section entitled "Disciplinary Policy" do, however, set out in definite language an offer of a unilateral contract for procedures to be followed in job termination. The handbook states that "[i]f an employee has violated a company policy, the following procedure will apply." This offer was communicated to the employees, including respondent. Mettille's continued performance of his duties despite his freedom to quit constitutes an acceptance of the bank's offer and affords the necessary consideration for that offer, with the bank gaining the advantages of a more stable and, presumably, more productive work force. [FN5] Here the jury could find, as it did, that the handbook provisions on disciplinary procedures had become part of respondent Mettille's employment contract, thus restricting the bank's right to terminate Mettille at will.

But in what way do the handbook procedures restrict the bank's right to discharge Mettille at will? Although the disciplinary procedures were admittedly not followed, the trial court apparently construed the handbook to allow summary dismissal for good cause. The jury was asked, in the verdict form, to find if Mettille's dismissal had been "without good cause," and, in instructions to the jury, the jury was told (apparently without objection) that good cause consisted of a breach of the standards of job performance established and uniformly applied by the bank. Whether, assuming a good cause requirement, this was a proper definition of good cause has not been made an issue, and we need not decide it. Nor need we decide if summary dismissal for good cause can be implied or inferred in Mettille's contract or, on the other hand, if summary good cause termination is precluded by the

handbook, since the issues were not raised and, in any event, are mooted by the jury's finding of lack of good cause.

It is enough for disposition of this case that the disciplinary provision was applicable and enforceable, and that it was not followed. The bank's only excuse for not following the disciplinary procedures was that it did not have to do so, since Mettille was an "at-will" employee. This argument is without merit, since we have found the procedures to be contractually binding. Had the procedural disciplinary steps been honored, Mettille might have corrected his deficiencies to the bank's satisfaction and have kept his job. The bank did not assert otherwise and there was evidence that the loan file deficiencies were rather easily correctable and that Mettille was amenable to correction. Therefore, we hold that as a matter of law the bank breached its employment contract with Mettille by not affording him the job termination procedures of its handbook, resulting in Mettille's unemployment.

IV.

The appellant bank also contends that the evidence does not support the jury's finding of lack of good cause, that the trial court erred on several evidentiary rulings, and that damages should not include lost wages to date of trial. We find no reversible error.

[12] There was evidence that Mettille's work was unsatisfactory; but there was also evidence of a personality conflict with a supervisor, that Mettille's errors were not serious and were easily correctable, and that other officers' errors were ignored or forgiven. The factual dispute was for the jury.

[13][14] While the trial court refused to allow into evidence the model handbook from which Griffith, the bank president, drafted his own handbook, the trial court did allow the employee's counsel to cross-examine Griffith about provisions in the model handbook. In particular, counsel was permitted to bring out that the model handbook's annotations contained language cautioning the bank executives that "your handbook constitutes your 'contract' with your employees." It would have been better not to have admitted this evidence. Since, however, the bank's purpose in drafting and issuing its own handbook was at issue, under the law of the case, and since Griffith said he relied on the model handbook in drafting his own, we cannot say that the allowance of this testimony so affected the results of the trial as to be prejudicial error. Poppenhagen v. Sornsin Construction Co., 300 Minn. 73, 79-80, 220 N.W.2d 281, 285-86 (1974). The bank also complains that the trial court refused to let it show why errors committed by other loan officers were not serious. The trial court did, however, allow explanations of several of these errors and then sustained an objection because testimony of further errors was repetitious and irrelevant. It seems to us that the bank was given an opportunity to explain generally why these errors of other officers were not as serious as Mettille's, and we cannot say the trial court abused its discretion in so ruling.

[15] The bank also claims that damages should not include lost wages to date of trial. It may well be that had the bank complied with its handbook procedures it could, in due course,

have terminated Mettille, but the fact is that termination did not occur in this way. "The measure of damages for breach of an employment contract is the compensation which an employee who has been wrongfully discharged would have received had the contract been carried out according to its terms." Zeller v. Prior Lake Public Schools, 259 Minn. 487, 493, 108 N.W.2d 602, 606 (1961). On this record it is not shown that, if the progressive disciplinary steps had been followed, with the employee having been warned and given an opportunity to mend his ways, he would not have retained his employment to date of trial. We cannot say that the evidence does not sustain the damages award. Implicit in this award of lost wages to the date of trial is our recognition that the bank's disciplinary procedures confer some degree of substantive protection to the employee. Without that, the disciplinary procedures here would be virtually meaningless.

Finally, respondent Mettille argues that he should have a limited new trial to show additional damages for mental anguish. The issue is not before us, since respondent filed no notice of review. Minn.R.Civ.App.P. 106.

Affirmed.

Discussion points for Monge v. Beebe Rubber

This was one of the first cases to recognize the fact that the “at-will” doctrine of employment in reality favored the employer, to the detriment of the employee. So the courts began to carve out exceptions to the at-will doctrine, and allowed employees to sue in tort or contract when the reasons for dismissal violated generally accepted norms of civilized behavior. Is it important that the personnel manager of the Beebe rubber Company was aware of and did nothing to help Monge? Note what she gets for damages – would she have done better suing under a tort theory?

Olga MONGE
v.
BEEBE RUBBER COMPANY.

Supreme Court of New Hampshire.

Feb. 28, 1974.

LAMPRON, Justice.

Action of assumpsit to recover damages for an alleged breach of an oral contract of employment. Plaintiff was hired in September 1968 at wages of $1.84 per hour to work on a conversion machine in defendant's factory and was allegedly told that if she worked well she would get better jobs with better pay. Plaintiff claims that she was harassed by her foreman because she refused to go out with him and that his hostility, condoned if not shared by

defendant's personnel manager, ultimately resulted in her being fired. Trial by jury resulted in a verdict for the plaintiff in the amount of $2,500. Defendant's objections to denial of its motion to set aside the verdict, for judgment n.o.v. and to various evidentiary and substantive rulings were reserved and transferred by Loughlin, J.

Plaintiff, before coming to this country in 1964, was a school teacher in Costa Rica. She came to New Hampshire in 1965, and was attending college from 7 to 10 o'clock five nights a week to qualify to teach here. She used the money she earned from her employment with the defendant on the night shift beginning at 11 o'clock for her college expenses. She was employed by the defendant in a union shop and joined the union as required after her employment, thereby becoming subject to the seniority and other rules of the union contract. After working without incident on the conversion machine for about three months, she applied to fill an opening on a press machine at higher wages. She testified that her foreman told her that if she wanted the job she would have to be 'nice'. She got the job at $2.79 per hour and claims that her foreman then asked her to go out with him, which she refused to do because she was married and had three children. After working on the press machine for about three weeks, the machine was shut down and she was put on a degreaser machine at $1.99 per hour. Her overtime was taken away, although no one else's was. She testified that when she told her foreman she needed overtime money he told her she could sweep floors. She agreed to do this and claims the foreman also made her clean the washrooms and ridiculed her.

On July 23, 1969, she ran out of boxes for her machine. When she reported this to the foreman, he told her to make her own, which she claims she could not do while keeping up her production. When she spoke to the union steward about it, the foreman ordered her back to her machine and fired her at 2:00 o'clock in the morning when she refused to comply with his order. After complaining to the union, she was reinstated with a warning.

On Saturday, July 26, she called the personnel manager at his home to tell him that on advice of her lawyer she was calling to say she would not be in on Sunday because of illness. She also called in on Sunday, July 27, to say she would not be able to work because of illness and would enter the hospital the next day. The company's records show her absent with excuse on July 28 through 31.

She testified that when she reported for work at 11:00 p.m. on the night of August 4, the personnel manager was there, although she had never seen him at the plant before at that time of day, and that he asked her 'What kind of face I got to come back?' After being at work for two and one-half hours that same night, she was found unconscious in the ladies' room and was taken to the hospital. The company records show her hospitalized for the next four days including August 8. Nothing is shown in these records regarding the next two days but they show her absent on August 11, 12 and 13 without having called in. On August 13, 1969, the personnel manager sent her a letter stating that since she failed to report for work for three consecutive days without notification to the company, she was 'deemed a voluntary quit'.

There was evidence both from the plaintiff and the foreman that she did in fact call in on

Sunday, August 10, to report that she was still sick. There was also evidence that some time after defendant had refused her foreman's advances, the personnel manager had visited her at home about some annoying telephone calls she was receiving. In the course of their conversation, he told her he knew her foreman used his position to force his attentions on the female employees under his authority and he asked her 'not to make trouble.'

[1] Plaintiff sued for breach of an employment contract for an indefinite period of time. The employer has long ruled the workplace with an iron hand by reason of the prevailing common-law rule that such a hiring is presumed to be at will and terminable at any time by either party. When asked to reexamine the long- standing common-law rule of property based on an ancient feudal system which fostered in a tenancy at will a relationship heavily weighted in favor of the landlord, this court did not hesitate to modify that rule to conform to modern circumstances.

The law governing the relations between employer and employee has similarly evolved over the years to reflect changing legal, social and economic conditions. In this area '(w)e are in the midst of a period in which the pot boils the hardest and in the process of change the fastest.' Id. Although many of these changes have resulted from the activity and influence of labor unions, the courts cannot ignore the new climate prevailing generally in the relationship of employer and employee.

[2][3] In all employment contracts, whether at will or for a definite term, the employer's interest in running his business as he sees fit must be balanced against the interest of the employee in maintaining his employment, and the public's interest in maintaining a proper balance between the two. We hold that a termination by the employer of a contract of employment at will which is motivated by bad faith or malice or based on retaliation is not the best interest of the economic system or the public good and constitutes a breach of the employment contract. Such a rule affords the employee a certain stability of employment and does not interfere with the employer's normal exercise of his right to discharge, which is necessary to permit him to operate his business efficiently and profitably.

[6][7] The jury could draw the not-so-subtle inference from the evidence before it that the hostility of defendant's foreman and connivance of the personnel manager resulted in the letter of August 13, 1969, and that that letter was in effect a discharge. The foreman's overtures and the capricious firing at 2:00 a.m., the seeming manipulation of job assignments, and the apparent connivance of the personnel manager in this course of events all support the jury's conclusion that the dismissal was maliciously motivated.

[8][9] In our opinion, however, the verdict includes elements of damage not properly recoverable. The plaintiff lost 20 weeks employment at an average pay of $70.81 per week. This would account for $1,416.20 of the verdict, leaving $1,083.80 attributable to mental suffering. Such damages are not generally recoverable in a contract action. They could not be found in this case to have resulted from the discharge. Defendant had been having difficulty with her husband and had been receiving annoying telephone calls which upset her. She presented no medical testimony. Although she alleged that her discharge caused her

mental suffering, her difficulties all preceded the discharge. We therefore remand the case for a new trial unless the plaintiff consents to a reduction of the verdict by the amount of $1,083.80.

Remanded

Discussion points for Maddaloni v. Western Bus Lines

The doctrine of employment at will used to mean that you could get fired for any reason, and have no cause of action for being fired. But as you have seen, certain firings are based on facts so egregious as to require some form of remedy. In Monge, it was sex. In this case, it was greed. But note that the remedy is hardly compensatory, or stated another way, the punishment does not fit the crime. What incentive (or rather, disincentive) will discourage the employer from trying to screw over employees in the future?

Joseph MADDALONI
v.
WESTERN MASS. BUS LINES, INC.

Supreme Judicial Court of Massachusetts,
Hampden.

Decided July 27, 1982.

We consider whether an employee, serving under a contract of employment terminable at will, may recover for lost wages and fringe benefits in addition to commissions related to past services, when the employee is discharged in bad faith. After a trial in the Superior Court, the jury returned a verdict for the plaintiff on his claim that he was discharged in "bad faith." By interrogatories accompanying the general verdict, see note 6, infra, the jury determined that the plaintiff would have earned $61,000 in commissions for past services. The judge also submitted the issue of damages to the jury on a quantum meruit theory. The jury determined that on a quantum meruit basis, the plaintiff was entitled to damages in the amount of $28,000.

The judge entered a judgment on the quantum meruit theory. Both parties appealed. The Appeals Court concluded that the plaintiff was entitled to $61,000 in lost commissions, and that the issue of damages for lost wages and fringe benefits should have been submitted to the jury. For the reasons set forth in this opinion, we agree with the Appeals Court that the plaintiff was entitled to $61,000 in damages for lost commissions. A majority conclude that the judge correctly declined to allow the jury to consider the issue of the plaintiff's damages

for lost wages and fringe benefits.

We summarize the evidence most favorable to the plaintiff and resolve in his favor all reasonable inferences that could be drawn from that evidence. The plaintiff was hired by the defendant, Western Mass. Bus Lines, Inc. (WMBL), as general manager in April, 1964. At that time, the president of WMBL, John F. Fortier, was interested in obtaining a grant of interstate charter rights from the Interstate Commerce Commission (ICC). The plaintiff had considerable experience appearing before the Massachusetts Department of Public Utilities (DPU) and the ICC, in order to secure new operating authorities. Besides dealing with the ICC, the plaintiff's duties as general manager of WMBL included arranging the operating schedule, soliciting, advertising for, and quoting prices on charter trips, preparing the billing, checking employee time-cards, and generally overseeing the entire operation.

[1] About six weeks after the plaintiff was hired, the plaintiff drafted, and the parties executed, a contract setting forth the terms of his employment. [FN2] No definite term of employment was set out in the contract, and thus the contract was terminable at will. The contract provided that the plaintiff would receive a salary of $120 a week plus Blue Cross and Blue Shield insurance benefits. Additional weekly compensation was to be provided at the discretion of the defendant. The contract also provided that after the ICC granted the defendant interstate charter rights, the plaintiff would receive a five per cent commission on the special and charter revenues of the defendant as reported to the DPU and the ICC. The commission was to be paid to the plaintiff on the fifteenth of each month.

> FN2. The contract provides in pertinent part: "For Good and Valuable Consideration and in consideration of mutual covenants and agreements contained herein, the parties hereto agree as follows:
> "1. That the Employer shall engage the services of the Employee as General Manager.
> "2. The Employee agrees to work for the Employer in an industrious and capable manner.
> "3. The Employer agrees to compensate the Employee as follows:
> "a. The same as presently paid, namely $120.00 per week. In addition, Blue Cross and Blue Shield monthly insurance cost for the Employee will be paid by the Employer.
> "b. Any additional weekly compensation to that mentioned in paragraph 3a will rest with the Employer.
> "c. Immediately after the grant of Inter-state Charter Rights to the Employer by the Interstate Commerce Commission, the Employer further agrees to compensate the Employee, at the rate of 5% commission of the total Special and Charter revenue income as reported to the Massachusetts Department of Public Utilities and the Interstate Commerce Commission. This 5% commission compensation will be paid to the Employee by the Employer each month, namely, on the 15th day of each month, of the total Special and Charter revenue income received by the Employer for the past month."

The defendant obtained interstate charter rights in June, 1966, and the plaintiff received the

commissions called for in the contract for five and one-half months. In November, 1966, the grant was revoked after the United States District Court for the District of Massachusetts held that the ICC had erred in granting the interstate charter rights to the defendant. The plaintiff's commissions under the contract ceased thereafter.

In September, 1970, Mario Cantalini bought WMBL and became its president. The plaintiff remained as general manager. In October or November, 1970, the plaintiff met with Cantalini and his attorney to discuss the need for obtaining interstate charter rights. Cantalini then took out the plaintiff's employment contract and handed it to his attorney to read. The attorney read it and returned it to Cantalini, stating that "this would be all right with the company."

Sometime later the plaintiff and Cantalini sought to obtain from the ICC a grant of interstate charter rights. On October 1, 1973, the ICC again granted interstate charter rights to the defendant. About a week later, the plaintiff told Cantalini, "[N]ow that we [have] received the operating authority from the I.C.C., ... that portion of my agreement on the commission [is] now in effect." Cantalini replied that "he didn't understand it to be that way, but that ... he would check the agreement." On November 14, 1973, a day before the plaintiff's commissions for October became payable under the contract, Cantalini telephoned the plaintiff and asked him if he had to pay the five per cent commission for the month of October. The plaintiff responded, "[Y]es, that was in accordance with the agreement he [Cantalini] had accepted." Cantalini replied "that it was a lot of money, that it was cream off the top." Cantalini sought to postpone the discussion, but the plaintiff stated, "We are not going to talk about it later because tomorrow is the day that I am supposed to be paid ...." The last thing Cantalini said before he hung up was "all right."

In addition to the payment for October, the plaintiff received commissions for November and December. On January 19, 1974, Cantalini discharged the plaintiff from his employment. Cantalini stated that he was discharging the plaintiff because the plaintiff was responsible for the poor profit statement which Cantalini claimed was inhibiting his attempt to sell the company. "[B]esides," stated Cantalini, "you wanted to get paid the commission under the agreement you made with Jack [Fortier]." Thereafter, the plaintiff filed a complaint in the Superior Court alleging that the defendant's termination of the contract was based on a bad faith attempt to avoid paying the plaintiff his commissions.

1. Liability of defendant for breach of contract. The defendant claims that there was insufficient evidence to support the jury's verdict, and that the judge should have granted its motion for a directed verdict or judgment notwithstanding the verdict. The Appeals Court concluded that "[f]rom the evidence as set out above, the jury could have found facts which bring this case within Fortune." We agree.

In Fortune, we held "that an employer may not in every instance terminate without liability an employment contract terminable at will.... [W]e upheld the plaintiff's claim for future commissions based on past service when the employer terminated the plaintiff's employment without good cause and for the purpose of retaining the sales commissions for itself." In that

case we declined to "speculate as to whether [a] good faith requirement is implicit in every contract for employment at will." We believe that the plaintiff in this case, like the plaintiff in Fortune, could reasonably expect that his employment would not be terminated by the defendant in order to deny him commissions.

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There is no merit to the defendant's claim that the plaintiff's interest in the commissions is distinguishable from the interest of the plaintiff in the Fortune case. The defendant claims that the plaintiff's right to commissions only vested each month that the plaintiff was employed, and, therefore, there were no commissions due the plaintiff. Contrary to the defendant's argument that the commissions payable in Fortune are distinguishable because they had already vested, in that case we stated, it is "clear that under the express terms of the contract Fortune ... received all the bonus commissions to which he [was] entitled." Fortune, supra at 101, 364 N.E.2d 1251.

In this case the plaintiff used his skills, knowledge, and experience to assist the defendant in obtaining interstate charter rights from the ICC. The contract provided for compensation in the form of commissions if the charter rights were secured. The plaintiff is entitled to receive the commissions, and a discharge to avoid payment of commissions is a discharge in bad faith. An employer may not discharge an employee in order to avoid the payment of commissions or to reap for itself financial benefits due its employee. Id. at 105, 364 N.E.2d 1251.

In his appeal, the plaintiff claims that the jury should have been allowed to consider the issue of damages for lost wages and fringe benefits. In Fortune v. National Cash Register Co., 373 Mass. 96, 101 n.7, 364 N.E.2d 1251 (1977), we left open the question whether such damages "might be justified in cases of bad faith termination." A majority of the court believe that the judge properly refused to instruct the jury on the issue of lost wages and fringe benefits unrelated to past services.

We therefore vacate the judgment and remand the case to the Superior Court for entry of judgment for the plaintiff in accordance with this opinion.

So ordered.

Discussion points for Siles v. Travenol Labs

The historical development of the at-will employment doctrine has come a long way in a short time. Borrowing again from contract law, Massachusetts now implies a covenant of good faith and fair dealing in employment contracts. How meaningful this is in reality is something which must be considered. Just because you don’t have a good reason for firing somebody, it does not mean you’ve violated the covenant of good faith and fair dealing.

Who has the burden of proof in these cases, and how important is that?

Richard J. SILES
v.
TRAVENOL LABORATORIES, INC.

Appeals Court of Massachusetts, Essex.

Decided March 30, 1982.

The plaintiff, Richard J. Siles, brought suit against his former employer, the defendant Travenol Laboratories, Inc., for wrongful termination of employment. Following a jury verdict for the plaintiff which awarded Siles $250,000 in damages, the Superior Court judge allowed the defendant's motion for judgment notwithstanding the verdict. We hold that the judge was correct in concluding that the evidence was insufficient to support a finding that the defendant's termination of the plaintiff's at-will employment was the result of "bad faith," and affirm the judgment.

We review the evidence in the light most favorable to the plaintiff, and resolve in his favor all reasonable inferences that could be drawn from that evidence. In October, 1977, Siles was hired to work for Travenol as a respiratory therapy specialist at a starting salary of $14,500 per year plus commissions and other employment benefits. The employment agreement was terminable at will by either party. Siles participated in a two-week training program and was assigned to sell various items to hospitals in the southern region of New England.

Siles's immediate supervisor was Howard Small, the person who hired him. Once or twice a month for about two or three days at a time Small would work with Siles, making calls with him to customers and evaluating Siles's performance. Approximately five months after beginning employment, Siles, accompanied by Small, went to the Miriam Hospital on a routine sales call. At the hospital, a verbal confrontation occurred between Siles, Small and the hospital delivery receiver, Stephen Tremblay, apparently concerning delivery truck problems. Tremblay reported the incident to his superiors. Both the assistant purchasing agent and the director of purchasing for the hospital spoke with Siles and Small. After the incident, Small orally rebuked Siles for his conduct.

The director of purchasing at the hospital, Robert Hoag, subsequently wrote to Travenol to complain about the conduct of Siles and Small. He demanded an apology and excluded Siles and Small from conducting business activities at the hospital for a one-year period. The letter also indicated that the hospital was reviewing all existing purchase agreements with Travenol in order to determine the feasibility of obtaining an alternative supplier. Small called Siles at his home and asked him to write an apology to Hoag and to Tremblay. Small

also informed Siles that he would be coming to Boston one week later to give Siles his six-month review.

Siles met Small at the airport the following week. At that meeting, Small informed Siles that he was unhappy with Siles's sales performance and that Siles should consider himself fired. Siles had not been advised prior to that meeting that Travenol was considering the termination of his employment. At the time of his discharge, Siles had earned about $17,000 for the six-month period of employment with Travenol.

Vito Manon, the national sales representative of the respiratory division of Travenol, testified that he had conducted an investigation of the Miriam Hospital incident. Small had recommended that Siles be put on probation; however, Manon decided to fire Siles in order to preserve customer good will. According to Manon, factors such as the lack of new business development and complaints concerning Sile's attitude contributed to his decision. Manon also testified that Travenol pays commissions to the salesmen assigned to particular territories on goods sold by them, regardless of who first brought in the account. Thus, Siles was entitled to commissions from the first day he was assigned to a sales territory, even though those commissions were the result of customer contacts made by previous salesmen in that territory. Similarly, any subsequent commissions resulting from accounts originated by Siles would, after the termination of Siles's employment, be paid to Siles's successor.

After his termination, Siles was unable to find new employment in the medical sales field, and eventually obtained employment as an electronic parts salesman, earning approximately $400 per week. Siles's wife testified, over the objection of Travenol, that she has been forced to return to full-time work for financial reasons, even though such employment was against her doctor's orders.

Based upon the evidence put forth, Siles alleged that Travenol had wrongfully terminated his employment. In particular, Siles claimed that Small had deceived or misled representatives of Travenol concerning the Miriam Hospital incident so as to protect his own self-interest at the expense of Siles's job. Furthermore, Siles alleged that, by refusing to allow Siles to resign, and by refusing to give Siles any references, Travenol prevented Siles from getting another job in the health care field.

After trial, the jury returned a verdict in favor of Siles and assessed damages against the defendant Travenol in the amount of $250,000. The trial judge subsequently allowed the defendant's motion for judgment notwithstanding the verdict, ruling that "the evidence taken in a light most favorable to the plaintiff was insufficient as a matter of law to warrant a finding that the defendant's termination of the plaintiff's employment was the result of bad faith." The judge reserved a final ruling on the defendant's motion for a new trial, noting in his "Conclusion and Order" that "(s)hould an appeal result in a decision that the evidence warranted a finding for the plaintiff, I would then order a remittitur or order a new trial on the issue of damages only." Siles appeals from the judgment. We hold that the judge correctly allowed the defendant's motion for judgment notwithstanding the verdict on the plaintiff's claim that Travenol terminated his employment in bad faith.

[1][2][3] Massachusetts now recognizes that an employer may not in every instance terminate without liability an employment contract which is terminable at will. As was stated in the Fortune case, an employment at will contract, in the circumstances described there, "contains an implied covenant of good faith and fair dealing, and a termination not made in good faith constitutes a breach of the contract." Fortune, 373 Mass. at 101, 364 N.E.2d 1251. However, the mere absence of good cause to discharge an employee, while tending to negate the existence of good faith, does not by itself give rise to an enforceable claim for breach of a condition of good faith and fair dealing. Rather, our cases indicate that a plaintiff generally does not have an enforceable claim for a "bad faith" termination of an at-will employment contract unless he can show that: (1) the discharge involved an intent of the defendant to benefit financially at the plaintiff's expense, such as for the purpose of retaining for itself sales commissions or pension benefits which would otherwise be due to the plaintiff, or (2) that the employer's reason for the discharge was contrary to public policy.

[4] There is no evidence in this case to suggest that Travenol discharged Siles so that it could retain certain sales commissions for itself, or otherwise benefit financially at Siles's expense. Indeed, the evidence made clear that Travenol would not keep for itself the commissions which would become due on sales accounts originated by Siles, but instead would pay those commissions to Siles's successor. Contrast Fortune v. National Cash Register Co., 373 Mass. at 105, 364 N.E.2d 1251.

Nor is this a case in which public policy considerations justify the imposition of liability on the employer. To the contrary, in light of the incident at Miriam Hospital, to deny that Travenol acted within its discretion by discharging Siles would violate "the general principles that an employer is entitled to be motivated by and to serve its own legitimate business interests; that an employer must have wide latitude in deciding whom it will employ in the face of the uncertainties of the business world; and that an employer needs flexibility in the face of changing circumstances." Fortune v. National Cash Register Co., 373 Mass. at 101-102, 364 N.E.2d 1251.

We hold that the judge was correct in concluding that the evidence was insufficient to support a finding that the defendant's termination of the plaintiff's at-will employment was the product of bad faith. We further conclude that the testimony regarding Travenol's refusal to give Siles business references, even if believed, does not by itself support a finding that Siles was barred by Travenol from ever obtaining employment in the health care field or that such refusal would be improper in the light of the justifiable termination. Because we affirm the judgment by the Superior Court, we need not reach the other questions argued.

Judgment affirmed.

Discussion points for Brockmeyer v. Dun & Bradstreet

The Wisconsin rebuttal to the Massachusetts approach. Note that the Wisconsin court is very much interested in retaining employer flexibility in hiring and firing. While willing to give fired employees some redress, Wisconsin won't go as far as Massachusetts. What's interesting is that Wisconsin insists on applying contract law to these situations, but then chooses to ignore the "implied covenant of good faith and fair dealing" found in all UCC contracts, and in the Restatement 2d of Contracts, at section 205. This leads to three questions. First, is the difference in the approaches by the Massachusetts courts and the Wisconsin courts all that different, or is it all just words? Stated another way, would a fired employee's case which is a loser in Wisconsin be a winner in Massachusetts? If this is true, and you represent a company with a sales force spread throughout the country, does the Wisconsin approach offer some planning ideas? And finally, assume you are in Massachusetts and you know you are about to be fired. What might you do prior to the axe falling on you?

Charles J. BROCKMEYER,
v.
DUN & BRADSTREET,

No. 81-2024.

Supreme Court of Wisconsin.

Decided July 1, 1983.

STEINMETZ, Justice.

The principal issue on appeal is whether Wisconsin has any judicial exceptions to the employment at will doctrine. [FN1] We hold that in certain limited circumstances as discussed below, there are exceptions.

I.

This is a review of the court of appeals decision reversing the circuit court for Milwaukee county, the Honorable Ralph G. Gorenstein. The plaintiff, Charles J. Brockmeyer, began his employment with Dun & Bradstreet in August, 1969, as a business analyst trainee. From June, 1977, until his termination in May, 1980, he held a management position as district manager of the credit services division for the State of Wisconsin. Brockmeyer had no contract of employment.

Brockmeyer's career with Dun & Bradstreet as a district manager could be characterized as erratic. For a time in 1978, he was on employment probation. By improving his performance, Brockmeyer removed himself from probation. His sales ability potential was considered quite good. His income production was above average, but nevertheless, his superiors in Chicago were not satisfied with the performance of his other duties as a manager.

The events of the weekend of February 16, 1980, caused his immediate superiors some concern. They were informed that Brockmeyer, who was married but separated, was vacationing in Montana with his secretary when it was believed that he was performing his normal duties as district manager. Additional inquiries revealed that Brockmeyer had also smoked marijuana in the presence of company personnel. Supervisory personnel in Chicago sought permission from the national office to terminate or reassign Brockmeyer should they receive verification of these reports. Because of Brockmeyer's above average performance record, permission for termination or reassignment was denied. Instead, the supervisory personnel were directed to confront Brockmeyer with the information received to resolve the problem. Brockmeyer was called to a meeting in Chicago for this purpose. At that meeting he acknowledged the relationship with his secretary. He apologized for his absenteeism without notice. He admitted smoking marijuana and promised not to do it again. It was suggested at this meeting that either Brockmeyer or his secretary consider a job in another division of Dun & Bradstreet. At the conclusion of the meeting, Brockmeyer was firmly told that he would be terminated or reassigned if existing conditions did not improve.

Brockmeyer attempted to find a position for his secretary within the company, but was unsuccessful. The Chicago office then told him that the only remaining alternative was to obtain her resignation. Her resignation was received on February 25, 1980.
Shortly thereafter, Brockmeyer's former secretary filed a sex discrimination claim against Dun & Bradstreet. In May, 1980, on a variety of separate occasions, Brockmeyer was asked by his superiors to submit a written report about the course of events which led to her resignation. Brockmeyer refused because he feared he would become Dun & Bradstreet's scapegoat for the alleged discrimination actions taken against his former secretary. He also indicated that if called to testify at a hearing or trial, he would tell the truth.

On May 27, Dun & Bradstreet settled the claim with Brockmeyer's former secretary for $12,000. Three days later, Brockmeyer was discharged. At the time of the discharge, he was offered $8,500 if he would sign a release agreeing not to sue Dun & Bradstreet. Brockmeyer refused the offer.

Brockmeyer then initiated this action alleging that he was wrongfully discharged. He also requested damages for intentional infliction of emotional harm. Dun & Bradstreet claimed that Brockmeyer was terminated for: (1) smoking marijuana in front of employees; (2) lack of attention to job duties; (3) an open affair with his secretary; and (4) low morale among employees in his office.

At trial the jury was instructed that a terminated employee can recover damages from his or

her employer "where the discharge violates some clear and specific public policies or where the discharge is retaliatory or is motivated by bad faith or malice." The jury found that Dun & Bradstreet had wrongfully discharged Brockmeyer and awarded him $250,000 in compensatory damages and $250,000 in punitive damages. The jury rejected Brockmeyer's claim for intentional infliction of emotional harm.

On appeal, the court of appeals held that: "Recovery will be permitted if termination offends clearly defined public policy, or results from the exercise of bad faith, or results from malicious or retaliatory activity on the part of the employer." 109 Wis.2d 44, 46-47, 325 N.W.2d 70 (Ct.App.1982). However, the court reversed the judgment and remanded the case with instructions to dismiss the complaint on the merits because the record contained insufficient evidence to sustain Brockmeyer's claim that he was wrongfully discharged. For the reasons explained below, neither the trial court nor the court of appeals applied the proper law.

II.

[1][2] Under English common law, an employment contract for an indefinite period was presumed to extend for one year unless there was reasonable cause to discharge. The English rule had evolved from the Statute of Labourers, which provided that "no master can put away his servant." Early American courts followed this approach. In the late nineteenth century, apparently influenced by the laissez-faire climate of the Industrial Revolution, the American courts then rejected the English rule and developed their own common- law rule, the employment at will doctrine. The doctrine recognized that where an employment was for an indefinite term, an employer may discharge an employee "for good cause, for no cause, or even for cause morally wrong, without being thereby guilty of legal wrong."

By the turn of the twentieth century, the at will doctrine was absolute and was even temporarily afforded constitutional protection. However, since the New Deal, government regulation in the workplace has increased dramatically as Congress and state legislatures recognized the need to curb harsh applications and abuse of the rule in an effort to stabilize labor relations.

Statutory modification of the at will doctrine can be found in a variety of federal and state laws prohibiting certain forms of discrimination. Both Title VII of the Civil Rights Act of 1964 and Wisconsin's Fair Employment Act, secs. 111.31-111.395, Stats., make it unlawful for an employer to discharge an employee because of race, color, religion, sex or national origin. Similarly, the National Labor Relations Act and the Wisconsin Employment Peace Act, sec. 111.06(1)(c)1, prevent discharges for union activities. Other forms of discriminatory discharges have also been prohibited by the legislature.

Consistent with the philosophy of the statutory modifications, many state courts have recognized the need to protect workers who are wrongfully discharged under circumstances not covered by any legislation or whose job security is not safeguarded by a collective bargaining agreement or civil service regulations. The courts have accomplished this

objective by modifying the at will doctrine. The courts have recognized both contract and tort actions under assorted legal theories. Two theories are often utilized by the courts. The adoption of either theory or both theories is urged by Brockmeyer.

The first, and the more expansive of the two theories, is imposing upon an employer an implied duty to terminate an employee only in good faith. Two cases frequently cited for this theory are Monge v. Beebe Rubber Co., 114 N.H. 130, 316 A.2d 549 (1974) and Fortune v. National Cash Register Co., 373 Mass. 96, 364 N.E.2d 1251 (1977). In Monge, a female employee was terminated because she refused to date her foreman. In Fortune, a salesman was discharged to avoid payment of commissions. Both courts held that the employment contract contained an implied covenant of good faith and fair dealing and that a discharge made in bad faith constituted a breach.

[3] We refuse to impose a duty to terminate in good faith into employment contracts. To do so would "subject each discharge to judicial incursions into the amorphous concept of bad faith." Moreover, we feel it unnecessary and unwarranted for the courts to become arbiters of any termination that may have a tinge of bad faith attached. Imposing a good faith duty to terminate would unduly restrict an employer's discretion in managing the work force.

The second, and more popular of the two theories, is widely known as the "public policy exception." This theory allows the discharged employee to recover if the termination violates a well-established and important public policy.

The leading case on the public policy exception is Petermann v. Teamsters Local 396, 174 Cal.App.2d 184, 344 P.2d 25 (1959). In Petermann, the employee was instructed by the defendant to commit perjury before a legislative committee. He was discharged when he refused. The California Court of Appeals reasoned:

> "It would be obnoxious to the interests of the state and contrary to public policy and sound morality to allow an employer to discharge any employee ... on the ground that the employee declined to commit perjury, an act specifically enjoined by statute.... [I]n order to more fully effectuate the state's declared policy against perjury, the civil law, too, must deny the employer his generally unlimited right to discharge an employee whose employment is for an unspecified duration, when the reason for the dismissal is the employee's refusal to commit perjury." 344 P.2d at 27.

Other states similarly recognize the public policy exception in those instances where the employee is discharged for refusing to violate a statute.

Some states have applied the public policy exception when an employee was terminated for activities consistent with a legislative policy. In Frampton v. Central Indiana Gas Co., 260 Ind. 249, 297 N.E.2d 425 (1973), the employee was discharged for filing a workmen's compensation claim. The court noted that the state's workmen's compensation laws give employees a right to such compensation and that "If employers are permitted to penalize employees for filing workmen's compensation claims, a most important public policy will be

undermined. The fear of being discharged would have a deleterious effect on the exercise of a statutory right." 297 N.E.2d at 427.

Other states have applied the public policy exception where the discharge violates judicially conceived and defined notions of public policy, but does not necessarily contravene any explicit statutory provision. This broadest view of the public policy exception was expressed in Palmateer v. International Harvester Co., 85 Ill.2d 124, 52 Ill.Dec. 13, 421 N.E.2d 876 (1981). In Palmateer, the court permitted a cause of action by an employee who had been discharged for supplying information about a fellow employee to local law enforcement authorities. The court stated: "No specific constitutional or statutory provision requires a citizen to take an active part in the ferreting out and prosecution of crime, but public policy nevertheless favors citizen crime-fighters." 52 Ill.Dec. at 17, 421 N.E.2d at 880.

Other states recognize the public policy exception in principle, but take a strict view of what public policies would support an action for wrongful discharge. In Geary v. United States Steel, 456 Pa. 171, 319 A.2d 174 (1974), no relief was granted to an employee who was discharged for objecting to the marketing of a potentially defective product. The court noted that notwithstanding the employee's praiseworthy motives, no clear and compelling mandate of public policy was violated. Similar reasoning was applied in Pierce v. Ortho Pharmaceutical Corp., 84 N.J. 58, 417 A.2d 505 (1980). In Pierce, the court found no violation of a clear mandate of public policy when a physician employee was terminated for refusing to work on a drug research project which she contended was medically unethical.

*****

III.

[4] We have concluded that in the interests of employees, employers and the public, a narrow public policy exception should be adopted in Wisconsin. Accordingly, we hold that an employee has a cause of action for wrongful discharge when the discharge is contrary to a fundamental and well- defined public policy as evidenced by existing law.

Public policy is a broad concept embodying the community common sense and common conscience. The provisions of the Wisconsin Constitution initially declared the public policies of this state. Each time the constitution is amended, that also is an expression of public policy. In addition, public policy is regularly adopted and promulgated in the form of legislation. These declarations of public policy are inherently incorporated into every employment at will relationship.

[5] Given the vagueness of the concept of public policy, it is necessary that we be more precise about the contours of the public policy exception. A wrongful discharge is actionable when the termination clearly contravenes the public welfare and gravely violates paramount requirements of public interest. The public policy must be evidenced by a constitutional or statutory provision. An employee cannot be fired for refusing to violate the constitution or a statute. Employers will be held liable for those terminations that effectuate an unlawful end.

We intend to recognize an existing limited public policy exception. An employer may not require an employee to violate a constitutional or statutory provision with impunity. If an employee refuses to act in an unlawful manner, the employer would be violating public policy by terminating the employee for such behavior. To say that the employer could be prosecuted for criminal involvement as a result of the activities would be little solace for the discharged employee.

[6] Courts should proceed cautiously when making public policy determinations. No employer should be subject to suit merely because a discharged employee's conduct was praiseworthy or because the public may have derived some benefit from it.

[7][8] A plaintiff-employee alleging a wrongful discharge has the burden of proving that the dismissal violates a clear mandate of public policy. Unless the employee can identify a specific declaration of public policy, no cause of action has been stated. The determination of whether the public policy asserted is a well-defined and fundamental one is an issue of law and is to be made by the trial court. Once the plaintiff has demonstrated that the conduct that caused the discharge was consistent with a clear and compelling public policy, the burden of proof then shifts to the defendant employer to prove that the dismissal was for just cause.

We believe that the adoption of a narrowly circumscribed public policy exception properly balances the interests of employees, employers and the public. Employee job security interests are safeguarded against employer actions that undermine fundamental policy preferences. Employers retain sufficient flexibility to make needed personnel decisions in order to adapt to changing economic conditions. Society also benefits from our holding in a number of ways. A more stable job market is achieved. Well-established public policies are advanced. Finally, the public is protected against frivolous lawsuits since courts will be able to screen cases on motions to dismiss for failure to state a claim or for summary judgment if the discharged employee cannot allege a clear expression of public policy.

[9][10][11] Whether the cause of action for wrongful discharge should be maintained in tort or contract or both needs to be resolved. Those cases implying a contractual term of good faith dealing sounded in contract. Most, though not all of the public policy exception cases from other states were tort actions. The most significant distinction in our view between the two causes of action in wrongful discharge suits is in the damages that may be recovered. In tort actions, the only limitations are those of "proximate cause" or public policy considerations. Punitive damages are also allowed. In contract actions, damages are limited by the concepts of foreseeability and mitigation. The remedies established by the majority of Wisconsin wrongful discharge statutes are limited to reinstatement and backpay, contractual remedy concepts. We believe that reinstatement and backpay are the most appropriate remedies for public policy exception wrongful discharges since the primary concern in these actions is to make the wronged employee "whole." Therefore, we conclude that a contract action is most appropriate for wrongful discharges. The contract action is essentially predicated on the breach of an implied provision that an employer will not discharge an

employee for refusing to perform an act that violates a clear mandate of public policy. Tort actions cannot be maintained.

IV.

[13] We now turn to the question of whether Brockmeyer's discharge violated a fundamental mandate of public policy. Brockmeyer initially contends that Dun & Bradstreet's actions violated public policy as expressed in sec. 134.01, Stats., and sec. 134.03. Sec. 134.01 prohibits willfully and maliciously injuring another in his reputation, trade, business or profession. Sec. 134.03 prohibits the use of threats, intimidation, force or coercion to keep a person from working. There is no evidence that Dun & Bradstreet engaged in any behavior of this sort. To hold that under the facts of this case, Dun & Bradstreet violated the policies as expressed in secs. 134.01 and 134.03 would completely abolish the at will doctrine. This court intends only a recognition of stated public policy as reflected in the constitution and statutes of Wisconsin. While Dun & Bradstreet's discharge of Brockmeyer may have constituted bad faith, which is what the jury in this case presumably believed, its actions did not contravene the policies of secs. 134.01 and 134.03.

Affirmed.

VI. Introduction to Notice and Knowledge

Notice is an important concept in agency law. It is broader than knowledge, and generally, the law provides that if you have notice of something, constructively or actually, then you have knowledge of it. And if you have knowledge of something, then liability might very well follow. Another general rule is that notice to the agent is notice to the principal. But keep in mind that notice to an agent has to be to an agent authorized to receive notice (in the scope of his agency). In other words, handing an antitrust lawsuit against Federal Express to a Federal Express truck driver is not notice to Federal Express, and the time frame for answering the complaint will not begin to run. Even though the truck driver is an agent of Federal Express, he or she is not an agent authorized to accept service of process in a lawsuit.

Discussion points for Farr v. Newman

This case is important for big city lawyers as well as small town lawyers, maybe even more so for the latter, because small town lawyers are more likely to end up representing opposing parties at some point in their professional lives. And then it gets even stickier, because client confidences remain confidences after the case is over. So read this case carefully, and ask yourself whether the attorney did anything wrong, and then ask how he should have handled this situation.

Franz FARR, Respondent,
v.
George W. NEWMAN, Defendant, and Elbert C. Hardy, Appellant.

Court of Appeals of New York.

April 30, 1964.

BURKE, Judge.

The plaintiff, Farr, entered into an agreement, evidenced by a memorandum, to purchase certain real property owned by the Newmans for $3,000. After the making of this agreement, which was not in a form to be recorded, the defendant, Hardy, took a conveyance of the subject property, paying $4,000 therefor. Hardy's attorney, however, had knowledge of the outstanding agreement between Farr and Newman. This knowledge was acquired directly from plaintiff, who stood upon his rights although the attorney had decided that the agreement was unenforcible. The attorney did not inform Hardy of plaintiff's alleged equity and Hardy then took the conveyance from the Newmans. Farr brings this action to compel Hardy to convey the property to him upon payment of $3,000.

The sole issue that merits discussion here is whether defendant Hardy may avoid the effect of his attorney's knowledge of plaintiff's equity, and the consequent application of the familiar maxim that he who takes with notice of an equity takes subject to that equity (Hodge v. Sloan, 107 N.Y. 244, 17 N.E. 335), by proof that the attorney also represented the grantors, the Newmans, in the transaction through which Hardy acquired title.

Defendant seeks to avoid the imputation of knowledge by the citation of cases holding that an agent's knowledge is not imputed to his principal when the agent is defrauding or otherwise acting against the interest of his principal for the benefit of another.
[1][2][3][4] The mere fact that the attorney acted for both parties in the real estate transfer, with defendant Hardy's knowledge, cannot insulate defendant from his agent's knowledge to the detriment of the otherwise superior right of a third party. Binding on this appeal in the finding of fact, made by the trial court and affirmed by the Appellate Division, that the

attorney believed in good faith that plaintiff's contract was unenforcible. That this belief was not without foundation is demonstrated by the holding of the trial court that the memorandum was insufficient under the Statute of Frauds. (The Appellate Division reversed this finding in an opinion in which we concur.) The attorney's sincere belief in the unenforcibility of plaintiff's contract precludes even a preliminary consideration of the applicability of the fraud cases to this case. It is certainly within the authority of an attorney to pass on legal questions potentially affecting the title of the purchaser whom he represents. Any criticism of the wisdom of consummating the transaction in the face of a threat of a lawsuit does not justify the conclusion that the attorney's decision to proceed was actuated by had faith in the face of a contrary finding by the trier of the facts.

It is well-settled that the principal is bound by notice to or knowledge of his agent in all matters within the scope of his agency although in fact the information may never actually have been communicated to the principal. Where, as here, there is a mere error of judgment on a legal question which the attorney had the professional responsibility of resolving, the rule that such knowledge is imputed to the principal applies. Here the attorney was employed to pass judgment on the state of the title by both parties. When he made a decision on which Judges have differed, it can hardly be found to be deceitful as a matter of law.

In addition, defendant's contention that his attorney's conflict of interest precludes the imputation of knowledge to him is made for the first time in this court. The argument was not made at the trial, and the evidence does not appear to have been introduced with that legal argument in mind. The memorandum decision of the Trial Justice does not advert to it, nor does the Appellate Division's opinion reflect concern with the attorney-client relationship beyond the finding that an agent's negligent failure to disclose relevant facts to his principal does not bar imputation of such knowledge when it is not of a confidential nature. On this state of the record it would be manifestly improper to now look at the evidence in a new light, draw an inference of duplicity therefrom, and then invoke the reasoning of the cases relieving a principal on that ground. The well-settled rule is that this court will not consider new arguments, whether of law or fact, or both, where it appears that if they had been raised at the trial an adequate defense might have been adduced by the other party. Quite obviously, the assertion of faithlessness comes within the above description of arguments that may not be made for the first time in this court.

Therefore, both because of the affirmed finding of fact and the want of timeliness in raising the issue, no faithlessness on the attorney's part may be assumed.

Since, however, the dissenting Judges have adopted the reasoning of the fraud cases, it is appropriate to make some observations on their applicability here. It seems to me that the presumption sometimes relied upon to support imputation, i. e., that an agent will communicate to his principal all relevant matters, has no place in this situation. If, under the substantive rules of equity and agency, actual knowledge by the principal is unnecessary, the presumption of communication becomes irrelevant. Such is the case here. The substantive rule of equity requires notice of outstanding equities, not necessarily actual knowledge. **** The giving of notice is itself the legally significant act, wholly apart from actual knowledge.

It then simply is a matter of combining the rules of agency with the notice rule of equity.

When a prospective purchaser of real estate engages an attorney as his agent in the negotiations, he clothes the attorney with the incidental authority to receive in his behalf notice of oustanding equities. 'If, under the circumstances known to him, the obvious consequence of the principal's own conduct in employing the agent is that the public understand him to have given the agent certain powers, he gives the agent those powers.' (Holmes, Agency, 5 Harv.L.Rev. 1, reprinted in Holmes, Collected Legal Papers (1952 ed.) 81.)

It may thus be seen that the question in this case is not an evidentiary one of presumptions or inferences; it is one of substantive law. If the agent was authorized to receive notice, and did receive it within the scope of his authority, that act as such binds the principal as does any act performed within an agent's authority. That is what happened here. Defendant's appointment of an attorney to represent him in the acquisition of this real property, and, incidentally, to receive notice of any outstanding equity, was also an invitation to the public to give such notice to the attorney. When plaintiff did so, that act of the attorney, within the scope of his actual and apparent authority, bound his principal. A diversity of interest on the part of the agent is of no significance to third persons, such as plaintiff, unless it placed the agent's act beyond his authority. Nothing can alter the fact that the attorney was held out as a proper person to whom notice of outstanding equities was to be given, and that his receipt of such notice from plaintiff was within his authority, both as actually conferred and as apparent to others. Clearly inapposite, therefore, are cases dealing with imputation of knowledge where knowledge itself is at issue, i. e., whether the principal is chargeable with the agent's conversion. Once the attorney received plaintiff's notification, as authorized by defendant, even a fraudulent or self-serving concealment of that fact from the defendant would no more extinguish plaintiff's protection than would a debtor's debt be revived where he had paid his creditor's authorized agent for collection, who thereafter embezzled the money collected.

The detailed analysis in the Restatement 2d of Agency fully supports the conclusion reached here. Notice affirmatively given by a third party is distinguished from knowledge acquired by an agent in the course of his investigations. Where, as here, a party gives an agent notice, which, if given directly to the principal would have a certain legal effect, the principal is bound by that effect, the agent's adverse interest notwithstanding. Section 271 states: 'A notification by or to a third person to or by an agent is not prevented from being notice to or by the principal because of the fact that the agent, when receiving or giving the notification, is acting adversely to the principal, unless the third person has notice of the agent's adverse purposes.' Even if the plaintiff had not affirmatively relied upon the agency of the attorney by giving notice, and the attorney had merely discovered plaintiff's equity in the course of his title investigation, the principal would still be bound by such knowledge. A conflict of interest does not avoid the imputation of knowledge. Comment c under section 282 states in relevant part: 'c. Meaning of 'acting adversely.' The mere fact that the agent's primary interests are not coincident with those of the principal does not prevent the latter from being affected by the knowledge of the agent if the agent is acting for principal's interests.'

The illustration is as follows: '4. P appoints A to negotiate for the purchase of Blackacre, agreeing to pay him a commission of 10 per cent if he succeeds in persuading the owner to sell it and if A finds no defects in the title of record or otherwise. In investigating the title, A discovers an unrecorded equitable interest owned by T and, believing that the transaction will not be consummated if he reveals this equity to P, conceals his knowledge from P, who buys Blackacre upon A's favorable report. P is affected by A's knowledge.'

It is only when no notice is given by the third party and the agent totally abandons his principal's business, as by taking a bribe from the grantor for his silence, that the principal is unaffected by the agent's knowledge. (s 282, comment f, Illustration 5.)

Judgment affirmed.

R & D MULLER, LTD.
v.
FONTAINE'S AUCTION GALLERY, LLC, & others.[FN1]

May 18, 2009.

RESCRIPT.

The plaintiff, R & D Muller, Ltd., appeals from the allowance of the defendants' motion to disqualify the plaintiff's attorneys, Cain, Hibbard, Myers & Cook, P.C., and attorney Diane M. DeGiacomo (Cain Hibbard). At issue is whether Cain Hibbard's prior representation of defendants John and Dina Fontaine (the Fontaines) is substantially related to the current litigation. See Mass.R.Prof.C. 1.9(a), 426 Mass. 1342 (1998).

The plaintiff brought the present suit against a number of defendants, including the Fontaines and certain companies and trusts established by them (Fontaine business entities), to recover damages sustained as a result of an auction gone awry. The plaintiff's predecessor, American Investment Properties, Inc. (AIP), consigned a 1,500-ounce solid gold statue of Mickey Mouse, called “Celebration Mickey,” for auction by Albany Auction Gallery and two of the Fontaine business entities-Fontaine's Auction Gallery, LLC, and Dina's Antiques, Inc. When the auction was held on February 8, 2003, the high bidder, Roger Jakubowski, was allowed to leave with “Celebration Mickey” without paying for it. AIP then assigned its interest in “Celebration Mickey” and any associated claims to the plaintiff, which expended nearly $300,000 to retrieve the statue. Seeking to recover these costs, the plaintiff sued the defendants, asserting various theories of recovery, including breach of contract, breach of fiduciary duty, breach of bailment obligations, and negligence.

Of particular pertinence to the disqualification issue, one count of the complaint seeks to

“pierce the corporate veil” so as to impose liability upon the Fontaines individually and as trustees of certain trusts, on account of the actions and omissions of Dina's Antiques, Inc., and Fontaine's Auction Gallery, LLC. In support of that claim, the plaintiff alleges that “Defendant Auction Gallery and Defendant Dina's Antiques failed to secure corporate formalities, or had nonfunctioning offices or directors, or failed to maintain corporate records.” The plaintiff also alleges that there was confused intermingling of assets and roles among the Fontaine business entities.

Affidavits and exhibits submitted in support of the motion to disqualify establish that, between 1980 and 1990, Cain Hibbard had represented the Fontaines on personal and business matters. Among other things, in 1987, Cain Hibbard helped Dina Fontaine (Dina) incorporate Dina's Antiques, Inc., and advised her on the proper maintenance of corporate formalities. Two years later, on March 14, 1989, Cain Hibbard sent Dina a letter reminding her of the necessity of maintaining the corporate records of Dina's Antiques, Inc., so that they reflected the current state of the corporation accurately. The letter also advised Dina that “these records are necessary to support the corporation's role as a separate entity, and they help to maintain a barrier against personal liability.” Shortly thereafter, on April 12, 1989, a Cain Hibbard paralegal wrote to Dina about updating her corporate minute book, and enclosed backdated stockholders' resolutions that she directed Dina to sign and return.

[1] On this record, the motion judge did not abuse his discretion in concluding that Cain Hibbard should be disqualified. The relevant provision of the Massachusetts Rules of Professional Conduct states: “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 consents after consultation.” Mass.R.Prof.C. 1.9(a). This rule applies where “the current representation [is] ‘adverse’ to the interests of the former client,” and “the matters of the two representations [are] ‘substantially related.’ ” *Adoption of Erica,* 426 Mass. 55, 61, 686 N.E.2d 967 (1997). It is undisputed that Cain Hibbard's representation of the plaintiff is adverse to its former clients; only the second element is contested.

[2][3] “Prohibition of successive representation arises from ‘the attorney's duty ... to preserve his client's confidences and secrets.’ ” *G.D. Mathews & Sons Corp. v. MSN Corporation,* 54 Mass.App.Ct. 18, 21, 763 N.E.2d 93 (2002), quoting from *Bays v. Theran,* 418 Mass. 685, 691, 639 N.E.2d 720 (1994). Thus, if the previous representation exposed counsel to confidential information that could be used against the client in the present litigation, the two matters will be deemed “substantially related.” See *G.D. Mathews, supra* at 22, 763 N.E.2d 93.

[4][5] Here, the judge determined that, even though considerable time had passed since Cain Hibbard represented the Fontaines, the attorneys had been exposed to confidential information that could be used to the Fontaines' disadvantage in the present case. The plaintiff's claim for piercing the corporate veil is grounded in the principle that, despite the general rule that a corporation and its stockholders are separate legal entities, “one corporation, or a person controlling it, may become liable for the acts or torts of an affiliate

or a subsidiary under common control" where additional facts "permit the conclusion that an agency or similar relationship exists between the entities." Among the several factors a court may consider to determine whether such a relationship exists is "nonobservance of corporate formalities."

The correspondence Cain Hibbard sent to Dina indicates that the firm had advised her and Dina's Antiques with respect to observing corporate formalities, in part to help "maintain a barrier against personal liability," and had provided her with backdated corporate resolutions to facilitate her belated compliance. In these circumstances, the judge could conclude in his discretion that Cain Hibbard had been exposed to confidential information germane to the present dispute and that the current and former matters are substantially related for purposes of rule 1.9(a).

We see no merit to the plaintiff's contention that the judge failed to perform a sufficiently "searching review" of the facts concerning the current and prior representations to warrant disqualification. See *Slade v. Ormsby,* 69 Mass.App.Ct. 542, 547, 872 N.E.2d 223 (2007). On the contrary, the judge in this case "examined the overlap and similarity" between the two representations, and found specific facts concerning the past and present matters in demonstrating that they were "substantially related." *Ibid.*

Order of disqualification affirmed.

Discussion points for Southern Farm v. Allen

This case would seem to be properly decided against the principal, as the Farr v. Newman case was. But in this case, notice to the agent is not imputed to the principal. Why not? What is the crucial difference between the two cases?

SOUTHERN FARM BUREAU
V.
ALLEN

WISDOM, Circuit Judge:

Southern Farm Bureau Casualty Insurance Company (Southern Farm) brings this diversity suit for a declaratory judgment that an automobile liability insurance policy it had issued to George Jezisek covering a 1960 model Chevrolet was void and that Southern Farm was relieved of all liability in connection with that policy.

In October 1963 Joe Jezisek, a minor having a record of one previous accident and two

'moving' violations, traded his 1957 Pontiac for a 1960 Chevrolet. The insurance on the Pontiac, issued by Southern Farm in his father's name, had expired. The bank holding the mortgage on the Chevrolet required that the automobile be insured. Joe applied to Southern Farm for coverage through a secretary at the Jack Wattenbarger Agency in Lamb County, Texas, an agency that had handled some insurance matters for Joe's brother George E. Jezisek, who lived in Milam County. The Lamb County office forwarded the application to the Southern Farm home office in Waco. After an investigation of the applicant, Southern Farm rejected Joe's application for insurance and returned his premium.

Both Joe and George Jezisek testified that on November 8, 1963, they spoke to Mr. Wattenbarger who suggested (or approved their suggestion) that they put title to the car in George's name for insurance purposes. This they did that same day. Wattenbarger, however, denied that the conversation ever took place.

Later in the day, the brothers returned to the agency office and applied for insurance in George's name through one of the secretaries in the office. A registration receipt, shown to the secretary at the time she took the application, revealed that title was transferred on that day 'for insurance purposes'. The application showed that the car would be kept in Spade, Texas, although George lived in Milam County, several hundred miles away. The Jeziseks did not divulge that Joe would be driving the car.

The secretary forwarded the policy to Milam, where George resided. The Milam County agent, who was not aware of the transfer of title, signed the policy and sent it to the Waco office. Since George Jezisek was already an approved insured, the main office, without further investigation, issued the liability policy to George Jezisek as owner of the Chevrolet. George received the policy and delivered it to Joe, who made all premium payments. Three months later Joe Jezisek, while driving his Chevrolet, was in an accident that resulted in fatal injuries to Cecil H. Allen.

Upon investigating the ownership of the automobile involved in the accident and finding that Joe Jezisek was its exclusive owner and driver, Southern Farm notified all interested parties that the policy was void ab initio and tendered to George Jezisek the amount of the paid premiums.

The trial court rendered judgment against Southern Farm in favor of the Jeziseks and the deceased's widow and children on the finding that Jack Wattenbarger, Southern Farm's agent, was aware of 'the expedients which ensued in quest of the insurance needed by Joe C. Jezisek.' The court held that this knowledge was imputed to Southern Farm. Southern Farm therefore was estopped from voiding the liability policy, and the declaratory judgment was denied. We reverse.

I.

The first issue on appeal concerns the district court's finding of fact: 'The plaintiff's agent, Wattenbarger, was in close touch by taking part and being aware of the expedients which

ensued in quest of the proper insurance needed by Joe C. Jezisek to make his required compliance with law.'

Southern Farm points out that Wattenbarger would receive no commission on the policy issued to George. Also, Wattenbarger testified that he did not meet with the Jeziseks on the day the application for insurance in George's name was sent in; in fact, he emphatically denied that he ever met George Jezisek until after the accident in February 1964. By the same token, both Jeziseks were positive about having discussed the transfer of title with Agent Wattenbarger before making application later that day. Thus, despite Wattenbarger's own testimony, there is evidence in the record that would support the court's finding of fact. Accordingly, we consider that this finding is not clearly erroneous.

It is undisputed that Wattenbarger did not actually transmit to Southern Farm any suggestion of the misrepresentation involved in the application, of which he was held to have had actual knowledge. Southern Farm, therefore, had no direct notice of them. The primary issue, then, is whether the knowledge of Wattenbarger is imputed to Southern Farm to estop it from voiding the policy on the basis of the misrepresentations in the application. The district court answered this issue in the affirmative; we do not.

II.

[1][2] We turn now to Texas law to ascertain the principles governing imputation of knowledge of an insurance agent to his principal, the insurance company. For if the agent's knowledge of the falseness of a statement of a material fact in the application of insurance is not imputable to the company, then under well-established authority the company may avoid liability under the policy.

[3][4][5] The general rule in insurance cases and other cases, of course, is that 'notice to the agent is notice to the principal. **** Two conditions are necessary for the application of this rule, however: (1) The agent must be acting within the scope of his authority and in reference to a matter over which his authority extends, **** and (2) the insured (or applicant) must not be involved with the agent, even informally, in perpetrating a fraud against the insurer. **** The Texas cases are clear that if these conditions do not exist, then the insurance company is not estopped from avoiding its policy.

[6][7][8] A. If Wattenbarger had no authority to bind Southern Farm by his activity as its agent in the issuance of the policy here in issue, then any knowledge he may have obtained concerning material misrepresentations in the application could not be imputed to the company. The actual scope of Wattenbarger's authority is not clear in the record. The Insurance Underwriting Supervisor of Southern Farm testified:

In general, he has the authority to secure applications to bind this company upon the agent's signature and the applicant's signature and upon-- in most cases-- the receipt of premium. Wattenbarger testified that he was the 'general agent' for Southern Farm in Lamb County and had the authority to 'write, take the application, collect the premium and send in the

application and money'. It is true that Wattenbarger did not actually accept the application-- that was done by his secretary who was not an agent of the insurer. Furthermore, Wattenbarger did not sign the application-- the agent in Milam County, to whom the application was forwarded by Wattenbarger's secretary, did this. Even so, Wattenbarger's knowledge of the paper title transfer was obtained in the course of his agency for the insurer, and on the question of authority alone we find that he had sufficient authority for that knowledge to be imputed to Southern Farm:

The rule is well settled in this state that where, as the facts show in this case, an insurance agent with authority to solicit business, to make and forward the application for insurance, to collect and transmit premium, and to deliver the policy of insurance, notice to him of any matter affecting the risk involved, and required to be placed in the application, is notice to the insurer; and the insurer will not be permitted to deny liability on the policy on account of the neglect, failure, or fraud of the agent in not informing the insurer of such matters.

[9] B. 'The authorities are uniform to the effect that a principal is not affected by notice to an agent who is acting adversely to the interests of his principal, and either for his own benefit or for the benefit of a third party.'

Plaintiff had alleged collusion between Weatherby and the assured and her husband to obtain the policy on false representations * * *. It is ordinarily true that a principal is affected with notice of such facts as come to the knowledge of his agent in the course of his business. When an agent, however, ceases to act for his principal in good faith and through collusion with another, desiring through him to cheat and defraud the principal, practically enters into the service of that other for the purpose of promoting the interest of that person, or the common interest of himself and that other, in fraud of his principal, then the person who so avails himself of the services of such an agent cannot claim that his act or his knowledge in reference to matters to which the fraudulent collusion relates are binding on the person intended to be defrauded. In such a case, the agent pro hac vice becomes the agent of the person he collusively serves. * * * If a person colludes with an agent to cheat the principal, the latter is not responsible for the acts or knowledge of the agent. The rule which charges the principal with what the agent knows is for the protection of innocent third persons, and not those who use the agent, to further their own frauds upon the principal.

[10][11] The defendants in the trial below argued, and the trial court found, that Wattenbarger actively participated in the scheme whereby paper title to the Chevrolet was transferred to George Jezisek for insurance purposes, with the insurance policy to be listed in his name, knowing that Joe Jezisek was to be the actual owner and sole operator of the vehicle. In the least, Wattenbarger is 'placed in the light of having assisted in bringing about the consummation of the fraudulent transaction * * *. Such action is sufficient to constitute collusion,' Standard Savings & Loan Ass'n v. Fitts, 1931, 120 Tex. 303, 39 S.W.2d 25, 26, and 'the principal would not be charged with his secret knowledge .' We therefore find Southern Farm not estopped to avoid the policy on account of its agent's knowledge.

III.

All the parties on appeal devote lengthy discussion in their briefs to our decision in General Ins. Co. v. Western Fire & Cas. Co., 5 Cir. 1956, 241 F.2d 289. That case involved a dispute between two insurance companies concerning liability coverage of a minor, Sherman Jones. The agent for Western Fire and Casualty Company had written a policy covering Jones and his mother, but had listed sole ownership of the covered vehicle in Mrs. Jones. Western sought to avoid the policy on the ground that 'the car 'really' belonged to the boy so that there was a breach of the representation of ownership.' 241 F.2d at 292. Judge Brown, for the Court, applying Texas law, held that the knowledge of Western's agent of the true state of ownership of the car was imputed to Western, and thus it could not void the policy on the basis of any material misrepresentation.

General contains extended reference to the authority of Western's agent to bind the company. But since we have found this not to be a key issue in this case, we need not enumerate distinctions on this ground. In General, however, the insured was in no way responsible for the misrepresentation:

For nowhere is there a suggestion that mother or son were knowingly misstating, or attempting to conceal, facts * * *. (They) were attempting fully to state all of the facts, furnish all of the information and answer all of the questions. * * * They gave Agent Hutson the full facts concerning the nature of Sherman's ownership and interest in the car. 241 F.2d at 292-293.

Thus there could be no collusion between the insured and the agent in fraud against the insurer which would prevent the knowledge of the agent from being imputed to his principal. General is therefore inapplicable to the instant case.

[12] Whenever, as here, the party contending for the validity of a policy has himself participated in perpetrating the fraud pursuant to which the policy was issued, Texas courts have consistently denied recovery. If he cannot prove that the insurer's agentknew of the scheme-- or knew of the false representations-- then he cannot show that the insurer has sufficient knowledge to estop it from voiding the policy. If he does prove complicity of the agent in the scheme and knowledge of the misrepresentations, he has proved too much: The agent then becomes involved in collusion against his principal and knowledge of the agent will not be imputed to his principle. we hold that the latter situation existed in this case.

We reverse the judgment of the district court and render judgment for the plaintiff in this action, declaring Southern Farm not liable on the policy issued on the 1960 Chevrolet in the name of George Jezisek.

Discussion points for Sutton Mutual v. Notre Dame Arena

In Massachusetts, you wake up one morning to find your car has been sideswiped overnight by a hit and run driver. How much time do you have to report the accident to your insurer? The Sutton case does not ask the question whether the President of the defendant corporation knew about the accident. Instead, it focuses on how he found out about it. That is, in what capacity did he learn of the accident? So ask yourself two questions. Why the distinction? What capacity was he operating in when he found out about the accident? Do you think it might have been important that Dr. Danais did not pay to get into the game?

SUTTON MUTUAL INSURANCE COMPANY
v.
NOTRE DAME ARENA, INC.

No. 5624.

Supreme Court of New Hampshire.

Decided Jan. 30, 1968.

LAMPTRON, Justice.

On February 6, 1966 the defendant had rented its arena for a fee of $100 to the Berlin Maroons, a local hockey team, for an afternoon game with the Manchester Black Hawks. The defendant 'simply rent(s) the facilities of the Arena for the purpose of the game' and has its own manager for the restaurant and furnishes two ice-tenders. The Maroons hire their own ticket sellers as well as police officers to maintain order and supervise what is going on in the arena. The defendant has 'nothing to do in which way either of the teams play hockey' and has 'no responsibilities in that respect.'

Florence Ploude who was a spectator at this game was struck by a puck. As a result of an announcement over the public address system she was treated by Dr. Couture who was present 'watching a hockey game.' He gave her a preliminary examination on the premises and sent her to a Berlin hospital for x- rays which disclosed a fractured jaw. Dr. Couture was in no way connected with the defendant and never informed 'any member of the corporation or any member of the Board of Directors of Notre Dame Arena of this accident on the premises of the arena. * * * I don't know who the Board of Directors is.'

There is no evidence that Florence Plurde or her husband Joseph, the plaintiffs in the tort actions in question, ever notified the defendant of this accident.

A few days before service of the writs in those actions, which took place on May 25, 1966, an attorney telephoned J. L. Blais, Esq., secretary of the defendant corporation, to advise him

that suit would be brought against the defendant and that service was to be made on him. 'No further detailed information was given to me * * * with respect to the nature of the claim, the time of the accident or the identity of the claimants.' By letter dated the day after such service of writs on him. Attorney Blais notified plaintiff of these actions and at about the same time also notified the Chairman of defendant's Board of Directors Rev. LeClerc. Mr. Blais' letter was the first notice of this accident received by the plaintiff.

Condition 9 of plaintiff's policy reads as follows: 'Notice of Accident. Whenever an accident occurs written notice shall be given by or on behalf of the insured to the company or any of its authorized agents as soon as practicable. Such notice shall contain particulars sufficient to identify the insured and also reasonably obtainable information respecting the time, place and circumstances of the accident, the names and addresses of the injured and of available witnesses.'

The purpose of such a provision is to give the insurer an opportunity to make a timely investigation of the incident and to prepare an adequate defense on behalf of the insured. This is a reasonable and valid stipulation which must be complied with by the insured in order to obligate the insurer to defend and pay under the terms of its policy. A material and substantial breach of this provision by the insured destroys its right to claim indemnity under the policy.

'A policy requirement that notice of the accident be given 'as soon as practicable' is commonly considered to require notice as soon as is reasonably possible' which is generally interpreted to call for notice to be given within a reasonable time in view of all the facts and circumstances of each particular case.

The timeliness of the notice must be determined in the light of the situation existing both when the accident occurred and when the notice was given. In deciding whether notice of the accident was given within a reasonable time, the following circumstances, among others, are to be considered: the length of the delay in giving notice, the reasons for it, and the probable effect of the delay on the insurer. Thus the absence, or extent, of prejudice to the insurer caused by the delay are factors to be considered in determining whether the insured has complied with the policy condition by giving notice within a reasonable time or has committed a substantial breach thereof by failing to give notice as soon as practicable.

The burden is on the insured to prove that notice of the accident was given as soon as practicable as required by the policy condition. 'Unless the circumstances are such that no reasonable man could find that notice was given as soon as was reasonably possible, the question of whether the policy requirements as to notice have been met is a question of fact for the Trial Court.' Pawtucket Mut. Ins. Co. v. Lebrecht, supra, 470, 190 A.2d 424.

The Trial Court properly found that Father LeClerc, Chairman of the Board of Directors of defendant, J. L. Blais, its secretary, and Father Cote, its treasurer, were not present at the arena at the time of the accident and had no knowledge whatever concerning the accident

until or shortly prior to service of the writs on May 25, 1966.

Dr. Danais was president of the defendant corporation and his principal duty under the By-Laws was 'to preside at all meetings of the members of the corporation.' He testified that he arrived at the arena after the accident had taken place. Somebody told him someone had been hurt. He went upstairs and saw 'the lady' and learned she had been hit by a puck and that she had been treated by Dr. Couture. There was nothing 'obvious about her appearance.' 'She was sitting on the bench there with a heavy coat, and I didn't see any marks. I did not examine her. * * * She was sitting there, and I just walked away.' He did not know she had fractured her jaw until a few days before the hearing in these proceedings.

Since a corporation can act only through its officers, agents and employees, it is necessarily chargeable with the knowledge of its officers and agents acting within the scope of their authority. **** The Trial Court properly found that Dr. Danais attended this hockey game not in his capacity as president of the defendant but merely as one of many spectators. The evidence failed to establish a duty on him as president of the defendant corporation to report this accident to anyone. Knowledge which might come to him as a private person and beyond the range of his official duties is not notice to the corporation.

Father Samson was assistant treasurer of defendant corporation, general manager and supervisor of activities at the arena. He was in New York on the day of the accident and returned to Berlin late that evening. He testified that he first learned 'officially' of Mrs. Plourde's injury when he was told of the recipt of a letter from the insurance company by Father LeClerc. He further testified being under the impression of having heard 'vaguely' about the accident but cannot say exactly when or from whom. 'Who it was, I don't know, or how badly she got hurt, I don't know.' It never 'came to my mind' to make an investigation to determine 'whether the lady was injured, who her physician was, and who treated her, etc.' 'If I had known of the name of this person and if I had known that this person was hurt, I would have reported to the insurance company.' 'I had nothing to report. I had no information, substantial information' before he was informed that suit had been brought. The evidence did not compel a finding that Father Samson had knowledge of the accident before suit or the duty to pursue and investigate the rumors which he was under the impression of having heard. The Trial Court could properly find him justifiably ignorant of the accident until suit was instituted by the plaintiffs.

The Trial Court found 'that the defendant corporation, prior to May 26, 1966, had no knowledge or reliable data as to the fact of injury, name of the injured party and/or the existence of a potential claim resulting from the accident of February 6, 1966. The Court further finds that the defendant lacked knowledcge of the essential elements of the occurrence of February 6, 1966, until May 25, 1966, or shortly before, when its agent, Mr. Blais, received a call from counsel for the Plourdes. It is further found that this lack of knowledge was not the result of or attributable to any conduct and/or actions of the defendant. On the contrary, the extenuating and surrounding circumstances were such that reasonable excuse existed for the initial delay in notifying the plaintiff until such time as the fact of injury had been disclosed to the defendant by virtue of the above-referred call to its

secretary. * * * After receipt of such notice, the defendant notified the plaintiff as soon as practicable (May 26, 1966).'

The Trial Court further found that: 'Under all the circumstances * * * the defendant reasonably complied with the terms of Condition 9 of the policy construed as a whole. * * * This notice (of May 26, 1966) was seasonable and the prior delay justifiable under all the circumstances. The intervening delay of approximately three months and twenty days was not, on the state of the record, of such duration so as to prejudice the rights of the plaintiff.'

The Trial Court's findings were warranted by the evidence. We cannot say as a matter of law that on the totality of the circumstances duly found by the Trial Court no reasonable man could conclude that notice was given as soon as practicable as required by the policy.

Exceptions overruled.

Discussion points for Georgia Pacific v. Great Plains

This case presents an issue different from Sutton, where the question there was how the President found out about the accident (in legal terms, how the agent was put on notice). In this case, the notice is given to the salespeople while they are acting in their official capacities, as agents of their employer. The question here is whether salespeople are agents authorized to receive notice. Does the court make a convincing distinction between salespeople and bookkeepers and workers on the loading dock?

GEORGIA-PACIFIC CORP., Appellant,
v.
GREAT PLAINS BAG CO., Appellee.

Appeal No. 79-544.

United States Court of Customs and Patent Appeals.

Jan. 24, 1980.

BALDWIN, Judge.

Background

Great Plains filed an application for registration of the mark for use on paper and plastic bags on January 23, 1970, alleging a first use of September 1, 1961. The registration was issued on June 8, 1971.

Georgia-Pacific petitioned for cancellation of the mark on July 11, 1973, on the grounds that it had been and is still engaged in the manufacture and sale in interstate commerce of a variety of forestry products including, specifically, paper bags and Kraft paper; it is owner of the trademark G-P, which mark has been used extensively as a portion of its corporate logo and on its various goods long prior to Great Plains' first use in 1961; it is the owner of registrations for a number of marks containing the letters G-P for use on lumber ***759** and plywood. Finally, Georgia-Pacific alleged that Great Plains' mark, as used on paper and plastic bags, so resembles its own mark as applied to its goods as to be likely to cause confusion, mistake or deception regarding the source of the goods.

Great Plains averred that Georgia-Pacific was barred from bringing the cancellation proceeding by reason of laches and estoppel. It argued that since the parties had engaged in various business dealings since 1962, including the sale of Kraft paper by Georgia-Pacific to Great Plains, Georgia-Pacific knew, or should have known, of its use of the mark in its corporate logo (said logo appearing on its bags, stationery and envelopes since 1961). Georgia-Pacific's failure to object to the use of the logo and the subsequent increase in its use results in Georgia-Pacific now being estopped from asserting a likelihood of confusion between the respective marks and from asserting that it would be damaged by this registration.

Board

The board found that Georgia-Pacific's use of the designation G-P has been well known in the lumber industry since the late 1940's both as an identification of the corporate entity and a trade designation identifying its marketed products.

The board admitted into evidence a survey (conducted for use in another proceeding) which tended to show that the verbal letters G-P were recognized, both by sixty percent of a group of executives from various paper purchasing companies and additionally by twenty-five percent of a group of regular readers of the Wall Street Journal, as a term representing Georgia-Pacific. Great Plains objected to admission of the survey on the basis of hearsay since without the inclusion of the interview sheets and recorded responses, the accuracy of the survey could not be verified. The individuals who conducted and designed the survey were deposed and made available for cross-examination. The board concluded that the survey should be admitted for consideration of the probative value to be attached thereto. The survey was qualified to sustain a recognition of G-P with Georgia-Pacific in the paper industry.

The board indicated that it is well settled in trademark law that the defenses of laches and estoppel are based on the concept that the owner and prior user of a mark having actual or constructive notice of another party's use of the same or similar mark for like or similar goods must be persevering. He must not sit on those rights for an exorbitant length of time and allow the subsequent user to build up a business and good will associated with such mark before taking action against that use.

To prove the defense of laches one must make a showing that the party, against which the defense is asserted, had actual knowledge of trademark use by the party claiming the defense or at least a showing that it would have been inconceivable that the party charged with laches would have been unaware of the use of the mark.

The board indicated that circumstantial evidence appeared to be overwhelming on the concept that Georgia-Pacific must have been aware of Great Plains' use of its logo containing the letters G-P.

The board detailed the evidence by Great Plains which would show the requisite knowledge. It pointed out that a vice-president of Georgia-Pacific visited the president of Great Plains to discuss a joint venture. A large corporate logo was present on a wall behind the receptionist's desk at the time of that visit. Numerous visits by salesmen and sales managers of Georgia-Pacific to two of Great Plains' locations were catalogued. Each salesman would have had to pass a large outside sign bearing Great Plains' G-P logo. Several sales of paper were made by Georgia-Pacific to Great Plains. Great Plains picked up the paper in trucks bearing the corporate logo, paid for it using checks using the corporate logo, and confirmed several of its telephone orders using purchase orders bearing the corporate logo.

Georgia-Pacific argues that Great Plains has produced evidence showing only that lower echelon employees (clerks, bookkeepers, dock workers) might have seen Great Plains' usage of the mark. Since no employee specifically charged with policing trademark infringement matters saw the usage, a corporation as large as Georgia-Pacific should not be charged with such knowledge. The board concluded that notice to a corporation via its sales personnel constitutes sufficient notice for the support of the equitable defenses of laches. Alternatively, the absence of question by the sales force concerning that mark's usage was considered as evidence that no likelihood of confusion exists.

Finally, the board considered the parties' respective marks on paper bags. Great Plains' mark, it is said, being a distinctive design mark, requires some effort to discern the letters G-P. For that reason, the board found "considerable doubt" existed that a prospective purchaser would equate the two marks or even form an association between them.

The board therefore concluded that the differences in the marks were sufficient to make the question of likelihood of confusion reasonably debatable and therefore to give effect to Great Plains' equitable defenses. Georgia- Pacific was held guilty of laches and estopped from asserting that it is and will be damaged by Great Plains' registration.

OPINION

[3] It must be remembered that Great Plains' trademark consists of highly stylized letters and is therefore in the gray region between pure design marks which cannot be vocalized and word marks which are clearly intended to be. Even accepting the argument that the mark could be verbalized, such is not the end of the inquiry. Verbalization of the mark must be

considered within the environs of the marketplace. The testimony of Mr. Naudain, vice-president of Georgia-Pacific, Mr. Pomerantz, former president of Great Plains, and Mr. Stearley, current president of Great Plains showed them to be in general agreement that purchasers in this market are of a fairly discriminating nature.

The record makes it quite clear that Georgia-Pacific was the first to use its mark G-P. The only evidence supporting the argument that the mark is famous appears to be the 1972 survey produced in conjunction with another matter. That survey only produced a discernible connection between the verbalized letters G-P and Georgia-Pacific in the paper industry. However, that is not the issue. The question to be resolved is the existence of a likelihood of confusion regarding the respective trademarks, not their verbalization. Even giving this survey all possible weight, it does not appear to show the mark to be so famous as to bridge the gap between the G-P and Great Plains' stylized mark and to create confusion.

*****

In the case at hand, Great Plains has introduced significant circumstantial proof that on a number of occasions salesmen from Georgia- Pacific were exposed to the corporate logo during the course of their duties in selling Kraft paper to Great Plains and knew that that paper was to be used in the production of bags. Georgia-Pacific argues that only its lower echelon personnel were said to have observed Great Plains' use of the mark. We agree that knowledge of mark usage gained by bookkeepers in receiving checks and dock workers in loading Great Plains' trucks should not normally be imputed to the corporation. Their duties are not of the type that would require sensitivity of the value of their employer's marks in the marketplace. However, salespeople produce the "stuff" of which a corporation's "good will" is made. Salespeople, if they are to be effective, must be present in the marketplace and cognizant of the various factors that effect present and future sales. Product "good will" is one such factor. A corporation which employs a professional salesperson who has knowledge of an offending trademark use will have imputed to it the knowledge of that employee.

[9] Other evidence tending to show Georgia-Pacific's "corporate" awareness of Great Plains' use of the mark include Stearley's testimony that Great Plains sold a significant number of multi-wall bags to Georgia-Pacific and that virtually all multi-wall bags produced by Great Plains had a logo imprinted thereon. In total, over thirty transactions (including nine sales of paper) took place between 1962 and 1969.

The totality of the evidence points to the existence of constructive knowledge by Georgia-Pacific of Great Plains' use of the mark.

[10][11] It is well settled that one who charges estoppel by laches must also show that it suffered or will suffer detriment as a result of inaction by the party against which laches is charged. United States v. Alex Dussel Iron Works, 31 F.2d 535 (5th Cir. 1929). Great Plains has shown that sales of its goods under the logo in question have grown from $372,000 in 1961 to about $28,000,000 in 1973. It is this extent of sales over a protracted length of time

without complaint from Georgia-Pacific upon which Great Plains relied to its detriment. Any change in trademark status at this point would be to the prejudice of Great Plains.

Conclusion

In sum, we hold the likelihood of confusion between the marks as applied to their respective goods unlikely and further hold that Georgia- Pacific is estopped from asserting such likelihood. Therefore, we affirm the decision of the board.

Linda S. BOWERS
v.
P. WILE'S, INC.[1]

Massachusetts Appeals Court

Decided May 15, 2015.

Background

Patron, who was injured when she fell after stepping on a small river stone about three-quarters of an inch in size, which was on the sidewalk after having been moved from an adjacent gravel area maintained by the store, brought premises liability action against store. The Superior Court Department, Middlesex County, Paul D. Wilson, J., entered summary judgment for store, and appeal was taken.

The Appeals Court, Green, J., held that whether store took adequate steps to address the risk posed by the inadvertent transfer of river stones from the gravel area onto sidewalk precluded grant of summary judgment to store on patron's premises liability claim.

So ordered.

Kantrowitz, J., filed dissenting opinion.

Procedural Posture(s): On Appeal; Motion for Summary Judgment.

Opinion

GREEN, J.

In *Sheehan v. Roche Bros. Supermarkets, Inc.,* 448 Mass. 780, 788, 863 N.E.2d 1276 (2007) (*Sheehan*), the Supreme Judicial Court adopted the so-called “mode of operation” approach to premises liability. Under that approach, a plaintiff injured as the result of a dangerous condition on an owner’s property is relieved of the need to prove that the owner had actual or constructive notice of the condition if he instead establishes that the dangerous condition was “related to the owner’s self-service mode of operation.” *Id.* at 786, 863 N.E.2d 1276. In the present case, a judge of the Superior Court allowed the defendant’s motion for summary judgment, based on his view that the mode of operation approach applies only where the dangerous condition results from breakage or spillage of items offered for sale.[2] We discern no such limitation in the mode of operation approach described by the Supreme Judicial Court in *Sheehan, supra,* or in the rationale supporting it. We also conclude that the summary judgment record does not foreclose the prospect that the plaintiff could succeed, at trial, in proving that the defendant failed to use reasonable measures to prevent injuries that could result from the foreseeable dangerous condition. See *Kourouvacilis v. General Motors Corp.,* 410 Mass. 706, 714, 575 N.E.2d 734 (1991). We accordingly reverse the judgment and the order denying the plaintiff’s motion to vacate the judgment, and remand the matter to the Superior Court for further proceedings.

Background. We review the entry of summary judgment de novo, construing all facts in favor of the nonmoving party. *Augat, Inc. v. Liberty Mut. Ins. Co.,* 410 Mass. 117, 120, 571 N.E.2d 357 (1991). We summarize the undisputed facts, construed in that manner, as they appear in the summary judgment record.

On the afternoon of December 28, 2011, the plaintiff rode with her father to the defendant’s store on Cape Cod.[3] The weather was clear, with no precipitation, and the ground was dry. After getting out of the car, the plaintiff walked on the “inner side of the sidewalk” toward the store. Before reaching the store, however, she fell after stepping on a small “river stone” about three-quarters of an inch in size.[4] The stone was on the sidewalk after having been moved (by some unknown means) from an adjacent gravel area maintained by the store. The plaintiff did not see the stone, or any other stones, on the sidewalk before falling. As a result of her fall, the plaintiff suffered a “displaced fracture of her right hip that required two surgical repairs.”

At the time of her accident, the plaintiff was looking at a birdbath on display in the gravel area. She was wearing shoes called “clogs,” and she had no difficulty with the shoes on that day or in the past. When she fell, she remained on the sidewalk and did not fall into the gravel area or strike any of the merchandise on display.

The plaintiff had visited the store on multiple occasions since the late 1980's or early 1990's. She had walked on the same sidewalk before and had seen similar river stones on it, without encountering difficulty.

The concrete sidewalk on which the plaintiff fell was about six feet wide and ran between the parking lot and the store, in front of, and parallel to, the store front. The gravel area, also about six feet wide, was between the sidewalk and the store front.

Between the gravel area and the front wall of the store building was a porch area. The porch floor surface was on the same plane as the sidewalk and gravel area and was about six feet wide. The store displays merchandise both within the porch area and on and around the gravel area, and customers are allowed to help themselves to products from those areas.

Jessica Wile, a store manager, testified that the store sells various outdoor products during the winter months, including pottery, birdbaths, and shovels. The store's cash registers are located inside and near the store's front doors. The front doors are the only entrance for customers in the winter months; an alternate entrance through the greenhouse, also at the front of the store, is closed during the winter.

The store constructed the gravel area about fifteen years before the accident.[5] Prior to the plaintiff's fall, no other complaints regarding river stones on the sidewalk were brought to the store's attention, and no accidents from river stones on the sidewalk had occurred. However, it was a common occurrence for customer foot traffic through the gravel area, or manipulation of merchandise displayed there, to cause river stones to move from the gravel area onto the sidewalk. When assisting customers in carrying merchandise to their cars, or when retrieving shopping carts from the parking lot, store employees would look to see if river stones were present on the sidewalk, and would kick any stones back into the gravel area. However, there was no formal schedule for inspections, and no policy requiring that inspections occur on a particular basis or by particular employees.

The store maintained a weekly cleaning list that included spaces for dates and initials from Wile or an assistant manager after an employee completed a task. The cleaning list included tasks such as wiping counters, cleaning doors, and cleaning floors. There was no similar list for outside inspections, including the gravel area.

Five employees, including Wile, were working on the day of the accident.[6] Also among those working on the day of the accident was an employee named Jason Bowman. In his deposition he testified that, on an "average day," he went outside the store about every fifteen minutes, while helping customers, and inspected the sidewalk for the presence of river stones on those occasions. According to Wile, Bowman was "at the register with [Wile]" at the time of the accident. Bowman likewise testified that he was working the cash register that day, and that business was "steady." The record furnishes no guidance whether, or (if at all) how often, Bowman left the register to inspect the sidewalk for river stones on the day of the accident.[7]

After the plaintiff fell, her father went into the store and asked Bowman to provide

assistance. Bowman went outside, where he found the plaintiff on the ground and initially attempted to help her get up. After realizing that the plaintiff was injured, and recalling that store policy was to inform a supervisor of an accident, Bowman went back inside the store to retrieve Wile.[8]

Wile went outside and spoke with the plaintiff, who stated that she could not stand and needed help. Wile went back inside the store and returned with a stool for the plaintiff. Wile then called 911 from her cellular telephone.

According to Wile, when they were waiting for the ambulance to arrive, the plaintiff stated that she had stepped on a rock, started to trip, crossed her leg in an attempt to catch herself, but then fell on her hip. Wile then returned to the store to retrieve a notepad on which to write down the plaintiff's name and information. When she returned, Wile obtained the plaintiff's contact information and gave the plaintiff her card. An ambulance then came to transport the plaintiff to the hospital. Wile "took the [river stone] and taped it onto a piece of paper and put it in [her] desk drawer." She then "went out and noted any pebbles [on the sidewalk] and kicked them back onto the [gravel] area."

Discussion. As we observed in the introduction, in *Sheehan,* 448 Mass. at 782–791, 863 N.E.2d 1276, the Supreme Judicial Court adopted the mode of operation approach to premises liability, in a departure from the "traditional approach."[9] The court introduced the doctrine by observing that it modifies how the notice requirement of premises liability is met:

> "Under the mode of operation approach, the plaintiff's burden to prove notice is not eliminated. Instead, the plaintiff satisfies the notice requirement if he establishes that an injury was attributable to a reasonably foreseeable dangerous condition on the owner's premises that is related to the owner's self-service mode of operation."

Id. at 786, 863 N.E.2d 1276.

To explain its decision to adopt the mode of operation approach, the court observed that modern merchandising techniques often call for customers to engage in "self-service" activities (in circumstances where store employees previously might instead have assisted them). See *id.* at 784, 863 N.E.2d 1276. The use of self-service operations in turn carries with it the foreseeable risk that customer carelessness could give rise to spillage and breakage that could cause dangerous conditions in the store premises—in contrast to store employees who generally would be expected to be more careful and, in any event, act under the supervisory oversight of their employer. See *id.* at 784–785, 863 N.E.2d 1276. However, the court was explicit that its rationale was based on the foreseeable likelihood that hazards could result from the owner's self-service mode of operation, and that such "conditions may include, but are not limited to, spilled foreign substances or fallen matter." *Id.* at 786 n. 6, 863 N.E.2d 1276.

In allowing the defendant's motion for summary judgment, the motion judge suggested that applying the mode of operation approach to the circumstances of the plaintiff's injury would

constitute an extension of the doctrine beyond the "spillage and breakage" paradigm involved in *Sheehan,*[10] and our dissenting colleague presses a similar suggestion. To the contrary, however, in our view the attempt to limit application of the mode of operation approach to spillage and breakage of products offered for sale (and, thereby, to limit *Sheehan* to its facts) is at odds both with the court's explanation of its holding, see *ibid.,* and with the fundamental tort principles on which the mode of operation approach is based.[11]

To return to first principles, "[a] landowner must act as a reasonable man in maintaining his property in a reasonably safe condition in view of all the circumstances, including the likelihood of injury to others, the seriousness of the injury, and the burden of avoiding the risk." *Mounsey v. Ellard,* 363 Mass. 693, 708, 297 N.E.2d 43 (1973), quoting from *Smith v. Arbaugh's Restaurant, Inc.* 469 F.2d 97, 100 (D.C.Cir.1972). The foreseeability of potential danger is an essential limiting characteristic, as is the opportunity of the landowner to take reasonable steps to mitigate the risk to visitors. See *Mounsey v. Ellard, supra* at 708–709, 297 N.E.2d 43. See also *Sheehan,* 448 Mass. at 783–784, 863 N.E.2d 1276. Accordingly, under the traditional approach, a store owner was held liable for injuries occurring on his premises only if he had "actual or constructive notice of the existence of the dangerous condition, [and] sufficient ... time ... to remedy the condition." *Id.* at 784, 863 N.E.2d 1276.

The rationale for adoption of the "modern" mode of operation approach was simple: in circumstances where store owners invite customers to use "self-service" to manipulate merchandise displays, there is a foreseeable risk that customers' handling of merchandise or displays will cause disruption of the store's arranged display, to the end that hazardous conditions will result. See *id.* at 784–786, 863 N.E.2d 1276. Put another way, "the owner of such a self-service establishment has actual notice that his mode of operation creates certain risks of harm to his customers. Since a self-service operation involves the reasonable probability that these risks will occur, these risks are foreseeable." *Id.* at 786, 863 N.E.2d 1276, quoting from *Pimentel v. Roundup Co.,* 100 Wash.2d 39, 43, 666 P.2d 888 (1983).[12]

We acknowledge that *Sheehan, supra* at 781, 863 N.E.2d 1276, itself, involved an injury caused by an item (a grape) that apparently fell from a self-service display to the supermarket floor before a customer slipped on it. However, under the rationale supporting the mode of operation approach, it should not matter whether the item that migrates from the self-service display to the floor (thereby causing a slipping hazard) is a grape or a quantity of shaved ice from the bed keeping the grapes cool. The distinction drawn by the motion judge between items offered for sale and other hazards foreseeably occurring as a result of the store's use of a self-service mode of operation accordingly should make no difference in the applicability of the mode of operation approach. Moreover, as we have observed, the Supreme Judicial Court explicitly cautioned that its adoption of the mode of operation was not limited to "spilled foreign substances or fallen matter." *Sheehan,* 448 Mass. at 786 n. 6, 863 N.E.2d 1276.

Returning to the facts of the instant case, on the summary judgment record it is undisputed that the gravel area, the source of the stone causing the plaintiff's injury, was a self-service area used for the display and sale of store merchandise, including large items, the

manipulation of which foreseeably could (and often did) cause stones to move onto the sidewalk, creating a risk of tripping or falling. In our view, it is accordingly an appropriate circumstance for application of the mode of operation approach.

Of course, application of the mode of operation approach does not alone establish liability of the landowner. It remains for the plaintiff to prove that “an ordinarily prudent person in the defendant’s position would have taken steps, not taken by the defendant, to prevent the accident that occurred.” *Id.* at 790–791, 863 N.E.2d 1276, quoting from *Toubiana v. Priestly,* 402 Mass. 84, 88–89, 520 N.E.2d 1307 (1988). On this question, the summary judgment record is inconclusive. Though the motion judge treated as established fact that every store employee was instructed to inspect the sidewalk for river stones, and that one employee (who was working on the day of the accident) conducted such an inspection every fifteen minutes, the record is less conclusive than that. As we have observed, the store had no formal policy in place concerning inspection of the outdoor sidewalks. Moreover, Bowman (the store employee who described making such inspections every fifteen minutes) described his practice in general terms, on an average day. He offered no testimony that he made any such inspections on the day of the accident, and we note that he was working the cash register that day, with a “steady” flow of customers past his register. We also note that (according to Wile) the store was staffed with only five employees, compared to a typical staffing complement on slow winter days of seven to ten employees. See note 6, *supra.* In short, on the summary judgment record there remains a genuine issue of material fact as to whether the store took adequate steps to address the risk posed by the inadvertent transfer of river stones from the gravel area onto the adjacent sidewalk. Though the burden to prove that the store failed to take adequate protective measures remains with the plaintiff, the defendant has not shown, on the present summary judgment record, that the plaintiff has no reasonable expectation of meeting her burden at trial. See *Kourouvacilis v. General Motors Corp.,* 410 Mass. at 714, 575 N.E.2d 734.

Conclusion. The judgment dismissing the plaintiff’s complaint and the order denying the plaintiff’s motion to vacate the judgment are reversed. The case is remanded to the Superior Court for further proceedings consistent with this opinion.

So ordered.

KANTROWITZ, J. (dissenting).

When granting summary judgment, the motion judge noted that the mode of operation approach adopted by the Supreme Judicial Court in *Sheehan v. Roche Bros. Supermarkets, Inc.,* 448 Mass. 780, 788, 863 N.E.2d 1276 (2007) (*Sheehan*), had thus far been applied routinely to “spillage and breakage” cases, or in cases where a plaintiff was injured by a product or an item that was available for customers to pick up and carry around the store. The

river stone in this case was not a product for sale, or an item intended for customers to pick up and carry, but rather part of the exterior design of the defendant's store. The majority's application of the mode of operation approach to these facts is an unnecessary expansion of that approach, needlessly broadening the field. Perhaps of equal significance, regardless of the approach used, summary judgment was appropriate.

In *Sheehan,* the Supreme Judicial Court cited several cases that illustrated the context of, and support for, the court's decision. Here, the majority decision stands in stark contrast to the cases cited by the Supreme Judicial Court. Notably, the cases cited in *Sheehan* supporting the mode of operation approach involved business establishments that invited customers to pick up and carry products in or around the store, with a plaintiff injured by a product that was capable of being handled and conceivably purchased. See *Tom v. S.S. Kresge Co.,* 130 Ariz. 30, 31, 633 P.2d 439 (1981) (customer slipped on clear liquid substance in self-service store that sold primarily dry goods but also soft drinks capable of being carried around store); *Chiara v. Fry's Food Stores of Ariz., Inc.,* 152 Ariz. 398, 399, 733 P.2d 283 (1987) (customer slipped on creme rinse at self-service store); *Safeway Stores, Inc. v. Smith,* 658 P.2d 255, 256 (Colo.1983) (customer in self-service grocery store slipped on substance that appeared to be hand lotion); *Meek v. Wal–Mart Stores, Inc.,* 72 Conn.App. 467, 469, 806 A.2d 546 (2002) (customer hit by boxed aluminum tables that fell from shelf in self-service retail store); *Gump v. Walmart Stores, Inc.,* 93 Hawai'i 428, 433, 5 P.3d 418 (Ct.App.1999) (customer slipped on french fry in self-service store that contained a restaurant), aff'd in part and rev'd in part on other grounds, 93 Hawai'i 417, 5 P.3d 407 (2000); *Jackson v. K–Mart Corp.,* 251 Kan. 700, 701, 840 P.2d 463 (1992) (customer in clothing section of self-service department store, which sold avocado juice at store cafeteria, slipped and fell on green liquid that was apparently avocado juice); *Wollerman v. Grand Union Stores, Inc.,* 47 N.J. 426, 428, 221 A.2d 513 (1966) (customer in vegetable section of self-service supermarket slipped and fell on string bean); *Canfield v. Albertsons, Inc.,* 841 P.2d 1224, 1225 (Utah Ct.App.1992) (customer in produce department of self-service store slipped on lettuce leaf); *Pimentel v. Roundup Co.,* 100 Wash.2d 39, 41, 666 P.2d 888 (1983) (customer at self-service department store was hit on foot by can of paint that fell from shelf).

Each of these cases involved a customer or visitor injured by a product for sale, or an item intended to be picked up and carried, within a self-service store. Here, in contrast to the cases cited in *Sheehan* and *Sheehan* itself, the object that caused the plaintiff's injury was not an item for sale that a customer could conceivably purchase from the store or an item that the store invited customers to pick up and carry, within its "self-service mode of operation." *Sheehan,* 448 Mass. at 786, 863 N.E.2d 1276.

The approach adopted in *Sheehan* applies if a plaintiff's injury is attributable to a "reasonably foreseeable dangerous condition on the owner's premises that is *related to* the owner's self-service mode of operation." *Ibid.* (emphasis supplied). Until now, no published opinion from this court or the Supreme Judicial Court (or apparently the Superior Court) has held that this approach applies to hazards on a store's premises resulting from anything other than an item that the store owner conceivably intended for customers to pick up and carry around (hence the phrase "self-service" as it appears in the *Sheehan* opinion).

Under the majority's expansive application of this approach, however, almost any potential hazard can be "related to" a defendant's self-service mode of operation. *Ibid.* Removal of the limits on the application of the mode of operation approach, which lower courts have followed until this point, will potentially expose self-service businesses in Massachusetts to premises liability not envisioned by the *Sheehan* court, because everything within such businesses is conceivably related to their mode of operation under the majority's new application of the approach.

A further problem with the majority's holding is that even assuming that the mode of operation approach should apply, summary judgment for the defendant was still appropriate, as the motion judge explained. The mode of operation approach only provides plaintiffs with a different (and less burdensome) method for proving the notice element. See *id.* at 790, 863 N.E.2d 1276. A plaintiff must still demonstrate that the defendant acted unreasonably. See *ibid.* Here, the plaintiff is unable to make such a showing.

The motion judge properly found that the plaintiff had no reasonable expectation of proving at trial that the defendant breached a duty of care, even assuming that the mode of operation approach applied. See *Flesner v. Technical Communications Corp.,* 410 Mass. 805, 809, 575 N.E.2d 1107 (1991). The plaintiff produced no affirmative evidence that a reasonable jury could use to infer that the store was negligent. See *Godbout v. Cousens,* 396 Mass. 254, 261, 485 N.E.2d 940 (1985) (nonmoving party may not rest upon mere allegations or denials, but must respond with specific facts); *Pederson v. Time, Inc.,* 404 Mass. 14, 17, 532 N.E.2d 1211 (1989) (once party moving for summary judgment establishes absence of triable issue, burden shifts to nonmoving party to offer affirmative evidence). See also Mass.R.Civ.P. 56(c), as amended, 436 Mass. 1404 (2002). Mere assertions that the defendant's evidence should not be believed is not affirmative evidence sufficient to withstand summary judgment. See *Godbout v. Cousens, supra* at 261–262, 485 N.E.2d 940. The bare fact that an accident occurred is not proof of negligence. See, e.g., *Tamagno v. Conley,* 322 Mass. 218, 219, 76 N.E.2d 637 (1948) ("The mere fact that the accident happened is of course no evidence of the defendant's negligence").

At their depositions, the defendant's employees testified on the store's practice of inspecting the sidewalk and pushing back any river stones that escaped from the gravel area. In contrast, the plaintiff merely argues that a jury could disbelieve these accounts of the employees' inspection efforts and find in her favor. Arguing that a fact finder could theoretically disbelieve a witness at trial is not affirmative evidence. See *Boston v. Santosuosso,* 307 Mass. 302, 349, 30 N.E.2d 278 (1940) ("[A]s has been pointed out many times, disbelief of evidence is not the equivalent of affirmative evidence to the contrary").[1]

The plaintiff has provided no affirmative evidence, for example, that store employees failed to inspect the sidewalk on the day of her accident, or that the employees who were supposed to inspect the sidewalk as part of their duties neglected to take proper care and unreasonably allowed a hazardous condition to exist on the sidewalk. She provided no evidence that demonstrated that the river stone on which she fell had been on the sidewalk for an

unreasonable amount of time. The mere fact that she fell on a river stone is not evidence of the store's alleged negligence. See *Tamagno v. Conley, supra.*

In contrast, the defendant's evidence showed that reasonable efforts were made to inspect the sidewalk, including a general practice of inspecting the outside area for safety. The defendant also showed that employee Bowman, who was working on the day of the accident, usually checked the sidewalk for river stones every fifteen minutes. If there were evidence that these employees neglected their duties that day, the plaintiff needed to place such evidence before the motion judge.

As the plaintiff produced no such evidence, the judge properly found that there were no genuine issues for trial because the plaintiff could not prove that the store acted improperly. See *Flesner v. Technical Communications Corp.,* 410 Mass. at 809, 575 N.E.2d 1107. Viewing the evidence in the light most favorable to the plaintiff, the defendant was entitled to judgment as a matter of law, even assuming that the mode of operation approach applied. See *Augat, Inc. v. Liberty Mut. Ins. Co.,* 410 Mass. 117, 120, 571 N.E.2d 357 (1991).

Because the majority's decision expands the application of the mode of operation approach, and because summary judgment was properly granted in any event, I respectfully dissent.

All Citations

87 Mass.App.Ct. 362, 30 N.E.3d 847

Footnotes

[1] Doing business as Agway of Cape Cod.

[2] In so doing, the motion judge appears to have followed a line of like rulings by other judges of the Superior Court.

[3] As the motion judge observed, the summary judgment record describes the store's location inconsistently, in both Dennis and Orleans. The disparity is immaterial.

[4] As the motion judge noted, the parties have referred to the object in question variously as a river stone, rock, or pebble. We adopt his choice to refer to the object generally as a river stone and agree with him that the precise label applied to the object is immaterial.

[5] Wile stated that the store constructed the gravel area of river stones because of a municipal building department requirement that the area be permeable for water drainage purposes.

[6] During the winter months, when the store was less busy, it usually had seven to ten employees working daily, according to Wile. The store consists of a showroom of about 4,000 square feet, and a warehouse, closed to the public, of about 7,000 square feet.

[7] The deposition transcript of Bowman included in the record presents only excerpts of Bowman's testimony.

[8] Once Bowman retrieved Wile, he remained inside the store.

[9] Under the traditional approach, a landowner is liable for injuries caused by dangerous conditions on his property if the owner knows or should know of an unreasonable risk of harm, visitors will not discover the danger or protect themselves, and the landowner fails to exercise reasonable care to protect them. See *Sheehan, supra* at 782, 863 N.E.2d 1276, quoting from Restatement (Second) of Torts § 343 (1965).

[10] In so doing, the motion judge cited a number of other cases decided in the Superior Court that similarly limited the mode of operation approach to dangerous conditions caused by spillage or breakage of products offered for sale. That articulation of the limitation—that the risk derive not simply from spillage or breakage but that the spillage or breakage be of a product offered for sale—imposes an even further restriction of the doctrine beyond the limitation expressly disclaimed by the court in its opinion.

[11] For another recent discussion of basic tort principles in the evaluation of a judicially formulated rule of convenience, see *Papadopoulos v. Target Corp.,* 457 Mass. 368, 370–378, 930 N.E.2d 142 (2010), citing *Sheehan,* 448 Mass. at 791–792, 863 N.E.2d 1276, in support of abrogating the rule that a property owner cannot be liable for a natural accumulation of snow or ice.

[12] In adopting the mode of operation approach, the Supreme Judicial Court also observed that several jurisdictions, while declining to adopt the mode of operation approach, nonetheless take account of "recurrent" risks in assessing whether a property owner should have known that a condition resulting from its regular operations posed a risk of injury to customers. See *Sheehan, supra* at 789, 863 N.E.2d 1276.

[1] Indeed, juries are routinely instructed: "If you do not believe a witness's testimony that something happened, of course your disbelief is not evidence that it did *not* happen. When you disbelieve a witness, it just means that you have to look elsewhere for credible evidence about that issue." Massachusetts Superior Court Civil Practice Jury Instructions § 1.2.8 (Mass. Cont. Legal Ed. 3d ed. 2014). See Criminal Model Jury Instructions for Use in the District Court, Instruction 2.260 (Mass. Cont. Legal Ed. 2009) (same).

John MACKEY

v.

ROOTES MOTORS INCORPORATED et al.

Supreme Judicial Court of Massachusetts
|
Decided Feb. 5, 1965.

Synopsis

Suit in equity to reach and apply motor vehicles owned by motor company to satisfy debt for services rendered. Defendant denied debt and filed counterclaim alleging overcharge by plaintiff. The Superior Court, Ford, J., entered interlocutory decree on master's report, and entered final decree for defendant, and plaintiff appealed. The Supreme Judicial Court, Spiegel, J., held that knowledge on the part of plaintiff at time he paid defendant's agent commissions with respect to business of defendant that agent was defendant's agent rather than middleman or independent broker was essential to impose liability upon plaintiff on counterclaim on basis of agent's secret commissions, and in absence of specific finding on question, the case would be remanded.

Reversed and remanded.

Opinion

SPIEGEL, Justice.

This is a bill in equity to reach and apply certain motor vehicles owned by Rootes Motors Incorporated (defendant),[1] in satisfaction of a debt for services rendered in 1962 by the plaintiff according to an account annexed. The defendant in its answer denied the debt and filed a counterclaim alleging that it was overcharged by the plaintiff for certain services and seeking recovery from the plaintiff of the amount of the overcharge. The suit was referred to a master, who concluded that the plaintiff owes $4,342 to the defendant and that the defendant owes $3,589.43 to the plaintiff, and ultimately found for the defendant in the amount of $752.57. The trial judge entered an interlocutory decree overruling the plaintiff's exceptions to the master's report and confirming the report. A final decree was entered for the defendant and the plaintiff appeals.

A summary of the pertinent facts follows. In March, 1955, one Kenneth G. Lewis was employed by the defendant as its 'full time' New England regional manager in charge of sales and warehousing. In 1956, the parties 'entered into a contractual arrangement for the storage and the making of certain repairs to vehicles owned by the defendant.' The defendant consulted with Lewis and relied on his advice and recommendations regarding the location for the warehousing of its vehicles. While thus employed as regional manager for the defendant, Lewis obtained business accounts for the plaintiff. From March, 1959, through April, 1962, Lewis received checks from the plaintiff as 'commissions for the storage of

motor vehicles belonging to the defendant' and other firms. The defendant was never notified of these payments to Lewis. Lewis 'recommended the continued use' of the plaintiff's facilities 'for the storage and warehousing of the defendant's vehicles.' Under this scheme, Lewis received a total of $4,342 from the plaintiff as secret profits or commissions in connection with the storage of the defendant's vehicles in 1959 and 1960 before his employment with the defendant terminated.

'[T]here was no price increase in the contractual arrangement between the * * * [parties] during the period * * * from 1958 until the contractual arrangement terminated in 1962. * * * [I]n 1959 there was a price reduction in * * * [this] arrangement.' '[T]he services rendered by the plaintiff to the defendant * * * were satisfactory during the * * * period of * * * [Lewis's employment with the defendant].' The plaintiff never charged the defendant 'as a result of any commission, or sum of money paid by the plaintiff's to Lewis during this period. The charges for services set forth in the plaintiff's account annexed cover a period during which Lewis was no longer employed by the defendant. The plaintiff made no payment to Lewis during this period.

The plaintiff objected to the master's conclusion that 'the plaintiff is indebted to * * * [the defendant] in the amount of $4,342' on the ground that the facts do not support that conclusion as a matter of law. On the same ground, the plaintiff objected to the general finding 'for the defendant * * * in the amount of $752.57.'
1. The plaintiff vaguely raises some doubt regarding the propriety of the defendant's counterclaim. In this connection, we note that Rule 32 of the Superior Court (1954) provides that in equity cases the answer may set up any counterclaim of a legal nature, against any one or more of the parties, arising out of the transaction that is the subject matter of the suit. Inasmuch as recovery on the counterclaim is based on a form of tort (as it is evident from our discussion, infra) it is 'of a legal nature.' See G.L. c. 231, § 1. 'The word 'transaction' in * * * [Rule 32] should be construed in a sense 'to effectuate the settlement in one proceeding of controversies so closely connected as appropriately to be combined in one trial in order to prevent duplication of testimony, to avoid unnecessary expense to the parties and to the public, and to expedite the adjudication of suits. * * *' Potier v. A. W. Perry, Inc., 286 Mass. 602, 608, 190 N.E. 822, 824.' Davis & O'Connor Co. v. Shell Oil Co., Inc., 311 Mass. 401, 405, 41 N.E.2d 287, 290; Stubbert v. Sergio, 335 Mass. 91, 93, 138 N.E.2d 592. But, in any event, since no answer based on the ground of want of equity was filed to the counterclaim pursuant to Rule 26 of the Superior Court (1954), we are of opinion that the plaintiff has waived any objection thereto based on that ground. Potier v. A. W. Perry, Inc., 286 Mass. 602, 609, 190 N.E. 822; Davis & O'Connor Co. v. Shell Oil Co., Inc., 311 Mass. 401, 405, 41 N.E.2d 287.

2. The defendant contends that the plaintiff's violation of G.L. c. 271, § 39,[2] by paying commissions to Lewis precludes the plaintiff from any recovery. It presumably bases its contention on the maxim that equity will not grant relief to one who is guilty of illegal conduct in a matter concerning which he seeks relief. New York, N. H. & H. R. R. Co. v. Pierce Coach Lines, Inc., 281 Mass. 479, 482, 183 N.E. 836. See Walsh v. Atlantic Research Associates, Inc., 321 Mass. 57, 65–66, 71 N.E.2d 580. However, the illegal conduct of the

plaintiff to which the defendant refers does not involve the same matters concerning which the plaintiff seeks relief, namely, services rendered by him in 1962. The services involved in the defendant's averment of illegality were separate and occurred in 1959 and 1960. Therefore, we need not pass on the question whether the plaintiff acted in violation of the criminal statute.

3. The facts show a breach by Lewis of his fiduciary duties to his principal, the defendant. 'Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.' Restatement 2d: Agency, § 387, See Restatement 2d: Agency, §§ 389, 391; J. C. Penney Co. v. Schulte Real Estate Co., 292 Mass. 42, 197 N.E. 458; Production Mach. Co. v. Howe, 327 Mass. 372, 377–378, 99 N.E.2d 32. The principal's basis of recovery against the agent where the agent makes a profit in connection with transactions conducted by him on behalf of the principal is the agent's 'duty to give such profit to the principal.' Restatement 2d: Agency, § 388. Cf. Raymond v. Davies, 293 Mass. 117, 119 N.E. 321, 102 A.L.R. 1112.

However, the basis of recovery by the defendant against the plaintiff is quite different. 'A person who, without being privileged to do so, intentionally causes or assists an agent to violate a duty to his principal is subject to liability to the principal.' Restatement 2d: Agency, § 312. Cf. Moran v. Dunphy, 177 Mass. 485, 59 N.E. 125, 52 L.R.A. 115; H. C. Girard Co. v. Lamoureux, 227 Mass. 277, 116 N.E. 542. So also, '[a] person who, knowing that the other party to a transaction has employed an agent to conduct a transaction for him, employs the agent on his own account in such transaction is subject to liability to the other party, unless he reasonably believes that the other party acquiesces in the double employment.' Restatement 2d: Agency, § 313(1). City of Boston v. Simmons, 150 Mass. 461, 466, 23 N.E. 210, 6 L.R.A. 629. In applying these principles to the case at bar, we note that nothing in the master's findings indicates that the plaintiff, during the period of his payments to Lewis, knew or should have known that Lewis was the agent of the defendant. A finding of such knowledge is essential to the defendant's counterclaim. See Restatement 2d: Agency, §§ 312, comment b, 313; City of Boston v. Simmons, supra. The facts as they appear in the report are consistent with the possibility that Lewis held himself out to the plaintiff as a 'middleman' or independent broker who would arrange for the storage of motor vehicles with the plaintiff on a free lance basis, and that the plaintiff paid commissions to Lewis believing these representations and unaware of Lewis's fiduciary relationship with the defendant. On those facts there would be no basis for recovery by the defendant on its counterclaim. Conversely, the counterclaim would be meritorious if knowledge by the plaintiff of Lewis's employment by the defendant during the time the commissions were paid could be shown. In either event, a specific finding one way or the other is necessary.

Hence, although no motion was made to recommit the case to the master on the ground that one of the issues raised by the counterclaim had not been passed on, we are of opinion that the case should be retried on that issue. 'Where the facts on which the rights of the parties depend have not been ascertained at the trial it is within the power of the court, in its discretion and of its own motion, to recommit the cause for retrial.' DeVeer v. Pierson, 222 Mass. 167, 175, 110 N.E. 154, 157;

N.E.2d 384; Lattuca v. Cusolito, 343 Mass. 747, 753, 180 N.E.2d 658. 'Whether the rehearing should be before the court or before a master is for the Superior Court to decide. In the event the latter course is pursued the judge is to determine to what extent the report of the master is to be set aside.' Lenari v. Town of Kingston, supra. Lattuca v. Cusolito, supra.

4. Although no appeal was taken from the interlocutory decree confirming the master's report, its correctness is open for consideration upon the appeal from the final decree. G.L. c. 214, § 27. Arsenault v. Arsenault, 337 Mass. 189, 193, 148 N.E.2d 662. Accordingly, the interlocutory decree is reversed; the final decree is reversed and the case is remanded to the Superior Court for further proceedings consistent with this opinion.

So ordered.

All Citations

348 Mass. 464, 204 N.E.2d 436

Footnotes

1 A temporary injunction was granted below restraining the other defendant, Albert H. Solomon, from disposing of the motor vehicles in his possession which are owned by Rootes Motors Incorporated. Solomon is not involved in this appeal and we do not hereinafter refer to him in this opinion.

2 This section provides, in part: '[A]n agent, employee or servant who, being authorized to procure materials, supplies or other articles either by purchase or contract, for his principal, employer or master, or to employ service or labor for his principal, employer or master, receives directly or indirectly, for himself or for another, a commission, discount or bonus from the person who makes such sale or contract, or furnishes such materials, supplies or other articles, or from a person who renders such service or labor; and any person who gives or offers such an agent, employee or servant such commission, discount or bonus, shall be punished by a fine.'

VII. When the Agent Competes Against the Principal– Introduction

As you may recall from your Contracts classes, it would be a breach of the duties an agent owes to his principal for the agent to compete against the principal while still employed by the principal. Two exceptions to this general rule come to mind. The first is if the principal approves of the agent competing while employed. This might happen when two people go into partnership together, and both agree beforehand that their running of the partnership business will not preclude either of them from running a similar business right down the street. The second involves the grey area of making preparations to compete after you leave

your employer.

The general rule in employment arrangements is that once the employment is ended, the former employee (agent) is free to compete against his former employer (principal). Employers have blunted this general rule by having employees sign covenants not to compete (or, noncompetition agreements) under which the employee agrees not to compete after leaving the company. Whole series of books have been written on this subject. The old, general rule is that, if an employer has a "protectable business interest," it can prevent an ex-employee from competing against it, as long as the agreement not to compete is tightly worded, that is, it is reasonable in terms of scope, duration, and geography. This approach has been made much more difficult with the advent of so many companies doing business over the internet.

Discussion points for Arthur Murray v. Witter

Reading this case, one can see that way back in 1952, when this case was decided, there was already a tremendous amount of literature on the subject of noncompetition agreements, and the court frankly admits that a cohesive and logical body of law on the subject did not exist, because judicial opinions were all over the place. Was the noncompete agreement signed by Witter reasonable in scope, duration, and geography? If so, why did the plaintiff employer lose this case? How would you like to have been this judge's law clerk for the summer?

ARTHUR MURRAY DANCE STUDIOS OF CLEVELAND, Inc.
v.
WITTER.

Court of Common Pleas of Ohio, Cuyahoga County.

Feb. 28, 1952.

HOOVER, Judge.

When the defendant, Clifford Witter, a dance instructor, waltzed out of the employment of the plaintiff, the Arthur Murry Dance Studios of Cleveland, Inc., into the employment of the Fred Astaire Dancing Studios, the plaintiff waltzed Witter into court. For brevity, the two studios are called 'Arthur Murray' and 'Fred Astaire'. At the time Witter took his contentious step, Arthur Murray had a string attached to him--a certain contract prohibiting Witter, after working for Arthur Murray no more, from working for a competitor. That Arthur Murray and Fred Astaire are rivals in dispensing Terpsichorean erudition is not disputed. Now Arthur Murray wants the court to pull that string and yank Witter out of Fred Astaire's pedagogical pavilion.

No layman could realize the legal complication involved in Witter's uncomplicated act. This is not one of those questions on which the legal researcher cannot find enough to quench his thirst. To the contrary there is so much authority it drowns him. It is a sea--vast and vacillating, overlapping and bewildering. One can fish out of it any kind of strange support for anything, if he lives so long. This deep and unsettled sea pertaining to an employee's covenant not to compete with his employer after termination of employment is really Seven Seas; and now that the court has sailed them, perhaps it should record those seas so that the next weary traveler may be saved the terrifying time it takes just to find them.

We trust we are justified in shifting figures of speech long enough to point out how ironic it is that the needles of justice can be buried in so huge a haystack. The average litigant will not find adequate justice in this subject matter until some one devotes a treaties solely to it. It has grown so elephantine yet so intricate that it now needs a complete, detailed treatment for which there is not room in general treatises on such omnibus subjects as injunctions or contracts.

The main facts are these: Arthur Murray is engaged in the business of teaching dancing. So is Fred Astaire. They are rivals in direct competition. Arthur Murray has two studios in this area. One is in downtown Cleveland at 1515 Euclid Ave. The other is a suburban studio at 13910 Cedar Road, in the Warrensville Road-Cedar Road section of the city of University Heights. The two studios are at least seven miles apart--as an automobile flies. Fred Astaire has but one studio in the area--on Euclid Avenue in downtown Cleveland not far from Arthur Murray's downtown studio.

There is little evidence about the nature and extent of Arthur Murray's business. He spends $50,000 annually for advertising and promotion. There is no evidence to show how far the goodwill of the business extends or from what area either of his studios draws its patrons.

Arthur Murray produced the following evidence as to the training he generally gives his prospective instructors. The prospect is given ten to twelve weeks of training. He is 'thoroughly indoctrinated with the methods of teaching as established by Arthur Murray' and 'given a thorough sales training'. Even after he starts teaching, his own training continues. Occasionally experts come from New York or other studios throughout the country 'to impart new methods and new dances to our staff.'

How Arthur Murray gets its prospective students is not clear. The evidence seems to indicate that prospects are procured through newspaper, radio and television advertising. There is no evidence that any are secured by any employee going out and personally soliciting them from the public.

When a pupil comes into the studio to take lessons, he is first interviewed by the sales staff. If he decides to buy a course he is turned over to an analyst who handles him for his first five hours of instruction. The analyst plans a tailor-made course for that pupil and then turns him over to an instructor or history teacher who is 'responsible for that pupil during his life in the studio'. Just what all that responsibility entails is not explained. Arthur Murray recognizes the

importance of a pupil dancing with more than one instructor and encourages the practice of the pupil having exchange lessons with other instructors. Appointments are made at the desk. The instructor is supposed to encourage the pupil to take as may lessons as possible each week to get the benefit of regularity of instruction.

Witter started to work for Arthur Murray in March 1949 on a part time basis. No written contract was produced covering the part time period. It is not clear when that period ended and full time employment began, but it seems to have been at the time a written 'Employment Agreement' was entered, dated January 11, 1950. Witter's employment ceased shortly thereafter, on April 20, 1950. Witter claims the cessation was involuntary; Arthur Murray claims it was voluntary. The evidence shows that Witter worked at Arthur Murray's Heights Studio. There is no evidence showing that he ever worked at Arthur Murray's downtown studio.

By the Employment Agreement Witter was hired as a dancing instructor for one year. It reads in part:

'Whereas the Employers conduct a dancing school with studios in the City of Cleveland and have expended and continue to expend large sums of money for the purposes thereof, including the development of methods of dancing and of obtaining pupils and the names of persons interested in dancing and generally in procuring patronage and good-will for their business, and

'Whereas the Employers have established unique methods of dancing instruction known as the Arthur Murray Methods of Instruction in Dancing and have attained a high reputation as a nationally known dancing school, and

'Whereas the Employers desire to employ the Employee as a dancing instructor or in other capacities, and

'Whereas the Employers will train and instruct the Employee in their methods, and disclose to the Employee confidential information as to their methods, the names of their pupils, etc. and desire to make suitable provision that such confidential disclosures shall not be abused, revealed to the Employers competitors or used by the Employee for his own benefit in competition with the Employers.'

* * *

'3. The Employers will give to the Employee a course of training in dance instruction in order to fit the trainee to teach dancing, or to interview or supervise according to the methods of the Employers. After such course of training is given to the Employee, there will be disclosed to him further information as to the methods of the Employers, the names of pupils and patrons of the Employers, and he will have occasion at the behest of the Employers, to meet such pupils and patrons. Proprietors, managers and all employees of hotels, resorts, ships or establishments of any kind at which the Employers had or may have branch studios,

shall among others, be considered patrons of the Employers.

* * *

'5. The Employee agrees that upon the termination of his employment for any cause and for a period of two (2) years thereafter, he will not, teach dancing or accept employment in any manner relating to dancing, dancing engagements, or exhibitions, dancing lessons or instruction or lectures in dancing in any form whatsoever, or become engaged directly or indirectly in business in any respects relating to dancing at any hotel, resort, ship or establishments, nor solicit business for himself or any other business in any manner related to dancing, nor directly nor indirectly engage in teaching of dancing to anyone within a radius of twenty-five (25) miles of Employer without the written consent of Employer.

* * *

'8. The Employee agrees to pay to the Employers the sum of $750.00 to compensate the Employers for the courses of training given to him at the cost and expense of the Employers, and not by way of satisfaction of any claim for damages for breach of contract, and does herewith deliver to the Employers two separate promissory notes in the sums respectively of $250.00 and $500.00 for such indebtedness. If the Employee within a period of two years after the termination of his employment for any cause, shall either become engaged directly or indirectly in business as a dancing instructor, teacher, supervisor or interviewer, or accept employment in any manner relating to dancing, but not in violation of the provisions of this agreement, said note of $500.00 in payment for training given to the Employee by the Employers shall be payable without further liability on the part of the Employee. If the Employee remains in the employ of the Employers for a period of not less than one year, from the date hereof, as he is required to do, the Employers will cancel and discharge the note for $250.00 The Employers also agree that they will not demand payment of such note for a period of one year from the date hereof, provided the Employee remains in their employ. If the Employee remains in the employ of the Employers for a period of at least one year from the date hereof and thereafter his employment is terminated and he thereafter for a period of two years, observes all of the restrictions and provisions of paragraphs 4 and 5 hereof, then and in that event the Employers will at the end of such two year period cancel and discharge the said note for $500.00. The Employers will not demand payment of the said note during the period of the Employee's employment, nor during the said period of two years thereafter, so long as the Employee continues to observe such restrictions.

'9. The parties hereto, recognizing that irreparable injury will result to the Employers in event of a breach of the terms of this contract on the part of the Employee, agree that in such event the Employers shall be entitled, in addition to any other remedies and damages available, to an injunction to restrain the violation (s) thereof by the Employee, and all persons acting for or with him.'

Arthur Murray produced no witness of his own to show what specific training he gave Witter. Witter admitted that from Arthur Murray he received his training to become a

dancing instructor and then become an Arthur Murray instructor; that he was taught 'the so-called Arthur Murray method of teaching dancing'; that in all he received about forty to fifty hours as to dancing instruction; that as an instructor he was introduced to students he was to teach; and that at the studio he met the pupils of other instructors.

Here there are large blind spots in the evidence. We are not told how many of his own pupils he taught or how many of other instructors' pupils he taught; nor how he taught them (whether individually or in classes); nor how regularly or often he taught them; nor how many hours he or other instructors spent on his pupils or on other instructors' pupils; nor over how long a period the course of instruction lasts (one month or one year).

Witter testified, without contradiction, that he received little or no sales or business training and that the Arthur Murray sales manuals were not made accessible to him.

Within about six weeks after leaving Arthur Murray, Witter entered the employment of Fred Astaire where he teaches and supervises. In the interim he had a week's employment elsewhere. He approached Fred Astaire. Fred Astaire did not seek him out. At Fred Astaire's, Witter was given three weeks of training before he started to work--a daily training in dancing and sales of three or four hours. He was still receiving training at the time of the trial. There is no evidence that Witter ever engaged in solicitation to get customers either for Arthur Murray or Fred Astaire. Without contradiction, Witter testified:

> 'Q. Was there any technique or any secret technique of any kind or any sales manuals or dance technique that you have learned at Arthur Murray Studios that you are using at Fred Astaire Dance Studios? A. No, we didn't have access to that material.
> 'Q. Are you using any of their technique at all at the Fred Astaire Dance Studios today? A. None whatsoever.
> 'Q. Have you ever solicited or advertised the fact that you were a former Arthur Murray Studio instructor and using that to get business at the Fred Astaire Dance Studios? A. No.
> 'Q. Have you ever solicited any of the students at the Arthur Murray Studios and taken them to the Fred Astaire Dance Studios? A. No.'

It is stipulated that 'the restrictions in said contract in regard to the two-year time period and the twenty-five mile limitation * * * are valid and reasonable and not unduly in restraint of trade.' Other facts will come out in the discussion.

Arthur Murray does not seek damages. He seeks to enjoin Witter from working for Fred Astaire.

Over five hundred years of colorful history look down on this type of litigation. In the year 1415 Henry V was king. Skill in a trade was the vital factor in a man's economic status and it was obtainable only through apprenticeship to an experienced worker. The guild system permitted a man to work only in the trade in which he was apprenticed. Membership in a guild was not easily attained. Travel was difficult. Strangers were not welcome. If a man couldn't work at his trade in his particular locality, he could hardly work at all; might become

a pauper; and the public would be deprived of a worker at a time when the Black Death had made workmen scarce. In that background when, in 1415, the celebrated Dyer's Case (Y.B.2 Henry V, pl.26) came before Judge Hall (Hull?), he became so enraged by an attempt to restrain a dyer from working in a town for just a half year that in bad French he cursed the deal void: 'By God, if the plaintiff were here he should go to prison until he paid a fine to the king.'

[1][2] Pounded by the pressures of social, economic, industrial, communication and transportational change, the law has changed until today, as a rough rule of thumb, the law is that a covenant restraining an employee, on termination of employment, from competing with his former employer, is valid if it is reasonable in view of all of the circumstances of the particular case.

Such a statement, however, is misleading as over-simplification always is. Reasonableness, like Johnny's being a 'good' boy, is complicated. Immediately it breaks down into three divisions (then into numerous subdivisions), and one must consider whether the restraint is reasonable as to (1) the employer, (2) the employee and (3) the public. More elaborately, three questions are usually propounded:

1. Is the restraint reasonable in the sense that it is no greater than necessary to protect the employer in some legitimate interest?
2. Is the restraint reasonable in the sense that it is not unduly harsh and oppressive on the employee?
3. Is the restraint reasonable in the sense that it is not injurious to the public?

[3] In determining what is reasonable, the Goddess of Justice that hovers over the American court house with scale in hand has a delicate job of weighing; and it is a three--not a two--pan scale for she must balance the conflicting interests of employer, employee and public. Hers is the tedious task of reconciling the head-on clash of various, very basic policies, namely: freedom of contract, freedom of trade, sanctity of contract, individual liberty, protection of business, right to work, making of training available to employee, earning of livelihood for one's self and family, utilization of one's skill and talent, continued productivity, betterment of one's status, avoidance of one's becoming a public charge, encouragement of competition and discouragement of monopoly. There is no such thing as unlimited freedom of contract. 9 O.J. 337; 6 Corbin on Contracts 526, Sec. 1395. Courts too well know that freedom can be pushed to a point at which freedom is destroyed. One cannot not protect himself against everything. In this titanic struggle for protection, one cannot but sympathize with both employer and employee. Each is needled by need; each plagued by peril. One cannot condemn either for seeking protection.

An employer seeking an injunction in a case like this suddenly confronted with at least the following questions (some of which obviously overlap):

First. Are the ordinary elements of a contract present, such as consideration, etc.? Since relief is based on a covenant in a contract, the basis crumbles if there is no contract.

Second. Is the restraint reasonable in the sense that it is no greater than necessary to protect the employer in some legitimate interest? See authorities cited under statement of this question supra. If it is greater, generally it is held invalid. In Briggs v. Butler, 140 Ohio St. 499, 507, 45 N.E.2d 757, 761, it is said:

> 'The determination of the necessity for such restriction is dependent upon the nature and extent of the business and the nature and extent of the service of the employee in connection therewith and other pertinent conditions.'

No court seems to have attempted to make a list of those 'other pertinent conditions.' Indeed, if it were possible to make a complete list today, human ingenuity would render the list obsolete tomorrow. However, the interests of justice should warrant one's recording some of the important conditions which the cases consider. Preliminarily perhaps one should caution against an assumption some times erroneously made, i. e., that the restrictions on time and area are alone to be considered.

Third. Is the restraint reasonable in the sense that it is not unduly harsh and oppressive on employee? See authorities cited under statement of this question supra. If it is unduly harsh and oppressive, generally it is held invalid. There is a close relationship between the 'Second' question and this 'Third' one. Frequently courts say something like this, found in Heflebower v. Sand, D.C., 71 F.Supp. 607, 613:

> 'It is true that plaintiffs in the good will of their business have a legitimate interest to protect. However, the protection they exact therefor fails to meet the test of reasonableness * * * in that it is clear that such interest needed no protection from the defendant Sand.'

Fourth. Is the restraint reasonable in the sense that it is not injurious to the public? See authorities cited under statement of this question supra. If it is injurious to the public, generally it is held invalid. If a restraint is unduly harsh and oppressive on employee, generally it is injurious to the public. Though the restraint is no greater than necessary to protect employer it may be injurious to public. The restraint may not unduly oppress employee and yet it may be injurious to the public. The restraint may be injurious to the public though it is neither greater than necessary to protect the employer nor unduly harsh on employee. Moreover, a restraint may be bad in all three respects--over-protecting employer--unduly oppressing employee--and injuring public. As seen by examining the authorities referred to under this question 'Fourth', the courts, in determining whether a restraint injures the public, examine carefully such questions as: Does the restraint tend to deprive employee of a reasonable opportunity to make a living for himself and family? Is employee likely to become a public charge? Does the restraint interfere with the utilization of employee's skill, talent and continued productivity? Is there a shortage of employee's type of service in the restricted area? Does the restraint stifle competition, encourage monopoly? Does the restraint waste public money? Of course, since a restraint that unduly oppresses employees is also injurious to the public, the questions which are pertinent to former are also pertinent to latter.

Fifth. Are the unreasonable and invalid parts of the restraint severable?

Sixth. Did employee breach or threaten to breach this covenant?

[9] Seventh. Does employee's work for rival irreparably injure employer or threaten to injure him irreparably? If not, injunction is usually denied. This irreparable injury requirement is not peculiar to cases involving this peculiar type of negative covenant. Neither is it new. It's a standard standby--an old equitable custom applied to injunctions generally.

Mere difficulty in proving injury standing alone does not automatically mean irreparable injury. It does not even mean that there is injury. One must distinguish between something that is difficult to measure only because it is non-existent and something that is difficult to measure though existent.

Remembering that the burden is on Arthur Murray to prove irreparable injury, where is the proof? Certainly there is not one microscopic bit of evidence of actual injury. It is not shown that Arthur Murray lost one pupil or one penny. To the contrary, in Worrie v. Boze, 191 Va. 916, 928, syl. 9, 10, 62 S.E.2d 876, (an Arthur Murray teacher case) and in Briggs v. Butler, 140 Ohio St. 499, 504, 45 N.E.2d 757, there is actual irreparable injury; the ex- employee was starting to cut his ex-employer's business into ribbons, soliciting and taking away customers that the ex-employee had served for the ex-employer. That evidence was enough to satisfy the requirement of irreparable injury. It wasn't necessary to translate that deflection into dollar and cents damages. That would have been difficult to measure and therefore the injury was irreparable.

*****

Assuming that you might follow a waiter, barber or grocer a few doors or a few blocks, isn't there a limit to the distance and inconvenience you will go to follow him? You may like your milkman. You may like him so well that if he changes employers you will follow him. But if he moves across town to a route five miles away and if, instead of his bringing the milk to your door, you have to jump in your car and travel through five miles of traffic-infested streets to get the milk from him, are you going to do that, especially if another smiling representative of your old dairy stands ready to deliver milk at the handier doorstep where you are used to receiving it?

*****

2. Arthur Murray has proved no irreparable injury, actual or threatened.

In the event that Arthur Murray had established the prerequisites to equitable relief, the court would have been confronted with the question of what kind of an injunction to issue. The remedy must always be one that is fit and appropriate under all the circumstances. Would it have been sufficient merely to enjoin the disclosure of secrets or the solicitation of old customers? Or would it have been necessary to enjoin Witter from working for Fred

Astaire? See authorities cited under sub-question 38 of question 'Second,' supra. Not having arrived at the question of remedy, we express no opinion on that question.

A decree may be drawn accordingly.

Discussion points for Devoe v. Cheatham

Does this ex-employer have a protectable business interest? Is the noncompete agreement reasonable in scope, duration, and geography? If you answer no to either question, then what advice would you give to an employer who can't legally justify a covenant not to compete?

Richard M. DeVOE
v.
Robert L. CHEATHAM, et al.

Supreme Court of Alabama.

April 30, 1982.

FAULKNER, Justice.

This is an appeal from an action to enjoin Richard DeVoe from competing with his former employer by installing vinyl automobile roofs for another employer. The trial court granted the injunction. We reverse.

On April 30, 1979, Richard DeVoe entered into an employment contract with Pop's Vinyl Tops in Decatur, Alabama. The contract provided:

> "In consideration of the aftersaid Employment and the extensive training Employee shall receive in connection therewith Employee agrees that at no time while employed by Company nor within a two year period after the termination of such employeement [sic] will employee disclose any customer list or supplies to any person or firm, nor will he, within a five year period compete directly with Company or indirectly with Company in the business of selling, repairing, installing or manufacturing vinyl roofs within the areas of: Fifty mile radius of the city of Decatur, Alabama."

The contract also provided a weekly salary of $200.00. The contract did not provide a term of agreed employment, and thus was terminable at will.

DeVoe had little or no experience in installing vinyl tops. Mr. Cheatham, the owner of Pop's

Vinyl Tops, taught DeVoe how to install the tops. The record indicates that DeVoe became proficient in the installation of tops, moldings and stripes on cars.

Mr. Cheatham terminated DeVoe's employment, in May, 1980, and rehired him six weeks later. Mr. Cheatham testified that he discharged DeVoe because DeVoe was overextending himself with other odd jobs. DeVoe testified that Cheatham had fired him because the company was not making enough profit to pay his salary. DeVoe voluntarily terminated his employment with Cheatham in November, 1980, and became employed by a competing vinyl top shop.

Cheatham and Pop's Vinyl Tops brought suit to enjoin DeVoe from competing. The trial court granted a preliminary injunction. On March 10, 1981, the trial judge entered a motion granting a permanent injunction for five years.

[2] In the present case, the restriction is not enforceable because the employer, Cheatham, has no protectable interest in restraining DeVoe from working for another vinyl top business. In order to have a protectable interest, the employer must possess "a substantial right in its business sufficiently unique to warrant the type of protection contemplated by [a] noncompetition agreement."

If an employee is in a position to gain confidential information, access to secret lists, or to develop a close relationship with clients, the employer may have a protectable interest in preventing that employee from competing. But in the present case, DeVoe learned no more than the normal skills of the vinyl top installation trade, and he did not engage in soliciting customers. There is no evidence that he either developed any special relationship with the customers, or had access to any confidential information or trade secrets. A simple labor skill, without more, is simply not enough to give an employer a substantial protectable right unique in his business. To hold otherwise would place an undue burden on the ordinary laborer and prevent him or her from supporting his or her family.

In view of the facts of this case, we find that the trial court should not have granted injunctive relief. The judgment is reversed and the cause is remanded.

REVERSED AND REMANDED

Discussion points for 1st American Systems v. Rezatto

There is a distinction to be drawn between competing, and competing unfairly, and this is why the courts make a distinction between trade secrets and competition. Absent an enforceable noncompetition agreement, you are free to compete against your former employer. You can even open up shop right next door. But what about trade secrets and other confidential information you learned while employed? Are you free to use this

information, if no nondisclosure agreement has been signed?

1ST AMERICAN SYSTEMS, INC., Plaintiff and Appellant,
v.
Brian J. REZATTO, Defendant and Appellee.

Supreme Court of South Dakota.

MORGAN, Justice.

Plaintiff, 1st American Systems (appellant), appeals from a summary judgment and jury verdict for defendant, Brian Rezatto (appellee). Appellant prayed for injunctive relief and damages resulting from appellee's breach of contract and misuse of trade secrets. The trial court held that the contract was void as a restraint on trade and ordered summary judgment for appellee on that count. The action in tort, however, for misuse of trade secrets proceeded to trial. The jury found for appellee. Appellant raises numerous issues contesting the judgment and verdict which we treat severally. We hold for appellant, reversing and remanding this case to the trial court for proceedings consistent with this opinion.

Appellant, a corporation, owns an agency, Insurance Counselors of Aberdeen, which employed appellee for almost seven years. During appellee's employment, he began as a salesman and later managed appellant's Aberdeen office. In June 1979, appellant terminated appellee.

The employment contract in force at the date of termination provided appellee with a salary and bonus for the sale of insurance contracts. In addition, it contained several post-employment restraints, as follow:

> 7. The Employee (appellee) acknowledges that as a result of his employment he will have and be given access to information as to renewal dates of insurance policies and to prospective customers which is usually and ordinarily kept confidential by the Company (appellant), and the Employee acknowledges that he understands that competition with the Company in the event of termination of this agreement would be unfair due to disclosures and confidences involved in the employment of this nature ... The Employee hereby agrees that in the event his employment with the Company is terminated ... that he shall not and will not for a period of ten (10) years following the date of the termination of his employment ... engage in the soliciting of general insurance business as follows:
>
> (a) The Employee shall not canvass, solicit, or accept any business from any customer or customers who have been named in the books or records of the Company during the period of the Employee's employment.
> ....
> (c) The Employee shall not directly or indirectly in any way request or advise any customer or customers whose names are on the books and records of the Company during the period

of the Employee's employment, to withdraw or cancel or divert his, or her or any of their business with the Company or then owner of such business.

....

(e) The Employee further agrees that he will not reveal any information concerning any policy or policies of insurance, or the expiration dates thereof, to any person whomsoever, except to officers of the Company,and that he will not solicit renewals of any insurance that is for any person or organization other than the Employer. The Employee further agrees that upon the termination of his employment for any cause whatsoever, he will not directly or indirectly solicit the insurance customers of the Company, either verbally or in writing, nor will he keep in his possession a list of customers of the company nor contact the customers of the Company in any manner, not use the names and addresses of the customers of the Company for solicitation by him or his agents after the termination of his employment....

(f) The Employee shall not canvass, solicit or accept any business from any person, partnership, corporation or other entity, whatsoever, who is listed or has been listed at any time during the Employee's employment with the Company, as a prospect by any person, firm, partnership, corporation or other entity with which the Company has a franchise agreement or any exclusive listing agreement.

8. It is further agreed that in the event of termination of the Employee's employment, the Employee will not engage directly or indirectly, either personally or as an employee, associate, partner, manager, agent or otherwise, or by means of any corporation or other legal entity or devise, in the same business as that of the Company, or in any casualty, life, health and group insurance sales business or occupation, or in any way compete with the Company or the Company's successor, if any, within the City of Aberdeen, South Dakota, or within a radius of twenty-five (25) miles from the City of Aberdeen, South Dakota, for a period of ten (10) years from the date hereof, or from January 1 of each year hereafter (the renewal date of this agreement) whichever is later. The Employee further agrees that in consideration for the continued employment with the Company that this provision shall be deemed renewed as of the first day of January of each year hereafter for so long as he remains in the employ of the Company.

It is further agreed that this entire paragraph and all the subparagraphs thereof, shall be the proper subject for injunctive relief in addition to any other remedies available in equity or in law.

9. It is agreed that if any part, term, paragraph or provision of this agreement is by the courts or any tribunal held to be illegal, void or unenforceable, or to be in conflict with any law or the state of South Dakota, the validity of the remaining portions or provision shall not be affected, and the rights and obligations of the parties shall be construed and enforced as if this agreement did not contain the particular part, term, paragraph or provision held to be invalid, illegal, void or unenforceable.

Appellee received an attorney's advice before signing this agreement.

While employed, appellee sold approximately ninety percent of the insurance at Insurance

Counselors. Consequently, he had access to allegedly confidential customer data, including customer names and the type and amounts of insurance purchased by each, policy expiration dates, pricing data, premium amounts and the insurance company issuing the policy.

Although appellee offered to purchase Insurance Counselors, negotiations broke down. Subsequently, appellee was terminated. Shortly thereafter, he associated with Stellner-Rivett Agency, then, a few months later, opened Rezatto Agency. These agencies were both located in Aberdeen and directly competed with Insurance Counselors.

At the time of trial, appellee had 101 insurance customers, 49 of which were former customers of Insurance Counselors. The former customers supplied more than fifty percent of the total premiums generated by the Rezatto Agency. Although Insurance Counselors usually experienced a normal attrition rate of about ten percent, the rate increased to twenty-six percent after appellee began work elsewhere. Appellee admitted using customer data to solicit former customers of Insurance Counselors. Moreover, he admitted obtaining the data from the files of Insurance Counselors after his termination. Finally, appellant informed appellee and appellee admitted knowing that the information he used was deemed confidential by appellant.

First, we address whether the noncompetition clause, in paragraph 8 of the employment contract, is a restraint on trade void under SDCL 53-9-8. This statute voids contracts which generally restrain a profession, trade or business unless enumerated exceptions apply. One such exception provides,

> An employee may agree with an employer ... not to engage directly or indirectly in the same business or profession as that of his employer for any period not exceeding ten years from date of such agreement and within any specified territory not exceeding a radius of twenty-five miles from the principal place of business of the employer, ... but such contracts between employee and employer shall apply only to those engaged in some profession, the practitioners of which must be duly licensed in the state of South Dakota.

SDCL 53-9-11 (emphasis added).

Since paragraph 8 of the contract in question parallels the statute's territorial and temporal terms, our only concern is construction of the last phrase of the statute. Although SDCL 53-9-11 uses the term "business or profession," the final proviso uses only the word "profession." Our inquiry focuses on whether the sale of insurance contracts is a profession as that term is used in SDCL 53-9-11. We hold that such an occupation is not a profession, since the legislature has not referred to insurance agents as professionals or their business as a profession.

The procedural history of SDCL 53-9-11 enlightens our construction of the statute. See Oahe Conservancy Subdistrict v. Janklow, 308 N.W.2d 559 (S.D.1981). The statute began as Senate Bill No. 17. When the South Dakota Senate passed this bill, it did not contain the proviso at issue here. The House specifically modified the Senate version by adding the proviso. Thereafter, the Senate confirmed the amendment. Based on this history, the maxim, expressio unius est exclusio alterius, the express mention of one thing is the exclusion of

another, applies. Although application of this maxim creates only a negative implication that SDCL 53-9-11 applies to professions, not businesses and professions, our decision is also supported by rules of construction.

[1] In dealing with statutory exceptions, this court construes the language strictly resolving doubt in favor of the general provision. Moreover, we construe the provision consistent with the overall purpose of the entire statute. The general provision promotes competition by voiding contracts which generally restrain trade. Noncompetition clauses, like paragraph 8 of the instant agreement, constrain competition. By reading the proviso in a reasonably limited fashion, instead of in a broader manner, we construe the exception strictly and promote the purpose of the proscription against general restraints on trade. For this reason, we reject those decisions which broadly define profession as occupation, calling, location or employment.

We also reject a reading of SDCL 53-9-11 which would negate the legislature's use of "profession" as a limitation. We read the phrase, "the practitioners of which must be duly licensed in the state of South Dakota" as modifying and conditioning the use of the word "profession." Similarly, to read the statute as applicable to "profession" alone is to circumvent the licensing requirement. To bring any state licensed business within the purview of SDCL 53-9-11 is to avoid "profession" as an additional limitation.

[2][3] We hold that SDCL 53-9-11 applies to legislatively designated professions which also require licensing pursuant to a state statute. Although insurance companies and their agents must obtain state licenses, SDCL 58-30- 2.1, 58-6-1 et seq., the South Dakota Code makes a single, veiled reference to the sale of insurance contracts as a profession. SDCL 58-2-3. That reference is too attenuated to confer status as a profession on appellee's business. Although the trial court found that appellee was not engaging in a profession, it went too far in voiding the entire contract as a restraint on trade.

Appellant moved to limit the trial court's summary judgment ruling to the noncompetition clause in paragraph 8 of the employment contract. It wished to prosecute a breach of contract action based on paragraph 7 of the contract. Basically, in this paragraph appellee agreed that certain information; e. g., renewal dates of insurance policies, and names and addresses of customers and prospective customers (expirations), was confidential. Additionally, he agreed to refrain from using expirations to solicit customers of Insurance Counselors. Appellee argued that paragraph 7 was nothing more than a species of the noncompetition covenant in paragraph 8. Apparently, the trial court agreed with appellee since it denied appellant's motion. We hold that the trial court erred because the contract was divisible and a nondisclosure agreement differs from a noncompetition agreement.

[4] In paragraph 9, appellee and appellant agreed that each provision of their contract must stand or fall on its own merits regardless of the illegality of a different provision. Moreover, so long as an illegal covenant is divisible, the remaining legal covenants are enforceable. Finally, SDCL 53-9-8 provides that the contract is void only to the extent that it is a restraint of trade. Although a noncompetition agreement is a restraint on trade, the instant

nondisclosure provision differs significantly.

The courts are split on whether nondisclosure clauses are void as restraints on trade. In Mackie v. State Farm Mutual Auto. Ins. Company, 13 Mich.App. 556, 600, 164 N.W.2d 777 (1968), the Michigan Court held that an employment contract containing a nondisclosure and noncompetition clause was void. It treated the two provisions as "variations on the same theme." Id., at 779. Although the instant facts resemble those in Mackie, the Michigan statute, declaring such contracts void, is substantively distinguishable from SDCL 53-9-8.

The Michigan statute prohibits "reasonable or unreasonable, partial or general, limited or unlimited," restraints on trade. Id., at 779. Our statute, however, prohibits contracts only to the extent that they restrain trade. SDCL 53-9-8. Unlike the Michigan statute, it does not contain the broad sweeping language which expressly prohibits a nondisclosure clause.

The California statute, however, is a verbatim copy of SDCL 53-9-8. Loescher v. Policky, 84 S.D. 477, 173 N.W.2d 50, 53 (1970). The California statute was construed in State Farm Mutual Automobile Ins. Co. v. Dempster, 174 Cal.App.2d 418, 344 P.2d 821 (1959), a case indistinguishable from the instant case, since it concerned the enforcement of a contract against the use of expirations by a former insurance salesman to solicit customers. There, the court noted that "prohibition of a contract forbidding one from engaging in business is not prohibition from solicitation of customers made known to him in confidence." Id., at 825. In affirming the trial court's issuance of a protective injunction, the California court also distinguished cases where the employee accepts business from a former employer's customers without post- employment solicitation by the employee.

[5][6] The Oklahoma statute is similar to SDCL 53-9-8. Loescher v. Policky, 173 N.W.2d at 53. In Tatum v. Colonial Life & Accident Ins. Co. of America, 465 P.2d 448 (Okl.1970), that court affirmed an injunction issued on the basis of a nondisclosure provision in an insurance salesman's employment contract. It expressly distinguished noncompetition clauses from clauses, like paragraph 7 here. "(T)he contractual provision in the present case does not ... restrain the defendant from exercising a lawful profession, trade or business of any kind whatsoever, either in competition with the plaintiff or otherwise." Id., at 451. The nondisclosure clause was characterized as preventing unfair competition which occurs when the soliciting agent uses expirations of a former employer's insureds to compete with the former employer. Id., at 451. Similarly, under SDCL 53-9-8, an agreement not to disclose information or solicit, unlike a covenant not to compete, is free from challenge as a general restraint on trade.. The trial court erred in completely voiding the instant contract since it is divisible and paragraph 7 is not a general restraint on trade.

[7][8] Nondisclosure clauses support the public policy of fair competition by protecting confidential and secret information which stimulates research and development. On the other hand, to the extent that the law protects confidential information, that information possesses monopoly power. Id. Because this dialectic exists, covenants, like paragraph 7, are strictly construed and enforced only to the extent reasonably necessary to protect the employer's interest in confidential information. In addition, these covenants are not enforced if (1) a trade secret or confidential relationship does not exist, (2) the employer discloses the

information to others not in a confidential relationship, or (3) it is legitimately discovered and openly used by others. Although the presence or absence of a contract, like the instant agreement, is important, all in all, whether relief will be granted depends more on the above criteria than the presence of a covenant not to disclose trade secrets or solicit the employer's customers.

The nondisclosure provisions are contained throughout paragraph 7 of the employment contract. Appellee agreed not to reveal renewal dates, "any information concerning any policy or policies of insurance or expiration dates thereof," "customer lists," "names and addresses of customers" and information ordinarily kept confidential. These terms are enforced only to the extent that they involve trade secrets or a confidential relationship. A trade secret is any commercially valuable device, machine, product, formula, pattern, compilation of information, etc., which gives the user a business advantage over competitors who lack the information. Whatever the genus of the trade secret, it must be information not publicly known and protected from disclosure. Id., at 59-18.

In Mid-America, 281 N.W.2d at 423, we said that customer lists could become trade secrets. See, e. g., Town and Country House & Homes Serv., Inc. v. Evans, 150 Conn. 314, 189 A.2d 390 (1963). In Jewel Tea Co. v. Grissom, 66 S.D. 146, 279 N.W.2d 544 (1938), this court limited protection of customer lists to written lists since an employer does not possess a property right in the mental processes of the employee. Central Plastics Company v. Goodson, 537 P.2d 330, 334 (Okl.1975). Although these cases are instrumental in our decision, they are not dispositive. Unlike Jewel Tea, appellant claims a trade secret exists for expirations which, of course, include customer names and addresses but also encompass expiration dates, policy limits and customer need assessments. Although Mid-America Marketing discusses trade secrets in detail, there, we were concerned with a manufacturing process or a product. Here, we face a more difficult question, whether the information in an insurance agency's customer file is protected as a trade secret. See State Farm Mutual Automobile Ins. Co. v. Dempster, 344 P.2d at 827.

[12] It is undisputed in the record that expirations are customarily considered confidential. The agreement between appellee and appellant makes these materials appellant's exclusive property. Moreover, appellee was put on notice by the employment contract that appellant considered the information secret and intended to seek remedial action to prevent a disclosure. See Lear Siegler, Inc. v. Ark-Ell Springs, Inc., 569 F.2d 286. Even if the contract protects information which is technically not a trade secret, it clearly reveals the intent of the parties to create a confidential relationship. A breach of this relationship is actionable even if Rezatto could glean some of the information from public sources.

Almost fifty percent of appellee's current customers were former customers of Insurance Counselors. In selling these contracts, he relied on the entire file, not merely a customer list or the expiration dates. On at least two occasions he obtained access to files after his termination. It follows that the information was valuable and appellant was damaged by its unauthorized use. Moreover, the files contain personal data on each customer obtained in a confidential business relationship. They also contain expiration dates which are valuable in

the highly competitive insurance business since policies are seldom cancelled during their term.

Although, generally, a contract is not significant, the circumstances surrounding the instant agreement lend it greater importance. At the time appellee signed the contract, he had sold insurance for at least six years. He also consulted an attorney regarding this contract of employment. We hold that the expiration and renewal dates, personal customer data and customer names and addresses within appellant's files taken together and construed in light of the contract's express creation of confidentiality comprise a trade secret even though separately each item may not rise to that level. See American Welding & Eng. Co. v. Luebke, 37 Wis.2d 697, 155 N.W.2d 576 (1968); Mercer v. C. A. Roberts Co., 570 F.2d at 1232 (no agreement and information generally known and not protected).

Although the covenants at issue here are subject to the rule of reason, a term of art in this area of the law, "most courts hold today that many covenants which violate the rule may be partially enforced." Indeed, South Dakota has "blue lined" similar covenants since 1969. Although Loescher v. Policky, 173 N.W.2d at 53, dealt with the sale of goodwill of a business, this court upheld an agreement even though its terms exceeded the maximum statutory time limit. In reaching its decision, this court relied on a Washington case which modified an employment agreement like the one before us today. Moreover, this court specifically stated that post-employment restrictions are closely related to a sale of a business' goodwill. Id., at 54.

The reasonableness of each provision is the benchmark for partial enforcement of the instant covenants. "(A) covenant is reasonable only if it (1) is no greater than required for the protection of the employer, (2) does not impose undue hardship on the employee and (3) is not injurious to the public." This test is then applied to the duration, and range of activities covered in the agreement.

[14] The nondisclosure covenant in paragraph 7 has a term of ten years. We can find no case which upholds such a duration as reasonable. The reasonableness of ten years raises a factual question for determination by the trial court on remand. Under similar circumstances, the criteria for a reasonable duration appears to be the time necessary to develop and establish personal relations with appellant's customers. See, e. g., Ehlers v. Iowa Warehouse Co., 188 N.W.2d 368 (Iowa 1971). In Ehlers the Iowa Supreme Court held two years was reasonable. In Fullerton Lumber Co., the Wisconsin Supreme Court upheld a minimum of three years. Similarly, on remand the trial court should set a reasonable duration based on the evidence. Appellant bears the burden of proof on this issue.

[15] The covenant in paragraph 7 does not contain an area restriction. Instead, it attempts to prevent canvassing, soliciting or accepting business from past, present and prospective customers of appellant. It is overbroad, however, placing an undue burden on appellee and the public to the extent that paragraph 7(a) and (f) prohibit accepting appellant's customers' business, Continental Car-Na-Var Corp. v. Mosely, 24 Cal.2d 104, 148 P.2d at 13, and that

paragraph 7(f) includes prospective customers. Id. We remand for determination of whether and to what extent appellee solicited persons who were appellant's customers at the time of appellee's termination. Appellant again bears the burden of proof on this issue.

As to the remainder of appellant's arguments, we find they are not meritorious or mooted by our decision. We reverse the trial court's summary judgment and remand the instant case for consideration in light of this opinion. We hold that since insurance agents are not professionals for the purposes of SDCL 53-9-11, the trial court properly voided the instant noncompetition clause as a restraint on trade proscribed by SDCL 53-9-8, but that in also voiding the nondisclosure provisions the trial court erred because these provisions are not within SDCL 53-9-8's proscription to the extent specified in this opinion. We reverse the trial court's summary judgment and remand for trial on the issues of liability and relief for breach of contract.

All the Justices concur.

Discussion points for National Recruiters v. Cashman

The general rule in traditional contract law is that if parties wish to modify a contract, then the modification must be supported by mutual consideration (part of the rule known as the pre-existing duty rule). But this traditional requirement of exalting consideration as the litmus test for enforceability has gone by the wayside (witness, for example, UCC section 2-209).

The majority of courts have long used a different test when it came to employment agreement modifications. They look to the sufficiency of the consideration after the employee agrees to the additional noncompete terms. What are the factors which courts look at to determine sufficiency? Does Minnesota have its head in the sand?

NATIONAL RECRUITERS, INC., Respondent,
v.
Daniel CASHMAN, et al., Appellants.

Supreme Court of Minnesota.

Aug. 27, 1982.

This appeal involves four cases consolidated for trial in Hennepin County District Court. Respondent National Recruiters, Inc. (National) sought damages and an injunction to enforce a restrictive covenant against appellants, four of its former employees. National also brought actions against Career Resources, Inc.; Career Resources' president, Micah Garber; and Corporate Resources, Inc., for tortious interference with contractual relations between National and its employees. Appellant employees counterclaimed for their vested interests in

National's profit-sharing plan and trust, and appellant Cashman counterclaimed for defamation of his business, trade and professional reputation. The trial court found the restrictive covenant valid and awarded National liquidated damages, denied National's claim of tortious interference, granted appellants' counterclaims for their vested interests in the profit- sharing plan and denied Cashman's defamation claim. We affirm in part, reverse in part, and remand for further proceedings.

National is an employment agency owned and managed by Arnold Stern. It hires recruiters who are responsible for finding applicants and filling orders from companies that are looking for employees. The recruiters work in one of four areas of specialization, making phone contact with personnel people at various companies and gathering information about available jobs. National does not have exclusive agreements with either the applicants or the companies from which it seeks job orders. Much of the information handled by the recruiters is public and readily accessible.

Appellants Bujold, Strong, Cashman and Holtzman were all employed as recruiters for National. Each had prior sales experience, and each had been unemployed for a period of time before beginning with National. Strong, Cashman and Holtzman were 51, 50 and 45 years of age respectively and were highly experienced. During the employment interview, each appellant was told of the compensation he would receive by way of commissions and bonuses and of National's pension plan. None was told that he would be required to sign a noncompetition agreement.

Appellants were told to report to work on Monday morning. After coming to work, they were told they would have 2 days to prepare for a State Licensing Examination which they took the following Wednesday. Thereafter, each was presented with a noncompetition agreement and told that he must sign the agreement in order to work for National. Bujold was given the contract sometime after he had taken the examination, Cashman and Holtzman were given the contract on Friday of their first week, and Strong was shown the contract 1 week after starting work. Each signed the noncompetition provision under protest.

The noncompetition covenant consisted of an agreement not to compete for a period of 1 year within 50 miles of the Minneapolis office of National or the Minneapolis Courthouse. It provided that, upon violation of the covenant, National could seek injunctive relief to prevent further competition and could obtain liquidated damages equal to an "agreed value" for the training received. For Bujold, Holtzman and Strong, this amount was $2,500. For Cashman, this was $5,000 for the training, plus an additional $10,000 as "liquidated damages." The contracts also provided for an additional payment in the event a former employee became associated as "owner, operator, partner, officer, principal, shareholder, manager, departmental supervisor or in any other equity position in an employment agency" within 1 year after leaving National. (Emphasis in original.) The Bujold, Holtzman and Strong contracts provided for $15,000 payments and the Cashman contract for a $50,000 payment in the event of a breach of this clause.

All four appellants went to work at other employment-recruitment agencies after leaving

National. Bujold, who was fired in July 1978, and Strong, who left National in 1980, went to Corporate Resources, Inc., one of the defendants in the court below. After being fired by Stern, Cashman went to Career Resources, Inc., another of the defendants in this case. Holtzman left National in January 1980 and began work in April of that year at another employment agency which he later purchased.

Bujold made three placements between 6 months and 1 year after leaving National, two of which grossed fees in the amounts of $4,300 and $2,800. Strong made one placement generating a $3,440 fee after leaving National. Cashman made two placements after termination of his employment with National, one for $4,000 and another for $7,500. Holtzman was the most successful of the appellants, making two placements within the 6 months following termination, and several placements thereafter.

Stern drafted the noncompetition agreement to prevent employees from setting up a business and placing applicants whose names they had obtained while employed at National. The agreement had been modified over the years to protect against any competition that would be damaging to Stern's firm's business. National sued each of the appellants for violating terms of the noncompetition agreement and, in addition, refused to pay appellants their vested interests in National's profit-sharing plan because of the alleged breach. National contended at trial that it could suffer damages in several ways: (1) if a former employee were to make placements at a firm National also contacts, (2) if a former employee were getting job orders from a company National also contacts, or (3) if a former employee were to deal with an applicant with whom National also dealt. In the first instance, the damages would be the net profit National would have earned by making the placement; in the second and third instances, damages would be more difficult to determine.

In the course of working as employment recruiters at their new firms, appellants had occasion to call many of the same companies they had called while searching for job openings at National. However, they did not try to imply to these companies that they still worked for National and, with one exception, did not keep in contact with applicants with whom they had worked at National. The exception involved an applicant with whom Cashman had dealt. Cashman stopped dealing with the applicant and with the company that had the job opening after Stern complained to Cashman's superior.

While working for National, recruiters worked with several different forms that Stern had developed over the years. These included referral notices, acceptance letters and job-order forms. They also had access to lists of companies that had provided job orders and maintained files on the people they had contacted. Corporate Resources uses a referral notice and acceptance letter which are very similar to those used by National, but its job-order form is somewhat different.

In preparation for their licensing examination, National's recruiters read training materials and listened to tapes that Stern purchased several years earlier for approximately $400. The trial court found that this training was of little value. The useful training that the recruiters received was their on-the-job work contact with other recruiters and attendance at morning

meetings.

The trial court weighed the evidence and decided that:

> The legitimate needs of plaintiff, if any, are (1) for protection against employees taking applicants who are about to be placed with them when they leave plaintiff to go in competition with it; and (2) for protection against employees taking plaintiff's current files, lists, and job orders, or copies thereof, with them when they leave plaintiff to go in competition with it.

The court went on to find that appellants had not violated National's legitimate needs. However, the court enforced the noncompetition covenant and assessed damages based on the liquidated-damages clause in the contracts.

Cashman's counter-claim for defamation rests on the following evidence: When Stern learned that Cashman had gone to work for Career Resources, he called its president, Micah Garber, and demanded that Cashman be fired. During the conversation, Stern told Garber that Cashman was "nothing but a god damn loser, a no good son of a bitch," and that "if he hired [Cashman], he was a fool." The court, while finding that the statement had been made, found no evidence of actual damage to Cashman's reputation.

This appeal raises four issues: (1) whether the noncompetition covenant, which is part of each appellant's employment contract, is valid and enforceable; (2) whether appellants have forfeited their vested interests in National's profit-sharing plan; (3) whether Corporate Resources, Inc., or Career Resources, Inc., and its president, Micah Garber, are subject to damages for tortious interference of contractual relations between Cashman and National; and (4) whether the trial court erred in denying Cashman's defamation claim because Cashman had not proved actual damages.

[1][2][3] 1. We look upon restrictive covenants with disfavor, carefully scrutinizing them because they are agreements in partial restraint of trade. Where such a covenant is not ancillary to the initial oral employment contract, it can be sustained only if supported by independent consideration. Appellants in the case at bar were told of National's compensation provisions and pension plan before beginning work. They agreed to work for National and, in fact, did begin work before being presented with the noncompetition clause and told they were required to sign it. The clause was not bargained for. It was not ancillary to the employment agreement. It must be supported by independent consideration.

Was the noncompetition agreement supported by independent consideration? National argues, as did the employer in Davies & Davies Agency, Inc. v. Davies, 298 N.W.2d 127 (Minn.1980), that continued employment is sufficient consideration for a noncompetition agreement even where that agreement has not been bargained for. In Davies we required more. As to one employee, Richard Davies, who had not been shown the agreement and did not sign it until 4 months after beginning work, we found that continued employment for 10 years, advancement within the agency, and increased responsibility formed sufficient consideration to support a restrictive covenant in the employment agreement.

A second employee of the Davies Agency, Robert Buckingham, knew before beginning

work that he would be required to sign a noncompetition agreement. He was not aware of the terms of the agreement and was not shown and asked to sign the agreement until 11 days after beginning work. We held that continued employment alone was not sufficient to support the covenant. Unlike Richard Davies, Buckingham had not "derived substantial economic and professional benefits from the agency after signing the contract." Id. at 131. We affirmed the trial court's decision that the noncompetition agreement was without consideration and unenforceable.

[4] "The adequacy of consideration for a noncompetition contract or clause in an ongoing relationship should depend on the facts of each case." Id. at 130. The training that appellants received and which was set forth as consideration in the written contract did not, in fact, constitute consideration for the noncompetition clause because it was part of the oral employment agreement. It was not a real advantage bargained for in consideration of signing the contract. There was no advantage which inured to appellants' benefit as a result of the signing of the noncompetition agreement.

[5] The practice of not telling prospective employees all of the conditions of employment until after the employees have accepted the job, like the practice of requiring a lie detector test in State v. Century Camera, Inc., 309 N.W.2d 735 (Minn.1981), takes undue advantage of the inequality between the parties. Appellants and National were parties to an employment agreement after they had completed negotiations on compensation, duties, benefits and other terms of employment. An addition to that agreement would require independent consideration. We hold the noncompetition clause invalid because it was unsupported by such additional independent consideration. Because we reverse the trial court on this issue and find the noncompetition clause invalid, we do not consider the propriety of either the liquidated-damages clause or the denial of injunctive relief.

[6] 2. National argues that its profit-sharing plan was properly amended after appellants began work to provide for a forfeiture of benefits in the event of an employee's breach of the noncompetition agreement and that, by breaching the agreement, appellants forfeited their vested interests in that plan. Since we have held that the noncompetition agreement is invalid because unsupported by consideration, there can be no breach of the agreement. We affirm the trial court's determination that appellants did not forfeit their vested interests in the profit-sharing plan.

[7] 3. National's argument that Corporate Resources, Inc., Career Resources, Inc., and Micah Garber induced appellants Strong and Cashman to breach their noncompetition covenants is without merit. National did not prove a necessary element of a claim of tortious interference: that either Corporate Resources, Inc., Career Resources, Inc., or Micah Garber intentionally procured a breach of the contract. In order to prove that the two companies and Garber intentionally induced Cashman and Strong to violate their noncompetition covenant, National must show more than the mere offering of a job. We affirm the trial court's finding that there has been no tortious interference with contractual relations between National and its former employees, Cashman and Strong.

[8] 4. Cashman contends that the trial court erred in refusing to find slander per se on the basis that no actual damages were proved. In Minnesota, "[w]hen words are defamatory per se * * * punitive damages are recoverable without proof of actual damages." Therefore, the question is not whether Cashman suffered actual damages but whether Stern's words were defamatory per se.

[9] The determination of whether Stern's communication was defamatory was a question of fact for the court.

> [I]mputations affecting a person's conduct of business, trade, or profession are actionable without proof of special damage. The words, however, must be peculiarly harmful to the person in his business. General disparagement is insufficient. It must depend on the occupation and the particular statement. In other words, the remarks must relate to the person in his professional capacity and not merely as an individual without regard to his profession.

Id. at 372.

[10] Stern characterized Cashman to his new employer, Garber, as "nothing but a god damn loser, a no good son of a bitch." Stern testified at trial that desire, motivation, commitment to business, intelligence and maturity are critical to success in the employment agency business. To characterize Cashman as a loser was to attack those qualities which are essential to success. We find as a matter of law that the words "nothing but a god damn loser, a no good son of a bitch," applied to an employment recruiter in a conversation with that employee's subsequent employer, to be slander per se and remand this part of the case to the trial court for assessment of punitive damages.

We reverse the judgment of the trial court insofar as it upholds the noncompetition clause and awards damages for breach of that clause. We affirm the trial court's determination that appellants did not forfeit their vested interests in a profit-sharing plan and its finding of no tortious interference with contractual relations. We remand to the trial court only the defamation counterclaim for a determination of punitive damages.

Reversed in part, affirmed in part and remanded.

Discussion points for Maryland Metals v. Metzner

As mentioned earlier, an agent (employee) breaches his duty of loyalty to his employer if he competes while employed. But the law allows an employee, while still employed, to make preparations to compete. Another duty an agent owes a principal is to not usurp opportunities which came to the agent in his capacity as an agent. We'll talk about this more in the context of the duties partners owe each other. But if the employer is presented with an opportunity and then decides not to pursue it, can the employee go and run with it? The doctrine is known as the corporate opportunity doctrine, or the business opportunity doctrine,

and the failure to pursue the opportunity is known as abandonment. It's the "use it or lose it" approach to business, not too much unlike the doctrine of adverse possession you learned about in your Property course.

MARYLAND METALS, INC.
v.
Sidney S. METZNER et al.

Court of Appeals of Maryland.

Feb. 1, 1978.

LEVINE, Judge.

In this appeal we consider the extent to which officers and high-level managerial employees may, prior to termination of the employment relationship, make preparations to compete with their corporate employer without violating fiduciary obligations running to the corporation. The chancellor (Rutledge, J.), sitting in the Circuit Court for Washington County, denied the request of appellant, Maryland Metals, Inc., for injunctive relief and damages against two former employees and corporations formed by them (appellees here), ruling that the individual appellees had not acted wrongfully in merely preparing to form and finance a competitive enterprise before severing their ties with appellant. Upon issuance of an order dismissing its amended bill of complaint, appellant noted an appeal to the Court of Special Appeals, but we granted certiorari in advance of oral argument in that court. We now affirm.

I

Appellant, located in Hagerstown, is engaged in the business of buying, processing and selling scrap metal obtained from automotive, industrial and miscellaneous sources. Prior to its incorporation in 1955, the company had been operated as a sole proprietorship by the late Harry Kerstein (Harry), who founded the business in the 1930's and later became the corporation's sole stockholder. On his death in June 1973, he was succeeded as president by his son, Robert Kerstein (Robert), a graduate of the University of Pennsylvania, Wharton School of Finance.

In 1951, Harry engaged, at a starting salary of $85 per week, appellee Sidney S. Metzner (Metzner), who was then recently graduated from college with a degree in business administration and had been employed by a national retail chain in its management training program. With Metzner playing a major role, the business grew and prospered in the ensuing years. On formation of the corporation in 1955, he was named secretary. By June 1974, when he resigned, Metzner had risen to the position of executive vice president and was earning in excess of $80,000 a year. In 1970, appellant employed appellee George W. Sellers, III (Sellers), on Metzner's recommendation, at a starting annual salary of $20,000.

Initially Sellers occupied the position of operations manager because of his proven talents in maintaining heavy machinery. He gradually demonstrated managerial capability as well and at the time of his dismissal in late May 1974, held the position of vice president in charge of operations, earning in excess of $31,000 a year.

Rapid technological advances in the design and manufacture of scrap processing machinery contributed significantly to the genesis of this dispute. In 1966, appellant purchased at a total cost of some $400,000 a piece of equipment described in the trade as a guillotine shear. Even as it was awaiting delivery of the shear, appellant was already studying the potential of a newer and more revolutionary machine known as a "shredder."

Between 1966 and 1973, Metzner was dispatched on several assignments to inspect shredding operations in other parts of the country. On returning from certain key inspection trips, he submitted recommendations urging the acquisition of a shredder. His last such report and recommendation was dated May 1, 1974, only four weeks before he tendered his resignation.

In September 1970, appellant's board of directors authorized Harry Kerstein to purchase a shredding machine from Newell Manufacturing Company of San Antonio, Texas, one of two leading manufacturers of such machines, for the sum of $384,000. Appellant thereupon entered into a cancellable purchase agreement with Newell and also acquired an option to purchase some 40 acres of land in the Hetzler Industrial Park near Hagerstown, which was suitable for a shredding operation from both a physical and a zoning standpoint. Several weeks later, however, appellant's board of directors voted to defer purchase of the shredding machine, citing several reasons, including a downward trend in the market price for shredded scrap, which apparently proved to be temporary, and some uncertainty as to the proficiency of the machine. Consequently the order was cancelled and the option on the land allowed to expire without being exercised.

Following Harry's death in June 1973, appellant resumed its interest in a shredding operation. Once again Metzner, now assisted by Sellers, was instructed to conduct an appropriate investigation in the summer and fall of 1973, and to report the outcome of those efforts to the corporation. Metzner and Sellers complied with these instructions in some detail and urged Robert to acquire a shredder immediately.

What transpired beginning in November 1973, is the subject of some dispute in the testimony. Metzner maintains that he had a discussion with Robert in November during which he expressed his unwillingness to continue with appellant unless he could own some equity in the corporation. Robert replied that this was impossible because his father, as sole stockholder, had transferred his holdings to a testamentary trust. According to his testimony, Metzner then proposed that a new corporation be formed to acquire and operate a shredder in which he, Sellers and Robert (or appellant) would each own a one- third interest, with the necessary initial capital investment of some $300,000 being advanced by Robert or appellant. Robert acknowledges the substance of this discussion, but beyond this point the Metzner-Sellers version of what occurred differs in one material respect from Robert's account.

Metzner testified that he then flatly advised Robert that if he would not join with Metzner and Sellers in the equal ownership of a shredder, they would purchase and operate one without his participation. This was corroborated by Sellers who had held his own independent discussion with Robert.

Conceding the first part of the discussion, Robert maintained that he never received explicit notice of any intention on the part of Metzner or Sellers to leave Maryland Metals and to start their own competing business. He testified that he had merely offered to consider the possibility of a profit-sharing plan for both Metzner and Sellers. Robert further claims to have informed them unequivocally in November that he would not consider any arrangement in which he or Maryland Metals did not own the entire shredding operation.

In the meantime Metzner and Sellers had initiated in November a series of steps preparatory to the establishment of a shredding facility independent of Maryland Metals. These measures, which we shall recount later, are the basis for the present dispute. Professing to be unaware of the preparations being made by Metzner and Sellers, Robert raised Sellers' salary in March 1974 from $25,000 to $31,200. Despite the plans being made by Sellers and Metzner in 1974, they both continued until the very last day of their employment, as they had throughout their careers, to apply their considerable talents and to work long hours in behalf of Maryland Metals.

II

Appellant's principal contention on appeal is that by deliberately failing to disclose in detail their preliminary arrangements to enter into competition with Maryland Metals, while serving as appellant's officers and employees, appellees committed a "gross breach of their fiduciary duty" of loyalty, thereby entitling appellant, as a matter of law, to an injunction restraining further operation of appellees' rival scrap metal processing business.

[1][2] In defining the scope of the right of an employee or corporate officer to enter into competition with his former principal and in delimiting the countervailing right of an employer to restrain his agent's competitive endeavors both before and after termination of employment, the law seeks to harmonize two important and ofttimes conflicting policies. The first of these policy considerations is that commercial competition must be conducted according to basic rules of honesty and fair dealing. As we stated in Edmondson Vil. Theatre v. Einbinder, 208 Md. 38, 44, 116 A.2d 377 (1955), the tendency of the law, both legislative and common, has been in the direction of enforcing increasingly higher standards of fairness or commercial morality in trade. In policing the ethics and conventions of the marketplace, courts have paid particular attention to problems associated with competition between employees and their former employers. Because corporate managerial personnel enjoy a high degree of trust and confidence in performing their assigned functions, a potential exists for serious abuse of confidentiality whenever personnel attempt to aggrandize their own economic interests at the expense of the employer. Fairness dictates that an employee not be permitted to exploit the trust of his employer so as to obtain an unfair advantage in competing with the employer in a matter concerning the latter's business.

This concern for the integrity of the employment relationship has led courts to establish a rule that demands of a corporate officer or employee an undivided and unselfish loyalty to the corporation. Thus, we have read into every contract of employment an implied duty that an employee act solely for the benefit of his employer in all matters within the scope of employment, avoiding all conflicts between his duty to the employer and his own self-interest.

[5][6] A direct corollary of this general principle of loyalty is that a corporate officer or other high-echelon employee is barred from actively competing with his employer during the tenure of his employment, even in the absence of an express covenant so providing. Thus, prior to his termination, an employee may not solicit for himself business which his position requires him to obtain for his employer. He must refrain from actively and directly competing with his employer for customers and employees, and must continue to exert his best efforts on behalf of his employer.

Once the employment relationship comes to an end, of course, the employee is at liberty to solicit his former employer's business and employees, subject to certain restrictions concerning the misuse of his former employer's trade secrets and confidential information.

The second policy recognized by the courts is that of safeguarding society's interest in fostering free and vigorous competition in the economic sphere. Thus, as Judge Oppenheimer stated for this Court in Operations Research v. Davidson, 241 Md. 550, 575, 217 A.2d 375, 389 (1966):

> "(I)t is important to the free competition basic to our national development as well as to the individual rights of employees who want to go into business for themselves that their spirit of enterprise be not unduly hampered."

Furthermore, courts have been receptive to the view that every person has or at least ought to have the right to ameliorate his socio-economic status by exercising a maximum degree of personal freedom in choosing employment.

[8][9] This policy in favor of free competition has prompted the recognition of a privilege in favor of employees which enables them to prepare or make arrangements to compete with their employers prior to leaving the employ of their prospective rivals without fear of incurring liability for breach of their fiduciary duty of loyalty.

> "Admittedly the mere decision to enter into competition will eventually prove harmful to the former employer but because of the competing interests of allowing an employee some latitude in switching jobs and at the same time preserving some degree of loyalty owed to the employer, the mere entering into competition is not enough. It is something more than preparation which is so harmful as to substantially hinder the employer in the continuation of his business.

Moreover, while an employee is under an obligation to be candid with his employer in preparing to establish a competing enterprise, , he is not bound to reveal the precise nature of his plans to the employer unless he has acted inimically to the employer's interest beyond the mere failure to disclose.

The right to make arrangements to compete is by no means absolute and the exercise of the privilege may, in appropriate circumstances, rise to the level of a breach of an employee's fiduciary duty of loyalty. Thus, the privilege has not been applied to immunize employees from liability where the employee has committed some fraudulent, unfair or wrongful act in the course of preparing to compete in the future.

Within these broad principles, the ultimate determination of whether an employee has breached his fiduciary duties to his employer by preparing to engage in a competing enterprise must be grounded upon a thoroughgoing examination of the facts and circumstances of the particular case. As the California Supreme Court has observed:

> "No ironclad rules as to the type of conduct which is permissible can be stated, since the spectrum of activities in this regard is as broad as the ingenuity of man itself."

Turning now to the facts in the case at hand, we consider the evidence produced at trial in a light most favorable to the prevailing party; and if substantial evidence is present to support the trial court's determination, it is not clearly erroneous and hence will not be disturbed on appeal.

[10] As we noted earlier, appellees Metzner and Sellers met with appellant's president, Robert Kerstein, in mid-November 1973, after having recently completed a comprehensive study of shredding operations around the country on behalf of Maryland Metals. At the November meeting appellees demanded and were refused an equity participation in Maryland Metals because the company's capital stock was completely tied up in Harry Kerstein's testamentary trust. The chancellor found from the evidence that upon receiving this initial rebuff, appellees then notified Robert that if Maryland Metals was not willing to take a part in a proposed shredding operation, appellees would go into business for themselves without appellant. Shortly thereafter appellees set in motion a scheme designed to permit them to establish an independent shredding business in the event appellant decided not to participate in the venture. It is this secretive, preparatory effort which appellant claims amounted to a breach of appellees' fiduciary duty to the corporation.

Appellees' initial act was the formation of a Delaware corporation named "Conservit, Inc." on December 11, 1973, which qualified to do business in Maryland on January 14, 1974. It is undisputed, however, that appellees never utilized the Delaware corporation to conduct any business in Maryland or elsewhere. After having made contact with Henry Schloss, a prospective investor from Baltimore, and after having consulted with representatives of the Maryland Economic Development Commission late in 1973, Metzner filed a preliminary application with the Maryland National Bank on January 2, 1974, for a loan to purchase a shredding machine. The loan request was approved on March 14, 1974, in the amount of $1,300,000, but was not actually closed until August 1974, two months after Metzner had left

Maryland Metals.

As early as December 1973, Sellers contacted representatives of the Potomac Edison Company concerning the power requirements for the proposed shredder. These negotiations continued through the remainder of appellees' employment. On February 7, 1974, appellees succeeded in securing an option on the same tract of land appellant had considered acquiring in 1970. This option was exercised on June 27, 1974, at a purchase price of approximately $180,000.

On February 20, 1974, Henry Schloss, on behalf of appellees, and on his own behalf, executed an agreement with Hammermills, Inc. of Iowa for the purchase of a car shredder at a price of $1,200,000. Throughout late winter and spring of 1974, appellees contacted and consulted with various municipal agencies, utility companies, construction contractors, manufacturers and engineers concerning the improvement of the contemplated shredder site and the purchase of equipment necessary to operate and maintain the proposed shredder business.

On May 22, 1974, appellant discharged Sellers, while Metzner submitted his resignation on May 28, 1974, continuing at appellant's request until June 15, 1974, when he ceased all work for Maryland Metals. A Maryland corporation was formed in July 1974 to carry on the business of the nascent enterprise. In that same month the United States Farmers Home Administration agreed to guarantee the loan from Maryland National Bank, which was finally consummated in August 1974. Appellees' shredder operation opened for business in March 1975, some nine months after Metzner had departed from appellant's employ. It is conceded that at no time during the course of their employment did appellees ever inform appellant of the details of their preparations other than to notify Robert of their intention to compete if Maryland Metals was not interested in cooperating in the proposed shredder operation. In fact there is evidence that appellants actively concealed their preparations from appellant.

In sum, from the date of Harry Kerstein's death in June 1973 to the termination of their employment in mid-1974, appellees' various activities were manifestly preparatory in nature. Since, as we have noted earlier, employees are privileged to make arrangements to compete even while they remain on their employer's payroll, it was therefore incumbent upon appellant to demonstrate that appellees had been guilty of unfair, fraudulent or wrongful conduct beyond the mere failure to disclose, which impacted on the economic interest of their former principal in some detrimental fashion.

We are unable to identify any conduct of appellees from June 1973 to June 1974 that was unfair, wrongful or inimical to appellant's interest. Indicative of Metzner's allegiance to the corporation was the undisputed evidence that even in the final months and weeks of his employment, he had negotiated for the sole benefit of his employer a number of valuable contracts yielding profits totalling many thousands of dollars; indeed, Metzner actually consummated at least one of those agreements after submitting his resignation in late May. Likewise, Sellers devoted to his employer approximately 12 hours a day, six days a week

during the entire period of his employment, and continued to do so until the very day of his departure. Small wonder, then, that appellant's president admittedly could find no fault with the quality of appellees' services up to the time of their departure.

In all the cases cited by appellant in which a court has granted relief against competition by a former employee, the employee was invariably guilty of serious misconduct other than the mere failure to disclose his plans to compete at some future date. So it was in Ritterpusch v. Lithographic Plate, 208 Md. 592, 119 A.2d 392, where this Court upheld a jury verdict for the employer against an employee who had actively solicited the employer's major customers on behalf of a competitor with whom the employee intended to associate.

C-E-I-R, Inc. v. Computer Corp., 229 Md. 357, 183 A.2d 374, not only entailed a proven charge of customer solicitation, but also involved improper employee enticement and misuse of confidential and unique information of the employer corporation. To a similar effect is Standard Brands, Inc. v. U. S. Partition and Packaging Corp., 199 F.Supp. 161 (E.D.Wis.1961), where the court awarded a former employer injunctive relief on the grounds that the defendant employees had misappropriated numerous drawings and designs belonging to the plaintiff; had solicited numerous employees; and had misappropriated customer goodwill by expending large sums of plaintiff's funds to woo plaintiff's customers, many of whom transferred their business to the defendants after the latter commenced doing business.

[11] The final case cited by appellant worthy of mention here, Patient Care Services S.C. v. Segal, 32 Ill.App.3d 1021, 337 N.E.2d 471 (1975), involved application of the so-called doctrine of "corporate opportunity," an offshoot of the general duty of loyalty owed by corporate officers, directors and upper-level management employees. There it was held that the defendant had breached his duty of loyalty by usurping for his personal benefit the corporation's sole asset a medical services contract with a local hospital while still serving as president. The defendant's actions resulted not merely in damaging his former principal, but in effectively destroying it.

In each of the foregoing cases, the defendant employees had clearly exceeded their privilege to prepare for later competition with their employers by committing patently wrongful acts in derogation of the trust and confidence reposed in them by the complaining employers. No such conduct ever transpired here. First, the chancellor expressly found that appellees never solicited appellant's customers during the period of employment. While there was evidence that appellant's business may have suffered somewhat after appellees' shredder business became operational, we have stated that "business energy and initiative by former employees in securing work after their employment has been terminated are not synonymous with treachery during the employment."

[12] The chancellor also found as a fact that appellees never misappropriated any trade secrets or other confidential information belonging to appellant. Whatever information appellees acquired regarding the operation and economics of automobile shredders as a result of their inspection tours of shredder sites and other research, was shown by substantial evidence to have been generally available to the public through trade and government

publications. This Court has long subscribed to the view that an employee enjoys a right, in competing against his former employer, to utilize general experience, knowledge, memory and skill as opposed to specialized, unique or confidential information gained as a consequence of his employment.

[13] Finally, we cannot say that appellees were guilty of usurping a business opportunity of appellant either in purchasing the option on the Hetzler Industrial Park property or in purchasing an automobile shredder from Hammermills, Inc. As to the latter, Maryland Metals was perfectly free to purchase an identical model either before or after appellees consummated the purchase, as appellees had urged, and was therefore not deprived of any opportunity to obtain a shredder. With respect to the option property, it need only be said that appellant deliberately let its previous option on the same site expire some four years before appellees acquired their interest without making any attempt to preserve a right to the location. In light of appellees' continual exhortations to enter the shredding business, appellant's procrastination and intransigence amounted to no less than an abandonment of whatever corporate opportunity might have existed in regard to the option property.

Reduced to its essence, then, appellant's claim is that Metzner and Sellers violated their fiduciary duties by concealing the details of their preparatory activities aimed at setting up a competitive business in the future. Despite appellant's strenuous protestations, the conduct complained of is precisely what the law permits. In support of its argument, appellant points to a statement in C-E-I-R, Inc. v. Computer Corp., 229 Md. at 367, 183 A.2d at 380, where we indicated in dicta that "an agent is under a duty to disclose to his employer any information which the employer would be likely to want to know." Since appellant states predictably that it would have certainly wanted to be apprised of the specifics of appellees' preliminary arrangements, it claims that appellees were obliged to divulge this information.

Our answer to appellant's argument is twofold. First, as we ourselves emphasized in C-E-I-R, Inc. v. Computer Corp., 229 Md. at 367, 183 A.2d at 379, it is not necessary "that in all cases an employee . . . tell his employer of his future plans to become a competitor." More importantly, appellant fails to recognize that an employee's privilege to plan and prepare for future competition while in the employ of a prospective competitor would be rendered practically meaningless if the employee were required by law to reveal the details of such arrangements. Holding employees to a continuing obligation, prior to severing their employment, to divulge in detail the full extent of their preparatory arrangements to compete, as appellant suggests, would, in our opinion, constitute an unjustifiable infringement upon the individual's right to select his employment and would create an undesirable impediment to free competition in the commercial and industrial sectors of our economy.

In light of his factual findings, the chancellor, in our opinion, was entirely correct in dismissing appellant's amended bill of complaint. We hold that appellees' conduct here falls within the mere preparation privilege accorded employees contemplating termination of employment. Looking beyond the mere failure to disclose the details of their preparations, we have been unable to find in the record any evidence of such unfair, fraudulent or wrongful conduct on the part of appellees as would entitle appellant to relief in the form of an

injunction, damages or an accounting for profits. Both Metzner and Sellers served appellant diligently for twenty-three and four years, respectively, comporting themselves with the utmost good faith and fidelity. Their foresighted suggestions that appellant expand into the shredder business were intended to benefit the company, not harm it. Indeed, appellees offered Maryland Metals the chance to participate in the proposed venture up to the very time of their departure. Had appellant heeded its employees' suggestions or had it previously exacted from them a covenant not to compete, it might have avoided its present dilemma. Unfortunately for appellant, it pursued neither of these options and cannot now be heard to complain.

Discussion points for BBF v. Germanium Power

A second corporate opportunity case, with a different result. Note what the defendants did. The liability should seem to be clear cut. The real issue in this case are the damages as a result of the breach of fiduciary duty. Should BBF be entitled to recover the salaries paid to Driscoll and Adams during their period of disloyalty? What other damages should BBF try to prove, and how would you suggest proving them?

BBF, INC.
v.
GERMANIUM POWER DEVICES CORPORATION et al.

Appeals Court of Massachusetts, Middlesex.

Decided Feb. 5, 1982.

CUTTER, Justice.

BBF Group, Inc. (BBF), in December, 1972, acquired by merger all the assets of Silicon Transistor Corporation (Silicon) which was engaged in the manufacture and sale of silicon and germanium transistors. Since the merger, Silicon has continued this operation as a division of BBF. Francis B. Driscoll, a defendant, was general manager of the operation from the date of BBF's acquisition of the Silicon division until his resignation in 1973. The defendant John Q. Adams, Jr., during the same period was the division's marketing manager. Mr. Oliver O. Ward, an attorney, also a defendant, had known the other individual defendants for some time, but had no connection with BBF or with Silicon.

Solitron Corporation (Solitron), a competitor of BBF, also made silicon and germanium transistors. In 1973, its then president, Ben Friedman, told James France of BBF that Solitron was interested in selling its germanium operation, a matter not then of public

knowledge. In March, 1973, Friedman met with France, Driscoll, Adams, and Boruch B. Frusztajer, chief executive officer of BBF, to discuss the sale for $350,000 of Solitron's germanium operation, including equipment, piece parts, inventory, and customer lists. The BBF representatives decided to investigate the operation including an on- site inspection of Solitron's plant at Riviera Beach, Florida. Driscoll, chosen to investigate, recommended in his first report the purchase of the Solitron germanium operation. In his second report, he recommended the purchase only if there should be further negotiations.

A meeting of the BBF representatives on May 22 was attended by France, Frusztajer (who had the power to make the final decision), Adams, and Driscoll. Frusztajer decided that, although "the acquisition of Solitron's assets would be beneficial, ... he did not think Solitron could sell its germanium operations to anyone other than ... (BBF) and (that) if BBF ... bided its time Solitron would come back with a more attractive offer."

In July, 1973, Driscoll spoke to Mr. Ward about the possibility that they form their own germanium business. Late in September or in October, 1973, Mr. Ward spoke to Trevison (see note 5) at Solitron about buying Solitron's germanium assets. On October 6, November 6, and November 15, Driscoll alone, or with Adams or Mr. Ward, visited the Solitron plant. Neither Adams nor Driscoll disclosed to BBF either these visits or that they were interested in acquiring any part of Solitron's germanium assets for themselves.

Trevison of Solitron called France of BBF on October 26, 1973, to tell him that "any part of ... (Solitron's) germanium operations was now for sale." France directed Driscoll to investigate the offer. Driscoll did not follow through on France's request or divulge the interest he and his associates had in acquiring Solitron's assets for themselves. On November 7, 1973, France learned by a telephone call to Solitron that some BBF employees were visiting the Florida plant "on their own." France then met with Driscoll and Mr. Ward on November 13, 1973, and discussed Driscoll's resignation from BBF. France did not want Driscoll to return to BBF, but his resignation was made effective on November 21, 1973, to enable Driscoll to have some vacation that was due to him.

Germanium Power Devices Corporation (Germanium) was incorporated by Mr. Ward in Delaware on November 1, 1973, and was qualified to do business in Massachusetts. Mr. Ward became its president and a director at once upon its incorporation. In its behalf, Driscoll and Mr. Ward purchased for $200,000 from Solitron a part of its germanium assets including certain equipment, piece parts, and inventory. They bought no customer lists. By then Solitron had ceased to conduct germanium operations. By the time of the purchase on November 15, Driscoll had ceased to work for BBF but was still carried as a BBF employee until November 21, because of the unused vacation time.

Driscoll started work with Germanium on November 19, 1973, as its production and plant manager. He acquired eleven percent of its stock. Adams resigned from BBF on November 13 and began work as Germanium's vice-president in charge of marketing. While Driscoll

was still an employee of BBF in October, 1973, he approached William J. Dawson who was then BBF's maintenance manager for its germanium operations. He put Dawson in touch with Mr. Ward and on November 6, 1973, Dawson went with Driscoll to Solitron's Florida plant. Dawson resigned from BBF on November 13, 1973, and went to work for Germanium on the same day. Driscoll also approached Peter J. Ulaskiewicz about joining the new venture. Ulaskiewicz was BBF's "manager of the front end of the germanium production line," charged with adjusting the ovens to suit particular germanium material and customer specification. Ulaskiewicz resigned from BBF and went to work for Germanium on November 12, 1973.

On November 3, 1973, BBF had twenty-six production employees and about twenty- five more in various related operations. By January 18, 1974, eleven of these BBF employees had become employees of Germanium.

On January 14, 1974, this complaint was filed by BBF (in its then corporate form, see note 2, supra) seeking relief against Germanium, Driscoll, Adams, and Mr. Ward based upon the alleged improper use by these four defendants of a corporate opportunity belonging to BBF in their acquisition of assets of Solitron and damages for injuries alleged to have been caused by the breach of the duty of loyalty owed by Driscoll and Adams to BBF and by their inducing various employees of BBF to go to work for Germanium.

(1) 1. The trial judge reached the following conclusion concerning the defendants' appropriation of a corporate opportunity owned by BBF. Driscoll and Adams owed a duty of loyalty to BBF at all times in 1973 relevant to this action. They acted unfairly toward BBF in making use of information, acquired by them in confidence, concerning the opportunity to acquire Solitron's assets. Driscoll, a BBF employee who knew that BBF remained interested in acquiring Solitron's germanium assets, discussed with Mr. Ward in July or August, 1973, the possibility of forming a new germanium company. As a consequence, Mr. Ward made various visits to the Solitron plant. Driscoll went with Dawson to the Solitron plant, participated with Mr. Ward in negotiating the purchase of part of Solitron's assets, and helped Adams and Mr. Ward to select a site for Germanium's new plant. He did not comply with France's order to investigate Solitron's revised offer of October 26, 1973. He also approached Dawson and Ulaskiewicz about working for the new corporation. Adams knew that Germanium's acquisition of Solitron's assets would be harmful to BBF. He violated his duty of loyalty by using confidential information and helping to select the new plant site. Mr. Ward knew or should have known of Driscoll's and Adam's duty of loyalty to BBF. Nevertheless, he participated with them in acquiring for Germanium some Solitron assets.

On these subsidiary facts, the judge was justified in concluding that the three individual defendants and Germanium had appropriated a corporate opportunity of BBF. Accordingly, she reasonably decided that the defendants were jointly and severally subject to liability for injuries to BBF proximately caused by their actions.

(2) The defendants contend that the Solitron offer ceased to be a confidential corporate opportunity in the autumn of 1973 when it became public knowledge that Solitron's assets

were for sale. Even before that time, however, Driscoll and Adams for their own advantage had begun to use information which came to them in confidence as trusted BBF employees. Indeed, Driscoll, at the expense of BBF, had investigated the opportunity to acquire Solitron's assets and had formed the opinion that BBF in its own interest should acquire these assets or some of them. When the availability of Solitron's assets became public, he and his associates were ready to move. The defendants also place some emphasis on the fact that the assets acquired by Germanium from Solitron represented only part of the assets offered to BBF by Solitron and were "readily available from industrial suppliers." Whatever bearing these circumstances may have had on issues of causation and of the extent of damages, the judge was not required to conclude that they, by themselves, necessarily operated to relieve the defendants of liability for their misuse of Driscoll's and Adams's confidential knowledge of BBF's corporate opportunity.

VIII. Introduction to General (Possessory, and Retaining) Liens and Charging Liens

The courts have always allowed a self-help mechanism in contracts cases. For instance, in the case of a non-UCC contract where the breaching party has substantially performed, the non-breaching party's duty to pay arises, so he must pay. But he need not pay the full amount. He is entitled to withhold from his payment an amount equal to the amount of money necessary to cure the breach. So, if the contract price is $10,000, and the contractor substantially performs but there is still $100 worth of work to be done, the non-breaching party's duty to pay arises, but he need only pay $9,900.

The same thinking goes into the idea of liens, which are classified as retaining (possessory) liens, and charging (non-possessory) liens. A lien is a charge upon someone else's property, for the payment or discharge of a particular debt.

Discussion points for Matter of Heinsheimer

As you might have guessed, attorneys are the ones who get involved with slapping liens on the work products and documents they prepare for their clients. In order to have a general lien, you need possession of the thing in question (for an attorney, that might be a settlement fund). Unfortunately for Heinsheimer, there can be no such lien, either general or charging, on a claim for unpaid salary. Assume that a client signs his will, and promises to pay tomorrow when he will come back and pick up the will. He never does pay, and now wants the wills. Do you have a general, or a charging lien? What if the client dies while the bill is still unpaid? Does this change anything?

In re HEINSHEIMER.

MEYER
v.
SCHULTE et al.

Court of Appeals of New York.

March 23, 1915.

CARDOZO, J.

The petitioner is a member of the bar. He was retained by the United States Restaurant & Realty Company as its general counsel at a salary of $5,000 a year, payable semiyearly. In February 1910, there was due to him under this retainer a balance of $3,096.92. The client then terminated the general employment and selected other counsel. The petitioner declined to surrender his papers unless the arrears of salary were paid. In this he acted within his rights. At the client's request, however, he tried an action then upon the calendar, and recovered a judgment against one Schulte for $4,176.64. For this he was to be paid whatever the service was worth. The client then made an assignment for the benefit of creditors. The assignee was substituted as plaintiff, and another lawyer was substituted as attorney, without prejudice, however, to the petitioner's right to enforce his lien, if any there was found to be. After appeals, first to the Appellate Division and then to this court, the judgment was affirmed.

This proceeding was thereupon begun by the petitioner to determine the extent of his lien on the proceeds of the judgment . The value of the services rendered in the trial of the action against Schulte, after the general employment was ended, has been fixed by the Appellate Division at $500. That the petitioner has a lien to this extent is conceded. The question is whether he has a lien for the unpaid balance of his salary. The services under the general retainer included many matter other than the Schulte case. They included many matters having no relation to any lawsuit. All services alike were to be paid for by this salary, and the order under review makes the entire balance of salary a lien upon the judgment.

[1] We think that this is an unwarranted extension of the scope of an attorney's lien. At common law, the liens available to an attorney were of two kinds. There was a retaining lien on all papers, securities, or moneys belonging to his client which came into his possession in the course of his professional employment. This was a general lien for the entire balance of account. It was dependent, however, upon possession. There was also a charging lien, which bound a judgment recovered through the attorney's efforts. This lien was not dependent on possession. The very reason for its existence was to save the attorney's rights where he had been unable to get possession. 'It was a device invented by the courts for the protection of attorneys against the knavery of their clients, by disabling clients from receiving the fruits of recoveries without paying for the valuable services by which the recoveries were obtained.' A clandestine or collusive payment, after notice, actual or constructive, of the lien, did not discharge the debtor.

But the reason for the existence of this lien suggests the limitation of its scope. It was not a lien for a general balance of account. It was a lien for the value of the services rendered in that very action. If the attorney got possession of the fund, he had a general lien. If he did not get possession, his lien was for the services that brought the fund into existence, This charging lien still exists under our statutes. It has been enlarged to the extent that it now attaches to a cause of action even before judgment. 'From the commencement of an action or special proceeding' the attorney now has a lien 'upon his client's cause of action, claim or counterclaim, which attaches to a verdict, report, decision, judgment or final order in his client's favor, and the proceeds thereof in whosesoever hands they may come.' Except as thus changed, the charging lien is to-day what it was at common law.

Neither at common law nor to-day does such a lien embrace a claim for unpaid salary. Meritorious the petitioner's services doubtless were. They cannot, however, be made a charge upon the judgment. In serving under his general retainer, he was in the same position as any other salaried employe. He was to receive $5,000 a year, payable semiannually. In return, he was to do anything and everything in the line of a lawyer's work that his client might require. It was a mere accident that part of his work included a lawsuit in which the client was a plaintiff. He would have earned his pay just the same if he had done office work exclusively. He might, indeed, have earned it, though he had done nothing at all. In point of fact, the work that he did in the Schulte case, while the general retainer was in force, must have been insignificant in amount. We think it cannot be made use of as an excuse for charging the entire salary on the proceeds of the judgment.

The charging lien of an attorney has been likened to the lien of an artisan or mechanic. But even the lien of an artisan or mechanic will be lost if the terms of payment are inconsistent with its existence. Chase v. Westmore, 5 M. & S. 186. If the work is done, not on the credit of the thing itself, but solely on the credit of the owner, there is a waiver of the lien. Such a waiver will result, for illustration, where the agreement is that the thing shall be first returned and payment made thereafter. It was pointed out by Lord Ellenborough in Chase v. Westmore, supra, that this has long been the law. We are referred by him to the Year Book, Easter Term, 5 Edw. IV, fol. 2 b:

> 'Note, also, by Haydon, that an hosteler may detain a horse, if the master will not pay him for his eating. The same lawis, if a tailor make for me a gown, he may keep the gown until he is paid for his labour. And the same law is, if I buy of you a horse for 20s., you may keep the horse until I pay you the 20s.; but if I am to pay you at Michaelmas next ensuing, here you shall not keep the horse until you are paid.'

The same rule has been followed in this court. In Wiles Laundering Co. v. Hahlo, 105 N. Y. 234, 241, 11 N. E. 500, 503, 59 Am. Rep. 496, the plaintiff was in the laundry business. Its agreement was that the goods laundered for the manufacturer should be returned as fast as the work was done, and payment made at the beginning of the following month. 'The return of the goods * * * was to precede the right to demand payment for the work, by a longer or shorter period, according to circumstances.' This was held to establish a waiver of the lien. Many other cases enforce the same rule.

We think the petitioner's contract is inconsistent with an intent that he should be protected by a charging lien upon the fruits of the judgment. 'The facts of the case must be looked at to see whether the solicitor has taken a security incompatible with the existence of his lien, or has made with his client an arrangement which sufficiently indicates the intention of the parties that the right shall no longer be enforced.' The nature of the services for which the salary was to be paid is one token of intent. The time of payment of the salary, at semiannual intervals, is another. Both tokens in the case at hand forbid the implication of a lien . The petitioner was not in the position of an artisan bestowing labor on the credit of the cause of action or the judgment. His salary covered services that had no relation to the judgment, and the right to payment did not accrue, even though judgment was recovered, until the semiannual period had gone by. The same statute that gives an attorney a lien on the judgment gives him a lien on the cause of action, and the lien attaches the moment that the action is begun. But plainly no such lien attached in favor of the petitioner. The cause of action was not security for the prospective installment of his salary; and the merger of the cause of action in the judgment did not change the security. The prospective salary was a claim against the client personally, and not a lien upon anything. A charging lien cannot exist, unless it is an element, express or implied, of the agreement that the lawyer is to be paid out of the fruits of the judgment. The petitioner waived that right by his agreement. He could not have arrested payment of the judgment and tied up the fund till his salary became due. He could not have prevented the judgment debtor from making payment at once and directly to the creditor, though his salary was to fall due the following day. His agreement in substance was that there should be no relation, either in time or in amount of payment, between his receipt of salary and his services in lawsuits. The laundry, in Wiles Laundering Co. v. Hahlo, supra, waived its lien when it agreed to deliver goods as fast as the work was done, and postpone payment till the following month. The petitioner waived his lien when he agreed that the proceeds of judgment should be remitted as collected, and payments of salary received at stated intervals. In both cases, it so happened that before the services were completed the hour of payment had been reached, and the employer was in default. The lien is not affected by these accidents of time. It depends upon the nature of the agreement, and not upon the moment of performance. The agreement in its inception was eitherconsistent with a lien or inconsistent. Whether it was the one or the other must be determined as of the hour of its making.

We think, for these reasons, that the lien for salary must fail.

The motion to dismiss the appeal, in so far as it brings up for review the intermediate order of the Appellate Division, should be denied; and the final order of that court should be modified, by subtracting from the lien awarded to the petitioner the sum of $3,096.92, with accrued interest thereon, and, as so modified, the order should be affirmed, with costs to the appellant in this court.

Ordered accordingly.

Discussion points for Upgrade v. Michigan Carton

At least for attorneys, you can now see that even a retaining lien is not all that it is cracked up to be. It can still be taken away, if equity or circumstances dictate that it be taken away. How does the result in this case compare to an eminent domain proceeding?

The UPGRADE CORPORATION, Plaintiffs-Appellees,
v.
MICHIGAN CARTON CO., Defendant,
On Appeal of Harry Shriman, Appellant.

Appellate Court of Illinois, First District, Third Division.

Aug. 13, 1980.

McGILLICUDDY, Presiding Justice:

Attorney Harry Shriman, appellant, formerly represented the plaintiffs in an action for breach of trade secret agreements and obligations. Shriman withdrew his appearance as one of the plaintiffs' attorneys by leave of court. The plaintiffs' remaining attorney filed a petition asking the court to order appellant to turn over all files in his possession concerning the pending cause of action. The appellant claimed a common law retaining lien and a right to refuse to turn over the files until he was compensated for his legal services. The court granted plaintiffs' petition but ordered that the appellant be given a statutory lien pursuant to "An Act creating attorney's lien . . ." (Ill.Rev.Stat.1977, ch. 13, par. 14). The court stated that the amount of such lien would be determined upon settlement or favorable judgment for the plaintiffs. The appellant appeals this order.

On appeal the appellant contends that the trial court erroneously entered the production order thereby denying him a retaining lien on the lawsuit files. He also claims that the court erred in failing to hold an evidentiary hearing to determine the plaintiffs' indebtedness to appellant for legal services rendered. While the plaintiffs have not filed a brief in this matter, we shall consider the merits of the appellant's contentions.

[1] An attorney who withdraws from a case for a justifiable cause or is terminated without cause may recover compensation for his services. Justification exists when the client fails or refuses to pay the proper fees or expenses of the attorney after being reasonably requested to do so. The measure of the lawyer's recovery lies in quantum meruit for the services actually

rendered.

[2][3][4] A retaining lien is strictly a common law possessory lien in favor of an attorney for his fees and was first recognized in Illinois in Sanders v. Seelye (1889), 128 Ill. 631, 21 N.E. 601. Notwithstanding the creation of a statutory lien for attorney's fees in Illinois, the common law retaining lien remains a right in favor of the attorney. A charging or special lien attaches only to the proceeds recovered by the attorney through his professional services, whereas the retaining or general lien attaches to any property belonging to the client which the attorney received professionally. The retaining lien is a possessory lien that merely gives the attorney a right to retain the client's property and cannot be actively enforced by judicial proceeding. It continues until the attorney's charges are liquidated or the attorney surrenders the property with or without payment. Once the attorney surrenders the property, his retaining lien is lost.

[5][6] In the instant case the appellant is not seeking to enforce his retaining lien by judicial proceedings. Rather, he is using the existence of his retaining lien as a defense in proceedings initiated by his former clients to compel him to turn over his files on their pending lawsuit.

The appellant relies on Ross v. Wells (1955), 6 Ill.App.2d 304, 127 N.E.2d 519, the only Illinois case to our knowledge that discusses the right of an attorney to claim a retaining lien when an order to produce the client's property in the attorney's possession is issued. In Ross, however, the attorney instituted the legal proceedings by filing a complaint for attorney's fees. The defendants, during discovery, sought the production of certain written documents, that would reflect the services rendered by the plaintiff, and the plaintiff refused on the ground that he had an attorney's lien. The trial court dismissed the defendants' petition for a rule to show cause but the Appellate Court reversed stating:

> "There is logic in the rule that a lawyer should be protected in his retaining lien until he is paid, and should not be compelled to produce and surrender the records and papers upon which he has such lien in any proceeding other than a suit by the attorney to recover his fees." 6 Ill.App.2d at 308, 127 N.E.2d at 520.

The court distinguished the situation before it based on the fact that the attorney was suing for his fees and would have to prove the nature of his services rendered and the amount of time expended using the records and papers sought by the defendants.

The majority of jurisdictions have recognized the attorney's property right in his retaining lien in cases where the termination of the attorney-client relationship is not attributable to improper conduct by the attorney. However, the courts have exercised their inherent power to order an attorney to release property in his possession in the interest of equity and fairness. Thus, courts have released retaining liens where the client pays the asserted claim or furnishes adequate security.

Applying the above principles to the case at bar, the trial court correctly ordered appellant to turn over files concerning his former clients' pending cause of action based on the clients'

claim that the documents were needed to proceed with the litigation. However, we find that the appellant was given inadequate security in the form of a statutory lien.

A similar lien was found to be inadequate in In re Makames (1933), 238 App.Div. 534, 265 N.Y.S. 515. In that case the attorneys claimed a retaining lien over the insurance policies of their former client which were needed by the client in a pending action. The attorneys were ordered to turn over the policies in their possession upon the payment of $50, the amount of their disbursements, and were given a first lien upon all moneys recovered by the client in its action against certain insurance companies. This order was reversed because the new lien was not on anything in existence but on something that may possibly come into existence in the future. There was no certainty that the client would be successful in its pending litigation and thus the security was deemed worthless. We agree with this analysis. We hold that in the instant case the statutory lien on the proceeds of the pending litigation was inadequate security since such a lien would only attach if proceeds were in fact recovered.

[7][8] We also find that the trial court erred when it did not determine the value of the appellant's services to the plaintiffs. Where the attorney is brought into court upon the petition of his client to compel the attorney to turn over money or paper upon which a retaining lien is claimed, the court may ascertain the extent of the lien and enforce it. The attorney who claims compensation for services rendered by him to the client is entitled to a summary determination fixing the value of his services so that such amount can be paid or otherwise adequately secured before the production order may be enforced. Morse v. Eighth Judicial District Court ; see Annot., 124 A.L.R. 725, 738-43 (1940) and 7A C.J.S. Attorney & Client sec. 390, at 779.

In view of the foregoing reasons, we affirm that portion of the order requiring the appellant to turn over his litigation files to the plaintiffs and reverse and remand that portion of the order substituting a statutory lien for appellant's retaining lien. The production order should not be given effect, however, until the value of the appellant's services is determined and the appellant is compensated or given a guaranty satisfactory to the appellant that he will be compensated.

Affirmed in part; reversed in part; remanded with directions.

Gormley v. Wilkins

George F. GORMLEY, P.C.,
v.
Charles Oscar WILKINS, Third.

Appeals Court of Massachusetts.

Oct. 3, 2002.

The plaintiff, George F. Gormley, P.C. (the attorney), appeals from the Probate Court's dismissal of his petition filed pursuant to G.L. c. 221, § 50, to enforce an attorney's lien. The attorney contends that the lien attached to a $40,000 escrow account established following the sale of a parcel of property pursuant to a divorce agreement. We affirm.

1. *Background facts.*The divorce proceedings were bifurcated, and a judgment of divorce nisi entered on March 15, 1996. A year later, on March 16, 1997, the attorney began representing the husband.[FN1]On June 6, 1997, the Probate Court issued a supplemental judgment. The supplemental judgment incorporated a separation agreement dated June 5, 1997, which the court found was fair and reasonable. The agreement comprehensively addressed all aspects of the marital dissolution, including, as pertinent here, the property division.

> FN1. The husband retained the attorney to handle the property and alimony aspects of the marital dissolution, which, it appears, were still under negotiation and had not been finalized as of the entry of the nisi judgment.

In the agreement, both the husband and wife relinquished all interest in each other's real and personal property, with the exception of a parcel of property located at 5 Agassiz Park in Jamaica Plain (the Agassiz property). The Agassiz property was to be placed on the market for sale. The agreement provided that "[t]he proceeds from the sale or other disposition shall be utilized in the following priority: i) to pay all amounts necessary to discharge all liens, mortgages and encumbrances of record, capital gain taxes, and all legal fees and costs necessary to sell the property in accordance with Bankruptcy Code § 363; [FN2] [and] ... iv) all remaining proceeds shall be the sole property of [the wife] or her nominee...."

In 1999, when the Agassiz property was to be sold, the husband refused to execute a deed. The wife filed a complaint for contempt. On January 15, 1999, the Probate Court issued an order directing the husband to execute the deed and establishing an escrow from the sale proceeds. It is this escrow fund which is the subject of the attorney's lien claim. The escrow order provided in pertinent part:

"Husband is to forthwith execute the deed to the real estate; all liens, mortgages, encumbrances of record are to be discharged and *$40,000 is to be held in escrow by both counsel in an interest bearing account to satisfy any capital gains tax when due. Any balance remaining from the escrow reverts to Wife; balance of proceeds to be distributed per parties separation agreement"* (emphasis added).

The conditions in the escrow order involving the payment of capital gains taxes and payment of the remainder to the wife were in accord with, and enforced, the corresponding provisions of the agreement.

The sale of the Agassiz property was closed on February 18, 1999. Pursuant to the escrow order, a check for $40,000 issued jointly to the parties' attorneys to be held in escrow. However, the husband refused to provide his tax identification, prompting his counsel, the plaintiff attorney, to file a motion to have the $40,000 paid into an escrow account to be

established in the Probate Court.[FN3]

On December 27, 1999, the attorney filed a lien petition of $39,204.76 against the Probate Court escrow account for unpaid legal fees incurred by the husband. The wife objected. After hearing, the Probate Court judge denied the lien petition, concluding that:

“[N]o judgment or decree entered by this court in favor of the Husband, nor any proceeds derived therefrom, to which a statutory lien could attach.... Aside from whatever personal property the Husband was allowed to retain under the terms of the agreement, the Supplemental Judgment of Divorce, which incorporated the parties' agreement, did not enter in favor of the Husband since it was the Wife who received all of the net proceeds from the sale of the property. [Consequently,] ... the Husband did not receive any proceeds from the Supplemental Judgment to which Attorney Gormley's statutory lien could attach. Since the property was the parties' only significant asset, and the net proceeds from its sale were awarded to the Wife, there remains no other assets or ‘proceeds' derived from the Supplemental Judgment entered in the Husband's favor from which the lien could be satisfied.... [A]ny money that is not used to satisfy the capital gains obligation reverts back to the Wife in accordance with the Judgment.”

2. *Analysis.* We agree with the Probate Court judge's analysis that the attorney's lien does not satisfy the requisite elements of G.L. c. 221, § 50.[FN4] Reduced to essentials, the elements for an attorney's lien under § 50 are that (1) the attorney must have appeared and rendered representation in a Federal or State court or designated administrative agency; (2) the fees must be reasonable; (3) a judgment, decree or other order must have entered in connection with the attorney's representation; and (4) the judgment, decree or order must be in the client's favor. Here the attorney's claim falters on the last ground.

FN4. G.L. c. 221, § 50, provides in pertinent part as follows:

> “From the authorized commencement of an action, counterclaim or other proceeding in any court, or appearance in any proceeding before any state or federal department, board or commission, the attorney who appears for a client in such proceeding shall have a lien for his reasonable fees and expenses upon his client's cause of action, counterclaim or claim, upon the judgment, decree or other order in his client's favor entered or made in such proceeding, and upon the proceeds derived therefrom. Upon request of the client or of the attorney, the court in which the proceeding is pending or, if the proceeding is not pending in a court, the superior court, may determine and enforce the lien; provided, that the provisions of this sentence shall not apply to any case where the method of the determination of attorneys' fees is otherwise expressly provided by statute.”

“[S]ince there was no decree in [the client's] favor there was nothing to which the statutory lien could attach.” The escrow order was not an order in the husband's favor. To the contrary, the escrow order ensured compliance with the terms of the agreement earmarking payment of capital gains taxes and encumbrances and, then, to the wife's favor, protecting the

remainder for reversion to the wife.FN5FN6 So viewed, the funds in the escrow account were to be held in a neutral depository: "for a special purpose which was inconsistent with the [attorney's] claim of lien.... This is not an uncommon type of arrangement, partaking of the nature of a trusteeship.... To permit one who has so acted [as attorney] to assert a possessory lien on the property as security for professional services would ... discourage similar arrangements in the future...."

Finally, the attorney asserts that it was through his efforts that a real estate broker marketed the property for a substantially higher price than that originally sought by the wife. He also contends that the motion filed for the establishment of the Probate Court escrow account served as a buffer against a "side deal" by the wife which would have left no funds for the payment of capital gains taxes owed by the husband. The attorney presented these factual claims to the Probate Court judge, who did not enter findings to this effect. But even if these were the established facts, that would not change the analysis because these events would still not create an order in the husband's favor.

Order dismissing petition affirmed.

Richard DUDLEY, Jr.
v.
MASSACHUSETTS STATE POLICE.

Supreme Judicial Court of Massachusetts

Decided June 1, 2017.

Synopsis
Background: Bystander filed a negligence action under the Tort Claims Act against the state police for injuries sustained when he was mistakenly attacked by a trained police dog who was pursuing a suspect. The Superior Court Department, William F. Sullivan, J., granted the state police summary judgment. Bystander appealed.
The Appeals Court, Maldonado, J., held that state police was not entitled to immunity from liability for negligence claim brought by bystander.

Vacated and remanded.

Procedural Posture(s): On Appeal; Motion for Summary Judgment.

The case was heard by William F. Sullivan, J., on a motion for summary judgment.

Opinion

MALDONADO, J.

The plaintiff, Richard Dudley, Jr., commenced this negligence action, pursuant to the Massachusetts Tort Claims Act (Act), G. L. c. 258, seeking damages from the defendant, Massachusetts State Police (State police), for injuries he suffered as a result of being attacked, in a public parking lot, by a trained police dog. Moments before the attack occurred, State Trooper Edward T. Blackwell, an experienced police canine handler, had been in pursuit of a criminal suspect who fled, on foot, taking a circuitous route through that parking lot.

Dudley sued the State police, a public employer and agent of the Commonwealth,[2] alleging that Trooper Blackwell's conduct, in releasing the police dog to apprehend a suspect in a public space, where the presence of others would be expected, created a foreseeable and substantial risk of harm to an innocent bystander.

The State police answered the complaint, engaged in discovery, and then filed a motion for summary judgment, based on the ground of sovereign immunity under G. L. c. 258. Following a hearing, a judge of the Superior Court allowed the State police's motion, ruling that Dudley's negligence claim was barred by the immunity provisions of the Act, § 10(b) and (j). Dudley appeals from the separate and final judgment. See Mass.R.Civ.P.54(b), 365 Mass. 820 (1974). We reverse.

1. Background. The chase. In the early afternoon of May 6, 2011, William P. Monopoli led several State police troopers on a high-speed motor vehicle chase, which began in Boston and ended in West Bridgewater.

While speeding down the highway, Monopoli abruptly pulled his truck off the road onto an exit ramp. At the top of the ramp, Monopoli lost control of his truck, crossed the roadway's double yellow lines, and crashed into a guardrail or curb. He then exited his truck and quickly fled on foot, jumping over a fence into a park and ride commuter lot. Trooper Blackwell, who was following the suspect in a State police cruiser, pulled behind Monopoli's truck.

The bite. Trooper Blackwell stepped outside of the cruiser, with his trained patrol dog, Jager,[3] on a leash. Trooper Blackwell yelled to Monopoli and ordered him to give himself up, adding that, if he did not do so, the dog would be sent after him. Monopoli did not stop. He scaled over the fence into the commuter parking lot, out of the Trooper's immediate vision. Trooper Blackwell, knowing the lot was more than half full, commanded Jager to apprehend and he let go of the dog's leash, releasing him toward the parking lot. Jager hopped the fence, but in the midst of the parked cars, he, as did Blackwell, lost sight of Monopoli.

Meanwhile, Dudley, while on his way home from work, was dropping his coworker, Schiller, off at the commuter parking lot, heard the crash of a car. The two men exited Dudley's truck. Dudley observed Monopoli as he zig-zagged through the parking lot toward a structure situated outside the lot. At about this same time, Trooper Blackwell came onto the scene.

Pointing towards where Monopoli had fled, the two men yelled, "He went that way." Jager's attention focused on Dudley and Schiller. Trooper Blackwell, who had also lost sight of Jager, had now regained sight of him. Jager was about fifteen feet from Dudley when he jumped up and bit Dudley in the stomach. Meanwhile, Trooper Blackwell yelled for Dudley to get inside the truck and lock the doors. Dudley tried to dive in the interior compartment of his truck headfirst. He made it halfway in but Jager clenched onto Dudley's leg and dragged him out of the vehicle. Trooper Blackwell commanded Jager to "release," and Jager complied.[4] Trooper Blackwell then took hold of Jager's leash and continued his pursuit of Monopoli. Other officers had arrived by then, and within a short time, they apprehended Monopoli outside the periphery of the parking lot. Trooper Blackwell returned to Dudley, who was taken to a local hospital by ambulance, where he was treated for his wounds. Dudley was discharged the same day.

2. Discussion. "In reviewing a grant of summary judgment, 'we assess the record de novo and take the facts, together with all reasonable inferences to be drawn from them, in the light most favorable to the nonmoving party.' " Pugsley v. Police Dept. of Boston, 472 Mass. 367, 370–371, 34 N.E.3d 1235 (2015), quoting from Bulwer v. Mount Auburn Hosp., 86 Mass. App. Ct. 316, 318, 16 N.E.3d 1090 (2014). Here, we review the judge's grant of immunity under the Act, G. L. c. 258.

The Act provide[s] "a comprehensive and uniform regime of tort liability for public employers." Morrissey v. New England Deaconess Assoc.—Abundant Life Communities, Inc., 458 Mass. 580, 588, 940 N.E.2d 391 (2010). See Greenwood v. Easton, 444 Mass. 467, 469–471, 828 N.E.2d 945 (2005). As is pertinent in this case, the Act exempts a public employer from liability for "any claim based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a public employer or public employee, acting within the scope of his office of employment, whether or not the discretion involved is abused." G. L. c. 258, § 10(b). The parties agree that the State police is a public employer entitled to the protections of the discretionary function exemption in § 10(b), which, if applicable in this case, would immunize it from liability.

In deciding whether § 10(b)'s discretionary function exemption precludes a plaintiff's tort claim, we first look to "whether the governmental actor had any discretion ... to do or not to do what the plaintiff claims caused [the] harm." Greenwood, supra at 469, 828 N.E.2d 945, quoting from Harry Stoller & Co. v. Lowell, 412 Mass. 139, 141, 587 N.E.2d 780 (1992).

"[I]f the governmental actor had no discretion because a course of action was prescribed by a statute, regulation, or established agency practice, [§ 10(b)'s] discretionary function exception to government liability has no role to play in ... the case." Ibid. Here, Dudley cannot reasonably contest the State police's assertion that the use of the trained police canine, Jager, was not prescribed by a statute, regulation, or established agency practice. The State police's contention, at least with respect to the first prong of the Greenwood/Harry Stoller test, is aided by our opinion in Audette v. Commonwealth, 63 Mass. App. Ct. 727, 829 N.E.2d 248 (2005), which held that State police canine handlers did have "discretion" as to the course of conduct to follow in the police canine's training and use in police operational

activities. Id. at 731, 829 N.E.2d 248. As was true with a similar State police general order in Audette, the State police's general order for canine units (effective November 5, 2008) gives discretion to its canine handlers for determining "whether a situation justifies canine use and the appropriate tactical measures that should be taken." We turn, then, to the second (and final) step in deciding whether § 10(b)'s discretionary function exemption applies. In this step we must determine "whether the discretion that the [governmental] actor had is that kind of discretion for which § 10(b) provides immunity from liability." Greenwood, supra at 470, 828 N.E.2d 945, quoting from Harry Stoller, supra at 141, 587 N.E.2d 780. The essential measure, under governing case precedent, is whether the governmental actor's conduct, i.e., Trooper Blackwell's act of releasing Jager to apprehend the suspect in a moderate to heavily occupied commuter parking lot, involved discretionary activity of the "planning or policy-making type" that is immunized under § 10(b), as opposed to particular conduct that involves the "implementation" of government policy, for which there is no immunity. Ibid.

In our view, particularly at the summary judgment stage, we cannot say Trooper Blackwell's injury producing conduct of commanding and releasing Jager to apprehend a criminal suspect involved the use of planning or policy making discretion. Rather, it was conduct that carried out or implemented the State police's general policy for police canine use in the field. Where, as here, the allegedly tortious conduct of the governmental actor concerns the "carrying out of previously established policies or plans, such acts should be governed by the established standards of tort liability applicable to private individuals or entities." Greenwood, supra at 471, 828 N.E.2d 945, quoting from Whitney v. Worcester, 373 Mass. 208, 218–219, 366 N.E.2d 1210 (1977).

We reject the State police's contention that Audette controls the result in this case. In Audette, unlike the situation presented here, a trained State police canine was off leash during a motor vehicle search for contraband when he attacked the victim when the police handler neither ordered an attack nor an apprehension. See Audette, supra at 729, 829 N.E.2d 248. In our view, that is significantly different from the situation here, where a trained, experienced police canine handler ordered a police dog to apprehend another individual, that is to bite and hold a person, in a moderate to heavily occupied public parking lot. It is immaterial that Jager had never attacked anyone without a command from his handler because, here, Jager was commanded to attack. He was ordered to apprehend, and that order contemplated Jager's hunting down, biting, and holding an individual, which is precisely what Jager did to Dudley.

The State police is not assisted by the governmental immunity provision set forth in § 10(j) either, because § 10(j) does not preclude suit where the governmental actor is an "original cause" in creating the harmful condition that resulted in injury to the plaintiff. Kent v. Commonwealth, 437 Mass. 312, 318, 771 N.E.2d 770 (2002). See Serrell vs. Franklin County, 47 Mass. App. Ct. 400, 405–406, 713 N.E.2d 389 (1999), where § 10(j) did not bar recovery for the affirmative actions of correction officers, who, while intervening in a fight, struck and injured the plaintiff. The same is true here. Trooper Blackwell, while trying to capture a fleeing suspect, ordered and released Jager, in a moderate to heavily occupied parking lot, to attack a suspect and, in doing so, the Trooper created the harmful condition

that resulted in Dudley's injury. Accord Gennari v. Reading Pub. Sch., 77 Mass. App. Ct. 762, 764, 933 N.E.2d 1027 (2010) (§ 10[j] did not provide immunity where school principal ordered recess in a concrete playground and, therefore, created the situation in which a child would be pushed and fall onto the concrete while playing tag). The judgment is vacated, and the case is remanded to the Superior Court for trial consistent with this opinion.

So ordered.

All Citations

91 Mass.App.Ct. 616, 78 N.E.3d 136

Footnotes

1 Justice Cypher participated in the deliberation of this case while an Associate Justice of this court, prior to her appointment as an Associate Justice of the Supreme Judicial Court.

2 His claims against the criminal suspect (William P. Monopoli) and an automobile insurer are not at issue in this appeal.

3 A German shepherd weighing about eighty-two pounds.

4 The use of force by the State police is governed by written policies and procedures. A trooper and his State police dog operate as a team and, when given the order to apprehend a suspect, the dog will "bite and hold" the suspect.

Introduction to Third Party Rights Against Principals and Agents

If a third party is injured by the negligence of an agent, then the agent is liable under ordinary negligence principles, and the principal is liable under the doctrine of respondeat superior. If a third party contracts with an agent for an undisclosed or partly disclosed principal, then both the agent and the principal are liable. But you already knew that. And it only stands to reason that while you might have two viable defendants, there can be only one recovery for the plaintiff. But there is more to this matter than meets the eye.

Discussion points for Williams v. Investors Syndicate

The doctrine of election in Massachusetts. Truly a trap for the unwary, and a windfall to either the agent or the principal, depending upon who the plaintiff decided to make the election to go after.

WILLIAMS
v.
INVESTORS SYNDICATE et al.

Supreme Judicial Court of Massachusetts, Hampden.

Decided March 5, 1951.

WILLIAMS, Justice.

This is a bill in equity in which Bradford Estates, Inc., a Massachusetts corporation, and

Investors Syndicate, a Minnesota corporation, are joined as defendants. Hereinafter they are referred to as Bradford and Investors. It is alleged in the bill that the plaintiff obtained a 'finding' against Bradford in the District Court of Western Hampden in the sum of $3,295.89 on April 21, 1948; that on August 12, 1947, Bradford gave a mortgage to Investors on certain premises in Westfield designated as certain lots on page 130 of book of plans 25 at the registry of deeds; that Investors proposed to foreclose the mortgage on April 23, 1948; that the real estate mortgaged constituted the only asset of Bradford; that Bradford and Investors 'are, in fact if not in legal phraseology, one and the same person and that the unjust enrichment of Bradford will enure to the benefit of Investors'; that the premises in question were conveyed to Bradford by deed on June 19, 1947, for $15,000 by Robert P. Lane and Sara M. Lane; that the purchase price was provided by Investors; that 'there was a fraud and collusion between Bradford and Investors and that, as a result thereof, the plaintiff is out of pocket in the sum of $3,295.89, together with interest thereon.' The plaintiff prays that Investors be ordered to pay to the plaintiff $3,295.89 with interest and until such time as payment is made be restrained from foreclosing its mortgage. The evidence is reported and the judge has reported findings of material facts substantially as follows: that Bradford received a deed of the premises on June 19, 1947, and on the same day gave a mortgage on the land to Investors in the sum of $15,000; that 'Bradford Estates, Inc., and Investors Syndicate were, in reality, one and that Bradford Estates, Inc., was acting as a 'straw' for Investors Syndicate, and that the transactions were in fraud of creditors * * * that in August, 1947, the plaintiff delivered loam on the above mentioned land which was in the name of Bradford Estates, Inc., for which he has not been paid, and got an execution, from the District Court of Western Hampden, which has not been satisfied * * * that the loam was utilized for the benefit of the defendant Investors Syndicate and that it has been unjustly enriched at the expense of the plaintiff, and that Investors Syndicate owes the plaintiff the sum of $3,295.89.' He entered a final decree, from which Investors has appealed, ordering Investors to pay that sum to the plaintiff. The record does not show that Bradford appeared, answered, or has appealed from the decree.

We have difficulty in understanding the theory on which the plaintiff's bill is drawn. From the judge's findings he apparently regarded it as alleging that the plaintiff was entitled to recover from Investors $3,295.89 as the amount by which Investors has been unjustly enriched through the delivery of loam by the plaintiff on land which 'in reality' belonged to Investors. We first consider the case on the basis.

[1] There are annexed to the plaintiff's bill copies of his declaration and the findings and decision of the judge in the action brought by the plaintiff against Bradford in the District Court of Western Hampden, in which action, the plaintiff alleges, he obtained a 'finding' against Bradford in the sum of $3,295.89. These copies indicate that the finding was for the value of loam sold and delivered by the plaintiff to Bradford. This declaration and the judge's findings were not introduced as evidence in the instant case. The only document in evidence pertaining to that action was an execution which recited a judgment for the plaintiff in the amount above stated. The only reference to the subject matter of that action was in a question to the plaintiff by his counsel, 'And are you the man who furnished the loam on the property on Western Avenue was developed as the Bradford Estates?' to which the plaintiff

answered, 'Yes.' There was no evidence of the delivery by the plaintiff of loam on the premises described in his bill, of its value if delivered, or of the time of delivery. The judge, therefore, had no evidence to warrant his finding that Investors was enriched at the expense of the plaintiff to the extent of $3,295.89 by reason of loam delivered on land standing in the name of Bradford, and the decree for the plaintiff based on this finding cannot stand.

[2] Neither is the plaintiff entitled to a decree if the bill be interpreted as seeking to enforce against Investors a judgment obtained by the plaintiff against Bradford. As Investors is not a party to the judgment, the plaintiff cannot recover against it on the judgment in an action at law.

[3] We take the finding of the judge that Bradford was a 'straw' for Investors to mean that Bradford was holding the land as agent for Investors. If Investors was an undisclosed principal at the time of the loam transaction, the plaintiff, on discovering the relationship, could have proceeded on his claim for the delivery of the loam against either the agent or the principal at his election. He could not have proceeded against both jointly. He has proceeded against the agent and obtained a judgment which is unsatisfied. If Investors remained an undisclosed principal when the plaintiff commenced his action against the agent Bradford, institution of the action was not conclusive of an election by the plaintiff to hold the agent rather than the principal. Upon discovery of the existence of the principal he could then have proceeded against it. The plaintiff, however, has not done this but, on that interpretation of the bill which we are now considering, is seeking to enforce against the principal his judgment obtained against the agent. As was said in Old Ben Coal Co. v. Universal Coal Co., 248 Mich. 486, 491, 227 N.W. 794, 795, a case similar on its facts to the instant case, 'As plaintiff's right to recovery asserted here is alternative, depending upon the doctrine of election, plaintiff cannot stand on the judgment against the agent as valid and binding and treat such judgment as a cause of action against the principal.' Investors and Bradford are separate corporate entities, and by his judgment against the latter the plaintiff has acquired no equitable right against the former.

The bill should have been dismissed as against Investors.

Decree reversed with costs of this appeal.

Introduction to Partnership Law

Partnerships are just one of many recognized and accepted forms of doing business. If you run your own business, either as a sole proprietor of a small office out of your house, or as the CEO of your ultra-successful business with 3000 fat and happy employees, and you bring in just one person to be your partner, then you have transformed your sole proprietorship into a partnership. In statutory terms, a partnership is defined as the carrying on of a business for profit by two or more persons as co-owners of the business. There are no formalities required to become a partnership, but they are highly recommended (such as a written

partnership agreement), so that all parties going into the business know (more or less) exactly what is expected of them.

In the absence of an express agreement governing the affairs of the partners and the partnership, then the Uniform Partnership Act, at M.G.L.c. 108, will govern disputes between the partners. Truth be told, most of the case law about partners and partnerships arises because of the failure to draw up partnership papers.

At the outset, understand that partners are agents of one another, and of the partnership. And applying agency law principles, one could forcefully argue that a partner in a partnership has the apparent authority to bind the partnership to most contracts in the ordinary course of the partnership business.

And, absent an express agreement to the contrary, each partner has the right to manage the partnership. So you can see that in a two-person partnership, it is important to have mechanisms to resolve disputes about who gets to decide when the partners disagree (otherwise, you have a stalemate, and dissolution of the partnership might be the only option).

There are a couple of other important points to keep in mind when reading the following cases. First, whether a partnership exists is a fact-based decision. What the parties call themselves is not dispositive of the issue. Second, keep in mind that there are all sorts of motivations and competing interests at play in these cases, not all of which are explicitly acknowledged by the courts or the parties involved. And finally, keep in mind that with all of the benefits one gets as a partner in a partnership, there are a whole host of liabilities and duties that come with the territory.

Discussion points for Kaufman-Brown v. Long

In these next two cases, what the parties call themselves does not decide the issue. As a matter of fact, whether you are or are not a partnership depends on who is doing the asking, as you will see.

This case stands for several propositions, the main one being whether the plaintiffs were partners of Horton and Althouse, or whether they were just creditors of Horton and Althouse. There are two reasons why this is important. If they are creditors of Horton and Althouse, then they might actually get paid something when Horton and Althouse file for bankruptcy. If they are partners, however, they drop farther down the pecking order of payments. See UPA § 40. In deciding their status, look at all of the facts, and decide if each fact is consistent with their status as creditors, or partners, or both. Then ask yourself the fundamental question: Did they act as co-owners of a business engaged in for the purpose of making a profit?

If you find that they did act as co-owners, then you know where they stand regarding

payment out of the bankruptcy proceeding. But that is nowhere near the end of the story. See what might now happen, looking specifically at UPA section 15.

KAUFMAN-BROWN POTATO CO. et al.
v.
LONG et al.

United States Court of Appeals Ninth Circuit.

May 11, 1950.

STEPHENS, Circuit Judge.

The individuals, Charles H. Kaufman and Albert H. Brown, doing business as Kaufman-Brown Potato Company, a partnership, joined with two others in a petition filed in federal district court alleging that they were creditors of Gerry Horton and J. D. Althouse, individually, and creditors of them doing business as Gerry Horton Company, a partnership, and Gerry Horton and J. D. Althouse doing business as Gerry Horton Farms, a partnership. The petition contained appropriate allegations upon which bankruptcy adjudication was pronounced against both Horton and Althouse and against the two partnerships of which they were members. No petition for review of such adjudication has ever been filed nor has the adjudication been vacated although it was ordered amended by adding to those declared bankrupt.

As will later herein appear, the referee and the district court in response to a petition of the trustee in bankruptcy subsequently made an order declaring among other things, that there was a second partnership by the name of Gerry Horton Farms which was composed of the first mentioned partnership of the same name and the partnership of Kaufman-Brown Potato Company. This second 'Gerry Horton Farms' is distinguished by the bankruptcy court by adding after the name 'engaged in raising potatoes'. We shall designate it 'Gerry Horton Farms (partnership combination).' By the amended order 'Gerry Horton Farms (partnership combination)' as a distinct and separate enterprise is added to those adjudged bankrupt in the original adjudication. It will be necessary to an understanding of the problems presented and to their solution to keep in mind the fact that although the individuals Gerry Horton and J. D. Althouse and the two partnerships comprised of them alone are declared bankrupt, the individuals Charles H. Kaufman and Albert H. Brown and the partnership Kaufman- Brown Potato Company are not so declared. We quote the amended adjudication in the margin. It may be said in passing that the trustee's petition which called forth the amendments did not request that additional bankrupts be included in the order of adjudication but did call attention to the contracts hereinafter to be analyzed and to their questioned effect upon the bankruptcy proceedings. The amended adjudication is the subject of two of three appeals, all of which have been consolidated and are here for decision, one of them being an appeal from the court's minute order, the other from the court's formal written order.

Separate proceedings were had as to the allowability of Kaufman-Brown Potato Company's unsecured claim, as set up in the original petition and as to which form of proof was later filed, and such claim was ordered allowed in part as against Gerry Horton Company, and wholly disallowed as against Gerry Horton Farms, the partnership comprised of Horton and Althouse only. As against Gerry Horton Farms (partnership combination), such claim was allowed but payment thereon was deferred until after all other creditors' and all administration expenses had been paid. The order as to such claim is the subject of one of the consolidated appeals. Charles H. Kaufman, Albert H. Brown, and Kaufman- Brown Potato Company are the appellants in all three appeals.

It is contended by appellants that the contracts by and between Gerry Horton Farms, a partnership composed of Gerry Horton and J. D. Althouse, and Kaufman- Brown Potato Company a partnership composed of Charles H. Kaufman and Albert H. Brown, are not partnership agreements and did not constitute a partnership of such partnerships and that no conduct of any persons brought such status to functioning under them; that even if they are wrong in the contention that a partnership was not created by the contracts and conduct and the agreements between the partnerships did create another partnership, it was not within the power of the court, in the circumstances, to adjudge such partnership bankrupt. Appellants also contend that the disposition of their claim against the bankrupts was erroneous.

The Partnership Issue

Appellants rely mainly upon these arguments: The dealings between Gerry Horton, J. D. Althouse, Charles H. Kaufman, and Albert H. Brown could not constitute (as is claimed they must under California law to constitute a partnership) an association for the purpose of jointly carrying on a business together. The word 'partner' used twice in each of the written agreements was inadvertent and is not conclusive. The written contracts or agreements themselves in certain particulars and the conduct of the parties under such written agreements negative both any intent to form a partnership or that a partnership in fact was formed or existed.

It appears from the evidence that Horton and Althouse, prior to any association with Kaufman-Brown Potato Company, were doing business in partnership both as Gerry Horton Company and Gerry Horton Farms, under the former name as farm produce distributors and under the latter name as producers. In 1944 they held two parcels of California farm land under lease. As to each parcel separately Horton and Althouse as Gerry Horton Farms contracted in writing with Kaufman and Brown Potato Company, who were distributors, relative to planting, raising, and harvesting potatoes on such land.

It was agreed in each contract that Kaufman and Brown would purchase from Horton and Althouse for a certain amount an undivided interest (50% as to one parcel; 40$ as to the other parcel) in all potato crops to be planted, raised and harvested upon such leased land during the year 1944. Horton and Althouse agreed to pay all costs and expenses of planting and raising in excess of the amount above mentioned to be paid in by Kaufman and Brown for

the above undivided interests. The costs incurred for harvesting were to be shared in the ratio of such interests. The net proceeds after repayment to Kaufman and Brown of the amount they paid in and of any amounts paid by Horton and Althouse in addition thereto for the expenses of planting and raising were to be divided 'between the partners' (quoting from such contracts) in like manner. The over-all losses sustained in the venture were to be borne by the parties in their interest ratio. It was also provided that Horton and Althouse would keep full and accurate accounts of the enterprise at their place of business. The written contracts provided for an option to Kaufman and Brown Potato Company to purchase the crop raised and harvested on each parcel of land for a price equal to the prevailing market price but if there were no prevailing market price upon harvest Kaufman and Brown agreed to handle all the potatoes as agents for Horton and Althouse for a stated commission 'for said services rendered on behalf of the partners hereto' and pay to Horton and Althouse all money received from the sale thereof 'subject to accounting and distribution as hereinbefore set forth.' (Quotations are from each contract.) In the event that Kaufman and Brown exercised their option to purchase, Horton and Althouse could add to the purchase price any markups allowed by O.P.A. regulations but that the total amount of such markups would be divided between the parties in the ratio of their interests. Horton and Althouse were to furnish all the necessary farming equipment. The contracts also provided for the execution of a crop mortgage as security for faithful performance by Horton and Althouse and for a promissory note also to be executed in an amount which as above mentioned Kaufman and Brown were to pay in. After each contract had been fully complied with, the mortgage and note were to be surrendered and cancelled. It was declared that the mortgage and note were executed solely as security for performance and that Horton and Althouse were not to be held liable for any losses resulting from causes beyond their control. The contracts did not provide for a firm bank account nor for a firm name of the business to be conducted under the provisions of the contracts. Both agreements were prepared by Horton and Althouse's attorney pursuant to Horton's instructions.

As to their farming activities, during the year 1944 Horton and Althouse devoted themselves solely to operations under and in conformity with the written agreements. Potatoes were farmed, harvested and sold and Kaufman-Brown Potato Company, exercising its option, purchased some and paid to Horton and Althouse the prevailing market price therefor. In the aggregate (as to both leases) Kaufman and Brown in fact advanced to Horton and Althouse some $43,000 and had been repaid $20,000. The latter had issued bank checks for the balance of such advances not repaid but they were not honored for lack of sufficient funds. The total of such dishonored checks represents the amount of the claim asserted by Kaufman and Brown in the instant involuntary petition in bankruptcy. It was testified that such checks were accepted in payment of the mortgages and notes executed by Horton and Althouse pursuant to each contract. Appellants assert their claim here as unsecured.

No assignments of the leases held by Horton and Althouse were ever made to the purported partnership with Kaufman-Brown Potato Company. No bank account was maintained separate from those kept in the names of each of the partnerships of which Horton and Althouse were the sole members. There was no evidence that any of the creditors of the 1944 farming enterprise were told or knew that Kaufman-Brown Potato Company was a

partner in the farming of the leased ground or that any of them knew anything about Kaufman-Brown's association or interest.

[2][3][4][5] A partnership may be formed for a single venture. Whether or not a partnership relationship exists is determinable by the intent of the parties to do things which constitute a partnership. It is immaterial that the parties deign not to call their relationship. or believe it not to be, a partnership, especially where as here the rights of third persons are involved. It is true that a mere agreement to share profits and losses does not make a partnership but both the sharing of profits and losses are usual in partnership agreements and practices.

[6][7] It is plain that the contracts in question were drawn with some of the usual covenants and conditions both of a straight financing contract with options and of a partnership agreement. Appellants point especially to the provisions for crop mortgages as supporting the former relation but their argument is offset by the proviso that such were to be security only for performance on the part of Horton and Althouse and that Horton and Althouse would not be liable for any losses occasioned by causes beyond their control. The non-mention of capital contribution of each of the parties is stressed, but all partners need not contribute capital in the strict sense of the word; some may invest their labor and skill. These contracts provide that Kaufman and Brown were to put up so much money for initial expense but note that all of it was to be returned out of the product as expense before division of sales returns. Horton and Althouse were to devote themselves to the farming aspect using their own equipment, and Kaufman and Brown were to use their sales organization and experience if necessary to effect distribution of the crop. However, the provision that the amounts paid in by Kaufman and Brown were to be repaid before division of sales returns is consistent with a partnership relationship. See California Civil Code section 2412(a) (California Corporations Code section 15018(a)). There is a provision in each of the contracts that in certain circumstances Kaufman and Brown would act as agents for Horton and Althouse to dispose of the potatoes upon harvest through Chicago markets for a stated commission and would pay to Horton and Althouse money obtained from sales. This provision appears to be more unusual in a partnership contract than inconsistent with one, for Horton and Althouse were to keep the accounts and all such provisions were stated to be 'subject to accounting and distribution as hereinbefore set forth.' The use of the word 'partner' in each agreement could have been but a handy work to include personnel without naming them but the fact-finder, on analyzing the complicated contracts, would not be justified in rejecting its possible bearing on the issue entirely. The contracts also provide that Horton and Althouse keep the 'books of account and all other records' of the enterprise at their place of business and that each of the partners hereto 'shall at all times have access to and may inspect and copy any of them.' The latter quoted language is taken verbatim from California Civil Code section 2413 (California Corporations Code section 15019), which relates to 'partnership books'.

It is evident that Kaufman and Brown advanced more than was required by the contracts. This fact could be accounted for by their desire to protect their interests in either relation. Further, there is testimony to the effect that both Messrs. Kaufman and Brown came to California and made recommendations relative to operations under the contracts. Of course,

their interest in the contracts could have justified their personal presence on the ground, either as partners or joint venturers, but it is consistent with partnership interest.

[8] We are of the opinion that the record contains the essentials of a partnership and also substantial proof that such was the intention at least of Horton and Althouse, the authors of the contracts. Upon a review of the record as a whole we do not find that a mistake has been made. Compare Westcott v. Gillman, supra; Associated Piping & Engineering Co. Ltd. v. Jones, supra.

The orders here appealed from which adjudge Gerry Horton Farms (partnership combination) bankrupt are reversed and the order in regard to Kaufman-Brown Potato Company's claim is affirmed. The case is remanded to the district court for further proceedings in conformity with this opinion.

Affirmed, reversed, and remanded.

Discussion points for Martin v. Peyton

This case is somewhat hard to follow, but slog through it, because the ramifications are so important. Martin is a creditor of Peyton, who of course has no money. So Martin is claiming that KNK is not a creditor of Peyton, but a partner of Peyton, and that KNK is therefore liable for the debts of Peyton. There seems to be a moral to this story. If you are a bank, and you lend money to risky clients, you are going to want as much security and collateral to protect your loan with the client. But the more you take, the more control you are able to exercise over the client's business affairs, the more you become at risk for being transformed from a creditor into a partner.

MARTIN
v.
PEYTON et al.

Court of Appeals of New York.

July 20, 1927.

ANDREWS, J.

[1] Much ancient learning as to partnership is obsolete. Today only those who are partners between themselves may be charged for partnership debts by others. Partnership Law (Consol. Laws, c. 39), § 11. There is one exception. Now and then a recovery is allowed where in truth such relationship is absent. This is because the debtor may not deny the claim. Section 27.

[2][3] Partnership results from contract, express or implied. If denied, it may be proved by the production of some written instrument, by testimony as to some conversation, by circumstantial evidence. If nothing else appears, the receipt by the defendant of a share of the profits of the business is enough. Section 11.

[4][5][6][7] Assuming some written contract between the parties, the question may arise whether it creates a partnership. If it be complete, if it expresses in good faith the full understanding and obligation of the parties, then it is for the court to say whether a partnership exists. It may, however, be a mere sham intended to hide the real relationship. Then other results follow. In passing upon it, effect is to be given to each provision. Mere words will not blind us to realities. Statements that no partnership is intended are not conclusive. If as a whole a contract contemplates as association of two or more persons to carry on as co-owners a business for profit, a partnership there is. Section 10. On the other hand, if it be less than this, no partnership exists. Passing on the contract as a whole, an arrangement for sharing profits is to be considered. It is to be given its due weight. But it is to be weighed in connection with all the rest. It is not decisive. It may be merely the method adopted to pay a debt or wages, as interest on a loan or for other reasons.

[8][9] An existing contract may be modified later by subsequent agreement, oral or written. A partnership may be so created where there was none before. And again, that the original agreement has been so modified may be proved by circumstantial evidence--by showing the conduct of the parties.

[10] In the case before us the claim that the defendants became partners in the firm of Knauth, Nachod & Kuhne, doing business as bankers and brokers, depends upon the interpretation of certain instruments. There is nothing in their subsequent acts determinative of or indeed material upon this question. And we are relieved of questions that sometimes arise. 'The plaintiff's position is not,' we are told, 'that the agreements of June 4, 1921, were a false expression or incomplete expression of the intention of the parties. We say that they express defendants' intention and that that intention was to create a relationship which as a matter of law constitutes a partnership.' Nor may the claim of the plaintiff be rested on any question of estoppel. 'The plaintiff's claim,' he stipulates, 'is a claim of actual partnership, not of partnership by estoppel, and liability is not sought to be predicated upon article 27 of the New York Partnership Law.'

Remitted then, as we are, to the documents themselves, we refer to circumstances surrounding their execution only so far as is necessary to make them intelligible. And we are to remember that although the intention of the parties to avoid liability as partners is clear, although in language precise and definite they deny any design to then join the firm of K. N. & K.; although they say their interests in profits should be construed merely as a measure of compensation for loans, not an interest in profits as such; although they provide that they shall not be liable for any losses or treated as partners, the question still remains whether in fact they agree to so associate themselves with the firm as to 'carry on as co-owners a business for profit.'

In the spring of 1921 the firm of K. N. & K. found itself in financial difficulties. John R. Hall was one of the partners. He was a friend of Mr. Peyton. From him he obtained the loan of almost $500,000 of Liberty bonds, which K. N. & K. might use as collateral to secure bank advances. This, however, was not sufficient. The firm and its members had engaged in unwise speculations, and it was deeply involved. Mr. Hall was also intimately acquainted with George W. Perkins, Jr., and with Edward W. Freeman. He also knew Mrs. Peyton and Mrs. Perkins and Mrs. Freeman. All were anxious to help him. He therefore, representing K. N. & K., entered into negotiations with them. While they were pending a proposition was made that Mr. Peyton, Mr. Perkins, and Mr. Freeman, or some of them, should become partners. It met a decided refusal. Finally an agreement was reached. It is expressed in three documents, executed on the same day, all a part of the one transaction. They were drawn with care and are unambiguous. We shall refer to them as 'the agreement,' 'the indenture,' and 'the option.'

[11] We have no doubt as to their general purpose. The respondents were to loan K. N. & K. $2,500,000 worth of liquid securities, which were to be returned to them on or before April 15, 1923. The firm might hypothecate them to secure loans totaling $2,000,000, using the proceeds as its business necessities required. To insure respondents against loss K. N. & K. were to turn over to them a large number of their own securities which may have been valuable, but which were of so speculative a nature that they could not be used as collateral for bank loans. In compensation for the loan the respondents were to receive 40 per cent. of the profits of the firm until the return was made, not exceeding, however, $500,000, and not less than $100,000. Merely because the transaction involved the transfer of securities and not of cash does not prevent its being a loan, within the meaning of section 11. The respondents also were given an option to join the firm if they, or any of them, expressed a desire to do so before June 4, 1923.

Many other detailed agreements are contained in the papers. Are they such as may be properly inserted to protect the lenders? Or do they go further? Whatever their purpose, did they in truth associate the respondents with the firm so that they and it together thereafter carried on as co-owners a business for profit? The answer depends upon an analysis of these various provisions.

As representing the lenders, Mr. Peyton and Mr. Freeman are called 'trustees.' The loaned securities when used as collateral are not to be mingled with other securities of K. N. & K., and the trustees at all times are to be kept informed of all transactions affecting them. To them shall be paid all dividends and income accruing therefrom. They may also substitute for any of the securities loaned securities of equal value. With their consent the firm may sell any of its securities held by the respondents, the proceeds to go, however, to the trustees. In other similar ways the trustees may deal with these same securities, but the securities loaned shall always be sufficient in value to permit of their hypothecation for $2,000,000. If they rise in price, the excess may be withdrawn by the defendants. If they fall, they shall make good the deficiency.

So far, there is no hint that the transaction is not a loan of securities with a provision for compensation. Later a somewhat closer connection with the firm appears. Until the securities are returned, the directing management of the firm is to be in the hands of John R. Hall, and his life is to be insured for $1,000,000, and the policies are to be assigned as further collateral security to the trustees. These requirements are not unnatural. Hall was the one known and trusted by the defendants. Their acquaintance with the other members of the firm was of the slightest. These others had brought an old and established business to the verge of bankruptcy. As the respondents knew, they also had engaged in unsafe speculation. The respondents were about to loan $2,500,000 of good securities. As collateral they were to receive others of problematical value. What they required seems but ordinary caution. Nor does it imply an association in the business.

The trustees are to be kept advised as to the conduct of the business and consulted as to important matters. They may inspect the firm books and are entitled to any information they think important. Finally, they may veto any business they think highly speculative or injurious. Again we hold this but a proper precaution to safeguard the loan. The trustees may not initiate any transaction as a partner may do. They may not bind the firm by any action of their own. Under the circumstances the safety of the loan depended upon the business success of K. N. & K. This success was likely to be compromised by the inclination of its members to engage in speculation. No longer, if the respondents were to be protected, should it be allowed. The trustees therefore might prohibit it, and that their prohibition might be effective, information was to be furnished them. Not dissimilar agreements have been held proper to guard the interests of the lender.

As further security each member of K. N. & K. is to assign to the trustees their interest in the firm. No loan by the firm to any member is permitted and the amount each may draw is fixed. No other distribution of profits is to be made. So that realized profits may be calculated the existing capital is stated to be $700,000, and profits are to be realized as promptly as good business practice will permit. In case the trustees think this is not done, the question is left to them and to Mr. Hall, and if they differ then to an arbitrator. There is no obligation that the firm shall continue the business. It may dissolve at any time. Again we conclude there is nothing here not properly adapted to secure the interest of the respondents as lenders. If their compensation is dependent on a percentage of the profits, still provision must be made to define what these profits shall be.

The 'indenture' is substantially a mortgage of the collateral delivered by K. N. & K. to the trustees to secure the performance of the 'agreement.' It certainly does not strengthen the claim that the respondents were partners.

Finally we have the 'option.' It permits the respondents, or any of them, or their assignees or nominees to enter the firm at a later date if they desire to do so by buying 50 per cent. or less of the interests therein of all or any of the members at a stated price. Or a corporation may, if the respondents and the members agree, be formed in place of the firm. Meanwhile, apparently with the design of protecting the firm business against improper or ill-judged action which might render the option valueless, each member of the firm is to place his

resignation in hands of Mr. Hall. If at any time he and the trustees agree that such resignation should be accepted, that member shall then retire, receiving the value of his interest calculated as of the date of such retirement.

[12] This last provision is somewhat unusual, yet it is not enough in itself to show that on June 4, 1921, a present partnership was created, nor taking these various papers as a whole do we reach such a result. It is quite true that even if one or two or three like provisions contained in such a contract do not require this conclusion, yet it is also true that when taken together a point may come where stipulations immaterial separately cover so wide a field that we should hold a partnership exists. As in other branches of the law, a question of degree is often the determining factor. Here that point has not been reached.

The judgment appealed from should be affirmed, with costs.

CARDOZO, C. J., and POUND, CRANE, LEHMAN, KELLOGG, and O'BRIEN, JJ., concur.

Judgment affirmed, etc.

Discussion points for Frank v. R.A. Pickens

Partners are free to structure their partnership arrangements any way they like. But there are practical as well as legal limits to how far out one can go and still be a partner. In the two cases that follow, ask yourself whether these parties were really partners in a partnership, or were they in fact something else? And while it may not be explicitly stated, ask yourself about the motivations of the parties in these cases.

Note that all partners are not created equally, nor should they be. Let’s assume that I have been working as a sole proprietor attorney for the last 20 years, and I hire you as a attorney fresh out of MSL. After two years as my employee, you are ready to move on to greener pastures, but you are valuable to me, so I decide to bring you into the partnership. Now, keep in mind, these are all my clients, and all my goodwill, so initially, I will give you a 10% interest in the partnership. So 90% of the profits are mine. And if there are disputes, my decision is final. Your voting rights do not equal mine. You are a junior partner, and you better learn to live with it.

This is Mr. Frank’s dilemma. Ask yourself why the arrangement was structured this way. And figure out what the court means when it talks of “book value” and ask yourself how fair that might be.

Louis Sterling FRANK, Appellant,

v.

R. A. PICKENS & SON COMPANY et al., Appellees.

No. 78-58.

Supreme Court of Arkansas, Division No. 1.

Oct. 2, 1978.

Rehearing Denied Nov. 13, 1978.

Appellant brought this action seeking an accounting and liquidation of the partnership affairs of appellee R. A. Pickens and Son Company, a farming partnership which leases and farms some 13,000 acres of land owned by another partnership, R. A. Pickens & Son. The partnership in question has existed in one form or another since 1925. Appellee R. A. Pickens has managed the firm since 1937. At the close of business on December 31, 1975, there were 22 partners of which R. A. Pickens & Son owned the largest interest, 31%. R. A. Pickens is not a partner in R. A. Pickens & Son Company but is a partner of R. A. Pickens & Son. Appellant employee was brought into the farming partnership on January 1, 1968, initially acquiring a 2% Interest and eventually acquiring a total interest of 3%. His initial investment ($21,600) was made by giving his note to the partnership with the understanding that his share of the profits would apply to its payment. He remained an active partner until May 31, 1976, when appellee Pickens, as manager of the partnership, terminated appellant's partnership interest and tendered him a check in the amount of $35,805.97. This sum represented 3% Of the partnership capital account of $1,950,000 as of December 31, 1975, or $58,500 plus 10% Interest on this amount from January 1, 1976, until May 31, 1976, less a $17,000 note and 5 months interest owed by appellant to the partnership and less $7,706.53 owed by appellant to the partnership store account. Appellant refused to accept the check. That sum has, to date, been retained by the partnership as part of the partnership capital and carried on the books as a credit due appellant and a partnership liability. Appellant has had no active duties in the partnership affairs since May 31, 1976.

About a month thereafter, appellant filed a petition seeking an accounting of the partnership affairs, alleging that he had been wrongfully excluded. This petition was later amended to seek judicial dissolution and liquidation of the partnership assets. Appellees filed a counter-complaint seeking judicial recognition of the dissolution assertedly effected by appellee R. A. Pickens' notification to appellant on May 31, 1976, of his election to dissolve the partnership, which was a partnership at will. The counter-complaint also alleged the existence of an oral agreement for the purchase and termination of an interest in the partnership. The purchase of an interest in the partnership was based upon book value. Upon termination or dissolution, the value of the outgoing partner's interest was based upon the book value of such an interest as of December 31 of the year preceding such dissolution, plus 10% Interest per annum from December 31 of that year to the date of dissolution. As previously indicated, appellees computed the amount due appellant at his partnership termination to be $35,805.97, after

reduction of appellant's indebtedness to the partnership.

The trial court found that a partnership existed between the parties; that appellant purchased his 3% Interest at book value; that Pickens, as managing partner, had the contractual right to terminate appellant's interest at will; that under the terms of the agreement appellant's contractual interest at termination was 3% Of the book value of the partnership, or $58,500 as of December 31, 1975; that termination occurred on May 31, 1976, and the 10% Interest on that amount, as alleged in the counter-complaint, was not included within the proved contractual terms relating to the calculation of appellant's partnership interest at termination; that appellant's capital and services were used by the partnership until the date of his termination; and therefore he was entitled to $13,843.48 which was 5/12 Ths of his 3% Interest of the net profit for 1976, plus interest. These amounts were to be reduced by appellant's indebtedness to the partnership on his note and store account which were also ordered to bear interest.

Appellant contends that the court erred in not finding that he was entitled to a full share of the profits of the partnership so long as the partnership retained and used his capital contribution, the court erred in finding that R. A. Pickens had a contractual right to terminate appellant's partnership interest and erred in not ordering a termination and winding up of the partnership affairs. As we understand the thrust of appellant's argument, the Uniform Partnership Act is applicable here and therefore appellant has the right to a forced sale and liquidation of the partnership assets and his proper share of the net proceeds.

Pickens testified that appellant, upon becoming a partner, understood that he purchased his interest at book value. Upon leaving, he would be paid the book value and his status as a partner was dependent upon Pickens' willingness for him to continue in that status. It appears undisputed that at the conclusion of each year Pickens conferred with each partner about their individual equity or earnings in the profit sharing venture.

Numerous past and present partners testified. According to them the understanding was they bought their interest in the partnership at book value. The length of their membership was at the will and pleasure of Pickens, the general manager, and upon leaving the company they would be paid at book value. Although appellant denies the oral agreement asserted by Pickens, he admits he acquired his interest at book value based upon a loan of the purchase funds to him by the company as evidenced by a note. Appellant is a college graduate with a business degree. It appears his duties as an employee with the partnership consisted of general office work and bookkeeping a short time before acquisition of his interests and during the 8 1/2 years he was a partner. He was familiar with transactions at book value with respect to incoming and outgoing partners. As indicated, upon termination he refused a tender of payment of his interest after a settlement of accounts.

[2][3][4] Here the chancellor had the advantage of seeing and hearing the witnesses and at the same time study the exhibits to their testimony. We do not reverse a chancellor's finding unless it is against the preponderance of the evidence. Here the chancellor's finding is clearly supported by the preponderance of the evidence. Therefore, in view of the agreement, the

Uniform Partnership Act is not applicable and consequently appellant cannot force a liquidation and sale of the appellee partnership.

Affirmed.

Discussion points for Fenwick v. Unemployment Commission

See in this case that sometimes the calculus of whether a person is or is not a partner in a partnership depends on who is doing the asking. Note too there are a number of factors that go into determining whether a person is a partner. And finally, note the unhidden gender bias of the court. They actually refer to the alleged partner as a 'girl." That choice of word alone tells you what this court thought of her status as either an employee or as a partner.

FENWICK
v.
UNEMPLOYMENT COMPENSATION COMMISSION.

This is an appeal from a judgment of the Supreme Court reversing a determination of the Unemployment Compensation Commission. The question involved is whether one Arline Chesire was, from January 1, 1939, to January 1, 1942, a partner or an employee of the prosecutor-respondent, John R. Fenwick, trading as United Beauty Shoppe. If she was an employee, then she was the eighth and deciding employee for the purpose of determining the status of the respondent for the year 1939 as an employer subject to the terms of the statute. N.J.S.A. 43:21-1 et seq. It is not the contention of the appellant commission that there was a fraudulent intent to avoid the act but the case is submitted as one of legal construction of the relation between Mrs. Chesire and the respondent.

Respondent Fenwick commenced operation of the beauty shop in Newark in November, 1936. In either 1937 or early 1938 he employed Mrs. Chesire as a cashier and reception clerk. Apparently her duties were to receive customers, take their orders for services to be performed by the operators, and collect the charges therefor. The shop did not work on an appointment basis but on a 'first come-first served' plan. Mrs. Chesire was employed at a salary of $15 per week and continued at that salary until December, 1938, when she requested an increase. Respondent expressed a willingness to pay higher wages if the income of the shop warranted it. Thereupon an agreement was entered into by the parties. This agreement was drawn by a lawyer who had offices nearby and provided:

1. That the parties associate themselves into a partnership to commence January 1, 1939.

2. That the business shall be the operation of the beauty shop.

3. That the name shall be United Beauty Shoppe.

4. That no capital investment shall be made by Mrs. Chesire.

5. That the control and management of the business shall be vested in Fenwick.

6. That Mrs. Chesire is to act as cashier and reception clerk at a salary of $15 per week and a bonus at the end of the year of 20% of the net profits, if the business warrants it.

7. That as between the partners Fenwick alone is to be liable for debts of the partnership.

8. That both parties shall devote all their time to the shop.

9. That the books are to be open for inspection of each party.

10. That the salary of Fenwick is to be $50 per week and at the end of the year he is to receive 80% of the profits.

11. That the partnership shall continue until either party gives ten days' notice of termination.

The relationship was terminated on January 1, 1942, at the request of Mrs. Chesire who desired to cease work and remain at home with her child.

The Commission held that the agreement was nothing more than an agreement fixing the compensation of an employee. The Supreme Court held that the parties were partners. The court apparently gave great weight to the fact that the parties had entered into the agreement, had called themselves partners, had designated the relationship one of partnership, and held that the surrounding circumstances, the conduct of the parties, etc., were not such as to overcome the force and effect to be given the declaration of the agreement.

Most of the cases wherein the courts have undertaken to determine whether or not a partnership existed, or whether certain persons were members of existing partnerships, have been those in which creditors have sought to impose liability upon alleged partners. In most cases, too, there have been no written partnership agreements to assist in fixing the status. However, the principles of law to be applied are the same. We think there can be no doubt of the right of the Commission, in the circumstances of this case, to raise the question and have a determination of the question of whether a partnership exists in law even though there is this agreement which is called a partnership agreement. We need not consider here what the effect of the agreement on the parties inter sese would be, but only its effect on the application of the unemployment compensation law.

[1][2] There are several elements that the courts have taken into consideration in determining the exercise or non-existence of the partnership relation. The first element is that of the intention of the parties and here, of course, the agreement itself is evidential although not conclusive. Light on the intent of the parties is shed by the testimony of the

respondent as follows:

'Q. When was she first hired by you? A. That is what I said, either 1937 or 1938, I can't say definitely what it was without looking it up: I couldn't give you the exact date. And she felt as though she was not getting enough money. Well, we were doing a lot of business, but the prices were very low at the time; it was in the depression and you had to bring your prices down to get business. And I told her I did not want to lose her because she was a very very good girl to me in that office, she was what I needed. I told her I couldn't see where I could afford to give her any more. And I did not want to lose her. So it went back and forth, back and forth. Finally I said, 'I will tell you what I will do: If we make any more money I will pay you more, if you want to go along on that agreement.' And that is where the partnership thing came in; that is how we started to be on the partnership concern at that time; that is when that was all discussed and arranged.'

That statement is persuasive that the intention of the parties was to enter into an agreement that would provide a possibility of increase of compensation to Mrs. Chesire and at the same time protect Fenwick from being obliged to pay such increase unless business warranted it. The whole thing was prompted and instigated by the demand of the employee for an increase. The employer valued her services and did not wish to lose her. He wished to retain her in the exact same capacity as before but was afraid to promise a straight increase for fear it might mean loss to him. There is no suggestion that anything but the financial relation between the parties, with respect to compensation for services, was the thing they had in mind. After January 1st, 1939, the date the alleged partnership became effective, the operation of the business continued as before. Mrs. Chesire continued to serve in precisely the same capacity as before and Fenwick continued to have complete control of the management of the business. It would seem that, as far as the intention of the parties is concerned, the effect of the statements in the agreement has been met and overcome by the sworn testimony of Fenwick and by the conduct of the parties.

[3][4] Another element of partnership is the right to share in profits and clearly that right existed in this case. However, not every agreement that gives the right to share in profits is, for all purposes, a partnership agreement.

Another factor is the obligation to share in losses, and this is entirely absent in this case because the agreement provides that Mrs. Chesire is not to share in the losses.

Another is the ownership and control of the partnership property and business. Fenwick contributedall the capital and Mrs. Chesire had no right to share in capital upon dissolution. He likewise reserved to himself control.

The next is community of power in administration, and the reservation in the agreement of the exclusive control of the management of the business in Fenwick excludes this element so far as Mrs. Chesire is concerned. In Wild v. Davenport, supra, Mr. Justice Depue, speaking for this court, said [48 N.J.L. 129, 7 A. 297]:

'In Voorhees v. Jones [29 N.J.L. 270], the decision that a servant or agent who had a share of profits simply as compensation for services was neither a partner, nor liable for partnership debts, was placed by Chief Justice Whelpley on the ground that such a person had no control over the operation of the firm, and could not direct its investments, nor prevent the contracting of debts; in other words, had none of the prerogatives of a principal in the management and control of the business.'

The law as stated in these opinions has been followed by our courts.
Another element is the language in the agreement, and although the parties call themselves partners and the business a partnership, the language used excludes Mrs. Chesire from most of the ordinary rights of a partner.

The conduct of the parties toward third persons is also an element to be considered and the conduct of the parties here does not support a finding that they were partners. They did file partnership income tax returns and held themselves out as partners to the Unemployment Compensation Commission, and Fenwick in his New York state income tax return reported that his income came from the partnership. But to no one else did they hold themselves out as partners. They did not inform the persons they purchased materials from, although Fenwick says this was not necessary since all purchases were for cash and they neither sought nor gave credit. The right to use the trade name had apparently come to Fenwick from one Florence Meola, by lease, and the partnership was given that name by Fenwick. There is no evidence that the trade name was ever registered as that of the partnership.

Another element is the rights of the parties on dissolution and apparently in this case the result of the dissolution, as far as Mrs. Chesire is concerned, was exactly the same as if she had quit an employment. She ceased to work and ceased to receive compensation and everything reverted to the condition it was in prior to 1939, except that Fenwick carried on with a new receptionist.

[5][6] Under all these circumstances, giving due effect to the written agreement and bearing in mind that the burden of establishing a partnership is upon the one who alleges it to exist, we think that the partnership has not been established, and that the agreement between these parties, in legal effect, was nothing more than one to provide a method of compensating the girl for the work she had been performing as an employee. She had no authority or control in operating the business, she was not subject to losses, she was not held out as a partner. She got nothing by the agreement but a new scale of wages.

The question as presented to this court is one of law and not one of fact. The facts are really not in dispute. The contest concerns the inferences of law to be drawn from the facts as found by the Supreme Court.

The Uniform Partnership Act defines a partnership as an association of 'two or more persons to carry on as co-owners a business for profit.' N.J.S.A. 42:1-6. Essentially the element of co-ownership is lacking in this case. The agreement was one to share the profits resulting from a business owned by Fenwick. He contributed all the capital, managed the business and

took over all the assets on dissolution. Ownership was conclusively shown to be in him.

The Act further provides that sharing of profits is prima facie evidence of partnership but 'no such inference shall be drawn if such profits were received in payment * * * as wages of an employee.' R.S. 42:1-7, N.J.S.A., and it seems that is the legal inference to be drawn from the factual situation here.

The judgment is reversed.

Jensen Farms v. Cargill

Supreme Court of Minnesota.

A. GAY JENSON FARMS CO., et al., Respondents,
v.
CARGILL, INCORPORATED, Appellant,
Warren Grain & Seed Company, et al., Defendants.

Aug. 14, 1981.

Heard, considered, and decided by the court en banc.

OPINION

PETERSON, Justice.

Plaintiffs, 86 individual, partnership or corporate farmers, brought this action against defendant Cargill, Inc. (Cargill) and defendant Warren Grain & Seed Co. (Warren) to recover losses sustained when Warren defaulted on the contracts made with plaintiffs for the sale of grain. After a trial by jury, judgment was entered in favor of plaintiffs, and Cargill brought this appeal. We affirm.

This case arose out of the financial collapse of defendant Warren Seed & Grain Co., and its failure to satisfy its indebtedness to plaintiffs. Warren, which was located in Warren, Minnesota, was operated by Lloyd Hill and his son, Gary Hill. Warren operated a grain elevator and as a result was involved in the purchase of cash or market grain from local farmers. The cash grain would be resold through the Minneapolis Grain Exchange or to the terminal grain companies directly. Warren also stored grain for farmers and sold chemicals, fertilizer and steel storage bins. In addition, it operated a seed business which involved buying seed grain from farmers, processing it and reselling it for seed to farmers and local elevators.

Lloyd Hill decided in 1964 to apply for financing from Cargill. Cargill's officials from the Moorhead regional office investigated Warren's operations and recommended that Cargill finance Warren.

Warren and Cargill thereafter entered into a security agreement which provided that Cargill would loan money for working capital to Warren on "open account" financing up to a stated limit, which was originally set as $175,000. Under this contract, Warren would receive funds and pay its expenses by issuing drafts drawn on Cargill through Minneapolis banks. The drafts were imprinted with both Warren's and Cargill's names. Proceeds from Warren's sales would be deposited with Cargill and credited to its account. In return for this financing, Warren appointed Cargill as its grain agent for transaction with the Commodity Credit Corporation. Cargill was also given a right of first refusal to purchase market grain sold by Warren to the terminal market.

A new contract was negotiated in 1967, extending Warren's credit line to $300,000 and incorporating the provisions of the original contract. It was also stated in the contract that Warren would provide Cargill with annual financial statements and that either Cargill would keep the books for Warren or an audit would be conducted by an independent firm. Cargill was given the right of access to Warren's books for inspection.

In addition, the agreement provided that Warren was not to make capital improvements or repairs in excess of $5,000 without Cargill's prior consent. Further, it was not to become liable as guarantor on another's indebtedness, or encumber its assets except with Cargill's permission. Consent by Cargill was required before Warren would be allowed to declare a dividend or sell and purchase stock.

Officials from Cargill's regional office made a brief visit to Warren shortly after the agreement was executed. They examined the annual statement and the accounts receivable, expenses, inventory, seed, machinery and other financial matters. Warren was informed that it would be reminded periodically to make the improvements recommended by Cargill.[FN3] At approximately this time, a memo was given to the Cargill official in charge of the Warren account, Erhart Becker, which stated in part: "This organization (Warren) needs very strong paternal guidance."

> FN3. Cargill headquarters suggested that the regional office check Warren monthly. Also, it was requested that Warren be given an explanation for the relatively large withdrawals from undistributed earnings made by the Hills, since Cargill hoped that Warren's profits would be used to decrease its debt balance. Cargill asked for written requests for withdrawals from undistributed earnings in the future.

In 1970, Cargill contracted with Warren and other elevators to act as its agent to seek growers for a new type of wheat called Bounty 208. Warren, as Cargill's agent for this project, entered into contracts for the growing of the wheat seed, with Cargill named as the

contracting party. Farmers were paid directly by Cargill for the seed and all contracts were performed in full. In 1971, pursuant to an agency contract, Warren contracted on Cargill's behalf with various farmers for the growing of sunflower seeds for Cargill. The arrangements were similar to those made in the Bounty 208 contracts, and all those contracts were also completed. Both these agreements were unrelated to the open account financing contract. In addition, Warren, as Cargill's agent in the sunflower seed business, cleaned and packaged the seed in Cargill bags.

During this period, Cargill continued to review Warren's operations and expenses and recommend that certain actions should be taken.[FN4] Warren purchased from Cargill various business forms printed by Cargill and received sample forms from Cargill which Warren used to develop its own business forms.

> FN4. Between 1967 and 1973, Cargill suggested that Warren take a number of steps, including: (1) a reduction of seed grain and cash grain inventories; (2) improved collection of accounts receivable; (3) reduction or elimination of its wholesale seed business and its speciality grain operation; (4) marketing fertilizer and steel bins on consignment; (5) a reduction in withdrawals made by officers; (6) a suggestion that Warren's bookkeeper not issue her own salary checks; and (7) cooperation with Cargill in implementing the recommendations. These ideas were apparently never implemented, however.

Cargill wrote to its regional office in 1970 expressing its concern that the pattern of increased use of funds allowed to develop at Warren was similar to that involved in two other cases in which Cargill experienced severe losses. Cargill did not refuse to honor drafts or call the loan, however. A new security agreement which increased the credit line to $750,000 was executed in 1972, and a subsequent agreement which raised the limit to $1,250,000 was entered into in 1976.

Warren was at that time shipping Cargill 90% of its cash grain. When Cargill's facilities were full, Warren shipped its grain to other companies. Approximately 25% of Warren's total sales was seed grain which was sold directly by Warren to its customers.

As Warren's indebtedness continued to be in excess of its credit line, Cargill began to contact Warren daily regarding its financial affairs. Cargill headquarters informed its regional office in 1973 that, since Cargill money was being used, Warren should realize that Cargill had the right to make some critical decisions regarding the use of the funds. Cargill headquarters also told Warren that a regional manager would be working with Warren on a day-to- day basis as well as in monthly planning meetings. In 1975, Cargill's regional office began to keep a daily debit position on Warren. A bank account was opened in Warren's name on which Warren could draw checks in 1976. The account was to be funded by drafts drawn on Cargill by the local bank.

In early 1977, it became evident that Warren had serious financial problems. Several farmers, who had heard that Warren's checks were not being paid, inquired or had their agents inquire at Cargill regarding Warren's status and were initially told that there would be no problem with payment. In April 1977, an audit of Warren revealed that Warren was $4 million in debt. After Cargill was informed that Warren's financial statements had been deliberately falsified, Warren's request for additional financing was refused. In the final days of Warren's operation, Cargill sent an official to supervise the elevator, including disbursement of funds and income generated by the elevator.

After Warren ceased operations, it was found to be indebted to Cargill in the amount of.$3.6 million. Warren was also determined to be indebted to plaintiffs in the amount of $2 million, and plaintiffs brought this action in 1977 to seek recovery of that sum. Plaintiffs alleged that Cargill was jointly liable for Warren's indebtedness as it had acted as principal for the grain elevator.

1. The major issue in this case is whether Cargill, by its course of dealing with Warren, became liable as a principal on contracts made by Warren with plaintiffs. Cargill contends that no agency relationship was established with Warren, notwithstanding its financing of Warren's operation and its purchase of the majority of Warren's grain. However, we conclude that Cargill, by its control and influence over Warren, became a principal with liability for the transactions entered into by its agent Warren.

Agency is the fiduciary relationship that results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act. In order to create an agency there must be an agreement, but not necessarily a contract between the parties. An agreement may result in the creation of an agency relationship although the parties did not call it an agency and did not intend the legal consequences of the relation to follow. Id. The existence of the agency may be proved by circumstantial evidence which shows a course of dealing between the two parties. When an agency relationship is to be proven by circumstantial evidence, the principal must be shown to have consented to the agency since one cannot be the agent of another except by consent of the latter.

Cargill contends that the prerequisites of an agency relationship did not exist because Cargill never consented to the agency, Warren did not act on behalf of Cargill, and Cargill did not exercise control over Warren. We hold that all three elements of agency could be found in the particular circumstances of this case. By directing Warren to implement its recommendations, Cargill manifested its consent that Warren would be its agent. Warren acted on Cargill's behalf in procuring grain for Cargill as the part of its normal operations which were totally financed by Cargill. Further, an agency relationship was established by Cargill's interference with the internal affairs of Warren, which constituted de facto control of the elevator.

A creditor who assumes control of his debtor's business may become liable as principal for the acts of the debtor in connection with the business. Restatement (Second) of Agency s 14

O (1958). It is noted in comment a to section 14 O that:

> A security holder who merely exercises a veto power over the business acts of his debtor by preventing purchases or sales above specified amounts does not thereby become a principal. However, if he takes over the management of the debtor's business either in person or through an agent, and directs what contracts may or may not be made, he becomes a principal, liable as a principal for the obligations incurred thereafter in the normal course of business by the debtor who has now become his general agent. The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.

A number of factors indicate Cargill's control over Warren, including the following:

(1) Cargill's constant recommendations to Warren by telephone;

(2) Cargill's right of first refusal on grain;

(3) Warren's inability to enter into mortgages, to purchase stock or to pay dividends without Cargill's approval;

(4) Cargill's right of entry onto Warren's premises to carry on periodic checks and audits;

(5) Cargill's correspondence and criticism regarding Warren's finances, officers salaries and inventory;

(6) Cargill's determination that Warren needed "strong paternal guidance";

(7) Provision of drafts and forms to Warren upon which Cargill's name was imprinted;

(8) Financing of all Warren's purchases of grain and operating expenses; and

(9) Cargill's power to discontinue the financing of Warren's operations.

We recognize that some of these elements, as Cargill contends, are found in an ordinary debtor-creditor relationship. However, these factors cannot be considered in isolation, but, rather, they must be viewed in light of all the circumstances surrounding Cargill's aggressive financing of Warren.

It is also Cargill's position that the relationship between Cargill and Warren was that of buyer-supplier rather than principal-agent. Restatement (Second) of Agency s 14K (1958) compares an agent with a supplier as follows:

> One who contracts to acquire property from a third person and convey it to another is the agent of the other only if it is agreed that he is to act primarily for the benefit of the other and not for himself.

Factors indicating that one is a supplier, rather than an agent, are:

> (1) That he is to receive a fixed price for the property irrespective of price paid by him. This is the most important. (2) That he acts in his own name and receives the title to the property which he thereafter is to transfer. (3) That he has an independent business in buying and selling similar property.

Restatement (Second) of Agency s 14K, Comment a (1958).

Under the Restatement approach, it must be shown that the supplier has an independent business before it can be concluded that he is not an agent. The record establishes that all portions of Warren's operation were financed by Cargill and that Warren sold almost all of its market grain to Cargill. Thus, the relationship which existed between the parties was not merely that of buyer and supplier.

Further, we are not persuaded by the fact that Warren was not one of the "line" elevators that Cargill operated in its own name. The Warren operation, like the line elevator, was financially dependent on Cargill's continual infusion of capital. The arrangement with Warren presented a convenient alternative to the establishment of a line elevator. Cargill became, in essence, the owner of the operation without the accompanying legal indicia.

The amici curiae assert that, if the jury verdict is upheld, firms and banks which have provided business loans to county elevators will decline to make further loans. The decision in this case should give no cause for such concern. We deal here with a business enterprise markedly different from an ordinary bank financing, since Cargill was an active participant in Warren's operations rather than simply a financier. Cargill's course of dealing with Warren was, by its own admission, a paternalistic relationship in which Cargill made the key economic decisions and kept Warren in existence.

Although considerable interest was paid by Warren on the loan, the reason for Cargill's financing of Warren was not to make money as a lender but, rather, to establish a source of market grain for its business. As one Cargill manager noted, "We were staying in there because we wanted the grain." For this reason, Cargill was willing to extend the credit line far beyond the amount originally allocated to Warren. It is noteworthy that Cargill was receiving significant amounts of grain and that, notwithstanding the risk that was recognized by Cargill, the operation was considered profitable.

On the whole, there was a unique fabric in the relationship between Cargill and Warren which varies from that found in normal debtor-creditor situations. We conclude that, on the facts of this case, there was sufficient evidence from which the jury could find that Cargill was the principal of Warren within the definitions of agency set forth in Restatement (Second) of Agency ss 1 and 140.

Vohland v. Sweet

Court of Appeals of Indiana, First District.

Paul Eugene **VOHLAND**, Defendant-Appellant,
v.
Norman E. **SWEET**, Plaintiff-Appellee.

April 20, 1982.

NEAL, Judge.

Plaintiff-appellee Norman E. Sweet (Sweet) brought an action for dissolution of an alleged partnership and for an accounting in the Ripley Circuit Court against defendant-appellant Paul Eugene Vohland (Vohland). From a judgment in favor of Sweet in the amount of $58,733, Vohland appeals.

We affirm.

STATEMENT OF THE FACTS

The undisputed facts reveal that Sweet, as a youngster, commenced working in 1956 for Charles Vohland, father of Paul Eugene Vohland, as an hourly employee in a nursery operated by Charles Vohland and known as Clarksburg Dahlia Gardens. Upon the completion of his military service, which was performed from 1958 to 1960, he resumed his former employment. In approximately 1963 Charles Vohland retired, and Vohland commenced what became known as Vohland's Nursery, the business of which was landscape gardening. At that time Sweet's status changed. He was to receive a 20 percent share of the net profit of the enterprise after all of the expenses were paid. Expenses included labor, gasoline, insurance, burlap, nails, insecticide, fertilizer, seed, straw, plants, stock and seedlings, and any other expense. The compensation was paid on an irregular basis. Every week, two weeks, or perhaps even a month, Sweet and Vohland sat down and computed all income that had been received and all expenses that had been incurred since the last settlement. After the expenses had been deducted from the income, Sweet would receive a check for 20 percent of the balance. Occasionally Sweet would receive an advance draw which would be deducted from his next settlement. No Social Security or income tax was withheld from the checks.

No partnership income tax returns were filed. Vohland and his wife, Gwenalda, filed a joint return in which the business of Vohland's Nursery was reported in Vohland's name on Schedule C. Money paid Sweet was listed as a business expense under "Commissions." Also listed on Schedule C were all of the expenses of the nursery, including investment credit and depreciation on trucks, tractors, and machinery. Sweet's tax returns declared that he was a self-employed salesman at Vohland's Nursery. He filed a self-employment Schedule C and listed as income the income received from the nursery; as expenses he listed travel, advertising, phone, conventions, automobile, and trade journals. He further filed a Schedule

C-3 for self-employment Social Security for the receipts from the nursery.

Vohland handled all of the finances and books and did most of the sales. He borrowed money from the bank solely in his own name for business purposes, including the purchase of the interests of his brothers and sisters in his father's business, operating expenses, bid bonds, motor vehicles, taxes, and purchases of real estate. Sweet was not involved in those loans. Sweet managed the physical aspects of the nursery and supervised the care of the nursery stock and the performance of the contracts for customers. Vohland was quoted by one customer as saying Sweet was running things and the customer would have to see Sweet about some problem.

Evidence was contradictory in certain respects. The Vohland Nursery was located on approximately 13 acres of land owned by Charles Vohland. Sweet testified that at the commencement of the arrangement with Vohland in 1963, Charles Vohland grew the stock and maintained the inventory, for which he received 25 percent of the gross sales. In the late 1960's, because of age, Charles Vohland could no longer perform. The nursery stock became depleted to nearly nothing, and new arrangements were made. An extensive program was initiated by Sweet and Vohland to replenish and enlarge the inventory of nursery stock; this program continued until February, 1979. The cost of planting and maintaining the nursery stock was assigned to expenses before Sweet received his 20 percent. The nursery stock generally took up to ten years to mature for market. Sweet testified that at the termination of the arrangement there existed $293,665 in inventory which had been purchased with the earnings of the business. Of that amount $284,860 was growing nursery stock. Vohland, on the other hand, testified that the inventory of 1963 was as large as that of 1979, but the inventory became depleted in 1969. Vohland claimed that as part of his agreement with Charles Vohland he was required to replenish the nursery stock as it was sold, and in addition pay Charles Vohland 25 percent of the net profit from the operation. He contends that the inventory of nursery stock balanced out. However, Vohland conceded on cross- examination that the acquisition and enlargement of the existing inventory of nursery stock was paid for with earnings and, therefore, was financed partly with Sweet's money. He further stated that the consequences of this financial arrangement never entered his mind at the time.

Sweet's testimony, denied by Vohland, disclosed that, in a conversation in the early 1970's regarding the purchase of inventory out of earnings, Vohland promised to take care of Sweet. Vohland acknowledged that Sweet refused to permit his 20 percent to be charged with the cost of a truck unless his name was on the title. Sweet testified that at the outset of the arrangement Vohland told him, "he was going to take ... me in and that ... I wouldn't have to punch a time clock anymore, that I would be on a commission basis and that I would be, have more of an interest in the business if I had 'an interest in the business.' ... He referred to it as a piece of the action." Sweet testified that he intended to enter into a partnership. Vohland asserts that no partnership was intended and that Sweet was merely an employee, working on a commission. There was no contention that Sweet made any contribution to capital, nor did he claim any interest in the real estate, machinery, or motor vehicles. The parties had never discussed losses.

After Charles Vohland died (in 1973) Vohland contends that he paid $1,000 a year to Mary Crystal Vohland, his stepmother and current owner of the 13 acres, as a gift, and in addition replenished the nursery stock as it was taken and sold. Sweet contends the payments were a flat fee for the use of the land.

ISSUES

IV. Was the evidence sufficient to support the conclusion of law of the trial court that the business relationship of the parties, Vohland and Sweet, was a partnership?

DISCUSSION AND DECISION

Issues I, II and IV. Existence of partnership

The principal point of disagreement between Sweet and Vohland is whether the arrangement between them created a partnership, or a contract of employment of Sweet by Vohland as a salesman on commission. It therefore becomes necessary to review briefly the principles governing the establishment of partnerships.

It has been said that an accurate and comprehensive definition of a partnership has not been stated; that the lines of demarcation which distinguish a partnership from other joint interests on one hand and from agency on the other, are so fine as to render approximate rather than exhaustive any attempt to define the relationship.

A partnership is defined by Ind.Code 23-4-1-6(1) (Uniform Partnership Act of 1949):

"A partnership is an association of two or more persons to carry on as co- owners a business for profit."

Ind.Code 23-4-1-7 sets forth the rules for determining the existence of a partnership:

"In determining whether a partnership exists, these rules shall apply:

(1) Except as provided by section 16 persons who are not partners as to each other are not partners as to third persons.

(2) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property.

(3) The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.

(4) The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:

(a) As a debt by instalments or otherwise,

(b) As wages of an employee or rent to a landlord,

(c) As an annuity to a widow or representative of a deceased partner,

(d) As interest on a loan though the amount of payment vary with the profits of the

business,
(e) As the consideration for the sale of a good will of a business or other property by instalments or otherwise."

[1][2][3] Under Ind.Code 23-4-1-7(4) receipt by a person of a share of the profits is prima facie evidence that he is a partner in the business. Lack of daily involvement for one partner is not per se indicative of absence of a partnership. A partnership may be formed by the furnishing of skill and labor by others. The contribution of labor and skill by one of the partners may be as great a contribution to the common enterprise as property or money. It is an established common law principle that a partnership can commence only by the voluntary contract of the parties. Bond v. May, (1906) 38 Ind.App. 396, 78 N.E. 260. In Bond it was said, "(t)o be a partner, one must have an interest with another in the profits of a business, as profits. There must be a voluntary contract to carry on a business with intention of the parties to share the profits as common owners thereof." Id., 38 Ind.App. at 402, 78 N.E. 260. In Bacon, supra, in reviewing the law relative to the creation of partnerships, the court said:

"From these, and other expressions of similar import, it is apparent to establish the partnership relation, as between the parties, there must be (1) a voluntary contract of association for the purpose of sharing the profits and losses, as such, which may arise from the use of capital, labor or skill in a common enterprise; and (2) an intention on the part of the principals to form a partnership for that purpose. But it must be borne in mind, however, that the intent, the existence of which is deemed essential, is an intent to do those things which constitute a partnership. Hence, if such an intent exists, the parties will be partners notwithstanding that they proposed to avoid the liability attaching to partners or (have) even expressly stipulated in their agreement that they were not to become partners. (Citation omitted)

It is the substance, and not the name of the arrangement between them, which determines their legal relation toward each other, and if, from a consideration of all the facts and circumstances, it appears that the parties intended, between themselves, that there should be a community of interest of both the property and profits of a common business or venture, the law treats it as their intention to become partners, in the absence of other controlling facts."

From all the circumstances we cannot say that the court erred in finding the existence of a partnership.

Affirmed

Humble Oil v. Martin

Supreme Court of Texas.

HUMBLE OIL & REFINING CO. et al.

v.
MARTIN et al.

No. A-2052.

June 15, 1949.

GARWOOD, Justice.

Petitioners Humble Oil & Refining Company and Mrs. A. C. Love and husband complain here of the judgments of the trial court and the Court of Civil Appeals in which they were held in damages for personal injuries following a special issue verdict at the suit of respondent George F. Martin acting for himself and his two minor daughters. The injuries were inflicted on the three Martins about the noon hour on May 12, 1947, in the City of Austin, by an unoccupied automobile belonging to the petitioners Love, which, just prior to the accident, had been left by Mrs. Love at a filling station owned by petitioner Humble for servicing and thereafter, before any station employee had touched it, rolled by gravity off the premises into and obliquely across the abutting street, striking Mr. Martin and his children from behind as they were walking into the yard of their home, a short distance downhill from the station.

The trial court rendered judgment against petitioners Humble and Mrs. Love jointly and severally and gave the latter judgment over against Humble for whatever she might pay the respondents. The Court of Civil Appeals affirmed the judgment after reforming it to eliminate the judgment over in favor of Mrs. Love. The petitioners here respectively complain of the judgment in favor of the Martins, and each seeks full indemnity (as distinguished from contribution) from the other.

The apparently principal contention of petitioner, Humble, is that it is liable neither to respondent Martin nor to petitioner Mrs. Love, since the station was in effect operated by an independent contractor, W. T. Schneider, and Humble is accordingly not responsible for his negligence nor that of W. V. Manis, who was the only station employee or representative present when the Love car was left and rolled away. In this connection, the jury convicted petitioner Humble of the following acts of negligence proximately causing the injuries in question: (a) Failure to inspect the Love car to see that the emergency brake was set or the gears engaged; (b) failure to set the emergency brake on the Love car; (c) leaving the Love car unattended on the driveway. The verdict also included findings that Mrs. Love 'had delivered her car to the custody of the defendant Humble Oil & Refining Company, before her car started rolling from the position in which she had parked it'; that the accident was not unavoidable; and that no negligent act of either of petitioners was the sole proximate cause of the injuries in question. We think the Court of Civil Appeals properly held Humble responsible for the operation of the station, which admittedly it owned, as it did also the principal products there sold by Schneider under the so-called 'Commission Agency Agreement' between him and Humble which was in evidence. The facts that neither Humble,

Schneider nor the station employees considered Humble as an employer or master; that the employees were paid and directed by Schneider individually as their 'boss', and that a provision of the agreement expressly repudiates any authority of Humble over the employees, are not conclusive against the master-servant relationship, since there is other evidence bearing on the right or power of Humble to control the details of the station work as regards Schneider himself and therefore as to employees which it was expressly contemplated that he would hire. The question is ordinarily one of fact, and where there are items of evidence indicating a master-servant relationship, contrary items such as those above mentioned cannot be given conclusive effect. Restatement of the Law, Agency, Sec. 220; Even if the contract between Humble and Schneider were the only evidence on the question, the instrument as a whole indicates a master-servant relationship quite as much as, if not more than, it suggests an arrangement between independent contractors. For example, paragraph 1 includes a provision requiring Schneider 'to make reports and perform other duties in connection with the operation of said station that may be required of him from time to time by Company.' (Emphasis supplied). And while paragraph 2 purports to require Schneider to pay all operational expenses, the schedule of commissions forming part of the agreement does just the opposite in its paragraph (F), which gives Schneider a 75% 'commission' on 'the net public utility bills paid' by him and thus requires Humble to pay three-fourths of one of the most important operational expense items. Obviously the main object of the enterprise was the retail marketing of Humble's products with title remaining in Humble until delivery to the consumer. This was done under a strict system of financial control and supervision by Humble, with little or no business discretion reposed in Schneider except as to hiring, discharge, payment and supervision of a few station employees of a more or less laborer status. Humble furnished the all important station location and equipment, the advertising media, the products and a substantial part of the current operating costs. The hours of operation were controlled by Humble. The 'Commission Agency Agreement', which evidently was Schneider's only title to occupancy of the premises, was terminable at the will of Humble. The so-called 'rentals' were, at least in part, based on the amount of Humble's products sold, being, therefore, involved with the matter of Schneider's remuneration and not rentals in the usual sense. And, as above shown, the agreement required Schneider in effect to do anything Humble might tell him to do. All in all, aside from the stipulation regarding Schneider's assistants, there is essentially little difference between his situation and that of a mere store clerk who happens to be paid a commission instead of a salary. The business was Humble's business, just as the store clerk's business would be that of the store owner. Schneider was Humble's servant, and so accordingly were Schneider's assistants who were contemplated by the contract. Upon facts similar to those at bar but probably less indicative of a master-servant relationship, the latter has been held to exist by respectable authority, which seems to reflect the prevailing view in the nation. Gulf Refining Company v. Brown, supra, and cases cited therein. If the Brown case be said to conflict with the later decision of the 5th Circuit in Bartle v. Travellers Insurance Co., 171 F.2d 469, the facts of the latter are yet more persuasive of an independent contractor type of relationship than the instant case, so the decision is not contrary to our holding.

The evidence above discussed serves to distinguish the instant case from The Texas Company v. Wheat, 140 Tex. 468, 168 S.W.2d 632, upon which petitioner Humble

principally relies. In that case the evidence differed greatly from that now before us. It clearly showed a 'dealer' type of relationship in which the lessee in charge of the filling station purchased from his landlord, The Texas Company, and sold as his own, and was free to sell at his own price and on his own credit terms, the company products purchased, as well as the products of other oil companies. The contracts contained no provision requiring the lessee to perform any duty The Texas Company might see fit to impose on him, nor did the company pay any part of the lessee's operating expenses, nor control the working hours of the station.

The judgment of the Court of Civil Appeals should be reversed, and the judgment of the trial court should be affirmed.

Hoover v. Sun Oil

Superior Court of Delaware, New Castle County.

Gerald E. **HOOVER** and Jule B. Hoover, Plaintiffs,
v.
SUN OIL COMPANY, James F. Barone and John Smilyk, Defendants.

July 20, 1965.

CHRISTIE, Judge:

This case is concerned with injuries received as the result of a fire on August 16, 1962 at the service station operated by James F. Barone. The fire started at the rear of plaintiff's car where it was being filled with gasoline and was allegedly caused by the negligence of John Smilyk, an employee of Barone. Plaintiffs brought suit against Smilyk, Barone and Sun Oil Company (Sun) which owned the service station.

Sun has moved for summary judgment as to it on the basis that Barone was an independent contractor and therefore the alleged negligence of his employee could not result in liability as to Sun. The plaintiffs contend instead that Barone was acting as Sun's agent and that Sun may therefore be responsible for plaintiff's injuries.

Barone began operating this business in October of 1960 pursuant to a lease dated October 17, 1960. The station and all of its equipment, with the exception of a tire stand and rack, certain advertising displays and miscellaneous hand tools, were owned by Sun. The lease was subject to termination by either party upon thirty days' written notice after the first six months and at the anniversary date thereafter. The rental was partially determined by the

volume of gasoline purchased but there was also a minimum and a maximum monthly rental.

At the same time, Sun and Barone also entered into a dealer's agreement under which Barone was to purchase petroleum products from Sun and Sun was to loan necessary equipment and advertising materials. Barone was required to maintain this equipment and to use it solely for Sun products. Barone was permitted under the agreement to sell competitive products but chose to do so only in a few minor areas. As to Sun products, Barone was prohibited from selling them except under the Sunoco label and from blending them with products not supplied by Sun.

Barone's station had the usual large signs indicating that Sunoco products were sold there. His advertising in the classified section of the telephone book was under a Sunoco heading and his employees wore uniforms with the Sun emblem, the uniforms being owned by Barone or rented from an independent company.

Barone, upon the urging of Robert B. Peterson, Sun's area sales representative, attended a Sun school for service station operators in 1961. The school's curriculum was designed to familiarize the station operator with bookkeeping and merchandising, the appearance and proper maintenance of a Sun station, and the Sun Oil products. The course concluded with the operator working at Sun's model station in order to gain work experience in the use of the policy and techniques taught at the school.

Other facts typifying the company-service station relationship were the weekly visits of Sun's sales representative, Peterson, who would take orders for Sun products, inspect the restrooms, communicate customer complaints, make various suggestions to improve sales and discuss any problems that Barone might be having. Besides the weekly visits, Peterson was in contact with Barone on other occasions in order to implement Sun's 'competitive allowance system' which enabled Barone to meet local price competition by giving him a rebate on the gasoline in his inventory roughly equivalent to the price decline and a similarly reduced price on his next order of gasoline.

While Peterson did offer advice to Barone on all phases of his operation, it was usually done on request and Barone was under no obligation to follow the advice. Barone's contacts and dealings with Sun were many and their relationship intricate, but he made no written reports to Sun and he alone assumed the overall risk of profit or loss in his business operation. Barone independently determined his own hours of operation and the identity, pay scale and working conditions of his employees, and it was his name that was posted as proprietor.

Plaintiffs contend in effect that the aforegoing facts indicate that Sun controlled the day-to-day operation of the station and consequently Sun is responsible for the negligent acts of Barone's employee. Specifically, plaintiffs contend that there is an issue of fact for the jury to determine as to whether or not there was an agency relationship.

[1] The legal relationships arising from the distribution systems of major oil-producing

companies are in certain respects unique. As stated in an annotation collecting many of the cases dealing with this relationship:

> 'This distribution system has grown up primarily as the result of economic factors and with little relationship to traditional legal concepts in the field of master and servant, so that it is perhaps not surprising that attempts by the court to discuss the relationship in the standard terms have led to some difficulties and confusion.' 83 A.L.R.2d 1282, 1284 (1962).

In some situations traditional definitions of principal and agent and of employer and independent contractor may be difficult to apply to service station operations, but the undisputed facts of the case at bar make it clear that Barone was an independent contractor.

Barone's service station, unlike retail outlets for many products, is basically a one-company outlet and represents to the public, through Sunoco's national and local advertising, that it sells not only Sun's quality products but Sun's quality service. Many people undoubtedly come to the service station because of that latter representation.

However, the lease contract and dealer's agreement fail to establish any relationship other than landlord-tenant, and independent contractor. Nor is there anything in the conduct of the individuals which is inconsistent with that relationship so as to indicate that the contracts were mere subterfuge or sham. The areas of close contract between Sun and Barone stem from the fact that both have a mutual interest in the sale of Sun products and in the success of Barone's business.

[2] The cases cited by both plaintiffs and defendant indicate that the result varies according to the contracts involved and the conduct and evidence of control under those contracts. Both lines of cases indicate that the test to be applied is that of whether the oil company has retained the right to control the details of the day-to-day operation of the service station; control or influence over results alone being viewed as insufficient.

The facts of this case differ markedly from those in which the oil company was held liable for the tortious conduct of its service station operator or his employees. Sun had no control over the retails of Barone's day-to-day operation. Therefore, no liability can be imputed to Sun from the allegedly negligent acts of Smilyk. Sun's motion for summary judgment is granted.

It is so ordered.

Introduction to Partner Duties Toward Other Partners

The next three cases explore the degree of loyalty and fidelity a partner in a partnership owes to other partners. One is a chestnut – where Cardozo coins the phrase "a punctilio of an honor most sensitive" to describe just how tightly bound partners are to one another. The second and third cases are much more recently decided, with one adhering to the Cardozo standard, the other taking what seems to be a much more relaxed view of the duties owed.

Discussion points for Amory v. Checroune

What happens when the defendant uses one theory (agency law), but the plaintiff wants to sue you on another theory (partnership by estoppel)? Another lesson in dotting the "i"s and crossing the "t"s. What would you as Checroune's attorney have advised him to do to avoid this mess? Would your advice work, in real life?

Massachusetts Appellate Division, District Court Department, Southern District.

David **AMORY** d/b/a David Amory Architects
v.
Alain **CHECROUNE**, Paul Atlan, and South Shore Realty, LLC.

Opinion Certified Jan. 22, 2004.

WILLIAMS, J.

The defendant Alain Checroune ("Checroune") appeals pursuant to Dist./ Mun.Cts R.A.D.A. 8C the finding of the trial judge that Checroune is individually liable to the plaintiff, David Amory d/b/a David Amory Architects ("Amory"), for certain architectural fees. Specifically, Checroune asserts he cannot properly have been found liable because he was acting solely as an agent for a principal, the defendant corporation South Shore Realty, LLC ("South Shore"). We affirm the judgment in favor of Amory.

In a proposal letter of 29 October 1997 Amory sent to Checroune, Paul Atlan ("Atlan"), and something called "South Shore Realty Investors" in care of Boston United Realty Corp., Amory agreed to perform architectural services for the renovation of the "old *Patriot Ledger* Building" in Quincy. Atlan apparently signed the "acceptance" line of the letter. On 16 October 1997, Checroune and Atlan had created South Shore for the purpose of buying real estate, and indeed that day South Shore bought the building from Boston United Realty Corp., of which corporation Checroune was president and treasurer.

> [1] Pursuant to the accepted proposal, Amory performed his work, completing it in December 1997. Amory was not told he was working for anyone other than what he thought to be a partnership called "South Shore Realty Investors." He normally did not conduct a title search to confirm that a client was the record owner of property on which he worked, and he did not so here. Atlan apparently made the only payment to Amory, of $2,500.00. The balance, nearly $13,000.00, was not paid. Amory filed suit in 1998 against Checroune and Atlan. Atlan was never served. In October 2002,

Amory amended his complaint to add South Shore as a defendant. The trial judge found in Amory's favor, against both Checroune and South Shore. Checroune appealed the finding in general, but at the trial judge's rulings on his request for rulings with a mention that does not rise to the level of appellate argument and so effectively waives appellate consideration of those requests.

[2] Checroune's argument is based in agency law; Amory's, in partnership law. Checroune asserts he was acting solely as an agent for South Shore, the disclosed principal, or for some undisclosed principal, and cannot be found individually liable in either case. Amory asserts, on the other hand, that his uncontroverted trial testimony established that Checroune and Atlan had held themselves out to him as partners doing business as "South Shore Realty Investors," and thus Checroune could be, and properly was, found personally liable as an ostensible partner.

FN3. Checroune focused on the "disclosed principal" argument. Even if one considered South Shore a "partially disclosed principal," one purporting to contract with another for a partially disclosed principal is a party to the contract unless there is an agreement otherwise. "It is the duty of the agent, if he would avoid personal liability on a contract entered into by him on behalf of his principal, to disclose not only that he is acting in a representative capacity, but also the identity of his principal." *Atlantic Salmon., supra,* at 492, 591 N.E.2d 206.

[3] Checroune's argument, in part, assumes a duty on Amory to ascertain the precise identity of the owner of the building. Had Amory checked at the Registry of Deeds--between 16 and 29 October 1997--he would have learned, the argument runs, that South Shore owned the building and would thus have realized Checroune was acting on behalf of that corporate principal. This Court is provided nothing, though, suggesting either that Amory's failure to research deeds was somehow a failing on his part, or that he is charged with knowledge of the deed to South Shore simply because it was available in the Registry of Deeds for his inspection. Checroune suggests further that even if Amory were ignorant of the deed and had no duty to search for it he knew Checroune and Atlan "were acting on behalf of another entity" because Amory himself used the name "South Shore Realty Investors" in the letter contract he drafted and on his invoices. It does not follow, however, that Amory's awareness of the name "South Shore Realty Investors" signifies he should have then gone on to deduce there was a corporate principal of that or a similar name for which Checroune was an agent. Amory believed the name was simply one under which Checroune and Atlan did business. There was, in short, no evidence tending to urge the trial judge to find that Amory knew or should have known that Checroune was acting as agent of any corporate entity, disclosed or undisclosed, and none suggesting Amory was unjustified in believing Checroune and Atlan were partners.

[4] Having so said, we go on to observe that the main substantive issue here was whether the

doctrine of partnership-by-estoppel applied. *See* M.G.L. c. 108A, § 16. Amory's position is essentially that the trial judge properly found Checroune individually liable because Checroune and the absent Atlan had held themselves out to Amory as partners and so could not later deny that relationship. [FN5] Whether partnership-by-estoppel may be found is a question of fact.

> FN5. M.G.L. c. 108A, § § 13 & 15, read together, provide that partnership liability resulting from "any wrongful act or omission of any partner" is borne jointly and severally by all partners. Thus, were Checroune a partner, either real or apparent, he could be held individually liable for his own acts or those of Atlan. As a general proposition, to prevail on that theory, Amory would have had to have proven: (1) that Checroune had held himself out as a partner; (2) that Checroune had effected such holding out either directly or with his consent; (3) that Amory knew of such holding out; and (4) that Amory relied on the ostensible partnership to his prejudice.

> FN6. Amory, the sole trial witness, testified he understood Checroune and Atlan were partners. The basis, though, of that understanding was thin. Asked about the source of that understanding, Amory said Checroune called him to say "we" were ready to proceed with the project. (Amory also testified, though, that he understood Atlan "would be handling the project for the partnership"). Asked if "they"-Checroune and Atlan-told Amory they were partners, Amory answered, "I believe so, yes. Again, this was five years ago." The trial judge then ruled that anything Atlan had said on that topic was inadmissible hearsay since Atlan was not a defendant, having never been served. Whether Checroune himself had said *anything* to Amory about he and Atlan being "partners" was not demonstrated.

Discussion points for Meinhard v. Salmon

Call it a joint venture, call it what you will, it's still a partnership. Cardozo likens a partnership to a marriage – note the language in the opinion that Meinhard and Salmon were in the partnership business together "for better or worse." In this case, we once again meet up with the corporate opportunity doctrine, and viewed strictly in that light, maybe the result in this case is justified.

As in all of these partnership cases, there is a drafting moral to be learned (agree in advance, in writing, about the respective rights and duties of the partners, unless you want the UPA to control). Ask yourself whether the result would have been different if Salmon's brother had called him and persuaded him to invest in an alligator ranch in Florida, and Salmon did, without consulting Meinhard. What if Salmon had heard of a great opportunity to invest in nearby New York City real estate while riding the subway to work one morning? And finally, what should Salmon have done to avoid the costly mess he finds himself in? If he came to you before going forward with his plan, what would you advise him to do?

Note that partners are agents of one another, and agents of the partnership. They therefore cannot profit at the expense of the principal, they must disclose information, they can't use confidential information for their own benefit, they can't compete, and they can't have interests which conflict with the principal's interests.

MEINHARD
v.
SALMON et al.

Court of Appeals of New York.

Dec. 31, 1928.

CARDOZO, C. J.

On April 10, 1902, Louisa M. Gerry leased to the defendant Walter J. Salmon the premises known as the Hotel Bristol at the northwest corner of Forty-Second street and Fifth avenue in the city of New York. The lease was for a term of 20 years, commencing May 1, 1902, and ending April 30, 1922. The lessee undertook to change the hotel building for use as shops and offices at a cost of $200,000. Alterations and additions were to be accretions to the land.

Salmon, while in course of treaty with the lessor as to the execution of the lease, was in course of treaty with Meinhard, the plaintiff, for the necessary funds. The result was a joint venture with terms embodied in a writing. Meinhard was to pay to Salmon half of the moneys requisite to reconstruct, alter, manage, and operate the property. Salmon was to pay to Meinhard 40 per cent. of the net profits for the first five years of the lease and 50 per cent. for the years thereafter. If there were losses, each party was to bear them equally. Salmon, however, was to have sole power to 'manage, lease, underlet and operate' the building. There were to be certain pre- emptive rights for each in the contingency of death.

[1] The were coadventures, subject to fiduciary duties akin to those of partners. As to this we are all agreed. The heavier weight of duty rested, however, upon Salmon. He was a coadventurer with Meinhard, but he was manager as well. During the early years of the enterprise, the building, reconstructed, was operated at a loss. If the relation had then ended, Meinhard as well as Salmon would have carried a heavy burden. Later the profits became large with the result that for each of the investors there came a rich return. For each the venture had its phases of fair weather and of foul. The two were in it jointly, for better or for worse.

When the lease was near its end, Elbridge T. Gerry had become the owner of the reversion. He owned much other property in the neighborhood, one lot adjoining the Bristol building on

Fifth avenue and four lots on Forty-Second street. He had a plan to lease the entire tract for a long term to some one who would destroy the buildings then existing and put up another in their place. In the latter part of 1921, he submitted such a project to several capitalists and dealers. He was unable to carry it through with any of them. Then, in January, 1922, with less than four months of the lease to run, he approached the defendant Salmon. The result was a new lease to the Midpoint Realty Company, which is owned and controlled by Salmon, a lease covering the whole tract, and involving a huge outlay. The term is to be 20 years, but successive covenants for renewal will extend it to a maximum of 80 years at the will of either party. The existing buildings may remain unchanged for seven years. They are then to be torn down, and a new building to cost $3,000,000 is to be placed upon the site. The rental, which under the Bristol lease was only $55,000, is to be from $350,000 to $475,000 for the properties so combined. Salmon personally guaranteed the performance by the lessee of the covenants of the new lease until such time as the new building had been completed and fully paid for.

The lease between Gerry and the Midpoint Realty Company was signed and delivered on January 25, 1922. Salmon had not told Meinhard anything about it. Whatever his motive may have been, he had kept the negotiations to himself. Meinhard was not informed even of the bare existence of a project. The first that he knew of it was in February, when the lease was an accomplished fact. He then made demand on the defendants that the lease be held in trust as an asset of the venture, making offer upon the trial to share the personal obligations incidental to the guaranty. The demand was followed by refusal, and later by this suit. A referee gave judgment for the plaintiff, limiting the plaintiff's interest in the lease, however, to 25 per cent. The limitation was on the theory that the plaintiff's equity was to be restricted to one-half of so much of the value of the lease as was contributed or represented by the occupation of the Bristol site. Upon cross-appeals to the Appellate Division, the judgment was modified so as to enlarge the equitable interest to one-half of the whole lease. With this enlargement of plaintiff's interest, there went, of course, a corresponding enlargement of his attendant obligations. The case is now here on an appeal by the defendants.

[2] Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

[3] The owner of the reversion, Mr. Gerry, had vainly striven to find a tenant who would favor his ambitious scheme of demolition and construction. Baffled in the search, he turned to the defendant Salmon in possession of the Bristol, the keystone of the project. He figured to himself beyond a doubt that the man in possession would prove a likely customer. To the

eye of an observer, Salmon held the lease as owner in his own right, for himself and no one else. In fact he held it as a fiduciary, for himself and another, sharers in a common venture. If this fact had been proclaimed, if the lease by its terms had run in favor of a partnership, Mr. Gerry, we may fairly assume, would have laid before the partners, and not merely before one of them, his plan of reconstruction. The pre-emptive privilege, or, better, the pre-emptive opportunity, that was thus an incident of the enterprise, Salmon appropriate to himself in secrecy and silence. He might have warned Meinhard that the plan had been submitted, and that either would be free to compete for the award. If he had done this, we do not need to say whether he would have been under a duty, if successful in the competition, to hold the lease so acquired for the benefit of a venture than about to end, and thus prolong by indirection its responsibilities and duties. The trouble about his conduct is that he excluded his coadventurer from any chance to compete, from any chance to enjoy the opportunity for benefit that had come to him alone by virtue of his agency. This chance, if nothing more, he was under a duty to concede. The price of its denial is an extension of the trust at the option and for the benefit of the one whom he excluded.

No answer is it to say that the chance would have been of little value even if seasonably offered. Such a calculus of probabilities is beyond the science of the chancery. Salmon, the real estate operator, might have been preferred to Meinhard, the woolen merchant. On the other hand, Meinhard might have offered better terms, or reinforced his offer by alliance with the wealth of others. Perhaps he might even have persuaded the lessor to renew the Bristol lease alone, postponing for a time, in return for higher rentals, the improvement of adjoining lots. We know that even under the lease as made the time for the enlargement of the building was delayed for seven years. All these opportunities were cut away from him through another's intervention. He knew that Salmon was the manager. As the time drew near for the expiration of the lease, he would naturally assume from silence, if from nothing else, that the lessor was willing to extend it for a term of years, or at least to let it stand as a lease from year to year. Not impossibly the lessor would have done so, whatever his protestations of unwillingness, if Salmon had not given assent to a project more attractive. At all events, notice of termination, even if not necessary, might seem, not unreasonably, to be something to be looked for, if the business was over the another tenant was to enter. In the absence of such notice, the matter of an extension was one that would naturally be attended to by the manager of the enterprise, and not neglected altogether. At least, there was nothing in the situation to give warning to any one that while the lease was still in being, there had come to the manager an offer of extension which he had locked within his breast to be utilized by himself alone. The very fact that Salmon was in control with exclusive powers of direction charged him the more obviously with the duty of disclosure, since only through disclosure could opportunity be equalized. If he might cut off renewal by a purchase for his own benefit when four months were to pass before the lease would have an end, he might do so with equal right while there remained as many years. He might steal a march on his comrade under cover of the darkness, and then hold the captured ground. Loyalty and comradeship are not so easily abjured.

We have no thought to hold that Salmon was guilty of a conscious purpose to defraud.

Very likely he assumed in all good faith that with the approaching end of the venture he might ignore his coadventurer and take the extension for himself. He had given to the enterprise time and labor as well as money. He had made it a success. Meinhard, who had given money, but neither time nor labor, had already been richly paid. There might seem to be something grasping in his insistence upon more. Such recriminations are not unusual when coadventurers fall out. They are not without their force if conduct is to be judged by the common standards of competitors. That is not to say that they have pertinency here. Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation. He was much more than a coadventurer. He was a managing coadventurer. For him and for those like him the rule of undivided loyalty is relentless and supreme. A different question would be here if there were lacking any nexus of relation between the business conducted by the manager and the opportunity brought to him as an incident of management. For this problem, as for most, there are distinctions of degree. If Salmon had received from Gerry a proposition to lease a building at a location far removed, he might have held for himself the privilege thus acquired, or so we shall assume. Here the subject-matter of the new lease was an extension and enlargement of the subject-matter of the old one. A managing coadventurer appropriating the benefit of such a lease without warning to his partner might fairly expect to be reproached with conduct that was underhand, or lacking, to say the least, in reasonable candor, if the partner were to surprise him in the act of signing the new instrument. Conduct subject to that reproach does not receive from equity a healing benediction.

A question remains as to the form and extent of the equitable interest to be allotted to the plaintiff. The trust as declared has been held to attach to the lease which was in the name of the defendant corporation. We think it ought to attach at the option of the defendant Salmon to the shares of stock which were owned by him or were under his control. The difference may be important if the lessee shall wish to execute an assignment of the lease, as it ought to be free to do with the consent of the lessor. On the other hand, an equal division of the shares might lead to other hardships. It might take away from Salmon the power of control and management which under the plan of the joint venture he was to have from first to last. The number of shares to be allotted to the plaintiff should, therefore, be reduced to such an extent as may be necessary to preserve to the defendant Salmon the expected measure of dominion. To that end an extra share should be added to his half.

Subject to this adjustment, we agree with the Appellate Division that the plaintiff's equitable interest is to be measured by the value of half of the entire lease, and not merely by half of some undivided part. A single building covers the whole area. Physical division is impracticable along the lines of the Bristol site, the keystone of the whole. Division of interests and burdens is equally impracticable. Salmon, as tenant under the new lease, or as guarantor of the performance of the tenant's obligations, might well protest if Meinhard, Claiming an equitable interest, had offered to assume a liability not equal to Salmon's, but only half as great. He might justly insist that the lease must be accepted by his coadventurer in such form as it had been given, and not constructively divided into imaginery fragments. What must be yielded to the one may be demanded by the other. The lease as it has been executed is single and entire. If confusion has resulted from the union of adjoining parcels,

the trustee who consented to the union must bear the inconvenience.

Partnership Law (Cons. Laws, c. 39), § 53, subd. 1, is to the effect that 'a conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.' This statute, which took effect October 1, 1919, did not indeed revive the enterprise if automatically on the execution of the assignment a dissolution had resulted in 1917. It sums up with precision, however, the effect of the assignment as the parties meant to shape it. We are to interpret their relation in the revealing light of conduct. The rule of the statute, even if it has modified the rule as to partnerships in general, is an accurate statement of the rule at common law when applied to these adventurers. The purpose of the assignment, understood by every one concerned, was to lower the plaintiff's tax by taking income out of his return and adding it to the return to be made by his wife. She was the appointee of the profits, to whom checks were to be remitted. Beyond that, the relation was to be the same as it had been. No one dreamed for a moment that the enterprise was to be wound up, or that Meinhard was relieved of his continuing obligation to contribute to its expenses if contribution became needful. Coadventurers and assignee, and most of all the defendant Salmon, as appears by his own letters, went forward on that basis. For more than five years Salmon dealt with Meinhard on the assumption that the enterprise was a subsisting one with mutual rights and duties, or so at least the triers of the facts, weighing the circumstantial evidence, might not unreasonably infer. By tacit, if not express approval, he continued and preserved it. We think it is too late now, when charged as a trustee, to come forward with the claim that it had been disrupted and dissolved.

The judgment should be modified by providing that at the option of the defendant Salmon there may be substituted for a trust attaching to the lease a trust attaching to the shares of stock, with the result that one-half of such shares together with one additional share will in that event be allotted to the defendant Salmon and the other shares to the plaintiff, and as so modified the judgment should be affirmed with costs.

Discussion points for Meehan v. Shaughnessy

This occurs all the time in large law firms. Partners look around, see that other partners are not working that hard but are making more money than them, so they want to leave and make all the money for themselves. After Meehan, Boyle, and Cohen (MBC) left Parker Coulter (PC), they sued for the money they were owed under the partnership agreement. PC counterclaimed for damages based upon breach of loyalty.

Think about what MBC did to their fellow partners before leaving PC, and consider how lightly the Court dismisses their actions as more or less non-objectionable. What would

Cardozo have done? Compare these two statements from the opinions: (1) "thought of self was to be renounced" with (2) [they are] obliged to consider their co-partners' welfare, and not merely their own." Which one do you agree with?

So, exactly what did MBC do wrong? What should they have done to avoid this mess?

James F. MEEHAN et al.

v.

Maurice F. SHAUGHNESSY et al. Cynthia J. Cohen et al., third-party defendants.

Supreme Judicial Court of Massachusetts,
Suffolk.

Decided March 28, 1989.

HENNESSEY, Chief Justice.

The plaintiffs, James F. Meehan (Meehan) and Leo V. Boyle (Boyle), were partners of the law firm, Parker, Coulter, Daley & White (Parker Coulter). After Meehan and Boyle terminated their relationship with Parker Coulter to start their own firm, they commenced this action both to recover amounts they claim the defendants, their former partners, owed them under the partnership agreement, and to obtain a declaration as to amounts they owed the defendants for work done at Parker Coulter on cases they removed to their new firm. The defendants (hereinafter collectively Parker Coulter) counterclaimed that Meehan and Boyle violated their fiduciary duties, breached the partnership agreement, and tortiously interfered with their advantageous business and contractual relationships. As grounds for these claims, Parker Coulter asserted that Meehan and Boyle engaged in improper conduct in withdrawing cases and clients from the firm, and in inducing employees to join the new firm of Meehan, Boyle & Cohen, P.C. (MBC). Parker Coulter also filed a third-party action with similar claims against MBC and against Cynthia J. Cohen (Cohen), a former junior partner, and Steven H. Schafer (Schafer), a former associate, who, among others, left the firm to join MBC.

> FN4. When a partner leaves a partnership, the partnership is dissolved. G.L. c. 108A, § 29 (1986 ed.). When necessary, we will distinguish between the Parker, Coulter, Daley & White which included Meehan and Boyle as partners, and which has been dissolved, and the current Parker, Coulter, Daley & White, which includes only the defendants as partners.

After a jury-waived trial, a Superior Court judge rejected all of Parker Coulter's claims for relief, and found that Meehan and Boyle were entitled to recover amounts owed to them

under the partnership agreement. The judge also found, based on the partnership agreement and a quantum meruit theory, that Parker Coulter was entitled to recover from Meehan and Boyle for time billed and expenses incurred on the cases Meehan and Boyle removed to their own firm. Parker Coulter appealed from the judgment, and we granted direct appellate review.

Although we are in agreement with most of the judge's reasoning and conclusions which he reached after lengthy and painstaking proceedings, we nevertheless reverse the judgment entered below and remand for further findings and a hearing, consistent in all respects with this opinion. This result follows from our conclusion, infra, that the judge erred in deciding that Meehan and Boyle acted properly in acquiring consent to remove cases to MBC.

We summarize the facts as found by the judge. Aside from certain conclusions which the judge reached, and which we address in more detail below, the parties agree that these findings were warranted by the evidence. Parker, Coulter, Daley & White is a large partnership which specializes in litigation on behalf of both defendants and plaintiffs. Meehan joined the firm in 1959, and became a partner in 1963; his practice focuses primarily on complex tort litigation, such as product liability and aviation defense work. Boyle joined Parker Coulter in 1971, and became a partner in 1980; he has concentrated on plaintiffs' work. Both have developed outstanding reputations as trial lawyers in the Commonwealth. Meehan and Boyle each were active in the management of Parker Coulter. They each served, for example, on the partnership's executive committee and, as members of this committee, were responsible for considering and making policy recommendations to the general partnership. Boyle was also in charge of the "plaintiffs department" within the firm, which managed approximately 350 cases. At the time of their leaving, Meehan's interest in the partnership was 6% and Boyle's interest was 4.8%.

Meehan and Boyle had become dissatisfied at Parker Coulter. On June 27, 1984, after unsuccessfully opposing the adoption of a firm-wide pension plan, the two first discussed the possibility of leaving Parker Coulter. Another partner met with them to discuss leaving but told them their proposed firm would not be suitable for his type of practice. On July 1, Meehan and Boyle decided to leave Parker Coulter and form their own partnership.

Having decided to establish a new firm, Meehan and Boyle then focused on whom they would invite to join them. The two spoke with Cohen, a junior partner and the de facto head of Parker Coulter's appellate department, about joining the new firm as a partner. They arranged to meet with her on July 5, and told her to keep their conversations confidential. The day before the July 5 meeting, Boyle prepared two lists of what he considered to be his cases. The lists contained approximately eighty to 100 cases, and for each case indicated the status, fee arrangement, estimated settlement value, and potential fee to MBC. Boyle gave these lists to Cohen for her to examine in preparation for the July 5 meeting.

At the July 5 meeting, Meehan and Boyle outlined to Cohen their plans for the new firm, including their intent to offer positions to Schafer, Peter Black (Black), and Warren

Fitzgerald (Fitzgerald), who were associates at Parker Coulter. Boyle stated that he hoped the clients he had been representing would go with him to the new firm; Meehan said he would take the aviation work he had at Parker Coulter with him. Both stated that they felt others at Parker Coulter were getting paid as much as or more than they were, but were not working as hard. Cohen decided to consider the offer from Meehan and Boyle, and agreed to keep the plans confidential until formal notice of the separation was given to the partnership. Although the partnership agreement required a notice period of three months, the three decided to give only thirty days' notice. They chose to give shorter notice to avoid what they believed would be an uncomfortable situation at the firm, and possible retaliatory measures by the partnership. Meehan and Boyle had agreed that they would leave Parker Coulter on December 31, 1984, the end of Parker Coulter's fiscal year.

During the first week of August, Cohen accepted the offer to join the new firm as a partner. Her primary reason for leaving Parker Coulter to join MBC was that she enjoyed working with Meehan and Boyle.

In July, 1984, Boyle offered a position at MBC to Schafer, who worked closely with Boyle in the plaintiffs department. Boyle told Schafer to organize his cases, and "to keep an eye towards cases to be resolved in 1985 and to handle these cases for resolution in 1985 rather than 1984." He also told Schafer to make a list of cases he could take with him to MBC, and to keep all their conversations confidential.

Late in the summer of 1984, Meehan asked Black and Fitzgerald to become associates at MBC. Fitzgerald had worked with Meehan in the past on general defense work, and Black worked with Meehan, particularly in the aviation area. Meehan was instrumental in attracting Black, who had previously been employed by U.S. Aviation Underwriters (USAU), to Parker Coulter. Although Black had already considered leaving Parker Coulter, he was concerned about whether USAU would follow him to a small firm like MBC, and wanted to discuss his leaving Parker Coulter with the vice president of USAU. In October, 1984, Black and Meehan met with the USAU vice president in New York. They later received assurances from him that he would be interested in sending USAU business to the proposed new firm. Black then accepted the offer to join MBC. Fitzgerald also accepted. Schafer, Black, and Fitzgerald were the only associates Meehan, Boyle, and Cohen approached concerning the new firm.

During July and the following months, Meehan, Boyle, and Cohen made arrangements for their new practice apart from seeking associates. They began to look for office space and retained an architect. In early fall, a lease was executed on behalf of MBC in the name of MBC Realty Trust. They also retained an attorney to advise them on the formation of the new firm.

Boyle was assigned the task of arranging financing. He prepared a personal financial statement and obtained a bank loan in September, 1984. During that fall, two other loans were made on MBC's credit. Cohen, at the request of an accountant, had been trying to develop projections of MBC's expected revenue in order to obtain long-term financing. The

accountant requested a list of cases with indications as to MBC's expected fees for this purpose. In November, Boyle updated and revised the list of cases he expected to take to MBC which he had compiled in July. The November list contained approximately 135 cases. The increase in Boyle's caseload from July to November resulted in part from the departure of a Parker Coulter attorney in early September, 1984. Boyle was in charge of reassigning the cases this attorney worked on. Although another attorney requested transfer of some of these cases, Boyle assigned none to that attorney, and assigned most of the cases to himself and Schafer. Meehan, Cohen, and Black also prepared lists of cases which they anticipated they would remove, and included the potential fee each case would generate for MBC.

Toward the end of November, Boyle prepared form letters to send to clients and referring attorneys as soon as Parker Coulter was notified of the separation. He also drafted a form for the clients to return to him at his home address authorizing him to remove cases to MBC. An outside agency typed these materials on Parker Coulter's letterhead. Schafer prepared similar letters and authorization forms.

While they were planning their departure, from July to approximately December, Meehan, Boyle, Cohen, Schafer, Black, and Fitzgerald all continued to work full schedules. They settled cases appropriately, made reasonable efforts to avoid continuances, tried cases, and worked on discovery. Each generally maintained his or her usual standard of performance.

Meehan and Boyle had originally intended to give notice to Parker Coulter on December 1, 1984. Rumors of their leaving, however, began to circulate before then. During the period from July to early fall, different Parker Coulter partners approached Meehan individually on three separate occasions and asked him if the rumors about his leaving were true. On each occasion, Meehan denied that he was leaving. On November 30, 1984, a partner, Maurice F. Shaughnessy (Shaughnessy), approached Boyle and asked him whether Meehan and Boyle intended to leave the firm. Shaughnessy interpreted Boyle's evasive response as an affirmation of the rumors. Meehan and Boyle then decided to distribute their notice that afternoon, which stated, as their proposed date for leaving, December 31, 1984. A notice was left on the desk of each partner. When Meehan, Boyle, and Cohen gave their notice, the atmosphere at Parker Coulter became "tense, emotional and unpleasant, if not adversarial."

On December 3, the Parker Coulter partners appointed a separation committee and decided to communicate with "important sources of business" to tell them of the separation and of Parker Coulter's desire to continue representing them. Meehan and Boyle asked their partners for financial information about the firm, discussed cases and clients with them, and stated that they intended to communicate with clients and referring attorneys on the cases in which they were involved. Sometime during the week of December 3, the partners sent Boyle a list of cases and requested that he identify the cases he intended to take with him.

Boyle had begun to make telephone calls to referring attorneys on Saturday morning, December 1. He had spoken with three referring attorneys by that date and told them of his departure from Parker Coulter and his wish to continue handling their cases. On December 3, he mailed his previously typed letters and authorization forms, and by the end of the first

two weeks of December he had spoken with a majority of referring attorneys, and had obtained authorizations from a majority of clients whose cases he planned to remove to MBC.

Although the partners previously were aware of Boyle's intention to communicate with clients, they did not become aware of the extent of his communications until December 12 or 13. Boyle did not provide his partners with the list they requested of cases he intended to remove until December 17. Throughout December, Meehan, Boyle, and Schafer continued to communicate with referring attorneys on cases they were currently handling to discuss authorizing their transfer to MBC. On December 19, 1984, one of the partners accepted on behalf of Parker Coulter the December 31 departure date and waived the three-month notice period provided for by the partnership agreement. Meehan, Boyle, and Cohen formalized their arrangement as a professional corporation on January 1, 1985.

MBC removed a number of cases from Parker Coulter. Of the roughly 350 contingent fee cases pending at Parker Coulter in 1984, Boyle, Schafer, and Meehan removed approximately 142 to MBC. Meehan advised Parker Coulter that the 4,000 asbestos cases he had attracted to the firm would remain, and he did not seek to take certain other major clients. Black removed thirty-five cases; Fitzgerald removed ten; and Cohen removed three. A provision in the partnership agreement in effect at the separation provided that a voluntarily retiring partner, upon the payment of a "fair charge," could remove "any matter in which the partnership had been representing a client who came to the firm through the personal effort or connection of the retiring partner," subject to the right of the client to stay with the firm. Approximately thirty-nine of the 142 contingent fee cases removed to MBC came to Parker Coulter at least in part through the personal efforts or connections of Parker Coulter attorneys other than Meehan, Boyle, Cohen, Schafer, Black, or Fitzgerald. In all the cases removed to MBC, however, MBC attorneys had direct, existing relationships with the clients. In all the removed cases, MBC attorneys communicated with the referring attorney or with the client directly by telephone or letter. In each case, the client signed an authorization.

Schafer subsequently separated his practice from MBC's. He took with him a number of the cases which had been removed from Parker Coulter to MBC.

Based on these findings, the judge determined that the MBC attorneys did not manipulate cases, or handle them differently as a result of their decision to leave Parker Coulter. He also determined that Parker Coulter failed to prove that the clients whose cases were removed did not freely choose to have MBC represent them. Consequently, he concluded that Meehan and Boyle neither violated the partnership agreement nor breached the fiduciary duty they owed to their partners. In addition, the judge also found that Meehan and Boyle did not tortiously interfere with Parker Coulter's relations with clients or employees. He similarly rejected Parker Coulter's claims against Cohen and Schafer.

1. Statutory Considerations; the Partnership Agreement.

Before we address Parker Coulter's claims of wrongdoing, we first review the statutory right a partner has to cease his or her association with a partnership, and the statutory right the partner has to assets of the partnership upon leaving. We then examine how the partners in this case have modified these statutory rights in their partnership agreement.

General Laws c. 108A (1986 ed.) governs the formation, conduct, and liquidation of partnerships. Under § 29, a "change in the relation of the partners caused by any partner ceasing to be associated in the carrying on ... of the business" results in dissolution of the partnership. The statute enumerates specific changes which cause a dissolution. A partnership may be dissolved at any time, for example, by the express will of a partner. G.L. c. 108A, § 31(1)(b), (2).

Where a partnership agreement provides that the partnership is to continue indefinitely, and the partnership is therefore "at will," a partner has the right to dissolve the partnership, and the dissolution occurs "[w]ithout violation of the agreement between the partners." G.L. c. 108A, § 31(1). In a dissolution which occurs "[w]ithout violation of the agreement," the statute expressly defers to the method of dividing the partnership's assets which the parties bargained for in their partnership agreement. G.L. c. 108A, § 38(1). In contrast, where the partnership agreement provides that the partnership is to continue for a definite term, a partner has merely the power to dissolve, and the dissolution occurs "[i]n contravention of the agreement between the partners." G.L. c. 108A, § 31(2). If the dissolution occurs in contravention of the agreement, the dissolving partner is subject to certain damages, and the statute does not expressly allow the partnership agreement to control the division of the partnership's assets. G.L. c. 108A, § 38(2). [FN6]

> FN6. The wrongful conduct described in §§ 31 and 38 consists of dissolving the partnership before its term. We have noted that the dissolution of a partnership at will, "however unseemly in manner and method, [is] not a legal wrong." Johnson, supra (citing G.L. c. 108A, § 38[1]). This statement from Johnson recognizes that dissolution of a partnership at will is not "wrongful" or "in contravention of the agreement" within the meaning of either § 31 or § 38, and is therefore not a "legal wrong" which would trigger the remedies of § 38(2). See id. We emphasize that the § 38(2) remedy is in addition to, and distinct from, the remedy provided by § 21 for wrongdoing which is not connected with a premature dissolution.

In addition to giving a partner the power to dissolve a partnership, and to specifying the effects of a premature dissolution, c. 108A also provides a method for dividing the assets of a dissolved partnership. In the absence of an agreement otherwise, upon dissolution a partner may liquidate the partnership's assets and obtain his or her share of the surplus. G.L. c. 108A, § 38(1). Because it may be impossible to liquidate certain partnership assets immediately, the statute provides that "[o]n dissolution [a] partnership is not terminated, but continues until the winding-up of partnership affairs is completed." G.L. c. 108A, § 30. Each partner has a fiduciary duty to wind up this unfinished partnership business solely for the benefit of the former partnership. G.L. c. 108A, §§ 18(f), 21, 35. Once the windup is complete, the total value of the dissolved partnership's assets can be determined. Each

partner then receives his or her share. G.L. c. 108A, §§ 18, 38(1).

The Parker Coulter partnership agreement provided for rights on a dissolution caused by the will of a partner which are different from those c. 108A provides. Because going concerns are typically destroyed in the dissolution process of liquidation and windup, the agreement minimizes the impact of this process. The agreement provides for an allocation to the departing partner of a share of the firm's current net income, and a return of his or her capital contributions. In addition, the agreement also recognizes that a major asset of a law firm is the expected fees it will receive from unfinished business currently being transacted. Instead of assigning a value to the departing partner's interest in this unfinished business, or waiting for the unfinished business to be "wound up" and liquidated, which is the method of division c. 108A provides, the agreement gives the partner the right to remove any case which came to the firm "through the personal effort or connection" of the partner, if the partner compensates the dissolved partnership "for the services to and expenditures for the client." Once the partner has removed a case, the agreement provides that the partner is entitled to retain all future fees in the case, with the exception of the "fair charge" owed to the dissolved firm.

[1] Although the provision in the partnership agreement which divides the dissolved firm's unfinished business does not expressly apply to the removal of cases which did not come to Parker Coulter through the efforts of the departing partner, we believe that the parties intended this provision to apply to these cases also. We interpret this provision to cover these additional cases for two reasons. First, according to the Canons of Ethics and Disciplinary Rules Regulating the Practice of Law (S.J.C. Rule 3:07, Canon 2, as amended through 398 Mass. 1108 [1986]), a lawyer may not participate in an agreement which restricts the right of a lawyer to practice law after the termination of a relationship created by the agreement. One reason for this rule is to protect the public. The strong public interest in allowing clients to retain counsel of their choice outweighs any professional benefits derived from a restrictive covenant. Thus, the Parker Coulter partners could not restrict a departing partner's right to remove any clients who freely choose to retain him or her as their legal counsel. Second, we believe the agreement's carefully drawn provisions governing dissolution and the division of assets indicate the partners' strong intent not to allow the provisions of c. 108A concerning liquidation and wind-up to govern any portion of the dissolved firm's unfinished business. Therefore, based on the partners' intent, and on the prohibition against restrictive covenants between attorneys, we interpret the agreement to provide that, upon the payment of a fair charge, any case may be removed regardless of whether the case came to the firm through the personal efforts of the departing partner. This privilege to remove, as is shown in our later discussion, is of course dependent upon the partner's compliance with fiduciary obligations.

Under the agreement, therefore, a partner who separates his or her practice from that of the firm receives (1) the right to his or her capital contribution, (2) the right to a share of the net income to which the dissolved partnership is currently entitled, and (3) the right to a portion of the firm's unfinished business, and in exchange gives up all other rights in the dissolved firm's remaining assets. As to (3) above, "unfinished business," the partner gives up all right

to proceeds from any unfinished business of the dissolved firm which the new, surviving firm retains. Under the agreement, the old firm's unfinished business is, in effect, "wound up" immediately; the departing partner takes certain of the unfinished business of the old, dissolved Parker Coulter on the payment of a "fair charge," and the new, surviving Parker Coulter takes the remainder of the old partnership's unfinished business. The two entities surviving after the dissolution possess "new business," unconnected with that of the old firm, and the former partners no longer have a continuing fiduciary obligation to windup for the benefit of each other the business they shared in their former partnership.

> FN11. A more equitable provision would require that the new, surviving partnership also pay a "fair charge" on the cases it takes from the dissolved partnership. This "fair charge" from the new firm, as is the "fair charge" from the departing partner, would be an asset of the dissolved partnership, in which the departing partner has an interest.

In sum, the statute gives a partner the power to dissolve a partnership at any time. Under the statute, the assets of the dissolved partnership are divided among the former partners through the process of liquidation and windup. The statute, however, allows partners to design their own methods of dividing assets and, provided the dissolution is not premature, expressly states that the partners' method controls. Here, the partners have fashioned a division method which immediately winds up unfinished business, allows for a quick separation of the surviving practices, and minimizes the disruptive impact of a dissolution.

2. Fiduciary Duties; Breach.

We now consider Parker Coulter's claims of wrongdoing. Parker Coulter claims that the judge erred in finding that Meehan, Boyle, Cohen, and Schafer fulfilled their fiduciary duties to the former partnership. In particular, Parker Coulter argues that these attorneys breached their duties (1) by improperly handling cases for their own, and not the partnership's benefit, (2) by secretly competing with the partnership, and (3) by unfairly acquiring from clients and referring attorneys consent to withdraw cases to MBC. We do not agree with Parker Coulter's first two arguments but agree with the third. We first address the claims against Meehan and Boyle, and then turn to those against Cohen and Schafer.

It is well settled that partners owe each other a fiduciary duty of "the utmost good faith and loyalty." As a fiduciary, a partner must consider his or her partners' welfare, and refrain from acting for purely private gain. Partners thus "may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty." Meehan and Boyle owed their copartners at Parker Coulter a duty of the utmost good faith and loyalty, and were obliged to consider their copartners' welfare, and not merely their own.

[4] Parker Coulter next argues that the judge's findings compel the conclusion that Meehan and Boyle breached their fiduciary duty not to compete with their partners by secretly setting up a new firm during their tenure at Parker Coulter. We disagree. We have stated that fiduciaries may plan to compete with the entity to which they owe allegiance, "provided that

in the course of such arrangements they [do] not otherwise act in violation of their fiduciary duties." Here, the judge found that Meehan and Boyle made certain logistical arrangements for the establishment of MBC. These arrangements included executing a lease for MBC's office, preparing lists of clients expected to leave Parker Coulter for MBC, and obtaining financing on the basis of these lists. We believe these logistical arrangements to establish a physical plant for the new firm were permissible under Chelsea Indus., especially in light of the attorneys' obligation to represent adequately any clients who might continue to retain them on their departure from Parker Coulter. Canons of Ethics and Disciplinary Rules Regulating the Practice of Law (S.J.C. Rule 3:07, Canon 7, as appearing in 382 Mass. 784 [1981]). There was no error in the judge's determination that this conduct did not violate the partners' fiduciary duty.

[5] Lastly, Parker Coulter argues that the judge's findings compel the conclusion that Meehan and Boyle breached their fiduciary duties by unfairly acquiring consent from clients to remove cases from Parker Coulter. We agree that Meehan and Boyle, through their preparation for obtaining clients' consent, their secrecy concerning which clients they intended to take, and the substance and method of their communications with clients, obtained an unfair advantage over their former partners in breach of their fiduciary duties.

A partner has an obligation to "render on demand true and full information of all things affecting the partnership to any partner." G.L. c. 108A, § 20. See Shelley, supra 271 Mass. at 115, 170 N.E. 826. On three separate occasions Meehan affirmatively denied to his partners, on their demand, that he had any plans for leaving the partnership. During this period of secrecy, Meehan and Boyle made preparations for obtaining removal authorizations from clients. Meehan traveled to New York to meet with a representative of USAU and interest him in the new firm. Boyle prepared form letters on Parker Coulter's letterhead for authorizations from prospective MBC clients. Thus, they were "ready to move" the instant they gave notice to their partners.

On giving their notice, Meehan and Boyle continued to use their position of trust and confidence to the disadvantage of Parker Coulter. The two immediately began communicating with clients and referring attorneys. Boyle delayed providing his partners with a list of clients he intended to solicit until mid-December, by which time he had obtained authorization from a majority of the clients.

Finally, the content of the letter sent to the clients was unfairly prejudicial to Parker Coulter. The ABA Committee on Ethics and Professional Responsibility, in Informal Opinion 1457 (April 29, 1980), set forth ethical standards for attorneys announcing a change in professional association. Because this standard is intended primarily to protect clients, proof by Parker Coulter of a technical violation of this standard does not aid them in their claims. We will, however, look to this standard for general guidelines as to what partners are entitled to expect from each other concerning their joint clients on the division of their practice. The ethical standard provides that any notice explain to a client that he or she has the right to decide who will continue the representation. Here, the judge found that the notice did not "clearly

present to the clients the choice they had between remaining at Parker Coulter or moving to the new firm." By sending a one-side announcement, on Parker Coulter letterhead, so soon after notice of their departure, Meehan and Boyle excluded their partners from effectively presenting their services as an alternative to those of Meehan and Boyle.

Meehan and Boyle could have foreseen that the news of their departure would cause a certain amount of confusion and disruption among their partners. The speed and preemptive character of their campaign to acquire clients' consent took advantage of their partners' confusion. By engaging in these preemptive tactics, Meehan and Boyle violated the duty of utmost good faith and loyalty which they owed their partners. Therefore, we conclude that the judge erred in deciding that Meehan and Boyle acted properly in acquiring consent to remove cases to MBC.

We next consider Parker Coulter's claims against Cohen and Schafer. We have determined that "[e]mployees occupying a position of trust and confidence owe a duty of loyalty to their employer and must protect the interests of their employer." Cohen was a junior partner, and acting head of Parker Coulter's appellate department. Schafer was an associate responsible for a substantial case load. Both had access to clients and information concerning clients and therefore occupied positions of trust and confidence. We conclude that their participation in the preemptive tactics of Meehan and Boyle violated the duty they owed the partnership.

3. Consequences of Breach.

Before we examine the consequences of the MBC attorneys' breach of duty, we briefly outline what is at stake. If there had been no breach of duty, the assets of the partnership upon dissolution would be divided strictly according to the partnership agreement. Under the agreement, Meehan and Boyle would be entitled to the return of their capital contributions and their share of the dissolved firm's profits. They would also possess the right to remove cases from the old partnership, and to retain all future fees generated by these cases in excess of the fair charge owed to the partnership for work performed there on the removed cases. Because the fair charge is an asset of the dissolved firm under the agreement, Meehan and Boyle would share in this amount according to their respective interests in the former partnership. Thus, of the fair charges returned to their former partnership, Meehan and Boyle would receive their combined 10.8% partnership share, and their former partners would receive the remainder.

Parker Coulter essentially argues that, because of their breach of fiduciary duty, Meehan and Boyle forfeit all rights under the partnership agreement. Thus, Parker Coulter contends, Meehan and Boyle are not entitled to their capital contributions or their share of the dissolved partnership's profits. More importantly, according to Parker Coulter, because of their breach Meehan and Boyle have lost the right to retain any fees generated by the cases they removed. Instead, Parker Coulter claims, these fees are owed to them directly. Parker Coulter further argues that, because the third-party defendants, Cohen and Schafer, breached their duty to Parker Coulter, they also owe any fees they may receive on removed cases directly to Parker

Coulter. Finally, Parker Coulter contends that the MBC attorneys have forfeited all rights to the compensation they received from July through December, 1984. We reject this extreme remedy. First, we examine the consequences to Meehan and Boyle of their breach; then we turn to Cohen and Schafer.

For Parker Coulter to recover any amount in addition to what it would be entitled to receive upon dissolution under the partnership agreement or the statute, there must be a causal connection between its claimed losses and the breach of duty on the part of the MBC attorneys. Production We have concluded that the MBC attorneys unfairly acquired consent from clients. Parker Coulter, therefore, is entitled to recover only those amounts which flow from this breach of duty.

[6] There is no conceivable connection between the attorneys' breach of duty and Parker Coulter's claims to the capital contributions and profit shares of Meehan and Boyle. We have ruled that a partner does not forfeit his or her right to the accrued profits of a partnership by simply breaching the partnership agreement. The same rule applies to a partner's capital contributions. These amounts are not a form of liquidated damages to which partners can resort in the event of a breach. We conclude, therefore, that Parker Coulter is not entitled to recover these amounts. The judge correctly found that Meehan and Boyle are entitled to a return of their capital contributions (their interest, as determined by the judge, in the partners' reserve account and the partners' capital account), and to the receipt of a portion of the old firm's profits (their interest in the income earned but not distributed account).

We similarly reject Parker Coulter's claims that the MBC attorneys should be required to forfeit all compensation during the period of their breach. Parker Coulter is correct in stating that a fiduciary "can be required to forfeit the right to retain or receive his compensation for conduct in violation of his fiduciary duties." Parker Coulter fails to consider, however, that a fiduciary may be required "to repay only that portion of his compensation, if any, that was in excess of the worth of his services to his employer." Chelsea Indus., supra. Here, the judge found that throughout the period in question the MBC attorneys worked as hard, and were as productive as they had always been. This finding was warranted, and is unchallenged by Parker Coulter. In these circumstances, we conclude that the value of the MBC attorneys' services was equal to their compensation. Parker Coulter, therefore, is not entitled to this relief.

Parker Coulter's claim that it is entitled to all fees from removed cases, however, rests on a different footing from its claims to compensation, capital contributions, and profit shares. We therefore examine more closely Parker Coulter's allegations of a causal connection between the breach of duty and its loss of clients.

Although the judge found that the MBC attorneys did not breach their fiduciary duties in acquiring consent from clients, he nonetheless stated, as an alternative ground for denying relief on this claim, that Parker Coulter had shown no causal connection between the departing attorneys' acts and its loss of clients. He ruled that Parker Coulter failed to show that clients who left the firm would have remained had the plaintiffs and third-party

defendants acted properly. Parker Coulter argues that the standard of causation the judge imposed was too strict. We agree that the judge's ruling placed an inappropriate burden on Parker Coulter.

[7] In these circumstances, it is appropriate to place on the party who improperly removed the case the burden of proving that the client would have consented to removal in the absence of any breach of duty. Based on similar reasoning, courts in other jurisdictions have shifted the burden of proof in cases involving a breach of fiduciary duty. Once it is established that a partner or corporate manager has engaged in self-dealing, or has acquired a corporate or partnership opportunity, these courts require the fiduciary to prove that his or her actions were intrinsically fair, and did not result in harm to the corporation or partnership.

We conclude that Meehan and Boyle had the burden of proving no causal connection between their breach of duty and Parker Coulter's loss of clients. Proof of the circumstances of the preparations for obtaining authorizations and of the actual communications with clients was more accessible to Meehan and Boyle than to Parker Coulter. Furthermore, requiring these partners to disprove causation will encourage partners in the future to disclose seasonably and fully any plans to remove cases. This disclosure will allow the partnership and the departing partner an equal opportunity to present to clients the option of continuing with the partnership or retaining the departing partner individually.

We remand the case to the Superior Court for findings consistent with our conclusion that the MBC attorneys bear the burden of proof. We emphasize that we do not remand the case for the presentation of additional evidence on this issue. At trial, both parties argued whether the MBC attorneys' actions in removing cases affected the clients' right to choose, and introduced a substantial amount of evidence bearing on clients' reasons for selecting MBC. The parties have had a full opportunity to present evidence concerning what might have influenced clients' decisions, and are not now entitled to a further evidentiary hearing on this issue.

In those cases, if any, where the judge concludes, in accordance with the above analysis, that Meehan and Boyle have met their burden, we resolve the parties' dispute over fees solely under the partnership agreement. Under the agreement's terms, as we have interpreted them, Meehan and Boyle owe a fair charge to their former partnership for its "services to and expenditures for" the clients in these matters. Meehan and Boyle are entitled to their combined 10.8% partnership share of this amount, and their former partners are entitled to the remainder. We agree with the judge that a "fair charge" on a removed case consists of the firm's unreimbursed expenses plus the rate billed per hour by members of the firm multiplied by the hours expended on the case. In fixing this hourly rate, the firm made a determination that the time charged was reasonable and fair compensation for the services rendered. We conclude, therefore, that, in accordance with the partnership agreement, Meehan and Boyle must reimburse their former partnership for time billed and expenses incurred at that firm on all cases which were fairly removed. We further conclude that, under the agreement, Meehan and Boyle have the right to retain all fees generated by these cases in excess of the fair charge.

We now address the correct remedy in those cases, if any, which the judge determines Meehan and Boyle unfairly removed. In light of a conclusion that Meehan and Boyle have failed to prove that certain clients would not have preferred to stay with Parker Coulter, granting Parker Coulter merely a fair charge on these cases pursuant to the partnership agreement would not make it whole. We turn, therefore, to c. 108A. Section 21 of c. 108A provides: "Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct or liquidation of the partnership...." We have consistently applied this statute, and held that a partner must account for any profits which flow from a breach of fiduciary duty. **** We have reasoned that this rule requiring the imposition of a constructive trust "does not rest [merely] upon the narrow ground of injury or damage to the [partnership] resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation." Under this rule, "the innocent partner is to be put as nearly as possible in the same position which he would have occupied if there had been no wrongdoing." We do not, however, seek to "deprive the wrong-doing partner of any participation in the fruits of his wrongful actions" (emphasis added). We merely require that the fruits be shared among the parties as if they had been "earned by the partnership in the usual course of its business." Id.

Meehan and Boyle breached the duty they owed to Parker Coulter. If the judge determines that, as a result of this breach, certain clients left the firm, Meehan and Boyle must account to the partnership for any profits they receive on these cases pursuant to c. 108A, in addition to paying the partnership a fair charge on these cases pursuant to the agreement. The "profit" on a particular case is the amount by which the fee received from the case exceeds the sum of (1) any reasonable overhead expenses MBC incurs in resolving the case, and (2) the fair charge it owes under the partnership agreement. We emphasize that reasonable overhead expenses on a particular case are not the equivalent of the amount represented by the hours MBC attorneys have expended on the case multiplied by their hourly billing rate. Reasonable overhead expenses are to include only MBC's costs in generating the fee, and are not to include any profit margin for MBC. We treat this profit on a particular case as if it had been earned in the usual course of business of the partnership which included Meehan and Boyle as partners. Shulkin, supra 301 Mass. at 193, 16 N.E.2d 644. Failing to treat this profit as if it had been earned by Meehan or Boyle while at their former partnership would exclude Meehan and Boyle from participating in the fruits of their labors and, more importantly, would provide Parker Coulter with an unjustified windfall. Parker Coulter would receive a windfall because there is no guarantee that the profit would have been generated had the case not been handled at MBC. Meehan's and Boyle's former partners are thus entitled to their portion of the fair charge on each of the unfairly removed cases (89.2%), and to that amount of profit from an unfairly removed case which they would have enjoyed had the MBC attorneys handled the case at Parker Coulter (89.2%). Id.

The MBC attorneys argue that any remedy which grants Parker Coulter a recovery in excess

of a fair charge on cases removed impermissibly infringes on an attorney's relationship with clients and reduces his or her incentive to use best efforts on their behalf. We agree that punitive measures may infringe on a client's right to adequate representation, and to counsel of his or her own choosing. We believe, however, that the remedy we impose does not suffer from the MBC attorneys' claimed defects. Under the constructive trust we impose, Meehan and Boyle will receive a share of the fruits of their efforts in the unfairly removed cases which is the same as that which they would have enjoyed at Parker Coulter. We note, moreover, that incentives other than profit motivate attorneys. These incentives include an attorney's ethical obligations to the client and the profession, and a concern for his or her reputation.

4. Conclusion and Order.

In sum, we conclude that the MBC attorneys' breach of duty consisted of their method of acquiring consent from clients to remove cases. We therefore limit Parker Coulter's recovery to only those losses which were caused by this breach of duty, but place on the MBC attorneys the burden of disproving causation. On remand, the judge is to determine, based on the record and his findings as they now stand, whether the MBC attorneys have met their burden as to each case removed from Parker Coulter. A constructive trust for the benefit of the former partnership is to be imposed on any profits which Meehan, Boyle, Cohen, or Schafer receive on cases which the judge determines they unfairly removed. Because the fair charge which Meehan and Boyle owe on all removed cases is an asset of the former partnership, and because the constructive trust we impose is for the benefit of the former partnership, each former partner is entitled to his or her partnership share of these amounts. The Parker Coulter defendants are thus entitled to 89.2% of the fair charges on all removed cases, and 89.2% of the profits from the unfairly removed cases; Meehan and Boyle are entitled to 6% and 4.8%, respectively, of these amounts. Additionally, under the agreement's terms, Meehan and Boyle are to receive the return of their capital contributions and their profit shares.

The judgment below is reversed and the case is remanded to the Superior Court (1) for findings, in accordance with the factors we have identified, as to which cases were unfairly removed, (2) for a further evidentiary hearing to determine the reasonable overhead and thus the "profits" on the cases, if any, which were unfairly removed, and (3) for entry of a new judgment dispositive of all issues.

SO ORDERED.

Gibbs v. Breed

Supreme Court, Appellate Division, First Department, New York.

Charles F. **GIBBS**, et al., Plaintiffs-Appellants,

v.
BREED, ABBOTT & MORGAN, et al., Defendants-Respondents.

July 13, 2000.

MAZZARELLI, J.

Plaintiffs Charles Gibbs and Robert Sheehan are former partners of Breed Abbott & Morgan ("BAM") who specialize in trust and estate law. They withdrew from BAM in July 1991 to join Chadbourne & Parke ("Chadbourne"), and brought this action for monies due to them under their BAM partnership agreement. Defendants asserted various counterclaims alleging that plaintiffs breached their fiduciary duty to BAM. The counterclaims were severed and tried without a jury. Plaintiffs appeal from the trial court's determination that, in the course of both partners' planning and eventually implementing their withdrawal from BAM, they breached their fiduciary duty to the partnership. Plaintiffs also appeal from the trial court's determination that $1,861,045 in damages resulted from these transgressions.

From January 1991 until July 1991, plaintiffs were the only partners in the Trusts and Estates department ("T/E") at BAM; plaintiff Gibbs was the head of the department. A third partner, Paul Lambert, had been the former head of the department, and he had obtained many, if not most of the department's clients. In 1989 he had left the firm to become the United States Ambassador to Ecuador and was still on leave in 1991. Lambert intended to return to the firm upon completion of his term as ambassador. The BAM trusts and estates department also employed three associate attorneys, Warren Whitaker (fifteenth year), Austin Wilkie (fourth year), and Joseph Scorese (first year); two accountants, Lois Wetzel and Ellen Furst; and two paralegals, Lee Ann Riley and Ruth Kramer.

On June 24, 1991, Gibbs and Sheehan sent Chadbourne a memo listing the names of the personnel in the T/E department at BAM, their respective salaries, their annual billable hours, and the rate at which BAM billed out these employees to clients. The memo included other information about the attorneys, including the colleges and law schools they attended, and their bar admissions. This list had been prepared by Sheehan on April 26, 1991, months before the partners announced they were leaving. Sheehan specifically testified that the memo was prepared in anticipation of discussions with prospective firms, and both Gibbs and Sheehan testified at trial that the recruitment of certain associates and support personnel was discussed with different firms between March and May, as the partners were considering various affiliations. While Gibbs and Sheehan were still partners at BAM, Chadbourne interviewed four BAM employees that Gibbs had indicated he was interested in bringing to Chadbourne with him. On June 27, 1991, plaintiffs submitted their written resignations. Before Gibbs and Sheehan left BAM, they wrote letters to clients served by them, advising that they were leaving BAM and that other attorneys at BAM could serve them. These letters did not mention the fact that the two partners were moving to Chadbourne. Although the partnership agreement required 45 days notice of an intention to withdraw, BAM waived this provision upon plaintiffs' production of their final billings for work previously performed [FN1]. Gibbs left BAM on July 9, 1991, and Sheehan left on July 11, 1991, both taking various documents, including their respective "chronology" or desk files [FN2]. With the assistance of his chronology file, Gibbs began to contact his former clients on July 11, 1991.

On July 11th, Chadbourne made employment offers to Whitaker, Wilkie, Wetzel, and Riley. Wilkie, Wetzel, and Riley accepted that same day; Whitaker accepted on July 15, 1991. In the following weeks, 92 of the 201 BAM T/E clients moved their business to Chadbourne.

After hearing all the testimony and the parties' arguments, the trial court determined that Gibbs' actions in persuading his partner Sheehan to leave BAM, "and the way in which the leave was orchestrated, were done, at least partially, with the intention of crippling BAM's Trusts and Estates ("T/E") department", and constituted a breach of loyalty to BAM. The court also found that Gibbs and Sheehan had breached their fiduciary duties to BAM by sending Chadbourne the April 26, 1991 memo detailing personal information about the individuals in the T/E Department at BAM, because this gave Chadbourne a competitive advantage in offering employment to other members of the department. Finally, the court found that Gibbs and Sheehan breached their fiduciary duties to BAM by taking their chronology files with them to Chadbourne. Specifically, the court concluded that by taking their respective chronology files, the partners "to a large degree hobbled their former partners in their effort to rebuild the Trusts and Estates department, in order to maintain a viable department, and in their ability to serve clients without undue disruption".

With respect to damages, the court concluded that both Gibbs and Sheehan were entitled to recover their share of BAM profits accruing until the end of July 1991, and that Sheehan was entitled to the remainder of his capital account with the firm. Although there was no evidence that the partners had improperly solicited former BAM clients, the court found that despite BAM's efforts to mitigate damages by hiring a new partner and two associates into the T/E Department, that department suffered financial losses as a result of plaintiffs' conduct, and concluded that it was entitled to recover lost profits for a reasonable period following plaintiffs' departure. The court directed that lost profits be calculated from July 1991, when the partners left the firm, to November 1993, when BAM dissolved. Gibbs and Sheehan were held jointly and severally liable for $1,861,045. The court also awarded defendants prejudgment interest and attorneys' fees. The court's liability finding should be modified, the damage award vacated, and the matter remanded for a determination of the financial loss, if any, occasioned by plaintiffs' disloyal act of supplying competitors with BAM's confidential employee data.

The members of a partnership owe each other a duty of loyalty and good faith, and "[a]s a fiduciary, a partner must consider his or her partners' welfare, and refrain from acting for purely private gain" (*Meehan v. Shaughnessy,* 404 Mass. 419, 434, 535 N.E.2d 1255). Partners are constrained by such duties throughout the life of the partnership and "[t]he manner in which partners plan for and implement withdrawals ... is [still] subject to the constraints imposed on them by virtue of their status as fiduciaries." According the trial court's findings on issues of fact and credibility appropriate deference, we uphold that portion of the court's liability determination which found that plaintiffs breached their fiduciary duty as partners of the firm they were about to leave by supplying confidential employee information to Chadbourne while still partners at BAM. However, we find no breach with respect to Gibbs' interactions with Sheehan, or with respect to either partner's removal of his desk files from BAM.

Defendants did not establish that Gibbs breached any duty to BAM by discussing with Sheehan a joint move to another firm, or that Sheehan's decision was based upon anything other than his own personal interests. In addition, while in certain situations "[A] lawyer's removal or copying, without the firm's consent, of materials from a law firm that do not belong to the lawyer, that are the property of the law firm, and that are intended by the lawyer to be used in his new affiliation, could constitute dishonesty, which is professional misconduct under [Model] Rule 8.4(c)" (D.C. Bar Legal Ethics Comm. Op. 273 at 192), here, the partners took their desk copies of recent correspondence with the good faith belief that they were entitled to do so.

[4] Contrary to the finding of the trial court, and applying the principle that "[t]he distinction between motive and process is critical to a realistic application of fiduciary duties", we find no breach of duty in plaintiffs' taking their desk files. These were comprised of duplicates of material maintained in individual client files, the partnership agreement was silent as to these documents, and removal was apparently common practice for departing attorneys

[5] However, the record supports the court's finding that both partners committed a breach of their fiduciary duty to the BAM partners by supplying Chadbourne, and presumably the other partnerships they considered joining, with the April 26, 1991 memorandum describing the members of BAM's T/E department, their salaries, and other confidential information such as billing rates and average billable hours, taken from personnel files. Moreover, a closer examination of the record does not support the dissent's conclusion that these partners did not engage in surreptitious recruiting. The partners may not have discussed with firm employees the possibility of moving with them prior to June 20, 1991, but they indicated to Chadbourne the employees they were interested in prior to this date, and Gibbs specifically testified that he refrained from telling one of his partners, to whom he had a duty of loyalty, about his future plans to recruit specific associates and support staff from the partnership.

There is no evidence of improper client solicitation in this case, nor is it an issue on this appeal. Although the analogy could be useful in concluding that Gibbs did not breach his fiduciary duty to the partnership by working with Sheehan to find a new affiliation, the fiduciary restraints upon a partner with respect to client solicitation are not analogous to those applicable to employee recruitment. By contrast to the lawyer-client relationship, a partner does not have a fiduciary duty to the employees of a firm which would limit its duty of loyalty to the partnership. Thus, recruitment of firm employees has been viewed as distinct and "permissible on a more limited basis than ... solicitation of clients" (Hillman, *supra* at 1031). Pre-withdrawal recruitment is generally allowed "only after the firm has been given notice of the lawyer's intention to withdraw" (*id.*).

However, here, Sheehan prepared a memo in April of 1991, well in advance of even deciding, much less informing his partners, of his intention to withdraw. There is ample support in the record for the trial court's finding that the preparation and sending of the April 26, 1991 memo, combined with the subsequent hiring of certain trusts and estates personnel, constituted an egregious breach of plaintiff's fiduciary duty to BAM. Moreover, it is not

speculative to infer more widespread dissemination given Sheehan's trial testimony that the memo "was prepared in connection with talking to other firms", and that "he was sure the subject of staffing was discussed at firms other than Chadbourne". Sheehan's disclosure of confidential BAM data to even one firm was a direct breach of his duty of loyalty to his partners. Because the memo gave Chadbourne confidential BAM employment data as well as other information reflecting BAM's valuation of each employee, Chadbourne was made privy to information calculated to give it an unfair advantage in recruiting certain employees

While partners may not be restrained from inviting qualified personnel to change firms with them, here Gibbs and Sheehan began their recruiting while still members of the firm and prior to serving notice of their intent to withdraw. They did so without informing their partners that they were disseminating confidential firm data to competitors. Their actions, while still members of the firm, were intended to and did place BAM in the position of not knowing which of their employees were targets and what steps would be appropriate for them to take in order to retain these critical employees. The dissent's analysis, that once the firm was notified of the partners' departure, there was no breach of fiduciary duty, is flawed. The breach occurred in April of 1991 and could not be cured by any after-the-fact notification by the fiduciary who committed the breach that he was withdrawing from the firm. Chadbourne still had the unfair advantage of the confidential information from the April 1991 memo, and still had the upper hand, which was manifested by its ability to tailor its offers and incentives to the BAM recruits.

Contrary to the dissent, I would characterize the memo distributed to prospective competitors as confidential. The data was obtained from BAM personnel files which Sheehan had unique access to as a BAM partner. The dissent's statement that such financial information is generally known to "headhunters" is without foundation. While the broad outlines of the partners' profits at a select number of large New York firms and the incremental increases in the base compensation of young associates at some firms are published in professional publications such as the New York Law Journal, or known to some recruitment firms, the available figures often vary substantially from the actual compensation received by specific individuals.

Moreover, the memo contained more than a list of salaries. It itemized each of the employees' annual billable hours, and the rates at which BAM billed these employees out to their clients, information which was not otherwise publically available. These facts go directly to a potential employee's value and were accessible only to members of the BAM partnership. Selected partners providing BAM's confidential information, which they were able to obtain by virtue of their position as fiduciaries, to Chadbourne was an act of disloyalty to their partnership. The confidential information placed Chadbourne, as a competing prospective employer, in the advantageous position of conducting interviews of the associates and support staff with more knowledge than any firm could obtain through independent research, as well as providing it with information BAM partners did not know it had, thereby prejudicing their own efforts to retain their associates and support staff.

All concur except WALLACH and SAXE, JJ. who concur in part and dissent in part in an

Opinion by SAXE, J.

SAXE, J. (concurring in part and dissenting in part)

Much has been written about the ethical and fiduciary obligations of attorneys upon withdrawal from their law firms, particularly with regard to their solicitation of firm clients. However, rather than involving the improper solicitation of former clients, this case concerns claims of wrongful "solicitation" or "taking" of a withdrawing attorney's own partners, associates, and support staff. We are also required to address the propriety of departing attorneys removing the duplicate copies of letters and memos in their possession that they personally prepared and issued over the preceding years, which plaintiffs term "desk chronology files" or "correspondence chronology files".

In view of the limited case authorities directly on point, resolution of this appeal requires a review of the general principles concerning client solicitation and attorneys' covenants not to compete, as well as the general policy considerations discussed in numerous scholarly articles concerning the competing interests in law firm breakups. The trial court's liability determination runs counter to these principles and policies and it is not supported by the evidence. Therefore, I would reverse the judgment in its entirety. To the extent the majority affirms one aspect of the liability determination, I dissent. As to the remainder of the majority opinion, I concur in the result, based upon the following discussion.

This lawsuit concerns the 1991 move of the core of the trusts and estates department of Breed, Abbott & Morgan ("Breed, Abbott") to Chadbourne & Parke ("Chadbourne"). According to the findings of the trial court, plaintiff Charles Gibbs, a partner in the trusts and estates department of Breed, Abbott, began making inquiries into joining another firm, and spoke with his colleague in the trusts and estates department, plaintiff Robert Sheehan, about the possibility of their moving as a team, ultimately convincing him. Once plaintiffs accepted offers to join Chadbourne, they notified Breed, Abbott. A few days later they provided Chadbourne with a list of four out of the seven associates and support personnel remaining in Breed, Abbott's trusts and estates department, containing salary information that Sheehan had compiled a few months earlier. Shortly after Gibbs and Sheehan left Breed, Abbott, Chadbourne made employment offers to those four employees: two of the department's three associates, one of its two paralegals and one of its two accountants; all of them accepted the offers. Finally, upon leaving Breed, Abbott, plaintiffs took with them their "desk chronology files" or "correspondence chronology files", containing duplicate copies of their memos and correspondence from the previous years, although the firm's copies of this correspondence remained with the firm, filed in the appropriate client files.

The trial court concluded that plaintiffs breached their fiduciary duty to their former partners in several ways. First, that plaintiff Charles Gibbs improperly "solicited" his partner Robert Sheehan to leave Breed, Abbott with him; second, that it was improper for the two attorneys to take their chronological correspondence files with them; lastly, that the plaintiffs

furnished to their new law firm, prior to their departure from Breed, Abbott, confidential information regarding their support staff, whom Chadbourne then hired. The trial court also explicitly found that plaintiffs' move to Chadbourne & Parke was "orchestrated to cripple" Breed, Abbott.

The evidence before the trial court fails to support its findings that plaintiffs violated their fiduciary duty to their partners at Breed, Abbott. I agree with the majority's holding that Gibbs's pre-departure discussions with Sheehan cannot constitute a breach of Gibbs's fiduciary duty to Breed, Abbott, and that plaintiffs' removal of their desk chronology files breached no obligation to their former partners. However, I disagree with the conclusion that defendants are entitled to damages based upon plaintiffs having provided Chadbourne with information about other employees of the firm's trusts & estates department, which information was provided in the interests of bringing these employees along with them in their move to Chadbourne.

Persuading a Partner to Leave the Firm as a Team

Turning first to the trial court's finding that Gibbs "actively encouraged" or "persuaded" Sheehan to leave the firm with him, and "orchestrated" their move to cripple Breed, Abbott's trusts and estates department, there is no established fiduciary duty that can be stretched to cover Gibbs's conduct. The standard employed by the trial court, if applied generally, would too severely restrict attorneys' rights to change affiliations, compete with former partners, and offer clients full freedom of choice with respect to retaining counsel.

Initially, the "solicitation" of one's own partners to make a joint move simply does not qualify as a breach of fiduciary duty. Indeed, *Graubard Mollen Dannett & Horowitz v. Moskovitz,* 86 N.Y.2d 112, 629 N.Y.S.2d 1009, 653 N.E.2d 1179, which actually involved a joint move by several partners, only discussed a breach of fiduciary duty regarding the solicitation of firm clients.

In *Graubard Mollen, supra,* defendant senior partner Irving Moskovitz, along with two other partners from his department, left plaintiff law firm and joined another firm, LeBoeuf Lamb Leiby & MacCrae. Prior to announcing their departure, the senior partner had arranged meetings between members of LeBoeuf and a major client, F. Hoffman LaRoche & Co., Ltd. ("Roche"); allegedly, LeBoeuf would not finalize any arrangement with Moskovitz and the colleagues going with him, unless Roche agreed to transfer its business to go along with defendants' move.

In affirming a denial of Moskovitz's motion for summary judgment, the Court of Appeals articulated certain basic principles regarding which conduct is clearly proper and which is clearly improper in withdrawing from a law firm. The Court recognized that an attorney's fiduciary duty is not violated by "taking steps to locate alternative space and affiliations" (*see, Graubard Mollen, supra* at 120, 629 N.Y.S.2d 1009, 653 N.E.2d 1179). The Court also noted that "departing partners have been permitted to inform firm clients with whom they have a prior professional relationship about their impending withdrawal and new

practice, and to remind the client of its freedom to retain counsel of its choice [citations omitted]," although it added that "[i]deally, such approaches would take place only after notice to the firm of the partner's plans to leave [citations omitted]" (*id.*).

Among the clearly improper conduct identified by the Court as "[a]t the other end of the spectrum" was "attempting to lure firm clients (even those the partner has brought into the firm and personally represented) to the new association" (*id.*). "[A]s a matter of principle, preresignation surreptitious 'solicitation' of firm clients for a partner's personal gain ... exceeds what is necessary to protect the important value of client freedom of choice in legal representation, and thoroughly undermines another important value--the loyalty owed partners" (*id.* at 119-120, 629 N.Y.S.2d 1009, 653 N.E.2d 1179).

The "solicitation" of one's own partners to make a joint move is fundamentally different than the solicitation of firm clients; the analysis which concludes that surreptitious solicitation of clients or secreting client files is improper is irrelevant to partners' conduct toward one another. "Soliciting" another member of one's firm does not involve the same concerns.

Although clients are not, technically, an "asset" or "property" of the firm, subject to possession, the rules regarding their solicitation treat them as something of an equivalent The wrongfulness in preresignation solicitation of clients lies in directly and unfairly competing with the firm for *business,* while still a partner of it, taking unfair advantage of knowledge the firm lacks.

While it is arguable whether clients should be treated, for purposes of this analysis, as assets of the firm, it is clear that partners in a law firm cannot be treated as such.

Law partners "are bound by a fiduciary duty requiring 'the punctilio of an honor the most sensitive'." Yet, neither this duty nor any rules of ethics prohibit partners in a law firm from leaving the firm, or from competing with their former firm immediately upon their departure, or even from making plans while still a member of the firm to compete with it following their departure What is prohibited is *actual* competition with the firm while still a member of it

An overall guiding principle limiting the conduct of departing partners is that the process must be handled properly and fairly so that the withdrawing partner, while in possession of information that the firm lacks (namely, his impending departure), may not take unfair advantage of that information. Thus, where a partner surreptitiously approaches firm clients to obtain assurances that the clients will remain with him if he forms a new law firm, the partner has breached his duty to his partners and his firm The prohibition against secretly soliciting clients, or removing client files, prior to one's resignation, is founded upon the prohibition against taking unfair advantage of the knowledge of his impending departure, while his partners are still unaware of it. It constitutes not a mere plan to compete in the future with his former law partners, but a present act of direct competition with those to whom he still owes a duty of loyalty.

An equally important principle in these circumstances, providing something of a

counterweight to the duty of loyalty partners owe one another, is "the important value of client freedom of choice in legal representation." Imposition of a limitation which restricts the ability of a departing partner to offer the client the ability to continue to serve as counsel may violate the ethical prohibition against restricting an attorney's practice of law.

A partner planning a move necessarily makes numerous arrangements in anticipation of withdrawal, to ensure a smooth transition, including ensuring the capability of continuing to serve those former clients who choose to retain the departing partner (*see, Meehan v. Shaughnessy, supra,* at 435, 535 N.E.2d 1255). The same considerations apply equally when two partners plan a joint move. The fact that one partner conceived of the move first and approached the other with the idea, or even convinced an initially content colleague to embark upon a joint departure, cannot change the attorneys' right to leave their firm.

Nor is there is any evidence that Sheehan's decision to interview jointly with Gibbs or to leave Breed, Abbott was anything other than his own considered decision. The testimony that he felt "under pressure" from a number of sources does not alter the fundamental fact that he was always free to make that decision for himself. Merely approaching another partner, in order to broach and explore the subject of a joint move to another firm, even to attempt to convince him of the advantages of such a joint move, simply cannot serve as the foundation for liability to the firm.

Furthermore, should the two partners finally agree on a move, and ultimately arrive at an arrangement with another firm acceptable to both, the "orchestration" of the move cannot serve as a basis for liability in the absence of a type of sneaky or malicious conduct present in *Kantor v. Bernstein,* 225 A.D.2d 500, 640 N.Y.S.2d 40, and *Graubard Mollen Dannett & Horowitz v. Moskovitz, supra,* but absent here.

The observation of the trial court that plaintiffs' joint departure "denuded" Breed, Abbott's trusts and estates department is irrelevant to the issue of breach of fiduciary duty. Where a department of a law firm contains two active partners, a few associates and support staff, a decision by the two partners to withdraw from the firm will of necessity "denude" the department, and may indeed even "cripple" it, at least temporarily. However, it does not follow that the departure violates the duty owed by the departing partners to the firm. Partners' freedom to withdraw from a firm simply cannot be reconciled with a requirement that their departure be arranged in such a way as to protect the integrity of the department, and ensure its continued profit levels.

Partners who choose to leave a firm and join another presumably believe they will do better at their new affiliation. We can thus assume that as a result of the withdrawal, the old firm may well be economically damaged. Yet, the mere fact of such damage does not make it compensable.

Introduction to a Partner's Right to Manage the Partnership

Unless the partners agree otherwise, each partner of a partnership has the right to manage the partnership's affairs in the ordinary course of business. (Think of what this means in the context of a partner's apparent authority.) Conversely, limited partners have no right to manage the affairs of the partnership (which tells you something about their apparent authority). With two partners, and no written or express agreement, you end up with what is known as a deadlock, which results in litigation.

Discussion points for Nabisco v. Stroud

Two partners, with no agreed-upon mechanism to break deadlocks if they happen to disagree with each other on how the business of the partnership is supposed to be run. Guess what happens? Litigation happens. In this case, Stroud pulls an Al Haig and tells everybody he is in charge, and that nobody should do business with his partner, Freeman. Should he get away with such a power grab? Where does this leave Stroud, if he does not want to be liable for the debts incurred by Freeman in the ordinary course of the partnership's business? What would you advise at this late date?

NATIONAL BISCUIT COMPANY, Inc.
v.
C. N. STROUD and Earl Freeman, trading as Stroud's Food Center.

Supreme Court of North Carolina.

Jan. 28, 1959

C. N. Stroud and Earl Freeman entered into a general partnership to sell groceries under the firm name of Stroud's Food Center. There is nothing in the agreed statement of facts to indicate or suggest that Freeman's power and authority as a general partner were in any way restricted or limited by the articles of partnership in respect to the ordinary and legitimate business of the partnership. Certainly, the purchase and sale of bread were ordinary and legitimate business of Stroud's Food Center during its continuance as a going concern.

Several months prior to February 1956 Stroud advised plaintiff that he personally would not be responsible for any additional bread sold by plaintiff to Stroud's Food Center. After such notice to plaintiff, it from 6 February 1956 to 25 February 1956, at the request of Freeman, sold and delivered bread in the amount of $171.04 to Stroud's Food Center.

In Johnson v. Bernheim, 76 N.C. 139, this Court said: 'A and B are general partners to do some given business; the partnership is, by operation of law, a power to each to bind the partnership in any manner legitimate to the business. If one partner go to a third person to buy an article on time for the partnership, the other partner cannot prevent it by writing to the third person not to sell to him on time; or, if one party attempt to buy for cash, the other has no right to require that it shall be on time. And what is true in regard to buying is true in regard to selling. What either partner does with a third person is binding on the partnership. It is otherwise where the partnership is not general, but is upon special terms, as that purchases and sales must be with and for cash. There the power to each is special, in regard to all dealings with third persons at least who have notice of the terms.'

Freeman as a general partner with Stroud, with no restrictions on his authority to act within the scope of the partnership business so far as the agreed statement of facts shows, had under the Uniform Partnership Act 'equal rights in the management and conduct of the partnership business.' Under G.S. s 59-48(h) Stroud, his co-partner, could not restrict the power and authority of Freeman to buy bread for the partnership as a going concern, for such a purchase was an 'ordinary matter connected with the partnership business,' for the purpose of its business and within its scope, because in the very nature of things Stroud was not, and could not be, a majority of the partners. Therefore, Freeman's purchases of bread from plaintiff for Stroud's Food Center as a going concern bound the partnership and his co- partner Stroud. The quoted provisions of our Uniform Partnership Act, in respect to the particular facts here, are in accord with the principle of law stated in Johnson v. Bernheim, supra; same case 86 N.C. 339.

In Crane on Partnership, 2d Ed., p. 277, it is said: 'In cases of an even division of the partners as to whether or not an act within the scope of the business should be done, of which disagreement a third person has knowledge, it seems that logically no restriction can be placed upon the power to act. The partnership being a going concern, activities within the scope of the business should not be limited, save by the expressed will of the majority deciding a disputed question; half of the members are not a majority.'

The judgment of the court below is

Affirmed.

Roach v. Mead

Supreme Court of Oregon.

William **ROACH**, Petitioner on review/Respondent on review,
v.
Kenneth E. **MEAD**, dba Berentson & Mead, Respondent on review,
and

Decided July 29, 1986.

JONES, Justice.

At trial, defendant, David J. Berentson, moved for a directed verdict, contending that he was not vicariously liable for the negligent acts of his partner, Kenneth E. Mead, because the negligent acts were outside the scope of the partnership's business. The trial court denied the motions, and the jury found defendant liable. The Court of Appeals held that defendant attorney was vicariously liable for his former partner's negligence, but not liable under the UTPA claim. We affirm the Court of Appeals.

Mead, defendant's former law partner, first represented plaintiff in December 1974 on a traffic charge and later represented plaintiff on several occasions. On November 1, 1979, Mead and defendant formed a law partnership. Mead continued to advise plaintiff on other traffic charges and on business dealings. Defendant prepared plaintiff's income tax returns.

In June 1980, plaintiff sold his meter repair business for $50,000. On November 25, 1980, plaintiff asked for Mead's advice on investing $20,000 in proceeds from the sale. Plaintiff testified that Mead told plaintiff that "he would take [the money] at 15 percent. So, I let him have it. * * * I trusted him and felt he would look out for me." Plaintiff considered Mead's advice to be legal advice; he testified that otherwise he would not have consulted an attorney.

After plaintiff agreed to the loan, Mead executed a promissory note for $20,000 payable on or before November 25, 1982, at 15 percent interest. Mead said that he would be receiving a large sum of money with which he would repay plaintiff. Mead offered to secure the loan with a second mortgage on his house, and plaintiff replied that he should do "whatever you think is best." Mead did not secure the loan.

On May 1, 1981, Mead went to plaintiff's home and requested a $1,500 loan, telling plaintiff he was in financial trouble but "had big money coming in." Plaintiff agreed to the loan and Mead added the $1,500 to the amount due on the promissory note. Mead did not repay any money to plaintiff and later was declared bankrupt. [FN1]

> FN1. On January 18, 1983, this court accepted Mead's resignation from the bar. He stated that he had chosen not to contest disciplinary charges alleging that he had "borrowed $45,000 from a client, that he misrepresented the priority of the security given for the loan and that he subsequently forged a satisfaction of the mortgage given as security." Mead was convicted of theft by deception because of the loan referred to in the disciplinary charges.

Plaintiff sued defendant's partnership for negligence, alleging that the partnership failed to disclose the conflicting interests of plaintiff and Mead, to advise plaintiff to seek independent

legal advice, to inform plaintiff of the risks involved in an unsecured loan, and to advise plaintiff that the loan would not be legally enforceable because the rate of interest was usurious, ORS 82.010 (1979), *former* ORS 82.110 (*repealed by* Or.Laws 1981, ch. 412, § 24). Plaintiff also alleged under the UTPA that the partnership created a likelihood of confusion concerning the service it provided to plaintiff, ORS 646.608(1)(b), represented the legal service as having qualities that it did not possess, ORS 646.608(1)(g), and misleadingly represented the nature of the loan, ORS 646.608(1)(k).

The trial jury found defendant vicariously liable for Mead's negligence in advising plaintiff on the $20,000 loan [FN2] and for violations of the UTPA. The trial court awarded $8,000 in attorney fees under the UTPA. On appeal, the Court of Appeals held that although defendant was liable for Mead's negligence, defendant was not liable under the UTPA because "the UTPA does not cover such service for a mere loan of money at interest, whatever the lender's intended use of the profits of the loan." 76 Or.App. 83, 87, 709 P.2d 246 (1985). The Court of Appeals' reversal of the UTPA claim did not affect the amount of the jury award but did eliminate the award of attorney fees. We affirm the Court of Appeals.

> FN2. The jury found defendant not liable for the additional $1,500 loan, presumably because it determined that the loan was personal and that giving legal advice concerning the loan was not within the scope of the partnership's business.

I. VICARIOUS LIABILITY

Plaintiff contends that Mead negligently advised him about the loan and that defendant should be vicariously liable for Mead's negligent legal advice. Defendant, while conceding that Mead was negligent, [FN3] argues that the transaction between plaintiff and Mead was a personal loan outside the scope of the partnership, and that the evidence did not prove that soliciting personal loans was within Mead's express, implied or apparent authority as defendant's law partner.

Oregon's Uniform Partnership Law, ORS 68.010 to 68.650, governs the liability of partnerships for the acts of partners. ORS 68.210 provides in pertinent part:

> "(1) Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which the partner is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom the partner is dealing has knowledge of the fact that the partner has no such authority.
> "(2) An act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners.
> " * * *

> "(4) No act of a partner in contravention of a restriction on authority shall bind the partnership to persons having knowledge of the restriction."

Liability of partners for the acts of copartners is based on a principal-agent relationship between the partners and the partnership. "Partners are jointly and severally liable for the tortious acts of other partners if they have authorized those acts or if the wrongful acts are committed 'in the ordinary course of the business of the partnership.' ORS 68.250, 68.270." The issue in this case is whether Mead's failure to advise plaintiff on the legal consequences of the loan was "in the ordinary course of the business of the partnership."

In *Croisant v. Watrud,* 248 Or. 234, 432 P.2d 799 (1967), this court confronted a similar issue of the vicarious liability of a partnership for the wrongful acts of a partner. In *Croisant,* the client of an accountant sued the accounting partnership, claiming damages for the accountant's breach of trust. The accountant collected income from the client's property and then made unauthorized payments to the client's husband from the money. The defendant partnership contended that the collection services were personal dealings of the accountant with the client and not part of the partnership's business. This court held:

> "If a third person reasonably believes that the services he has requested of a member of an accounting partnership is undertaken as a part of the partnership business, the partnership should be bound for a breach of trust incident to that employment even though those engaged in the practice of accountancy would regard as unusual the performance of such services [collecting and disbursing funds] by an accounting firm." 248 Or. at 242, 432 P.2d 799.

The court stated that the reasonableness of the third person's belief that "the service he seeks is within the domain of the profession is a question which must be answered upon the basis of the facts in the particular case." *Id.* at 243, 432 P.2d 799.

Defendant contends that *Croisant* may be distinguished from the case at bar because in *Croisant* "the misconduct occurred in the course of * * * activities which the court held could reasonably be viewed as within the scope of the accounting firm's business," while in this case "[t]here was no evidence that the act of an attorney in taking a personal loan from a client could reasonably be viewed as part of the business of a law firm." However, defendant admits that "the evidence most favorable to Plaintiff was simply that Plaintiff thought Mead was giving him investment advice and that the giving of advice regarding legal aspects of loans and investments in general is a normal part of law practice." Defendant thus concedes the validity of plaintiff's argument that plaintiff reasonably believed that investment advice was within the scope of the partnership's business; plaintiff does not contend that soliciting loans from clients was partnership business.

In the case at bar, the jury determined that plaintiff reasonably believed that the partnership's legal services included investment advice. We agree with the Court of Appeals that:

> " * * * There is expert and other testimony from which the jury could have found that plaintiff relied on Mead for legal advice concerning the loan, that a lawyer seeking a loan from a client would be negligent if the lawyer did not tell the client to get independent legal

> advice and that a lawyer advising a client about this particular loan would seek to secure it and would warn the client of the risks involved in providing a usurious interest rate." 76 Or.App. at 85, 709 P.2d 246.

The Court of Appeals' rationale is buttressed by our decisions in bar disciplinary proceedings concerning loans from clients to lawyers. *See, e.g., In re Montgomery,* 292 Or. 796, 643 P.2d 338 (1982); *In re Drake,* 292 Or. 704, 642 P.2d 296 (1982). In *Montgomery* this court reprimanded a lawyer for failing to disclose his conflict of interest, holding that:

> "When a lawyer borrows money from a non-lawyer client who is not in the business of lending money, the lawyer should assume that the client is relying on the lawyer for the legal aspects of the transaction to the same extent that the client would rely on the lawyer for advice were the client making the loan to a third person, unless the opposite is expressly stated.
>
> "It would not occur to a trusting client that the lawyer would advise the client to enter into an unlawful contract. Thus, had [the client] consulted [the attorney] about a loan to a third person, although advice as to the creditworthiness of the third person would likely not be expected, advice as to the legal effect of the usurious rate of interest would likely have been given. In addition, a competent lawyer might have recommended that security be given by the borrower." 292 Or. at 802, 642 P.2d 296.

[1] When a lawyer borrows money from a client, this court requires that the lawyer advise the client about the legal aspects of the loan. Mead's failure to advise plaintiff to seek independent legal advice, that loans usually should be secured and the debtor's financial status checked, and that the rate of interest was usurious were all failures of Mead as a lawyer advising his client. Because these failures occurred within the scope of the legal partnership, responsibility for Mead's negligence was properly charged to defendant as Mead's law partner. The trial court did not err in submitting the negligence issue to the jury.

The Court of Appeals is affirmed.

<u>Dissolving the Partnership</u>

Partners can agree to dissolve the partnership if they do not get along. They can also agree in advance (a very wise idea) about how everything is going to be split up at the time of dissolution. But what if one partner wants to walk away, in effect divorcing himself (or herself) from the other partner? Can he do so easily, without liability for dissolving the partnership, or should liability attach, at least in some cases?

Discussion points for Prentiss v. Sheffel

What good is a minority (15%) voting interest in a partnership, when it comes down to who is really the boss? How much say do you really have? In this case, on what conceivable

grounds would Sheffield want to prevent Prentiss from bidding on the partnership assets?

Chris PRENTISS, Appellant,
v.
Donald J. SHEFFEL and Mortimer Iger; W. Miller Bennett, Receiver, Appellees.

Court of Appeals of Arizona, Division 1, Department B.

Sept. 13, 1973.

OPINION

HAIRE, Judge.

[1] The question presented by this appeal is whether two majority partners in a three-man partnership-at-will, who have excluded the third partner from partnership management and affairs, should be allowed to purchase the partnership assets at a judicially supervised dissolution sale. We hold that on the facts of this case, such a purchase is proper, and affirm the judgment entered by the trial court.

Suit was originally brought by plaintiffs-appellees seeking dissolution of a partnership they had formed with defendant-appellant. The partnership was created for the purpose of acquiring and operating the West Plaza Shopping Center located at Bethany Home Road and 35th Avenue in Phoenix, Arizona. (Hereinafter referred to as the Center).

As grounds for dissolution the plaintiffs contended that the defendant had in general been derelict in his partnership duties, and in particular that he had failed to contribute the balance of his proportionate share ($6,000) of the operating losses incurred by the Center. The plaintiffs also sought the trial court's permission to continue the partnership business both during the pendency of the suit and thereafter, and requested that a value be fixed on the defendant's interest in the partnership.

Defendant filed a counterclaim seeking a winding up of the partnership and the appointment of a receiver. He contended that his rights as a partner had been violated in that he had been wrongfully excluded from the partnership.

After an extended evidentiary hearing, the trial court made certain pertinent findings of fact which are here summarized:

1. That each of the plaintiffs owned a 42 1/2% Interest in the partnership, with an aggregate interest of 85%, while the defendant was the owner of a 15% Interest.

2. That no detailed partnership agreement as to how the business would be supervised, how management decisions would be made, or the term of the partnership's existence, was ever

made or entered into at any time between the parties, although there were frequent attempts to arrive at such an agreement.

3. That numerous unresolved disputes arose between the parties, most notably as to how title to the partnership property was to be held, and how management decisions should be made.

4. That as a result of these disputes the relationship between the parties deteriorated, culminating with plaintiffs notifying defendant that any further dealings between them should be through their attorney.

5. That defendant had never been denied physical access to the Center; that he visted there from time to time; and that he also engaged in conversations with the resident manager of the Center.

6. That because of his poor financial condition, defendant had not made payments of all of his pro-rata share of the deficits incurred by the Center when called upon to do so.

7. That since its acquisition, the Center's losses from operations had been materially reduced, and certain more advantageous lease provisions had been secured; that there had been no showing of waste nor detriment to the Center as a result of management operations.

8. That there was a freeze-out or exclusion of the defendant from partnership management and affairs.

Based upon these and other findings of fact the trial court concluded that a partnership-at-will existed between the plaintiffs and the defendant which was dissolved as a result of a freeze-out or exclusion of the defendant from the management and affairs of the partnership. A receiver was appointed by the court until the partnership property could be sold and a partition and distribution of assets could be made. The trial court expressly refused the defendant's request that an order be entered forbidding the plaintiffs from bidding at the contemplated judicial sale.

The receiver and the trial court proceeded with the liquidation and sale of the Center. The plaintiffs were the high bidders at the sale which was held in open court. Subsequently, the court entered an order confirming the sale of the Center to them. It is from this order that the defendant appeals.

The principal contention urged by the defendant is that he was Wrongfully excluded from the management of the partnership, and therefore, because he would in some way be disadvantaged, the plaintiffs should not be allowed to purchase the partnership assets at a judicial sale. The record, however, does not support the defendant's position on two particulars. While the trial court did find that the defendant was excluded from the management of the partnership, there was no indication that such exclusion was done for the wrongful purpose of obtaining the partnership assets in bad faith rather than being merely the

result of the inability of the partners to harmoniously function in a partnership relationship.

Moreover, the defendant has failed to demonstrate how he was injured by the participation of the plaintiffs in the judicial sale. To the contrary, from all the evidence it appears that if the plaintiffs had not participated, the sales price would have been considerably lower. Absent the plaintiffs' bid, there would have been only two qualified initial bids, which were $2,076,000 and $2,040,000 respectively. However, with the participation of plaintiffs, whose initial bid was $2,100,000, the final sales price was bid to $2,250,000. Thus it appears that defendant's 15% Interest in the partnership was considerably Enhanced by the plaintiffs' participation.

The cases the defendant relies upon to support his contention that the plaintiffs should not have been allowed to bid on the partnership assets all deal with instances where, unlike here, a partner has acted in bad faith, engaged in wrongful or fraudulent conduct, or has attempted to avoid paying an adequate consideration for the minority partner's interest. The defendant characterizes the sale to plaintiffs as a forced sale of his partnership interest. However, defendant was not forced to sell his interest to the plaintiffs. He had the same right to purchase the partnership assets as they did, by submitting the highest bid at the judicial sale. His argument that the plaintiffs were bidding 'paper' dollars due to their 85% Partnership interest is without force. He too could have bid 'paper' dollars to the extent of his 15% Interest. Moreover, the fact that the plaintiffs could bid 'paper' dollars made it possible, as defendant recognizes in his brief, for them to bid higher than outsiders. As a consequence of this ability to enter a higher bid, the value of the defendant's 15% Interest in the sale proceeds increased proportionately.

The defendant has cited no cases, nor has this court found any, which have prohibited a partner from bidding as a judicial sale of the partnership assets. The rights of a partner with respect to the partnership property upon dissolution are contained in A.R.S. s 29--238.

[2] It appears that if the defendant has suffered any legal injury as a result of his exclusion from the partnership affairs, then under the facts of this case his remedy would be pursuant to A.R.S. s 29--238, subsec. B, par. 1(b), Supra, rather than attacking the plaintiffs' participation in the judicial sale. It must be emphasized that on this appeal the defendant does not attack the fact that the trial court ordered a sale of the assets. The only area of attack is that plaintiffs have been allowed to participate and bid in that sale.

[3] The defendant makes one final contention which we must consider. He alleges that a statement made by plaintiff's attorney during the course of the bidding had a 'chilling effect' on the sale, thus rendering it invalid. See Ex Parte Keller, 185 S.C. 283, 194 S.E. 15 (1937). Counsel's statement was as follows:

> 'We will close it right now. Bid number two on behalf of the plaintiffs, $2,175,000. Come on, you fellows come up with your cash. We're prepared to go to three.' (Emphasis added).

Ten bids were thereafter entered, including one almost immediately following the above statement. This, coupled with the fact that the trial judge, who was in the best position to assess the impact of the remark, indicated that he did not feel it was intimidating, leads us to believe that there is no merit in defendant's contention. The remark was not one which tended to stifle or suppress free competition or bidding as in Ex Parte Keller, Supra.

[4][5] In view of all the circumstances of the sale it is our opinion that it was properly conducted and that the trial judge acted within his discretion in confirming it. The method of conducting and the confirmation of a judicial sale lie within the sound discretion of the court ordering the sale. The general policy of the law is to sustain judicial sales where there has been no injustice.

The judgment of the superior court is affirmed.

Discussion points for Monin v. Monin

Did Sonny really breach his fiduciary duties to his partner/brother? What should he have done to make this a less costly trip to the judicial altar?

Charles MONIN, Individually and as a Partner in Monin Bros., Appellant,
v.
Joseph E. MONIN, Individually and as a Partner in Monin Bros., and Sonny Monin, Inc., Appellees.

Court of Appeals of Kentucky.

Oct. 13, 1989.

McDONALD, Judge.

This is a partnership case. The parties, Charles Monin and Joseph Monin (a/k/a Sonny), are brothers who formed a partnership in 1967 for the purpose of hauling milk. In 1984 the relationship between Charles and Sonny deteriorated such that Sonny no longer desired to continue the partnership. Some efforts were made to resolve their affairs, to no avail. In July, 1984, Sonny notified Charles of his intention to dissolve the partnership, and the next day wrote to Dairymen Incorporated (DI) to notify them that he was canceling the partnership's contract with DI effective October 16, 1984, the annual renewal date of the hauling contract. Sonny also informed DI he wanted to apply for the right to haul milk for DI after the expiration of the partnership's contract. On September 24, 1984, Charles and Sonny executed an agreement to resolve their business arrangement. The document entitled "Partnership Sales Agreement" provided that they would hold a private auction between

themselves for all the assets of the partnership "including equipment, and milk routes." As the contract with DI required approval of any sale or transfer of the milk hauling agreement, the sales agreement provided that such approval from DI would be sought and the sales agreement would be "null and void" if approval from DI was not forthcoming. The agreement also contained a covenant not to compete. Charles was the successful bidder at the auction, having bid $86,000.

On the same day as the auction, September 27, 1984, DI called a producers meeting at which time those present voted not to approve Charles as their hauler. Instead they voted to have Sonny haul their milk. Sonny accepted the offer and has since hauled milk for DI as Sonny Monin, Inc. As a result Sonny ended up with the major asset of the partnership, the milk hauling contract, at no cost to him.

On February 11, 1985, Charles commenced this action in the Nelson Circuit Court alleging that Sonny violated his fiduciary duty to the partnership and that he had tortiously interfered with the partnership's contractual relations with clients and customers. A bench trial was conducted in December, 1986. In its judgment for Sonny the trial court reasoned as follows:

> When Charles was the high bidder at $86,000.00, the value of the partnership assets, including milk routes, was established as far as Charles was concerned. Sonny had no further say in establishing a value for such assets. When the producers and D.I. rejected Charles as a milk hauler, the value of the partnership assets became adjusted from $86,000.00 to $22,000.00 (the value of the milk hauling equipment).
>
> When the producers voted for Sonny to haul their milk, they were not voting on a partnership matter. They were voting on Sonny's individual application. Furthermore, they were privileged to vote for some third person to haul their milk.
>
> In summary, the affairs of the Monin Brothers partnership were finally settled on September 27, 1984. As a result of the actions of that date, the assets of the partnership were finally valued at $22,000.00. When Charles was rejected as the D.I.'s milk hauler on that date, the partnership had no interest in the milk routes and neither partner had any claim to same as part of their partnership interests.

[1] We conclude the trial court's reasoning is flawed in that it ignores Sonny's duties to the partnership with respect to the most valuable asset of that entity, the milk hauling contract. As stated in Van Hooser v. Keenon, Ky., 271 S.W.2d 270, 273 (1954), "[T]here is no relation of trust or confidence known to the law that requires of the parties a higher degree of good faith than that of a partnership. Nothing less than absolute fairness will suffice." (emphasis added.) Importantly, that decision holds that a partner's fiduciary duties extend beyond the partnership "to persons who have dissolved partnership, and have not completely wound up and settled the partnership affairs." Sonny's continuing duty was especially applicable here as he agreed to sell his interest to Charles so Charles could continue the partnership business. Nothing in the Uniform Partnership Act (KRS Chapter 362) changes the high degree of good faith partners must maintain in their relations with one another.

[2] Thus, when Sonny failed to withdraw his application with D.I. for the milk routes after agreeing to allow Charles to buy his interest in those routes and continue the partnership business, Sonny obviously breached his duties to the partnership. As the court found, the value of the partnership assets dropped from $86,000 to $22,000 when Sonny was awarded the contract by D.I. While it is possible D.I. would not have awarded the contract to Charles even if Sonny had withdrawn his name from contention, there is no evidence that any other person or entity was available or willing to take over the route. The law is clear that one partner cannot benefit at the expense of the partnership. Van Hooser, supra. Sonny, by agreeing to sell his share of the assets to Charles and by actively pursuing those same assets from D.I., positioned himself such that whatever D.I. did, he could not lose. Understandably, Charles believes he was abused by the obvious conflict of interest. Thus, the trial court's dismissal of Charles's breach of fiduciary duty claim is reversed and remanded for entry of judgment in favor of Charles. We do not believe a new trial on damages is required; nor do we believe Charles is entitled to an accounting from Sonny for profits made since 1984. The value of the asset at issue was determined by the parties at or very near the time of Sonny's breach of duty to the partnership ($86,000 minus $22,000, or $64,000), and that should form the measure of damages to which Charles is entitled.

[3] Finally, the trial court's findings concerning the tortious interference with contractual relations are supported by substantial evidence and will not be disturbed. CR 52.01. The evidence of Sonny's behind-the-back efforts to convince producers not to work with or accept Charles as their hauler was conflicting, and the trial court, as fact finder, could believe Sonny's version of the facts on that claim.

Accordingly, the judgment of the Nelson Circuit Court is reversed and remanded for entry of a new judgment consistent with this opinion.

Discussion points for Johnson v. Kennedy

So much for the fiduciary duties partners owe other partners. But, aside from being an unsavory character with whom you would not want to go into business, is Kennedy guilty of any breaches of fiduciary duties?

Roger C. JOHNSON et al.
v.
Donald C. KENNEDY et al.

Supreme Judicial Court of Massachusetts, Plymouth.

Decided Feb. 14, 1966.

KIRK, Justice.

In this bill in equity for an accounting and for damages consequent upon the dissolution of a partnership, formed by oral agreement, all of the issues presented for determination are effectively raised by the plaintiffs' appeal from the final decree. The issues involved are, first, whether the dissolution was lawful or wrongful, and second, whether an appropriate method of accounting was employed in distributing the firm's assets. The facts underlying these issues appear in the initial and supplementary reports of the master.

In his initial report the master found the following facts. In April, 1961, the plaintiffs Johnson and Walker joined with the defendant Donald C. Kennedy (Kennedy) in forming an insurance agency partnership to be known as the Triangle Insurance Agency (Triangle). The arrangement was oral. There was no agreement as to how long the partnership would continue. It was agreed that each would have a one-third interest in the partnership. The place of business was in Rockland where the partners rented and modestly furnished an office adjacent to another insurance agency operated by Johnson's mother-in- law, who answered the daytime telephone calls to Triangle. In the evening the men serviced the accounts and telephone calls. Triangle's business certificate was signed by and named Kennedy only, and the bank accounts were opened in his name. Originally the partners were to work part time for the agency. Each brought in some business. In April, 1962, Kennedy began to devote full time to the business. Johnson and Walker continued to work part time. Kennedy's wife assisted the firm by doing clerical work, and, from September, 1963, received $25 a week. When Kennedy went to work full time, it was agreed that he would receive $100 a week when the business could afford the salary. It is unclear when the firm began paying Kennedy, but it appears that it was at least from the summer of 1962.

In August 1963, the partners retained counsel to prepare a written partnership agreement. By December 7, 1963, the agreement was drawn. It provided that the partnership was to last for twenty-five years from January 1, 1964. The three partners were to meet, discuss and sign the agreement on December 16, 1963.

Meanwhile, early in December, 1963, Kennedy secretly consulted an attorney about owning the business himself, and, without consulting Johnson and Walker, arranged that the Triangle bank accounts be held jointly with his wife. In November, Kennedy drew more than twice his salary from the agency. This caused some dispute among the partners, and Johnson took the agency's books to his home for review. On December 13, Kennedy transferred the agency funds to two Boston banks, concealing their location from the other partners, opening one account in his wife's name alone, and the other in the name of Triangle with his wife having the right to withdraw. On the night of December 14, 1963, Kinnedy secretly removed all books, records and furniture from the office to another office a block away where he opened for business under the Triangle name. On December 17, Johnson and Walker brought this bill, claiming wrongful dissolution and a right to damages. Kennedy denied, inter alia, that the dissolution was wrongful or that damages were due. By way of

counterclaim, he sought alleged unpaid compensation for his work and also contribution pursuant to an alleged agreement by the plaintiffs to pay his costs in defending an action against him which was commenced before but tried after the partnership was formed.

In his initial report, the master found that there had been a rapid and substantial growth in Triangle's business, that total receipts for 1962 were $30,484.94 and for 1963 were $57,777.62. He found that Kennedy took $1,600 more than he was entitled to in 1963. He further found that, in light of local conditions, low operating costs, and a low business loss ratio, the fair market value of the firm was $25,000. He stated that there was insufficient evidence to make an accounting.

On these subsidiary facts, the master concluded generally that the dissolution of the firm caused by Kennedy's actions was wrongful, and that damages should be assessed against Kennedy in the amount of $8,333.33 in favor of each plaintiff, that amount being one third of what the master found to be the firm's fair market value, namely, $25,000.

The defendants Kennedy objected to various parts of the report, and specifically asked that the case be recommitted for an accounting. The case was recommitted for that purpose.

The supplemental report set out the debits and credits of the agency for 1962 and 1963. The gross profit for 1962 was $5,338.53, and $7,842.96 for 1963. On the basis of the 1963 profit, the master computed the fair market value of the agency at $25,000, the same estimate made in the initial report. He cross- checked the estimate by capitalizing the increase in gross profits from 1962 to 1963, $2,504.43, at ten per cent, arriving at the same estimate of approximately $25,000. On this basis, the master found that Johnson was entitled to the net sum of $9,663.48 and Walker to $9,313.48. The excess over $8,333.33 (one third of $25,000) in each case ($1,330.15 as to Johnson and $980.15 as to Walker) was accounted for by adjustments because of overdrawings by Kennedy and items received by Kennedy for the partnership and not accounted for, and by the apportionment of the value of the office furniture and equipment and sundry items, all subject to a deduction of one half of Kennedy's original capital contribution to the firm.

The master found that there was no agreement whereby Johnson and Walker undertook to share the cost of the defense of the action referred to in Kinnedy's counterclaim.

He made the additional finding that since April 30, 1964, Kennedy has done business under the name of D.C. Kennedy Insurance Agency. Walker and Johnson are still in the insurance business. All three now have customers who formerly did business with the partnership. None of the partners now uses the name Triangle.

The case came before another judge for hearing on the two reports of the master. Kennedy moved to expunge both the finding that the dissolution was wrongful and the assessment of damages. The plaintiffs moved to confirm the reports. An interlocutory decree was entered expunging the finding of wrongful dissolution and the assessment of damages and confirming the reports as thus modified. The final decree adjudged that the dissolution was

not wrongful and that the plaintiffs were not entitled to damages for breach of the agreement. Kennedy was ordered to pay Johnson $1,330.15 and to pay Walker $980.15. Johnson and Walker were ordered to convey all of their interest in the physical property of the partnership to Kennedy. The bill was dismissed as to the defendants Rockland Trust Company and Rockland Credit Union.

[1][2][3][4] We consider the final decree. There was no error in the rulings that the dissolution of the partnership was not wrongful and that the plaintiffs were not entitled to damages for breach of the agreement. Inasmuch as the oral agreement did not specify the life of the agency, the partnership was at the will of the partners. As G.L. c. 108A, § 31, provides, 'Dissolution is caused: (1) Without violation of the agreement between the partners * * * (b) By the express will of any partner when no definite term or particular undertaking is specified.' Thus, in a partnership of indefinite duration, any partner may lawfully dissolve the firm at any time. The unexecuted agreement specifying a duration of twenty-five years did not affect the nature of the existing partnership. Because the firm was a partnership at will, Kennedy's termination of it, however unseemly in manner and method, was not a legal wrong. G.L. c. 108A, § 38(1). When, as here, the dissolution was not wrongful, the partners are entitled to an equal share of the firm's assets. The master accounted for these assets. However, the master made a finding that the business at the time of dissolution had a fair market value of $25,000. We perceive no demonstrable basis on the record for this figure other than the wholly irrelevant considerations affecting the value of the partnership as a continuing enterprise, which it was not to be.

[5] Our conclusion is that the final decree entered by the judge was correct in all particulars but two. It should have disposed of the defendant's counterclaim. In view of the master's adverse finding on that issue the decree should be modified by dismissing the counterclaim. It should also be modified by dismissing the bill as to the defendant Marjorie Kennedy. As thus modified it is affirmed.

So ordered.

Dreifuerst v. Dreifuerst

Court of Appeals of Wisconsin.

Cletus **DREIFUERST** and Roy Dreifuerst, Plaintiffs-Respondents,
v.
Claude **DREIFUERST**, Defendant-Appellant.

Opinion Filed May 25, 1979.

BROWN, Presiding Judge.

The plaintiffs and the defendant, all brothers, formed a partnership. The partnership operated two feed mills, one located at St. Cloud, Wisconsin and one located at Elkhart Lake, Wisconsin. There were no written Articles of Partnership governing this partnership.

On October 4, 1975, the plaintiffs served the defendant with a notice of dissolution and wind-up of the partnership. The action for dissolution and wind-up was commenced on January 27, 1976. The dissolution complaint alleged that the plaintiffs elected to dissolve the partnership. There was no allegation of fault, expulsion or contravention of an alleged agreement as grounds for dissolution. The parties were unable, however, to agree to a winding-up of the partnership.

Hearings on the dissolution were held on October 18, 1976 and March 4, 1977. Testimony was presented regarding the value of the partnership assets and each partner's equity. At the March 4, 1977 hearing, the defendant requested that the partnership be sold pursuant to sec. 178.33(1), Stats., and that the court allow a sale, at which time the partners would bid on the entire property. By such sale, the plaintiffs could continue to run the business under a new partnership, and the defendant's partnership equity could be satisfied in cash.

On February 20, 1978, the trial court, by written decision, denied the defendant's request for a sale and instead divided the partnership assets in- kind according to the valuation presented by the plaintiffs. The plaintiffs were given the physical assets from the Elkhart Lake mill, and the defendant was given the physical assets from the St. Cloud mill. The defendant appeals this order and judgment dividing the assets in-kind.

[1] Under sec. 178.25(1), Stats.,[FN1] a partnership is dissolved when any partner ceases to be associated in the carrying on of the business. The partnership is not terminated, but continues, until the winding-up of partnership is complete. Sec. 178.25(2), Stats.[FN2] The action started by the plaintiffs, in this case, was an action for dissolution and wind-up. The plaintiffs were not continuing the partnership and, therefore, secs. 178.36 and 178.37, Stats.,[FN3] do not apply. The sole question in this case is whether, in the absence of a written agreement to the contrary, a partner, upon dissolution and wind-up of the partnership, can force a sale of the partnership assets.

At the outset, we note, and the parties agree, that the appellant was not in contravention of the partnership agreement since there was no partnership agreement. The partnership was a partnership at will. They also agree there was no written agreement governing distribution of partnership assets upon dissolution and wind-up. The dispute, in this case, is over the authority of the trial court to order in-kind distribution in the absence of any agreement of the partners.

Section 178.33(1), Stats., provides:

> When dissolution is caused in any way, except in contravention of the partnership agreement, each partner, as against his copartners and all persons claiming through them in respect to their interests in the partnership, Unless otherwise agreed, may have the

partnership property applied to discharge its liabilities, and the surplus applied to pay In cash the net amount owing to the respective partners. (Emphasis supplied.)

The appellant contends this statute grants him the right to force a sale of the partnership assets in order to obtain his fair share of the partnership assets in cash upon dissolution. He claims that in the absence of an agreement of the partners to in-kind distribution, the trial court had no authority to distribute the assets in-kind. He is entitled to an in-cash settlement after judicial sale.

The respondents contend the statute does not entitle the appellant to force a sale and grants the trial court the power to distribute the assets in-kind if in-kind distribution is equitably possible and doesn't jeopardize the rights of creditors.

We do not believe that the statute can be read in any way to permit in-kind distribution unless the partners agree to in-kind distribution or unless there is a partnership agreement calling for in-kind distribution at the time of dissolution and wind-up.

[2] A partnership at will is a partnership which has no definite term or particular undertaking and can rightfully be dissolved by the express will of any partner. In the present case, the respondents wanted to dissolve the partnership. This being a partnership at will, they could rightfully dissolve this partnership with or without the consent of the appellant. In addition, the respondents have never claimed the appellant was in violation of any partnership agreement. Therefore, neither the appellant nor the respondents have wrongfully dissolved the partnership.

[3][4] Unless otherwise agreed, partners who have not wrongfully dissolved a partnership have a right to wind up the partnership. Sec. 178.32, Stats. Winding-up is the process of settling partnership affairs after dissolution. Winding-up is often called liquidation and involves reducing the assets to cash to pay creditors and distribute to partners the value of their respective interests. Thus, lawful dissolution (or dissolution which is caused in any way except in contravention of the partnership agreement) gives each partner the right to have the business liquidated and his share of the surplus paid In cash. In-kind distribution is permissible only in very limited circumstances. If the partnership agreement permits in-kind distribution upon dissolution or wind-up or if, at any time prior to wind-up, all partners agree to in-kind distribution, the court may order in-kind distribution.

That is not the case here. There was no showing that there were no creditors who would be paid from the proceeds, nor was there a showing that no one other than the partners would be interested in the assets. These factors are important if an in-kind distribution is to be allowed. Section 178.33(1) and s 38 of the Uniform Partnership Act are intended to protect creditors as well as partners. In-kind distributions may affect a creditor's right to collect the debt owed since the assets of the partnership, as a whole, may be worth more than the assets once divided up. Thus, the creditor's ability to collect from the individual partners may be jeopardized. Secondly, if others are interested in the assets, a sale provides a more accurate means of establishing the market value of the assets and, thus, better assuring each partner

his share in the value of the assets. Where only the partners are interested in the assets, a fair value can be determined without the necessity of a sale. The sale would be merely the partners bidding with each other without any competition. This process could be accomplished through negotiations or at trial with the court as a final arbitrator of the value of the assets.

However, even assuming the respondents in this case can show that there are no creditors to be paid, no one other than the partners are interested in the assets, and in-kind distribution would be fair to all partners, we cannot read s 38 of the Uniform Partnership Act or sec. 178.33(1), Stats. (the Wisconsin equivalent), as permitting an in-kind distribution under any circumstances, unless all partners agree. The statute and s 38 of the Uniform Partnership Act are quite clear that if a partner may force liquidation, he is entitled to his share of the partnership assets, after creditors are paid In cash. To the extent that Rinke v. Rinke, supra, creates an exception to cash distribution, we decline to adopt that exception. We, therefore, must hold the trial court erred in ordering an in-kind distribution of the assets of the partnership.

[5] The last question that arises is whether the appellant can force an actual sale of the assets or whether the trial court can determine the fair market value of the assets and order the respondents to pay the appellant in cash an amount equal to his share in the assets.

As discussed above, a sale is the best means of determining the true fair market value of the assets. Generally, liquidation envisions some form of sale. Since the statutes provide that, unless otherwise agreed, any partner who has not wrongfully dissolved the partnership has the right to wind up the partnership and force liquidation, he likewise has a right to force a sale, unless otherwise agreed. While judicial sales in some instances may cause economic hardships, these hardships can be avoided by the use of partnership agreements.

Judgment reversed and cause remanded for further proceedings not inconsistent with this opinion.

8182 Maryland Associates v. Sheehan

Supreme Court of Missouri,
En Banc.

8182 MARYLAND ASSOCIATES, LIMITED PARTNERSHIP, Appellant,
v.
Kathryn SHEEHAN, Administratrix for The Estate of Richard Sheehan, et al., Respondents.

March 7, 2000.

WILLIAM RAY PRICE, Jr., Chief Justice.

I.
Summary of Opinion

This case concerns the personal liability of withdrawing and incoming partners to a law firm under a long-term lease. Central to the resolution of the case is the principle that when a partner withdraws or when a new partner is admitted, the existing partnership dissolves and a new partnership is created. Although debts of the dissolved partnership may become debts of the new partnership, they remain the personal obligations of the old partnership's partners. The new partners of the newly created partnership are not personally liable for those debts.

A lease of real property involves liability that arises out of both privity of contract and privity of estate. In this case, Defendant Sheehan was a partner of Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz that entered into the lease agreement with 8182 Maryland Associates ("8182 Maryland"). Even though Sheehan withdrew from the firm, causing its dissolution, he remains personally liable on the lease by privity of contract unless an agreement to the contrary or some other defense is established. It was error for the trial court to grant him summary judgment.

At the various times Defendants Noelker, Burdette, Lageson, and Klar were admitted as partners to Popkin & Stern, new partnerships were created. These partnerships, and their respective partners, however, were not bound by privity of contract to 8182 Maryland because neither the partners nor any of the partnerships of which they were members signed the lease or expressly assumed the lease obligations. Although the new firms and their partners were presumed assignees of the lease and liable by privity of estate to 8182 Maryland, this liability was limited to the time period of their occupation of the premises. No amount was established as due for the time period these individuals were members of a partnership in possession of the premises. The trial court correctly granted them summary judgment.

II.
Facts

On April 5, 1984, the Missouri general partnership of Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz, a law firm, entered into a lease agreement with 8182 Maryland. Defendant Richard J. Sheehan, a general partner of Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz, signed the lease along with the other thirteen general partners. This lease was for the use of two floors and space in the parking garage of an office building that had yet to be constructed. The term of the lease was 120 months and commenced on the date the space was made "ready for occupancy" by 8182 Maryland. Rent was to be paid on the first day of each month. The lease was silent as to liability for incoming or withdrawing partners from Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz. The lease did, however,

contain a clause requiring the written consent of the landlord for assignment of the lease.

In October of 1985, Sheehan withdrew from the partnership. On December 31, 1985, Sheehan assigned his interest in the partnership to the remaining partners. Neither this document nor the partnership agreement was made a part of the record on appeal. In January of 1986, Sheehan's resignation became effective and the partnership formally adopted the shorter name of "Popkin & Stern." Apparently, the lease with 8182 Maryland was not expressly assigned in writing by the old partnership of Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz to the new partnership of Popkin & Stern, nor did Popkin & Stern assume the obligations of the lease in writing. On or before April 26, 1986, Popkin & Stern began occupancy of the leased premises.

At varying points between January 1, 1985, and January 1, 1986, Defendants Timothy Noelker, Douglas Burdette, Barbara Lageson, and Jeffrey Klar became partners of Popkin & Stern. There is no evidence in the record that any partnership agreement signed by these partners contained language concerning personal liability on the lease for incoming partners. None were asked to sign the lease agreement or any assumption agreement. It does not appear that the lease agreement was ever expressly assigned in writing to any of the new partnerships that resulted from the changing composition of the firm, or that any of these new partnerships assumed the obligation of the lease in writing. Noelker, Burdette, Lageson, and Klar all withdrew from the firm on or before December 1, 1989. None entered into a withdrawal agreement with any Popkin & Stern partnership or 8182 Maryland.

In September of 1991, Popkin & Stern defaulted on its lease obligation to 8182 Maryland and subsequently filed for bankruptcy in 1992. The third amended petition in this case, filed on January 13, 1993, alleged that 8182 Maryland suffered damages in the amount of $865,488.53 for past-due rent and the partnership's pro rata share of the building's operating expenses and parking garage expenses and $4,891,975.91 for the "present value of the Premises for the remainder of the stated term over the reasonable value of the Premises for the remainder of the stated term," a remedy the lease expressly allowed to the landlord upon the partnership's default. 8182 Maryland named as defendants all past and present general partners of the firm since April 4, 1984, but has dismissed thirty-six of those defendants.

Noelker and Klar filed partial motions for summary judgment seeking to limit any recovery of damages to partnership assets, not their individual assets. The trial court entered an order of partial summary judgment in favor of Noelker on January 22, 1993, and in favor of Klar on February 10, 1993. Later, Sheehan, Noelker, Klar, Burdette, and Harris filed separate motions for summary judgment requesting the circuit court dismiss, in all respects, the third amended petition against each of them. In separate orders, the trial court granted these motions in favor of all defendants. It is from the granting of these motions that 8182 Maryland appeals.

On February 20, 1998, the trial court found there was no reason for delay of plaintiff's

appeal and certified its judgment as final under Rule 74.01(b).

III.
Missouri Partnership Law

Partnership law in Missouri is governed by the Uniform Partnership Law (UPL). Sections 358.010 to 358.430, RSMo 1994. The UPL is nearly identical to the Uniform Partnership Act (UPA), adopted in most states. The UPL "shall be so interpreted and construed as to effect its general purpose to make uniform the law of those states which enact it."

[1][2] Central to the determination of personal liability for Defendant Sheehan and Defendants Noelker, Burdette, Lageson, and Klar is the legal effect the withdrawal of existing partners and the addition of incoming partners has on a partnership. The withdrawal of an existing partner dissolves the partnership. "The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business." Section 358.290; *see also Warren v. Warren,* 784 S.W.2d 247, 256 (Mo.App.1989). Dissolution, however, is not a termination of the partnership business. "On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed." A partner's personal liability is not discharged merely by the dissolution of the partnership. Section 358.360.1. However, a partner may be "discharged from any existing liability upon dissolution of the partnership by an agreement to that effect between himself, the partnership creditor and the person or partnership continuing the business." Section 358.360.2. Under certain circumstances, such an agreement may even be inferred. *Id.*

The remaining partners may choose not to terminate and wind up, but to continue the partnership business. "The Uniform Partnership Law contemplates that dissolved partnerships may continue in business for a short, long or indefinite period of time, ... so long as none of the partners insist on a winding up and final termination of the partnership business." The result is that the old firm continues until its affairs are wound up and a new partnership is formed, consisting of the remaining members of the old partnership. Any creditors of the old partnership also become creditors of the new partnership continuing the business.

The UPL does not expressly make the admission of a new partner a ground for dissolution. However, "[i]t is universally admitted that any change in membership dissolves a partnership, and creates a new partnership."

> A partnership is a contractual and fiduciary relation, dependent on the personality of its members, and the withdrawal or admission of a member changes so radically the contractual rights and duties inter se as to produce essentially a new relation, even though the parties contemplate no actual dissolution of the firm and continue to carry on business under the original articles and with the same account books.

59A Am.Jur.2d *Partnerships* section 826 n. 37

[6] Moreover, "it is generally accepted that since the Uniform Act only incorporated in part the common law on dissolutions, other means of dissolution known to the common law are not precluded by the Act." Under Missouri common law, a partnership is dissolved by the admission of a new partner.

IV.
The Claim Against Sheehan

[7] Defendant Sheehan was a partner who personally signed the lease, but withdrew from the partnership of Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz before the leas
e agreement commenced or was breached by Popkin & Stern. There is no doubt Sheehan was personally liable for the lease while still a partner at Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz. "Every partner is an agent of the partnership for the purpose of its business, and the act of every partner ... binds the partnership...." Section 358.090.1. "All partners are liable [j]ointly and severally for ... all ... debts and obligations of the partnership." Section 358.150. When Sheehan and the other general partners of Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz signed the lease agreement with 8182 Maryland, each partner of the partnership became personally liable on the agreement.

A.

Sheehan first claims his withdrawal from the partnership terminated his personal liability because his withdrawal became effective before the lease agreement "commenced." We do not agree. A party becomes liable on a contractual agreement, even a lease agreement with a future date of commencement, at the moment it is executed. Thus, occupation, even if it is the triggering event for "commencement" of the lease, is not necessary under privity of contract for liability to attach. Commencement, under the terms of this lease, was merely the starting point for the collection of rent and the possibility of occupancy, not the beginning of contractual liability. Once Sheehan signed the lease agreement, he became jointly and severally liable for all existing and future obligations under that lease.

B.

Sheehan also claims his liability terminated at withdrawal because he withdrew before any breach of the lease occurred. We again disagree. When Sheehan withdrew from Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz, the partnership was dissolved, and the new partnership of Popkin & Stern resulted among the remaining partners. Section 358.290; 358.300. Dissolution, however, "of the partnership does not of itself discharge the existing liability of any partner." Liability for partnership obligations does not die simply by disassociating oneself from the partnership business.

[13] Moreover, withdrawing partners retain personal liability after withdrawal, even for contingent obligations. In *Thompson,* two partners of a law partnership that contracted with Thompson for representation in a wrongful death action, subsequently withdrew. The remaining partners failed to file Thompson's claim before the statute of limitations ran. The

court expressly held the two partners who had withdrawn liable for the contingent obligation assumed by the law firm before they left. *Thompson by Thompson v. Gilmore,* 888 S.W.2d at 716.

V.

The Claims Against Noelker, Burdette, Langeson and Klar

Defendants Noelker, Burdette, Lageson, and Klar became partners of Popkin & Stern at various times subsequent to the lease agreement, but all left the partnership before the breach occurred. Defendants rely exclusively on section 358.170 for the proposition that their liability can only be satisfied out of partnership assets.

Section 358.170 states: "A person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, except that this liability shall be satisfied only out of partnership property." Defendants argue that because the lease was a pre-existing obligation of the previous partnership, which they never signed, they cannot be held individually liable for the lease obligations.

A.

[15] We have not had occasion to interpret section 358.170. Several other states, however, have adopted identical language in their partnership laws and have analyzed the implications of that section in the context of lease agreements.

i.

Generally, these states have approached the issue of liability by focusing upon when the obligation of a lease "arises." The first of these cases is *Barbro Realty Co. v. Newburger,* 53 A.D.2d 34, 385 N.Y.S.2d 68 (1976). There, a landlord let premises to the partnership of Newburger, Loeb & Co. as tenant. Years after the lease was entered into and modified, Rubin and Searles became partners. Several years later, there was a default in the payment of rent. Neither Rubin nor Searles had withdrawn from the partnership before the time of default. Because the partnership was liable on the lease but its assets were insufficient to pay the rent due, the question became whether Rubin and Searles could be held individually liable for the rent amount.

The court, acknowledging New York's version of UPA section 17, began by trying to determine when the "obligation" of a lease becomes "due."

> We find that the obligation to pay rent does not constitute a preexisting debt. The lease agreement may have been executed prior to the entry of the defendants into the partnership, but the rent as a debt arose only when it became due and accordingly the defendants, who were partners at the time of the default, may be held personally liable therefor.

Id. at 70 (citations omitted). Thus, *Barbro* held that because the obligation of a lease does not arise until rent becomes due, those who are partners in a partnership at the time of default

of a lease agreement are personally liable.

59th and Park Associates v. Inselbuch, 68 A.D.2d 838, 414 N.Y.S.2d 537 (1979), further discussed the issue of when the obligations of a lease agreement arise. At issue was the liability of a partner who joined a partnership after a lease agreement had been executed but withdrew from the partnership before any breach of that agreement occurred. The three judge majority opinion noted that "the covenant to pay rent creates no debt until the time stipulated for payment arrives, and that the obligation to pay rent is 'altogether contingent.' " *Id.* at 538 (quoting *In re Ryan's Estate,* 294 N.Y. 85, 60 N.E.2d 817, 821 (1945)). The majority opinion also stated that, "defendants Lamm and Klineman had withdrawn from the partnership before the time stipulated for payment; hence, there was no debt at the time of withdrawal." *Id.* [FN3]

The majority, however, went on to discuss a "surrender" agreement entered into between the landlord and the surviving partnership as a separate reason for finding no liability. The two other judges sitting in the case concurred in two separate opinions based on the surrender agreement.

The final case discussing when the obligation of a lease arises is *Setzer's Steel Systems v. Chenault Development Corporation,* 725 S.W.2d 22 (Ky.App.1987). There, two companies signed a lease and construction agreement and agreed it would commence upon completion of the proposed facility. Thereafter, the lease was assigned to a joint venture of which the defendant was a partner and, on that same date, commenced. Later, the joint venture stopped paying rent and the personal liability of the incoming partner, who joined the partnership only after execution of the lease, was at issue. The court determined that the obligation of a lease is incurred when it is signed, but arises only when rent is due, thus utilizing the same logic of *In re Ryan's Estate* as do *Inselbuch* and *Barbro.*

ii.

The court also found that although the original partnership expressly assumed the lease and was, therefore, liable both under the lease contract and as a tenant, the addition of a new partner caused the first partnership to be dissolved and a new partnership came into being composed of the old members and the new partner. "This second partnership did not expressly assume the obligations of the lease, but it occupied the premises. Whether it was liable contractually on the lease is immaterial; it became liable for rent as a tenant." *Id.* Thus, the members of the new partnership were liable for rent not because of when the obligation of a lease arose, but because they were in occupation of the premises. This liability "arises and binds ... continually *throughout the period of ... occupation.*" *Id.* at 510 (emphasis added).

B.

The analysis set out in *Ellingson* provides the clearest framework for determining the

personal liability of partners relative to a partnership lease consistent with the UPA and Missouri landlord/tenant law. In Missouri, a lease agreement has a dual nature; it is both a conveyance and a contract.

Thus, the original partnership of Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz had privity of contract upon signing the lease agreement. When Sheehan withdrew, however, the original partnership was dissolved and a new one, Popkin & Stern, comprised of the remaining members of the original partnership, was formed. This new partnership continued the partnership business, acquiring the creditors of the old partnership. Although not a party to the lease between Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz and 8182 Maryland, Popkin & Stern occupied the leased premises and paid the rent. Unfortunately, there was no assignment and/or assumption agreement specifically defining the relationship of the old partnership and its partners, the new partnership and its partners, and 8182 Maryland.

"When a party other than a tenant is shown to be in possession of the premises, and paying rent therefor, there is a presumption that the lease has been assigned to him." The lease was, therefore, presumably assigned to the resulting partnership. Over the years, each time an old partner left or a new partner joined the partnership, a similar dissolution occurred, and when the remaining partners joined by any incoming partners continued to occupy the leased premises and pay rent, another assignment of the lease to the resulting partnership was presumed.

Although the lease here contained an anti- assignment clause, such that Popkin, Stern, Heifitz, Lurie, Sheehan, Reby & Chervitz could not assign its interest in the lease without the written consent of 8182 Maryland, a violation of an anti-assignment clause does not terminate the contract unless a lease provision provides otherwise. "In the absence of such a provision, the breach by one of the parties does not ipso facto terminate the agreement. The aggrieved party may terminate the contract or waive the breach and treat the contract as in full force."

Because the lease did not contain a termination provision, and because 8182 Maryland continued to accept rent payments from each successive partnership, the anti-assignment clause in this lease does not defeat the presumption of assignments.

Due to its occupation of the premises and the presumed assignment, Popkin & Stern, and each partnership thereafter, was in privity of estate with 8182 Maryland. "Upon an assignment by the lessee, the privity of estate between the lessee and lessor is destroyed, and a new privity of estate is created between the assignee and the lessor." *Siragusa v. Park,* 913 S.W.2d at 918. Privity of contract, however, was not created by the presumed assignment. "Such assignment does not create privity of contract between the lessor and assignee, even if the lessor assents to the assignment, and accepts the assignee as his tenant."

In addition, there is no corresponding presumption of an assumption of the lease obligations that would be binding once the partnership no longer occupied the premises. Without an

assumption, "the assignee is liable only by virtue of privity of estate, and he can, therefore, relieve himself of all liability by at any time assigning the lease; and he may assign to a man of straw for the purpose of escaping liability."

Privity of estate creates liability only for payment of rent and other covenants running with the land while the tenant is in possession. Thus, each succeeding Popkin & Stern partnership, and each of the partnerships' varying partners, became jointly and severally liable for rent payments only during the period their partnerships were in privity of estate with 8182 Maryland. When each Defendant withdrew from the partnership they were a member of, that partnership ceased to exist and ceased to occupy the land. Its privity of estate ended, and thus the withdrawing partner's personal liability for rent ended as well.

8182 Maryland was left to look to the partnership it contracted with and the subsequent assignees for its claims for future rent. Defendants Noelker, Burdette, Lageson, and Klar are not personally liable for rent arising subsequent to the time they were members of a partnership in occupation of the premises when the lease breach occurred subsequent to their withdrawal. We affirm the judgments entered in their favor.

All concur.

IX. Limited Liability Partnerships; Limited Liability Companies

Discussion points for Bassan v. Investment Exchange

Limited partners in limited partnerships are limited in two ways. First, unlike general partners in a partnership, they enjoy limited liability. If things go really bad, they can only lose their investment in the partnership, as it dwindles down to zero. General partners will lose their houses and cars and gold fillings, because their liability is unlimited. But limited partners pay a price for this limitation on liability. As limited partners, they are forbidden from actively engaging in managing the partnership. In short, their input into partnership affairs is limited. They are nothing more than passive investors, hoping that their investment does well, like small stockholders who own 5 shares of Microsoft.

This case explores the question of how much of a fiduciary duty the general partner owes to the limited partners. Did the general partner really do anything wrong? Are the limited partners getting a windfall? Is this case closer to Meinhard, or Meehan?

Morton E. BASSAN et al., Appellants, M. L. Grout, Plaintiff,
v.

INVESTMENT EXCHANGE CORPORATION, a Washington corporation, and Auburn West
Associates, a Washington limited partnership, Respondents,
James L. Charlton et al., Defendants.

Supreme Court of Washington, En Banc.

June 20, 1974.

Action by limited partners against sole general partner for an accounting and dissolution of partnership. The Superior Court, King County, Charles Z. Smith, J., dismissed the action, and limited partners appealed. The Supreme Court, Utter, J., held that under the partnership articles limited partners could consent to a profit to be realized by general partner on sale of his land to partnership only after the sale, that consent of limited partners could not be implied from their conduct after they were informed of profit, and that general partner was accountable for profit to which limited partners did not give their consent.

Reversed and remanded.

Rosellini, J., filed a dissenting opinion in which Hunter and Hamilton, JJ., concurred.

UTTER, Associate Justice.

The appellants are limited partners in Auburn West Associates, and the respondent Investment Exchange **c**orporation is the sole general partner. This action was brought for an accounting and dissolution upon the theory that the general partner had, in purchasing land and selling it to Auburn West Associates, derived profits without the consent of the limited partners in breach of its fiduciary relationship. The cause was tried to the court which dismissed the action after hearing the evidence.

The controlling issue in this case is whether the partners consented to the profit made by the general partner in the sale of the Murakami property to the partnership. We find an absence of such consent in the record and reverse the trial court.

In 1964 Investment Exchange Corporation, a Washington corporation, formed Auburn West Associates as a limited partnership. The purpose of the partnership as stated in the articles of partnership was

> (to) initially acquire, for investment, improve and hold for lease or resale, a tract of real property. The General Partner presently is the owner of interests in said real property. To additionally acquire from the General Partner such other adjacent and contiguous tracts as, in the sole determination of the General Partner, will enhance the Partnership properties and objectives.

The general partner was given broad discretion in the articles to manage the affairs of the partnership and they acknowledged the right of all partners, including the general partner, to engage in

> and/or possess an interest in other business ventures of every nature, and description, independently or with others, including but not limited to the ownership, financing, leasing, operation, management, syndication, brokerage and/or development of real property; . . .

They also gave the general partner the right to have an interest in or be employed by another business which might deal with the partnership.

The articles provided that the general partner might devote such of its time as in its discretion it deemed necessary to the partnership affairs and business, and that it should be reimbursed by the partnership for all the costs and expenses which it incurred in connection therewith, in addition to its respective share of the profits of the partnership.

The partnership articles provided that 100 units of the partnership, consisting of 40 units as general partner and 60 units as limited partner totaling $100,000, should be given to the general partner as partial payment of the purchase price of the original piece of real property, the purchase price being $593,000. That price was greater than the acquisition cost to the general partner.

Each of the appellants owned one or more limited partnership units. The remaining 29 limited partners did not elect to join in the action.

The general partner annually mailed out a financial statement to the limited partners. These financial statements advised the limited partners of the price the partnership paid for the real estate purchased from the general partner. The limited partners were represented at the partnership council meetings by plaintiff Milton Grout and others.

The last transaction upon which the appellants claimed a right to receive the benefit of the profit made by the general partner was the Murakami property. All claims by the limited partners except that one were held barred by the statute of limitations.

The general partner had formed a real estate subsidiary and informed the limited partnership it intended to utilize this corporation as sales and purchase agent for partnership property. The court found the articles of limited partnership and prospectus had authorized the real estate subsidiary to retain commissions on sales and purchases. This subsidiary received a $24,500 commission from Murakami in the sale of the property in addition to the markup of $167,500 by the general partner.

The court found that in the issuance of the prospectus, the publication of financial statements and in its dealings with the appellant and its conduct of partnership affairs, the general partner made no false or fraudulent representations and did not engage in any improper conduct. It found no breach in its fiduciary obligations to the limited partners inasmuch as the price charged for the Murakami parcel was fair and the amount of profit made by the general

partner was reasonable. There is no substantial dispute regarding the facts in this case and all of the claims prior to the Murakami transaction are barred by the statute of limitations. The validity of this transaction is our only concern in this appeal.

[1] Under the Washington Uniform Limited Partnership Act, the general partner has all the rights and powers, and is subject to all the restrictions and liabilities, of a partner in a partnership without limited partners. RCW 25.08.090. He is therefore accountable to the limited partners as a fiduciary. The Washington Uniform Partnership Act requires every partner to 'account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the . . . conduct . . . of the partnership . . .' RCW 25.04.210(1).

[2] The partnership agreement does not provide consent by the limited partners to the general partner for a profit on the sale of the Murakami property to the partnership. The articles contain no provision setting forth the price to be paid for this property nor any method for determining such a price. Partners may include in the partnership articles practically any agreement they wish and if the asserted self-dealing was actually contemplated and specifically authorized with a method for determining, in advance, the amount of the profit it would not, ipso facto, be impermissible and deemed wrongful. Here, however, the partnership agreement is silent as to any formula to determine the general partner's profit.

The prospectus, from which it could be argued most earlier purchases by the partnership from the general partner were contemplated, does not mention the Murakami piece. It also fails to set forth a formula to determine the general partner's profit in either the anticipated purchases or in any future transactions by the general partner on behalf of the partnership. The articles of limited partnership merely state that five parcels, the Henack, Nelson, Coast No. 2, Belus and Coast No. 1 were to be acquired at a cost of $593,000 from the general partner. The prospectus disclosed that the general partner intended, as well, to acquire the Davis parcel for $50,000 but the articles and prospectus do not specifically describe any other anticipated acquisitions.

Neither the articles nor prospectus disclose the actual amount of the profit to be made by Investment Exchange Corporation in their resale of properties to the Auburn West Associates partnership. The only source of information to the limited partners on the profits by the general partner was an accounting footnote in the 1964 partnership financial statement issued after the limited partners had invested funds in the partnership, indicating that property acquired by Auburn West Associates for $642,342 had previously cost the general partner $459,000.

The only other report indicating the amount of profit to the general partner was found in a prospectus required by the Securities and Exchange Commission. This indicated that from May 1964 through December 1965, prior to the Murakami purchase, Auburn West Associates had acquired eight parcels of property from Investment Exchange Corporation for $749,250 which property had cost Investment Exchange Corporation $488,221.

An investigation of the separate transactions prior to the Murakami purchase showed no consistent percentage of profit taken by the general partner on these transactions. Of those parcels described in the prospectus to be acquired by the general partner, the highest profit received was $67,000 on a piece sold for $182,000 (the Henack parcel). The smallest was a $20,000 profit on a price sold for $180,000 to the partnership (the Belus parcel). Of those properties not described in the prospectus, and purchased subsequent to those described in the prospectus, the highest profit was $80,000 on a piece sold for.$108,750 to the partnership (the Layos parcel) and the lowest was $24,000 on a piece sold to the partnership for $50,000 (the Davis parcel).

[3] The trial court found an understanding did exist that the general partner would acquire property and sell it to the partnership at a fair price and would realize a profit on the transaction. It did not and could not find that a formula existed or was agreed upon explicitly or inferentially that established a basis upon which the exact amount of this profit was to be determined. The limited partners, therefore, could only consent after the fact to whatever profit the general partner determined it should have as to a particular transaction. Because of this, although the limited partners may have consented after the fact to specific profits taken on previous transactions, this could not imply consent to the Murakami transaction because the limited partners could not know what the profit to Investment Exchange Corporation was until after the sale closed.

[4] No consent may be implied from the conduct of the limited partners regarding Murakami after they were informed of the profits. The formal action of Investment Exchange Corporation adopting the $167,500 profit was on November 15, 1969, and suit was brought on November 26, 1969 by appellants.

[5] Where consent is lacking, the general partner is held under RCW 25.04.210, as a trustee, to account to the partnership for any profits derived by it. That standard, by the terms of the statute, is not whether the general partner acted fairly and reasonably, but whether it acted as a fiduciary.

[6] The benefit of this standard is nowhere more apparent than in a limited partnership of this nature. The articles give the general partner the authority to conduct 'any and all of the business of the Partnership . . .' Once the limited partner has joined the partnership he has no effective voice in the decision-making process. He must, then, be able to rely on the highest standard of conduct from the general partner. Any deviation from this must be clearly stated in terms that would give the limited partner the option of deciding whether or not, in the first instance, to join the partnership.

[7] The duty of loyalty resulting from a partner's fiduciary position is such that the severity of a partner's breach will not be questioned. The question is only whether there has been any breach at all. Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928).

This is to be distinguished from questions related to the use of business judgment of a

partner in partnership affairs. Here the degree of care required is one of reasonableness, or in some jurisdictions, of good faith.. This is the standard the trial court apparently applied.

[8] This case does not involve the issue of whether the general partner is entitled to make a profit for use of its expertise. Compensation may be provided for the general partner by specific consent of the parties. There is also no issue about the general partner's right to be reimbursed for its expenses. Article 8, section 2 of the partnership articles provides that the general partner shall be reimbursed for all the costs and expenses it incurs in the devotion of its time to the partnership business.

[9] Investment Exchange Corporation did not act in a fiduciary capacity regarding the profits it obtained in the Murakami transaction. Consent was not given by the appellants as to the profit taken in that transaction and Investment Exchange Corporation should be held accountable to the partnership for the profits it there realized.

[10][11] This will result in the establishment of a common fund for the benefit of the partnership. The expense of legal services, including counsel fees, is a proper charge against the common fund so preserved or protected.

The judgment is reversed and remanded to the trial court to determine counsel fees.

ROSELLINI, Associate Justice (dissenting.)

The majority in this case has overturned the finding of the trial court that it was the understanding and agreement of the parties to the limited partnership agreement that the general partner would buy land and would resell it to the partnership at a reasonable profit to itself. In doing so, it has not made so bold as to assert that there was no substantial evidence to support this finding. The trial court found that this agreement, while not expressed in the articles of limited partnership, was established by the evidence showing the course of dealing between the general partner and the limited partners over a period of years.

The court specifically found that, prior to purchasing their units of limited partnership, each of the appellants was advised and understood that the general partner had sold and would sell property to the partnership and in connection with such sales had made and would make a profit. It found that, prior to purchasing his units, each partner was informed and understood that contiguous properties could and would be purchased and that, in connection with said sales of property by the general partner to the partnership, the general partner would make a profit.

The court also found that in each transaction the markup in price was fair and reasonable and that the transactions were in all respects fair and reasonable to the limited partnership. According to the findings, the general partner exercised its particular skill and knowledge in the purchase of properties and was able to acquire properties at a price lower than the fair market value of the property. Although the properties were transferred to Auburn West Associates for a price in excess of that paid by the general partner, the fair market value of

the properties at the time of transfer with respect to each parcel was in excess of the price charged Auburn West Associates.

The most recent transaction upon which the appellants claimed a right to receive the benefit of the profit made by the general partner involved the acquisition of a tract of land known as the Murakami property. The trial court found that a number of events which occurred subsequent to the acquisition of this land by the general partner, and prior to its sale to the partnership, substantially increased its value. The court found that it was sold to the partnership for a sum which was $138,000 below its fair market value.

The court further found that Auburn West Associates has made and will make a substantial profit on the Murakami property and upon all of the property transferred to the partnership by the general partner. It found that the limited partners have received back nearly all of their initial $10,000 in capital from proceeds of sales and condemnation, all of the debts of the partnership have been paid and there remain approximately 50 acres of property worth approximately $25,000 per acre.

The majority does not pretend that any of these findings is unsupported by the evidence. Rather, it rests its reversal of the trial court upon an implied holding either (1) that partners are not bound under an agreement that the general or managing partner may make a fair and reasonable profit on a transaction with the partnership, unless the agreement spells out the method of determining the amount of such profit, or (2) that the terms of an agreement may not be established by the course of dealing between the parties.

No authority is cited for either proposition and I am convinced that if any such authority exists, it is contrary to the general principles of contract law, and to those which this court has applied in determining the rights and obligations of parties who have entered into contracts of partnership.

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Puleo v. Topel

Appellate Court of Illinois,First District, Fourth Division.

Philip **PULEO et. Al.,** Plaintiffs-Appellants,
v.
Michael **TOPEL**, Individually and d/b/a Thinktank, LLC, and Thinktank, LLC, an Illinois Limited Liability Company in Dissolution, Defendants-Appellees.

Sept. 29, 2006.

Presiding Justice QUINN delivered the opinion of the court:

Plaintiffs Philip Puleo, Malex Corporation, Amy Derksen, Chani Derus, Robert Filiczkowski, YSPEX, Inc., Jacob Lesgold, Van Ratsavongsay, and Bryan Weiss appeal the order of the circuit court dismissing their claims against defendant Michael Topel (Topel). On appeal, plaintiffs contend that the circuit court erred by finding that Topel could not be held personally liable for obligations incurred on behalf of defendant Thinktank, LLC (Thinktank), after the company was involuntary dissolved.

The record shows that effective May 30, 2002, Thinktank, a limited liability company (LLC) primarily involved in web design and web marketing, was involuntarily dissolved by the Illinois Secretary of State. The dissolution was due to Thinktank's failure to file its 2001 annual report as required by the Illinois Limited Liability Company Act (the Act) (805 ILCS 180/35-25(1) (West 2004)).

Thereafter, on December 2, 2002, plaintiffs, independent contractors hired by Topel, filed a complaint against Topel and Thinktank in which they alleged breach of contract, unjust enrichment, and claims under the account stated theory. Those claims stemmed from plaintiffs' contention that Topel, who plaintiffs alleged was the sole manager and owner of Thinktank, knew or should have known of Thinktank's involuntary dissolution, but nonetheless continued to conduct business as Thinktank from May 30, 2002, through the end of August 2002. They further contended that on or about August 30, 2002, Topel informed Thinktank employees and independent contractors, including plaintiffs, that the company was ceasing operations and that their services were no longer needed. Thinktank then failed to pay plaintiffs for work they had performed.

On or about April 4, 2003, Thinktank and Topel served their answer to the complaint on plaintiffs. In response, plaintiffs filed a motion for summary judgment on April 25, 2003. In that motion, plaintiffs argued that the only allegations that Thinktank and Topel denied in their answer pertained to Lesgold. As such, plaintiffs contended that there was no genuine issue of material fact and, thus, they were entitled to judgment as a matter of law. Subsequently, on June 6, 2003, plaintiffs filed a request to admit.

Although neither Thinktank nor Topel filed a response to plaintiffs' motion for summary judgment, they filed a response to plaintiffs' request to admit. Therein, defendants denied that Topel, as sole manager and owner of Thinktank, was in a position to know that Thinktank had been involuntarily dissolved by the Illinois Secretary of State or that the company was operating while dissolved during the period beginning on May 30, 2002.

On September 2, 2003, the circuit granted plaintiffs' motion for judgment on the pleadings against Thinktank. Thereafter, on October 16, 2003, plaintiffs filed a separate motion for summary judgment against Topel.[FN2] Relying on *Gonnella Baking Co. v. Clara's Pasta Di Casa, Ltd.,* 337 Ill.App.3d 385, 272 Ill.Dec. 224, 786 N.E.2d 1058 (2003), plaintiffs contended that Topel, as a principal of Thinktank, an LLC, had a legal status similar to a shareholder or director of a corporation, who courts have found liable for a dissolved corporation's debts. Thus, plaintiffs argued that Topel was personally liable for Thinktank's

debts. Topel did not file a response, and plaintiffs subsequently argued that Topel's failure to respond should be treated as a failure to contest their motion and that judgment should be entered for them.

On March 25, 2004, the circuit court denied plaintiffs' motion for summary judgment against Topel. Subsequently, plaintiffs filed a motion to reconsider on July 1, 2004, which the circuit court denied on August 23, 2004.

Plaintiffs then filed a motion for clarification on September 13, 2004, in order to obtain the circuit court's basis for denying their motion to reconsider. On October 12, 2004, the circuit court granted plaintiffs' motion for clarification. In doing so, the circuit court acknowledged that Topel continued to do business as Thinktank after its dissolution and that the contractual obligations at issue were incurred after the dissolution. However, the court then stated:
" This court bases its decision on its reading of the Illinois Limited Liability Company Act. Specifically, this court reads 805 ILCS 180/10-10 in concert with 805 ILCS 180/35-7 as well as the legislative notes to 805 ILCS 180/10-10 to determine that the Illinois Legislature did not intend to hold a member of a Limited Liability Company liable for debts incurred after the Limited Liability Company had been involuntarily dissolved."

Finally, on January 6, 2005, the circuit court entered a final order dismissing all of plaintiffs' claims against Topel with prejudice. The court stated in pertinent part:" Based upon the Court's prior finding that the Illinois Legislature did not intend to hold a member of a Limited Liability Company liable for debts incurred after the Limited Liability Company had been involuntarily dissolved, the Court finds that all of Plaintiffs' claims against Defendant Topel within the Complaint fail as a matter of law, as they are premised upon Defendant Topel's alleged personal liability for obligations incurred in the name of Thinktank LLC after it had been involuntarily dissolved by the Illinois Secretary of State."

Plaintiffs now appeal that order.

In this court, plaintiffs contend that the circuit court erred in dismissing their claims against Topel. In making that argument, plaintiffs acknowledge that the issue as to whether a member or manager of an LLC may be held personally liable for obligations incurred by an involuntarily dissolved LLC appears to be one of first impression under the Act. That said, plaintiffs assert that it has long been the law in Illinois that an officer or director of a dissolved corporation has no authority to exercise corporate powers and, thus is personally liable for any debts he incurs on behalf of the corporation after its dissolution. Plaintiffs reason that Topel, as managing member of Thinktank, similarly should be held liable for debts the company incurred after its dissolution.

[3] We first look to the provisions of the Act as they provided the trial court its basis for its ruling.

As stated, the circuit court relied on sections 10-10 and 35-7 of the Act in making its ruling. Section 10-10 provides:

“ (a) Except as otherwise provided in subsection (d) of this Section, the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.
(b) (Blank)
(c) The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.
(d) All or specified members of a limited liability company are liable in their capacity as members for all or specified debts, obligations, or liabilities of the company if:
(1) a provision to that effect is contained in the articles of organization; and
(2) a member so liable has consented in writing to the adoption of the provision or to be bound by the provision.” 805 ILCS 180/10-10 (West 2004).

Section 35-7 provides:“ (a) A limited liability company is bound by a member or manager's act after dissolution that:
(1) is appropriate for winding up the company's business; or
(2) would have bound the company under Section 13-5 before dissolution, if the other party to the transaction did not have notice of the dissolution.
(b) A member or manager who, with knowledge of the dissolution, subjects a limited liability company to liability by an act that is not appropriate for winding up the company's business is liable to the company for any damage caused to the company arising from the liability.” 805 ILCS 180/35-7 (West 2004).

[4] Section 10-10 clearly indicates that a member or manager of an LLC is not personally liable for debts the company incurs unless each of the provisions in subsection (d) is met. In this case, plaintiffs cannot establish either of the provisions in subsection (d). They have not provided this court with Thinktank's articles of organization, much less a provision establishing Topel's personal liability, nor have they provided this court with Topel's written adoption of such a provision. As such, under the express language of the Act, plaintiffs cannot establish Topel's personal liability for debts that Thinktank incurred after its dissolution.

As plaintiffs contend, similar to the Business Corporation Act (BCA) (see 805 ILCS 5/12.30 (West 2004)), the Act explicitly provides that an LLC continues after dissolution only for the purpose of winding up its business (805 ILCS 180/35-3 (West 2004)). However, as plaintiffs concede in their brief, the Act does not contain a provision similar to section 3.20 of the Business Corporation Act, which provides:
“ All persons who assume to exercise corporate powers without authority so to do shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof.” 805 ILCS 5/3.20 (West 2004).

Moreover, we observe that section 35-7 of the Act explicitly provides that a member or manager of an LLC who, with knowledge of the dissolution, exceeds the scope of his authority during the wrapping up of a company's business is liable *to the company* for any damages arising from the liability. 805 ILCS 180/35-7(b) (West 2004). The Act, however, contains no language concerning a member or manager's liability to a third party. That silence speaks volumes when viewed in conjunction with the legislature's amendment of the former version of section 10-10.

Prior to its amendment, section 10-10 provided:
" (a) A member of a limited liability company shall be personally liable for any act, debt, obligation, or liability of the limited liability company or another member or manager to the extent that a shareholder of an Illinois business corporation is liable in analogous circumstances under Illinois law.
(b) A manager of a limited liability company shall be personally liable for any act, debt, obligation, or liability of the limited liability company or another manager or member to the extent that a director of an Illinois business corporation is liable in analogous circumstances under Illinois law." 805 ILCS 180/10-10 (West 1996).

[5] In 1998, however, the legislature amended section 10-10 and in doing so removed the above language which explicitly provided that a member or manager of an LLC could be held personally liable for his or her own actions or for the actions of the LLC to the same extent as a shareholder or director of a corporation could be held personally liable. As we have not found any legislative commentary regarding that amendment, we presume that by removing the noted statutory language, the legislature meant to shield a member or manager of an LLC from personal liability. *Drury Displays, Inc.,* 327 Ill.App.3d at 888, 261 Ill.Dec. 875, 764 N.E.2d 166 (" When a statute is amended, it is presumed that the legislature intended to change the law as it formerly existed").

Nonetheless, plaintiffs ask this court to disregard the 1998 amendment and to imply a provision into the Act similar to section 3.20 of the Business Corporation Act. We cannot do so.

This court recently rejected a similar request in *In re Application of County Collector,* 356 Ill.App.3d 668, 673-74, 292 Ill.Dec. 515, 826 N.E.2d 951 (2005). There, petitioner Dream Sites, LLC, purchased property at an annual tax sale as a result of respondent Grace Apostolic Church's delinquent general real estate taxes. Petitioner then filed a petition for issuance of a tax deed and lodged a " Notice of expiration of period of redemption" pursuant to section 22-10 of the Property Tax Code (Code) (35 ILCS 200/22-10 (West 2002)) which provided in pertinent part " [i]n counties with 3,000,000 or more inhabitants, the notice shall also state the address, room number, and time at which the hearing is set." The petition, however, omitted a street address and merely stated that the hearing for issuance of the tax deed would be held in " Room 1704, Richard J. Daley Center in Chicago, Illinois." Respondent filed an objection arguing that the notice was insufficient due to the lack of a street address. The circuit court denied the motion and entered an order granting petitioner's

petition.

On appeal, respondent argued that the circuit court's ruling was against the manifest weight of the evidence because it ignored the plain language of section 22-10 of the Code. Conversely, petitioner argued that despite the language of section 22-10, this court should find that " Daley Center, Chicago, Illinois" was an adequate address for purposes of the petition. This court, however, concluded that by amending section 22-10 to require that a notice provide an address and not merely a building name, the legislature intended a notice to include a street address to denote the physical location of a building. As such, this court reversed the circuit court's ruling and remanded the cause for further proceedings.

[6] In the case at bar, we similarly decline plaintiffs' request to ignore the statutory language. When the legislature amended section 10-10 (805 ILCS 180/10-10 (West 2004)), it clearly removed the provision that allowed a member or manager of an LLC to be held personally liable in the same manner as provided in section 3.20 of the Business Corporation Act. Thus, the Act does not provide for a member or manager's personal liability to a third party for an LLC's debts and liabilities, and no rule of construction authorizes this court to declare that the legislature did not mean what the plain language of the statute imports. *Solich,* 158 Ill.2d at 83, 196 Ill.Dec. 655, 630 N.E.2d 820.

We, therefore, find that the circuit court did not err in concluding that the Act did not permit it to find Topel personally liable to plaintiffs for Thinktank's debts and liabilities. We agree with plaintiff that the circuit court's ruling does not provide an equitable result. However, the circuit court, like this court, was bound by the statutory language.

Accordingly, we affirm the judgment of the circuit court of Cook County.

Harbison v. Strickland

Supreme Court of Alabama.

Suzy Strickland **HARBISON**
v.
Bonnie Sue **STRICKLAND**.

Oct. 22, 2004.

SEE, Justice.

Suzy Strickland Harbison appeals from a summary judgment in favor of the defendant, Bonnie Sue Strickland. We reverse and remand.

I.

Bonnie Sue Strickland is the manager and a 17% equity owner of the Strickland Family Limited Liability Company (“ the LLC”). The LLC was formed by Bonnie Sue Strickland and her now deceased husband, Jake Strickland, on August 4, 2000, as part of their estate plan.[FN1] The LLC was formed under the Alabama Limited Liability Company Act, § 10-12-1 et seq., Ala.Code 1975 (“ ALLCA”).

In accordance with their estate plan, the Stricklands, on December 24, 2000, transferred 83% of the equity shares of the LLC to their daughter Suzy Strickland Harbison. The Stricklands retained a 17% interest in the LLC and acted as comanagers of the LLC for the next two years.

On January 17, 2002, Jake Strickland died. Under the operating agreement for the LLC, Bonnie Sue Strickland became the sole manager of the LLC and retained the 17% equity in the LLC she had held in common with Jake. Harbison retained 83% of the equity shares in the LLC.

On December 24, 2002, Strickland conveyed three parcels of real property belonging to the LLC to her son David Strickland. David is not a member of the LLC. Strickland transferred the parcels of real property for an amount Harbison believes was less than fair market value. Harbison sued Strickland, claiming that Strickland had breached her fiduciary duty to the LLC under the ALLCA and that she had violated the terms of the operating agreement when she failed to make managerial decisions based on the best interests of the LLC and the equity owners.

Strickland moved for a summary judgment. After a hearing, the trial court entered a summary judgment in favor of Strickland, stating in pertinent part:
“ This Court must look to the four corners of the governing document in determining whether the defendant breached her fiduciary duty to the LLC in selling LLC property to her son. In the present case the governing document is the operating agreement of the Strickland Family, LLC. In interpreting the LLC operating agreement this Court finds that Defendant did not breach her fiduciary duty to the LLC when Defendant sold LLC property to David....
“ In interpreting the intent of the operating agreement through a four corners interpretation, this Court finds that the purpose of the LLC operating agreement was for distribution of the assets of the Defendant and Jake Strickland. This Court takes these purposes into account when in [sic] determining fiduciary duty. The Plaintiff applies a fiduciary standard as would be applicable to a for-profit business. However, the operating agreement clearly states that this LLC is not for profit:
“ ‘ The managers do not, in any way guarantee ... a profit for the Equity Owners from the operations of the Company. Decisions with respect to the conduct, dissolution and winding up of the business of the company shall be made in the sole discretion of the Equity Owners and such other matters as the Managers consider relevant. There shall be no obligation on the part of the Managers to maximize financial gain or to make any or all of the Company

Property productive.' *Strickland Family LLC Operating Agreement,* Article VI, Section 6.4.1." [FN3]

FN3. The trial court's order omits significant language from the middle sentence quoted above from the operating agreement. That sentence of Article VI, Section 6.4.1, of the operating agreement reads as follows:
" Decisions with respect to the conduct, dissolution and winding up of the business of the Company shall be made in the sole discretion of *the Managers based on the best interest of the Company, the best interests of* the Equity Owners, and such other matters as the Managers consider relevant."
(Omitted language emphasized.)

The trial court further ruled that because the LLC was ostensibly created for a nonprofit purpose, namely, for the distribution of LLC property to the Stricklands' children, Strickland was free to distribute the real property of the LLC as she saw fit. The trial court stated:
" Plaintiff argues that the property should have been sold at fair market value based on the most recent appraisal. However, in accordance with the operating agreement defendant had authorization to dispose of the property in anyway she saw fit. This included disposing of the property by gift.... Whether Defendant sold the LLC assets for $1.00 or $1,000,000, or decided to give the property away, Defendant had authority to do so in her capacity as manager of the LLC."

II.

Harbison argues that the trial court erred in referring only to the four corners of the document in interpreting the operating agreement. Harbison contends that the ALLCA imposes upon members and managers of limited liability companies fiduciary duties that cannot be eliminated by the adoption of an operating agreement. Thus, Harbison argues, by failing to incorporate the fiduciary duties mandated by the ALLCA into the operating agreement, the trial court has committed reversible error. This is an issue of first impression in this State.

The Legislature has imposed on corporations and partnerships fiduciary duties that cannot be waived.[FN4] We have similarly held that partners are bound by the fiduciary duties provided by statute. *Cox v. F & S,* 489 So.2d 516, 518 (Ala.1986).

FN4. *See* § 10-2B-2.02, Ala.Code 1975, allowing the corporate charter to include a clause limiting the liability of directors, *except* liability for
" (A) the amount of a financial benefit received by a director to which he or she is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of Section 10-2B-8.33; (D) an intentional violation of criminal law; or (E) a breach of the director's duty of loyalty to the corporation or its shareholders."
See also § 10-8A-103, Ala.Code 1975, discussing the effect of the partnership agreement on fiduciary duties:

" (b) The partnership agreement may not:
" ....
" (3) eliminate the duty of loyalty ...
" ....
" (4) unreasonably reduce the duty of care...."

In 1997 the Legislature added subsections (e) through (*l*) to § 10-12-21, Ala.Code 1975, a part of the ALLCA. Those subsections provide that a member owes a duty of loyalty to the LLC.[FN5]

> FN5. " (e) In a limited liability company managed by its members under subsection (a) of Section 10-12-22, the only fiduciary duties a member owes to the company or to its other members are the duty of loyalty and the duty of care imposed by subsections (f) through (g).
> " (f) A member's duty of loyalty to a member-managed limited liability company and its members is limited to each of the following:
> " (1) To account to the limited liability company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the limited liability company's business or derived from a use by the member of the limited liability company's property, including the appropriation of the limited liability company's opportunity.
> " (2) To refrain from dealing with the limited liability company in the conduct or winding up of the limited liability company's business as or on behalf of a party having an interest adverse to the limited liability company.
> " (3) To refrain from competing with the limited liability company in the conduct of the limited liability company's business before the dissolution of the limited liability company.
> " (g) A member's duty of care to a member-managed limited liability company and its other members in the conduct or winding up of the limited liability company's business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law.
> " (h) A member shall discharge the duties to a member-managed company and its other members under this chapter or under the operating agreement and exercise any rights consistently with the obligation of good faith and fair dealing.
> " (i) A member of a member-managed company does not violate a duty or obligation under this chapter or under the operating agreement merely because the member's conduct furthers the member's own interest."

Section 10-12-21, Ala.Code 1975, imposes these same duties on managers,[FN6] plus the following additional burdens:

> FN6. " (k) If the management of a limited liability company is vested in a manager or managers pursuant to subsection (b) of Section 10-12-22, each of the following applies:

> “ (1) The only duty a member who is not also a manager owes to the company or to the other members solely by reason of being a member is to not disclose or otherwise use information described in subsection (b) of Section 10-12-16, whether or not obtained under the authority of subsection (b) of Section 10-12-16, to the detriment of the company or the other members.
> “ (2) A manager is held to the same standards prescribed for members in subsection (f) through (i).
> “ (3) A member who pursuant to the operating agreement exercises some or all of the rights of a manager in the management and conduct of the company's business is held to the standards of conduct in subsections (f) through (i) to the extent that the member exercises the managerial authority vested in a manager by this chapter.
> “ (4) A manager is relieved of liability by law for violation of the standards prescribed by subsections (f) through (i) to the extent of the managerial authority delegated by the operating agreement.”

“ (*l*) The articles of organization or operating agreement may modify the duties contained in subsections (e) through (k) but may not provide for the following:
“ (1) Unreasonably restrict a right to information or access to records under Section 10-12-16;
“ (2) Eliminate the duty of loyalty under subsection (f) or subsection (e) of 10-12-36 ...;
“ (3) Unreasonably reduce the duty of care under subsection (g) or subsection (e) of Section 10-12-36;
“ (4) Eliminate the obligation of good faith and fair dealing under subsection (h), but the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.”

Thus, the plain language of § 10-12-21(*l*), Ala.Code 1975, does not allow an operating agreement for a limited liability company to unreasonably restrict a member's right to information, to eliminate a manager's duty of loyalty, or to unreasonably reduce the duty of care as defined in § 10-12-36, Ala.Code 1975.[FN7] We hold that operating agreements of limited liability companies, like those of corporations and limited partnerships, incorporate the provisions of the statutes that allow for the creation of such agreements. Thus, the trial court erred in failing to look past the “ four corners” of the document to determine Strickland's fiduciary obligations, if any, to the LLC and its members. On remand the trial court is to determine whether Strickland breached the fiduciary duties imposed on her by the ALLCA.

III.

Harbison also argues that the trial court erroneously concluded that it was within Strickland's authority under the operating agreement to “ dispose of the [LLC] property in any way she saw fit,” because the LLC is “ not for profit.” The trial court's interpretation of the operating agreement depends on its finding that the purpose of the LLC was to distribute the Stricklands' assets. The trial court apparently relied on Strickland's testimony that, regardless of what the operating agreement actually provided, her “ intent was to give their two children

David Strickland ... and the Plaintiff, Suzy Strickland Harbison, each one-half of what was left of their estate assets."

Operating agreements of limited liability companies serve as contracts that set forth the rights, duties, and relationships of the parties to the agreement.

Article III of the operating agreement clearly states that " [t]he company is organized to make a profit, increase wealth and provide a means for the Equity Owners to become knowledgeable of, manage and preserve the Company Property." This language indicates that the trial court's ruling suggesting that the LLC was meant to serve as a " nonprofit" vehicle and that Strickland could therefore dispose of the property as she wished is not supported by the terms of the operating agreement. Indeed, the very provision that the trial court relies upon to support its ruling-Article VI, Section 6.4.1-authorizes the manager of the LLC to make business decisions for the LLC, " based on the best interest of the LLC, [and] the best interests of the Equity Owners." Article VI, Section 6.3.3, further provides:
" Notwithstanding any other provisions of this section 6.3 to the contrary, neither the Managers nor any Member or Members shall have the authority to amend this Operating Agreement or take any action that would have a Material Adverse Effect on a similarly situated group of Equity Owners ... without the consent of Equity Owners...."

The trial court's finding that Strickland could dispose of the property of the LLC as she saw fit is irreconcilable with the language of the operating agreement that requires Strickland to consider the best interests of the LLC and the other equity owner, Harbison, before making any business decisions regarding the LLC. Strickland has not produced evidence indicating that she considered the interests of the LLC before she sold the real property. On remand, the trial court is to determine whether Strickland violated her duties as manager of the LLC, under the plain language of the operating agreement.

IV.

The summary judgment is reversed and the case remanded for proceedings consistent with this opinion.
REVERSED AND REMANDED.

Knapp v. Neptune Towers

Russell S. KNAPP et al.

v.

NEPTUNE TOWERS ASSOCIATES et al

Superior Court of Massachusetts, Suffolk County.

Aug. 2, 2007.

ALLAN VAN GESTEL, Justice.
This matter is before the Court on cross motions for summary judgment. Each side asserts that there are no material facts in dispute.

BACKGROUND

Neptune Towers Associates ("Neptune Towers") is a Massachusetts limited partnership, formed in 1971 for the purpose of developing, owning, and managing 334 units of rental housing in Lynn, Massachusetts. Neptune Towers is governed by a written partnership agreement (the "Partnership Agreement").

The principal asset of Neptune Towers was the property known as Neptune Towers Apartments located at 130-160 Neptune Boulevard in Lynn. This property was sold on February 28, 2002 to Community Development Trust ("CDT") for $13.2 million. About 1/2 of the sale price was available for distribution after payment of the mortgage and other expenses.

The General Partners of Neptune Towers are: Irene M. Bailey, with a 23.595% capital ownership and profit sharing interest; Ricci A. LaCentra, with a 10.285% interest; Loretta C. LaCentra, with a 10.285% interest; the late Irene M. LaCentra, with a 10.285% interest; Roy Cheever, with a 3.025% interest; and Phyllis Kerr, with a 3.025% interest. These General Partners hold a 60.5% capital ownership and profit sharing interest in Neptune Towers.

Ricci A. LaCentra is Irene M. Bailey's brother; Loretta C. LaCentra is married to Ricci A. LaCentra; and the late Irene M. LaCentra was Irene M. Bailey's mother.

Roy Cheever and Phyllis Kerr were long standing employees of the LaCentra family business.

Irene M. Bailey and Ricci A. LaCentra are the two "Managing General Partners" of Neptune Towers.

The Partnership Agreement includes two classes of Limited Partners, Class A and Class B. In the Rule 9A statement of the plaintiffs only those Class A Limited Partners who are plaintiffs are mentioned. They include the following: Russell S. Knapp, with a 8.75% capital ownership and profit sharing interest; Stephen A. Lieber, with a 6.5625% interest; the Trustees of the Emil Buehler Perpetual Trust, with a 5.625% interest; Peter Cohen, with a 2.91% interest; Ronald N. Cohen, with a 2.92% interest; Christopher Brody, with a 1.46% interest; and Greg Brody with a 1.46% interest. These Class A Limited Partners hold a

29.6875% capital ownership and profit sharing interest in Neptune Towers.

The remaining 9.8125% capital ownership and profit sharing interest in Neptune Tower is not accounted for in the Rule 9A statement, or otherwise.

The Partnership Agreement requires the prior written approval by at least two-thirds of the Class A Limited capital ownership interest before Neptune Towers may sell the partnership assets, the Neptune Apartments.

The Partnership Agreement gives the General Partners the sole right to manage the business of Neptune Towers. It also provides that no Limited Partner shall participate in or have control over the partnership business and that the Limited Partners consent to the employment by the General Partners “when and if, in the sole discretion of the General Partners, the same is deemed necessary or advisable, of such brokers, agents, or attorneys as the General Partners may determine (notwithstanding that any parties to this Agreement may have an interest in, or be one of, such brokers, agents or attorneys).”

The Partnership Agreement also authorized the General Partners to enter into agreements and contracts with affiliated persons. It specifically states in Section 6.9 that the “fact that a Partner or a member of his family is employed or directly interested in or connected with any Person or Entity employed by the Partnership to render or perform a service ... shall not prohibit the General Partners from employing or otherwise dealing with such Person or Entity ...”

On May 3, 1999, Neptune Towers entered into a written Real Estate Brokerage Agreement (the “Broker Agreement”) with William E. Bailey, who is Irene M. Bailey's husband. The Broker Agreement gives William Bailey the sole and exclusive authority to sell the Neptune Apartments during the period from May 3, 1999 through May 3, 2003, specifies a price of $20 million, and provides for payment of a 6% commission to William Bailey upon the sale of the Neptune Apartments. The Broker Agreement was executed on behalf of Neptune Towers by Irene M. Bailey, Irene M. LaCentra and Loretta C. LaCentra.

On August 30, 1999, Neptune Towers entered into a written agreement with Timothy J. Aluise (“Aluise”) providing that if Aluise found a buyer for the Neptune Apartments he “would be compensated like a broker, receiving 2% of the sale price as a fee.”

By July of 2000, it was “pretty much” determined that CDT would be the buyer of the Neptune Apartments. By letter dated July 12, 2000, William Bailey informed the Limited Partners that Neptune Towers was pursuing the sale of the Neptune Apartments. In that letter he identified members of the team working on the sale as including accountant Joseph Stanton, attorney Jerrold Olanoff, and Aluise. He also noted that Aluise “has introduced us to three prospective buyers” and that “[t]wo of these parties have expressed strong interest in buying the property.”William Bailey did not describe his role as a broker in the effort to sell the Neptune Apartments. Under his signature, he describes himself as “Counsel to Neptune Tower Associates.”

By letter dated September 26, 2000, William Bailey announced to the Limited Partners that the Managing General Partners had decided to sell the Neptune Apartments to CDT. Knowing that they needed a percentage of the Limited Partners to approve the sale, the September 26 letter included a statement that it was "imperative" that each partner sign and return an enclosed authorization form. This letter did not disclose that William Bailey had a broker's interest in the transaction.

The required Class A Limited Partner authorization was obtained by October 2000. William Bailey then sent an October 31, 2000, letter to the Limited Partners informing them that a majority of the partners had authorized the Managing General Partners to proceed with the sale to CDT. The letter was signed as "William Bailey, J.D ., Ph.D. Counsel to Neptune Tower Associates."

There was no communication with any of the Limited Partners from William Bailey regarding the Broker Agreement.

Neptune Towers paid a broker's fee to William Bailey of $796,327.74 in February 2002. William Bailey paid $398,163.87 to Ricci A. LaCentra as a "consultant fee."

All parties agree that the Class A Limited Partners would not have consented to the sale of the Neptune Apartments if they had known that William Bailey was getting a $796,000 broker's fee. It was not until October 18, 2002, however, in correspondence between Mr. Olanoff and attorney Charles Knapp, the latter of whom was acting for Russell Knapp, a Limited Partner, that William Bailey was identified as the broker. This letter also identified payments of $8,280 to an accountant, $78,720 to Mr. Olanoff, and a "Finders fee" of $40,000 [FN4] to Aluise.

FN4. In November 2002, the agreement between Neptune Towers and Aluise that provided for a 2% commission was changed by a new written agreement that provided for payment of $40,000 if and when the sale to CDT was completed "as full compensation for your assistance in locating a buyer."

William Bailey also was paid $173,936.20 for legal services in connection with the Neptune Apartments sale.

The plaintiff Russell Knapp is an attorney as, of course, is William Bailey. This may well have contributed to the fact that there are seven separate counts in the Complaint and the Counterclaims, as follows: in the Complaint-Count I, a derivative claim for breach of fiduciary duty against the General Partners; Count II, a derivative claim against William Bailey; Count III, a claim for breach of fiduciary duty against the General Partners; and Count IV, a breach of fiduciary duty claim against William Bailey; and in the Counterclaims-Count I, for abuse of process; Count II, for civil conspiracy; and Count III for defamation.

DISCUSSION

The Claims in the Complaint.

The legal question that dominates the Complaint relates to the duty, if any, of the General Partners to the Class A Limited Partners, under the Neptune Towers Agreement, to have disclosed that William Bailey was acting as the real estate broker-and the details of his commission agreement-on the sale of the Neptune Apartments to CDT.

[N]ondisclosure does not amount to fraud and is not a conventional tort of any kind. The classic expression of this view is by Justice Qua in *Swinton v. Whitinsville Sav. Bank,* 311 Mass. 677 (1942)... We note that the nondisclosure question is revisited in Restatement (Second) of Torts, sec. 551 [1977]. The Restatement concludes that nondisclosure can be actionable only where there is a “duty” to disclose, and a duty arises only in a number of discrete situations described in sec. 551.

The Court turns then to the Restatement (Second) of Torts, sec. 551(2), and the parts thereof that may apply here. It reads:

(2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,

(a) matters known to him that the other is entitled to know because of a fiduciary or similar relation of trust and confidence between them; and

(b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statements of facts from being misleading; and

* * * * *

(e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

The General Partners here are partners with the Class A Limited Partners in a Massachusetts limited partnership. “[A] general partner of a limited partnership is subject to the liabilities of a partner in a partnership without limited partners and ... is subject to the restrictions of a partner in a partnership without limited partners.”G.L.c. 109, sec. 24. A general partner owes “to the other general partners a duty of utmost good faith and loyalty.” Consequently, under sec. 551(2)(a) of the Restatement, the defendants who are General Partners of Neptune Towers had a fiduciary relationship with the Class A Limited Partners.

Thus, the question under this portion of the Restatement becomes whether the General Partners breached that fiduciary relationship or duty.

The Supreme Judicial Court, as recently as June 4, 2007, when speaking of the fiduciary duty owed by directors to their stockholders, said:

Directors owe a fiduciary duty to their shareholders ... When the rights of stockholders arise under a contract, however, the obligations of the parties are determined by reference to contract law, and not by the fiduciary principles that would otherwise govern. When a director's contested action falls entirely within the scope of a contract between the director and the shareholders, it is not subject to question under fiduciary duty principles.

Here the management of Neptune Towers is wholly controlled by the Partnership Agreement. By that Agreement the General Partners have the sole right to manage the business of Neptune Towers. No Limited Partner shall participate in or have control over the partnership business and the Limited Partners consented to the employment by the general partners "when and if, in the sole discretion of the General Partners, the same is deemed necessary or advisable, of such brokers, agents, or attorneys as the General Partners may determine (notwithstanding that any parties to this Agreement may have an interest in, or be one of, such brokers, agent or attorneys)."

The Partnership Agreement also authorized the General Partners to enter into agreements and contracts with affiliated persons. The "fact that a Partner or a member of his family is employed or directly interested in or connected with any Person or Entity employed by the Partnership to render or perform a service ... shall not prohibit the General Partners from employing or otherwise dealing with such Person or Entity ..."

Therefore, when selling partnership real estate the General Partners had full and unfettered authority to engage a real estate broker; and it would not be a violation of the Partnership Agreement if that broker-like William Bailey-was a member of a General Partner's family. There can be no finding of a breach of a partner's fiduciary duty to another partner to take action specifically authorized by the Partnership Agreement.

The Court turns next to Restatement sec. 551(2)(b). Were any matters known to the General Partners regarding the engagement of William Bailey to act as the broker for the CBT deal information that the General Partners knew to be necessary to prevent any partial or ambiguous statements of facts by them from being misleading to the Class A Limited Partners? This Court thinks not.

Here there were no statements at all by the General Partners about who would be the broker, what he or she might do, or what any commission might be. There was, therefore, nothing ambiguous in anything the General Partners said on that subject. Nor, as observed above, it cannot be said to be misleading to proceed with a major real estate transaction without stating the obvious-that a broker or brokerage firm would be involved and be paid a commission for the work involved. Certainly, people like the Limited Partners here, with years of experience involved with Neptune Towers and other sophisticated real estate deals, cannot reasonably say that they were misled into approving the sale of the Neptune Apartments without being told there would be a compensated broker involved.

While not of any particular relevance to the present issues, the Court observes the June 1, 2007 Affidavit of John M. Peckham ("Peckham"), attached to the defendants' materials. Peckham describes himself as the principle [sic] of Peckham Boston Company, apparently a real estate brokerage, who opines that the "6% commission [paid to William Bailey] was fair compensation for a sale of this complexity."In short, the broker's commission was fair, and consistent with local custom and practice. There is no contrary affidavit submitted on behalf of the Class A Limited Partners.

Finally, the Court directs its attention to Restatement sec. 551(2)(e). Were the facts that William Bailey was the broker on the sale of the Neptune Apartments, "facts basic to the transaction" and did the General Partners know that the Class A Limited Partners were about to approve the sale "under a mistake as to them"? Was this a matter which the General Partners, because of the relationship between them and Class A Limited Partners, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts? Again, this Court thinks not.

The fact that there would be a broker involved, who would be paid for his or her services, is no more basic to a real estate transaction of the kind involved here than would be the fact that there was a purchase and sale agreement, a deed, a recording of the deed, perhaps a discharge of a mortgage, perhaps the provision for title insurance, and the assistance of counsel as well. As stated in Comment on Clause (e), j, to Restatement sec. 551, "[a] basic fact is a fact that is assumed by the parties as a basis for the transaction itself. It is a fact that goes to the basis, or essence, of the transaction, and is an important part of the substance of what is bargained for or dealt with."

"In general, the cases in which the rule stated in Clause (e) has been applied have been those in which the advantage taken of the plaintiff's ignorance is so shocking to the ethical sense of the community, and is so extreme and unfair, as to amount to a form of swindling, in which the plaintiff is led by appearances into a bargain that is a trap, of whose essence and substance he is unaware."Comment on Clause (e), l. Nothing of that sort is shown here.

William Bailey was not a partner or trustee of any of the Class A Limited Partners, he was not engaged by them as their attorney, and, obviously, he was not engaged by them to sell the Neptune Apartments. There is nothing in the summary judgment record showing that William Bailey owed any fiduciary duty to the Class A Limited Partners. Nor is there anything in the summary judgment record to show that he owed any common-law or contractual duty to the Class A Limited Partners.

Thus neither Count III by the Class A Limited Partners for breach of fiduciary duty against the General Partners, nor Count IV by the Class A Limited Partners for breach of fiduciary duty claim against William Bailey can stand.

Further, and for similar reasons, particularly the fact that the General Partners run Neptune Towers and did nothing not authorized in the Partnership Agreement, neither Count I stating

a derivative claim for breach of fiduciary duty against the General Partners, nor Count II stating a derivative claim against William Bailey can stand.

The Counterclaims

Count I of the Counterclaims seeks relief for abuse of process. To succeed on such a claim the defendants must show: the use of process; for an ulterior or illegitimate purpose; resulting in damage.

The Class A Limited Partners here, however, used the process of the court for a legitimate, not an ulterior or illegitimate, purpose. Suit for alleged breaches of fiduciary duty, either directly or derivatively, are not an abuse of process. Further, the mere fact that summary judgment against such a suit has been found does not mean that the Complaint was an abuse of process.

Count II presents a claim for civil conspiracy. There must be shown a combination of two or more persons, acting by illegal means, or for an illegal purpose, resulting in damages. As with Count I, neither the requisite illegal means or illegal purpose have been demonstrated in the summary judgment record.

Count III presents a claim for defamation. This Count requires a defamatory statement of fact made either negligently in the case of a private figure or with malice in the case of a public official or figure resulting in damage. Here, the defamation is said to be the bringing of the Complaint and the allegations therein. There is, however, an absolute privilege for statements made by a party or counsel during the course of a governmental proceeding, including court proceedings. That privilege applies here.

None of Count I for abuse of process, Count II for civil conspiracy or Count III for defamation can survive summary judgment.

ORDER

For the foregoing reasons, the Defendants' Joint Motion for Summary Judgment, Paper # 38, and the Plaintiffs' Motion for Summary Judgment, Paper # 39, are each *ALLOWED.*Judgment dismissing the Complaint and all Counterclaims shall enter accordingly.

Milliken v. Duro Textiles

MILLIKEN & COMPANY
v.
DURO TEXTILES, LLC, & others

Supreme Judicial Court of Massachusetts, Bristol.

Decided May 30, 2008.

On November 14, 2002, Milliken & Company (Milliken) filed an action in the Superior Court to recover a $8,754,680.11 trade debt owed by Duro Industries, Inc. (Old Duro). Milliken sought recovery from Duro Textiles, LLC (New Duro), as the corporate successor of Old Duro. The essence of Milliken's first amended complaint for damages and declaratory relief (complaint) was that Patriarch Partners, LLC (Patriarch), and related entities, orchestrated a scheme to acquire the assets of Old Duro, while shedding Old Duro's debts to unsecured creditors, including Milliken. In Count I of its complaint, Milliken asserted a successor liability claim for breach of contract against New Duro, under theories of "de facto merger" or "mere continuation" of the same business, and, in Count VII of its complaint, Milliken sought, inter alia, a declaratory judgment that New Duro was liable for the debts and obligations of Old Duro. As also is pertinent here, in Count VI of its complaint, Milliken asserted that New Duro, Patriarch; Ark CLO2001-1, Limited; Ark Investment Partners II, LP; and Lynn Tilton (collectively, the defendants) engaged in unfair or deceptive trade practices in violation of G.L. c. 93A, §§ 2, 11.

The parties filed cross motions for summary judgment on Counts I and VII of the complaint, and the defendants also filed a motion for summary judgment on Count VI. Following a hearing, a judge in the Superior Court allowed, in part, Milliken's motion for summary judgment on Count I to the extent that its claim was predicated on a determination that, under either the "de facto merger" or "mere continuation" theory of successor liability, Old Duro became New Duro for purposes of its corporate debt. The judge otherwise denied Milliken's motion for summary judgment on Count I, concluding that a trial was necessary on the issue whether Milliken was an "innocent creditor," entitled to equitable relief. The judge denied the defendants' cross motion for summary judgment on Count I, concluding that they had not shown a lack of harm to Milliken such as would preclude recovery under any theory of successor liability. The judge allowed the defendants' motion for summary judgment on Count VI and dismissed Milliken's claim pursuant to G.L. c. 93A. Finally, the judge denied the parties' cross motions for summary judgment on Count VII with respect to a declaration of successor liability insofar as a trial was necessary on the "innocent creditor" issue. Following a bench trial, the judge found that Milliken was an innocent creditor, one which had not acted with "unclean hands," and, therefore, was entitled to collect its debt from New Duro pursuant to the equitable doctrine of successor liability. A final judgment entered on Count I of the complaint ordering New Duro to pay Milliken $8,754,680.11, plus interest and costs, and on Count VII of the complaint declaring that New Duro was liable to Milliken for the debt of Old Duro under theories of successor liability.

[1][2][3] New Duro appealed from the judgments in favor of Milliken on Counts I and VII of

its complaint, pertaining to successor liability, and Milliken cross-appealed from the dismissal, on summary judgment, of Count VI of its complaint, pertaining to the defendants' alleged violation of G.L. c. 93A. We transferred the case from the Appeals Court on our own motion. New Duro now contends that (1) the requirements of the "de facto merger" or "mere continuation" theories of successor liability were not met where Old Duro remains a corporation in good standing and the owner of substantial assets" in the form of real estate and the right to collect tax refunds; (2) the judge erred in imposing successor liability on New Duro where Milliken failed to demonstrate that it suffered any actual harm as a result of a foreclosure sale of Old Duro's assets; and (3) the judge erred in imposing successor liability on New Duro where such action risks the dissolution of New Duro with no offsetting benefit to Milliken. In contrast, Milliken asserts that (1) the judge erred in dismissing its claim under G.L. c. 93A because a declaratory judgment of successor liability can form the basis for a c. 93A violation; (2) the judge erred in dismissing its claim under c. 93A on the grounds that Milliken did not have a commercial relationship with the defendants and could not establish that it had suffered a loss of money or property within the meaning of the statute; and (3) the judge erred in concluding that a judgment concerning successor liability was independent of c. 93A, and was not predicated on a finding of unfair or deceptive acts or practices. For the reasons that follow, we now affirm the thorough and well-reasoned decisions of the judge below.

1. *Background.* Old Duro, a Massachusetts corporation, was one of the largest independent dyers, printers, finishers, and distributors of textile products in the United States and was headquartered in Fall River. Milliken, a Delaware corporation, was one of Old Duro's primary suppliers of greige goods, the raw materials used to make textiles. In 1997, investors purchased a majority interest in Old Duro in a leveraged buyout. A consortium of banks, led by Bank of America as agent (the bank group), helped to finance the purchase with loans and revolving credit commitments, as set forth in a credit agreement with Old Duro dated October 31, 1997. These commitments were secured by liens on Old Duro's real property and by security interests in its personal property. Bank of America filed financing statements pursuant to the Uniform Commercial Code, evidencing the bank group's security interests in Old Duro's personal property, and it recorded mortgages on Old Duro's real property.

Beginning in 1999, Old Duro began to experience financial problems due to a downturn in the textile industry and due to its debt structure resulting from the leveraged buyout. By March, 2000, Milliken was aware that Old Duro was behind in its payments, suffering substantial losses, missing its financial projections, defaulting on its loan commitments to secured lenders, and operating with its revolving line of credit suspended. Milliken decided at this time not to increase its exposure to Old Duro above $2.5 million, but it eventually did agree to extend Old Duro's credit terms from thirty to sixty days. In December, 2000, Old Duro underwent a capital restructuring, entering into, among other agreements, an amended and restated credit agreement with the bank group that reduced its total bank debt from $85 million to approximately $46 million. As a result of this restructuring, the bank group acquired 51% of the equity in Old Duro, while other entities held the remaining 49%.

Patriarch, a Delaware limited liability company, was established in 2000 by Lynn Tilton

(Tilton), who is its principal and manager. Patriarch acts as the collateral manager or investment advisor for funds with portfolios of distressed secured debt. Its business model is to restructure or reorganize the companies in its portfolios to allow borrowers the time, liquidity, and strategic support to turn around their operations. Ark CLO2001-1, Limited (Ark I), is one of the investment funds created by Tilton for which Patriarch serves as collateral manager.[FN7] On December 28, 2000, Ark I purchased from one member of the bank group its 29% interest in the bank group's secured debt of Old Duro.

By the spring of 2001, Milliken was working on “Project Conceal,” its effort to develop a camouflage-dyed nylon product to compete with Old Duro's product for the United States military. Around the same time, Milliken learned that the Balson Hercules apparel lining division of The Balson Hercules Group, Ltd. (Balson), Milliken's largest customer for greige goods, was for sale. Milliken was concerned that if Balson did not survive, it would hurt Milliken's business, so Milliken helped to finance Old Duro's acquisition of Balson by providing it with a $2 million unsecured note. By October, 2001, Old Duro owed Milliken almost $10 million in unsecured trade debt. As of March, 2002, Milliken was “treading water” on its debt from Old Duro, receiving payments that were not sufficient to reduce receivables or to reduce their further aging. By May, 2002, Old Duro was operating at a loss, was in default under its credit agreement, and owed the bank group $41.7 million. At this time, Patriarch prepared and submitted a report to the bank group that valued Old Duro's assets at $16 million, based either on an orderly liquidation of the corporation or on an asset-based refinancing.

Ark Investment Partners II, LP (AIP), is a private equity fund created by Tilton to purchase additional lender interests in borrowers that are in other Patriarch-managed funds. AIP is an equity investor in Ark I. In May, 2002, Larry Himes (Himes), the president and chief executive officer of Old Duro, met with Tilton in an effort to persuade Patriarch to rescue the company. AIP offered to purchase the bank group's remaining 71% interest in Old Duro's secured debt for approximately $11.3 million. After receiving a separate purchase proposal from Old Duro, contingent on an asset-based financing arrangement, the bank group rejected both offers and directed Old Duro's management to begin liquidation. Old Duro retained bankruptcy counsel, and Patriarch offered to provide debtor-in-possession financing and exit financing on emergence in the event that Old Duro wanted to put together a bankruptcy plan. Around the same time, Tilton told Himes that Patriarch had no interest in liquidating Old Duro, and that, if Patriarch could purchase the bank group's remaining 71% interest, she hoped to obtain a consensual restructuring of the company. Himes proposed that Old Duro pay down $2 million of its outstanding secured debt, and the bank group agreed to sell its interest in the remaining secured debt to AIP, based on an agreement to distribute the $2 million to the members of the bank group other than Ark I.

By July, 2002, Old Duro owed Milliken approximately $8,580,565 for raw materials. Milliken's credit manager knew that if Old Duro were liquidated or declared bankruptcy, then its unsecured creditors, including Milliken, would recover nothing. Nonetheless, Milliken

continued to accept and fill orders from Old Duro. On July 15, 2002, AIP paid approximately $11.4 million to purchase the bank group's remaining 71% interest in Old Duro's secured debt and equity. After Old Duro paid $2 million to the members of the bank group other than Ark I, it still owed approximately $38.6 million on its outstanding loans and revolving credit commitments. Following this buyout, Ark I and AIP (the Ark lenders) collectively held a first priority, perfected security interest in all of Old Duro's assets, and owned 51% of its stock. Around this same time, efforts by Old Duro and Milliken to renegotiate the terms of Old Duro's indebtedness so that the company could remain operational were wholly unsuccessful, and Milliken wrote off $2.5 million of Old Duro's debt as uncollectible. On August 7, 2002, Milliken's vice-president wrote to Himes demanding full payment of Old Duro's outstanding balance within five days.

On August 23, 2002, Milliken filed an action in the Supreme Court of the State of New York, New York County, to collect its unsecured trade debt, plus interest and costs, from Old Duro.[FN8] That same day, with the strategic support of Patriarch, Old Duro's board of directors voted to file a petition in the United States Bankruptcy Court for the District of Massachusetts for protection under Chapter 11 of the Bankruptcy Code. Its purpose was to effectuate a sale of Old Duro as a going concern under § 363 of the Bankruptcy Code, 11 U.S.C. § 363 (2000), within ninety days after the bankruptcy filing.[FN9] Milliken, which chaired the unsecured creditors' committee, strongly objected to a proposed agreement among Old Duro, the Ark lenders, and Old Duro's unsecured creditors that would have paid such creditors $1 million, plus 20% of any proceeds from the bankruptcy sale of Old Duro's assets in excess of $32 million. On September 26, 2002, Old Duro's bankruptcy petition was dismissed by the consent of the parties due to insufficient marketing efforts by Old Duro that gave the appearance of guaranteeing a sale of the company to the Ark lenders. Milliken immediately wrote off 80% of Old Duro's debt as uncollectible, and, over subsequent fiscal periods, it wrote off the remainder of the debt.

On September 29, 2002, just a few days after the bankruptcy petition was dismissed, the Ark lenders scheduled a foreclosure sale in accordance with the Massachusetts Uniform Commercial Code, G.L. c. 106, § 9-601 (*f*), to allow for the sale of Old Duro's assets, with the hope that the company could continue normal operations without interruption. On September 30, 2002, the Ark lenders formed New Duro, a Delaware limited liability company created for the purpose of bidding on Old Duro's assets and capitalized with $2,000. It did not have any other cash or liquid assets. The manager of New Duro was Duro Textiles Management, Inc., a wholly owned subsidiary of the Ark lenders. New Duro's limited liability company agreement, dated October 15, 2002, was signed by Tilton as collateral manager of Patriarch on behalf of Ark I, Tilton as president of AIP, and Tilton as president of Duro Textiles Management, Inc.

Marketing efforts for the foreclosure sale were somewhat limited, ostensibly to preserve Old Duro's customer base, and, on October 18, 2002, Old Duro's assets, excluding real estate, were sold to New Duro, the only bidder, for $26.2 million.[FN10] The Ark lenders funded New Duro's purchase of Old Duro's assets through loans and a revolving credit commitment, and they used the $26.2 million from the foreclosure sale, less expenses, to reduce Old Duro's

secured debt to them, which then exceeded $41 million. On the same day as the foreclosure sale, Patriarch Partners Agency Services, LLC, on behalf of the Ark lenders, recorded with the Delaware Secretary of State an all asset security interest in New Duro's assets.

Old Duro filed an amendment to its articles of organization changing its name to "Chace Street, Inc." (Chace Street), and it leased to New Duro all of its real estate and improvements in Fall River, including Old Duro's principal place of business.[FN11] Chace Street has no offices or employees. At its 2002 annual meeting, Old Duro's chairman of the board of directors stated that Old Duro intended to deed its real estate to New Duro within ninety days.[FN12] The president and chief executive officer of Old Duro, Larry Himes, became the president and chief executive officer of New Duro. New Duro's operations are essentially the same as those of Old Duro. It has the same process capability, it continues to sell the same product lines, it originally employed all of Old Duro's employees, it honored all of Old Duro's existing collective bargaining agreements and certain of its customer contracts, it assumed some of Old Duro's equipment leases, it paid off several of Old Duro's existing debts, and it uses Old Duro's telephone number.

On November 13, 2002, the Supreme Court of the State of New York, New York County, entered a judgment in favor of Milliken against Old Duro in the amount of $8,754,680.11. Milliken then commenced the present action.

2. *Successor liability*. (a) *Dissolution of corporate entity*. New Duro first contends that the judge erred in imposing on it successor liability where Old Duro remains a Massachusetts corporation in good standing and in possession of substantial assets. New Duro points out that Old Duro never sold or otherwise transferred its real property, and Old Duro receives $50,000 a month in rental payments from New Duro for the use of such property, which was valued at approximately $6 million. A mere "cessation of ordinary business operations" does not, in New Duro's view, equate with dissolution. Therefore, on this basis, New Duro argues that it should not be deemed the successor of Old Duro. We disagree.

When analyzing a claim for successor liability under theories of "de facto merger" or "mere continuation" of the predecessor, our focus is on whether one company has become another for the purpose of eliminating its corporate debt. "Most jurisdictions, including Massachusetts, follow the traditional corporate law principle that the liabilities of a selling predecessor corporation are not imposed upon the successor corporation which purchases its assets, unless (1) the successor expressly or impliedly assumes liability of the predecessor, (2) the transaction is a de facto merger or consolidation, (3) the successor is a mere continuation of the predecessor, or (4) the transaction is a fraudulent effort to avoid liabilities of the predecessor." The public policy underlying the imposition of successor liability is the fair remuneration of innocent corporate creditors.

The "de facto merger" theory of successor liability "has usually been applied to situations in which the ownership, assets and management of one corporation are combined with those of

another, preexisting entity." "The factors that courts generally consider in determining whether to characterize an asset sale as a de facto merger are whether (1) there is a continuation of the enterprise of the seller corporation so that there is continuity of management, personnel, physical location, assets, and general business operations; whether (2) there is a continuity of shareholders which results from the purchasing corporation paying for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation; whether (3) the seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible; and whether (4) the purchasing corporation assumes those obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation." We have stated that "[n]o single factor is necessary or sufficient to establish a de facto merger."

The "mere continuation" theory of successor liability "envisions a reorganization transforming a single company from one corporate entity into another." "[T]he indices of a 'continuation' are, at a minimum: continuity of directors, officers, and stockholders; and the continued existence of only one corporation after the sale of assets." *McCarthy v. Litton Indus., Inc., supra* at 23, 570 N.E.2d 1008. In essence, the purchasing corporation "is merely a 'new hat' for the seller." *Id.* at 22, 570 N.E.2d 1008, quoting *Bud Antle, Inc. v. Eastern Foods, Inc.,* 758 F.2d 1451, 1458 (11th Cir. 1985). "[T]he imposition of liability on the purchaser is justified on the theory that, in substance if not in form, the purchasing corporation is the same company as the selling corporation." *McCarthy v. Litton Indus., Inc., supra.* See 15 W.M. Fletcher, *supra* at § 7124.10, at 287 ("The 'mere continuation' of business exception reinforces the policy of protecting rights of a creditor by allowing a creditor to recover from the successor corporation whenever the successor is substantially the same as the predecessor"). Similar to the considerations underlying a finding of a "de facto merger," the factors characterizing a continuing corporation are traditional indicators, but no single factor is dispositive, and the facts of each case must be examined independently.

When considering New Duro's contention that the imposition of successor liability is inappropriate here because the corporate dissolution of Old Duro never occurred, we are mindful that no single indicator of succession is controlling. In *Cargill, Inc. v. Beaver Coal & Oil Co., supra* at 361, 676 N.E.2d 815, this court opined that the mere fact that a corporate entity has not been formally dissolved does not preclude a finding of a de facto merger. Rather, the principles of successor liability will be imposed where a corporation ceases all of its ordinary business operations, which are assumed by another corporation, and liquidates its assets. See *id.* When this occurs, the predecessor corporation, for all practical purposes, has ceased to exist. See *id.* In a legally related, but factually distinguishable vein, we stated in *McCarthy v. Litton Indus., Inc., supra* at 22, 570 N.E.2d 1008, that the purchaser of a corporation's assets "would not be considered to be the alter ego of the seller where the seller continues to exist after the transfer of its assets." See *Roy v. Bolens Corp.,* 629 F.Supp. 1070, 1072 (D.Mass.1986) (continued partial existence of manufacturing company, ostensibly capable of satisfying products liability judgment, precluded imposition of successor liability on purchaser of remainder of manufacturing company). In *McCarthy v. Litton Indus., Inc., supra* at 22-23, 570 N.E.2d 1008, where one corporation transferred a portion of its

operations to a second corporation, we concluded that the second corporation was not a "continuation" of the first because the original corporation survived the sale of a portion of its assets and continued to manufacture its own products. Thus, a determination whether a predecessor corporation continues to exist for purposes of successor liability is wholly fact specific.

Here, it was undisputed that Old Duro ceased its ordinary business operations following the foreclosure sale, it currently has no offices or employees, and the former chief executive officer of Old Duro is now the chief executive officer of New Duro. Fundamentally, Old Duro, as a dyer, printer, finisher, and distributor of textile products, no longer exists. It sold its operating assets to New Duro, thereby enabling New Duro to maintain the same production capabilities and sell the same goods without any interruption to the business. We recognize that Old Duro did not legally dissolve as a corporate entity. Instead, it changed its name, and now rents to New Duro the real estate that it still owns in Fall River and recovers tax refunds.[FN16] Notwithstanding this particular fact, only one among several for consideration, we decline to elevate form over substance by concluding that the nature of Old Duro's corporate existence as Chace Street trumps the existence of New Duro as the successor corporation on whom liability properly should be imposed. The existence of Chace Street simply does not undermine the nonexistence of Old Duro as a going concern.

(b) *Harm resulting from foreclosure sale*. New Duro argues that the judge below erred in imposing on it successor liability because Milliken was not actually harmed by the sale of Old Duro's assets at the foreclosure sale. New Duro points out that harm is a requirement of any equitable claim, and that the Ark lenders, as secured creditors, possessed a contractual right to foreclose on Old Duro's assets when it defaulted on its loan agreements. As such, New Duro continues, the judge incorrectly concluded that Milliken, an unsecured creditor, was harmed by losing the opportunity to wait and see if Old Duro's financial condition improved over time. We disagree.

We agree with New Duro that the Ark lenders, as secured creditors, possessed a contractual right to foreclose on Old Duro's assets in October, 2002, after Old Duro had defaulted on its loan agreements. See G.L. c. 106, § 9-601 (*a*) (1), as appearing in St.2001, c. 26, § 39 (after default, secured party may reduce claim to judgment or foreclose by any available judicial procedure). As such, Old Duro could have sold its assets to a third party and, to the extent that the proceeds from the foreclosure sale were insufficient to satisfy Old Duro's obligations to the Ark lenders, Milliken, as an unsecured creditor, would not have been able to recover its outstanding trade debt because, generally speaking, the liabilities of a predecessor corporation are not imposed on the successor corporation that purchases its assets. See *Guzman v. MRM/Elgin,* 409 Mass. 563, 566, 567 N.E.2d 929 (1991). However, that is not what occurred here. Rather, at the October, 2002, foreclosure sale, Old Duro sold all of its assets (excluding its real estate) to a reconstituted version of itself, New Duro, in an effort to maintain its textile business as a going concern with the potential for future profits, while shedding its debt obligations to unsecured creditors. Consequently, Milliken was harmed by the sale of Old Duro's assets to New Duro at the foreclosure sale-precisely the kind of harm

to innocent creditors that the successor liability doctrine was designed to prevent.

The harm suffered by Milliken and the imposition of successor liability on New Duro go hand in hand. As the judge below properly found, Milliken was deprived of the opportunity to wait and see whether Old Duro's business, now being conducted by New Duro, turned around financially to where it was able to repay its debt obligations. Contrary to New Duro's assertion, it was, in fact, the “debtor” by virtue of its status as the successor corporation, and, therefore, it was legally responsible for the corporate liabilities incurred by Old Duro. The fact that at the time of the foreclosure sale Old Duro's debts exceeded its assets is of no consequence to Milliken's ability to recover its trade debt. Milliken did not lose the right to recover the trade debt owed by Old Duro simply because its corporate successor, New Duro, had insufficient assets in October, 2002, to repay the debt.

(c) *Balancing of competing interests*. New Duro contends that the judge's determination on successor liability must be reversed because it threatens the dissolution of New Duro without any offsetting benefit to Milliken. As New Duro correctly points out, we have explicitly recognized that there is often a tension between public policy concerns for “the fair remuneration of corporate creditors” and “our strong interest in respecting corporate structures.” Notwithstanding our respect for the integrity of corporate structures, we are troubled by the notion that by merely changing its form, without significantly changing its substance, a single corporation can wholly shed its debts to unsecured creditors, continue its business operations with an eye toward returning to profitability, and have no further obligation to pay such creditors. The application of principles of successor liability is designed to remedy this fundamental inequity as factual circumstances, such as those presented here, dictate.

New Duro further argues that holding it liable for Old Duro's debt obligations will set the stage for New Duro's likely dissolution. While such a consequence may eventually come to pass, it is mere speculation at this juncture, and there is no evidence that at the time the Ark lenders formed New Duro they were unaware of Old Duro's considerable debt. The possibility of New Duro's dissolution at some point in the future does not foreclose Milliken's successor liability claim to recover at least a portion of the money it is owed.

For the foregoing reasons, we conclude that New Duro was not entitled to summary judgment on Counts I and VII of Milliken's complaint, pertaining to successor liability.

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We agree with the judge below that a determination of successor liability, in and of itself, need not be predicated on a finding of unfair or deceptive acts or practices such that the successor corporation necessarily will be subject to liability under G.L. c. 93A. By the same token, as Milliken points out, a determination of successor liability *could* result in c. 93A liability for the successor corporation. To the extent that a predecessor corporation engages in unfair or deceptive acts or practices within the meaning of c. 93A, principles of successor liability would dictate that legal responsibility for such acts should pass to the successor

corporation. Here, the thrust of Milliken's argument is not that Old Duro, with whom Milliken had a commercial relationship in a business context, committed unfair or deceptive acts or practices in violation of c. 93A. Rather, Milliken contends that Patriarch, the Ark lenders, Tilton, and New Duro orchestrated a comprehensive and nefarious scheme to acquire the assets of Old Duro, while shedding Old Duro's debts to unsecured creditors. These are the defendants on whom c. 93A liability theoretically could be imposed, but for the determinative fact that Milliken's “relationship” with these entities did not satisfy the criteria necessary for a viable claim under c. 93A.

For the foregoing reasons, we conclude that the defendants were entitled to summary judgment on Count VI of Milliken's complaint, pertaining to c. 93A liability.

4. *Conclusion.*The order dated June 14, 2005, granting summary judgment in favor of the defendants on Count VI of the complaint is affirmed. The final judgments entered on June 12, 2006, as amended on August 16, 2006, are affirmed.

So ordered.

Fronk v. Fowler

Robert L. **FRONK** & others
v.
John P. **FOWLER** & others.

Decided April 4, 2008.

KAFKER, J.

The plaintiffs, limited partners in a commercial real estate venture, appeal from a judgment for the general partners following a jury-waived trial in Superior Court on claims for breach of contract and fiduciary duty and for misappropriation of partnership opportunities. The issues on appeal concern various transactions by the general partners, including their purchase, without the involvement of the limited partners, of large real estate parcels neighboring the building project for which the limited partnership was formed. The plaintiffs also contest fees charged for services provided by the general partners to the limited partnership. As the limited partnership agreement expressly allowed the general partners' actions, we affirm the judgment rejecting all the limited partners' claims.

We recount the facts, here and in our discussion, from the judge's June 6, 2006, findings of fact, conclusions of law, and order, which were fully supported in the record.[FN3] In 1984, the defendants, Robert L. Wolff, Jr., John P. Fowler, and Jeffrey A. Millman, formed The Cambridge Company, Inc. (TCC), to acquire, renovate, and operate commercial real estate. Wolff was a real estate developer; Fowler was a mortgage broker; and Millman was an architect and project manager. TCC's first project was a building at 160 Concord Avenue in Cambridge. The defendants formed a separate partnership specifically for that project. TCC has since developed approximately eleven properties, all through separate entities.

In 1985, TCC undertook its second project, the acquisition and development of the Maple Leaf Building, a six-story hot dog factory at 23 East Street in Cambridge. The plaintiffs, Edward S. Walter,[FN4] Jack Saltiel, and Robert Fronk, became acquainted with Wolff when they sought to lease three floors of the building for their company, Compumart Corporation. During the lease negotiations, the parties decided that the plaintiffs would participate in the limited partnership that would purchase 23 East Street. The plaintiffs' contribution to the limited partnership was the lease of the three floors for a term of fifteen years by Compumart, and a $500,000 letter of credit, to be used as security only for any cost overruns during the development of the project.[FN5]

The parties executed the Maple East Associates Limited Partnership Agreement (partnership agreement) on May 7, 1985. Under the partnership agreement, the three plaintiffs were limited partners, collectively holding a forty percent interest; the three defendants were general partners, collectively holding a sixty percent interest. All three plaintiffs were experienced and sophisticated businesspeople, represented by counsel.

Section 4 of the partnership agreement set forth the partnership's purpose:

> “The purpose of the partnership shall be (i) to acquire approximately 32,268 square feet of land and the six story concrete building thereon located at 23 East Street, Cambridge, Massachusetts (the ‘Property’); (ii) to renovate such building in such manner as the General Partners shall determine (the ‘Project’); (iii) to own, operate and manage the Project; and (iv) to lease, sell, acquire or otherwise deal with the Project and other real estate in such manner as the General Partner shall determine.”

Section 5 provided, in relevant part:

> “In furtherance of its purpose, but subject to all other provisions of this Agreement, the partnership is authorized to:
>
> “...
>
> “5.2 acquire by purchase, lease or otherwise any real or personal property which may be necessary, convenient or incidental to the accomplishment of the purpose of the partnership;
>
> “5.3 own, construct, operate, maintain, finance, improve, sell, convey, assign, mortgage or lease any real estate and any personal property necessary, convenient or incidental to the accomplishment of the purposes of the partnership.”
>
> Section 13.2 provided, in relevant part:
>
> “It is expressly understood that a General Partner may engage in any other business or investment, including the ownership of or investment in real estate and the operation and management of real estate, and neither the partnership nor any of the partners thereof shall have any rights in and to said businesses or investments, or the income or profits derived therefrom.”

The judge found that, over the ensuing years, the general partners successfully managed 23 East Street through numerous financial crises, including, in December, 1986, the bankruptcy of Compumart and its departure from the building after less than one year of its fifteen-year lease. The general partners performed many services for the limited partnership without compensation, drawing on their respective skills and experience. For example, from 1999 to 2002, Wolff and Millman devoted 1,100 hours to permitting activities. The partnership agreement also authorized the general partners to pay entities owned by or related to them for performance of services. With respect to those related-party transactions, the partnership agreement provided, in § 12.5:

> “The General Partners shall not enter into any contract, agreement, lease or other arrangement for the furnishing to or by the partnership of goods, [or] services ... for compensation with any party or entity related to or affiliated with any partner ... unless such contract ... is on terms and conditions which are not materially less favorable to the

partnership than the terms and conditions which would be available from unrelated parties. At least five (5) business days prior to entering into such contract, lease or other agreement, the General Partners shall send a copy of such document to the Limited Partners."

The general partners paid themselves or their related entities fees for negotiating a lease, fees for locating and negotiating financing, a sales commission for the sale of the property in 2002, and reimbursements for costs incurred in permitting and finalizing that sale. The judge found that payments to related entities were in keeping with market rates, though she also found that the defendants failed to provide the plaintiffs with copies of written contracts in advance, as § 12.5 of the partnership agreement required.[FN6] She further found that the failure to provide advance copies of written contracts caused the plaintiffs no financial harm.

In 1994, the defendants created a separate entity, Maple Research Park Limited Partnership, to acquire and operate property at 9 East Street, which consisted of two warehouse buildings adjacent to 23 East Street. The defendants neither disclosed the purchase nor invited the plaintiffs to take part in the investment. In 1997, the defendants created another entity, WS Lexington Street Limited Partnership, to purchase 1 East Street, a warehouse also located nearby. Again, the plaintiffs were not informed and were not invited to participate.[FN7]

In 1998 and 1999, the defendants negotiated the sale of 23 East Street, along with 1 and 9 East Street, to Charles E. Smith Residential Realty, L.P. (Smith), a large, publicly-owned residential real estate investment trust. Smith was not interested in purchasing 23 East Street, which was not a commercially attractive property for Smith's development plans, but the defendants insisted that the purchase include 23 East Street. Smith eventually purchased all three parcels, with the proceeds for 23 East Street amounting to $7,279,210.[FN8] The judge found the sale price for 23 East Street was "extremely favorable to the [p]artnership." She also determined that since the plaintiffs withdrew their expert testimony, they "had no evidence that the method of valuation, nor the valuation itself, of 23 East Street was in any way inadequate or improper." She also credited the defendants' testimony as to valuation and found it to be expert.

All told, the judge found that over the course of the limited partnership, each of the plaintiffs, having invested no money and having reneged on their fifteen-year lease obligation, nevertheless received $153,000 in cash distributions, and $307,200 in sales proceeds.[FN9]

The plaintiffs filed their first amended complaint against the defendants alleging breach of contract, breach of fiduciary duty, fraud, and misrepresentation and misappropriation of business opportunities. Prior to trial, the judge ruled that 1 and 9 East Street were not partnership opportunities, as the limited partnership had as its sole purpose the acquisition, renovation, and operation of 23 East Street. The case was tried on the remaining claims involving breach of the partnership agreement, the related-party transactions, and the valuation of 23 East Street at the time of sale. The judge, in a thoughtful and comprehensive decision, found for the defendants on all counts, and the plaintiffs filed this appeal.

[1][2] 1. *Corporate opportunity.* The first issue presented is whether the defendants'

acquisition of the neighboring properties at 1 and 9 East Street, without involving the limited partners of the Maple East Associates Limited Partnership, constituted a misappropriation of the partnership's opportunities. The plaintiffs argue that the general partners' purchase of the neighboring parcels violated both the partnership agreement and the general partners' fiduciary duties. We conclude that there is no merit to either claim because the partnership agreement expressly authorized the general partners' actions, and where the partnership agreement expressly addressed the action, “the obligations of the parties are determined by reference to contract law, and not by the fiduciary principles that would otherwise govern.”

The essential and express purpose of the limited partnership agreement was the acquisition, development, and management of 23 East Street. As the trial judge found, the partnership agreement was “a standard type of investment vehicle for investing in a particular commercial real estate property or project.” Section 13.2 of the partnership agreement also expressly reserved the right of the general partners, who were real estate developers, to pursue other real estate businesses or investments and further provided that “neither the partnership nor any of the partners thereof shall have any rights in and to said businesses or investments, or the income or profits derived therefrom.”

[3] These provisions complemented one another, defining a single purpose for the limited partnership and a narrow restriction on other real estate activities by the general partners. They also expressly authorized the general partners to engage in the other real estate ventures undertaken here without involving the limited partners. The investors were all sophisticated businesspeople and represented by able counsel. “[W]here sophisticated parties choose to embody their agreement in a carefully crafted document, they are entitled to and should be held to the language they chose.”

[4] Even if we were to interpret the partnership agreement as not specifically authorizing the general partners' purchase of the adjacent properties, and therefore only shaping rather than eclipsing ordinary fiduciary duties regarding partnership opportunities, we would come to the same conclusion. “Normally, a corporate opportunity is thought of as a business or investment opportunity within the sphere of, or somehow related to, the corporation's own activities.”

In stark contrast to the cases upon which the plaintiffs rely, this limited partnership was not a general purpose enterprise that encompassed a wide range of business activities and pursuits.[FN10] The “sphere” of activity of the limited partnership was quite limited here. The venture was controlled by a partnership agreement that set forth the particular purpose of the limited partnership, that being the acquisition, development, and management of 23 East Street, and thus defined the scope of partnership opportunities as those directly related to the acquisition, development, and management of 23 East Street. And significantly, where the partnership agreement expressly permitted the general partners to acquire other real estate for themselves without offering the limited partners the opportunity to participate, the boundaries of what constituted partnership opportunities were tightly circumscribed around the project itself.

The plaintiffs premise their own contractual and fiduciary duty arguments on isolated provisions in the agreement that “authorized” the general partners to “acquire ... any real or personal property which may be necessary, convenient or incidental to the accomplishment of the purposes of the partnership.” See, e.g., partnership agreement § 5.2. The plaintiffs claim that these provisions anticipated that additional opportunities to acquire real estate might become available and that the general partners were directed by the partnership agreement to pursue such partnership opportunities.

We interpret these provisions much more narrowly. They simply authorized the purchase of property deemed necessary, convenient, or incidental to the development of the 23 East Street project contemplated in the partnership agreement. We also conclude that the purchases of 1 and 9 East Street, and the three large warehouses located on those properties, were in size and scope of a very different dimension than that contemplated by the additional property provisions in the partnership agreement and were therefore not “directed” by the single purpose, limited partnership agreement. Twenty-three East Street represented, for example, only twelve percent of the square footage of the combined properties. The other large properties were not necessary, incidental, or convenient to the 23 East Street project, as those words are commonly understood. Rather they were significant, independent purchases.

Occasional references in the trial record to the easements held by 23 East Street for access over 1 and 9 East Street also do not support the plaintiffs' contention, asserted at oral argument, that those easements supplied the “silver bullet” that rendered acquisition of 1 and 9 East Streets necessary, convenient, or incidental to the limited partnership. Those easements, which provided 23 East Street with access between the building and East Street, ran in favor of 23 East Street. The plaintiffs point to nothing in the record or the law to indicate that the acquisition of properties that were burdened by those easements would further the limited partnership's purpose.

As to parking, the judge found that 23 East Street began leasing parking spaces from adjacent properties in 1999, at market prices, only after a disgruntled commercial neighbor constructed a fence that curtailed access to parking that had been previously used by 23 East Street for many decades. Again, the occasional leasing of parking spaces from adjacent properties did not render the acquisition of the entire 1 and 9 East Street parcels necessary, convenient, or incidental to the 23 East Street project.

Accordingly, the general partners committed a breach neither of their fiduciary duty nor of the partnership agreement when they acquired the properties at 1 and 9 East Street without disclosing the purchases or offering the limited partners the opportunity to participate in the investments. As such, judgment was properly entered for the defendants on the plaintiffs' claims for misappropriation of partnership opportunity and for breach of contract stemming from the acquisition of those properties.

2. *Related-party transactions.* The plaintiffs claimed that the general partners wrongly made payments to themselves and to their affiliated entities for services that should have been disclosed to the limited partners in advance, as § 12.5 of the partnership agreement required.

The services themselves were expressly authorized by § 12.5. As to the lack of advance notice, the judge found that no harm was shown to have resulted from the omission. Her finding was based on the overwhelming evidence that the compensation paid to the defendants and their related entities was fair and reasonable.

The plaintiffs additionally complain that the judge improperly placed the burden of proving the unreasonableness of the fees on them, rather than on the defendants. See, e.g., *Starr v. Fordham,* 420 Mass. at 183, 648 N.E.2d 1261 (where judge concluded that partner had engaged in self-dealing, it was the partner's "burden to prove the fairness of his actions and to prove that his actions did not result in harm to the partnership"). The judge expressly found, however, that the defendants' activities giving rise to related-party transactions "were reasonable, and within the ordinary management of commercial real estate," and that the defendants offered evidence "that established that all fees and commissions paid to them or affiliates were well within market rates." The judge therefore concluded that "[e]ven if the burden fell on the defendants to show the fees were reasonable, *Starr v. Fordham,* 420 Mass. [at] 183 [648 N.E.2d 1261] ..., they amply met that burden." Finally, the judge properly found that the evidence submitted at trial by the defendants fully supported the valuation of 23 East Street, and the plaintiffs failed to introduce any material evidence to the contrary.[FN13]

The defendants have requested attorney's fees and costs on appeal pursuant to Mass.R.A.P. 25, as appearing in 376 Mass. 949 (1979). Within fourteen days of the date of rescript, they shall submit to this court a petition for fees and costs, together with supporting materials, as described in *Fabre v. Walton,* 441 Mass. 9, 10-11, 802 N.E.2d 1030 (2004). The plaintiffs shall have fourteen days thereafter to respond.

Judgment affirmed.

Pierce v. Morrison Mahoney LLP

Supreme Judicial Court of Massachusetts,
Suffolk.
Joel F. **PIERCE** & others
v.
MORRISON MAHONEY LLP

Decided Dec. 9, 2008.

CORDY, J.

In *Pettingell v. Morrison, Mahoney & Miller,* 426 Mass. 253, 256, 687 N.E.2d 1237 (1997) (*Pettingell*), we precluded the enforcement of a provision in the Morrison, Mahoney & Miller partnership agreement that "impose [d] adverse consequences on a withdrawing

partner" who competed with the law firm. We precluded enforcement because the provision did not impose such adverse consequences on a withdrawing partner who did not compete with the firm. We concluded that the provision violated the public policy of protecting the rights of clients and potential clients to their choice of counsel, as embodied in S.J.C. Rule 3:07, Canon 2, DR 2-108(A), 382 Mass. 773 (1981), now Mass. R. Prof. C. 5.6, 426 Mass. 1411 (1998) (rule 5.6).[FN4] In this case, we must decide whether that firm's amended partnership agreement, which imposes identical financial consequences on all partners who voluntarily withdraw from the firm, regardless of whether they compete with the firm after withdrawing, also violates rule 5.6. We conclude that it does not. We also conclude that the plaintiffs' claim that Morrison Mahoney was collaterally estopped from contesting liability in this case was properly rejected.

Background. The following facts are taken from the parties' stipulations, which we have supplemented with additional undisputed facts from the record.

The defendant Morrison Mahoney LLP (Morrison Mahoney or the firm) [FN6] is a limited liability partnership engaged in the practice of law. The plaintiffs Joel F. Pierce, John J. Davis, Elizabeth M. Fahey, Mitchell S. King, and Alice Olsen Mann are lawyers admitted to the practice of law in Massachusetts who became partners of Morrison Mahoney (or its predecessor) in 1981, 1987, 1987, 1987, and 1985 respectively. On January 17, 1989, Morrison Mahoney adopted a new partnership agreement, which each plaintiff signed. The partnership agreement provided that any provision of the agreement could be amended by vote of the partners.

Under the 1989 partnership agreement Morrison Mahoney maintained its financial accounts and reported its income to the Internal Revenue Service on a cash basis. Morrison Mahoney also maintained its financial accounts on an accrual basis. Income reported on an accrual basis included some components that were not included in Morrison Mahoney's cash basis income for the same year, such as work that had not yet been billed and the estimated potential amount collectible on subrogation cases and contingent fee cases. Income reported on a cash basis included some components that were not included in Morrison Mahoney's accrual basis income for the same year, such as fees that were received for billings in a prior year and fees collected on subrogation and contingent fee cases.

Under the 1989 partnership agreement, Morrison Mahoney partners received annual drawing accounts, paid out in equal instalments during the year. From time to time, partners received additional distributions from the firm. The 1989 partnership agreement also allocated the increase or decrease in the net worth of the partnership resulting from each year's operation (i.e., net income or loss), determined on an accrual basis, among the partners. The increase or decrease in the firm's net worth was divided into portions and allocated to each partner as annual partnership interest credits (APICs). The amount of APICs allocated to each partner was noted on the accrual reports prepared by Morrison Mahoney's accountants and on yearly records kept for each partner.

The 1989 partnership agreement described several ways in which partners could receive

payments on account of their APICs. With respect to active partners, the agreement provided that "[a]t the end of each fiscal year, an amount equal to 50 percent of the cash surplus, if any, shall be paid as extra compensation to the partners who have positive [APICs] standing in their name from previous years." This practice was known in the firm as the "50/50 Rule." Payments to active partners on account of APICs from the firm's cash surplus were made on a "First In, First Out" basis. That is, the oldest APICs allocations were paid first, such that partners with more seniority were paid before partners with less seniority. The amount distributed to such partners on account of their APICs was attributable to them as earned income for income tax purposes for that year and was reflected in Morrison Mahoney's financial statements. Partners departing from Morrison Mahoney could also receive APICs payments after their departure in certain circumstances. For example, departing partners who retired under the terms of the agreement after having been a Morrison Mahoney partner for twenty years or attaining the age of sixty could receive payment on account of their APICs after departing the firm.[FN7] However, if such a partner subsequently resumed the practice of law "other than [at] the ... firm," the agreement treated that partner as a voluntarily withdrawn partner.[FN8] Departing partners who voluntarily withdrew from the firm would receive APICs payments only if they did not compete with the firm.

This forfeiture-for-competition provision for voluntarily withdrawing partners became the subject of litigation. In 1993, two Morrison Mahoney partners, Richard Pettingell and Joseph Regan, voluntarily withdrew from the firm and established a competing law practice. Morrison Mahoney refused to make APICs payments to them on the grounds that the voluntarily withdrawn partners had forfeited their right to receive APICs payments under the 1989 partnership agreement. A lawsuit followed. In May, 1996, a Superior Court judge granted summary judgment to Pettingell and Regan, and on December 10, 1997, this court also ruled in their favor, concluding that the forfeiture-for-competition provision violated the polices underlying DR 2-208(A). *Pettingell, supra* at 255, 687 N.E.2d 1237.

While the *Pettingell* litigation was pending, the partners of Morrison Mahoney voted to amend the 1989 partnership agreement (1995 amendments). The 1995 amendments froze the APICs accounts, so that there was no further accrual for any year after 1994.[FN10] They also deleted the "50/50 Rule." Most importantly to this case, the 1995 amendments deleted the forfeiture-for-competition provision for voluntarily withdrawing partners and replaced it with a provision that provided that all partners voluntarily withdrawing from the firm would forfeit their APICs, regardless of whether the partners competed with Morrison Mahoney after withdrawal.[FN11] Pierce, Davis, King, and Mann attended the meeting at which the 1995 amendments were adopted and all of them voted for the amendments. Fahey did not attend the meeting or vote for the amendments by proxy.

The plaintiffs Pierce, Davis, and Fahey voluntarily withdrew from Morrison Mahoney effective September 18, 1998, to form a new law firm. Mann voluntarily withdrew from Morrison Mahoney effective October 5, 1998, to form her own law office. King voluntarily withdrew from Morrison Mahoney effective February 18, 2000, to join another law firm. None of the plaintiffs had reached age sixty or served as a Morrison Mahoney partner for twenty years, and each planned to continue practicing law.[FN12] Relying on the 1995

amendments, Morrison Mahoney made no payments on account of APICs to any of the plaintiffs.

In August, 2004, Pierce, Fahey, and Davis sued Morrison Mahoney in the Superior Court. Mann and King brought separate actions in the Superior Court against Morrison Mahoney in October, 2004, and February, 2006, respectively. All five plaintiffs sought APICs payments from Morrison Mahoney. On cross motions for summary judgment, a judge ruled that Morrison Mahoney was not collaterally estopped from contesting liability by reason of an adverse ruling against it in a prior arbitration. All three cases were consolidated at the request of the parties for a trial on stipulated facts and exhibits. The judge concluded that to the extent the 1995 amendments did not permit voluntarily withdrawn partners who continued to practice law to receive APICs payments, the amendments violated rule 5.6, and ordered Morrison Mahoney to make APICs payments to the plaintiffs. Morrison Mahoney appealed from the judgment and the plaintiffs cross-appealed. We granted Morrison Mahoney's application for direct appellate review.

[3] Rule 5.6 provides in pertinent part: “A lawyer shall not participate in offering or making ... a partnership or employment agreement that restricts the right of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement....” Our cases make clear that rule 5.6 exists primarily to protect the interests of clients, not lawyers. As noted above, we previously reviewed the enforceability of the forfeiture-for-competition provision in Morrison Mahoney's 1989 partnership agreement, holding that it violated DR 2-108(A), the predecessor to rule 5.6, and was therefore void as against public policy. We reasoned that such a provision would “discourage a lawyer who leaves a firm from competing with it,” which “would tend to restrict a client or potential client's choice of counsel.” *Id.* at 257, 687 N.E.2d 1237.

[4][5] We reached a similar conclusion in *Eisenstein, supra.* At issue in that case was “whether a law firm may contractually bind former partners to share fees they earn from the firm's current and former clients after the partners leave the firm.” *Id.* at 259, 827 N.E.2d 686. We held that such provisions are unenforceable because they “provide clear disincentives for former ... partners” to serve the firm's clients, even though “those clients [may] have determined that their own interests would best be served by such representation.” *Id.* at 264, 827 N.E.2d 686. Thus, such fee-sharing provisions “impinge on the ‘strong public interest in allowing clients to retain counsel of their choice.’ ” *Id.* at 259, 827 N.E.2d 686, quoting *Meehan v. Shaughnessy, supra* at 431, 535 N.E.2d 1255. The *Eisenstein* case made clear that “[r]ule 5.6 exists to protect the strong interests clients have in being able to choose freely the counsel they determine will best represent their interests. The rule furthers the client's right freely to select counsel by prohibiting attorneys from engaging in certain practices that effectively shrink the pool of qualified attorneys from which clients may choose.” *Id.* at 262, 827 N.E.2d 686. Accordingly, “[t]he ‘broad prophylactic object’ of rule 5.6... requires close judicial scrutiny of any partnership provision that imposes financial disincentives on attorneys who leave a firm *and then compete* with it” (emphasis added). *Id.* at 263, 827 N.E.2d 686, quoting *Pettingell, supra* at 257, 687 N.E.2d 1237.

Central to our holdings in both *Pettingell* and *Eisenstein* were the different fates of a lawyer who withdrew and competed and one who withdrew but did not compete. In each case, the partnership agreement created a strong disincentive for withdrawing partners to represent clients who formerly had been represented by the prior firm, or whose representation might be viewed as competitive to the firm. The problem in *Pettingell* was not that a forfeiture occurred, but that after voluntarily withdrawing from Morrison Mahoney, a partner who wanted to compete had to choose between (1) representing Client A and forfeiting his APICs account or (2) declining to represent Client A and retaining his APICs. The problem in *Eisenstein* was similar in that after leaving the firm, the former partner had to choose between (1) representing the former firm's clients and remitting a portion of the fees from those clients to that firm or (2) declining to represent the former firm's clients in order to keep one hundred per cent of the fees generated from other clients. The financial disincentives in those cases tended to limit a client's choice of counsel by discouraging former firm lawyers from representing certain clients. In this case, however, the fate of a lawyer who voluntarily withdraws and competes with Morrison Mahoney for its clients is precisely the same as the fate of a lawyer who voluntarily withdraws and does not: both forfeit their APICs on withdrawal. Thus, a Morrison Mahoney partner who voluntarily withdraws and competes is no longer faced with the choice that was problematic in *Pettingell.* Instead, that lawyer may accept the representation of any client without triggering a financial forfeiture. This does nothing to "shrink the pool of qualified attorneys from which clients may choose."

Nevertheless, the plaintiffs argue that this constituted a "de facto forfeiture-for-competition provision" because no partner could voluntarily withdraw from Morrison Mahoney, compete with the firm, and receive APICs payments. However, the plaintiffs fail to acknowledge the difference between a loss of benefits that is triggered by the decision to compete and one that is triggered by the decision to leave, whether or not one later competes. Only the first limits client choice in violation of the public policy behind rule 5.6. The purpose of rule 5.6 is not to protect lawyer mobility. A provision that makes a lawyer reluctant to leave, but that does not restrict the lawyer's conduct after he or she departs, does nothing to prevent the lawyer from thereafter accepting clients in competition with the firm. In restructuring its partnership agreement in this fashion, Morrison Mahoney has created a financial disincentive for its partners to leave the firm before they reach age sixty or serve as partners for twenty years. There is nothing inherently violative of public policy in partners agreeing to such disincentives in the interests of the long-term financial and professional health of their enterprises.

The plaintiffs argue further that the partnership agreement's definition of "retirement" allows the firm to discriminate between partners who leave to compete and those who do not by classifying competing partners as "voluntarily withdrawn" (and thus not entitled to APICs) and classifying noncompeting partners as "retired." Notably, not all "retired" partners are entitled to APICs payments. As we have already explained, of the partners who meet the agreement's definition of retirement, only those who do so *after* reaching age sixty or serving as a partner for twenty years receive APICs payments upon their departure. See note 7, *supra*. Regardless of whether Morrison Mahoney classifies a departing partner as

“voluntarily withdrawn” or “retired,” that partner is not eligible to receive APICs payments before reaching either the age or seniority benchmark.

The plaintiffs direct us to Morrison Mahoney's alleged “disparate treatment” of two partners who left the firm after reaching the age or seniority benchmarks for APICs payments. Although both of these partners met the definition of retirement on departing Morrison Mahoney**,** one later began to compete and had to forfeit APICs payments, while the other joined the Attorney General's office and continued to receive APICs payments. The plaintiffs point to this as evidence that Morrison Mahoney “had a singular goal of denying partners who competed with the Firm repayment of their APIC[s] accounts.” Morrison Mahoney responds by characterizing APICs as “retirement benefits” that fit within the retirement benefits exception in rule 5.6. See Mass. R. Prof. C. 5.6 (“A lawyer shall not participate in offering or making ... a partnership or employment agreement that restricts the right of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement ...”). The plaintiffs dispute Morrison Mahoney's characterization of APICs as “retirement benefits” and argue that APICs in fact represent each partner's ownership interest in the firm, which was “fixed and vested at the time allocated and reflected a return of income that had been earned and deferred.”

We need not decide, however, whether APICs are a “retirement benefit” or some other form of interest or expectancy. The answer to that question is only relevant to the class of partners whose receipt of APICs may be contingent on whether they compete, that is, partners who have reached age sixty or served as a Morrison Mahoney partner for twenty years. No plaintiff in this case had reached those benchmarks on departing from Morrison Mahoney. Whether Morrison Mahoney's amended partnership agreement shrinks the pool of attorneys who have reached the age or seniority benchmark in derogation of client choice is thus not before us.

Finally, plaintiffs cite *Weiss v. Carpenter, Bennett & Morrissey,* 143 N.J. 420, 672 A.2d 1132 (1996), for the proposition that a provision in a partnership agreement can violate rule 5.6 even though it treats all departing partners equally. In *Weiss,* the Supreme Court of New Jersey affirmed an arbitration award in favor of a departing partner who claimed that a provision of the partnership agreement that prohibited a withdrawing attorney from receiving a distribution of his capital account if he was withdrawing “for any reason other than death, permanent disability, attainment of age sixty-five, or appointment to the judiciary” violated the New Jersey version of rule 5.6. *Id.* at 422, 448, 672 A.2d 1132. Morrison Mahoney, on the other hand, cites a similar case decided by the New York Court of Appeals, *Hackett v. Milbank, Tweed, Hadley & McCloy,* 86 N.Y.2d 146, 150-151, 630 N.Y.S.2d 274, 654 N.E.2d 95 (1995), which reinstated an arbitration award in favor of a law firm whose partnership agreement had provided for limiting supplemental payments for all withdrawing partners based on the level of their income at their new employment.[FN14] This provision applied to all withdrawing partners regardless of the nature of their subsequent occupation or practice. *Id.* The award had been set aside on public policy grounds by a lower court. *Id.* at 149, 630 N.Y.S.2d 274, 654 N.E.2d 95. The Court of Appeals disagreed, noting that the reduction “applies to all withdrawing partners and no financial disincentive specifically devolves on

partners withdrawing to compete with [the firm] in contrast to all other withdrawing partners." *Id.* at 156, 630 N.Y.S.2d 274, 654 N.E.2d 95. Insofar as both cases turn on their respective State's strong public policy in favor of enforcing arbitration awards, they are of limited utility.

In sum, we are persuaded that, in the circumstances of this case, the provisions of Morrison Mahoney's amended partnership agreement resulting in the plaintiffs' forfeiture of APICs did not violate the policy embodied in rule 5.6 as we have interpreted it in *Pettingell* and *Eisenstein.*

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Conclusion. We reverse the judgments for the plaintiffs on their claims that Morrison Mahoney's partnership agreement violates rule 5.6 by depriving them of their APICs. We affirm entry of partial summary judgment for Morrison Mahoney on the plaintiffs' claims of collateral estoppel. The case is remanded for entry of judgments in favor of Morrison Mahoney.

So ordered.

Appeals Court of Massachusetts,
Norfolk.

FIRST BOSTONVIEW MANAGEMENT, LLC
v.
BOSTONVIEW CORPORATION & others.[1]

Decided Aug. 19, 2015.

Synopsis

Background: Prospective purchaser of church's real property held by charitable corporation sued corporation, its president, and treasurer for breach of purchase and sale agreement, breach of indemnification agreement, conspiracy, damages for money had and received, and other claims arising out of failed transaction. The Superior Court Department, Norfolk County, Kenneth J. Fishman, J., entered summary judgment for corporation and then entered separate and final judgment dismissing remaining claims. Prospective purchaser appealed.

Holdings: The Appeals Court, Berry, J., held that:

- proposed sale of substantially all of corporation's church real property was extraordinary transaction that church board of trustees lacked actual authority to

delegate to corporation's president and treasurer;

- doctrine of apparent authority did not apply to determination whether board of trustees could delegate to corporation's president and treasurer authority to sell corporation's primary asset;

- board of trustees' failure to repudiate purchase and sale agreement did not constitute ratification of president's and treasurer's authority to sell property;

- board of trustees' resolution that purchaser was given first option to purchase property did not constitute ratification of president's and treasurer's authority to sell property;

- purchaser could not recover on claim for breach of indemnification agreement; and

- purchaser could not recover on claim for civil conspiracy.

Affirmed.

Procedural Posture(s): On Appeal; Motion for Summary Judgment.

Opinion

BERRY, J.

The plaintiff, First Bostonview Management, LLC (First Bostonview), appeals from the judgment entered pursuant to Mass.R.Civ.P. 54(b), 365 Mass. 821 (1974), after the allowance of the summary judgment motion by the defendant, Bostonview Corporation (Bostonview), a charitable corporation, on First Bostonview's claims stemming from its attempt to purchase substantially all of Bostonview's real property. We affirm the judgment.

As is further discussed herein in more particularized detail, the corporate board of directors of a charity and the powers of corporate officers in a charitable organization, such as Bostonview, are subject to strict fiduciary standards in the conduct of the charity's business affairs. The Supreme Judicial Court has made clear that only specific authorization can bind a charitable corporation to an "extraordinary transaction" entered into by its corporate officers, and that authority to enter into a contract which would divest the charitable corporation "of the very essence" of its existence lies beyond the power of the charitable corporate board to delegate to corporate officers. *Boston Athletic Assn. v. International Marathons, Inc.,* 392 Mass. 356, 364–367, 467 N.E.2d 58 (1984).

In this case, the sale of substantially all of the Bostonview church property (consisting of a church sanctuary, a parish meeting hall, a large apartment complex, offices, and parking spaces on prime land on Beacon Hill near the Massachusetts State House) was indisputably

an "extraordinary transaction," and, if completed to the end would have stripped Bostonview of the very essence of its existence as a charitable corporation, organized "exclusively for religious, charitable, scientific and education purposes" subject to the holding of the church property and the collection of income from that property for the church. We conclude that the authority to make such a divesting asset/property sale contract in the case of Bostonview was beyond the power of the charitable corporate board to delegate to two of its officers. The contract was void. The "shady" nature of the underlying prenegotiations to sell the church's very valuable (but sole) asset for $30 million—including combined cash payments of close to $100,000 to two of the executive officers, and the purchase of the $94,000 luxury car for the church secretary—only serves to demonstrate why restrictions on "extraordinary transactions" must be closely scrutinized by the charity's corporate board. Otherwise intemperate wrongful delegations and improper business deals may result, as here threatening the existence of the charity.

Background. We take the undisputed facts from the Superior Court judge's August 15, 2012, Memorandum of Decision and Order on Defendant Bostonview Corporation's Motion for Summary Judgment, which we supplement from the record, as noted. First Bostonview is a Massachusetts limited liability company managed by Michael Perry, a real estate developer with over forty years of experience. Roger J. Lehrberg, a real estate attorney, acted as a signatory for First Bostonview for real estate filings.

The defendant Bostonview is a charitable corporation, incorporated in Delaware and registered in Massachusetts to do business on behalf of the Boston Society of New Jerusalem, Inc. (church). Bostonview was organized "exclusively for religious, charitable, scientific and education purposes with the specific object of holding title to properties and collecting the income therefrom and turning over the entire amount thereof, less expenses," to the church. The property at issue here is located at 130–140 Bowdoin Street, and includes 146 rental apartments, eighty-two parking spaces, offices, a religious sanctuary, and a parish meeting hall (church property). A 1978 amendment to Bostonview's certificate of incorporation included provisions allowing Bostonview to "enter into, perform, and carry out contracts of any kind necessary to, or in connection with, or incidental to, the accomplishment of the purposes of the corporation," and to "acquire any property real or personal ... necessary for the construction and operation of such project."

The defendant, Thomas J. Kennedy, served on Bostonview's board of directors from September 22, 2003, until July, 2005, and served as its president for a time starting on September 22, 2003. The defendant, Edward J. MacKenzie, Jr., served as the treasurer of Bostonview, also starting on September 22, 2003, and served as the director of operations as well.[2]

On April 22, 2004, a purchase and sale agreement for the church property was signed by Kennedy, as president of Bostonview, by MacKenzie, as Bostonview's treasurer, and by Lehrberg, on behalf of First Bostonview. The agreement listed a purchase price of $30 million and acknowledged receipt of $50,000. It also provided that the purchaser could pay the balance of $29,950,000, with a note to the seller, secured by a purchase money mortgage.

A closing was set for August 16, 2004, at the Suffolk County registry of deeds.

There is no record of the $50,000 deposit Perry claimed to have made to Bostonview. But Perry claims that in addition to that check, he made cash payments totaling $15,000 to Kennedy and MacKenzie personally, as well as paid $94,000 to purchase a Mercedes Benz for the church secretary. He also paid $10,000 to a trust set up for MacKenzie's daughter and $20,000 to a nominee trust set up by Kennedy.

On August 16, 2004, the date scheduled for the closing, no one from Bostonview appeared. Kennedy and MacKenzie later told Perry that the closing was delayed due to litigation, and that additional payments were needed to extend the closing. Perry paid another $60,000 to the aforementioned trusts.

According to the plaintiff, the parties subsequently entered into an exclusive option to purchase agreement, dated January 2, 2005 (2005 option). The document consists of a one-page letter, signed by Bostonview's then-president, John B. Burke. The 2005 option provided an expiration date of January 2, 2008, but failed to state a purchase price, deposit amount, or the manner in which the purchaser was to exercise the option. A few weeks later, on January 23, 2005, a one-page document, entitled Resolution by the Board of Trustees Boston Society of the New Jerusalem Inc. (2005 resolution), stated that First Bostonview was given the first option to purchase the property, for a purchase price of "30 million dollars, four apartments of the Church's choice, ten parking spaces on the top level and the space now occupied by the Church." Although the 2005 resolution expressly provided that it was only valid with the official church seal affixed, no seal appears on the document. The document shows the signatures of eight members of Bostonview's board of trustees, but four of those members claimed they did not actually sign it.[3]

A second option was executed on February 19, 2008, to expire December 31, 2008 (2008 option). It was signed by Perry and by Robert von Wolfgang, chairman of Bostonview's board of trustees, though Wolfgang denied he signed it. The option contained a description of the property, similar to that set forth in the 2005 resolution, but did not include a purchase price or the manner in which to exercise the option. It did provide that "[t]his agreement supersedes all other agreements." Perry claims that he and his business partner wrote checks to Bostonview totaling $30,000 toward the 2008 option.

First Bostonview brought this action to recover for breach of the purchase and sale agreement. The complaint included additional counts for breach of an indemnification agreement, damages for money loaned and for money had and received, misrepresentation, civil conspiracy, and violation of G.L.c.93A. Kennedy and MacKenzie were also named as defendants.[4] The judge allowed Bostonview's motion for summary judgment, ruling that the purchase and sale agreement was not enforceable because the corporate officers lacked authority to bind Bostonview. Bostonview's motion for entry of final and separate judgment was allowed, and First Bostonview appealed.

Discussion. 1. *Actual authority.* To begin, the plaintiff argues that Kennedy and MacKenzie

had actual authority to enter into the purchase and sale agreement by virtue of their respective corporate offices and the Bostonview corporate by-laws, which allowed the president to execute certain mortgages and other contracts.[5] We disagree. It is well established that corporate officers do not have authority to sell the principle asset of a corporation without specific authorization from its board of directors. See *Stoneman v. Fox, Film Corp.,* 295 Mass. 419, 425, 4 N.E.2d 63 (1936); *Boston Athletic Assn. v. International Marathons, Inc.,* 392 Mass. at 365, 467 N.E.2d 58; *Kanavos v. Hancock Bank & Trust Co.,* 14 Mass.App.Ct. 326, 333, 439 N.E.2d 311 (1982).

Moreover, because Bostonview is a charitable corporation, the powers of its corporate officers are more strictly construed. See *Boston Athletic Assn. v. International Marathons, Inc.,* 392 Mass. at 366, 467 N.E.2d 58. To that end, the Supreme Judicial Court has made clear that only specific authorization can bind a charitable corporation to an extraordinary transaction entered into by its corporate officers. *Id.* at 364–365, 467 N.E.2d 58. The court, in fact, went further, holding that authority to make a contract that divested the charitable corporation "of the very essence" of its existence, in that case the exclusive right to promote the Boston Marathon, was beyond the power of the board to delegate to its president. *Id.* at 366–367, 467 N.E.2d 58.

Here, in our view, the sale of substantially all of the church property can only be characterized as an extraordinary transaction, and, indeed, one that would divest Bostonview of the very essence of its existence as a charitable corporation. Bostonview was formed "exclusively for religious, charitable, scientific and education purposes" and to hold the church property and collect its income for the church. We believe the authority to make such a contract was beyond the power of the board of trustees to delegate to Kennedy and MacKenzie. See *ibid.* At the very least, if such power could be delegated at all, the corporate officers required specific authorization from the board of trustees to bind Bostonview to the purchase and sale agreement, and no such authority was conferred here. See, e.g., *Bisceglia v. Bernadine Sisters of the Third Order of St. Francis of Mass., Inc.,* 29 Mass.App.Ct. 959, 960–961, 560 N.E.2d 567 (1990) (treasurer's authority "most certainly does not extend to agreements to dispose of real estate owned by the corporation, whose principal activity was the pursuit of its religious purposes").

The plaintiff counters that the cases relied upon by the judge, requiring specific authorization, involved only one corporate officer. Because both the president and the treasurer of Bostonview signed the purchase and sale agreement here, the plaintiff posits that the requirement of specific authorization does not apply to these facts. We note, however, that in *People's Natl. Bank of Boston v. New England Home for Deaf Mutes, Aged, Blind & Infirm,* 209 Mass. 48, 49–50, 95 N.E. 77 (1911), cited in *Boston Athletic Assn. v. International Marathons, Inc.,* 392 Mass. at 366, 467 N.E.2d 58, the court held unenforceable, for lack of authority, a promissory note signed by both the president and treasurer on behalf of a charitable corporation[6] IN a transaction involving the transfer of a major asset of a charitable corporation, specific authorization from the board of directors is required, regardless of the number of corporate officers involved.

2. *Apparent authority.* Even if they were without actual authority, the plaintiff maintains that Kennedy and MacKenzie had apparent authority to sign the purchase and sale agreement on Bostonview's behalf. The judge correctly ruled that the doctrine of apparent authority has no application in this context.

Apparent authority is "created as to a third person by written or spoken words or any other conduct of the principal which, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf by the person purporting to act for him." *Theos & Sons, Inc. v. Mack Trucks, Inc.,* 431 Mass. 736, 745, 729 N.E.2d 1113 (2000). In the case of a charitable corporation, however, apparent authority cannot be relied upon to enforce an agreement that transfers the charity's primary asset or principal function. See *Boston Athletic Assn. v. International Marathons, Inc.,* 392 Mass. at 367, 467 N.E.2d 58; *Bisceglia v. Bernadine Sisters of the Third Order of St. Francis of Mass., Inc., supra* at 960–961, 560 N.E.2d 567. Furthermore, as here, "[w]here the sale of corporate real estate is 'outside the scope of ... [the corporation's] usual activity,' the doctrine of apparent authority does not apply." *Id.,* at 961, 560 N.E.2d 567, quoting from *Kanavos v. Hancock Bank & Trust Co.,* 14 Mass.App.Ct. at 333, 439 N.E.2d 311.

3. *Ratification.* The plaintiff additionally argues that the apparent authority of Bostonview's corporate officers was established by the actions of Bostonview's board of trustees after the purchase and sale agreement was executed. The plaintiff points to cases holding that even in the absence of actual authority, the corporation may be bound if it later ratified the transaction. See, e.g., *Bloomberg v. Greylock Bdcst. Co.,* 342 Mass. 542, 548, 174 N.E.2d 438 (1961) (corporate president's authority to sell major asset of corporation must be shown either by express delegation of such authority or that a majority of directors knew of the sale and approved or ratified it); *Boice–Perrine Co. v. Kelley,* 243 Mass. 327, 330–331, 137 N.E. 731 (1923).

To clarify, ratification is not apparent authority. Ratification, which may be established by the principal's subsequent acquiescence or approval of, or failure to repudiate, a transaction conducted by it agent, "relates back, and has the same effect, as a prior grant of authority by the principal to the agent." *Linkage Corp. v. Trustees of Boston Univ.,* 425 Mass. 1, 18, 679 N.E.2d 191 (1997). Nevertheless, in a transaction involving the transfer of a major asset of a charitable corporation, the requirement of specific authorization is presumed, and the burden is on the purchaser to inquire as to the authority conferred before entering into the transaction. *Bisceglia v. Bernadine Sisters of the Third Order of St. Francis of Mass., Inc.,* 29 Mass.App.Ct. at 960, 560 N.E.2d 567. "Persons dealing with a corporation are presumed to know the extent of its powers." *Boston Athletic Assn. v. International Marathons, Inc.,* 392 Mass. at 367, 467 N.E.2d 58, quoting from *Wiley & Foss, Inc. v. Saxony Theatres, Inc.,* 335 Mass. 257, 260–261, 139 N.E.2d 400 (1957).

It is true that the above cases, cited by the plaintiff, identified ratification as an alternative to actual authority. Nevertheless, that aspect of the analysis has not been adopted in subsequent cases involving charitable corporations. See, e.g., *Boston Athletic Assn. v. International Marathons, Inc.,* 392 Mass. at 364–366, 467 N.E.2d 58;

Third Order of St. Francis of Mass., Inc., 29 Mass.App.Ct. at 960–961, 560 N.E.2d 567. Because of the heightened public interest involved in the disposition of charitable assets, officers of a charitable corporation must have specific authorization to bind the charity to an extraordinary transaction. *Boston Athletic Assn. v. International Marathons, Inc.,* 392 Mass. at 364–365, 467 N.E.2d 58. "Those entrusted with the management of funds dedicated to charitable purposes and donated out of a sense of social or moral responsibility owe an especially high degree of accountability to the individual donors as well as to the community." *Id.* at 366, 467 N.E.2d 58. We therefore conclude that subsequent approval or other conduct by the board of directors of a charitable corporation will not substitute for prior specific authorization to commit the charity to an extraordinary transaction.

For that reason, we reject the plaintiff's assertion that Bostonview's board of trustee's failure to repudiate the purchase and sale agreement, when the transaction came to light in 2008 in litigation involving the church, should be treated as proof of authorization. We reject, as well, the plaintiff's reliance on the 2005 resolution as reaffirming the plaintiff's right to purchase the church property. Even assuming its authenticity, the 2005 resolution was executed three weeks after the 2005 option to purchase and nine months after the purchase and sale agreement.[7] Contrary to the plaintiff's position, the evidence of subsequent conduct by the board of trustees did not create a question of fact regarding the authority of Bostonview's corporate officers to sell the church property.

4. *Separate and final judgment.* The plaintiff argues that the judge's allowance of Bostonview's motion for entry of separate and final judgment, whereby the judge dismissed the plaintiff's remaining claims, was error. We touch briefly on the dismissal of those claims, which we determine was not error.

The plaintiff sought damages for breach of an indemnification agreement, dated September 17, 2008, between Perry and Bostonview, signed by Rex Ellis, as president and chairman of the board of trustees of Bostonview. The plaintiff's one-paragraph argument in its brief on appeal does not establish that Ellis had authority to bind Bostonview to an agreement to pay up to $475,000 to indemnify Perry for amounts he had paid to MacKenzie towards the purchase of the church property. As previously explained, the power of an officer of a charitable corporation to enter into a transaction that falls outside the general managerial functions of the charity is narrowly construed. *Boston Athletic Assn. v. International Marathons, Inc.,* 392 Mass. at 364–366, 467 N.E.2d 58. And Perry, as the party dealing with a charitable corporation, was bound to inquire as to the extent of Ellis's authority. See *id.* at 367, 467 N.E.2d 58. Instead, the record indicates that Perry was aware that the church had filed a lawsuit against Ellis claiming that he had illegally gained control of the church, as Perry signed an affidavit in connection with the litigation on September 18, 2008, the day after Ellis executed the indemnification agreement in Perry's favor.

The plaintiff's claims for civil conspiracy and violation of G.L.c.93A, were properly dismissed, based on the judge's ruling regarding the lack of actual or apparent authority of Bostonview's corporate officers to transfer the church property, as the judge correctly determined that Kennedy and MacKenzie were not acting on Bostonview's behalf or in

concert with Bostonview in signing the purchase and sale agreement.

We do not reach the plaintiff's following claims. The plaintiff devotes two sentences in its brief to its claim for monies loaned and monies had and received; as that does not constitute appropriate appellate argument, the issue is deemed waived. See Mass.R.A.P. 16(a)(4), as amended, 367 Mass. 921 (1975); *Morgan v. Laboratory Corp. of Am.,* 65 Mass.App.Ct. 816, 821 n. 6, 844 N.E.2d 689 (2006). The plaintiff's claim against Bostonview for misrepresentation, regarding the status of Kennedy and MacKenzie as corporate officers when they were negotiating the sale, was not set out in its complaint and may not be raised here. See *Flynn v. Boston,* 59 Mass.App.Ct. 490, 495, 796 N.E.2d 881 (2003).

Judgment affirmed.

All Citations

88 Mass.App.Ct. 89, 36 N.E.3d 55

Footnotes

[1] Thomas J. Kennedy, individually and doing business as JMJ Nominee Trust, and Edward J. MacKenzie, Jr., individually and as trustee of and doing business as Courmac Realty Trust.

[2] The dates that Kennedy and MacKenzie ceased to hold their respective offices are disputed.

[3] The summary judgment record contains affidavits from four of the members, asserting that they had never seen or signed the resolution. The affidavits were unopposed.

[4] MacKenzie and other codefendants were also the subject of Federal indictment concerning misadministration of the affairs of the church. In the indictment, MacKenzie was charged by a Federal grand jury in several counts with engaging in "a pattern of fraudulent acts," in order to "defraud the Church of its considerable financial holdings and profit from transactions involving the Church." On October, 23, 2014, MacKenzie pleaded guilty to the Federal charges. By his guilty pleas, MacKenzie was convicted of a series of Federal criminal offenses, including but not limited to racketeering conspiracy, racketeering, mail fraud, and money laundering. The predicate racketeering acts to defraud the church in the Federal criminal case were in addition to the subject asset sale transaction which is the subject of this appeal, and which was not incorporated in the Federal criminal indictment. This particular purported transaction to sell the church's sole asset—all as further described in this opinion—is, for the reasons stated herein, voided under Massachusetts law as in breach of fiduciary obligations. See *United States v. MacKenzie,* U.S. Dist. Ct., No. 13–cr–10149 (D.Mass. May 21, 2013). Also of note, Kennedy, after waving indictment, pleaded to criminal information charging mail fraud conspiracy and several counts of filing false individual tax returns. See *United States v. Kennedy,* U.S. Dist. Ct., No. 13–cr–10065 (D.Mass. Mar. 13, 2013).

[5] The plaintiff relies on the following: "[The president] shall execute bonds, mortgages and other contracts requiring a seal, under the seal of the corporation, except where required or permitted by law to be otherwise signed and executed and except where the signing and execution thereof shall be expressly delegated by the board of directors to some other officer or agent of the corporation."

[6] The plaintiff's argument on appeal, concerning enforcement of the purchase and sale agreement under G.L.c.156D, § 8.46, fails, if for no other reason than that the agreement lacked the statutorily required acknowledgement to constitute a recordable instrument. See G.L.c.183, § 30; *Bisceglia v. Bernadine Sisters of the Third Order of St. Francis of Mass., Inc., supra* at 961, 560 N.E.2d 567.

[7] Moreover, the 2005 resolution contained different terms than the 2005 option and, like the option itself, made no reference whatsoever to the purchase and sale agreement. It also lacked the official church seal, without which it was not valid as provided therein. We add here that, to the extent the plaintiff seeks to enforce the 2005 and 2008 options—its brief does not make that clear—the judge properly dismissed the claims, as both documents lacked essential terms, even apart from the issue of authorization. See, e.g., *Lewis v. Chase,* 23 Mass.App.Ct. 673, 676, 505 N.E.2d 211 (1987) (option agreements are "to be strictly construed").

X. Introduction to Corporations

It used to be common to classify partnerships (but not limited partnerships) as "de facto" which meant that no statutory formalities were required in order to become a partnership. All you needed to do was find some one else to go into business with you as a co-owner. M.G.L. c. 108A, the Massachusetts partnership statute, was enacted as a default provision., to bring uniformity to partnership law, much like the UCC was enacted to bring uniformity to contract law.

Corporations, on the other hand, were called "creatures of statute," because there were certain necessary documents which had to be filed before corporate status was granted. But with the advent of LLP's, LP's and LLC's, this distinction has become essentially meaningless.

Corporations in Massachusetts are governed by M.G.L. c. 156D. You do need to file documents in order to incorporate. And you incorporate for many reasons, not the least of which is to limit liability. The corporation is the principal, and its directors, officers, and employees are its agents. Respondeat superior applies against the corporation for the acts of its agents in the scope of their authority (but note, it is the corporation which is liable under respondeat superior, not the individual officers and directors of the corporation).

In essence, corporations are a way of divorcing ownership of the corporation (you own shares of stock in Microsoft, which means you own a piece of Microsoft) from control of the corporation (control of Microsoft is vested in its Board of Directors). As a partner (owner) in a partnership, you have a right to hire and fire employees in the ordinary course of the partnership business. As a shareholder (owner) of Microsoft, you have absolutely no right to hire and fire anyone at Microsoft. As we begin to discuss who does have power in corporations and how they operate in the real world, I will pass out Articles of Organization and proposed By-laws of a Massachusetts corporation, so you can better grasp how things actually work. This will be a hands-on exercise, which if successfully completed will give you a good working knowledge of how to incorporate a business in Massachusetts.

The Business Judgment Rule

In exchange for the benefit of limited liability, small stockholders in large corporations give up the right to manage the day to day affairs of the corporation (like a limited partner in a limited partnership, you invest in a large corporation to make money for yourself – it's simply a variant of the old saying, Buy low, sell high). If you don't like the way a company is being run, then your most likely option (though there are others) is to sell your shares of stock in the corporation, and walk away. Again, ownership of the corporation is divorced from control of the corporation.

As we will discuss in class, it is the directors and officers of the corporation who actually run the corporation. The directors are agents of the corporate principal, and as agents, they are bound to exercise their powers with "due care," and in an impartial manner (they have a duty of loyalty). If they exercise their duties responsibly and loyally, their decisions, however stupid in hindsight, will not be disturbed, or second guessed. The "Business Judgment Rule" will insulate them and their business decisions from stockholder or judicial scrutiny.

Discussion points for Smith v Barlow

As "creatures of statute," corporations can only do what they are allowed to do by statute. Which makes sense. If the corporation (through its officers) does something allowed by statute, it is said to be "intra vires" (literally, within the power). If it does something it is not authorized to do, it is said to be acting "ultra vires" and the board of directors will be liable to the stockholders for allowing this to happen.

This case starts from a simple proposition. The "purpose" of a corporation is to maximize the wealth of its shareholders (after all, they own the corporation). Which leads to the next question: Who decides how to best maximize the wealth of the shareholder owners? Should each and every shareholder be allowed to decide how to do this (is this a partnership?), or should the authority to make these decisions reside in the corporation's board of directors? If the latter, how much leeway should we give them? Please understand exactly what is going on here. The board of directors is taking corporate and therefore shareholder) money and giving it to their favorite charities (which may or may not be the shareholders/owners favorite charities). Isn't it a bit bothersome to you when other people decide which charity your money will go to? Could a bank do this with a portion of your checking account?

A. P. SMITH MFG. CO.
v.
BARLOW et al.

Supreme Court of New Jersey.

Decided June 25, 1953.

JACOBS, J.

The Chancery Division, in a well-reasoned opinion by Judge Stein, determined that a donation by the plaintiff The A. P. Smith Manufacturing Company to Princeton University

was Intra vires. Because of the public importance of the issues presented, the appeal duly taken to the Appellate Division has been certified directly to this court under Rule 1:5--1(a).

The company was incorporated in 1896 and is engaged in the manufacture and sale of valves, fire hydrants and special equipment, mainly for water and gas industries. Its plant is located in East Orange and Bloomfield and it has approximately 300 employees. Over the years the company has contributed regularly to the local community chest and on occasions to Upsala College in East Orange and Newark University, now part of Rutgers, the State University. On July 24, 1951 the board of directors adopted a resolution which set forth that it was in the corporation's best interests to join with others in the 1951 Annual Giving to Princeton University, and appropriated the sum of $1,500 to be transferred by the corporation's treasurer to the university as a contribution towards its maintenance. When this action was questioned by stockholders the corporation instituted a declaratory judgment action in the Chancery Division and trial was had in due course.

Mr. Hubert F. O'Brien, the president of the company, testified that he considered the contribution to be a sound investment, that the public expects corporations to aid philanthropic and benevolent institutions, that they obtain good will in the community by so doing, and that their charitable donations create favorable environment for their business operations. In addition, he expressed the thought that in contributing to liberal arts institutions, corporations were furthering their self-interest in assuring the free flow of properly trained personnel for administrative and other corporate employment. Mr. Frank W. Abrams, chairman of the board of the Standard Oil Company of New Jersey, testified that corporations are expected to acknowledge their public responsibilities in support of the essential elements of our free enterprise system. He indicated that it was not 'good business' to disappoint 'this reasonable and justified public expectation,' nor was it good business for corporations 'to take substantial benefits from their membership in the economic community while avoiding the normally accepted obligations of citizenship in the social community.' Mr. Irving S. Olds, former chairman of the board of the United States Steel Corporation, pointed out that corporations have a self-interest in the maintenance of liberal education as the bulwark of good government. He stated that 'Capitalism and free enterprise owe their survival in no small degree to the existence of our private, independent universities' and that if American business does not aid in their maintenance it is not 'properly protecting the long-range interest of its stockholders, its employees and its customers.' Similarly, Dr. Harold W. Dodds, President of Princeton University, suggested that if private institutions of higher learning were replaced by governmental institutions our society would be vastly different and private enterprise in other fields would fade out rather promptly. Further on he stated that 'democratic society will not long endure if it does not nourish within itself strong centers of non-governmental fountains of knowledge, opinions of all sorts not governmentally or politically originated. If the time comes when all these centers are absorbed into government, then freedom as we know it, I submit, is at an end.'

The objecting stockholders have not disputed any of the foregoing testimony nor the showing of great need by Princeton and other private institutions of higher learning and the important public service being rendered by them for democratic government and industry

alike. Similarly, they have acknowledged that for over two decades there has been state legislation on our books which expresses a strong public policy in favor of corporate contributions such as that being questioned by them. Nevertheless, they have taken the position that (1) the plaintiff's certificate of incorporation does not expressly authorize the contribution and under common-law principles the company does not possess any implied or incidental power to make it, and (2) the New Jersey statutes which expressly authorize the contribution may not constitutionally be applied to the plaintiff, a corporation created long before their enactment. See R.S. 14:3--13, N.J.S.A.; R.S. 14:3--13.1 et seq., N.J.S.A.

In his discussion of the early history of business corporations Professor Williston refers to a 1702 publication where the author stated flatly that 'The general intent and end of all civil incorporations is for better government.' And he points out that the early corporate charters, particularly their recitals, furnish additional support for the notion that the corporate object was the public one of managing and ordering the trade as well as the private one of profit for the members.

During the 19th Century when corporations were relatively few and small and did not dominate the country's wealth, the common-law rule did not significantly interfere with the public interest. But the 20th Century has presented a different climate. Control of economic wealth has passed largely from individual entrepreneurs to dominating corporations, and calls upon the corporations for reasonable philanthropic donations have come to be made with increased public support. In many instances such contributions have been sustained by the courts within the common-law doctrine upon liberal findings that the donations tended reasonably to promote the corporate objectives.

Thus, in the leading case of Evans v. Brunner, Mond & Company, Ltd. (1921) 1 Ch. 359, the court held that it was within the incidental power of a chemical company to grant 100,000 to universities or other scientific institutions selected by the directors 'forv the furtherance of scientific education and research.' The testimony indicated that the company desired to encourage and assist men who would devote their time and abilities to scientific study and research generally, a class of men for whom the company was constantly on the lookout. This benefit was not considered by the court to be so remote as to bring it outside the common-law rule. Similarly, in Armstrong Cork Co. v. H. A. Meldrum Co., 285 F. 58 (D.C.W.D.N.Y.1922), the court sustained contributions made by the corporation to the University of Buffalo and Canisius College. In the course of its opinion the court quoted the familiar comment from Steinway v. Steinway & Sons, 17 Misc. 43, 40 N.Y.S. 718 (Sup.Ct.1896), to the effect that as industrial conditions change business methods must change with them and acts become permissible which theretofore were considered beyond the corporate powers; and on the issue as to whether the corporation had received any corporvate benefit it said:

> 'It was also considered, in making the subscriptions or donations, that the company would receive advertisement of substantial value, including the good will of many influential citizens and of its patrons, who were interested in the success of the development of these branches of education, and, on the other hand, suffer a loss of prestige if the contributions were not made, in view of the fact that business competitors had donated and shown a

commendable public spirit in that relation. In the circumstances the rule of law that may fairly be applied is that the action of the officers of the company was not ultra vires, but was in fact within their corporate powers, since it tended to promote the welfare of the business in which the corporation was engaged.'

In American Rolling Mill Co. v. Commissioner of Internal Revenue, 41 F.2d 314 (C.C.A. 6, 1930), the corporation had joined with other local industries in the creation of a civic improvement fund to be distributed amongst community enterprises including the Boy Scouts and Girl Scouts, the Y.M.C.A., the Hospital, etc. The court readily sustained the contribution as an ordinary and necessary expense of the business within the Revenue Act. And in Greene County Nat. Farm Loan Ass'n v. Federal Land Bank of Louisville, 57 F.Supp. 783, 789 (D.C.W.D.Ky.1944), affirmed 152 F.2d 215 (6th Cir.1945), certiorari denied 328 U.S. 834, 66 S.Ct. 978, 90 L.Ed. 1610 (1946) the court in dealing with a comparable problem said:

'But it is equally well established that corporations are permitted to make substantial contributions to have the outward form of gifts where the activity being promoted by the so-called gift tends reasonably to promote the good-will of the business of the contributing corporation. Courts recognize in such cases that although there is no dollar and cent supporting consideration, yet there is often substantial indirect benefit accruing to the corporation which supports such action. So-called contributions by corporations to churches, schools, hospitals, and civic improvement funds, and the establishment of bonus and pension plans with the payment of large sums flowing therefrom have been upheld many times as reasonable business expenditures rather than being classified as charitable gifts.

The foregoing authorities illustrate how courts, while adhering to the terms of the common-law rule, have applied it very broadly to enable worthy corporate donations with indirect benefits to the corporations. In State ex rel. Sorensen v. Chicago B. & Q.R.Co., 112 Neb. 248, 199 N.W. 534, 537 (1924), the Supreme Court of Nebraska, through Justice Letton, went even further and without referring to any limitation based on economic benefits to the corporation said that it saw 'no reason why if a railroad company desires to foster, encourage and contribute to a charitable enterprise, or to one designed for the public weal and welfare, it may not do so'; later in its opinion it repeated this view with the expression that it saw 'no reason why a railroad corporation may not, to a reasonable extent, donate funds or services to aid in good works.' Similarly, the court in Carey v. Corporation Commission of Oklahoma, 168 Okl. 487, 33 P.2d 788, 794 (Sup.Ct.1934), while holding that a public service company was not entitled to an increase in its rates because of its reasonable charitable donations, broadly recognized that corporations, like individuals, have power to make them. Cf. New Jersey Bell Telephone Company v. Department of Public Utilities, 12 N.J. 568, 97 A.2d 602 (1953).

In the course of his opinion for the court in the Carey case Justice Bayless said:

'Next is the question of dues, donations, and philanthropies of the Company. It is a matter for the discretion of corporate management in making donations and paying dues. In that respect a corporation does not occupy a status far different from an individual. An

individual determines the propriety of joining organizations, and contributing to their support by paying dues, and all contribution to public charities, etc., according to his means. He does not make such contributions above his means with the hope that his employer will increase his compensation accordingly. A corporation likewise should not do so. Its ultimate purpose, from its own standpoint, is to earn and pay dividends. If, as a matter of judgment, it desires to take part of its earnings, just as would an individual, and contribute them to a worthy public cause, it may do so; but we do not feel that it should be allowed to increase its earnings to take care thereof.'

When the wealth of the nation was primarily in the hands of individuals they discharged their responsibilities as citizens by donating freely for charitable purposes. With the transfer of most of the wealth to corporate hands and the imposition of heavy burdens of individual taxation, they have been unable to keep pace with increased philanthropic needs. They have therefore, with justification, turned to corporations to assume the modern obligations of good citizenship in the same manner as humands do. Congress and state legislatures have enacted laws which encourage corporate contributions, and much has recently been written to indicate the crying need and adequate legal basis therefor. In actual practice corporate giving has correspondingly increased. Thus, it is estimated that annual corporate contributions throughout the nation aggregate over 300 million dollars, with over 60 million dollars thereof going to universities and other educational institutions. Similarly, it is estimated that local community chests receive well over 40% Of their contributions from corporations; these contributions and those made by corporations to the American Red Cross, to Boy Scouts and Girl Scouts, to 4-H Clubs and similar organizations have almost invariably been unquestioned.

[1] During the first world war corporations loaned their personnel and contributed substantial corporate funds in order to insure survival; during the depression of the '30s they made contributions to alleviate the desperate hardships of the millions of unemployed; and during the second world war they again contributed to insure survival. They now recognize that we are faced with other, though nonetheless vicious, threats from abroad which must be withstood without impairing the vigor of our democratic institutions at home and that otherwise victory will be pyrrhic indeed. More and more they have come to recognize that their salvation rests upon sound economic and social environment which in turn rests in no insignificant part upon free and vigorous nongovernmental institutions of learning. It seems to us that just as the conditions prevailing when corporations were originally created required that they serve public as well as private interests, modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate. Within this broad concept there is no difficulty in sustaining, as incidental to their proper objects and in aid of the public welfare, the power of corporations to contribute corporate funds within reasonable limits in support of academic institutions. But even if we confine ourselves to the terms of the common-law rule in its application to current conditions, such expenditures may likewise readily be justified as being for the benefit of the corporation; indeed, if need be the matter may be viewed strictly in terms of actual survival of the corporation in a free enterprise system. The genius of our common law has been its capacity for growth and its adaptability to the needs of the times.

Generally courts have accomplished the desired result indirectly through the molding of old forms. Occasionally they have done it directly through frank rejection of the old and recognition of the new. But whichever path the common law has taken it has not been found wanting as the proper tool for the advancement of the general good.

In 1930 a statute was enacted in our State which expressly provided that any corporation could cooperate with other corporations and natural persons in the creation and maintenance of community funds and charitable, philanthropic or benevolent instrumentalities conducive to public welfare, and could for such purposes expend such corporate sums as the directors 'deem expedient and as in their judgment will contribute to the protection of the corporate interests.' L.1930, c. 105; L.1931, c. 290; R.S. 14:3--13, N.J.S.A. See 53 N.J.L.J. 335 (1930). Under the terms of the statute donations in excess of 1% Of the capital stock required 10 days' notice to stockholders and approval at a stockholders' meeting if written objections were made by the holders of more than 25% Of the stock; in 1949 the statute was amended to increase the limitation to 1% Of capital and surplus. See L.1949, c. 171. In 1950 a more comprehensive statute was enacted. L.1950, c. 220; N.J.S.A. 14:3--13.1 et seq. In this enactment the Legislature declared that it shall be the public policy of our State and in furtherance of the public interest and welfare that encouragement be given to the creation and maintenance of institutions engaged in community fund, hospital, charitable, philanthropic, educational, scientific or benevolent activities or patriotic or civic activities conducive to the betterment of social and economic conditions; and it expressly empowered corporations acting singly or with others to contribute reasonable sums to such institutions, provided, however, that the contribution shall not be permissible if the donee institution owns more than 10% Of the voting stock of the donor and provided, further, that the contribution shall not exceed 1% Of capital and surplus unless the excess is authorized by the stockholders at a regular or special meeting. To insure that the grant of express power in the 1950 statute would not displace pre-existing power at common law or otherwise, the Legislature provided that the 'act shall not be construed as directly or indirectly minimizing or interpreting the rights and powers of corporations, as heretofore existing, with reference to appropriations, expenditures or contributions of the nature above specified.' N.J.S.A. 14:3--13.3. It may be noted that statutes relating to charitable contributions by corporations have now been passed in 29 states. See Andrews, supra, 235.

[2] The appellants contend that the foregoing New Jersey statutes may not be applied to corporations created before their passage. Fifty years before the incorporation of The A. P. Smith Manufacturing Company our Legislature provided that every corporate charter thereafter granted 'shall be subject to alteration, suspension and repeal, in the discretion of the legislature.' L.1846, p. 16; R.S. 14:2--9, N.J.S.A. A similar reserved power was placed into our State Constitution in 1875 (Art. IV, Sec. VII, par. 11), and is found in our present Constitution. Art, IV, Sec. VII, par. 9. In the early case of Zabriskie v. Hackensack & New York Railroad Company, 18 N.J.Eq. 178 (Ch.1867), the court was called upon to determine whether a railroad could extend its line, above objection by a stockholder, under a legislative enactment passed under the reserve power after the incorporation of the railroad. Notwithstanding the breadth of the statutory language and persuasive authority elsewhere (Durfee v. Old Colony & Fall River Railroad Company, 87 Mass. 230 (Sup.Jud.Ct.1862)), it

was held that the proposed extension of the company's line constituted a vital change of its corporate object which could not be accomplished without unanimous consent. See Lattin, A Primer on Fundamental Corporate Changes, 1 West.Res.L.Rev. 3, 7 (1949). The court announced the now familiar New Jersey doctrine that although the reserved power permits alterations in the public interest of the contract between the state and the corporation, it has no effect on the contractual rights between the corporation and its stockholders and between stockholders Inter se. Unfortunately, the court did not consider whether it was not contrary to the public interest to permit the single minority stockholder before it to restrain the railroad's normal corporate growth and development as authorized by the Legislature and approved, reasonably and in good faith, by the corporation's managing directors and majority stockholders. Although the later cases in New Jersey have not disavowed the doctrine of the Zabriskie case, it is noteworthy that they have repeatedly recognized that where justified by the advancement of the public interest the reserved power may be invoked to sustain later charter alterations even though they affect contractual rights between the corporation and its stockholders and between stockholders Inter se.

Thus, in the Berger case the Court of Errors and Appeals sustained the applicability under the reserved power of provisions relating to corporate borrowing and the purchase of corporate stock, and in considering the doctrine of the Zabriskie case noted that the rights of the stockholders Inter se may not be impaired 'except in so far as impairment may result from an alteration required by the public interest.' (63 N.J.Eq. 809, 53 A. 74.) And later in its opinion the court, referring to the provision in the Corporation Act of 1896 that the act and all amendments shall be a part of the charter of every corporation formed theretofore or thereafter, said: 'It is difficult to perceive how any substantial force can be accorded to it, unless some amendment may be made which may affect the rights of stockholders Inter sese to some extent.' In the Murray case the court sustained a statute substituting a discretionary power to pay dividends for a pre-existing duty; in the course of his opinion Justice Swayze indicated that even apart from stockholders' consent the statutory alteration could be sustained since it was 'a matter of state concern that a corporation should be permitted to accumulate a sufficient fund to secure its credit and make permanent its successful operation.' (79 N.J.Eq. 604, 82 A. 1040.) And in the Bingham case the court sustained a bank merger under the authority of legislation enacted after the incorporation of the bank, with Vice-Chancellor Backes pointing out that the office of the reserve power in our organic and statutory law 'is to safeguard the public interests in corporate grants.' (101 N.J.Eq. 413, 138 A. 660.)

This court had recent occasion to deal with the problem in In re Collins- Doan Co., supra. There it appeared that the board of directors was hopelessly deadlocked and application was duly made under L. 1938, c. 303 (N.J.S.A. 14:13--15) by the plaintiffs, representing half the directors and stockholders, for dissolution of the corporation. The defendants representing the other half resisted the application, contending that since the corporation was formed in 1916 it could not be dissolved except with the consent of two-thirds of the stockholders. This court, while recognizing that the later enactment did affect the rights between the corporation and its stockholders and between the stockholders Inter se, nevertheless held that it was applicable to the pre- existing corporation as a proper exercise of the reserved power.

In the course of his opinion for the court Justice Heher pointed out that 'the contractual rights of the stockholders Inter se are not proof against 'alteration required by the public interest." (3 N.J. 382, 70 A.2d 164.) It may be noted that the later enactment not only affected the relations between the corporation and stockholders and the stockholders Inter se, but also enabled complete termination of the original corporate objectives; yet this court found little difficulty in subordinating these considerations to the paramount public interest in avoiding the indefinite continuance of a corporation which could not function with propriety because of the 'stalemate in corporate management.' See In re Evening Journal Association, 1 N.J. 437, 444, 64 A.2d 80 (1948). The legislative function recognized here may be considered somewhat akin to that under the police power generally where private interests frequently are called upon to give way to the paramount public interest.

[3] State legislation adopted in the public interest and applied to pre- existing corporations under the reserved power has repeatedly been sustained by the United States Supreme Court above the contention that it impairs the rights of stockholders and violates constitutional guarantees under the Federal Constitution.

It seems clear to us that the public policy supporting the statutory enactments under consideration is far greater and the alteration of pre- existing rights of stockholders much lesser than in the cited cases sustaining various exercises of the reserve power. In encouraging and expressly authorizing reasonable charitable contributions by corporations, our State has not only joined with other states in advancing the national interest but has also specially furthered the interests of its own people who must bear the burdens of taxation resulting from increased state and federal aid upon default in voluntary giving. It is significant that in its enactments the State has not in anywise sought to impose any compulsory obligations or alter the corporate objectives. And since in our view the corporate power to make reasonable charitable contributions exists under modern conditions, even apart from express statutory provision, its enactments simply constitute helpful and confirmatory declarations of such power, accompanied by limiting safeguards.

[4] In the light of all of the foregoing we have no hesitancy in sustaining the validity of the donation by the plaintiff. There is no suggestion that it was made indiscriminately or to a pet charity of the corporate directors in furtherance of personal rather than corporate ends. On the contrary, it was made to a preeminent institution of higher learning, was modest in amount and well within the limitations imposed by the statutory enactments, and was voluntarily made in the reasonable belief that it would aid the public welfare and advance the interests of the plaintiff as a private corporation and as part of the community in which it operates. We find that it was a lawful exercise of the corporation's implied and incidental powers under common-law principles and that it came within the express authority of the pertinent state legislation. As has been indicated, there is now widespread belief throughout the nation that free and vigorous non-governmental institutions of learning are vital to our democracy and the system of free enterprise and that withdrawal of corporate authority to make such contributions within reasonable limits would seriously threaten their continuance. Corporations have come to recognize this and with their enlightenment have sought in varying measures, as has the plaintiff by its contribution, to insure and strengthen the society

which gives them existence and the means of aiding themselves and their fellow citizens. Clearly then, the appellants, as individual stockholders whose private interests rest entirely upon the well-being of the plaintiff corporation, ought not be permitted to close their eyes to present-day realities and thwart the long- visioned corporate action in recognizing and voluntarily discharging its high obligations as a constituent of our modern social structure.

The judgment entered in the Chancery Division is in all respects

Affirmed.

Discussion points for Bayer v. Beran

Note that under the Business Judgment Rule, directors of a corporation are free to make mistakes in their judgments, as long as they are impartial, and exercise due care when they make business decisions. But the line gets blurred when the directors hire their relatives to perform acts for the corporation. Did they exercise due care? Did they violate their duty of loyalty? Are they just feathering their own pockets?

BAYER et al.
v.
BERAN et al.

Supreme Court, Special Term, New York County.

April 18, 1944.

SHIENTAG, Justice.

There derivative stockholders' suits present for review two transactions upon which plaintiffs seek to charge the individual defendants, who are directors, with liability in favor of the corporate defendant, the Celanese Corporation of America. There are two causes of action alleging breach of fiduciary duty by the directors, one in connection with a program of radio advertising embarked upon by the corporation towards the end of 1941, and the other relating to certain payments of $30,000 a year made to Henri Dreyfus, one of its vice-presidents and a director, pursuant to a contract of employment entered into with him by the corporation. Before taking up the specific transactions complained of, I shall consider generally certain pertinent rules to be applied in determining the liability of directors of a business corporation such as is here involved.

[1] Despite abuses that have developed in connection with the derivative stockholders' suit,

abuses which should be dealt with promptly and effectively, it must be remembered that such an action is, at present, the only civil remedy that stockholders have for breach of fiduciary duty on the part of those entrusted with the management and direction of their corporations. We cannot therefore allow the prevailing mood of justifiable dissatisfaction with some of the temporary incidents of such suits to cause us to lose sight of certain deep-rooted, traditional concepts of the obligations of directors to their corporation and its stockholders.

[2] Directors of a business corporation are not trustees and are not held to strict accountability as such. Nevertheless, their obligations are analogous to those of trustees. Directors are agents; they are fiduciaries. The fiduciary has two paramount obligations: responsibility and loyalty. Those obligations apply with equal force to the humblest agent or broker and to the director of a great and powerful corporation. They lie at the very foundation of our whole system of free private enterprise and are as fresh and significant today as when they were formulated decades ago. The responsibility--that is, the care and the diligence--required of an agent or of a fiduciary, is proportioned to the occasion. It is a concept that has, and necessarily so, a wide penumbra of meaning--a concept, however, which becomes sharpened in its practical application to the given facts of a situation.

The concept of loyalty, of constant, unqualified fidelity, has a definite and precise meaning. The fiduciary must subordinate his individual and private interests to his duty to the corporation whenever the two conflict. In an address delivered in 1934, Mr. Justice, now Chief Justice, Stone declared that the fiduciary principle of undivided loyalty was, in effect, 'the precept as old as Holy Writ, that 'a man cannot serve two masters'. More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can long endure without loyalty to that principle'. He went on to say that 'The separation of ownership from management, the development of the corporate structure so as to vest in small groups control of resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function'.

[3] A director is not an insurer. On the one hand, he is not called upon to use an extraordinary degree of care and prudence; and on the other hand it is established by the cases that it is not enough for a director to be honest, that fraud is not the orbit of his liability. The director may not act as a dummy or a figurehead. He is called upon to use care, to exercise judgment, the decree of care, the kind of judgment that one would give in similar situations to the conduct of his own affairs.

The director of a business corporation is given a wide latitude of action. The law does not seek to deprive him of initiative and daring and vision. Business has its adventures, its bold adventures; and those who in good faith, and in the interests of the corporation they serve, embark upon them, are not to be penalized if failure, rather than success, results from their efforts. The law will not permit a course of conduct by directors, which would be applauded if it succeeded, to be condemned with a riot of adjectives simply because it failed. Directors of a commercial corporation may take chances, the same kind of chances that a man would

take in his own business. Because they are given this wide latitude, the law will not hold directors liable for honest errors, for mistakes of judgment. The law will not interfere with the internal affairs of a corporation so long as it is managed by its directors pursuant to a free, honest exercise of judgment uninfluenced by personal, or by any considerations other than the welfare of the corporation.

[6] To encourage freedom of action on the part of directors, or to put it another way, to discourage interference with the exercise of their free and independent judgment, there has grown up what is known as the 'business judgment rule'.'Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.' Indeed, although the concept of 'responsibility' is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest.

[7][8][9] The 'business judgment rule', however, yields to the rule of undivided loyalty. This great rule of law is designed 'to avoid the possibility of fraud and to avoid the temptation of self-interest. Such personal transactions of directors with their corporations, such transactions as may tend to produce a conflict between self-interest and fiduciary obligation, are, when challenged, examined with the most scrupulous care, and if there is any evidence of improvidence or oppression, any indication of unfairness or undue advantage, the transactions will be voided. 'Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation are challenged the burden is on the director not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.'

While there is a high moral purpose implicit in this transcendent fiduciary principle of undivided loyalty, it has back of it a profound understanding of human nature and of its frailties. It actually accomplishes a practical, beneficent purpose. It tends to prevent a clouded conception of fidelity that blurs the vision. It preserves the free exercise of judgment uncontaminated by the dross of divided allegiance or self-interest. It prevents the operation of an influence that may be indirect but that is all the more potent for that reason. The law has set its face firmly against undermining 'the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions.' Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546, 62 A.L.R. 1.

The first, or 'advertising', cause of action charges the directors with negligence, waste and improvidence in embarking the corporation upon a radio advertising program beginning in 1942 and costing about $1,000,000 a year. It is further charged that they were negligent in selecting the type of program and in renewing the radio contract for 1943. More serious than these allegations is the charge that the directors were motivated by a noncorporate purpose in causing the radio program to be undertaken and in expending large sums of money therefor.

It is claimed that this radio advertising was for the benefit of Miss Jean Tennyson, one of the singers on the program, who in private life is Mrs. Camille Dreyfus, the wife of the president of the company and one of its directors; that it was undertaken to 'further, foster and subsidize her career'; to 'furnish a vehicle' for her talents.

[10] Eliminating for the moment the part played by Miss Tennyson in the radio advertising campaign, it is clear that the character of the advertising, the amount to be expended therefor, and the manner in which it should be used, are all matters of business judgment and rest peculiarly within the discretion of the board of directors. Under the authorities previously cited, it is not, generally speaking, the function of a court of equity to review these matters or even to consider them. Had the wife of the president of the company not been involved, the advertising cause of action could have been disposed of summarily. Her connection with the program, however, makes it necessary to go into the facts in some detail.

Before 1942 the company had not resorted to radio advertising. While it had never maintained a fixed advertising budget, the company had, through its advertising department, spent substantial sums of money for advertising purposes. In 1941, for example, the advertising expense was $683,000, as against net sales for that year of $62,277,000 and net profits (before taxes) of $13,972,000. The advertising was at all times directed towards the creation of a consumer preference which would compel or induce the various trade elements linking the corporation to the consumer to label the corporation's products so that the consumer would know he was buying the material he wanted. The company had always claimed that its products, which it had called or labeled 'Celanese', were different from rayon, chemically and physically; that its products had qualities, special and unique, which made them superior to rayon. The company had never called or designated its products as rayon.

As far back as ten years ago, a radio program was considered, but it did not seem attractive. In 1937, the Federal Trade Commission promulgated a rule, the effect of which was to require all celanese products to be designated and labeled rayon. The name 'Celanese' could no longer be used alone. The products had to be called or labeled 'rayon' or 'celanese rayon'. This gave the directors much concern. As one of them expressed it, 'When we were compelled to put our product under the same umbrella with rayon rather than being left outside as a separate product, a thermo-plastic such as nylon is, we believed we were being treated in an unfair manner and that it was up to us, however, to do the best we could to circumvent the situation in which we found ourselves. * * * All manner of things were considered but there seemed only one thing we could do. We could either multiply our current advertising and our method of advertising in the same mediums we had been using, or we could go into radio'.

The directors, in considering the matter informally, but not collectively as a board, decided towards the end of 1941 to resort to the radio and to have the company go on the air with a dignified program of fine music, the kind of program which they felt would be in keeping with what they believed to be the beauty and superior quality of their products. The radio program was not adopted on the spur of the moment or at the whim of the directors. They acted after studies reported to them, made by the advertising department, beginning in 1939.

A radio consultant was employed to advise as to time and station. An advertising agency of national repute was engaged to take charge of the formulation and production of the program. It was decided to expend about $1,000,000 a year, but the commitments were to be subject to cancellation every thirteen weeks, so that the maximum obligation of the company would be not more than $250,000.

So far, there is nothing on which to base any claim of breach of fiduciary duty. Some care, diligence and prudence were exercised by these directors before they committed the company to the radio program. It was for the directors to determine whether they would resort to radio advertising; it was for them to conclude how much to spend; it was for them to decide the kind of program they would use. It would be an unwarranted act of interference for any court to attempt to substitute its judgment on these points for that of the directors, honestly arrived at. The expenditure was not reckless or unconscionable. Indeed, it bore a fair relationship to the total amount of net sales and to the earnings of the company. The fact that the company had offers of more business than it could handle did not, in law, preclude advertising. Many corporations not now doing any business in their products because of emergency conditions advertise those products extensively in order to preserve the good will, the public interest, during the war period. The fact that the company's product may not now be identifiable did not bar advertising calculated to induce consumer demand for such identification. That a program of classical and semiclassical music was selected, rather than a variety program, or a news commentator program, furnishes no ground for legal complaint. True, variety programs have a wider popular appeal than do musicals, but it would be a very sad thing if the former were the only kind of radio programs to be used. Some of the largest industrial concerns in the country have recognized this and have maintained fine musical programs on the radio for many years.

Now we have to take up an unfortunate incident, one which cannot be viewed with the complacency displayed by some of the directors of the company. This is not a closely held family corporation. The Doctors Dreyfus and their families own about 135,000 shares of common stock, the other directors about 10,000 shares out of a total outstanding issue of 1,376,500 shares. Some of these other directors were originally employed by Dr. Camille Dreyfus, the president of the company. His wife, to whom he has been married for about twelve years, is known professionally as Miss Jean Tennyson and is a singer of wide experience.

Dr. Dreyfus, as was natural, consulted his wife about the proposed radio program; he also asked the advertising agency, that had been retained, to confer with her about it. She suggested the names of the artists, all stars of the Metropolitan Opera Company, and the name of the conductor, prominent in his field. She also offered her own services as a paid artist. All of her suggestions as to personnel were adopted by the advertising agency. While the record shows Miss Tennyson to be a competent singer, there is nothing to indicate that she was indispensable or essential to the success of the program. She received $500 an evening. It would be far-fetched to suggest that the directors caused the company to incur large expenditures for radio advertising to enable the president's wife to make $24,000 in 1942 and $20,500 in 1943.

Of course it is not improper to appoint relatives of officers or directors to responsible positions in a company. But where a close relative of the chief executive officer of a corporation, and one of its dominant directors, takes a position closely associated with a new and expensive field of activity, the motives of the directors are likely to be questioned. The board would be placed in a position where selfish, personal interests might be in conflict with the duty it owed to the corporation. That being so, the entire transaction, if challenged in the courts, must be subjected to the most rigorous scrutiny to determine whether the action of the directors was intended or calculated 'to subserve some outside purpose, regardless of the consequences to the company, and in a manner inconsistent with its interests.'

[11] After such careful scrutiny I have concluded that, up to the present, there has been no breach of fiduciary duty on the part of the directors. The president undoubtedly knew that his wife might be one of the paid artists on the program. The other directors did not know this until they had approved the campaign of radio advertising and the general type of radio program. The evidence fails to show that the program was designed to foster or subsidize 'the career of Miss Tennyson as an artist' or to 'furnish a vehicle for her talents'. That her participation in the program may have enhanced her prestige as a singer is no ground for subjecting the directors to liability, as long as the advertising served a legitimate and a useful corporate purpose and the company received the full benefit thereof.

The musical quality of 'Celanese Hour' has not been challenged, nor does the record contain anything reflecting on Miss Tennyson's competence as an artist. There is nothing in the testimony to show that some other soprano would have enhanced the artistic quality of the program or its advertising appeal. There is no suggestion that the present program is inefficient or that its cost is disproportionate to what a program of that character reasonably entails. Miss Tennyson's contract with the advertising agency retained by the directors was on a standard form, negotiated through her professional agent. Her compensation, as well as that of the other artists, was in conformity with that paid for comparable work. She received less than any of the other artists on the program. Although she appeared with a greater regularity than any other singer, she received no undue prominence, no special build-up. Indeed, all of the artists were subordinated to the advertisement of the company and of its products. The company was featured. It appears also that the popularity of the program has increased since it was inaugurated.

[12][13] It is clear, therefore, that the directors have not been guilty of any breach of fiduciary duty, in embarking upon the program of radio advertising and in renewing it. It is unfortunate that they have allowed themselves to be placed in a position where their motives concerning future decisions on radio advertising may be impugned. The free mind should be ever jealous of its freedom. 'Power of control carries with it a trust or duty to exercise that power faithfully to promote the corporate interests, and the courts of this State will insist upon scrupulous performance of that duty.' Thus far, that duty has been performed and with noteworthy success. The corporation has not, up to the present time, been wronged by the radio advertising attacked in the complaints.

It is urged that the expenditures were illegal because the radio advertising program was not taken up at any formal meeting of the board of directors, and no resolution approving it was adopted by the board or by the executive committee. The general rule is that directors acting separately and not collectively as a board cannot bind the corporation. There are two reasons for this: first, that collective procedure is necessary in order that action may be deliberately taken after an opportunity for discussion and an interchange of views; and second, that directors are the agents of the stockholders and are given by law no power to act except as a board. Liability may not, however, be imposed on directors because they failed to approve the radio program by resolution at a board meeting.

It is desirable to follow the regular procedure, prescribed by law, which is something more than what has, at times, thoughtlessly been termed red tape. Long experience has demonstrated the necessity for doing this in order to safeguard the interests of all concerned, particularly where, as here, the company has over 1,375,000 shares outstanding in the hands of the public, of which about 10% are held by the officers and directors.

But the failure to observe the formal requirements is by no means fatal. The directorate of this company is composed largely of its executive officers. It is a close, working directorate. Its members are in daily association with one another and their full time is devoted to the business of the company with which they have been connected for many years. In this respect it differs from the boards of many corporations of comparable size, where the directorate is made up of men of varied interests who meet only at stated, and somewhat infrequent, intervals.

The same informal practice followed in this transaction had been the customary procedure of the directors in acting on corporate projects of equal and greater magnitude. All of the members of the executive committee were available for daily consultation and they discussed and approved the plan for radio advertising. While a greater degree of formality should undoubtedly be exercised in the future, it is only just and proper to point out that these directors, with all their loose procedure, have done very well for the corporation. Under their administration the company has thrived and prospered. Its assets increased from $44,500,000 in 1935 to upwards of $103,000,000 in 1942. Its net profits, after taxes, doubled during that period, rising from $4,000,000 in 1935 to $8,000,000 in 1942; its net sales rose from $27,000,000 to upwards of $86,000,000; and its dividend disbursements to stockholders exceeded $29,500,000.

[14][15] The expenditures for radio advertising, although made without resolution at a formal meeting of the board, were approved and authorized by the members individually, and may in no sense be considered to have been ultra vires. The resolution adopted by the board on July 6, 1943, with all of the directors present, except two who were resident in England, while expressly ratifying only the renewal of the broadcasting contract, may be deemed a ratification of all prior action taken in connection with the radio advertising. When this resolution was adopted, the Celanese Hour had been on the air to the knowledge of all the directors for eighteen months. Moreover, acceptance and retention of the benefits of the radio advertising, with full knowledge thereof, was as complete a ratification as would have

resulted from any formal all-inclusive resolution.

On the entire case, the directors acted in the free exercise of their honest business judgment and their conduct in the transactions challenged did not constitute negligence, waste or improvidence. The complaint is accordingly dismissed on the merits. The plaintiffs are granted appropriate exceptions. Settle judgment in accordance with the foregoing decision.

Discussion points for Shlensky v. Wrigley

The directors are accused of mismanagement and waste of corporate assets. How much deference will a court give to the directors? Stated another way, how strong and impregnable is the Business Judgment Rule defense? Can a board just walk into court, invoke the rule, and the court will back off, or does the board need to show some justification for its actions? The more self-interested or stupid the business transaction, the more a court will require of the board to justify its decision. Is it a sliding scale? Should it be?

William SHLENSKY, on Behalf of and as a Representative of Chicago National League Ball Club (Inc.), Plaintiff-Appellant, v. Philip K. WRIGLEY,

Appellate Court of Illinois, First District, Third Division.

April 25, 1968.

SULLIVAN, Justice.

This is an appeal from a dismissal of plaintiff's amended complaint on motion of the defendants. The action was a stockholders' derivative suit against the directors for negligence and mismanagement. The corporation was also made a defendant. Plaintiff sought damages and an order that defendants cause the installation of lights in Wrigley Field and the scheduling of night baseball games.

Plaintiff is a minority stockholder of defendant corporation, Chicago National League Ball Club (Inc.), a Delaware corporation with its principal place of business in Chicago, Illinois. Defendant corporation owns and operates the major league professional baseball team known as the Chicago Cubs. The corporation also engages in the operation of Wrigley Field, the Cubs' home park, the concessionaire sales during Cubs' home games, television and radio broadcasts of Cubs' home games, the leasing of the field for football games and other events

and receives its share, as visiting team, of admission moneys from games played in other National League stadia. The individual defendants are directors of the Cubs and have served for varying periods of years. Defendant Philip K. Wrigley is also president of the corporation and owner of approximately 80% Of the stock therein.

Plaintiff alleges that since night baseball was first played in 1935 nineteen of the twenty major league teams have scheduled night games. In 1966, out of a total of 1620 games in the major leagues, 932 were played at night. Plaintiff alleges that every member of the major leagues, other than the Cubs, scheduled substantially all of its home games in 1966 at night, exclusive of opening days, Saturdays, Sundays, holidays and days prohibited by league rules. Allegedly this has been done for the specific purpose of maximizing attendance and thereby maximizing revenue and income.

The Cubs, in the years 1961--65, sustained operating losses from its direct baseball operations. Plaintiff attributes those losses to inadequate attendance at Cubs' home games. He concludes that if the directors continue to refuse to install lights at Wrigley Field and schedule night baseball games, the Cubs will continue to sustain comparable losses and its financial condition will continue to deteriorate.

Plaintiff alleges that, except for the year 1963, attendance at Cubs' home games has been substantially below that at their road games, many of which were played at night.

Plaintiff compares attendance at Cubs' games with that of the Chicago White Sox, an American League club, whose weekday games were generally played at night. The weekend attendance figures for the two teams was similar; however, the White Sox week-night games drew many more patrons than did the Cubs' weekday games.

Plaintiff alleges that the funds for the installation of lights can be readily obtained through financing and the cost of installation would be far more than offset and recaptured by increased revenues and incomes resulting from the increased attendance.

Plaintiff further alleges that defendant Wrigley has refused to install lights, not because of interest in the welfare of the corporation but because of his personal opinions 'that baseball is a 'daytime sport' and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood.' It is alleged that he has admitted that he is not interested in whether the Cubs would benefit financially from such action because of his concern for the neighborhood, and that he would be willing for the team to play night games if a new stadium were built in Chicago.

Plaintiff alleges that the other defendant directors, with full knowledge of the foregoing matters, have acquiesced in the policy laid down by Wrigley and have permitted him to dominate the board of directors in matters involving the installation of lights and scheduling of night games, even though they knew he was not motivated by a good faith concern as to the best interests of defendant corporation, but solely by his personal views set forth above. It is charged that the directors are acting for a reason or reasons contrary and wholly

unrelated to the business interests of the corporation; that such arbitrary and capricious acts constitute mismanagement and waste of corporate assets, and that the directors have been negligent in failing to exercise reasonable care and prudence in the management of the corporate affairs.

[1] The question on appeal is whether plaintiff's amended complaint states a cause of action. It is plaintiff's position that fraud, illegality and conflict of interest are not the only bases for a stockholder's derivative action against the directors. Contrariwise, defendants argue that the courts will not step in and interfere with honest business judgment of the directors unless there is a showing of fraud, illegality or conflict of interest.

The cases in this area are numerous and each differs from the others on a factual basis. However, the courts have pronounced certain ground rules which appear in all cases and which are then applied to the given factual situation. The court in Wheeler v. Pullman Iron and Steel Company, 143 Ill. 197, 207, 32 N.E. 420, 423, said:

> 'It is, however, fundamental in the law of corporations, that the majority of its stockholders shall control the policy of the corporation, and regulate and govern the lawful exercise of its franchise and business. * * * Every one purchasing or subscribing for stock in a corporation impliedly agrees that he will be bound by the acts and proceedings done or sanctioned by a majority of the shareholders, or by the agents of the corporation duly chosen by such majority, within the scope of the powers conferred by the charter, and courts of equity will not undertake to control the policy or business methods of a corporation, although it may be seen that a wiser policy might be adopted and the business more successful if other methods were pursued. The majority of shares of its stock, or the agents by the holders thereof lawfully chosen, must be permitted to control the business of the corporation in their discretion, when not in violation of its charter or some public law, or corruptly and fraudulently subversive of the rights and interests of the corporation or of a shareholder.'

Plaintiff argues that the allegations of his amended complaint are sufficient to set forth a cause of action under the principles set out in Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668. In that case plaintiff, owner of about 10% Of the outstanding stock, brought suit against the directors seeking payment of additional dividends and the enjoining of further business expansion. In ruling on the request for dividends the court indicated that the motives of Ford in keeping so much money in the corporation for expansion and security were to benefit the public generally and spread the profits out by means of more jobs, etc. The court felt that these were not only far from related to the good of the stockholders, but amounted to a change in the ends of the corporation and that this was not a purpose contemplated or allowed by the corporate charter. The court relied on language found in Hunter v. Roberts, Throp & Co., 83 Mich. 63, 47 N.W. 131, 134, wherein it was said:

> 'Courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of the corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud or breach of

> that good faith which they are bound to exercise toward the stockholders.'

From the authority relied upon in that case it is clear that the court felt that there must be fraud or a breach of that good faith which directors are bound to exercise toward the stockholders in order to justify the courts entering into the internal affairs of corporations. This is made clear when the court refused to interfere with the directors decision to expand the business. The following appears on page 684 of 170 N.W.:

> 'We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company. In view of the fact that the selling price of products may be increased at any time, the ultimate results of the larger business cannot be certainly estimated. The judges are not business experts. It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. * * * We are not satisfied that the alleged motives of the directors, in so far as they are reflected in the conduct of business, menace the interests of the shareholders.' (Emphasis supplied)

Plaintiff in the instant case argues that the directors are acting for reasons unrelated to the financial interest and welfare of the Cubs. However, we are not satisfied that the motives assigned to Philip K. Wrigley, and through him to the other directors, are contrary to the best interests of the corporation and the stockholders. For example, it appears to us that the effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood. Furthermore, the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating. By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.

[2] While all the courts do not insist that one or more of the three elements must be present for a stockholder's derivative action to lie, nevertheless we feel that unless the conduct of the defendants at least borders on one of the elements, the courts should not interfere. The trial court in the instant case acted properly in dismissing plaintiff's amended complaint.

[3][4][5] We feel that plaintiff's amended complaint was also defective in failing to allege damage to the corporation. There is no allegation that the night games played by the other nineteen teams enhanced their financial position or that the profits, if any, of those teams were directly related to the number of night games scheduled. There is an allegation that the installation of lights and scheduling of night games in Wrigley Field would have resulted in large amounts of additional revenues and incomes from increased attendance and related sources of income. Further, the cost of installation of lights, funds for which are allegedly readily available by financing, would be more than offset and recaptured by increased revenues. However, no allegation is made that there will be a net benefit to the corporation from such action, considering all increased costs.

Plaintiff claims that the losses of defendant corporation are due to poor attendance at home

games. However, it appears from the amended complaint, taken as a whole, that factors other than attendance affect the net earnings or losses. For example, in 1962, attendance at home and road games decreased appreciably as compared with 1961, and yet the loss from direct baseball operation and of the whole corporation was considerably less.

The record shows that plaintiff did not feel he could allege that the increased revenues would be sufficient to cure the corporate deficit. The only cost plaintiff was at all concerned with was that of installation of lights. No mention was made of operation and maintenance of the lights or other possible increases in operating costs of night games and we cannot speculate as to what other factors might influence the increase or decrease of profits if the Cubs were to play night home games.

[7][8] Finally, we do not agree with plaintiff's contention that failure to follow the example of the other major league clubs in scheduling night games constituted negligence. Plaintiff made no allegation that these teams' night schedules were profitable or that the purpose for which night baseball had been undertaken was fulfilled. Furthermore, it cannot be said that directors, even those of corporations that are losing money, must follow the lead of the other corporations in the field. Directors are elected for their business capabilities and judgment and the courts cannot require them to forego their judgment because of the decisions of directors of other companies. Courts may not decide these questions in the absence of a clear showing of dereliction of duty on the part of the specific directors and mere failure to 'follow the crowd' is not such a dereliction.

For the foregoing reasons the order of dismissal entered by the trial court is affirmed.

Affirmed.

Menard v. Dage-MTI

Supreme Court of Indiana.

MENARD, INC., Appellant (Plaintiff below),
v.
DAGE-MTI, INC., Appellee (Defendant below).

April 17, 2000.

SULLIVAN, Justice.

Menard, Inc., offered to purchase 30 acres of land from Dage-MTI, Inc., for $1,450,000. Arthur Sterling, Dage's president, accepted the offer in a written agreement in which he

represented that he had the requisite authority to bind Dage to the sale. The Dage board of directors did not approve and refused to complete the transaction. We hold that as president, Sterling possessed the inherent authority to bind Dage in these circumstances.

Background

Dage-MTI, Inc., is a closely held Indiana corporation which manufactures specialized electronics equipment. At all times relevant to this appeal, Dage was governed by a six-member board of directors . . . Of the six directors, only Arthur and Marie Sterling resided in Indiana.

For many years, Sterling operated Dage without significant input from or oversight by the Board. Over the course of the summer and early fall of 1993, however, Kerrigan took steps to subject Dage management to Board control. Kerrigan hired New York-based financial consultant and future Board member Piccolo to assess the company's performance. Kerrigan also retained New York attorney Gerald Gorinsky to represent his interests concerning Dage.

In late October of 1993, the Dage shareholders met in New Jersey to discuss an offer by Sterling to purchase the Kerrigans' shares of Dage. During the course of the meeting, Sterling first informed other directors that Menard, Inc., had expressed interest in purchasing a 30-acre parcel of land owned by Dage and located in the Michigan City area. Menard is a Wisconsin corporation that owns and operates home improvement stores in the Midwestern region of the United States.

On October 30, 1993, Menard forwarded a formal offer to Sterling pertaining to the purchase of 10.5 acres of the 30-acre parcel. Upon receipt of the offer, Sterling did not contact Menard to discuss the terms and conditions of the offer. Instead, on or about November 4, 1993, he forwarded the offer to all the Dage directors with a cover note acknowledging that Board approval was required to accept or reject the offer. Ultimately, this offer was rejected.

On November 30, 1993, Sterling called Kerrigan and informed him that Menard would make a second offer for the entire 30-acre parcel. Sterling presented a two-part proposed resolution ("consent resolution") to the Board: the first part authorized Sterling to "offer and purchase" another parcel located immediately to the north of the 30-acre parcel and referred to as the "Simon property"; the second part authorized Sterling to "offer and sell" the 30-acre parcel. Sterling, Kerrigan, Piccolo, and Gorinsky discussed the offer and Sterling was told to change the "offer and sell" provision to "to offer for sale." He was also instructed that he could purchase the Simon property on behalf of Dage, but could only "offer" the 30-acre parcel to Menard at a particular price. Additionally, Sterling was told that in soliciting offers for the 30-acre parcel, he was not to negotiate the terms of a sale. Gorinsky reminded Sterling that any offer from Menard would require Board review and acceptance, and he instructed Sterling to forward any offer to the Board for approval or rejection.

Finally, Sterling was told that if Menard submitted an agreement with the same

objectionable provisions as the first offer, it would be rejected. Sterling agreed to follow the instructions of the Board "as long as I don't have to pay for" Gorinsky's and Piccolo's services in reviewing the offer. Based upon the discussion, Sterling drafted a new resolution, which stated that he was authorized "to take such actions as are necessary to offer for sale our 30 acre parcel ... for a price not less than $1,200,000."

On December 6, 1993, Sterling informed Piccolo that Menard had agreed to make another offer. Piccolo reminded Sterling of his obligation to secure Board approval of the offer. Menard forwarded a second proposed purchase agreement to Sterling. This agreement contained the same provisions that the Board found objectionable in the first proposed agreement. However, this offer differed in that it was for the purchase of the entire 30-acre parcel for $1,450,000.

During a week-long series of discussions beginning December 14, 1993, and unknown to any other member of the Dage Board, Sterling negotiated several minor changes in the Menard agreement and then signed the revised offer on behalf of Dage. Menard also signed, accepting the offer. Under Paragraph 5(c)(I) of the agreement, Sterling, as president of Dage, represented as follows: "The persons signing this Agreement on behalf of the Seller are duly authorized to do so and their signatures bind the Seller in accordance with the terms of this Agreement." (R. at 916; Finding of Fact No. 47.) (R. at 1144, 1149.) No one at Dage had informed Menard that Sterling's authority with respect to the sale of the 30-acre parcel was limited to only the solicitation of offers.

Upon learning of the signed agreement with Menard, the Board instructed Sterling to extricate Dage from the agreement. Later, the Board hired counsel to inform Menard of its intent to question the agreement's enforceability. However, it was not until March 29, 1994, that Dage first gave notice to Menard of this intent.

Menard ultimately filed suit to require Dage to specifically perform the agreement and to secure the payment of damages. Menard initially filed a motion for partial summary judgment, which was denied. Following a bench trial, the trial court ruled in favor of Dage. The Court of Appeals affirmed, finding that Sterling did not have the express or apparent authority to bind the corporation in this land transaction.

Discussion

I

We find the concept of inherent authority -- rather than actual or apparent authority -- controls our analysis in this case. Menard did not negotiate and ultimately contract with a lower-tiered employee or a prototypical "general" or "special" agent, with respect to whom actual or apparent authority might be at issue. Menard dealt with the president of the corporation, whom " ' "[t]he law recognizes ... [as one of] the officers [who] are the means, the hands and the head, by which corporations normally act." ' In so finding, we consider significant the " ' "distinction ... between a corporate act, performed through the

intermediation of a person specially empowered to act as its agent, and a like act done immediately by the corporation through its executive or administrative officers, which may be termed its *inherent agencies*."

II

Distilled to its basics, we find that Sterling had inherent authority here if: (1) first, Sterling acted within the usual and ordinary scope of his authority as president; (2) second, Menard reasonably believed that Sterling was authorized to contract for the sale and purchase of Dage real estate; and (3) third, Menard had no notice that Sterling was not authorized to sell the 30-acre parcel without Board approval.

[9] As to whether Sterling acted within the usual and ordinary scope of his authority as president, the trial court found that Sterling, a director and substantial shareholder of Dage, had served as Dage's president from its inception; had managed the affairs of Dage for an extended period of time with little or no Board oversight; and had purchased real estate for Dage without Board approval. (R. at 911, 912; Findings of Fact Nos. 7-9, 16.) However, the trial court reached the conclusion that "[t]he record persuasively demonstrates that the land transaction in question was an extraordinary transaction" for Dage, which manufactures electronic video products. (R. at 921; Conclusion of Law No. 11.) Thus, the court concluded that "Sterling was not performing an act that was appropriate in the ordinary course of Dage's business." *Id.*

We initially note that the Restatement looks at whether the acts "usually accompany or are incidental to transactions which *the agent* is authorized to conduct." Restatement (Second) of Agency § 161(emphasis added). On the other hand, our analysis of inherent agency in *Koval* was focused on whether " 'a general agent ... acted within the usual and ordinary scope of *the business* in which he was employed.'

[10] The Restatement looks at the agent's office or station in the company to gauge the scope of the agent's authority, whereas our analysis in *Koval* looked to the purpose and scope of the business in which the general agent (i.e., attorney) was employed. We find the Restatement, which is focused "solely [on] the agency relation," is more appropriate in the current situation involving corporate officers, who are "natural persons who hold and administer the offices of the corporation."

Given that the trial court found that Sterling, as president of the company since its inception, had managed its affairs for an extended period of time with little or no Board oversight and, in particular, had purchased real estate for Dage in the past without Board approval, we conclude that Sterling's actions at issue here were acts that "usually accompany or are incidental to transactions which [he was] authorized to conduct." Restatement (Second) of Agency § 161.

[11] Next, we must determine whether Menard reasonably believed that Sterling was authorized to contract for the sale and purchase of Dage real estate. While Sterling's

apparent authority to bind Dage was "vitiated" by Menard's knowledge that the sale of Dage real estate required Board approval, *see Menard, Inc.,* 698 N.E.2d at 1232, this information did not defeat Sterling's *inherent authority* as Dage president to bind the corporation in a "setting" where he was the sole negotiator, *see Cange,* 826 F.2d at 591.

Because the inherent agency theory "originates from the customary authority of a person in the particular type of agency relationship," *id.,* we look to the *agent's indirect or direct manifestations* to determine whether Menard could have "reasonably believe[d]" that Sterling was authorized to contract for the sale and purchase of Dage real estate. *Koval,* 693 N.E.2d at 1304 n.7. And considering that the "agent" in this case is a general officer of the corporation (as opposed to an "appointed general agent" or "company general manager"), we find that Menard "should not be required to scrutinize too carefully the mandates of [this] permanent ... agent[ ] ... who [did] no more than what is usually done by [a corporate president

Here, the facts establish that Menard reasonably believed that Sterling was authorized to contract for the sale and purchase of Dage real estate. We begin with the premise that " 'the acts of a corporation done through its officers are acts done per se.' Next, we note that at all times "Sterling held himself out as president of Dage." (R. at 919; Finding of Fact No. 67.) In fact, "Sterling ha[d] served as president of Dage since its inception"; as noted in the preceding section, he was a substantial shareholder and member of the six- person Board of Directors; he had managed the affairs of Dage for an extended period of time with little or no Board oversight; and he had purchased real estate for Dage without Board approval. (R. at 911, 912; Findings of Fact Nos. 7-9, 16.) And although "early in the transaction, Sterling advised [Menard] that he was required to go back to his 'partners' to obtain authority to sell the entire thirty acres[, Sterling later] confirmed that he had the authority from his Board of Directors to proceed." (R. at 922- 23; Conclusion of Law No. 19.)

We find it reasonable that Menard did not question the corporate president's statement that he had "authority from his Board of Directors to proceed" with the land transaction.

We also find it reasonable for Menard not to scrutinize Sterling's personal "acknowledge[ment] that he signed the agreement for the purchase and sale of the real estate by authority of Dage's board of directors." (R. at 919; Finding of Fact No. 67). We believe this especially to be the case where (1) Sterling himself was a member of the Board, (R. at 912; Finding of Fact No. 16); (2) the agreement contained an express representation that "[t]he persons signing this Agreement on behalf of the Seller are duly authorized to do so and their signatures bind the Seller in accordance with the terms of this Agreement," (R. at 916; Finding of Fact No. 47) (R. at 1144, 1149); and (3) Menard was aware that Dage's corporate counsel, Patrick Donoghue, was involved in the review of the terms of the agreement, (R. at 1133-34, 1141, 1391).

Finally, we consider whether Menard had notice that Sterling was not authorized to sell the 30-acre parcel without Board approval. The record does not indicate that Menard was aware of the existence of the consent resolution, much less that it limited Sterling's authority as

president. Nor was there evidence that either the Board or Sterling informed Menard that Sterling's authority with respect to the sale of the 30-acre parcel was limited to only the solicitation of offers. And, as discussed *supra,* Sterling personally acknowledged that he signed the agreement by authority of Dage's Board of Directors, of which he was a member.

It is true, as the Court of Appeals noted, that Menard was advised early in the transaction that Sterling had to go to the Board to obtain approval. *Menard,* 698 N.E.2d at 1232 (citing Conclusions of Law Nos. 16-22). This knowledge would have vitiated the apparent authority of a lower-tiered employee or a prototypical general or special agent. [FN10] But we do not find it sufficient notice that Sterling, an officer with inherent authority, was not authorized to bind Dage at the closing.

The trial court found that Sterling signed the agreement with Menard during the week of December 14, 1993; that he represented in the agreement that he was authorized to sign it and that his signature bound Dage; and that when Dage's lawyers contacted Menard on March 29, 1994, it "was the first notice given by Dage to Menard that there was any issue regarding the enforceability of the agreement." (R. at 916, 919; Findings of Fact 46, 47, 63.) Indeed, Sterling wrote to Menard on February 7, 1994, indicating that Dage was performing as required by the agreement. (R. at 2059.) We conclude that Menard had no notice that the Board had limited Sterling's authority with respect to 30-acre parcel.

The record fails to reveal a single affirmative act that Dage took to inform Menard of Sterling's limited authority with respect to the 30-acre parcel, and the Board did not notify Menard that Sterling had acted without its authority until 104 days after it learned of Sterling's action. (R. at 917, 919; Findings of Fact Nos. 52, 63.) By this time, Sterling had taken additional steps to close the transaction. (R. at 918; Finding of Fact No. 56.) Dage's failure to act should not now form the basis of relief, penalizing Menard and depriving it of its bargain. *See Federal Savings & Loan Ins. Corp.,* 658 F.Supp. at 1340 ("Factors such as duty of care required to exercise a high standard of supervision and whether the employee was a high level officer or director of the firm are also relevant [in establishing an employer's vicarious liability under an agency theory].").

Conclusion

We (1) grant transfer, (2) vacate the opinion of the Court of Appeals, and (3) remand to the trial court for further proceedings consistent with our conclusion that Dage was bound by Sterling's actions.

SHEPARD, Chief Justice, dissenting.

I think today's decision will leave most corporate lawyers wondering what the law actually is.

A board of directors authorizes the president to sell some real estate but requires that the sale be submitted to the board for approval or disapproval. The president understands that he must submit any sale to the board. He tells the potential buyer that he must submit it. The buyer knows that its offer must be submitted to the board after the president signs the sales agreement. The agreement is in fact submitted to the board and disapproved. Our Court holds that the agreement is binding anyway.

Burg v. Horn

United States Court of Appeals Second Circuit.

Lillian L. **BURG**, Plaintiff-Appellant,
v.
Max **HORN** and George **Horn,** Defendants-Appellees

Decided July 18, 1967.

LUMBARD, Chief Judge:

This appeal in a diversity action by the plaintiff, Lillian Burg, a citizen of California and a one-third stockholder of Darand Realty Corp., a New York corporation which owns and operates low-rent rooming and apartment buildings in Brooklyn, from a judgment of Judge Dooling in the Eastern District dismissing her derivative complaint insofar as it alleged that nine similar buildings in Brooklyn acquired by the defendants George and Max Horn, citizens of New York and holders of the remaining stock of Darand, were corporate opportunities belonging to Darand, requires us to consider the scope of the duty imposed by New York law on directors and majority stockholders not to appropriate for themselves opportunities which would be advantageous to their corporation. We hold that Judge Dooling correctly concluded that, under New York law, the properties acquired by defendants were not corporate opportunities of Darand, and we affirm the judgment below.

Darand was incorporated in September 1953 with a capital of $5500, subscribed equally by the three stockholders, Mrs. Burg and George and Max Horn, all of whom became directors, and immediately purchased a low-rent building in Brooklyn. The Horns, who were engaged in the produce business and had already acquired three similar buildings in Brooklyn through wholly-owned corporations, urged the Burgs, who were close friends then also residing in Brooklyn, to 'get their feet wet' in real estate, and the result was the formation of Darand. The Burgs testified that they expected the Horns to offer any low-rent properties they found in Brooklyn to Darand, but that there was not discussion or agreement to that effect. The Horns carried on the active management of Darand's properties, and the plaintiff's husband, Louis Burg, an accountant who became an attorney in 1957, handled its accounting and tax

planning. The stockholders generally drew equal amounts from Darand at the end of each taxable year, and then immediately repaid them to 'loan accounts,' from which they could draw when they desired.

Darand sold its first property and acquired another in 1956, and purchased two more buildings in 1959. From 1953 to 1963, nine similar properties were purchased by the Horns, individually or through wholly-owned corporations. One, purchased by Max Horn in 1954 and sold in 1955, was partly paid for by loans of $600 from Darand and $2000 from Louis Burg. Two others, acquired in 1955 by a corporation wholly owned by the Horns, were paid for in part by a loan of $200 from Darand to the wholly-owned corporation and, apparently, by loans aggregating $4250 from Louis Burg to Max Horn. The Burgs testified that they did not know the purposes of these loans, and that, while they knew of the Horns' ownership of some of the properties they now contend were corporate opportunities of Darand, they thought they and been acquired before 1953.

In 1962 the Burgs moved to California, and disagreements thereafter arose between them and the Horns concerning the accounting for rent receipts and expenditures of Darand. This action seeking an accounting for receipts and expenditures and the imposition of a constructive trust on the alleged corporate opportunities was brought in 1964. After a six-day trial, Judge Dooling held that the Horns had failed to account for $7,893.36 of rent receipts for 1961-1964. This holding has not been appealed. He found, however, that there was no agreement that all low-rent buildings found by the Horns should be offered to Darand, and that the Burgs were aware of the purposes of the loans from Darand and Louis Burg and of at least some of the Horns' post- 1953 acquisitions. He therefore declined to hold that those acquisitions were corporate opportunities of Darand.

Since the Horns are charged with breaching their fiduciary duty to a New York corporation doing business only in New York by acquiring properties located in New York, their liability is governed by New York law. Under New York law, property acquired by a corporate director will be impressed with a constructive trust as a corporation had opportunity only if the corporation had an interest or a 'tangible expectancy' in the property when it was acquired. Although some commentators have criticized the 'interest or expectancy' test as vague and unhelpful, it clearly expresses the judgment that the corporate opportunity doctrine should not be used to bar corporate directors from purchasing any property which might be useful to the corporation, but only to prevent their acquisition of property which the corporation needs or is seeking, or which they are otherwise under a duty to the corporation to acquire for it.

Thus a director may not purchase for himself property under lease to his corporation, or draw away existing customers of the corporation. Nor may he purchase property which the corporation needs or has resolved to acquire, or which it is contemplating acquiring. He may not take advantage of an offer made to the corporation. None of these proscriptions aids the plaintiff, however, for there is no evidence that the properties she seeks for Darand were offered to or sought by Darand, came to the Horns' attention through Darand, or were necessary to Darand's success.

[5][6] Plaintiff apparently contends that defendants were as a matter of law under a duty to acquire for Darand further properties like those it was operating. She is seemingly supported by several commentators, who have stated that any opportunity within a corporation's 'line of business' is a corporate opportunity. This statement seems to us too broad a generalization. We think that under New York law a court must determine in each case, by considering the relationship between the director and the corporation, whether a duty to offer the corporation all opportunities within its 'line of business' is fairly to be implied. Had the Horns been full-time employees of Darand with no prior real estate ventures of their own, New York law might well uphold a finding that they were subject to such an implied duty. But as they spent most of their time in unrelated produce and real estate enterprises and already owned corporations holding similar properties when Darand was formed, as plaintiff knew, we agree with Judge Dooling that a duty to offer Darand all such properties coming to their attention cannot be implied absent some further evidence of an agreement or understanding to that effect. Judge Dooling's finding that there was no such understanding is not clearly erroneous.

Although we have found no New York case involving similar facts, our holding that the scope of a director's duty to offer opportunities he has found to his corporation must be measured by the facts of each case seems more consistent than any other with the holdings of New York courts applying the 'interest or expectancy' test. [FN2] Moreover, the decisions of other courts in analogous cases support our conclusion. The Supreme Court of Delaware held in Johnston v. Greene, 35 Del.Ch. 479, 121 A.2d 919 (1956), that a director of several corporations who was offered the patents and stock of a corporation engaged in an unrelated business and who arranged for the purchase of the stock by one of the corporations of which he was a director did not appropriate a corporate opportunity of that corporation by retaining the patents. The court recognized that a corporation's need to invest funds and a director's duty to seek investments for it might convert an investment opportunity offered to the director into a corporate opportunity, but held that

'Whether it does * * *, in any particular case, depends on the facts-- upon the existence of special circumstances that would make it unfair for him to take the opportunity for himself.'

The court found especially persuasive against the existence of such special circumstances the fact that the director served on several boards. It has been urged that the reasoning of Johnston v. Greene is fallacious because the fact that a director may be under fiduciary obligations to more than one corporation should lead a court to find and enforce the strongest obligation, not to allow the director to disregard them all. This criticism seems to us to miss the point underscored by the facts of this case, that a person's involvement in more than one venture of the same kind may negate the obligation which might otherwise be implied to offer similar opportunities to any one of them, absent some contrary understanding. Thus we affirm Judge Dooling's holding that the properties acquired by defendants were not corporate opportunities of Darand. [FN3]

A director may be barred from competing with his corporation even though he does not by

doing so appropriate a corporate opportunity. But the duty not to compete, like the duty to offer opportunities to the corporation, is measured by the circumstances of each case, so that the considerations which led us to hold that the properties acquired by the Horns were not corporate opportunities strongly suggest a finding that the Horns were free to compete by acquiring them. In any event, there is no evidence in the record suggesting that Darand has been harmed by the Horns' ownership and operation of the properties they acquired.

Affirmed.

HAYS, Circuit Judge (dissenting):

I dissent.

My brothers hold that the scope of a director's duty to his corporation must be measured by the facts of each case. However, although they are unable to find any New York case presenting the same facts as those before us, they conclude that New York law does not support the imposition of liability in the circumstances of this case. I do not agree.

In an often quoted passage, the New York Court of Appeals laid down the principles of fiduciary conduct:

'Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.' Meinhard v. Salmon.

Applying these standards to the instant case it seems clear that in the absence of a contrary agreement or understanding between the parties, the Horns, who were majority stockholders and managing officers of the Darand Corporation and whose primary function was to locate suitable properties for the company, were under a fiduciary obligation to offer such properties to Darand before buying the properties for themselves. That the Horns used Darand's funds to effectuate certain of these purchases reinforces the conclusion that their conduct was improper and failed to comport with the standards established by law.

Since the Horns were under a fiduciary duty imposed by law not to take advantage for themselves of corporate opportunities, it is irrelevant that, as the district court found, there was no agreement under which 'the Horns would contract their real estate activities or offer every property they located to Darand.' A fortiori the Horns were not free to select the best properties for themselves.

Boylan v. Boston Sand Gravel

Dorothy L. BOYLAN and Paul F. Ryan, Plaintiffs,
v.
BOSTON SAND & GRAVEL CO.,et.al., Defendants.

Superior Court of Massachusetts, Suffolk County.

March 14, 2007.

The defendant Manchester Sand, Cement & Gravel Co., Inc. ("Manchester Sand"), a wholly-owned subsidiary of the defendant Boston Sand & Gravel Co. ("Boston Sand"), is in the business of acquiring property to mine sand, gravel, and stone that Boston Sand turns into ready-mix cement. Typically, after mining out the property, Manchester Sand will sell the property. Manchester Sand owns roughly 3,000 acres of property in Hooksett, New Hampshire. Most of this land is located on the east side of Route 3, but roughly 250 acres is located about one-half to one mile to the west of Route 3 ("the West Side Property"). Among Manchester Sand's mined-out property is a 42 acre parcel of land that is part of the West Side Property ("the 42 Acre Parcel"). On May 21, 1996, Boston Sand's Board of Directors unanimously authorized Manchester Sand to lease the 42 Acre Parcel to defendant, Ankat Properties Inc. ("Ankat"), a corporation owned by two of Boston Sand's officers and directors, defendant Dean M. Boylan, Jr. ("Dean, Jr.") and his sister, defendant Jeanne-Marie Boylan ("Jeanne-Marie"), for $2,000 per month, with a three-year option to buy. The Ground Lease ("the Lease") for the 42 Acre Parcel, providing a ten year lease term, was executed on June 30, 1996 by Dean, Jr. as Manchester Sand's President and Jeanne-Marie as President of Ankat.

At the time of the Lease, Daniel J. Boylan, Jr. ("Dan"), the uncle of Dean, Jr. and Jeanne-Marie, was a shareholder of Boston Sand and, indirectly, of Manchester Sand (since Boston Sand owns and controls Manchester Sand). As a result of the Separation Agreement he entered into with Boston Sand on June 15, 1995, Dan at the time of the Lease was no longer an officer or director of Boston Sand.

This action was filed by the plaintiffs, Dorothy L. Boylan (Dan's wife) and Paul F. Ryan, as co-executors of Dan's Estate ("the Estate"). Count I is brought as a shareholder derivative action on behalf of Boston Sand and Manchester Sand, alleging that Dean, Jr. and Jeanne-Marie breached their fiduciary duty by misappropriating a corporate opportunity-the Lease of the 42 Acre Parcel-for less than its fair market value. The Estate seeks rescission of the Lease and the disgorgement of all profits earned from the Lease prior to the rescission. Since the Estate is only a shareholder of Boston Sand, which wholly owns Manchester Sand, this is a "double derivative" action, meaning an action brought by a shareholder of a parent corporation on behalf of a subsidiary. "The wrongs addressed include wrongs directly

incurred by the parent corporation as well as those indirectly incurred, because of wrongs suffered by the subsidiary company."

Count II alleges that Boston Sand breached the Separation Agreement by causing Manchester Sand to enter into the Lease without prior notice to Dan, as required under that Agreement. It also alleges that Boston Sand breached the Separation Agreement by increasing the magnitude of its transactions with Collden Corporation ("Collden"), a corporation owned by Dean, Jr. and Jeanne-Marie which performed trucking services for Boston Sand, beyond the level approved by that Agreement without prior notice to Dan or the approval of the Board.

The matter is now before the Court on the defendants' motion for summary judgment.

BACKGROUND

In 1957, upon the death of Daniel J. Boylan, Sr., his two sons-Dan and Dean Boylan, Sr. ("Dean, Sr.)-became substantially equal shareholders in Boston Sand and its various subsidiaries. Dean, Sr., however, managed the family businesses; Dan relinquished financial control to his brother. Over the years, Dean, Sr. increased his family's ownership in the family corporations to 64 percent, while Dan's ownership interest decreased to 23 percent. Dean, Sr.'s two children, Dean, Jr. and Jeanne-Marie, with their father's approval, formed Collden, a company owned by them, that took over the trucking of the sand, gravel, and concrete that Boston Sand supplied to various businesses.

In the early 1990's, Dan consulted an attorney, Douglas Moxham, who prepared a draft shareholder derivative complaint alleging various breaches of fiduciary duty by Dean, Sr. and his family, including but not limited to wrongdoing regarding the related family transactions. The draft complaint was sent to Lawrence Silverstein, an attorney with the law firm of Bingham, Dana & Gould who served as corporate counsel to Boston Sand and was a member of the Boston Sand Board of Directors. The disputes set forth in that draft complaint were ultimately resolved without litigation through negotiations that led to the execution of a Settlement Agreement dated October 7, 1994. In addition, Dan's active employment at Boston Sand ended in 1988 when Dan underwent life threatening surgery due to an ulcer. Dan's resignation from his positions at Boston Sand were among the matters resolved through the June 15, 1995 Separation Agreement. Silverstein was actively involved on behalf of Boston Sand in the negotiations leading to both the Settlement and Separation Agreements.

Under the Separation Agreement, Dan resigned from all of his positions as an employee, officer, and director of Boston Sand. Since he still retained a substantial minority equity interest in Boston Sand, the Agreement provided various limitations on related party transactions. Certain specified existing transactions were expressly permitted to continue, provided the terms of those transactions did not materially change. Separation Agreement at ¶ 6(a). If Boston Sand were to consider entering into any other related party transaction with Dean, Sr. or his children, Boston Sand was required, no later than 30 days before Boston

Sand obtained Board of Director approval of the transaction, to provide Dan with written notice of the proposed transaction, along with certain information regarding the proposed transaction, including the information provided to the Board. Once Dan received such notice of a proposed related party transaction, he had 30 days to provide Boston Sand with his written objections to the transaction, or be deemed to have waived any such objection. *Id.*

Collden's provision of trucking services to Boston Sand was among the transactions that were specifically authorized by the Separation Agreement, in the absence of "material change." *Id.* at ¶ 6(a) & Schedule 6-1. If there were a "material change," this related party transaction would be treated as a new related party transaction, which must be approved by the Boston Sand Board, with the notice described above given to Dan. *Id.* The Separation Agreement provided:

[I]t is agreed and understood that any change or changes totaling in the aggregate 10% or more of any Baseline Level (as defined below) shall be considered such a material change.... For these purposes, the "*Baseline Levels* " are the price levels and the levels of volume or other quantity associated with the applicable Continuing Transaction ...*provided,* that all such price Baseline Levels shall be adjusted to reflect changes in the CPI from the date applicable to that Baseline Level.

The Lease of the 42 Acre Parcel

In 1988, Manchester Sand retained Leggatt-McCall ("McCall")to conduct an appraisal of all of its land in Hooksett. The McCall appraisal set a value of $4,000 per acre for land zoned residential and $10,000 per acre for land zoned for industrial use. The appraisal did not focus specific attention on the 42 Acre Parcel.

In May 1990, Hooksett adopted a local zoning ordinance entitled Mixed Use District 5-MUD 5 ("the MUD-5 Ordinance"). The MUD-5 Ordinance limited the development of Manchester's roughly 3,000 acres to "net usable acreage," which excludes wetlands, property burdened by easements, and rights-of way. The MUD-5 Ordinance also imposed various zoning restrictions on the property, restricting use in some areas to industrial, commercial, or residential, designating certain land for public use and conservation areas, and setting open space requirements. The MUD-5 Ordinance specifically limited the development of Manchester Sand's West Side Property by imposing a 25 percent cap on the net usable acreage that could be zoned for commercial use, designating the rest for industrial use.

In or about 1991, after consulting with David Campbell ("Campbell"), a real estate broker and attorney who specialized in local planning matters in New Hampshire, Manchester Sand designated the 42 Acre Parcel for commercial use under the MUD-5 Ordinance, and that designation was approved in 1991 and again in 1995 by the Hooksett Planning Board.[FN2]Once the excluded uses defined in the MUD-5 Ordinance were subtracted from the gross total acreage of the West Side Property, the 42 Acre Parcel was approximately 25 percent of its "net usable acreage."

FN2. Campbell had been advising Boston Sand and Manchester Sand about the marketing and disposition of its various New Hampshire properties since the 1980's. He also had represented Dean, Jr. and Jeanne-Marie in various real estate matters, serving both as a real estate advisor and attorney.

In 1995, Dean, Jr. was the President and Chief Executive Officer of Boston Sand, as well as a director of both Boston Sand and Manchester Sand. Jeanne-Marie was Vice-President, Treasurer, and Secretary of Boston Sand, and also a director of both Boston Sand and Manchester Sand. That year, when it was apparent that the 42 Acre Parcel would be mined out and therefore would no longer produce any income for Manchester Sand, Dean, Jr. and Jeanne-Marie spoke with Campbell regarding the possible sale of the 42 Acre Parcel. Campbell told them that the local market for commercial property remained weak at that time because of the real estate collapse of the late 1980's and early 1990's. He added that there were a number of unsold commercially designated parcels located nearby, including some owned by the Federal Deposit Insurance Corporation, that had direct frontage on Route 3 and would be more attractive to a commercial purchaser. The 42 Acre Parcel was located almost a half mile off of Route 3, behind an existing commercial use-the Granite State Marketplace.

Campbell later told Dean, Jr. and Jeanne-Marie that he had had discussions with potential buyers of the 42 Acre Parcel, including the owners of the Granite State Marketplace and a theater chain, but there was no interest in the property. He said that he did not think there was a ready market for sale of the property to a third-party buyer at that time.

Dean, Jr. and Jeanne-Marie told Campbell that they would be willing to purchase the 42 Acre Parcel.[FN3]They asked Campbell to obtain an independent, third-party valuation of the Parcel to determine a potential purchase price. Campbell chose to retain Applied Economic Research, Inc. ("AER"), a licensed New Hampshire appraisal company, to perform the valuation. On October 25, 1995, AER sent Campbell its written appraisal, entitled "Preliminary Limited Summary Appraisal Report" ("the AER Appraisal"), which estimated that the fair market value of the 42 Acre Parcel as of July 26, 1995 was between $240,000 and $270,000, or roughly $7,000 to $8,000 for each of the roughly 34 usable acres.[FN4]The AER Appraisal made clear that it was a "limited appraisal," not "a complete appraisal report," both of which are terms of art under the Uniform Standards of Professional Appraisal Practice. The AER Appraisal specifically declared, "It should be clearly understood that this Limited Summary Appraisal Report carries with it a lower degree of reliability than a complete appraisal that does not invoke the Departure Provision, and consequently the value estimate is presented in a value range rather than a single number."AER Appraisal at 1. The AER Appraisal noted that the appraiser had relied on second-hand sources of information, such as other appraisers and town records, and had not physically inspected the comparables used in the analysis nor confirmed the comparable sales with the buyer or seller. *Id.* The Appraisal, however, also declared, "It is the appraiser's determination that this appraisal was not so limited as to result in a misleading or confusing report."*Id.* Campbell, after reviewing the AER Appraisal, told Dean, Jr. and Jeanne-Marie that the valuation conclusions appeared reasonable.

On February 27, 1996, at a Board of Directors meeting of Boston Sand, Dean, Jr. and Jeanne-Marie provided the Board with a memorandum from Jeanne-Marie proposing that Dean, Jr. and Jeanne-Marie (or their nominee) be authorized to lease the 42 Acre Parcel from Manchester Sand, effective June 30, 1996, at $2,000 per month, with a three-year option to purchase the Parcel for $255,000.[FN5] The memorandum declared that Dean, Jr. and Jeanne-Marie intended to operate a driving range and recreation facility on the land. Dean, Jr. and Jeanne-Marie also provided the Board with a copy of the AER Appraisal. They asked the Board to consider their request to lease the 42 Acre Parcel, with an option to buy, at the next regularly scheduled Board meeting.

At the next regularly scheduled Board meeting on May 21, 1996, the Board voted unanimously to approve the transaction set forth in the February 27, 1996 memorandum. Voting at the meeting were the following Boston Sand directors:

• Dean Boylan family members Dean, Sr., Dean, Jr., and Jeanne-Marie;

• Silverstein, Boston Sand's corporate counsel;

• Dominic DiMaggio, the former great center fielder of the Boston Red Sox and, later, a businessman, who is also a lifelong friend of Dean, Sr.;

• John Graham, an industry consultant and lifelong friend of Dean, Sr.; and

• John Hallisey, a former Boston Sand executive who was elected Chairman of the Board at that meeting and continued as a director until his death in 1999.

Days before the May 21, 1996 Board meeting, Dan's attorney, Paul Ryan (“Ryan”), spoke with Silverstein and learned that Manchester was going to lease the 42 Acre Parcel to Dean, Jr. and Jeanne-Marie. This was the first time anyone associated with Dan had learned of this proposed transaction. On June 6, 1996, after the Board vote, Ryan received from Silverstein for the first time the written terms of the lease transaction and a copy of the AER Appraisal. Ryan complained that he and Dan had not been informed of this transaction, and Silverstein responded that Dean, Jr. and Jeanne-Marie did not have to inform them, because Manchester is a subsidiary of Boston Sand. Ryan did not accept this interpretation of the Separation Agreement.

On June 19, 1996, Ryan, on behalf of Dan, wrote Dean, Jr. and stated Dan's objection to the proposed lease. He asked the Boston Sand Board again to review this transaction. He attached a letter he had written that day to Silverstein stating that he had retained a real estate consultant whose preliminary view was that the purchase price of $7,500 per usable acre was low. Ryan wrote that he and Dan had authorized a full appraisal of this property and would make a copy of the appraisal available to the Board once it was completed. He asked that no steps be taken to implement this agreement until the Board could consider the new appraisal. Despite this request, on June 30, 1996, Dean, Jr., on behalf of Manchester, and Jeanne-Marie, on behalf of Ankat, signed a Ground Lease for the 42 Acre Parcel with the terms set forth in

the February 27, 1996 memorandum.

On September 23, 1996, Ryan provided Boston Sand with a copy of the appraisal prepared by David Kirk, the appraiser retained by Dan ("the Kirk Appraisal"). The Kirk Appraisal opined that the fair market value of the 42 Acre Parcel as of July 1, 1996 was $600,000. One of the "special assumptions" in the Kirk Appraisal is that "approximately 40 acres of the subject parcel are developable, although no certification is made."Kirk Appraisal at 4.

On November 4, 1996, attorney Moxham, on behalf of Dan, wrote a letter to Dean, Jr. asking the Boston Sand Board to rescind the Ground Lease and prevent the sale of the 42 Acre Parcel in view of the Kirk Appraisal, which he attached, stating that the purchase price under the option in the Ground Lease was "grossly unfair, ... especially when one considers that the $255,000 purchase price will be paid five years in the future, compared to an appraisal value of $600,000 in July, 1996."Moxham alternatively requested, "At a minimum, those Directors of [Boston Sand] who have no financial or family interest in the transaction should engage a totally independent appraiser to opine on both the value of the [42 Acre Parcel] and the benefit or detriment to [Manchester] and [Boston Sand] from separating the [42 Acre Parcel] from the larger 250 acre commercially zoned parcel."On November 6, 1996, Ryan, also on behalf of Dan, wrote Silverstein asking him to deliver to each of the Board members of Boston Sand and Manchester a copy of Moxham's submission at least one week before the next Boston Sand Board meeting if Dean, Jr. and Jeanne-Marie intended to continue with the transaction.

All the Boston Sand directors were provided with a copy of Moxham's submission on November 11, 1996, eight days before the next regularly scheduled Board meeting on November 19, 1996. At that Board meeting, the Board discussed Dan's objections to the Ground Lease but did not vote either to rescind the transaction or to ratify it.

The plaintiffs filed the instant action in 2002. On March 15, 2006, each director was provided with Jeanne-Marie's February 27, 1996 memorandum (including the AER Appraisal), the Moxham submission (including the Kirk Appraisal), the minutes prepared by Jeanne-Marie of the relevant prior Board meetings,[FN7] and the plaintiffs' verified complaint. The Boston Sand Board meeting took place at 10 a.m. on March 16, 2006. At that meeting, the directors unanimously voted to ratify the Board's decision on May 21, 1996 approving the lease of the 42 Acre Parcel to Ankat under the terms proposed in Jeanne-Marie's February 27, 1996 memorandum. Apart from Hallisey, who had died in 1999, the directors who voted at that meeting were the same who had originally voted to approve the transaction on May 21, 1996, with the addition of one director-John Mahoney, who had joined the Board in 1996.

The plaintiffs have also submitted a report from Richard A. Bonz (the "Bonz Report"), which states, as a hypothetical, that if Hooksett constructed a "Parkway Corridor" near the 42 Acre Parcel, the future value would increase. If built, the 42 Acre Parcel's present value would be $1,070,000 according to the Bonz Report. Notably, the Kirk Appraisal characterized the development of the Parkway Corridor as "speculative in nature."

The Provision of Trucking Services By Collden

Having alleged that Boston Sand increased the price levels and/or the volume of the trucking services that Collden provided to Boston Sand more than ten percent beyond the Baseline Level set in the Separation Agreement without prior notice to Dan or the approval of the Boston Sand Board, the plaintiffs were asked in Interrogatory No. 5 to state the amount of damages claimed and the factual basis for such an assertion of damages. In the initial answer to this interrogatory, no information was provided as to the Collden breach of contract claim. The defendants moved to compel an answer as to the damages asserted for this claim, and the motion was allowed by this Court on September 14, 2005, with the supplementary answer due fourteen days later. The Estate timely filed a supplemental answer but it simply asserted that it could not determine the profits derived by Collden from the prohibited transactions or the amount of damages "without further factual disclosure and expert analysis."To date, this supplemental answer has yet to be supplemented with a meaningful estimate of damages arising from the Collden claim.

DISCUSSION

Claims Arising From the Lease of the 42 Acre Parcel

Dean, Jr. and Jeanne-Marie, as directors of Boston Sand, owed a fiduciary duty to the corporation, which included both a duty of care and a duty of loyalty. Since they were both directors and shareholders of Boston Sand, and since Boston Sand was a closely-held corporation, they owed their fellow shareholders, including Dan, "substantially the same duty of utmost good faith and loyalty in the operation of the enterprise that partners owe to one another, a duty that is even stricter than that required of directors and shareholders in corporations generally."

If Dean, Jr. and Jeanne-Marie wished Boston Sand to engage in a self-dealing transaction, such as the lease or sale of the 42 Acre Parcel to Ankat, a corporation owned by them, they must:

1. make full and honest disclosure of all the known material facts of the proposed transaction, including the details of the transaction and their conflict of interest; *and*

2. "then either receive the assent of disinterested directors or shareholders, or otherwise prove that the decision is fair to the corporation."*Demoulas* at 533.The burden of proving that the assenting directors were disinterested rests with the self-dealing directors, see *Houle v. Low,* 407 Mass. 810, 824 (1990), as does the burden of proving that the self-dealing was "intrinsically fair, and did not result in harm to the corporation or partnership" if the transaction was approved by self-interested directors.

If the self-dealing directors fail to provide full disclosure of the material facts of their proposed transaction, then they breach their fiduciary duty by proceeding with the transaction, regardless of its approval by the Board or its fairness to the corporation. The

Board's approval is vitiated by the failure of full disclosure.

If the self-dealing directors provide full disclosure to the Board and the transaction is approved by the disinterested directors, then the decision enjoys the deference provided by the business judgment rule. If the self-dealing directors provide full disclosure to the Board and the transaction is approved by self-interested directors, the decision does not enjoy the benefit of the business judgment rule and must be demonstrated to be fair to the corporation.

In scrutinizing the May 21, 1996 approval of the terms of the lease of the 42 Acre Parcel to Ankat, this Court first must consider whether Dean, Jr. and Jeanne-Marie's disclosure to the Board constituted full and honest disclosure of all the known material facts of the proposed transaction. This Court does not accept the Estate's argument that the disclosure was inadequate because the AER Appraisal was only a limited appraisal. The AER Appraisal clearly so declared, and set forth the lower degree of reliability that arose from being only a limited appraisal. This Court, however, does find that Dean, Jr.'s and Jeanne-Marie's disclosure was less than full and honest as to one significant material fact-they did not inform the Board that they had failed to provide written notice to Dan of the proposed Ankat lease transaction at least thirty days before the Board meeting at which approval was to be sought, in violation of Section 6(b) of the Separation Agreement entered into between Dan and Boston Sand, which required such notice whenever Boston Sand was contemplating entering into any new related party transaction with Dean, Jr. or Jeanne-Marie. [FN8]

> FN8. The Separation Agreement barred Boston Sand from entering into any transactions with Dean, Sr. or his children, as long as Dan and his children owned at least five percent of Boston Sand, except those specifically delineated in Section 6(a). Separation Agreement at § 6(a). The fourth exception to this bar against self-dealing transactions delineated in Section 6(a) permitted "those other transactions on arms-length terms meeting the notice, information (including notice and information to auditors), and Board of Directors approval requirements set forth in Section 6(b)...."*Id.*Section 6(b) provided that "no later than thirty (30) days before [Boston Sand] obtains Board of Directors approval of any one-time or ongoing transaction" authorized within the fourth exception, Boston Sand was required to provide Dan with written notice of the proposed transaction, "any additional written information provided to [Boston Sand's] Board of Directors in connection with obtaining Board of Directors approval thereof, and a certificate of the President of [Boston Sand] stating that copies of such notice and information have been sent to [Boston Sand's] auditors."*Id.* at § 6(b). By failing to give Dan the advance notice required by this provision, Dean, Jr. and Jeanne-Marie both breached the Separation Agreement and the fiduciary duty they owed to Dan as a minority shareholder.

Under the Separation Agreement, Dan, once he received thirty days notice of the proposed transaction, was entitled to submit to Boston Sand's Board his position on the proposed transaction. Separation Agreement at § 6(b). If he did not provide Boston Sand with "written notice of objection to any such proposed transaction within thirty (30) days of his receipt of the notice and information described above, he ... shall be deemed to have approved of such

transaction and shall have waived all rights to object thereto...."*Id.*By failing to notify the Board of the failure to provide this required notice to Dan, the Board was denied material information that they should have considered before approving the lease of the 42 Acre Parcel to Ankat. Specifically, without this information, the Board did not know that Dan had not approved the proposed transaction by failing to submit a written objection, and also did not know that Boston Sand had breached its contractual obligation to Dan by failing to provide the required notice, thereby exposing Boston Sand to the risk of liability. By failing to provide this material information, Dean, Jr. and Jeanne-Marie failed to fulfil the essential element of full and fair disclosure of the proposed self-dealing transaction by denying the Board material information that it should have had the opportunity to consider before approving the lease of the 42 Acre Parcel to a corporation owned by Dean, Jr. and Jeanne-Marie. Therefore, this Court finds that Dean, Jr. and Jeanne-Marie breached their fiduciary duty in seeking the Board's approval of the Ankat lease on May 21, 1996 without informing the Board of their failure to provide Dan with the required thirty-day notice of the proposed transaction.[FN9]

Boston Sand contends that it had no obligation to give Dan notice of the proposed lease of the 42 Acre Parcel because the Parcel was owned by Manchester Sand and the Separation Agreement was executed by Boston Sand, and did not specifically define Boston Sand to include its wholly-owned subsidiaries. There are two fatal flaws with this argument. First, even if the Agreement bound only Boston Sand, not Manchester Sand, the proposed lease transaction was authorized by the Board of Directors of Boston Sand, not Manchester Sand, so Boston Sand plainly recognized that it had the authority to approve the transaction. Second, the release provision in the Separation Agreement released not only Boston Sand from liability for all prior claims (except those arising from the Settlement Agreement and the Separation Agreement) but also all entities controlled by Boston Sand, including Manchester Sand. In view of the language of the release, it is reasonable to infer that the related party transactions addressed in the Agreement included those between the Dean Boylan family and both Boston Sand and its wholly-owned subsidiaries.

The breach of fiduciary duty arising from the failure to provide the Board with full and fair disclosure of the absence of the required thirty-day notice to Dan renders ineffective the Board's approval of the proposed transaction on May 21, 1996, but it does not end the inquiry, because the Board considered the transaction again on November 19, 1996. Prior to this Board meeting, all the Boston Sand directors knew that Dan had learned of the lease transaction and had vigorously opposed it, and had received a copy of the Moxham submission, which included not only Dan's reasons for opposing the lease transaction but also the Kirk Appraisal, with its substantially higher fair market value for the 42 Acre Parcel. If the Board had formally ratified the Ground Lease, its ratification pragmatically may have cured the defective disclosure that nullified its original approval six months earlier. There is no dispute, however, that the Board did not vote at this meeting either to ratify or rescind the Ground Lease. Nor can this Court infer such ratification by the mere fact that the Board discussed the transaction and did not vote to rescind it. Indeed, even Jeanne-Marie's belatedly prepared minutes of the November 19, 1996, whose accuracy the Estate vigorously contests, do not support the inference that the Board ratified the May 21, 1996 approval. Rather, the

minutes reflect that Dean, Jr., Jeanne-Marie, Silverstein, DiMaggio, and Mahoney all agreed that a third appraisal should be conducted to establish the option price for the 42 Acre Parcel. Dan's attorney, Ryan, however, did not agree to be bound by the fair market value established in a third appraisal, and DiMaggio and Mahoney both declared that an agreement should be in place as to the practical consequence of a third appraisal before a third appraiser was engaged. As a result of this stand-off, nothing happened; no new appraiser was retained by Boston Sand and the earlier Board approval was neither ratified nor rescinded.

On March 16, 2006, four years into the litigation, the Board belatedly did unanimously ratify the Board's decision on May 21, 1996 approving the lease of the 42 Acre Parcel to Ankat under the terms proposed in Jeanne-Marie's February 27, 1996 memorandum. As noted earlier, the day before that Board meeting, each director was provided with Jeanne-Marie's February 27, 1996 memorandum (including the AER Appraisal), the Moxham submission (including the Kirk Appraisal), the minutes prepared by Jeanne-Marie of the relevant prior Board meetings, and the plaintiffs' verified complaint. As to this meeting, there is no reasonable dispute that formal ratification occurred and that the Board knew not only the details of the transaction and the conflict of interest but also the basis for Dan's strong opposition to the transaction. Therefore, to determine whether this ratification may legally bind the corporation to the Ground Lease, this Court must determine whether the ratification received the approval of disinterested directors.

Massachusetts courts have adopted the American Legal Institute's Principles of Corporate Governance regarding the definition of an "interested" director. Section 1.23(a) of ALI's Principles of Corporate Governance states that a director is "interested" if that director: (1) is a "party to the transaction"; (2) "has a business, financial, or familial relationship with a party to the transaction or conduct, and that relationship would reasonably be expected to affect the director's ... judgment with respect to the transaction or conduct in a manner adverse to the corporation"; (3) has associates who have a pecuniary interest in the transaction that "would reasonably be expected to affect the director's ... judgment"; or, (4) is "subject to a controlling influence" that could reasonably affect the director's judgment with respect to the transaction in a manner adverse to the corporation.

At the March 16, 2006 Board meeting, seven directors voted unanimously to ratify the May 21, 1996 Board decision: Dean, Sr., Dean, Jr., Jeanne-Marie, Silverstein, Graham, DiMaggio, and Mahoney. Dean, Sr., Dean, Jr., and Jeanne-Marie were plainly interested parties, and were recognized as such at the Board meeting. According to the Board minutes, there was a discussion prior to the vote as to whether they should abstain and it was determined that it did not matter whether they voted because the other four directors were going to vote unanimously to ratify.

Silverstein at the time of the vote was a partner in the law firm of Bingham McCutchen, LLP. He had performed legal work for Boston Sand and the other Boylan family companies since 1975, except for two years (1984-1986) when he left the law firm to become president of a real estate company. Apart from these two years, he was the principal corporate counsel for Boston Sand and its related companies since the late 1970's or early 1980's.. Apart from his

corporate work for these entities, he and his law firm had also done estate planning for the Dean Boylan family. This Court finds as a matter of law that the legal work that Silverstein performed for Boston Sand and its related companies, all of them controlled by Dean Boylan's family, and the estate planning he performed for the Dean Boylan family constituted a business and financial relationship with the Dean Boylan family that "would reasonably be expected to affect" his judgment as a director in determining whether to ratify a self-dealing transaction proposed by Dean, Jr. and Jeanne-Marie. In short, without in any way challenging Silverstein's integrity as corporate counsel, it would be reasonable to expect that Silverstein's judgment as to ratification would be affected by the prospect that, if he were to refuse to ratify the transaction, the Boylan family may be angry enough with him to transfer its legal business to another firm or another attorney within his firm, especially since he had advised the Boylan family as to the transaction back in 1996. The potential risk of financial loss to his law firm, of which he was a partner, or the potential reduction in his share of the profits of the law firm if he were to lose the Boylan family and its entities as clients, is sufficient to find that he was an interested director as to this ratification decision.

Graham, DiMaggio, and Mahoney, in contrast with Silverstein, had no business or financial relationship with the Dean Boylan family in 2006, apart from their service as directors. Graham joined the Boston Sand Board after retiring from a career in the cement business. He met Dean, Sr. in 1956 when Boston Sand was a customer of the cement company for which he served as sales director, and became his friend, seeing him for dinner roughly four times a year and golf three or four times per year. Each stayed as a guest in each other's homes over the years.

DiMaggio became close friends with Dean, Sr. about fifty years ago, meeting through their respective wives, and has remained close over the years. He knew Dean, Jr. and Jeanne-Marie through his relationship with their father, but did not socialize with them independently.

Mahoney, before joining the Boston Sand Board, had been a partner at Ernst & Young, Boston Sand's outside auditor, since 1986, and had been assigned to handle Boston Sand's account since at or about that time. He left Ernst & Young in 1996, and joined Staples later that year. As of the date of the ratification vote, he served as Staples' Chief Administrative Officer. He was also a close friend of the Dean Boylan family, having vacationed with them and entertained them in his home. Consequently, while Mahoney once had a business relationship with entities controlled by the Dean Boylan family until 1996, by the time of the ratification vote he had no business dealings with them, just a close personal friendship with the Dean Boylan family.

The Estate contends that the close personal friendships that Graham, DiMaggio, and Mahoney maintained with the Dean Boylan family meant that they were "subject to a controlling influence" that could reasonably affect their judgment as directors and, as a result, should be found to be interested directors. The Comment, however, to Section 1.23 of the ALI Principles specifically declares, "It is not intended that a person would be treated as subject to a controlling influence, and therefore interested, solely because of a long-time

friendship or other social relationship, or solely because of a long-time business association through service on the same board of directors or other relationship not involving direct pecuniary dealing."While there is no controlling Massachusetts authority adopting this particular comment, this Court anticipates that the Supreme Judicial Court would adopt, not merely the definition of an interested director in the ALI Principles, but this comment as to whether friendship alone is sufficient to show that a director is "subject to a controlling influence." See also *Beam v. Stewart,* 845 A.2d 1040, 1050 (Del.2004) ("allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence").

Nor does the fact that Graham and DiMaggio originally voted in favor of approving the lease in May 1996 cause them to be viewed as interested directors in a vote to ratify that decision, especially when they are not defendants in the instant shareholder derivative action. See ALI Principles, § 1.23(c).[FN10] Nor does the director's receipt of usual and customary director's fees from the corporation cause the director to become an interested director. See, Comment, ALI Principles, § 1.23(c). Therefore, this Court finds as a matter of law that Graham, DiMaggio, and Mahoney were not interested directors at the time of the ratification vote.

The fact that all three disinterested directors voted to ratify the May 21, 1996 Board decision does not mean, however, that their ratification vote must be examined under the relatively deferential business judgment rule. Under Mass. R. Civ. P. 23.1, before instituting a shareholder derivative action, the aggrieved shareholder must attempt to obtain the relief he seeks from the court from the directors of the corporation. "The rationale behind the demand requirement is that, as a basic principle of corporate governance, the board of directors or majority of shareholders should set the corporation's business policy, including the decision whether to pursue a lawsuit.... However, if a majority of directors are alleged to have participated in wrongdoing, or are otherwise interested, a plaintiff may seek to have the demand on the board excused as futile. This is referred to as a 'demand excused' case."

In a "demand excused" case, the Board, as it did in *Houle v. Low,* may still act after the suit is filed to determine the propriety of pursuing the shareholder derivative action by a vote of a Special Litigation Committee, appointed by the majority of the directors. As the Supreme Judicial Court in *Houle* noted, "The fact that the procedural requirement of demand is excused in a given case (as it was here) does not extinguish the substantive principle that the decision as to what is in the corporation's best interest is a matter of business judgment. An independent and unbiased committee can weigh and balance the divers factors in a given case and make a business judgment as to the proper course of action."*Houle,* 407 Mass. at 821.If the Special Litigation Committee voted to continue the derivative action, then the corporation would take over the prosecution of the suit; if it voted not to continue it, then the defendant corporation could move for the dismissal of the suit and the court would need to consider whether to adopt the decision of the Special Litigation Committee.

While the March 16, 2006 Board vote was characterized by Boston Sand as a ratification vote by the Board rather than a vote to determine whether to prosecute the shareholder derivative action, it was functionally the same. If the Board had refused to ratify the 1996

Board decision, Boston Sand would have provided the Estate with some form of the relief it seeks through this litigation. Since the Board ratified the decision, it argues that the ratification requires dismissal of the action. While the entire Board voted to ratify, as opposed to delegating the decision to a Special Litigation Committee of disinterested directors, this, too, is a distinction without a functional difference because the Board recognized that, regardless of the vote of the interested directors, the disinterested directors were all voting in favor of ratification. For all practical purposes, the Board effectively granted the authority to ratify to the disinterested directors, albeit without formally declaring them a Special Litigation Committee.[FN11]Therefore, in deciding the standard of judicial review of this Board vote of ratification, this Court adopts the standard of review found appropriate by the Supreme Judicial Court in *Houle,* when it considered whether to adopt the finding by a Special Litigation Committee that the corporation should not prosecute the shareholder derivative action and should seek its dismissal. See *Houle,* 407 Mass. at 813-814.

In *Houle,* the Supreme Judicial Court declared:

The value of a special litigation committee is coextensive with the extent to which that committee truly exercises business judgment. In order to ensure that special litigation committees do act for the corporation's best interest, a good deal of judicial oversight is necessary in each case. At the same time, however, courts must be careful not to usurp the committee's valuable role in exercising business judgment. At a minimum, a special litigation committee must be independent, unbiased, and act in good faith. Moreover, such a committee must conduct a thorough and careful analysis regarding the plaintiff's derivative suit.... The burden of proving that these procedural requirements have been met must rest, in all fairness, on the party capable of making that proof-the corporation.

The *Houle* Court later declared:
Suppose, however, that the corporate defendant satisfies the judge that the committee was independent. Such an eventuality would raise a second question, the one on which the Zapata and Auerbach courts parted ways. As noted, Massachusetts has always recognized the need for courts to abstain from interfering in business judgments. At the same time, this court has always “vigorously scrutinize[d] the situation” where a director's loyalty to the corporation is in conflict with his or her own self-interest. Both concerns are present in this case, as is the danger of “structural bias” recognized by so many courts and commentators. The balancing of these various concerns requires reviewing judges to go beyond establishing the committee's independence, good faith and the adequacy of its investigation.

The judge must determine, on the basis of the evidence presented, whether the committee reached a reasonable and principled decision. Even in those cases where a committee is independent and conducts a thorough investigation, the judge may conclude that the committee's decision is contrary to the great weight of evidence. In conducting its review, the court should look to factors such as those identified by ALI, which include the likelihood of a judgment in the plaintiff's favor, the expected recovery as compared to out-of-pocket costs, whether the corporation itself took corrective action, whether the balance of corporate interests warrants dismissal, and whether dismissal would allow any defendant who has

control of the corporation to retain a significant improper benefit.

This inquiry will allow the special litigation committee to point out to the judge on what factors it relied and why those factors support its decision. The test will also allow the derivative plaintiff to point out factors not considered by the committee or why those relied upon by the committee do not support its conclusion. Such a limited review by the judge will avoid the problem in the second level of the Zapata test, which requires the judge to exercise his or her own business judgment. The courts are better able to determine the merits of a law suit than whether a decision is correct based on a subjective evaluation of the business policies involved.

Essentially, the Supreme Judicial Court in *Houle* established a three-tiered test to evaluate these corporate decisions:

1. whether the directors who made the decision were “independent, unbiased, and [acted] in good faith,” and, if so,

2. whether the independent directors conducted “a thorough and careful analysis” and, if so,

3. whether the decision was “contrary to the great weight of the evidence.”

This is plainly a “heightened standard of review,” see *Harhen v. Brown,* 431 Mass. at 846, far more demanding than the usual business judgment test, motivated by the Court's concern for what it characterized as the “structural bias” of even disinterested directors to endorse the prior decisions of a Board comprised of a majority of interested directors and protect their fellow directors from the risk of liability.[FN12]

> This Court recognizes that the Supreme Judicial Court in *Harhen v. Brown,* decided ten years after *Houle,* held that the business judgment rule applied to the refusal of a pre-suit demand by a Board comprised of a majority of disinterested directors (or a Special Litigation Committee of disinterested directors appointed by that disinterested Board), “absent a showing of bad faith or lack of investigation into the demand.”431 Mass. at 847.The *Harhen* Court, however, specifically distinguished its facts from those in *Houle,* recognizing that it had established a “heightened standard of review” to the Board's decision in *Houle. Id.* at 846-847.The Court explained the distinction:
>
> The difference between *Houle* and the present case turns on whether a majority of the board is “interested.” In a demand refused case such as this, where the majority of the board is disinterested, the long-standing rule in Massachusetts is that the business judgment rule applies, absent a showing of bad faith or lack of investigation into the demand. See *Dunphy v. Traveller Newspaper Ass'n,* [146 Mass. 495, 497 (1888)] (“Intelligent and honest [people] differ upon questions of business policy. It is not always best to insist upon all one's rights ...”). When a

> disinterested board refers a demand to a disinterested standing committee, both receive the protection of the business judgment rule.

The summary judgment record does not permit this Court to find, as a matter of law, whether Boston Sand met its burden of proving any of these three-tier tests. While this Court has found that Graham, DiMaggio, and Mahoney were not interested directors solely because of their long friendship with Dean, Sr., the first-tier test requires the Court to determine whether they were "independent, unbiased, and [acted] in good faith," not simply whether they were disinterested. The Supreme Judicial Court in *Houle* implicitly recognized that the director who alone comprised the Special Litigation Committee was disinterested, because otherwise it would have disregarded her finding as to the propriety of the derivative action. See *id.* at 820 n. 6 (disregarding the interested Board's subsequent adoption of her finding). It also explicitly found that she acted in good faith. See *id.* at 823.Yet, the Court still found a material dispute of fact as to whether she was "independent and unbiased," noting that the pressures on her to recommend dismissal of the action "may have been strong," especially since her professional advancement as a physician depended on the directors who were defendants in the shareholder derivative action. *Id.* at 823.While that pressure is absent here, the Court more broadly observed that "typically there are relationships among directors that call for scrutiny of the independence of members of a litigation committee."*Id.*

There is also a genuine dispute of fact as to the second and third tiers of the test-whether the disinterested directors conducted "a thorough and careful analysis" and, if so, whether their decision was "contrary to the great weight of the evidence."To be sure, the summary judgment record raises a significant question as to whether "a thorough and careful analysis" was conducted. Not only did the directors only receive the written materials that they were thoroughly and carefully to analyze one day before the Board hearing, but there is no written statement, either reflected in the Board minutes or in a separate document, describing the care and analysis given to this decision, or the reasons for it.[FN13]

For these reasons, the defendants' motion for summary judgment must be denied as to the breach of fiduciary duty claim in Count I and the contract claim in Count II challenging the propriety of the lease of the 42 Acre Parcel. There must be an evidentiary hearing conducted by the Court to determine whether the ratification of the lease in 2006 by the disinterested directors of the Board satisfied the three-tier test established in *Houle.*

For the reasons stated above, this Court ***ORDERS*** as follows:

1. The defendants' motion for summary judgment is ***DENIED*** as to the breach of fiduciary duty claim in Count I and the contract claim in Count II challenging the propriety of the lease of the 42 Acre Parcel. There must be an evidentiary hearing conducted by the Court to determine whether the ratification of the lease in 2006 by the disinterested directors satisfied the three-tier test established in *Houle.*

2. The defendants' motion for summary judgment as to the breach of contract claim arising

from the provision of trucking services by Collden is ***DENIED,*** but this Court will limit the Estate to future injunctive relief if it prevails at trial.

3. Counsel shall confer with each other and the session clerk promptly to schedule a litigation control conference to determine how this case should best proceed in light of this decision.

Introduction to Piercing the Corporate Veil

At this point, the general rule is forever cemented into your brain: People incorporate to limit their liability. They are freely encouraged to do so. All you have to do is to incorporate, and follow the rules. If an accident occurs, sue the corporation. If a contract is breached, sue the corporation.

But every once in a while, equity rears its head, and demands that the corporate veil, which shields the owners of the corporation from personal liability, be lifted, so as to allow an aggrieved plaintiff to recover from the owners individually. Your job, and it is by no means an easy one, is to determine those instances where the corporate veil should be pierced. The following cases in this section will give you some guidelines (lack of corporate formalities) and buzz words ("confused intermingling of assets") to rely on in making your decision whether to pierce the corporate veil, but this area of law is by no means clear.

Zempel v. Liberty

Supreme Court of Montana.
Darwin Cloverton **ZEMPEL**, Plaintiff and Appellant,
v.
Lenora Linda **LIBERTY**, John Herak, and Tiny's Tavern of Charlo, Inc., Defendants and Respondents.
No. 04-595.

Submitted on Briefs April 5, 2005.
Decided Sept. 6, 2006.

Justice JAMES C. NELSON delivered the Opinion of the Court.

¶ 1 Darwin Cloverton Zempel (" Zempel") appeals from the orders of the District Court of the Twentieth Judicial District, Lake County, which dismissed his negligence claim against Lenora Linda Liberty (" Liberty"), John Herak (" Herak"), and Tiny's Tavern of Charlo, Inc. (" TTC"). We affirm in part, reverse in part, and remand.

¶ 2 In this appeal, we address the issue of tribal jurisdiction over a suit to which a non-tribal member is a party. We receive this appeal pursuant to the District Court's decision to dismiss the suit on jurisdictional grounds. Thus, we must determine whether the court erred in this regard.

FACTUAL AND PROCEDURAL BACKGROUND

¶ 3 The Flathead Indian Reservation is located in northwestern Montana and is home to the Confederated Salish and Kootenai Tribes (" CSKT"). TTC, a Montana corporation, operates a bar in the town of Charlo, which is located within the exterior boundaries of the Reservation. TTC's sole shareholder, Liberty, is a tribal member.

¶ 4 Zempel, who is not a tribal member, spent the evening of July 4, 2003, at TTC. Although he was not yet twenty-one years old, he was repeatedly served alcoholic beverages by one or more bartenders. In the early morning hours of July 5, another patron, Brandy Jo Moore (" Moore"), attempted to drive Zempel home in a car registered to one Tina Zempel. Proceeding south on Montana State Highway 212, Moore lost control of the vehicle, causing it to roll at least twice. Zempel was seriously injured in the accident. Moore sustained fatal injuries and was pronounced dead at the scene.

[1][2] ¶ 5 In January of 2004, Zempel filed a negligence claim against Liberty, Herak, and TTC. The Complaint alleged that: (1) Liberty and Herak were the owners and operators of TTC; (2) TTC's bartenders served Zempel numerous alcoholic beverages even though they knew he was not of legal drinking age; (3) the bartenders continued to serve Zempel after he became visibly intoxicated; (4) Zempel eventually vomited and lost consciousness as a result of the alcohol; (5) Zempel was then placed in the passenger seat of his car; (6) TTC's bartenders continued to serve Moore after she became visibly intoxicated; (7) the bartenders drank alcoholic beverages that evening, while on duty, with Zempel and Moore; (8) the bartenders knew that Zempel was incapacitated, that Moore was intoxicated, and that Moore intended to drive Zempel home; and (9) the bartenders made no effort to stop Moore from attempting to drive Zempel home. Upon these allegations, *inter alia,* Zempel claimed that the Defendants had acted negligently and violated Montana statutory law.

¶ 6 Liberty filed a Motion seeking dismissal of both herself and TTC. In doing so, Liberty acted on her own behalf and purported to act on behalf of TTC. With this Motion, Liberty argued that the District Court lacked jurisdiction to adjudicate the dispute because of her status as a CSKT member and TTC's status as an " Indian-owned business." In support of her arguments, she attached a certificate from the CSKT Enrollment Office, verifying her membership with the Tribe. She also attached a certificate, ostensibly issued by CSKT, which classified TTC as a " Certified Indian Preference Business" and identified Liberty as TTC's owner. The District Court dismissed Liberty, stating " this Court lacks jurisdiction over Plaintiff's complaint against a tribal member." The court declined to dismiss TTC, however, noting its status as a Montana corporation.

¶ 7 Herak also filed a *pro se* Motion to Dismiss wherein he argued that he was not properly

named as a defendant. In support of this contention, Herak claimed that he had no ownership interest in TTC. The District Court denied this request without addressing Herak's argument.

¶ 8 Thereafter, Liberty took a novel approach; she filed a document on behalf of TTC which she identified as a " Response" to the court's Order declining to dismiss the corporation. She also filed another Motion to Dismiss on behalf of TTC. In doing so, Liberty maintained that TTC " is an Indian-owned business and is entitled to Tribal Jurisdiction." To support this contention, Liberty attached copies of a number of business documents, including, *inter alia:* (1) TTC's Articles of Incorporation, showing the business to have been formed pursuant to the Montana Business Corporation Act; (2) TTC's liquor license, issued by the State of Montana, permitting TTC to sell alcoholic beverages in accordance with Montana law; (3) TTC's gambling operator license, issued by the State of Montana, permitting TTC to operate nine video gaming machines; and (4) a tax assessment for the premises which TTC occupied, issued by the Lake County Treasurer, assessing both state and county taxes.

¶ 9 Herak also filed a " Response" to the court's denial of his Motion to Dismiss, as well as another Motion to Dismiss. Once again, Herak claimed that he had no ownership interest in TTC. While making the same argument which he had advanced in his first Motion to Dismiss, Herak also referred the court to the documents which Liberty filed with TTC's second Motion to Dismiss.

¶ 10 The District Court then entered an Order dismissing Herak and TTC and, consequently, dismissing Zempel's Complaint in its entirety. As for Herak's Motion, the Court stated: " Herak has no ownership interest in [TTC or its] liquor license and his motion to dismiss must be granted for the failure of Plaintiff's complaint to state a claim entitling Plaintiff to relief from said Defendant." As for TTC's Motion, the court concluded that it lacked jurisdiction over the corporation, stating: " Liberty is the sole owner and stockholder of said Defendant corporation and its State of Montana liquor license and, therefore, said corporation Defendant is an Indian owned business." Zempel then appealed to this Court.

STANDARD OF REVIEW

[3][4] ¶ 11 When a party seeks dismissal of a suit based on the claim that jurisdiction properly lies in a tribal court, the trial judge must determine whether the complaint states facts which, if true, would vest the district court with subject matter jurisdiction. *See General Constructors, Inc., v. Chewculator, Inc.,* 2001 MT 54, ¶¶ 13, 16, 304 Mont. 319, ¶¶ 13, 16, 21 P.3d 604, ¶¶ 13, 16 (citing *Liberty Northwest Ins. Corp. v. State Compensation Ins. Fund,* 1998 MT 169, ¶ 7, 289 Mont. 475, ¶ 7, 962 P.2d 1167, ¶ 7). A district court's determination that it lacks subject matter jurisdiction is a conclusion of law which we review to ascertain whether the court's interpretation of the law is correct. *General Constructors,* ¶ 16 (citing *In re McGurran,* 1999 MT 192, ¶ 7, 295 Mont. 357, ¶ 7, 983 P.2d 968, ¶ 7).

DISCUSSION

[5] ¶ 12 Before commencing our jurisdictional analysis we address Herak's dismissal and two

issues regarding Liberty's status as an individual defendant in this suit.

¶ 13 Zempel purports to appeal from the District Court's Order dismissing Herak. However, Zempel has not properly raised Herak's dismissal as an issue in this appeal. As noted above, while the District Court dismissed TTC and Liberty on jurisdictional grounds, it dismissed Herak for a different reason-i.e., because he had no ownership interest in TTC. In his initial brief on appeal, Zempel only presents arguments challenging the District Court's conclusions regarding the issue of jurisdiction. Then, in his reply brief, Zempel presents a short argument challenging the District Court's decision to dismiss Herak. Essentially, Zempel seeks an opportunity to conduct discovery regarding Herak's ties to TTC. We will not address this argument because, as our well-settled precedent dictates, this Court does not consider issues raised for the first time in a reply brief. *Pengra v. State,* 2000 MT 291, ¶ 13, 302 Mont. 276, ¶ 13, 14 P.3d 499, ¶ 13 (citing *Loney v. Milodragovich, Dale & Dye, P. C.,* 273 Mont. 506, 512, 905 P.2d 158, 162 (1995)). Accordingly, the District Court's dismissal of Herak is affirmed.

[6] ¶ 14 As for Liberty's status in this suit, the record does not reveal why Zempel named her, TTC's sole shareholder, as an individual defendant. " Under Montana law, it is well settled that a corporation has a separate and distinct identity from its stockholders." *Moats Trucking Co., Inc. v. Gallatin Dairies, Inc.,* 231 Mont. 474, 477, 753 P.2d 883, 885 (1988) (citations omitted). As such, shareholders are not personally liable for the acts of a corporation, § 35-1-534(2), MCA, unless the distinction between the corporation and the shareholder may be disregarded-i.e., unless the " corporate veil" is pierced, *Peschel Family Trust v. Colonna,* 2003 MT 216, ¶¶ 21-42, 317 Mont. 127, ¶¶ 21-42, 75 P.3d 793, ¶¶ 21-42.

[7] ¶ 15 Zempel's Complaint does not allege any acts attributable to Liberty individually. Thus, it would seem that he may have sought to hold her accountable by piercing the corporate veil which separates Liberty from TTC for liability purposes. Yet, the Complaint does not allege any facts even remotely suggesting that TTC's corporate veil should be pierced in this case. Of course, the fact that Liberty is TTC's sole shareholder " is not, by itself, enough to warrant piercing the corporate veil." *Meridian Minerals Co. v. Nicor Minerals, Inc.,* 228 Mont. 274, 285, 742 P.2d 456, 462 (1987) (citation omitted).

[8][9] ¶ 16 We recognize that plaintiffs are generally not obligated to name a particular cause of action or plead the specific legal elements of a claim when filing a complaint, as we operate under " notice pleading" rules. *See Kunst v. Pass,* 1998 MT 71, ¶ 35, 288 Mont. 264, ¶ 35, 957 P.2d 1, ¶ 35 (citations omitted). Indeed, pursuant to M.R. Civ. P. 8(a), a complaint must only " put a defendant on notice of the *facts* the plaintiff intends to prove; the facts must disclose the elements necessary to make the claim; and the complaint must demand judgment for the relief the plaintiff seeks." *Kunst,* ¶ 35 (emphasis added) (citation omitted). We are also mindful that complaints must be construed broadly in the plaintiff's favor when determining whether he or she has stated a claim. *See Fennessy v. Dorrington,* 2001 MT 204, ¶ 9, 306 Mont. 307, ¶ 9, 32 P.3d 1250, ¶ 9 (citation omitted).

¶ 17 Here, construing the Complaint broadly, and recognizing that plaintiffs are generally not

subject to any technical pleading requirements, it nonetheless appears that Zempel failed to state a claim against Liberty. We make this observation because we are troubled by the fact that Liberty was put to the inconvenience and expense of defending herself in this suit even though Zempel failed to provide any justification for naming her as an individual defendant.[FN2] Having expressed our concern, we will not resolve this issue here, as the parties have focused their arguments on the jurisdictional issue.[FN3] We presume Liberty will be dismissed on remand unless Zempel properly amends his Complaint, pursuant to M.R. Civ. P. 15(a), to justify her inclusion as a defendant.

FN2. We are equally troubled that Zempel has dragged Herak into this litigation, as the Complaint does not state a claim against him. In fact, the record before us contains absolutely nothing to justify Herak's inclusion as a defendant in this suit. Yet, he has been forced to defend himself in the District Court proceedings and in this appeal.

FN3. Liberty has not filed a brief in this appeal.

[10] ¶ 18 Finally, as we did in *Audit Services, Inc. v. Frontier-West, Inc.,* 252 Mont. 142, 148, 827 P.2d 1242, 1246, (1992), we note another important issue which neither the parties nor the District Court have addressed. Non-lawyers may not represent corporations in district court proceedings. *Audit Services,* 252 Mont. at 148, 827 P.2d at 1246 (citing *Weaver v. Law Firm of Graybill,* 246 Mont. 175, 178, 803 P.2d 1089, 1091 (1990)) (holding that a corporation is a legal entity which is separate from the agents who act on its behalf, and it can not appear on its own behalf through an agent other than an attorney). We have explicitly warned the district courts regarding this subject, having identified it as " an issue of importance." *Audit Services,* 252 Mont. at 148, 827 P.2d at 1246. Indeed, we have observed that a non-lawyer who appears on behalf of another in a district court proceeding is guilty of contempt of court pursuant to § 37-61-210, MCA.[FN4] *Weaver,* 246 Mont. at 178, 803 P.2d at 1091.

FN4. Section 37-61-210, MCA, provides: **" Penalty for practicing without license.** If any person practices law in any court, except a justice's court or a city court, without having received a license as attorney and counselor, he is guilty of a contempt of court."

¶ 19 Here, as noted above, Liberty purported to act on behalf of TTC in the District Court proceedings, filing an initial Motion to Dismiss as well as a " Response" to the District Court's Order and a subsequent Motion to Dismiss. In doing so, she acted in contempt of court. Liberty is not licensed to practice law in Montana, nor did she claim to be in the proceedings below. Yet, the District Court failed to hold her in contempt. In fact, the court granted one the motions Liberty filed on behalf of TTC, allowing her to " represent" TTC and thereby practice law without a license. Consequently, we again admonish district courts to observe our case law on this important issue and exercise vigilance in ensuring that only licensed legal practitioners represent corporate entities in district court proceedings.

CONCLUSION

¶ 39 The CSKT Tribal Court does not have jurisdiction over this case brought by a nonmember against a Montana corporation and a tribal member. TTC has failed to identify any federal statute or treaty that provides for tribal adjudicative jurisdiction here. Further, TTC has failed to demonstrate either a qualifying consensual relationship or a threat to tribal self-government that would overcome *Montana's* general rule prohibiting tribal adjudicative jurisdiction over suits involving nonmembers. Thus, we conclude that the District Court erred in dismissing Zempel's claim against TTC and Liberty on jurisdictional grounds.

¶ 40 We affirm the District Court's dismissal of Herak. We reverse the court's dismissal of TTC and Liberty and the consequent dismissal of Zempel's Complaint. Accordingly, we remand for further proceedings.

We concur: KARLA M. GRAY, C.J., PATRICIA COTTER, JOHN WARNER, W. WILLIAM LEAPHART, BRIAN MORRIS and JIM RICE, JJ.

Discussion points for Walkovsky v. Carlton

The arguments for and against piercing the corporate veil in this case are easy to understand. The difficult part is figuring who the plaintiff is suing. So draw yourself a little chart of the parties, complete with arrows, to help you understand the plaintiff's arguments. If you do so, you can more easily see why his cause of action fails.

John WALKOVSZKY, Respondent,
v.
William CARLTON, Appellant, et al., Defendants.

Court of Appeals of New York.

Nov. 29, 1966.

FULD, Judge.

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

The complaint alleges that the plaintiff was severely injured four years ago in New York City when he was run down by a taxicab owned by the defendant Seon Cab Corporation and negligently operated at the time by the defendant Marchese. The individual defendant, Carlton, is claimed to be a stockholder of 10 corporations, including Seon, each of which has

but two cabs registered in its name, and it is implied that only the minimum automobile liability insurance required by law (in the amount of $10,000) is carried on any one cab. Although seemingly independent of one another, these corporations are alleged to be 'operated * * * as a single entity, unit and enterprise' with regard to financing, supplies, repairs, employees and garaging, and all are named as defendants. The plaintiff asserts that he is also entitled to hold their stockholders personally liable for the damages sought because the multiple corporate structure constitutes an unlawful attempt 'to defraud members of the general public' who might be injured by the cabs.

FN1 The corporate owner of a garage is also included as a defendant.

The defendant Carlton has moved, pursuant to CPLR 3211(a)7, to dismiss the complaint on the ground that as to him it 'fails to state a cause of action'. The court at Special Term granted the motion but the Appellate Division, by a divided vote, reversed, holding that a valid cause of action was sufficiently stated. The defendant Carlton appeals to us, from the nonfinal order, by leave of the Appellate Division on a certified question.

[1][2][3][4] The law permits the incorporation of a business for the very purpose of enabling its proprietors to escape personal liability (see, e.g., Bartle v. Home Owners Co-op., 309 N.Y. 103, 106, 127 N.E.2d 832, 833) but, manifestly, the privilege is not without its limits. Broadly speaking, the courts will disregard the corporate form, or, to use accepted terminology, 'pierce the corporate veil', whenever necessary 'to prevent fraud or to achieve equity'. (International Aircraft Trading Co. v. Manufacturers Trust Co., 297 N.Y. 285, 292, 79 N.E.2d 249, 252.) In determining whether liability should be extended to reach assets beyond those belonging to the corporation, we are guided, as Judge Cardozo noted, by 'general rules of agency'. (Berkey v. Third Ave. Ry. Co., 244 N.Y. 84, 95, 155 N.E. 58, 61, 50 A.L.R. 599.) In other words, whenever anyone uses control of the corporation to further his own rather than the corporation's business, he will be liable for the corporation's acts 'upon the principle of Respondeat superior applicable even where the agent is a natural person'. (Rapid Tr. Subway Constr. Co. v. City of New York, 259 N.Y. 472, 488, 182 N.E. 145, 150.)

[5] In the case before us, the plaintiff has explicitly alleged that none of the corporations 'had a separate existence of their own' and, as indicated above, all are named as defendants. However, it is one thing to assert that a corporation is a fragment of a larger corporate combine which actually conducts the business. (See Berle, The Theory of Enterprise Entity, 47 Col.L.Rev. 343, 348--350.) It is quite another to claim that the corporation is a 'dummy' for its individual stockholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends. (See African Metals Corp. v. Bullowa, 288 N.Y. 78, 85, 41 N.E.2d 366, 469.) Either circumstance would justify treating the corporation as an agent and piercing the corporate veil to reach the principal but a different result would follow in each case. In the first, only a larger Corporate entity would be held financially responsible while, in the other, the stockholder would be personally liable. Either the stockholder is conducting the business in his individual capacity or he is not. If he is, he will be liable; if he is not, then it does not matter-- insofar as his personal liability is

concerned--that the enterprise is actually being carried on by a larger 'enterprise entity'. (See Berle, The Theory of Enterprise Entity, 47 Col.L.Rev. 343.)

[7][8] The individual defendant is charged with having 'organized, managed, dominated and controlled' a fragmented corporate entity but there are no allegations that he was conducting business in his individual capacity. Had the taxicab fleet been owned by a single corporation, it would be readily apparent that the plaintiff would face formidable barriers in attempting to establish personal liability on the part of the corporation's stockholders. The fact that the fleet ownership has been deliberately split up among many corporations does not ease the plaintiff's burden in that respect. The corporate form may not be disregarded merely because the assets of the corporation, together with the mandatory insurance coverage of the vehicle which struck the plaintiff, are insufficient to assure him the recovery sought. If Carlton were to be held individually liable on those facts alone, the decision would apply equally to the thousands of cabs which are owned by their individual drivers who conduct their businesses through corporations organized pursuant to section 401 of the Business Corporation Law, Consol.Laws, c. 4 and carry the minimum insurance required by subdivision 1 (par. (a)) of section 370 of the Vehicle and Traffic Law, Consol.Laws, c. 71. These taxi owner-operators are entitled to form such corporations (cf. Elenkrieg v. Siebrecht, 238 N.Y. 254, 144 N.E. 519, 34 A.L.R. 592), and we agree with the court at Special Term that, if the insurance coverage required by statute 'is inadequate for the protection of the public, the remedy lies not with the courts but with the Legislature.' It may very well be sound policy to require that certain corporations must take out liability insurance which will afford adequate compensation to their potential tort victims. However, the responsibility for imposing conditions on the privilege of incorporation has been committed by the Constitution to the Legislature (N.Y. Const., art. X, s 1) and it may not be fairly implied, from any statute, that the Legislature intended, without the slightest discussion or debate, to require of taxi corporations that they carry automobile liability insurance over and above that mandated by the Vehicle and Traffic Law.

This is not to say that it is impossible for the plaintiff to state a valid cause of action against the defendant Carlton. However, the simple fact is that the plaintiff has just not done so here. While the complaint alleges that the separate corporations were undercapitalized and that their assets have been intermingled, it is barren of any 'sufficiently particular(ized) statements' (CPLR 3013; see 3 Weinstein-Korn-Miller, N.Y. Civ.Prac., par. 3013.01 et seq., pp. 30--142 et seq.) that the defendant Carlton and his associates are actually doing business in their individual capacities, shuttling their personal funds in and out of the corporations 'without regard to formality and to suit their immediate convenience.' (Weisser v. Mursam Shoe Corp., 2 Cir., 127 F.2d 344, 345, 145 A.L.R. 467, supra.) Such a 'perversion of the privilege to do business in a corporate form' (Berkey v. Third Ave. Ry. Co., 244 N.Y. 84, 95, 155 N.E. 58, 61, 50 A.L.R. 599, supra) would justify imposing personal liability on the individual stockholders. (See African Metals Corp. v. Bullowa, 288 N.Y. 78, 41 N.E.2d 466, supra.) Nothing of the sort has in fact been charged, and it cannot reasonably or logically be inferred from the happenstance that the business of Seon Cab Corporation may actually be carried on by a larger corporate entity composed of many corporations which, under general

principles of agency, would be liable to each other's creditors in contract and in tort.

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

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

The order of the Appellate Division should be reversed, with costs in this court and in the Appellate Division, the certified question answered in the negative and the order of the Supreme Court, Richmond County, reinstated, with leave to serve an amended complaint.

Discussion points for Howie v. Ikechukwuka

Almost 40 years later, and still the taxicab owners have not learned their lessons. But exactly what lessons are there to be learned? It would be helpful, in both this and the Walkovsky cases, to draw out a little chart of the players, to better see what is going on. What would you, as the corporate attorney for the defendant, have advised your client to do? How practical is such advice?

Superior Court of Massachusetts.

Jennifer **HOWIE**,
v.
Stephen O. **IKECHUKWUKA**, et al.

No. CA013279A.

Oct. 15, 2003.

MEMORANDUM AND ORDER ON THE DEFENDANT, EJT MANAGEMENT, INC'S MOTION FOR SUMMARY JUDGMENT

THOMAS E. CONNOLLY, Justice.

This personal injury case arises out of an incident at Logan Airport on March 7, 2000 around 10:15 a.m. The plaintiff, Ms. Jennifer Howie, was employed by Massachusetts Port Authority as a taxi dispatcher/controller and stationed at Terminal B. A taxi cab, owned by Elsie's Cab, Inc. and operated under an alleged "lease" by Stephen O. Ikechukwuka (aka "Ike"), entered a line of taxis, out of order, in the area of Terminal B. Ms. Howie requested Ike's authorization ticket and asked him to take his proper place in line. "Ike" refused. As Ms. Howie was writing a violation ticket to give to "Ike," "Ike" allowed his cab to roll over and onto Ms. Howie's left foot, causing an alleged severe and permanent injury. Upon making a claim, the plaintiff's counsel found that they had entered into and had to deal with the strange world of Boston taxicabs, their individual incorporations, their "self-insured" status and their attempts to avoid their financial responsibilities when one of its drivers is in a serious accident.

The cab involved in this accident was a "Boston Cab." It was a painted exactly like every other Boston cab in Boston. When one calls Boston Cab, the number is 617-536-5010, and the phone is answered as "The Boston Cab Company." Its drivers hand out business cards that have "Boston Cab Company" on them.

After a review of the submissions and from defendant's counsel's oral admissions in open Court the following facts were ascertained. Elsie's Cab, Inc. is a Massachusetts corporation with no assets or employees. It is self-insured up to the minimum liability amounts ($20,000 for injury to one person.) It is bonded by Arbella Insurance Company up to the minimum amount of insurance. The only officer of Elsie's Cab is one Edward Tutenjin. At hearing, defendant's counsel stated that Mr. Tutenjin owned approximately 75 Boston Cabs. Many are individual corporations with no assets, and some may have a few cabs, however, all without any assets. All are self-insured, with a bond with Arbella Insurance, in the minimum amount of insurance, namely, $20,000.

Mr. Edward Tutenjin is also the principal officer of the corporation, EJT Management, Inc. The letters "EJT" apparently are taken from Mr. Tutenjin's name. "EJT" was a company that "leased" out the 75 taxicabs (plus other cabs owned by other single cab corporations and other entities) to the individual drivers of the taxicabs. There was no written lease agreement between Elsie's Cab and "EJT." Basically, they were one and the same, both having as their address at 60 Kilmarnock Street, Boston, MA. Both corporations are owned by the same person Edward Tutenjin. EJT basically leased the cabs, manages the "Boston Cab Company," maintains and services the cab, staffs the Boston Cab telephone answering service, and repairs the cabs in its body shop. All the cabs are housed at 60 Kilmarnock Street, Boston. Further, Elsie's Cab, pays no money or fee for any services rendered by EJT Management. Specifically, Elsie's Cab does not pay any money to EJT, including any management fees, service or maintenance fees, fees for garaging the cab at 60 Kilmarnock St., and no fees for processing any claim made against it. No money is paid back to Elsie's Cab, Inc. by EJT Management from the "lessee" of the taxicab. The "lessee" ostensibly pays $75 per shift for the lease of the cab to EJT.

Basically, the Boston Cab Company is EJT Management. EJT provides all services for the cab, and is not paid any money for these services by Elsie's Cab. The attorneys fees for the defense of this case are not being paid by Elsie's Cab, Inc. or by Arbella Insurance (the bonder for the $20,000 self-insurance), according to defense counsel who represents all three entities.

Further, an alleged "separate" entity known as Arthur Gallagher Company handles any and all claims being made against any of the individual taxicab corporations. Arthur Gallagher Company had its offices in the exact same building as EJT at 60 Kilmarnock St., Boston, MA, and had its own telephone number (apart from Boston Cab's telephone number). Arthur Gallagher Company, for Elsie Cab's claims, would send out letters to any possible claimants on stationary entitled "Elsie Cab," and the phone number on the stationary was the claims phone of Arthur Gallagher Co. at 60 Kilmarnock Street. Evidently, the defendants Elsie's Cab and EJT did not want claimants and other people to know that Elsie Cab was associated with the longer entity, namely, Boston Cab.

The plaintiff's position on this motion is that there are sufficient facts to allow the plaintiff to attempt to pierce the corporate veil of "EJT," and to make it also liable for any judgment issued against Elsie's Cab, Inc. The case will go to the jury, at a minimum, against Elsie's Cab under chapter 231, § 85A.

From the evidence set out above, there is far more than sufficient evidence to send the case to the jury on a theory of "piercing the corporate veil." See: *My Bread Baking Co. v. Cumberland Farms, Inc.,* 353 Mass. 614 (1968). *Pepsi-Cola Metropolitan Bottling Co., Inc. v. Checkers, Inc.,* 754 F.2d, 10, 14-16 (1st Cir.1985); *Evans v. Multicon Construction Corp.,* 30 Mass.App.Ct. 728, 732-33 (1991). *Diane M. Dujon v. Terry Williams, et al,* 5 Mass. Law Reporter 456, 1996 WL 402344 (Mass.Superior) (Botsford, J., 1996) and *John Marrokanis v. Boston Cab Association, Inc. Locust Cab, Inc. and George Bowab,* Suffolk CA # 98-4172-B, decided on October 25, 2000 (Doerfer, J.). Here on the above-referenced facts, the jury could find that there was a "confused intermingling of activity of two or more corporations engaged in a common enterprise with substantial disregard of the separate nature of the corporate entities, or serious ambiguity about the manner and capacity on which the various corporations and their representatives are acting." *My Bread Baking Co. v. Cumberland Farms, Inc.,* 353 Mass. 614, 619 (1968). "Where there is common control of a group of separate corporations engaged in a single enterprise, failure ... to oversee with care the formal barrier between the corporations with a proper segregation of their separate businesses, records, and finances may warrant some disregard of the separate entities in rare particular situations in order to prevent gross inequity." *Id.,* p. 620.

Further, assuming *arguendo* that this issue was close, which this Court does not believe that it is, the Court is of the opinion that the better course to follow would be to deny this motion, try the entire case, and deal with this issue on a motion for a directed verdict or on a motion JNOV. In that way, the case will have to be tried only once and appealed once. Also, since the same attorney represents all three defendants, there would be little or no additional costs in attorneys fees.

Any other arguments in the motion for summary judgment are without merit, in light of the medicals and other documents submitted.

ORDER

The motion of the Defendant, EJT Management, Inc. for summary judgment is *DENIED* both as a matter of law and as a matter of discretion.

Discussion points for Sea-Land Services v. Pepper Source

It's easy to see why Sea-Land is suing Pepper Source's owner, Marchese, under a corporate veil piercing theory. And you get more buzz words to put into your legal arsenal. Note that the "unity of interest and ownership" test has four subparts, so see if each is satisfied. Then, if there is unity, you ask whether failing to pierce the corporate veil will either sanction fraud or promote injustice. Just because the corporation is bankrupt is insufficient. Want to know what happened on remand? Go to 993 F.2d 1309 (1993).

SEA-LAND SERVICES, INC., Plaintiff-Appellee,
v.
The PEPPER SOURCE, Caribe Crown, Inc., Gerald Marchese doing business as Jamar
Corporation, et al., Defendants-Appellants.

No. 90-2589.

United States Court of Appeals,
Seventh Circuit.

Argued April 17, 1991.

Decided Aug. 20, 1991.

BAUER, Chief Judge.

This spicy case finds its origin in several shipments of Jamaican sweet peppers. Appellee Sea-Land Services, Inc. ("Sea-Land"), an ocean carrier, shipped the peppers on behalf of The Pepper Source ("PS"), one of the appellants here. PS then stiffed Sea-Land on the freight bill, which was rather substantial. Sea-Land filed a federal diversity action for the money it was owed. On December 2, 1987, the district court entered a default judgment in favor of

Sea-Land and against PS in the amount of $86,767.70. But PS was nowhere to be found; it had been "dissolved" in mid- 1987 for failure to pay the annual state franchise tax. Worse yet for Sea- Land, even had it not been dissolved, PS apparently had no assets. With the well empty, Sea-Land could not recover its judgment against PS. Hence the instant lawsuit.

In June 1988, Sea-Land brought this action against Gerald J. Marchese and five business entities he owns: PS, Caribe Crown, Inc., Jamar Corp., Salescaster Distributors, Inc., and Marchese Fegan Associates. Marchese also was named individually. Sea-Land sought by this suit to pierce PS's corporate veil and render Marchese personally liable for the judgment owed to Sea-Land, and then "reverse pierce" Marchese's other corporations so that they, too, would be on the hook for the $87,000. Thus, Sea-Land alleged in its complaint that all of these corporations "are alter egos of each other and hide behind the veils of alleged separate corporate existence for the purpose of defrauding plaintiff and other creditors." Count I, ¶ 11. Not only are the corporations alter egos of each other, alleged Sea-Land, but also they are alter egos of Marchese, who should be held individually liable for the judgment because he created and manipulated these corporations and their assets for his own personal uses. Count III, ¶¶ 9-10. (Hot on the heels of the filing of Sea-Land's complaint, PS took the necessary steps to be reinstated as a corporation in Illinois.)

In early 1989, Sea-Land filed an amended complaint adding Tie-Net International, Inc., as a defendant. Unlike the other corporate defendants, Tie-Net is not owned solely by Marchese: he holds half of the stock, and an individual named George Andre owns the other half. Sea-Land alleged that, despite this shared ownership, Tie-Net is but another alter ego of Marchese and the other corporate defendants, and thus it also should be held liable for the judgment against PS.

Through 1989, Sea-Land pursued discovery in this case, including taking a two- day deposition from Marchese. In December 1989, Sea-Land moved for summary judgment. In that motion--which, with the brief in support and the appendices, was about three inches thick--Sea-Land argued that it was "entitled to judgment as a matter of law, since the evidence including deposition testimony and exhibits in the appendix will show that piercing the corporate veil and finding the status of an alter ego is merited in this case." Marchese and the other defendants filed brief responses.

[1] In an order dated June 22, 1990, the court granted Sea-Land's motion. The court discussed and applied the test for corporate veil-piercing explicated in Van Dorn Co. v. Future Chemical and Oil Corp., 753 F.2d 565 (7th Cir.1985). Analyzing Illinois law, we held in Van Dorn that

> a corporate entity will be disregarded and the veil of limited liability pierced when two requirements are met:
>
> [F]irst, there must be such unity of interest and ownership that the separate personalities of the corporation and the individual [or other corporation] no longer exist; and second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice.

753 F.2d at 569-70. As for determining whether a corporation is so controlled by another to

justify disregarding their separate identities, the Illinois cases, as we summarized them in Van Dorn, focus on four factors: "(1) the failure to maintain adequate corporate records or to comply with corporate formalities, (2) the commingling of funds or assets, (3) undercapitalization, and (4) one corporation treating the assets of another corporation as its own."

Following the lead of the parties, the district court in the instant case laid the template of Van Dorn over the facts of this case. Dist.Ct.Op. at 3- 12. The court concluded that both halves and all features of the test had been satisfied, and, therefore, entered judgment in favor of Sea-Land and against PS, Caribe Crown, Jamar, Salescaster, Tie-Net, and Marchese individually. These defendants were held jointly liable for Sea-Land's $87,000 judgment, as well as for post-judgment interest under Illinois law. From that judgment Marchese and the other defendants brought a timely appeal.

[2] The first and most striking feature that emerges from our examination of the record is that these corporate defendants are, indeed, little but Marchese's playthings. Marchese is the sole shareholder of PS, Caribe Crown, Jamar, and Salescaster. He is one of the two shareholders of Tie-Net. Except for Tie-Net, none of the corporations ever held a single corporate meeting. (At the handful of Tie-Net meetings held by Marchese and Andre, no minutes were taken.) During his deposition, Marchese did not remember any of these corporations ever passing articles of incorporation, bylaws, or other agreements. As for physical facilities, Marchese runs all of these corporations (including Tie-Net) out of the same, single office, with the same phone line, the same expense accounts, and the like. And how he does "run" the expense accounts! When he fancies to, Marchese "borrows" substantial sums of money from these corporations--interest free, of course. The corporations also "borrow" money from each other when need be, which left at least PS completely out of capital when the Sea-Land bills came due. What's more, Marchese has used the bank accounts of these corporations to pay all kinds of personal expenses, including alimony and child support payments to his ex-wife, education expenses for his children, maintenance of his personal automobiles, health care for his pet--the list goes on and on. Marchese did not even have a personal bank account! (With "corporate" accounts like these, who needs one?)

And Tie-Net is just as much a part of this as the other corporations. On appeal, Marchese makes much of the fact that he shares ownership of Tie-Net, and that Sea-Land has not been able to find an example of funds flowing from PS to Tie-Net to the detriment of Sea-Land and PS's other creditors. So what? The record reveals that, in all material senses, Marchese treated Tie-Net like his other corporations: he "borrowed" over $30,000 from Tie-Net; money and "loans" flowed freely between Tie-Net and the other corporations; and Marchese charged up various personal expenses (including $460 for a picture of himself with President Bush) on Tie-Net's credit card. Marchese was not deterred by the fact that he did not hold all of the stock of Tie-Net; why should his creditors be?

In sum, we agree with the district court that their can be no doubt that the "shared control/unity of interest and ownership" part of the Van Dorn test is met in this case:

corporate records and formalities have not been maintained; funds and assets have been commingled with abandon; PS, the offending corporation, and perhaps others have been undercapitalized; and corporate assets have been moved and tapped and "borrowed" without regard to their source. Indeed, Marchese basically punted this part of the inquiry before the district court by coming forward with little or no evidence in response to Sea-Land's extensively supported argument on these points. That fact alone was enough to do him in; opponents to summary judgment motions cannot simply rest on their laurels, but must come forward with specific facts showing that there is a genuine issue for trial.Regarding the elements that make up the first half of the Van Dorn test, Marchese and the other defendants have not done so. Thus, Sea-Land is entitled to judgment on these points.

[3] The second part of the Van Dorn test is more problematic, however. "Unity of interest and ownership" is not enough; Sea-Land also must show that honoring the separate corporate existences of the defendants "would sanction a fraud or promote injustice." Van Dorn, 753 F.2d at 570. This last phrase truly is disjunctive:

> Although an intent to defraud creditors would surely play a part if established, the Illinois test does not require proof of such intent. Once the first element of the test is established, either the sanctioning of a fraud (intentional wrongdoing) or the promotion of injustice, will satisfy the second element.

Id. (emphasis in original). Seizing on this, Sea-Land has abandoned the language in its two complaints that make repeated references to "fraud" by Marchese, and has chosen not to attempt to prove that PS and Marchese intended to defraud it--which would be quite difficult on summary judgment. Instead, Sea-Land has argued that honoring the defendants' separate identities would "promote injustice."

But what, exactly, does "promote injustice" mean, and how does one establish it on summary judgment? These are the critical, troublesome questions in this case. To start with, as the above passage from Van Dorn makes clear, "promote injustice" means something less than an affirmative showing of fraud--but how much less? In its one-sentence treatment of this point, the district court held that it was enough that "Sea-Land would be denied a judicially-imposed recovery." Dist.Ct.Op. at 11-12. Sea-Land defends this reasoning on appeal, arguing that "permitting the appellants to hide behind the shield of limited liability would clearly serve as an injustice against appellee" because it would "impermissibly deny appellee satisfaction." Appellee's Brief at 14-15. But that cannot be what is meant by "promote injustice." The prospect of an unsatisfied judgment looms in every veil- piercing action; why else would a plaintiff bring such an action? Thus, if an unsatisfied judgment is enough for the "promote injustice" feature of the test, then every plaintiff will pass on that score, and Van Dorn collapses into a one-step "unity of interest and ownership" test.

Because we cannot abide such a result, we will undertake our own review of Illinois cases to determine how the "promote injustice" feature of the veil- piercing inquiry has been interpreted. In Pederson, a recent case from the Illinois court of appeals, the court offered the following summary: "Some element of unfairness, something akin to fraud or deception or the existence of a compelling public interest must be present in order to disregard the corporate fiction." 214 Ill.App.3d at 821, 158 Ill.Dec. at 375, 574 N.E.2d at 169. (The court

ultimately refused to pierce the corporate veil in Pederson, at least in part because "[n]othing in these facts provides evidence of scheming on the part of defendant to commit a fraud on potential creditors [of the two defendant corporations].

****

Generalizing from these cases, we see that the courts that properly have pierced corporate veils to avoid "promoting injustice" have found that, unless it did so, some "wrong" beyond a creditor's inability to collect would result: the common sense rules of adverse possession would be undermined; former partners would be permitted to skirt the legal rules concerning monetary obligations; a party would be unjustly enriched; a parent corporation that caused a sub's liabilities and its inability to pay for them would escape those liabilities; or an intentional scheme to squirrel assets into a liability-free corporation while heaping liabilities upon an asset-free corporation would be successful. Sea-Land, although it alleged in its complaint the kind of intentional asset- and liability-shifting found in Van Dorn, has yet to come forward with evidence akin to the "wrongs" found in these cases. Apparently, it believed, as did the district court, that its unsatisfied judgment was enough. That belief was in error, and the entry of summary judgment premature. We, therefore, reverse the judgment and remand the case to the district court.

On remand, the court should require that Sea-Land produce, if it desires summary judgment, evidence and argument that would establish the kind of additional "wrong" present in the above cases. For example, perhaps Sea-Land could establish that Marchese, like Roth in Van Dorn, used these corporate facades to avoid its responsibilities to creditors; or that PS, Marchese, or one of the other corporations will be "unjustly enriched" unless liability is shared by all. Of course, Sea-Land is not required fully to prove intent to defraud, which it probably could not do on summary judgment anyway. But it is required to show the kind of injustice to merit the evocation of the court's essentially equitable power to prevent "injustice." It may well be that, after more of such evidence is adduced, no genuine issue of fact exists to prevent Sea-Land from reaching Marchese's other pet corporations for PS's debt. Or it may be that only a finder of fact will be able to determine whether fraud or "injustice" is involved here. In any event, the record as it currently stands is insufficient to uphold the entry of summary judgment.

Discussion points for Kinney Shoe v. Polan

Another piercing the corporate veil case, this time using West Virginia law. And again, it's a two part test, first looking at unity, then looking at equity. Polan fails to observe corporate formalities, and does not adequately capitalize the corporation. Big deal. If Kinney thought that Polan should be personally liable, he could easily have put Polan on the lease as a individual signatory. Or he could have been a surety. Or Kinney could have investigated how adequately capitalized Polan's corporation was before doing business with it. But he chose to go in blind, and is rewarded for his ignorance.

Note that there is probably a difference in tort cases. In tort cases, the injured party does not have a chance to look at corporate records to see if corporate formalities have been complied with. So, in tort cases, adequate capitalization should be the primary focus, and maybe corporate formalities (or the lack thereof) should be irrelevant.

KINNEY SHOE CORPORATION, a New York corporation, Plaintiff-Appellant,
v.
Lincoln M. POLAN, Defendant-Appellee.

No. 90-2466.

United States Court of Appeals,
Fourth Circuit.

Argued March 6, 1991.

Decided July 17, 1991.
As Amended Aug. 26, 1991.

OPINION

CHAPMAN, Senior Circuit Judge:

Plaintiff-appellant Kinney Shoe Corporation ("Kinney") brought this action in the United States District Court for the Southern District of West Virginia against Lincoln M. Polan ("Polan") seeking to recover money owed on a sublease between Kinney and Industrial Realty Company ("Industrial"). Polan is the sole shareholder of Industrial. The district court found that Polan was not personally liable on the lease between Kinney and Industrial. Kinney appeals asserting that the corporate veil should be pierced, and we agree.

I.

The district court based its order on facts which were stipulated by the parties. In 1984 Polan formed two corporations, Industrial and Polan Industries, Inc., for the purpose of re-establishing an industrial manufacturing business. The certificate of incorporation for Polan Industries, Inc. was issued by the West Virginia Secretary of State in November 1984. The following month the certificate of incorporation for Industrial was issued. Polan was the owner of both corporations. Although certificates of incorporation were issued, no organizational meetings were held, and no officers were elected.

In November 1984 Polan and Kinney began negotiating the sublease of a building in which Kinney held a leasehold interest. The building was owned by the Cabell County

Commission and financed by industrial revenue bonds issued in 1968 to induce Kinney to locate a manufacturing plant in Huntington, West Virginia. Under the terms of the lease, Kinney was legally obligated to make payments on the bonds on a semi-annual basis through January 1, 1993, at which time it had the right to purchase the property. Kinney had ceased using the building as a manufacturing plant in June 1983.

The term of the sublease from Kinney to Industrial commenced in December 1984, even though the written lease was not signed by the parties until April 5, 1985. On April 15, 1985, Industrial subleased part of the building to Polan Industries for fifty percent of the rental amount due Kinney. Polan signed both subleases on behalf of the respective companies.

Other than the sublease with Kinney, Industrial had no assets, no income and no bank account. Industrial issued no stock certificates because nothing was ever paid in to this corporation. Industrial's only income was from its sublease to Polan Industries, Inc. The first rental payment to Kinney was made out of Polan's personal funds, and no further payments were made by Polan or by Polan Industries, Inc. to either Industrial or to Kinney.

Kinney filed suit against Industrial for unpaid rent and obtained a judgment in the amount of $166,400.00 on June 19, 1987. A writ of possession was issued, but because Polan Industries, Inc. had filed for bankruptcy, Kinney did not gain possession for six months. Kinney leased the building until it was sold on September 1, 1988. Kinney then filed this action against Polan individually to collect the amount owed by Industrial to Kinney. Since the amount to which Kinney is entitled is undisputed, the only issue is whether Kinney can pierce the corporate veil and hold Polan personally liable.

The district court held that Kinney had assumed the risk of Industrial's undercapitalization and was not entitled to pierce the corporate veil. Kinney appeals, and we reverse.

II.

We have long recognized that a corporation is an entity, separate and distinct from its officers and stockholders, and the individual stockholders are not responsible for the debts of the corporation. See, e.g., DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 683 (4th Cir.1976). This concept, however, is a fiction of the law " 'and it is now well settled, as a general principle, that the fiction should be disregarded when it is urged with an intent not within its reason and purpose, and in such a way that its retention would produce injustices or inequitable consequences.' " Laya v. Erin Homes, Inc., 352 S.E.2d 93, 97-98 (W.Va.1986) (quoting Sanders v. Roselawn Memorial Gardens, Inc., 152 W.Va. 91, 159 S.E.2d 784, 786 (1968).

[1][2] Piercing the corporate veil is an equitable remedy, and the burden rests with the party asserting such claim. DeWitt Truck Brokers, 540 F.2d at 683. A totality of the circumstances test is used in determining whether to pierce the corporate veil, and each case must be decided on its own facts. The district court's findings of facts may be overturned only if clearly erroneous. Id.

[3] Kinney seeks to pierce the corporate veil of Industrial so as to hold Polan personally liable on the sublease debt. The Supreme Court of Appeals of West Virginia has set forth a two prong test to be used in determining whether to pierce a corporate veil in a breach of contract case. This test raises two issues: first, is the unity of interest and ownership such that the separate personalities of the corporation and the individual shareholder no longer exist; and second, would an equitable result occur if the acts are treated as those of the corporation alone. Laya, 352 S.E.2d at 99. Numerous factors have been identified as relevant in making this determination. [FN*]

FN* The following factors were identified in Laya:

(1) commingling of funds and other assets of the corporation with those of the individual shareholders;

(2) diversion of the corporation's funds or assets to noncorporate uses (to the personal uses of the corporation's shareholders);

(3) failure to maintain the corporate formalities necessary for the issuance of or subscription to the corporation's stock, such as formal approval of the stock issue by the board of directors;

(4) an individual shareholder representing to persons outside the corporation that he or she is personally liable for the debts or other obligations of the corporation;

(5) failure to maintain corporate minutes or adequate corporate records;

(6) identical equitable ownership in two entities;

(7) identity of the directors and officers of two entities who are responsible for supervision and management (a partnership or sole proprietorship and a corporation owned and managed by the same parties);

(8) failure to adequately capitalize a corporation for the reasonable risks of the corporate undertaking;

(9) absence of separately held corporate assets;

(10) use of a corporation as a mere shell or conduit to operate a single venture or some particular aspect of the business of an individual or another corporation;

(11) sole ownership of all the stock by one individual or members of a single family;

(12) use of the same office or business location by the corporation and its individual shareholder(s);

(13) employment of the same employees or attorney by the corporation and its shareholder(s);

(14) concealment or misrepresentation of the identity of the ownership, management or financial interests in the corporation, and concealment of personal business activities of the shareholders (sole shareholders do not reveal the association with a corporation, which makes loans to them without adequate security);

(15) disregard of legal formalities and failure to maintain proper arm's length relationships among related entities;

(16) use of a corporate entity as a conduit to procure labor, services or merchandise for another person or entity;

(17) diversion of corporate assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors, or the manipulation of assets and

liabilities between entities to concentrate the assets in one and the liabilities in another;
(18) contracting by the corporation with another person with the intent to avoid risk of nonperformance by use of the corporate entity; or the use of a corporation as a subterfuge for illegal transactions;
(19) the formation and use of the corporation to assume the existing liabilities of another person or entity.
Laya, 352 S.E.2d at 98-99 (footnote omitted).

The district court found that the two prong test of Laya had been satisfied. The court concluded that Polan's failure to carry out the corporate formalities with respect to Industrial, coupled with Industrial's gross undercapitalization, resulted in damage to Kinney. We agree.

It is undisputed that Industrial was not adequately capitalized. Actually, it had no paid in capital. Polan had put nothing into this corporation, and it did not observe any corporate formalities. As the West Virginia court stated in Laya, " '[i]ndividuals who wish to enjoy limited personal liability for business activities under a corporate umbrella should be expected to adhere to the relatively simple formalities of creating and maintaining a corporate entity.' " Laya, 352 S.E.2d at 100 n. 6 (quoting Labadie Coal Co. v. Black, 672 F.2d 92, 96-97 (D.C.Cir.1982)). This, the court stated, is " 'a relatively small price to pay for limited liability.' " Id. Another important factor is adequate capitalization. "[G]rossly inadequate capitalization combined with disregard of corporate formalities, causing basic unfairness, are sufficient to pierce the corporate veil in order to hold the shareholder(s) actively participating in the operation of the business personally liable for a breach of contract to the party who entered into the contract with the corporation." Laya, 352 S.E.2d at 101-02.

In this case, Polan bought no stock, made no capital contribution, kept no minutes, and elected no officers for Industrial. In addition, Polan attempted to protect his assets by placing them in Polan Industries, Inc. and interposing Industrial between Polan Industries, Inc. and Kinney so as to prevent Kinney from going against the corporation with assets. Polan gave no explanation or justification for the existence of Industrial as the intermediary between Polan Industries, Inc. and Kinney. Polan was obviously trying to limit his liability and the liability of Polan Industries, Inc. by setting up a paper curtain constructed of nothing more than Industrial's certificate of incorporation. These facts present the classic scenario for an action to pierce the corporate veil so as to reach the responsible party and produce an equitable result. Accordingly, we hold that the district court correctly found that the two prong test in Laya had been satisfied.

[4] In Laya, the court also noted that when determining whether to pierce a corporate veil a third prong may apply in certain cases. The court stated:

When, under the circumstances, it would be reasonable for that particular type of a party [those contract creditors capable of protecting themselves] entering into a contract with the corporation, for example, a bank or other lending institution, to conduct an investigation of the credit of the corporation prior to entering into the contract, such party will be charged

with the knowledge that a reasonable credit investigation would disclose. If such an investigation would disclose that the corporation is grossly undercapitalized, based upon the nature and the magnitude of the corporate undertaking, such party will be deemed to have assumed the risk of the gross undercapitalization and will not be permitted to pierce the corporate veil.

Laya, 352 S.E.2d at 100. The district court applied this third prong and concluded that Kinney "assumed the risk of Industrial's defaulting" and that "the application of the doctrine of 'piercing the corporate veil' ought not and does not [apply]." While we agree that the two prong test of Laya was satisfied, we hold that the district court's conclusion that Kinney had assumed the risk is clearly erroneous.

Without deciding whether the third prong should be extended beyond the context of the financial institution lender mentioned in Laya, we hold that, even if it applies to creditors such as Kinney, it does not prevent Kinney from piercing the corporate veil in this case. The third prong is permissive and not mandatory. This is not a factual situation that calls for the third prong, if we are to seek an equitable result. Polan set up Industrial to limit his liability and the liability of Polan Industries, Inc. in their dealings with Kinney. A stockholder's liability is limited to the amount he has invested in the corporation, but Polan invested nothing in Industrial. This corporation was no more than a shell--a transparent shell. When nothing is invested in the corporation, the corporation provides no protection to its owner; nothing in, nothing out, no protection. If Polan wishes the protection of a corporation to limit his liability, he must follow the simple formalities of maintaining the corporation. This he failed to do, and he may not relieve his circumstances by saying Kinney should have known better.

III.

For the foregoing reasons, we hold that Polan is personally liable for the debt of Industrial, and the decision of the district court is reversed and this case is remanded with instructions to enter judgment for the plaintiff.

REVERSED AND REMANDED WITH INSTRUCTIONS.

Baatz v. Arrow Bar

Supreme Court of South Dakota.

Kenny **BAATZ** and Peggy Baatz, Plaintiffs and Appellants,
v.
ARROW BAR a/k/a Arrow Bar, Inc., Edmond E. Neuroth, LaVella J. Neuroth, and Jacquette J. Neuroth, Defendants and Appellees.

No. 16597.

Considered on Briefs Nov. 29, 1989.

Decided Feb. 28, 1990.
Rehearing Denied April 16, 1990.

SABERS, Justice.

Kenny and Peggy Baatz (Baatz), appeal from summary judgment dismissing Edmond, LaVella, and Jacquette Neuroth, as individual defendants in this action.

Facts

Kenny and Peggy were seriously injured in 1982 when Roland McBride crossed the center line of a Sioux Falls street with his automobile and struck them while they were riding on a motorcycle. McBride was uninsured at the time of the accident and apparently is judgment proof.

Baatz alleges that Arrow Bar served alcoholic beverages to McBride prior to the accident while he was already intoxicated. Baatz commenced this action in 1984, claiming that Arrow Bar's negligence in serving alcoholic beverages to McBride contributed to the injuries they sustained in the accident. Baatz supports his claim against Arrow Bar with the affidavit of Jimmy Larson. Larson says he knew McBride and observed him being served alcoholic beverages in the Arrow Bar during the afternoon prior to the accident, while McBride was intoxicated. *See Baatz v. Arrow Bar,* 426 N.W.2d 298 (S.D.1988), for a more complete statement of the facts.

Edmond and LaVella Neuroth formed the Arrow Bar, Inc. in May 1980. During the next two years they contributed $50,000 to the corporation pursuant to a stock subscription agreement. The corporation purchased the Arrow Bar business in June 1980 for $155,000 with a $5,000 down payment. Edmond and LaVella executed a promissory note personally guaranteeing payment of the $150,000 balance. In 1983 the corporation obtained bank financing in the amount of $145,000 to pay off the purchase agreement. Edmond and LaVella again personally guaranteed payment of the corporate debt. Edmond is the president of the corporation, and Jacquette Neuroth serves as the manager of the business. Based on the enactment of SDCL 35-4-78 and 35-11-1 and advice of counsel, the corporation did not maintain dram shop liability insurance at the time of the injuries to Kenny and Peggy.

In 1987 the trial court entered summary judgment in favor of Arrow Bar and the individual defendants. Baatz appealed that judgment and we reversed and remanded to the trial court for trial. *Baatz, supra.* Shortly before the trial date, Edmond, LaVella, and Jacquette moved for and obtained summary judgment dismissing them as individual defendants. Baatz appeals. We affirm.

Baatz claims that even if Arrow Bar, Inc. is the licensee, the corporate veil should be pierced, leaving the Neuroths, as the shareholders of the corporation, individually liable. A

corporation shall be considered a separate legal entity until there is *sufficient reason* to the contrary. *Mobridge Community Indus., Inc. v. Toure, Ltd.,* 273 N.W.2d 128 (S.D.1978); *cf. Hamaker v. Kenwel-Jackson Mach., Inc.,* 387 N.W.2d 515 (S.D.1986). When continued recognition of a corporation as a separate legal entity would "produce injustices and inequitable consequences," then a court has sufficient reason to pierce the corporate veil. *Farmers Feed & Seed, Inc. v. Magnum Enter., Inc.,* 344 N.W.2d 699, 701 (S.D.1984). Factors that indicate injustices and inequitable consequences and allow a court to pierce the corporate veil are:

1) fraudulent representation by corporation directors;
2) undercapitalization;
3) failure to observe corporate formalities;
4) absence of corporate records;
5) payment by the corporation of individual obligations; or
6) use of the corporation to promote fraud, injustice, or illegalities.

Id. When the court deems it appropriate to pierce the corporate veil, the corporation and its stockholders will be treated identically. *Mobridge, supra.*

Baatz advances several arguments to support his claim that the corporate veil of Arrow Bar, Inc. should be pierced, but fails to support them with facts, or misconstrues the facts.

First, Baatz claims that since Edmond and LaVella personally guaranteed corporate obligations, they should also be personally liable to Baatz. However, the personal guarantee of a loan is a contractual agreement and cannot be enlarged to impose tort liability. Moreover, the personal guarantee creates individual liability for a corporate obligation, the opposite of factor 5), above. As such, it supports, rather than detracts from, recognition of the corporate entity.

Baatz also argues that the corporation is simply the alter ego of the Neuroths, and, in accord with *Loving Saviour Church v. United States,* 556 F.Supp. 688 (D.S.D.1983), *aff'd,* 728 F.2d 1085 (8th Cir.1984), the corporate veil should be pierced. Baatz' discussion of the law is adequate, but he fails to present evidence that would support a decision in his favor in accordance with that law. When an individual treats a corporation "as an instrumentality through which he [is] conducting his personal business," a court may disregard the corporate entity. *Larson v. Western Underwriters, Inc.,* 77 S.D. 157, 163, 87 N.W.2d 883, 886 (1958). Baatz fails to demonstrate how the Neuroths were transacting personal business through the corporation. In fact, the evidence indicates the Neuroths treated the corporation separately from their individual affairs.

Baatz next argues that the corporation is undercapitalized. Shareholders must equip a corporation with a reasonable amount of capital for the nature of the business involved. *See Curtis v. Feurhelm,* 335 N.W.2d 575 (S.D.1983). Baatz claims the corporation was started with only $5,000 in borrowed capital, but does not explain how that amount failed to equip the corporation with a reasonable amount of capital. In addition, Baatz fails to consider the personal guarantees to pay off the purchase contract in the amount of $150,000, and the $50,000 stock subscription agreement. There simply is no evidence that the corporation's

capital in whatever amount was inadequate for the operation of the business. Normally questions relating to individual shareholder liability resulting from corporate undercapitalization should not be reached until the primary question of corporate liability is determined. Questions depending in part upon other determinations are not normally ready for summary judgment. *See Van Knight Steel Erection, Inc. v. Housing and Redev. Auth. of the City of St. Paul,* 430 N.W.2d 1 (Minn.Ct.App.1988); *see also Candee Constr. Co., Inc. v. South Dakota Dep't of Transp.,* 447 N.W.2d 339, 346 (S.D.1989) (Sabers, J., dissenting). However, simply asserting that the corporation is undercapitalized does not make it so. Without some evidence of the inadequacy of the capital, Baatz fails to present specific facts demonstrating a genuine issue of material fact. *Ruane, supra.*

Finally, Baatz argues that Arrow Bar, Inc. failed to observe corporate formalities because none of the business' signs or advertising indicated that the business was a corporation. Baatz cites SDCL 47-2-36 as requiring the name of any corporation to contain the word corporation, company, incorporated, or limited, or an abbreviation for such a word. In spite of Baatz' contentions, the corporation is in compliance with the statute because its corporate name--Arrow Bar, Inc.--includes the abbreviation of the word incorporated. Furthermore, the "mere failure upon occasion to follow all the forms prescribed by law for the conduct of corporate activities will not justify" disregarding the corporate entity. *Larson, supra,* 77 S.D. at 164, 87 N.W.2d at 887 (quoting *P.S. & A. Realties, Inc. v. Lodge Gate Forest, Inc.,* 205 Misc. 245, 254, 127 N.Y.S.2d 315, 324 (1954)). Even if the corporation is improperly using its name, that alone is not a sufficient reason to pierce the corporate veil. This is especially so where, as here, there is no relationship between the claimed defect and the resulting harm.

In addition, the record is void of any evidence which would support imposition of individual liability by piercing the corporate veil under any of the other factors listed above in 1), 4) or 6).

In summary, Baatz fails to present specific facts that would allow the trial court to find the existence of a genuine issue of material fact. There is no indication that any of the Neuroths personally served an alcoholic beverage to McBride on the day of the accident. Nor is there any evidence indicating that the Neuroths treated the corporation in any way that would produce the injustices and inequitable consequences necessary to justify piercing the corporate veil. In fact, the only evidence offered is otherwise. Therefore, we affirm summary judgment dismissing the Neuroths as individual defendants.

WUEST, C.J., and MORGAN and MILLER, JJ., concur.

HENDERSON, Justice (dissenting).

This corporation has no separate existence. It is the instrumentality of three shareholders, officers, and employees. Here, the corporate fiction should be disregarded. The factors of *Curtis v. Feurhelm,* 335 N.W.2d 575 (S.D.1983) were disregarded by the trial court.

A corporate shield was here created to escape the holding of this Court relating to an individual's liability in a dram shop action. Thus, our holdings in *Baatz v. Arrow Bar,* 426 N.W.2d 298 (S.D.1988), *Selchert v. Lien,* 371 N.W.2d 791 (S.D.1985) and *Walz v. City of Hudson,* 327 N.W.2d 120 (S.D.1982) have been totally circumvented.

As a result of this holding, the message is now clear: Incorporate, mortgage the assets of a liquor corporation to your friendly banker, and proceed with carefree entrepreneuring.

In both of these briefs, the parties argue, all in all, about the facts. One may reasonably conclude that there exists questions of fact. *See, Deuchar v. Foland Ranch, Inc.,* 410 N.W.2d 177, 181 (S.D.1987) holding that: "Issues of negligence or related matters are ordinarily not susceptible of summary adjudication."

Baatzes had their case thrown out of court when many facts were in dispute. I am reminded of the old lawyer, before a jury, who expressed his woe of corporations. He cried out to the jury: "A corporation haveth no soul and its hind end you can kicketh not."

FACTS JUSTIFYING JURY TRIAL

Peggy Baatz, a young mother, lost her left leg; she wears an artificial limb; Kenny Baatz, a young father, has had most of his left foot amputated; he has been unable to work since this tragic accident. Peggy uses a cane. Kenny uses crutches. Years have gone by since they were injured and their lives have been torn asunder.

Uninsured motorist was drunk, and had a reputation of being a habitual drunkard; Arrow Bar had a reputation of serving intoxicated persons. (Supported by depositions on file). An eyewitness saw uninsured motorist in an extremely intoxicated condition, shortly before the accident, being served by Arrow Bar. Therefore, a question of fact exists as to liability being violated under SDCL 35-4-78(2). This evidence must be viewed most favorably to the nonmoving party. *American Indian Agr. Credit Consortium, Inc. v. Ft. Pierre Livestock, Inc.,* 379 N.W.2d 318 (S.D.1985). A police officer testified, by deposition, that uninsured motorist was in a drunken stupor while at the Arrow Bar.

Are the Neuroths subject to personal liability? It is undisputed, by the record, that the dismissed defendants (Neuroths) are immediate family members and stockholders of Arrow Bar. By pleadings, at settled record 197, it is expressed that the dismissed defendants are employees of Arrow Bar. Seller of the Arrow Bar would not accept Arrow Bar, Inc., as buyer. Seller insisted that the individual incorporators, in their individual capacity be equally responsible for the selling price. Thus, the individuals are the real party in interest and the corporate entity, Arrow Bar, Inc., is being used to justify any wrongs perpetrated by the incorporators in their individual capacity. Conclusion: Fraud is perpetrated upon the public. At a deposition of Edmond Neuroth (filed in this record), this "President" of "the corporation" was asked why the Neuroth family incorporated. His answer: "Upon advice of counsel, as a shield against individual liability." The corporation was undercapitalized

(Neuroths borrowed $5,000 in capital). For authorities establishing undercapitalization as an indication that a legitimate, separate corporate entity is not maintained, *see,* Vol. 1 W. Fletcher, Cyclopedia of Corporations, section 44.1, at 528 (rev. ed. 1983); *Curtis v. Feurhelm,* 335 N.W.2d 575 (S.D.1983); *Anderson v. Abbott,* 321 U.S. 349, 362, 64 S.Ct. 531, 538, 88 L.Ed. 793 (1944). In *Loving Saviour Church,* cited by the majority, the Eighth Circuit Court of Appeals reflected upon this Court's stance in casting aside corporate veils, expressing that this Court decides each case sui generis with the outcome in accordance with the underlying facts of each case. In *Loving Saviour Church,* it was held that a chiropractor could not use a church to escape income taxes; here, a corporation conceived in undercapitalization as "a shield," in the words of "the President," should not be used as an artifice to avoid the intent of SDCL 35-4-78(2). In *Curtis,* cited by the majority opinion, we held that corporate entity should be disregarded if use of the corporation was employed to promote fraud, injustice, and illegality.

Clearly, it appears a question arises as to whether there is a fiction established to escape our previous holdings and the intent of our State Legislature. Truly, there are fact questions for a jury to determine: (1) negligence or no negligence of the defendants and (2) did the Neuroth family falsely establish a corporation to shield themselves from individual liability, i.e., do facts in this scenario exist to pierce the corporate veil?

CONCLUSION

Plaintiffs are entitled to a jury trial under the State Constitution to have a jury resolve these two issues. The South Dakota Constitution, art. VI, § 6, begins with these words: "The right of trial by jury shall remain inviolate and shall extend to all cases at law without regard to the amount in controversy, ..." The majority writer, Justice Sabers, wrote in *Klatt v. Continental Insurance Company,* 409 N.W.2d 366, 368 (S.D.1987), for the majority and expressed: "Therefore, we affirm only if there are no genuine issues of material fact and the legal questions have been correctly decided." Genuine issues of material fact on negligence should be resolved by the jury and there are questions concerning the legality of this corporation which have not been, in my opinion, correctly decided.

Therefore, I respectfully dissent.

Discussion points for My Bread Baking v. Cumberland Farms

This is a tort case arising out of a contract case, where the parties had previous dealings. Would the result be different if one of the co-defendant’s trucks had run over the plaintiff? And note carefully how Cumberland Farms is dragged into this mess. Cumberland Farms Inc. owned no stock in the co-defendants, so how is it found liable for conversion? Would this theory make Byron Haseotes individually liable?

MY BREAD BAKING CO.
v.
CUMBERLAND FARMS, INC. et al.

CUTTER, Justice.

[1] The remaining count in this action alleges conversion of certain property by Cumberland Farms, Inc. (C.F. Inc.). There was a substantial verdict for the plaintiff (My Bread) against C.F. Inc. and also a verdict for each codefendant (fn. 1). The case is before us on C.F. Inc.'s exception to the judge's refusal to direct a verdict for it. The facts are stated in their aspect most favorable to My Bread.

In August, 1960, Byron Haseotes discussed with Joseph Duchaine, 'the sole proprietor' of My Bread, the sale of the latter's bakery products in 'Cumberland Farms' retail dairy stores. Haseotes was the secretary and treasurer and a stockholder of C.F. Inc., of each codefendant, and of fifteen other corporations.

After August, 1960, My Bread began selling its bakery products in the retail dairy stores, and provided bakery racks for use in this operation. The racks were delivered by My Bread directly to the local store in which they were used. In September, 1963, when the business arrangement with My Bread was terminated, My Bread sought the return of the racks. It was prevented by the local store managers, acting on the instructions of Haseotes, from recovering them from all but a few of the 'Cumberland Farms' stores. Title to the racks remained in My Bread at all times.

In August, 1960, the capital stock of C.F. Inc. and of each codefendant was owned by Haseotes, his parents, his brothers, and his sisters. There was no joint financing of these corporations. The officers and directors of each corporation were the same. The sole business of the codefendants 'was the operation of chains of (small) retail dairy stores * * * in Massachusetts * * *.' C.F. Inc. did not operate retail stores. It conducted 'a bottling * * * plant which processed and packaged milk and other diary products and * * * (sold) its dairy products at * * * wholesale * * * to the * * * five' codefendants. Haseotes testified that in August, 1960, C.F. Inc. did not sell dairy products to all of the 'Cumberland Farms' stores in which My Bread was to sell its bakery products. In 1962 or 1963, however, it began to do so. All of the defendants used the trade name 'Cumberland Farms.' Persons dealing with all of these corporations treated them as 'Cumberland Farms.'

C.F. Inc. never owned any stock interest in the five codefendants, nor did those corporations own any stock in it. The advertising of all six corporations was purchased in separate transactions and always used the trade name 'Cumberland Farms.' In August, 1960, the Haseotes family dairy businesses were operated out of headquarters in Woonsocket. Processing and bottling were then done in two plants, one in Woonsocket and the other in Boston. Prior to the alleged conversion, the Woonsocket and Boston plants were consolidated in a new plant in Canton, and each defendant corporation moved its principal

office to that plant. Thereafter the 'same business manager operated all the businesses from the Canton address.' Haseotes 'participated in the operation of all the corporations and it was his decision where money was to go in the various corporations.'

In August, 1963, Haseotes as sales manager of C.F. Inc., signed and sent out circular memoranda concerning the sale of bread (including My Bread products) in 'Cumberland Farms' stores. These were on C.F. Inc. letterhead and were addressed to a large number of retail stores or store managers in mandatory language, using such terms as 'must' and stating policies 'to be strictly adhered to.' There was in evidence a loaf which had on its wrapper the name 'Cumberland Farms' and a notation that it was distributed by 'Cumberland Farms, Inc. of Boston.'

Haseotes testified that, in his dealings with My Bread, he never acted on behalf of C.F. Inc. because that corporation did not operate retail stores, nor did it have any control over the store operating corporations. One of My Bread's officers, however, testified that he 'always dealt with * * * Haseotes as 'Cumberland Farms',' although he did on occasion on Haseotes's request make out checks to other corporations. He also obtained certificates of insurance which included the names of several of the Haseotes corporations.

1. C.F. Inc. contends that the conversions of the bakery racks were 'committed by the local store managers, employed by the (codefendant) store- operating corporations,' that there was no evidence that these managers were agents for C.F. Inc. so as to make that corporation liable for their acts, and that the codefendant corporations must each be treated as distinct and separate from C.F. Inc. and each other. The issue, of course, is whether there was evidence which, on any theory of law, would warrant the jury in finding C.F. Inc. liable for the conversions.

[2][3][4] C.F. Inc. thus seeks to have us apply the principle that corporations are generally to be regarded as separate from each other and from their respective stockholders (see Marsch v. Southern New England R.R., 230 Mass. 483, 498, 120 N.E. 120) where there is no occasion 'to look beyond the corporate form for the purpose of defeating fraud or wrong, or for the remedying of injuries.' See e.g. M. McDonough Corp v. Connolly, 313 Mass. 62, 65--66, 46 N.E.2d 576, 579. The general principle is not of unlimited application. A corporation or other person controlling a corporation and directing, or participating actively in (see Refrigeration Discount Corp. v. Catino, 330 Mass. 230, 234--236, 112 N.E.2d 790), its operations may become subject to civil or criminal liability on principles of agency or of causation. See Commonwealth v. Abbott Engr., Inc., 351 Mass. 568, 579--580, 222 N.E.2d 862. See also Rock-Ola Mfg. Corp. v. Music & Television Corp., 339 Mass. 416, 422--423, 159 N.E.2d 417. This may sometimes occur where corporations are formed, or availed of, to carry out the objectives and purposes of the corporations or persons controlling them. The circumstances in which one corporation, or a person controlling it, may become liable for the acts or torts of an affiliate or a subsidiary under common control have been frequently discussed. Although common ownership of the stock of two or more corporations together with common management, standing alone, will not give rise to liability on the part of one corporation for the acts of another corporation or its employees, additional facts may be such

as to permit the conclusion that an agency or similar relationship exists between the entities. Particularly is this true (a) when there is active and direct participation by the representatives of one corporation, apparently exercising some form of pervasive control, in the activities of another and there is some fraudulent or injurious consequence of the intercorporate relationship, or (b) when there is a confused intermingling of activity of two or more corporations engaged in a common enterprise with substantial disregard of the separate nature of the corporate entities, or serious ambiguity about the manner and capacity in which the various corporations and their respective representatives are acting. In such circumstances, in imposing liability upon one or more of a group of 'closely identified' corporations, a court 'need not consider with nicety which of them' ought to be held liable for the act of one corporation 'for which the plaintiff deserves payment.' See W. W. Britton, Inc. v. S. M. Hill Co., 327 mass. 335, 338--339, 98 N.E.2d 637, 639.

[5] It may be, as one commentator suggests (see Peairs, Business Corporations ss 8--10, esp. at p. 33), that Massachusetts has been somewhat more 'strict' than other jurisdictions in respecting the separate entities of different corporations. Nevertheless, our law concerning disregarding the corporate fiction has been stated, in cases already cited, essentially in the same general terms employed in decisions elsewhere (fn. 7). Where there is common control of a group of separate corporations engaged in a single enterprise, failure (a) to make clear which corporation is taking action in a particular situation and the nature and extnet of that action, or (b) to observe with care the formal barriers between the corporations with a proper segregation of their separate businesses (see Acton Plumbing & Heating Co. v. Jared Builders, Inc., 368 Mich. 626, 628--630, 118 N.W.2d 956), records, and finances, may warrant some disregard of the separate entitles in rare particular situations in order to prevent gross inequity.

[6] 2. On the evidence the jury could reasonably have reached the following conclusions. (a) Haseotes was responsible by an order to the local stores for a highhanded, inexcusable refusal by employees of the various retail stores to return My Bread's racks to it at the termination of the bread sale arrangement. (b) Although no one of the codefendant operating store corporations was a subsidiary of C.F. Inc. (in the sense that C.F. Inc. owned the whole or a part of its stock), all the defendant corporations (including C.F. Inc.) were under the full stock control of the Haseotes family and were operated as a closely coo rdinated single enterprise. Haseotes himself could be found to have been a dominant figure in the whole 'Cumberland Farms' enterprise. (c) The basic common enterprise was the processing, distribution, and sale of milk and dairy products. C.F. Inc., on the evidence, could reasonably be regarded as to the principal corporation of the enterprise and the codefendants as its affiliates or satellites so that, when one thought of 'Cumberland Farms,' one would naturally think of C.F. Inc. (d) Because all the corporations were operated ambiguously from the same headquarters as part of a single enterprise, the jury could reasonably infer that Haseotes, in furtherance of the interests of C.F. Inc. in the distribution of its products, was intervening actively in the conduct of the satellite corporations. (e) Haseotes without (so far as this record shows) clear indication of the capacity in which (and the corporations for which) he was acting, dealt in 1960 with Duchaine of My Bread for 'Cumberland Farms' in a very confused manner. Although My Bread's representatives probably knew of the existence

of the separate corporations, they might reasonably think (absent a clear indication by Haseotes that he was acting for the retail store corporations and not for C.F. Inc.) that My Bread, with respect to the general wholesale distribution of bread, was dealing with C.F Inc. That was the corporation which was engaged, for the whole 'Cumberland Farms' enterprise, in the general wholesale distribution of milk and other dairy products. It would have been the logical corporation to arrange to purchase bread at wholesale for distribution through the 'Cumberland Farms' stores. (f) The bill of exceptions reveals no basis for an inference that any of the codefendants was inadequately capitalized, a ground frequently relied upon, when taken with other factors, as permitting disregard of a corporate entity.

The jury could properly infer (because of Haseotes's actions, the general corporate situation, and Haseotes's failure to dispel ambiguities) that Haseotes in all matters connected with the My Bread arrangement was acting for C.F. Inc. and that the satellite companies in following Haseotes's orders concerning the bread racks (fn. 2) were caused to act by C.F. Inc. and were acting as its agents.

The jury could reasonably decide that C.F. Inc., through Haseotes, brought about and was liable for the conversions. A directed verdict was properly refused.

Exceptions overruled.

Gardemal v. Westin Hotel

United States Court of Appeals,
Fifth Circuit.

Lisa Cerza **GARDEMAL**, Administrator of the Estate of John W. Gardemal, Deceased,
Plaintiff-Appellant,
v.
WESTIN HOTEL COMPANY, doing business as Westin Regina Resort; Westin Mexico SA
de CV, Defendants-Appellees.

No. 98-50119.

Aug. 17, 1999.
Rehearing Denied Sept. 29, 1999.

DeMOSS, Circuit Judge:

Plaintiff-appellant, Lisa Cerza Gardemal ("Gardemal"), sued defendants- appellees, Westin Hotel Company ("Westin") and Westin Mexico, S.A. de C.V. ("Westin Mexico"), under Texas law, alleging that the defendants were liable for the drowning death of her husband in Cabo San Lucas, Mexico. The district court dismissed the suit in accordance with the

magistrate judge's recommendation that the court grant Westin's motion for summary judgment, and Westin Mexico's motion to dismiss for lack of personal jurisdiction. We affirm the district court's rulings.

I.

In June 1995, Gardemal and her husband John W. Gardemal, a physician, traveled to Cabo San Lucas, Baja California Sur, Mexico, to attend a medical seminar held at the Westin Regina Resort Los Cabos ("Westin Regina"). The Westin Regina is owned by Desarollos Turisticos Integrales Cabo San Lucas, S.A. de C.V. ("DTI"), and managed by Westin Mexico. Westin Mexico is a subsidiary of Westin, and is incorporated in Mexico. During their stay at the hotel, the Gardemals decided to go snorkeling with a group of guests. According to Gardemal, the concierge at the Westin Regina directed the group to "Lovers Beach" which, unbeknownst to the group, was notorious for its rough surf and strong undercurrents. While climbing the beach's rocky shore, five men in the group were swept into the Pacific Ocean by a rogue wave and thrown against the rocks. Two of the men, including John Gardemal, drowned.

Gardemal, as administrator of her husband's estate, brought wrongful death and survival actions under Texas law against Westin and Westin Mexico, alleging that her husband drowned because Westin Regina's concierge negligently directed the group to Lovers Beach and failed to warn her husband of its dangerous condition. [FN1] Westin then moved for summary judgment, alleging that although it is the parent company of Westin Mexico, it is a separate corporate entity and thus could not be held liable for acts committed by its subsidiary. The magistrate judge agreed with Westin, and recommended that Westin be dismissed from the action. In reaching its decision the magistrate judge rejected Gardemal's assertion that the state-law doctrines of alter-ego and single business enterprise allowed the court to disregard Westin's separate corporate identity.

In this action Gardemal seeks to hold Westin liable for the acts of Westin Mexico by invoking two separate, but related, state-law doctrines. Gardemal first argues that liability may be imputed to Westin because Westin Mexico functioned as the alter ego of Westin. *See Castleberry v. Branscum,* 721 S.W.2d 270, 272 (Tex.1986) (explaining that under Texas law corporate form may be disregarded if corporation functions as alter-ego of another corporation). Gardemal next contends that Westin may be held liable on the theory that Westin Mexico operated a single business enterprise. *See Old Republic Ins. Co. v. Ex-Im Servs. Corp.,* 920 S.W.2d 393, 395-96 (Tex.App.-- Houston [1st Dist.] 1996, no writ) (explaining that under Texas law corporate form may be disregarded when corporations are not operated as separate entities but rather integrate their resources to achieve a common business purpose). We consider first the issue of whether Westin may be held liable on an alter- ego theory.

1.

Under Texas law the alter ego doctrine allows the imposition of liability on a corporation for

the acts of another corporation when the subject corporation is organized or operated as a mere tool or business conduit. *Hall v. Timmons,* 987 S.W.2d 248, 250 (Tex.App.--Beaumont 1999, no writ); *Castleberry,* 721 S.W.2d at 272. It applies "when there is such unity between the parent corporation and its subsidiary that the separateness of the two corporations has ceased and holding only the subsidiary corporation liable would result in injustice." *Harwood Tire--Arlington, Inc. v. Young,* 963 S.W.2d 881, 885 (Tex.App.--Fort Worth 1998, writ dism'd by agr.). Alter ego is demonstrated "by evidence showing a blending of identities, or a blurring of lines of distinction, both formal and substantive, between two corporations." *Hideca Petroleum Corp. v. Tampimex Oil Int'l Ltd.,* 740 S.W.2d 838, 843 (Tex.App.--Houston [1st Dist.] 1987, no writ). An important consideration is whether a corporation is underfunded or undercapitalized, which is an indication that the company is a mere conduit or business tool. *Lucas v. Texas Indus., Inc.,* 696 S.W.2d 372, 374 (Tex.1984). [FN2]

On appeal Gardemal points to several factors which, in her opinion, show that Westin is operating as the alter ego of Westin Mexico. She claims, for example, that Westin owns most of Westin Mexico's stock; that the two companies share common corporate officers; that Westin maintains quality control at Westin Mexico by requiring Westin Mexico to use certain operations manuals; that Westin oversees advertising and marketing operations at Westin Mexico through two separate contracts; and that Westin Mexico is grossly undercapitalized. *See United States v. Jon-T Chemicals, Inc.,* 768 F.2d 686, 691-92 (5th Cir.1985) (listing the numerous factors used in alter ego analysis); *Castleberry,* 721 S.W.2d at 272 (same). Gardemal places particular emphasis on the last purported factor, that Westin Mexico is undercapitalized. She insists that this factor alone is sufficient evidence that Westin Mexico is the alter ego of Westin. *See Jon-T Chemicals, Inc.,* 768 F.2d at 692-93 (explaining that undercapitalization is an important factor in alter-ego analysis). We are not convinced.

[12] The record, even when viewed in a light most favorable to Gardemal, reveals nothing more than a typical corporate relationship between a parent and subsidiary. It is true, as Gardemal points out, that Westin and Westin Mexico are closely tied through stock ownership, shared officers, financing arrangements, and the like. But this alone does not establish an alter-ego relationship. As we explained in *Jon-T Chemicals, Inc.,* there must be evidence of complete domination by the parent.

> The control necessary ... is not mere majority or complete stock control but such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal.

Id. at 691 (citation and quotation omitted). Thus, "one-hundred percent ownership and identity of directors and officers are, even together, an insufficient basis for applying the alter ego theory to pierce the corporate veil." *Id.*

In this case, there is insufficient record evidence that Westin dominates Westin Mexico to

the extent that Westin Mexico has, for practical purposes, surrendered its corporate identity. In fact, the evidence suggests just the opposite, that Westin Mexico functions as an autonomous business entity. There is evidence, for example, that Westin Mexico banks in Mexico and deposits all of the revenue from its six hotels into that account. The facts also show that while Westin is incorporated in Delaware, Westin Mexico is incorporated in Mexico and faithfully adheres to the required corporate formalities. Finally, Westin Mexico has its own staff, its own assets, and even maintains its own insurance policies.

Gardemal is correct in pointing out that undercapitalization is a critical factor in our alter-ego analysis, especially in a tort case like the present one. *See Jon-T Chemicals, Inc.,* 768 F.2d at 693. But as noted by the district court, there is scant evidence that Westin Mexico is in fact undercapitalized and unable to pay a judgment, if necessary. This fact weighs heavily against Gardemal because the alter ego doctrine is an equitable remedy which prevents a company from avoiding liability by abusing the corporate form. "We disregard the corporate fiction ... when the corporate form has been used as part of a basically unfair device to achieve an inequitable result." *Castleberry,* 721 S.W.2d at 271-72 (citation and quotation omitted); *see also Roy E. Thomas Construction Co. v. Arbs,* 692 S.W.2d 926, 938 (Tex.App.-- Fort Worth 1985, writ ref'd n.r.e.) ("It is not possible to more emphatically express the necessity for a plaintiff to prove that he will suffer some type of harm or injustice by adhering to the corporate fiction before the corporate veil will be pierced."). In this case, there is insufficient evidence that Westin Mexico is undercapitalized or uninsured. Moreover, there is no indication that Gardemal could not recover by suing Westin Mexico directly. As a result, equity does not demand that we merge and disregard the corporate identities of Westin and Westin Mexico. We reject Gardemal's attempt to impute liability on Westin based on the alter-ego doctrine.

2.

Likewise, we reject Gardemal's attempt to impute liability to Westin based on the single business enterprise doctrine. Under that doctrine, when corporations are not operated as separate entities, but integrate their resources to achieve a common business purpose, each constituent corporation may be held liable for the debts incurred in pursuit of that business purpose. *Old Republic Ins. Co. v. Ex-Im Serv. Corp.,* 920 S.W.2d 393, 395-96 (Tex.App.-- Houston [1st Dist.] 1996, no writ). Like the alter-ego doctrine, the single business enterprise doctrine is an equitable remedy which applies when the corporate form is "used as part of an unfair device to achieve an inequitable result." *Id.* at 395.

On appeal, Gardemal attempts to prove a single business enterprise by calling our attention to the fact that Westin Mexico uses the trademark "Westin Hotels and Resorts." She also emphasizes that Westin Regina uses Westin's operations manuals. Gardemal also observes that Westin allows Westin Mexico to use its reservation system. Again, these facts merely demonstrate what we would describe as a typical, working relationship between a parent and subsidiary. Gardemal has pointed to no evidence in the record demonstrating that the operations of the two corporations were so integrated as to result in a blending of the two corporate identities. Moreover, Gardemal has come forward with no evidence that she has

suffered some harm, or injustice, because Westin and Westin Mexico maintain separate corporate identities.

Reviewing the record in the light most favorable to Gardemal, we conclude that there is insufficient evidence that Westin Mexico was Westin's alter ego. Similarly, there is insufficient evidence that the resources of Westin and Westin Mexico are so integrated as to constitute a single business enterprise. Accordingly, we affirm the district court's grant of Westin's motion for summary judgment on that issue. We turn next to whether the district court erred in granting Westin Mexico's motion to dismiss for lack of personal jurisdiction.

Philip Alan, Inc. v. Sarcia

PHILIP ALAN, INC.
v.
Michael SARCIA, Individually and dba Msarcia Construction Services, LLC et al.

Superior Court of Massachusetts,Middlesex County.

No. 0500437.

Feb. 6, 2007.

MEMORANDUM OF DECISION AND ORDER ON PLAINTIFF'S, DEFENDANT'S, AND THIRD-PARTY DEFENDANTS' MOTIONS FOR SUMMARY JUDGMENT

THOMAS R. MURTAGH, Justice.
The plaintiff, Philip Alan, Inc. ("Philip Alan"), commenced this action against the defendants in connection with a dispute that arose over a renovation project at the plaintiff's salon. The defendants filed various counterclaims. The defendant Michael Sarcia d/b/a MSarcia Construction Services, LLC ("Sarcia") filed third-party complaints against Eliot Square Enterprises, Inc. ("Eliot Square"), the owner of the property at which the salon is located, LDL Studio, Inc. ("LDL"), the project's architect, and Christine Perkins ("Perkins"), the president and principal operator of Philip Alan.

Currently before this court are a number of motions for summary judgment. Specifically, Philip Alan and Perkins move for summary judgment on all the claims asserted against them by the defendant Sarcia, third-party defendant LDL moves for summary judgment on the claims asserted by Sarcia, and defendant Nosal Builders, Inc. ("Nosal Builders") moves for summary judgment on the claims asserted by Philip Alan. For the reasons that follow, the parties' motions are *ALLOWED* in part and *DENIED* in part.

BACKGROUND

In deciding motions for summary judgment, this court relies upon the following undisputed

facts viewed, as always, in the light most favorable to the nonmoving party. *Augat, Inc. v. Liberty Mut. Ins. Co.,* 410 Mass. 117, 120 (1999).

Philip Alan operates the Pyara Spa & Salon at 104 Mount Auburn Street in Cambridge, Massachusetts. Perkins is the president and principal operator of Philip Alan. On May 27, 2004, prior to the salon's opening, Philip Alan hired LDL to provide architectural design services in connection with a planned build-out of commercial space leased from the property's owner, Eliot Square.

On September 27, 2004, Philip Alan accepted Sarcia's bid to serve as the project's general contractor. The subsequent contract was issued on letterhead purporting to be that of "Msarcia Construction Services, LLC" and was addressed to Perkins as owner of the salon. It was signed by Perkins as "owner" and by Sarcia as "contractor ." LDL was not a party to this contract and has never entered into an express contract with Sarcia. At the time of the agreement, Sarcia was doing business as "MSarcia Construction Services, LLC" but remained unregistered with any state. The corporate entity known as "MSarcia Construction Services, LLC" did not come into existence until July 1, 2005.

The original contract price for the project is in dispute but was to be paid to Sarcia in installments as work progressed. Per the terms of the agreement, tile "retail portion" of the salon was to be completed by November 7, 2004 with the remaining portions to be completed by November 27, 2004. The contract also provided that Sarcia was to earn a $10,000 bonus for each week of early completion but that he would incur a $20,000 "penalty" for each week, or portion thereof, that the project remained unfinished following the scheduled deadline.

Sarcia engaged the assistance of various subcontractors during the course of the renovation, including the defendants Nosal-Sarcia Contractors, LLC ("Nosal-Sarcia") and Nosal Builders. Nosal-Sarcia is an entity formed by Sarcia and his nephew, Joseph Nosal ("Nosal"), which shared office space with Sarcia. Nosal-Sarcia had worked on prior construction projects alongside Sarcia, typically serving as project manager. In the present case, however, there was some confusion regarding which entity was serving as general contractor or construction manager. Nosal, the on-site superintendent, and the flooring subcontractor all did not know which entity was primarily responsible for the project. The superintendent and Sarcia also disagree as to which entity employed the superintendent. Furthermore, each installment payment issued by Philip Alan was made payable to "Mike Sarcia Construction Services, LLC" but was deposited into an account held by Nosal-Sarcia.

Nosal Builders, the other relevant subcontractor, is an enterprise which Nosal incorporated in the late 1990s. Typically, Nosal Builders serves as a project's subcontractor offering a "general trades package" to tile general contractor. It has worked with Sarcia on previous occasions and has shared the same office space with Nosal-Sarcia. In connection with this project, Nosal Builders was paid by Nosal-Sarcia but did not add any markup to its stated costs. The two entities also employed the same bookkeeper who kept separate and distinct records for each business. On one occasion, Sarcia communicated with Perkins via a

facsimile bearing Nosal Builders' corporate logo. After the completion of the project, Nosal Builders remitted funds to several of Nosal-Sarcia's creditors in order to satisfy the creditors' claims. It is undisputed that neither Nosal-Sarcia nor Nosal Builders were parties to the contract between Sarcia and Philip Alan.

Various problems arose during the renovation that precluded the timely completion of the project. A dispute over the use of union labor, various design changes, and other unscheduled events transpired to delay performance. As a result, the retail portion of the salon was not finished until November 27, 2004. As of January 10, 2005, complete performance on the remaining portions of the salon had yet to occur. Specifically, a "wet treatment room," along with a host of "punch list" items, remained unfinished. Nonetheless, Philip Alan was issued a partial Certificate of Occupancy on that date which allowed the salon to open for business. On January 28, 2005, Philip Alan effectively terminated Sarcia's contract citing the project's unfinished state. The work was never completed by the defendants.

To date, Philip Alan has paid Sarcia $256,390 in connection with the renovation. Philip Alan has also expended a substantial amount of money in order to complete the portions left unfinished by the defendants.

On February 8, 2005, Philip Alan filed this lawsuit seeking to recover $125,714.29 from the defendants for the six-week, two-day delay in accordance with the contractual penalty provisions. Philip Alan alleges breach of contract, unfair and deceptive acts in violation of G.L.c. 93A, § 2, and seeks to pierce the corporate veil with respect to the corporate defendants. Sarcia counterclaimed and filed a third-party complaint against Perkins seeking $171,427.85 for the unpaid contractual balance. Sarcia maintains that Philip Alan and Perkins committed a breach of contract, breach of the implied covenant of good faith and fair dealing, unjust enrichment, and avers that Philip Alan interfered with his advantageous business relations, violated G.L.c. 93A, § 2, and committed an abuse of process. Sarcia also seeks a declaratory judgment regarding his and Perkins' personal obligations under the contract. Nosal Builders and Nosal-Sarcia also filed counterclaims alleging abuse of process, unjust enrichment, and seeking a declaratory judgment concerning their contractual obligations.

Sarcia also filed a third-party complaint against LDL. Sarcia seeks to impose liability on LDL for common-law indemnification and "equity for reliance."

On April 7, 2005, Sarcia recorded a lien against the Mount Auburn property in the amount of $171,427.85 and thereafter filed a third-party complaint against Eliot Square seeking to enforce this lien. The amount stated represents the alleged difference left unpaid on the original contract along with added expenses of $35,717 .85 for "agreed change orders" and $46,000 for "union premiums." On June 8, 2005, and again on July 19, 2005, Philip Alan moved to dissolve the lien arguing that Sarcia knowingly and willfully filed an inaccurate statement of account. This court denied Philip Alan's motions on both occasions, noting that the summary judgment record did not reveal that "any putative inaccuracies were 'knowingly and willfully' entered" on the account by Sarcia. However, on September 21, 2005, in

accordance with its lease obligations, Philip Alan posted a bond effectively dissolving the lien. Philip Alan now moves for summary judgment on Sarcia's third-party complaint for enforcement of the lien.

DISCUSSION

Summary judgment shall be granted where there are no genuine issues as to any material fact and where the moving party is entitled to a judgment as a matter of law. Mass.R.Civ.P. 56(c); *Cassesso v. Comm'r of Correction,* 390 Mass. 419, 422 (1983); *Community Nat'l Bank v. Dawes,* 369 Mass. 550, 553 (1976). The moving party assumes the burden of affirmatively demonstrating the absence of a triable issue and that the summary judgment record entitles the moving party to a judgment as a matter of law. *Pederson v. Time, Inc.,* 404 Mass. 14, 17 (1989). The moving party may satisfy this burden either by submitting affirmative evidence that negates an essential element of the opposing party's case or by demonstrating that the opposing party has no reasonable expectation of proving an essential element of his case at trial. *Flesner v. Technical Communications Corp.,* 410 Mass. 805, 809 (1991); *Kourouvacilis v. Gen. Motors Corp.,* 410 Mass. 706, 716 (1991). If this burden is met, the nonmoving party must respond by setting forth specific facts showing that there is a genuine issue for trial. *O'Brion, Russell & Co. v. LeMay,* 370 Mass. 243, 245 (1976). To defeat the motion, the nonmoving party cannot rest on his or her pleadings and mere assertions of disputed facts. *LaLonde v. Eissner,* 405 Mass. 207, 209 (1989).

I. Nosal Builders' Motion

A. Pierce the Corporate Veil

This court will first deal with Philip Alan's claim to pierce the corporate veil as the resolution of this count will guide the determination of the others. Nosal Builders moves for summary judgment arguing that Philip Alan has not alleged sufficient facts to proceed past this stage.

Generally, corporations are to be regarded as separate and distinct from each other and from their respective stockholders in order to promote capital investment in these enterprises. *My Bread Baking Co. v. Cumberland Farms, Inc.,* 353 Mass. 614, 618 (1968); *Birbara v. Locke,* 99 F.3d 1233, 1241 (1st Cir.1996). It is only when gross injustice must be prevented that resorting to the equitable tool of corporate disregard is warranted, i.e., it is permissible to pierce the corporate veil. *Attorney General v. M.C .K., Inc.,* 432 Mass. 546, 555 (2000); *Evans v. Multicon Constr. Corp.,* 30 Mass.App.Ct. 728, 732 (1991). What the plaintiff must establish is more than a mere showing of common ownership and management among the corporations. *My Bread Baking Co.,* 353 Mass. at 619.Additional facts must be presented in order to permit the conclusion that an agency or other relationship exists between the parties, thereby imposing potential liability. *Id.* This is particularly true:

> (a) when there is active and direct participation by the representatives of one corporation, apparently exercising some form of pervasive control, in the activities of another and there is some fraudulent or injurious consequence of the intercorporate relationship, or (b) when

> there is a confused intermingling of activity of two or more corporations engaged in a common enterprise with substantial disregard of the separate nature of the corporate entities, or serious ambiguity about the manner and capacity in which the various corporations and their respective representatives are acting.

Id.

Massachusetts has developed twelve factors which help guide a court in determining whether it is appropriate to pierce the corporate veil. These factors are: (1) common ownership; (2) pervasive control; (3) confused intermingling of business activity assets or management; (4) nonobservance of corporate formalities; (5) absence of corporate records; (6) thin capitalization (7) no payment of dividends; (8) insolvency at the time of the litigated transaction; (9) siphoning away of corporate assets by the dominant shareholders; (10) nonfunctioning of officers and directors; (11) use of the corporation for transactions of the dominant shareholders; and (12) use of the corporation in promoting fraud. *Evans,* 30 Mass.App.Ct. at 733, citing *Pepsi-Cola Metro Bottling Co. v. Checkers, Inc.,* 754 F.2d 10, 14-16 (1st Cir.1985).

It appears that Massachusetts is more strict than other jurisdictions in permitting the nonobservance of corporate formalities. *My Bread Baking Co.,* 353 Mass. at 619-20.Indeed, courts only allow such disregard in “rare” situations. *Id.* at 620;*Evans,* 30 Mass.App.Ct. at 732.Even more infrequent is the court which allows the disregard of corporate formalities in a contractual dispute rather than a tortious injury. *Birbara,* 99 F .3d at 1238.However, if one common theme threads through these decisions, it is “an element of dubious manipulation and contrivance, finagling, such that corporate identities are confused and third parties cannot be quite certain with what they are dealing .”*Evans,* 30 Mass.App.Ct. at 736.

As stated above, the first factor to consider is the existence of common ownership. Here, there is some overlapping of ownership between the three entities. Sarcia and Nosal each ran, and ultimately incorporated, their own construction companies. Together, they formed Nosal-Sarcia. But there is no indication that Nosal Builders, or Nosal personally, had any involvement with Sarcia's independent business. Nor is there evidence to suggest that Sarcia held any ownership interest in Nosal's independent corporation, Nosal Builders. Philip Alan has therefore shown no connection between the two relevant companies, Sarcia and Nosal Builders, with respect to the first factor.

The second factor to consider is the level of pervasive control rendered over or by Nosal Builders. Deposition testimony and corresponding affidavits, when read in the light most favorable to Philip Alan, reveal that both Sarcia and Nosal had some level of control over Nosal-Sarcia. In fact, each appeared to possess equal authority over the business as a result of their common ownership. The level of control exerted by each individual, however, failed to extend to the other's independent business. There is no evidence to indicate that Nosal had authority to affect or control Sarcia's business or that Sarcia could exert any influence over Nosal Builders.

Whether there was any confusing intermingling of business activity, assets, or management is the third consideration. There is no doubt that confusion abounded regarding the identity of the project's general contractor. Philip Alan hired Sarcia and issued checks in his name yet the payments were deposited into Nosal-Sarcia's account. The numerous parties were not sure which entity, Sarcia or Nosal-Sarcia, they were working for. Such a situation, when viewed in the light most favorable to Philip Alan, certainly raises a question with respect to Sarcia and Nosal-Sarcia. Notably absent, however, is any confusion regarding Nosal Builders' role. From the summary judgment record, there is no evidence to suggest that any of the subcontractors or suppliers thought they were working for Nosal Builders. In fact, it is undisputed that Nosal Builders was paid by Nosal-Sarcia. The fact that Nosal Builders later paid off some of Nosal-Sarcia's creditors and that Sarcia communicated with Philip Alan on Nosal Builders' stationary on one isolated occasion does not render the two corporations' identities meaningless. Like the two previous factors, Philip Alan has failed to establish any more than a tenuous connection linking Nosal Builders with Sarcia.

The fourth and fifth factors concern corporate formalities. Nosal Builders came into existence years prior to the creation of Nosal-Sarcia. There is no allegation, and no evidence to indicate, that appropriate corporate records and formalities were not followed during this time. In fact, the undisputed evidence reveals that Nosal Builders routinely filed corporate tax returns, maintained financial statements, and filed annual auditing statements. Although it is true that Nosal-Sarcia shared a bookkeeper and office space with Nosal Builders upon its creation, there is no evidence to suggest that the creation of Nosal-Sarcia somehow undermined the formalities previously followed by Nosal Builders. To the contrary, uncontroverted evidence suggests that the bookkeeper diligently maintained separate records distinguishing between the two entities.

The remaining seven factors need little discussion. Philip Alan has failed to produce any evidence indicating that any of the corporations were undercapitalized, failed to pay dividends, were insolvent at the time of the litigated transaction, or engaged in improper siphoning of corporate assets. Neither is there any evidence suggesting that Sarcia or Nosal were non-functioning directors, used the corporations for their own personal transactions, or that they engaged in fraudulent behavior with respect to the various companies.

In short, the summary judgment record reveals the possible presence of only one factor, the confusing intermingling of business activities. However, the confusing intermingling at issue here existed only between Sarcia and Nosal-Sarcia. Aside from the fact that Nosal Builders paid some of Nosal-Sarcia's creditors and that Nosal and Sarcia jointly operated Nosal-Sarcia, there is simply no evidence to suggest any corporate connection between Nosal Builders and Sarcia. Whether the evidence establishes a triable issue with regard to Sarcia and Nosal-Sarcia is a question this court need not answer. At issue is Nosal Builders' motion for summary judgment.[FN4]Philip Alan argues that the issue is fact-sensitive and should be reserved for trial. However, in order to survive summary judgment, Philip Alan must first produce sufficient evidence to establish that it has a reasonable expectation of proving the essential elements of its claim at trial. This it has not accomplished. Accordingly, Nosal Builders' motion for summary judgment with respect to piercing the corporate veil is

ALLOWED.

The third claim for declaratory judgment concerns Sarcia's personal liability. Philip Alan claims that Sarcia is personally obligated under the contract because the corporate entity which purportedly entered into the contract, MSarcia Construction Services, LLC, was not in existence at the time of contract formation. In Massachusetts, an agent is personally bound to a contract if he enters into it on behalf of a nonexistent principal.*Productora e Importadora de Papel, S.A. de C.V. v. Fleming,* 376 Mass. 826, 836 (1978). Although Sarcia issued the contract on letterhead purporting to be that of the corporate entity, it is undisputed that Sarcia did not incorporate his business until close to ten months later. Accordingly, this court finds that Sarcia is personally bound by the terms of the contract.[FN5]

ORDER

For the foregoing reasons, it is hereby *ORDERED* that Nosal Builders' motion for summary judgment on the claims asserted against it is *ALLOWED* and that it is entitled to a declaratory judgment holding that it is not bound by the terms of the contract. It is further ordered that LDL's motion for summary judgment is *ALLOWED* as to Sarcia's claim for common-law indemnification and *DENIED* with regard to the misrepresentation claim. Perkins' motion for summary judgment is *DENIED* as to Sarcia's claim for breach of contract, breach of the implied covenant of good faith and fair dealing, and unjust enrichment. Philip Alan's motion for summary judgment is *ALLOWED* with respect to Sarcia's claims for abuse of process, interference with advantageous business relations, and Chapter 93A and Nosal Builders' claim for unjust enrichment and *DENIED* with respect to Sarcia's claim for breach of contract, breach of the implied covenant of good faith and fair dealing, unjust enrichment, and enforcement of the mechanic's lien, Nosal-Sarcia's claims for declaratory judgment, unjust enrichment, and abuse of process, and Nosal Builders' claim for abuse of process. Finally, it is hereby declared that Sarcia is personally bound by the terms of the contract entered into with Philip Alan.

Wayne SCOTT, trustee

v.

NG U.S. 1, INC., & others.

Supreme Judicial Court of Massachusetts,Suffolk.

Argued Nov. 6, 2007.
Decided March 7, 2008.

Predominant among the issues raised in this appeal is whether a parent corporation first acquiring an ownership interest in a subsidiary corporation decades after the subsidiary both released environmentally hazardous material and sold the contaminated site, without more, may be liable under G.L. c. 21E for later incurred response costs at the site. We conclude that the parent corporation is not directly liable as an operator of the site. We also conclude that, in the circumstances of this case, the parent corporation is not indirectly liable as an operator of the site where there are no grounds for piercing the corporate veil of the parent. We affirm the grant of summary judgment for all defendants, vacate the order denying the defendants' motions for litigation costs and attorney's fees, and remand for further proceedings on that issue.

1. *Procedural background.* On cross motions for summary judgment and associated motions for attorney's fees and costs, a judge in the Superior Court granted the defendant corporations' motions for summary judgment and denied the plaintiff property owner's cross motion, concluding that the defendants were not liable to the plaintiff for response costs or damages, pursuant to G.L. c. 21E.[FN6] The judge also ruled that the defendants were not entitled to their attorney's fees and costs, pursuant to G.L. c. 21E, § 4A (*f*). The Appeals Court affirmed the judgment except on one point: it concluded that a genuine issue of material fact-concerning whether the corporate veil of New England Electric System (NEES), the defendant NG U.S. 1, Inc.'s, corporate predecessor, could be pierced to impose derivative liability-precluded entry of summary judgment, and accordingly vacated the entry of summary judgment for NG U.S. 1, Inc., on that issue.[FN7] *Scott v. NG U.S. 1, Inc.,* 67 Mass.App.Ct. 474, 485, 854 N.E.2d 981 (2006).

We granted the defendants' applications for further appellate review without limitation, and have considered all of the issues briefed and argued before the Appeals Court. See, e.g., *Brusard v. O'Toole,* 429 Mass. 597, 606 n. 11, 710 N.E.2d 588 (1999). For essentially the reasons stated by the motion judge, and those expressed by the Appeals Court in part one of its opinion, *Scott v. NG U.S. 1, Inc., supra* at 477-479, 854 N.E.2d 981, as well as those articulated in *United States v. Bestfoods,* 524 U.S. 51, 64-67, 118 S.Ct. 1876, 141 L.Ed.2d 43 (1998) (circumstances supporting direct liability of corporate parent as operator of facility), the order of the Superior Court judge concluding that NEES is not directly liable as an operator of the contaminated site pursuant to G.L. c. 21E, § 5 (*a*) (1), was correct.[FN8] Likewise, for essentially the reasons stated by the motion judge, and those expressed by the Appeals Court in part three of its opinion, *Scott v. NG U.S. 1, Inc., supra* at 485-488, 854 N.E.2d 981, the order of the Superior Court judge allowing the defendant Boston Gas Company's motion for summary judgment was correct. We proceed, focusing our discussion solely on two remaining issues: first, whether the judge correctly ruled that the undisputed facts present no occasion to disregard NEES's corporate form to impose operator liability indirectly; and second, whether the judge properly denied the defendants' motions for attorney's fees and costs.

2. *Corporate background.* In January, 2002, the plaintiff, Wayne Scott, trustee of 12 Woodbury Court Trust, purchased property in Salem, intending to develop and sell

townhouses on it. During construction, he discovered “highly volatile” coal tar, or a similar contaminant, on the property that, for purposes of summary judgment, was assumed to have migrated from abutting land on Northey Street (Northey Street property). From 1850 to 1890, the Northey Street property had been owned and operated by Salem Gas Light Company (Salem Gas) as a “gas works.” The gas works facility ceased gas production in 1890, Salem Gas conveyed the property to a third party,[FN10] and the facility was dismantled by 1906, at the latest. Salem Gas, incorporated in Massachusetts in 1847, existed as an independent gas utility company until at least 1927. It continued to manufacture gas at another site in Salem until 1953.

In 1926, some thirty-six years after Salem Gas sold the Northey Street property, North Boston Lighting Properties (North Boston) began acquiring Salem Gas stock; by the following year, New England Power Association (NEPA), a corporate predecessor of defendant NEES, had acquired almost six per cent of the voting power of outstanding shares of North Boston stock. By 1942-more than fifty years after the Northey Street property had been sold-North Boston owned almost 95% of Salem Gas and, by 1945, NEPA (through a holding company, Massachusetts Power and Light Associates [MPLA]) owned a substantial majority interest in North Boston. NEPA was reorganized in 1947, NEES was formed, and North Boston's assets (including its stock in Salem Gas) and obligations were transferred to NEES. Through these corporate transactions, Salem Gas became a subsidiary of NEES in 1947, and North Boston and MPLA were liquidated.

In 1951, NEES formed an unincorporated “gas division” and, in 1953, arranged for consolidation of the gas operations of Salem Gas and two other companies-Gloucester Gas Light Company and Beverly Gas and Electric Company-into a new company, North Shore Gas Company. In March, 1964, however, the Securities and Exchange Commission ordered NEES to divest itself of its gas operations. After its appeals were exhausted, on October 27, 1972, conditioned on regulatory approval, NEES sold all of its stock in North Shore Gas Company (of which the former Salem Gas was part) and two other companies (Lynn Gas Company and Mystic Valley Gas Company) to Eastern Gas & Fuel Associates. The stock purchase agreement provided that the companies would be acquired by or combined with Eastern Gas & Fuel Associates's subsidiary, Boston Gas Company (Boston Gas), one of the defendants in this action.

On January 23, 1973, Boston Gas, North Shore Gas Company, Lynn Gas Company, and Mystic Valley Gas Company executed an “Agreement for Purchase and Sale of Assets and Assumption of Liabilities.” Under that agreement, Boston Gas agreed to purchase all assets of North Shore Gas, Lynn Gas, and Mystic Valley Gas “as then constituted,” and to assume all liabilities of those three companies “as then existing.” The defendant, NG U.S. 1, Inc., also known as National Grid USA (National Grid), subsequently became the corporate successor to NEES.

3. *Indirect liability as an operator: piercing the corporate veil.* As we have said, NEES is not a present owner or operator of the Northey Street site, and is not directly liable to the plaintiff under G.L. c. 21E, § 5 (*a*) (1). *Griffith v. New England Tel. & Tel. Co.,* 414 Mass.

824, 827, 610 N.E.2d 944 (1993), *S.C.,*420 Mass. 365, 649 N.E.2d 766 (1995) (former lessee of site not liable as present operator). See *Scott v. NG U.S. 1, Inc., supra* at 478, 854 N.E.2d 981 (rejecting proposition that entity remains "present operator" of site until hazardous wastes removed). The question we now consider is whether NEES, which acquired a controlling interest in Salem Gas many years after the environmental release, may be derivatively liable for Salem Gas's actions as a past operator under G.L. c. 21, § 5 (*a*) (2) or (5).

The conduct giving rise to liability under G.L. c. 21E, § 5 (*a*) (5), is "caus[ing]" or being "legally responsible" for the release or threat of release of oil or hazardous material. Under § 5 (*a*) (5), therefore, "a past owner or operator of a site contaminated by oil can be held liable if that person 'caused' a release or threat of a release of oil from the site," or is otherwise legally responsible for it. *Griffith v. New England Tel. & Tel. Co., supra* at 830, 610 N.E.2d 944. See G.L. c. 21E, § 5 (*a*) (2) (liability rests on ownership or operation of a site "at the time" of storage or disposal). Assuming, for purposes of summary judgment, that Salem Gas-a past owner or operator-"caused or is legally responsible for a release,"G.L. c. 21E, at § 5 (*a*) (5), the question is whether NEES-which acquired its interest in Salem Gas decades after both the environmental contamination and sale of the site-is indirectly liable for that release through application of corporate veil piercing concepts. We think not.

Neither Federal (CERCLA) nor State environmental laws displace bedrock principles of corporate common law. See, e.g., *United States v. Bestfoods,* 524 U.S. 51, 61-62, 118 S.Ct. 1876, 141 L.Ed.2d 43 (1998). See generally *Martignetti v. Haigh-Farr, Inc.,* 425 Mass. 294, 680 N.E.2d 1131 (1997). One of the basic tenets of that body of law is that corporations-notwithstanding relationships between or among them-ordinarily are regarded as separate and distinct entities. See, e.g., *Attorney Gen. v. M.C.K., Inc.,* 432 Mass. 546, 555, 736 N.E.2d 373 (2000); *My Bread Baking Co. v. Cumberland Farms, Inc.,* 353 Mass. 614, 618, 233 N.E.2d 748 (1968). See also *United States v. Bestfoods, supra.*

> "Thus it is hornbook law that 'the exercise of the "control" which stock ownership gives to the stockholders ... will not create liability beyond the assets of the subsidiary. That "control" includes the election of directors, the making of by-laws ... and the doing of all other acts incident to the legal status of stockholders. Nor will a duplication of some or all of the directors or executive officers be fatal.' "

Id., quoting Douglas, Insulation from Liability Through Subsidiary Corporations, 39 Yale L.J. 193, 196 (1929) (Douglas). Indeed, the concept that "a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries," is "deeply 'ingrained in our economic and legal systems,' "*United States v. Bestfoods, supra* at 61, 118 S.Ct. 1876, quoting Douglas, *supra* at 193, and assures that "the exercise of the 'control' which stock ownership gives to the stockholders ... will not create liability beyond the assets of the subsidiary." *United States v. Bestfoods, supra* at 61-62, 118 S.Ct. 1876. Also settled is the equilibratory concept that the corporate veil between parent and subsidiary corporations may be pierced when, "inter alia, the corporate form would otherwise be misused to accomplish certain wrongful purposes, most notably fraud."

[FN13] *Id.* at 62, 118 S.Ct. 1876. Cf. 1 W.M. Fletcher, Cyclopedia of Corporations § 43, at 286-290 (rev. ed 2006) ("There is a presumption of separateness that a plaintiff must overcome to establish liability by showing that a parent is employing a subsidiary to perpetrate a fraud or commit wrongdoing and that this was the proximate cause of the plaintiff's injury"). "Nothing in CERCLA purports to rewrite this well-settled rule...." *Id.* at 63, 118 S.Ct. 1876.

In Massachusetts, the equitable doctrine of corporate disregard differs in no material respect from the description in *United States v. Bestfoods, supra* at 62-63, 118 S.Ct. 1876, and nothing in G.L. c. 21E displaces the doctrine's established scope. In the environmental context, as in other contexts, corporate veils are pierced only in "rare particular situations," and only when an "agency or similar relationship exists between the entities." *My Bread Baking Co. v. Cumberland Farms, Inc., supra* at 619, 620, 233 N.E.2d 748. A veil may be pierced where the parent exercises "some form of pervasive control" of the activities of the subsidiary "*and* there is some fraudulent or injurious consequence of the intercorporate relationship." *Id.* at 619, 233 N.E.2d 748. See *Hanson v. Bradley,* 298 Mass. 371, 381, 10 N.E.2d 259 (1937) ("The right and the duty of courts to look beyond the corporate forms are exercised only for the defeat of fraud or wrong, or the remedying of injustice"). See also 1 W.M. Fletcher, Cyclopedia of Corporations, *supra* at § 43, at 292 ("the injured party must show some connection between its injury and the parent's improper manner of doing business-without that connection, even when the parent exercises domination and control over the subsidiary, corporate separateness will be recognized"). Corporate formalities also may be disregarded "when there is a confused intermingling of activity of two or more corporations engaged in a common enterprise *with substantial disregard of the separate nature of the corporate entities,* or serious ambiguity about the manner and capacity in which the various corporations and their respective representatives are acting" (emphasis added). *My Bread Baking Co. v. Cumberland Farms, Inc., supra* at 619, 233 N.E.2d 748. Stated more directly, control, even pervasive control, without more, is not a sufficient basis for a court to ignore corporate formalities: "There is present in the cases which have looked through the corporate form an element of dubious manipulation and contrivance [and] finagling...." *Evans v. Multicon Constr. Corp.,* 30 Mass.App.Ct. 728, 736, 574 N.E.2d 395 (1991). See *United States v. Bestfoods, supra* at 62, 118 S.Ct. 1876 (veil piercing appropriate when, "inter alia, the corporate form would otherwise be used to accomplish certain wrongful purposes, most notably fraud, on the shareholder's behalf"); 1 W.M. Fletcher, Cyclopedia of Corporations, *supra* at § 43, at 296 ("although corporations are related, there can be no piercing of the corporate veil without a showing of improper conduct"). Ultimately, the decision to disregard settled expectations accompanying corporate form requires a determination that the parent corporation directed and controlled the subsidiary, and used it for an improper purpose, based on evaluative consideration of twelve factors:

> "(1) common ownership; (2) pervasive control; (3) confused intermingling of business assets; (4) thin capitalization; (5) nonobservance of corporate formalities; (6) absence of corporate records; (7) no payment of dividends; (8) insolvency at the time of the litigated transaction; (9) siphoning away of corporation's funds by dominant shareholder; (10) nonfunctioning of officers and directors; (11) use of the corporation for transactions of the

dominant shareholders; and (12) *use of the corporation in promoting fraud* " (emphasis added).

Attorney Gen. v. M.C.K., Inc., supra at 555 n. 19, 736 N.E.2d 373, citing *Pepsi-Cola Metro. Bottling Co. v. Checkers, Inc.,* 754 F.2d 10, 15-16 (1st Cir.1985) (categorizing *My Bread Baking Co.* factors).

In this case, the plaintiff makes no claim of "fraudulent or injurious consequence" under the first of the *My Bread Baking Co.* prongs, but relies instead on the second prong: confused intermingling with "substantial disregard of the separate nature of the corporate entitles." *Id.* He contends that during the period of 1931 to 1973, there is evidence of operational integration of the operations of NEES and the entities to which business of Salem Gas succeeded, including financial operations. Beginning in 1951, he alleges that Salem Gas and its successors were operated as an integrated part of NEES, without regard to corporate formality, and when the business of Salem Gas was sold, only NEES received the resulting funds.

Assuming, for summary judgment purposes, that Salem Gas's conduct, ownership, or operation of the Northey Street site during the 1800's meets the requirements of G.L. c. 21E, § 5 (*a*) (2) or (5), that activity concluded decades before any alleged "pervasive control," with "fraudulent or injurious consequence" or "confused intermingling ... with substantial disregard of the separate nature of the corporate entities." *My Bread Baking Co. v. Cumberland Farms, Inc., supra* at 619, 233 N.E.2d 748.[FN14] In this case, NEES's corporate form may not be pierced to impose liability for actions taken (or not taken) by another entity long before the formation of a corporate relationship.[FN15,FN16]

In determining whether one entity exercised "pervasive control" over another, and whether "confused intermingling" exists sufficient to disregard the corporate formalities, we focus on the events giving rise to liability: in this case, causing a release or threatened release, or owning or operating the facility at that time.[FN17] See *Attorney Gen. v. M.C.K., Inc., supra* at 557 n. 20, 736 N.E.2d 373 (determining whether control exercised at time of relevant acts); *Evans v. Multicon Constr. Corp.,* 30 Mass.App.Ct. 728, 732 n. 6, 574 N.E.2d 395 (1991) (rejecting without discussion piercing claim against partners who withdrew before relevant acts); *Pepsi-Cola Metro. Bottling Co. v. Checkers, Inc., supra* at 16-17 (distinguishing case in which parent acquired subsidiary after "event at issue"); *United States v. Wallace,* 961 F.Supp. 969, 979 (N.D.Tex.1996). See also *My Bread Baking Co. v. Cumberland Farms, Inc., supra* at 620-621, 233 N.E.2d 748 (analyzing whether, in refusing to return bread racks, subsidiary corporation acted as parent corporation's agents). See generally 1 W.M. Fletcher, Cyclopedia of Corporations, *supra* at § 41.10, at 143-144 (while various jurisdictions apply different veil-piercing factors, they commonly require control with respect to transaction at issue, such that, at that time, controlled corporation lacked "no separate mind, will or existence of its own"). Cf. *Lily Transp. Corp. v. Royal Inst. Servs., Inc.,* 64 Mass.App.Ct. 179, 188, 832 N.E.2d 666 (2005) ("Stockholders who are not involved in the improper transaction or wrongdoing are not liable even when the corporate veil is pierced"). We agree

with the Superior Court judge's conclusion that, “in the absence of some very special facts, a parent corporation should not be held responsible by veil piercing for the acts of a subsidiary that occurred decades before the parent acquired the subsidiary.”

> FN17. Both *My Bread Baking Co. v. Cumberland Farms, Inc., supra,* and *Attorney Gen. v.M.C.K., Inc., supra,* involved attempts to impose liability on a parent corporation for acts of a subsidiary during the existence of a parent-subsidiary relationship. In this case, however, the environmental release occurred-and the Northey Street site was sold-more than thirty years before the parent's predecessor acquired any interest in the subsidiary.

In the present case, the environmental releases occurred-and the contaminated property was sold-more than thirty years before North Boston purchased its first share of stock in Salem Gas, and before NEES's predecessor, NEPA, purchased its first share of stock in North Boston. The plaintiff does not suggest that NEPA's acquisition of North Boston was related to the then-discontinued operations at a site no longer owned by Salem Gas. Nor was there evidence that NEES had any ability to direct or control environmental measures on a site sold decades before, let alone any duty to do so. Indeed, G.L. c. 21E was enacted in 1983, ten years after NEES sold its interest in Salem Gas, and the plaintiff has identified no other source of statutory or common-law obligation of NEES (or of Salem Gas) during the period NEES had such an interest, to investigate, identify, or respond to possible environmental contamination from coal tar caused decades before, on property not owned by NEES or related entities. Cf. *John S. Boyd Co. v. Boston Gas Co.,* 992 F.2d 401, 408 (1st Cir.1993) (parent corporations liable “for the oil gas waste created while they were linked to the Lynn Gas Co.”).

We do not doubt that an important objective of G.L. c. 21E is prompt “assessment, containment and removal,” G.L. c. 21E, § 4, of hazardous materials. Nor do we question that the party that caused the environmental contamination should be responsible for its cleanup. *Garweth Corp. v. Boston Edison Co.,* 415 Mass. 303, 307, 613 N.E.2d 92 (1993). But it does no injustice to G.L. c. 21E to conclude that where the parent corporation lacked any interest in, and did not control, the subsidiary or its facility at the time of the acts giving rise to environmental liability, there is no occasion to disregard its corporate form. Summary judgment properly was granted to NEES.

5. *Conclusion.*On the facts contained in the summary judgment record, this case does not present a “rare situation,” *Attorney Gen. v. M.C.K., Inc., supra* at 555, 736 N.E.2d 373, warranting piercing the corporate veil of NEES to impose indirect liability for the environmental wrongdoing by Salem Gas more than one century ago. We affirm the decision of the Superior Court judge granting summary judgment to all defendants. We vacate the order denying the defendants' motions for litigation costs and attorney's fees, and we remand for further proceedings on those motions, consistent with this decision.

So ordered.

Court of Appeals of Maryland.

NISSEN CORPORATION et al.
v.
Warren G. **MILLER**, Individually and t/a Atlantic Fitness Products et al.

No. 110 Sept. Term, 1990.

Aug. 27, 1991.

CHASANOW, Judge.

On January 31, 1981, Frederick B. Brandt (Brandt) purchased from Atlantic Fitness Products (Atlantic) a treadmill that was designed, manufactured, and marketed by American Tredex Corporation (American Tredex). Later the same year, on July 31, Nissen Corporation (Nissen) entered into an asset purchase agreement with American Tredex. Pursuant to that agreement, Nissen purchased the trade name, patents, inventory and other assets of American Tredex. Nissen also assumed some of American Tredex's obligations and liabilities, but the contract expressly excluded assumption of liability for injuries arising from any product previously sold by American Tredex. The contract contemplated the continuation of the selling corporation, American Tredex, for five years and that during that period American Tredex would be known by a new name, AT Corporation.

Over five years after his purchase of the treadmill, on October 18, 1986, Brandt was injured while trying to adjust the running treadmill. More than a year later, on December 31, 1987, American Tredex (then known as AT Corporation) was administratively dissolved. Brandt and his wife filed suit on September 1, 1988, against American Tredex, AT Corporation, Nissen, and Atlantic, seeking damages for negligence, strict liability, breach of express and implied warranties, and loss of consortium. Atlantic cross-claimed against Nissen for indemnity and contribution. Nissen filed a motion for summary judgment, which was granted by the trial court and certified as a final judgment pursuant to Maryland Rule 2-602(b). Brandt and Atlantic appealed to the Court of Special Appeals. In *Miller v. Nissen Corp.,* 83 Md.App. 448, 575 A.2d 758 (1990), the Court of Special Appeals reversed the trial court. We granted Nissen's petition for writ of certiorari on the issue of whether it, as a successor to American Tredex, is liable to Brandt for his injuries.

The issue in the instant case is whether this Court should adopt the general rule of nonliability of successor corporations, with its four well-recognized traditional exceptions, or whether we should add a fifth exception for "continuity of enterprise."

The general or traditional rule of corporate successor liability has been stated by many cases

and treatises:

> "[A] corporation which acquires all or part of the assets of another corporation does not acquire the liabilities and debts of the predecessor, unless: (1) there is an express or implied agreement to assume the liabilities; (2) the transaction amounts to a consolidation or merger; (3) the successor entity is a mere continuation or reincarnation of the predecessor entity; or (4) the transaction was fraudulent, not made in good faith, or made without sufficient consideration. Thus, the general rule is one of successor nonliability, subject to four 'traditional' exceptions...." (Footnotes omitted.)

Respondents would only be entitled to recover if we expand the traditional "mere continuation" or continuity of *entity* exception and add the "continuity of *enterprise* " exception to the general rule of nonliability of corporate successors. [FN1] The mere continuation or continuity of entity exception applies where "there is a continuation of directors and management, shareholder interest and, in some cases, inadequate consideration. The gravamen of the traditional 'mere continuation' exception is the continuation of the *corporate entity* rather than continuation of the business operation." 1 Frumer & Friedman, *supra,* § 2.06[2][c], at 2-182 to 2- 183 (emphasis in original, footnote omitted); *accord* 1 *American Law of Products Liability 3d, supra,* § 7:14, at 30. This exception focuses on the continuation of management and ownership. In contrast, the continuity of *enterprise* theory focuses on continuation of the business operation or enterprise where there is no continuation in ownership. 1 *American Law of Products Liability 3d, supra,* § 7:20, at 36.

Respondents do not contend that Nissen is a "mere continuation" of American Tredex or that the sale of assets in the instant case falls within any of the traditional exceptions to the rule of nonliability of corporate successors, nor would the record support such an argument. Only if we expand the traditional exceptions to include a "continuity of enterprise" exception would Brandt be entitled to proceed against Nissen.

Brandt urges that we adopt the continuity of enterprise theory because it "is limited, proper and pertinent to the rights of a consumer who has suffered a personal injury for which some entity must be held responsible." He argues that "courts have logically prevented the evasion of liability by any part of the manufacturing and selling chain" and that, in recognition of this public policy, we should "not allow a major corporation to purchase only the benefits in an asset purchase transaction while denying its attendant liabilities to the consuming public, particularly where the successor corporation has held itself out to the public as the sponsor of the injury causing entity." Atlantic further argues that the traditional rule evolved to protect the rights of creditors and shareholders in the corporate context and is inapplicable in the case of products liability plaintiffs and that "[a] corporation contemplating not only the acquisition of the assets of another corporation, but also the continuation of the basic enterprise of that corporation must accept the burdens as well as the benefits of such a transaction." Atlantic contends that, because Nissen enjoyed American Tredex's goodwill and held itself out as the effective continuation of American Tredex, selling replacement parts, performing some contracts, retaining some employees, honoring existing 90-day warranties, and servicing customer accounts, it should bear the burden of American Tredex's liability for defective products.

Nissen counters that it was not part of the "manufacturing and selling chain"; it merely purchased American Tredex's assets. That transaction was fully negotiated, including the requirement that the predecessor corporation continue in existence after the sale, presumably so that it would be subject to suit in cases such as this. The price Nissen paid for the business was based on the total contract, including the provision that the predecessor retain all liability for injuries caused by defective products sold by it before the asset purchase. Nissen argues that we should adhere to "[t]he longstanding general rule and its well-defined limited exceptions" because they "have functioned well to balance the rights of creditors and successor corporations by preserving traditional principles of corporate law and promoting the free alienability of business assets while maintaining adequate protection for the interests of consumers and creditors from fraudulent and unjust corporate transactions." Nissen urges that the expansion of the traditional rule that Respondents propose would impose liability not only upon "a major corporation ... where the successor corporation has held itself out to the public as the sponsor of the injury causing entity," but also upon the small corporation that purchases assets and carries on a business but abandons its predecessor's defective, injury causing designs or practices.

The question of successor corporate liability in a products liability case has not heretofore been addressed by this Court. Interestingly, the issue was analyzed twice in 1988 by two different judges of the United States District Court for the District of Maryland, both applying Maryland law. Judge Niemeyer, on May 24, 1988, predicted Maryland would accept the continuity of enterprise theory. *Smith v. Navistar Intern. Transp. Corp.,* 687 F.Supp. 201, *republished as corrected,* 737 F.Supp. 1446 (D.Md.1988). Judge Smalkin, one week later, predicted we would not. *Giraldi v. Sears, Roebuck & Co.,* 687 F.Supp. 987 (D.Md.1988).

This Court espoused the doctrine of strict liability in tort as set forth in *Restatement (Second) of Torts* § 402A, in *Phipps v. General Motors Corp.,* 278 Md. at 353, 363 A.2d at 963, a case involving a defective automobile accelerator pedal. In that case, we traced the historical development of the tort and noted that "strict liability for defective products ... was imposed without privity or a showing of negligence beyond the defect in the product." *Id.* at 342, 363 A.2d at 957. Respondents argue that public policy demands that we accept the continuity of enterprise doctrine because, as stated by Brandt in his brief, "some entity must be held responsible" where "a consumer ... has suffered a personal injury." In *Phipps,* however, we clarified the basis for our adoption of strict products liability:

> "[T]he theory of strict liability is not a radical departure from traditional tort concepts. Despite the use of the term 'strict liability' the seller is not an insurer, as absolute liability is not imposed on the seller for any injury resulting from the use of his product. Proof of a defect in the product at the time it leaves the control of the seller implies *fault* on the part of the seller sufficient to justify imposing liability for injuries caused by the product." (Emphasis added, citation omitted.)

Id. at 351-52, 363 A.2d at 963. Thus, in adopting the cause of action for strict liability in tort, this Court has not abandoned the fundamental concept of fault.

We adopted the theory of strict liability in tort to foreclose the unfair result "where injured parties are forced to comply with the *proof requirements* of negligence actions or are confronted with the *procedural requirements* and limitations of warranty actions." *Id.* at 353, 363 A.2d at 963 (emphasis added). This rationale is echoed in our cases since *Phipps.* In *Harig v. Johns-Manville Products,* 284 Md. 70, 394 A.2d 299 (1978), we stated, "the theory of strict liability does not mark a 'radical departure' from established tort concepts. Rather, 'the major distinction between an action in strict liability in tort and one founded on traditional negligence theory relates to the *proof* which must be presented by the plaintiff.' " *Id.* at 83-84, 394 A.2d at 306-07 (quoting *Phipps,* 278 Md. at 350-51, 363 A.2d at 962) (emphasis added). In *Miles Laboratories v. Doe,* 315 Md. 704, 556 A.2d 1107 (1989), Chief Judge Murphy, writing for the Court, again stated the policy underlying strict products liability in Maryland:

> "The theory of strict liability, we said in *Phipps,* was not a radical departure from traditional tort concepts, even though the plaintiff in such an action need not prove any specific act of negligence on the part of the seller. What is required is proof of a defect existing in the product at the time it leaves the seller's control. Under strict liability principles, the seller is not an insurer, as absolute liability is not imposed on the seller for any injury resulting from the use of his product. Rather, '*[p]roof* of a defect in the product at the time it leaves the control of the seller *implies fault* on the part of the seller sufficient to justify imposing liability for injuries caused by the product.' "

It is clear that Maryland espoused the doctrine of strict liability in tort in order to relieve plaintiffs of the burden of proving specific acts of negligence by permitting negligence to be implied where plaintiffs can prove a product is defective and unreasonably dangerous when placed in the stream of commerce. While the "equity" of shifting the risk of loss to those better able to bear it financially was a policy consideration, it was neither the sole nor the predominant factor. It is clear from our decisions that inherent in our recognition of strict products liability is the concept that sellers who place defective and unreasonably dangerous products on the market are at fault when a user is injured by that activity and should bear responsibility. A corporate successor is not a seller and bears no blame in bringing the product and the user together. It seems patently unfair to require such a party to bear the cost of unassumed and uncontemplated products liability claims primarily because it is still in business and is perceived as a "deep pocket."

Respondent Atlantic argues that, because Nissen reaped the benefits of the goodwill of American Tredex, it would be unfair to permit it to escape the burden of paying American Tredex's tort liabilities. This argument lacks merit. It overlooks the fact that, if American Tredex products do cause injuries, Nissen will suffer a resultant loss in the value of the goodwill it purchased.

Although Brandt contends that we should "not allow a major corporation to purchase only the benefits in an asset purchase transaction while denying its attendant liabilities to the consuming public," he overlooks the fact that the remedy he seeks for this "injustice" may be unfairly broad. Were we to adopt continuity of enterprise, not only would liability be imposed upon "a major corporation," but it would also be imposed upon the small business

operation which may not be in a position to spread the risk or insure against it.

Brandt also complains that he was not "alerted to internal corporate changes which would prevent the protection properly due to a consumer of a product." We cannot accept the proposition implied by this argument that consumers retain products in reliance upon their ability to sue a certain entity if a problem develops with the product. Brandt was notified of the sale of American Tredex. Had he realized that he would not be able to sue the successor if he was injured, we doubt that he would have scrapped his treadmill and purchased a new one. Nissen did more than was required of it by providing the needed replacement parts at Brandt's request. The fact that Nissen maintained a network to service American Tredex customers and, in fact, furnished parts to Brandt for his treadmill does not give rise to successor liability. [FN3] Furthermore, we should not penalize Nissen for retaining a few of American Tredex's employees or for assuming some of American Tredex's commitments. All of these actions on Nissen's part have important societal value. While we recognize the societal value of permitting consumers to recover from those responsible when they are injured by a product, Nissen is not one of those responsible for Brandt's injuries.

The *Restatement (Second) of Torts* § 402A, upon which Maryland strict liability in tort law is based, *Phipps,* 278 Md. at 353, 363 A.2d at 963, does not contemplate imposition of liability upon successor corporations. *See Giraldi,* 687 F.Supp. at 991. As was noted by the Third Circuit in *Polius,*

"[T]he Restatement reaffirms the notion of a causal relationship between the defendant's acts and the plaintiff's injury--a concept that is fundamental to tort law. The corporate successor theories espoused by Michigan and California brush aside this bedrock requirement and impose liability on entities which in fact had no connection with the acts causing injury.

> Even the wholesaler or retailer who sells a defective product has some causal connection with the plaintiff's injury. The same cannot be said of the owner of a new business who manufactures an improved, defect-free, version of a product in a facility purchased from his predecessor....
>
> Under the continuity of enterprise theory, a new owner who continues his predecessor's operations may be liable if he manufactures some but not all of a number of items. If the new owner continues to manufacture ten items but decides not to produce one because it is too dangerous, he might nevertheless be liable for claims which his predecessor set in motion through the dangerous product." (Footnote omitted.)

802 F.2d at 81-82. The *Polius* court concluded that "the continuity of enterprise theory ... proposes an ill-considered extension of liability to an entity having no causal relationship with the harm." *Id.* at 82.

The status of acceptance of the continuity of enterprise doctrine has been reported as follows:

> "The continuity of enterprise exception to the general rule of successor nonliability has been adopted or treated as valid under the law of Alabama, Maryland [citing the Court of Special Appeals decision in the instant case], Michigan, Mississippi, and Ohio....

> The status of the continuity of enterprise exception has been a matter of uncertainty in ... New York, ... New Hampshire ... [and] South Carolina...." (Footnotes omitted.)

1 *American Law of Products Liability 3d, supra,* § 7:22, at 38-39. A brief review of the handful of cases relied on by Respondents to support the continuity of enterprise doctrine may be helpful.

Cyr v. B. Offen & Co., Inc., 501 F.2d 1145 (1st Cir.1974), was one of the first cases to grapple with the problem of successor corporate liability for injuries caused by defective products of a predecessor. The predecessor in *Cyr* was not a corporation, it was a sole proprietorship owned by Bernard Offen. Upon the death of the proprietor, the assets of Bernard Offen doing business as B. Offen Company were purchased by a group comprised of the employees of Bernard Offen and one outside financier. The business operation continued unchanged. The First Circuit, applying New Hampshire law, held that the successor could be liable for injuries caused by a product manufactured by its predecessor. The court reasoned that

> "a corporation itself cannot act. It can conduct its business only through its officers and employees. The negligence of employees in carrying out that business is the responsibility of the corporate body. If as a group the same employees continue, without pause to produce the same products in the same plant, with the same supervision, the ownership of the entity which maintains essentially the same name cannot be the sole controlling determinant of liability."

Id. at 1154. Although the successor was not a continuation of the entity of the predecessor under traditional analysis, the *Cyr* court apparently justified imposition of liability on the successor because it was owned by the employees of the predecessor. The court found a nexus between the owners of the successor corporation and those responsible for plaintiffs' injuries--the employees.

The leading case adopting the continuity of enterprise doctrine is *Turner v. Bituminous Cas. Co.,* 397 Mich. 406, 244 N.W.2d 873 (1976), a 3-2 decision involving a worker who suffered amputation of both hands as a result of a power press injury. The *Turner* majority refused to differentiate between a merger, a *de facto* merger, and a sale of assets for cash in the context of a products liability case. The court reasoned, "Products liability law is a fast-developing area. All the rules have not yet been formulated and products liability law, as it matures, has to shake off various impediments associated with traditional concepts, which, while relevant to other problems, are inappropriate for this new area." *Id.* 244 N.W.2d 873 at 877. Based on this nebulous rationale, the court determined that if products liability survived in a merger or *de facto* merger, it should also survive in a cash purchase of assets where the business operation continued uninterrupted. We do not agree that traditional rules of successor liability should be "shaken off" as "impediments." *Id.*

In *Andrews v. John E. Smith's Sons Co.,* 369 So.2d 781 (Ala.1979), the plaintiff had his right arm amputated after it was caught and pulled into a meat grinder. The meat grinder was manufactured by a corporation that later sold all of its assets to a successor. In that case, the Supreme Court of Alabama found the reasoning of *Turner* "persuasive" and stated that, where there was a continuity of enterprise, the successor corporation could be "estopped

from denying liability to innocent third parties." *Id.* at 786. Nevertheless, it affirmed summary judgment in favor of the successor corporation because plaintiff's complaint "g[ave] the defendant no notice whatsoever that it [was] to be held liable as the successor of the corporation that actually manufactured the meat grinder." *Id.* at 786.

Based on our examination of the decisions of our sister states adopting the continuity of enterprise theory, we fail to find a compelling reason to deviate from the traditional corporate successor liability rule.

For the reasons set forth in this opinion, we reject the continuity of enterprise theory of successor corporate liability. Like the majority of our sister states, we adhere to the general rule of nonliability of successor corporations, with its four traditional exceptions, in products liability cases.

In conclusion, our adoption of the cause of action for strict liability in tort does not abandon the fundamental principle that, in order to impose tort liability, there must be fault. The continuity of enterprise exception is inconsistent with Maryland law because "the basis for the continuity of enterprise exception is largely one of public or social policy under which it has been determined that, irrespective of fault, a party should be held to respond for the acts of another." 1 *American Law of Products Liability 3d, supra,* § 7:21, at 37. Since Respondents do not contend, and the record does not disclose, that Nissen is a continuity of entity of American Tredex under one of the traditional exceptions to the rule of nonliability of successor corporations, there is no genuine dispute as to a material fact. The Circuit Court for Baltimore City did not err in granting Nissen's motion for summary judgment.

JUDGMENT OF THE COURT OF SPECIAL APPEALS REVERSED

Attorney General v. M. C. K., Inc.

.

ATTORNEY GENERAL & another

v.

M.C.K., INC., & others.[FN2]

FN2. Reifer, Inc.; Nicha, Inc.; Parnasah, Inc.; Likra, Inc.; Mick D., Inc.; and Michael Konig.

Argued Sept. 7, 2000.
Decided Oct. 13, 2000.

GREANEY, J.

This case concerns the authority of a receiver appointed by the Superior Court under G.L. c. 111, § 72R (the so-called Patient Protector Receivership Act [Act]), to sell a nursing home which has been placed under court supervision, because financial responsibility for the home was disclaimed by the owner, and the home's residents were endangered. A judge in the Superior Court entered an order directing that the home be sold and reported the propriety of her order. Another judge in the Superior Court entered a subsequent order that the home be closed. We granted the plaintiffs' application for direct appellate review because this is the first case that requires an interpretation of a receiver's authority to deal with a facility under the provisions of the Act. We conclude that the order directing sale was proper, but that there must be further proceedings to decide whether the home should be sold or closed.

1. The following background provides an understanding of the issues in the case. In 1993, the defendant Michael Konig (Konig) purchased five nursing homes in Massachusetts. In each instance, Konig established a corporation to hold title to the real estate on which each home was located, and he created a separate corporation which applied for, and held, the license to operate each home. The Union Square Nursing Center (Union Square), a 150-bed long term care facility in the Brighton-Allston section of Boston, was one of these nursing homes. In the case of Union Square, Konig established Reifer, Inc. (Reifer), to hold title to the real estate and tangible assets used in the operation of the home, and M.C.K., Inc. (MCK), to apply for, and to hold, the home's license. Konig was the sole shareholder of both MCK and Reifer.

In 1995, the Department of Public Health (department) conducted its annual inspection survey of Valley View Nursing Home in Lenox, one of the five nursing homes purchased by Konig.[FN3] The survey disclosed conditions constituting an immediate and serious threat to the health and safety of the residents, resulting in a finding by the department of “jeopardy.”[FN4] When jeopardy conditions had not been corrected by the time of the department's follow-up survey, the department terminated Valley View's certification. Shortly thereafter, the department found jeopardy in another Konig-controlled home, the Crescent Hill Nursing Center in Springfield. The fact that jeopardy had been found at two Konig-controlled homes within a two-month period raised immediate concerns about the health and safety of residents at each of the five Konig-controlled homes. As a result, the department informed Konig that it might commence proceedings to revoke his licenses to operate the five nursing homes.[FN5]

The department, and the defendants involved here, entered into a settlement agreement. In the agreement, MCK and Reifer agreed, that, as to Union Square, unless both had executed a purchase and sale agreement with a prospective buyer that had submitted a notice of intent to acquire a license for Union Square, MCK would submit to the department a notice of intent to close Union Square. MCK and Reifer also agreed to continue to retain a management company, which had been acting as temporary manager of each of the five nursing homes, until Union Square was either sold or closed. In exchange, the department agreed not to take further regulatory action against Konig, or his nursing homes, based on the prior documented violations. Konig signed the agreement in his capacity as president of all the multiple

corporations involved in ownership of the nursing homes, including MCK and Reifer.[FN6]

FN6. Konig also signed in his individual capacity for the limited purpose of agreeing to a portion of the facts set forth in the agreement, and for the additional purpose of agreeing not to operate any nursing homes in the Commonwealth for a period of ten years from the date of execution of the agreement.

After passage of considerable time, Konig had neither closed nor sold Union Square. In a letter to the department dated June 12, 1997, and signed by Konig as president, MCK "disclaim[ed] responsibility and or liability with respect to ... closure and any operations of this facility [Union Square]." By this communication, MCK and Konig sought to abandon Union Square. Their conduct placed Union Square residents in imminent danger of death or serious physical harm.

The department and the Attorney General (Commonwealth) promptly filed a complaint in the Superior Court against MCK, Reifer, and Konig, seeking the appointment of a receiver under the provisions of G.L. c. 111, § 72M, and seeking injunctive relief and civil penalties under the provisions of G.L. c. 93A, §§ 2 and 4.[FN7] A judge of the Superior Court appointed a temporary receiver of "M.C.K., Inc. d/b/a Union Square (referred to as 'The Facility')." The judge also ordered that, under G.L. c. 111, § 72Q, a lien for the costs of the receivership be imposed on the property on which Union Square is located.

On March 18, 1999, the Commonwealth moved, under G.L. c. 111, § 72R, to terminate the receivership of Union Square by a court-ordered sale of the nursing home, including its equipment, and the building and the real estate upon which the nursing home is located. A judge in the Superior Court determined that, while G.L. c. 111, § 72R, clearly authorized a sale under court supervision of Union Square, the Act did not authorize a court-ordered sale of the separately owned real estate upon which the nursing home is located. The judge observed, however, that the language of § 72M might, in appropriate circumstances, justify disregard of a separate corporate entity, and so concluded that a lawful order to sell the real estate of Union Square, which is owned by Reifer, would require that the court first "pierce the corporate veil of Reifer, Inc." The judge denied the Commonwealth's motion to sell without prejudice; severed the receivership action from the Commonwealth's separate claims under G.L. c. 93A; and ordered an expedited trial for a factual determination whether circumstances warranted treatment in law of MCK and Reifer as essentially one and the same.

After that trial, the judge, based on her finding and ruling that, "MCK and Reifer are in fact the alter egos of Konig and disregard of their separate corporate forms is warranted," ordered the sale of Union Square. The judge then reported the propriety of her order.[FN9] We granted direct appellate review. Thereafter, the receiver of Union Square filed an unopposed motion for authority to close the nursing home. After a hearing, another judge in the Superior Court allowed the motion.

2. We next summarize the relevant features of the Act. The Act authorizes the Superior

Court, on a complaint by the Attorney General, the department of public health, or other interested parties, to "appoint a receiver for any institution subject to licensing under section seventy-one, hereinafter called a facility,"[FN12] when the court finds that an emergency exists [FN13]; when the facility is operating without a license; or in situations when the licensing status of the institution is otherwise uncertain, and the lives, health, safety, or welfare of the residents cannot be adequately assured pending the court's decision. G.L. c. 111, 72M. The purpose of a receivership under the Act is to "safeguard the health, safety and continuity of care to residents and to protect them from the adverse health effects and increased risk of death caused by abrupt or unsuitable transfer." G.L. c. 111, § 72N.

A receiver, with court approval, is authorized to "remedy violations of federal and state law and regulations governing the operation of the facility; to hire, direct, manage and discharge any consultant or employees, including the administrator of the facility; to receive and expend in a reasonable and prudent manner the revenues of the facility; to continue the business of the facility and the care of the residents; to perform those acts necessary or desirable to accomplish the purpose of the receivership; to perform regular accountings and make periodic reports to the court; and to exercise such additional powers and perform such additional duties, as the court may deem appropriate." G.L. c. 111, § 72O. The Act contemplates that the receiver may also make major repairs to the real or personal property of the facility, to the extent necessary to prevent or remove jeopardy to the health, safety, or welfare of the residents, or to minimally qualify the facility for continuing participation in Medicare or Medicaid programs.[FN14] *Id.* The purpose of this provision is to "protect residents and to prevent the closure of facilities which, given proper management, are likely to be viable operations." *Id.*

The Act further provides that the Commonwealth shall have a lien for any expenditure under the above provisions, on the building or the land upon which the facility is located, or on any fixtures, equipment, or goods used in the operation of the facility. G.L. c. 111, § 72Q. As an additional remedy for recovering Commonwealth expenditures, the licensee, persons responsible for the affairs of the licensee, or the owner, "may be held liable for such expenditures to the extent that any of these persons benefits financially from the expenditure." *Id.* Recovery of expenses incurred by the Commonwealth is also available against any person who, prior to the appointment of the receiver, violated a legal responsibility to assure appropriate maintenance of the facility, if any such violation necessitated the expenditure by the Commonwealth, and against any person who was responsible for the abandonment of the facility. *Id.*

Finally, the Act sets forth conditions whereby the court may terminate a receivership, and provides that, if the receivership has not been terminated within twelve months of the appointment of the receiver, the court shall order "either that the facility shall be closed, after an orderly transfer of the residents to appropriate alternative placements; or the facility shall be sold, under reasonable terms approved by the court, to a new owner approved for licensure by the department." G.L. c. 111, § 72R. The Act also provides that the receivership period may be extended as necessary to protect the health and safety of the residents. *Id.*

3. We turn now to the decision of the issues on appeal.

[1] (a) This case essentially concerns the propriety of the judge's order to sell Union Square, including the real estate on which the home is located. The defendants claim that events subsequent to the entry of this order, namely, an order allowing the home to be closed; the transfer of all of the home's residents to other placements; and the closing of the home, render the appeal moot. We disagree.

The receivership is still in effect, and, for reasons that we shall discuss shortly, whether Union Square remains viable as a long-term care facility, or whether its continued operation is still desirable to protect its residents, is a matter that the Superior Court should decide. Further, the overriding purpose of the Act is to safeguard the health, safety, and continuity of care of nursing home residents, and to protect them from adverse effects caused by transfer necessitated by the closing of a nursing home. Because it is clear that the closing of Union Square was due, in substantial part, to financial difficulties inherent in keeping the home open pending appeal of the receiver's authority to sell, we conclude that the appeal presents important issues which are clearly "capable of repetition, yet evading review," and which ought to be resolved. *Karchmar v. Worcester,* 364 Mass. 124, 136, 301 N.E.2d 570 (1973), quoting *Southern Pac. Terminal Co. v. ICC,* 219 U.S. 498, 515, 31 S.Ct. 279, 55 L.Ed. 310 (1911).

[2] (b) General Laws c. 111, § 72R, authorizes a court to order the sale of a "facility." The defendants maintain that the term "facility" refers solely to the entity that holds the license to operate a nursing home. Thus, while acknowledging that the court has the authority to order the sale of property owned by MCK, as the licensee, the defendants question the court's authority to order the sale of property owned by Reifer, a separate corporation. The Commonwealth, on the other hand, maintains that the term "facility" encompasses not only the licensed entity but also the real estate on which it is located, irrespective of the identity of the landowner. Neither argument is quite correct. We conclude that the term "facility," as used in G.L. c. 111, § 72R, may, in appropriate circumstances, encompass the real estate on which the nursing home is located.

The precise statutory meaning of the term "facility" is elusive. A "facility" is defined in the Act as "any institution subject to licensing under section seventy-one." G.L. c. 111, § 72M. Section 71 provides for the licensing of nursing homes, and defines a "nursing home," for purposes of § 72, as "any institution, however named, whether conducted for charity or profit, which is advertised, announced or maintained for the express or implied purpose of caring for four or more persons admitted thereto for the purpose of nursing or convalescent care." Department licensing regulations, in turn, define an "institution" as "an establishment housed in a single building or in two or more adjacent buildings"; define a "facility" as a long-term care facility; define a "long-term care facility" as an institution; and list nursing homes as long-term care facilities. 105 Code Mass. Regs. § 150.001 (1994). The only certainty offered by the circuitous language set forth above is that the terms "facility," "institution," "long-term care facility," and "nursing home" are, for our purposes, synonymous.

Common sense dictates that the authority to sell a “facility” cannot include, in every case, the authority to sell the building in which the home is housed, the land on which the home is located, and the personal property used in the operation of the home, regardless of its ownership.[FN15] The Act clearly contemplates that the owners of real property on which the home is located may not be the same as the licensee. See, e.g., G.L. c. 111, § 72O (requiring notice to owner of real estate, as well as to licensee, should receiver petition court for permission to apply for loan for capital repairs), § 72P (setting forth procedures whereby receiver may apply to court to set reasonable rental for certain leases when real or personal property subject to lease is necessary to continued operation of facility).[FN16] Noticeably absent from the Act is any requirement of notice to the owners of real estate and a hearing before the court orders the sale of a facility. We think this absence is some indication that the Legislature did not intend generally to authorize a court to sell the property of a third-party landowner. Furthermore, such a sale could present constitutional difficulties that the Legislature may not have contemplated or intended.[FN17]

While we recognize that the entity that holds the license is not required to be the owner of the real and personal property used in the operation of the home, the licensed entity must have a department-approved substantial ownership interest (a long-term lease, for example) in the property. The department requires that “[a]n applicant [for a license] or licensee must be the owner of the premises on which the facility is operated, or at least have such rights of ownership as the Commissioner or his/her designee finds necessary for the operation of a long-term care facility.” 105 Code Mass. Regs. § 153.008 (1994). We conclude, as did the judge in her decision for sale of Union Square, that the scope of the court's authority to sell a “facility,” pursuant to G.L. c. 111, § 72R, is essentially fact specific, and depends in each case on the particular ownership interests in the real and personal property possessed by the licensed entity.

When, as is the case here, the licensed corporate entity owns nothing but the license to operate the nursing home, the statutory authority to sell the “facility” may include the power to sell other property necessary to operate the facility. This is so because the license to operate a nursing home is terminated by the imposition of a receivership, rendering the former licensee a corporate shell. The power to sell a shell corporation, that has no ownership rights in the real and personal property used in the operation of the nursing home, would be meaningless. As the judge correctly concluded: “If Konig were able to place all real and tangible property used in the operation of Union Square beyond the power of sale granted by the Legislature by the simple expedient of creating separate corporations which have no real existence apart from him, the statutory objective served by the power of sale would be thwarted.” The court would lack any ability to protect nursing home residents from the trauma of abrupt transfer, a situation that would frustrate the Legislature's purpose. In such a case, a court may consider whether application of the doctrine of corporate disregard is warranted. See *Packard Clothes Inc. v. Director of the Div. of Employment Sec.,* 318 Mass. 329, 335, 61 N.E.2d 528 (1945).

The doctrine of corporate disregard is an equitable tool that authorizes courts, in rare

situations, to ignore corporate formalities, where such disregard is necessary to provide a meaningful remedy for injuries and to avoid injustice. See *My Bread Baking Co. v. Cumberland Farms, Inc.,* 353 Mass. 614, 620, 233 N.E.2d 748 (1968). In certain situations, the doctrine may also properly be used to carry out legislative intent and to avoid evasion of statutes. See *Packard Clothes Inc. v. Director of the Div. of Employment Sec., supra.* See also C.A. Peairs, Jr., Business Corporations § 646, at 565 (2d ed.1971) ("corporate entity will be disregarded when necessary to ... consummate the objective of a statute or other overriding public policy which would be frustrated by observance of the entity").

The judge here properly disregarded the corporate entities. She thoroughly reviewed the evidence and evaluated each of the twelve factors to be considered when a court is faced with the issue of setting aside corporate formalities.[FN19] She made careful findings of facts,[FN20] and was well warranted in concluding, that the facts demonstrated pervasive control of MCK and Reifer by Konig; confused intermingling of activity and assets among MCK, Reifer, and other Konig-controlled corporations; the existence of a common enterprise; the siphoning of corporate assets for the benefit of Konig and Konig-controlled and Konig-related entities; thin capitalization; failure to observe corporate formalities; and substantial disregard of corporate identities. The judge properly concluded that there was a clear showing of frustration of the Act, and a showing of the likelihood of injury to the residents of Union Square, if the court was not able to enter appropriate orders against Reifer, as well as MCK, which "are in fact the *alter egos* of Konig."

> FN19. The relevant factors are (1) common ownership; (2) pervasive control; (3) confused intermingling of business assets; (4) thin capitalization; (5) nonobservance of corporate formalities; (6) absence of corporate records; (7) no payment of dividends; (8) insolvency at the time of the litigated transaction; (9) siphoning away of corporation's funds by dominant shareholder; (10) nonfunctioning of officers and directors; (11) use of the corporation for transactions of the dominant shareholders; and (12) use of the corporation in promoting fraud. *Pepsi-Cola Metro. Bottling Co. v. Checkers, Inc.,* 754 F.2d 10, 14-16 (1st Cir.1985) (categorizing criteria set forth in *My Bread Baking Co. v. Cumberland Farms, Inc.,* 353 Mass. 614, 233 N.E.2d 748 [1968]); *Evans v. Multicon Constr. Corp.,* 30 Mass.App.Ct. 728, 733, 574 N.E.2d 395 (1991).

We reject the defendants' argument that, because the Commonwealth and the department were aware that MCK and Reifer were separate entities, the facts do not present an element of deception or fraud on the defendants' part, which, they claim, is required before a court may disregard corporate formalities. The facts here present a situation where two corporations (MCK and Reifer) were formed to carry out the objectives and purposes of the person controlling them (Konig). No impropriety is attached, necessarily, to the use of the corporate form in this way. Nevertheless, when one of the corporations (Reifer) later seeks to disassociate itself from the other (MCK), in a way that leads to complete frustration of a statutory purpose, the court may be warranted in carefully scrutinizing the corporate form, regardless whether actual fraud has been shown. See *My Bread Baking Co. v. Cumberland Farms, Inc., supra* at 618-619, 233 N.E.2d 748. "Where there is common control of a group

of separate corporations engaged in a single enterprise, failure (a) to make clear which corporation is taking action in a particular situation and the nature and extent of that action, *or* (b) to observe with care the formal barriers between the corporations with a proper segregation of their separate businesses (see *Acton Plumbing & Heating Co. v. Jared Builders, Inc.,* 368 Mich. 626, 628-630, 118 N.W.2d 956 [1962]), records, and finances, may warrant some disregard of the separate entities in rare particular situations in order to prevent gross inequity" (emphasis added). *Id.* at 620, 118 N.W.2d 956.

It is true that the Commonwealth and the department knew that MCK and Reifer were, in theory, separate corporations. In several instances, however, the actions of the Commonwealth and the department demonstrate their reasonable assumption that, for practical purposes, MCK and Reifer were one and the same entity, and that both corporations were alter egos of Konig. First, the department granted a license to MCK to operate Union Square, in spite of the fact that MCK had no ownership interest in any of the real and personal property required for the home's operation. Second, the receiver never paid, and was never asked to pay, rent to Reifer during the two years of the receivership.[FN22] Third, from the beginning, settlement negotiations between the Commonwealth and the defendants included Reifer as an active participant in the operations of the nursing home.[FN23] It is apparent here that both the Commonwealth and the department relied on their knowledge, and reasonable expectations, that MCK and Reifer were both owned and controlled solely by Konig, and were, in practical terms, one and the same entity.[FN24]

We conclude that when, as here, the license, the real estate, and the personal property are held by entities that are treated as one, the court is authorized, pursuant to G.L. c. 111, § 72R, to order the sale of the real estate and tangible property used in the operation of a nursing home.[FN25]

(c) We also conclude that the receiver's power to sell was not terminated by the transfer of the residents of Union Square to other facilities. Section 72R authorizes a judge overseeing a receivership to "order either that the facility shall be closed, after an orderly transfer of the residents to appropriate alternative placements; or [that] the facility shall be sold, under reasonable terms approved by the court, to a new owner approved for licensure by the department." We are of the view that the power to sell ends only when the judge concludes that the facility in issue should be *permanently* closed. The power to sell, therefore, remains extant when appropriate circumstances dictate that the facility be *temporarily* closed, but the opportunity exists to reopen it under new ownership. Our view necessarily supports what appears to be a clear legislative intent to provide residents of facilities with safe and humane care at a time when there might be a shortage of adequate facilities to do so.

A few examples will illustrate the point.

(i) Suppose the receiver determines that the facility in receivership needs major capital improvements in order to satisfy legal requirements and ensure the health and safety of its residents. The improvements are such that they cannot be done with the residents remaining in the facility, and so, in order to do the improvements, the residents are transferred. The

improvements are made and the facility is ready to reopen. Surely, no one could persuasively argue that the judge, on proper motion by the receiver, could not allow the facility to be sold to a new licensed owner so that the facility remains available for any former residents, who are able to return, or for new residents.

(ii) Suppose that the receiver determines that the residents of the facility need to be transferred for reasons other than those given in example (i). Suppose then that the judge orders the facility to be sold, but that efforts to sell are frustrated by the owner or operator of the facility (or both) pursuing an appeal, as they have a right to do. The normal delay in the appellate process dampens the receiver's efforts to sell, but the receiver believes and maintains, and the judge agrees, that the appeal's having been decided in favor of the receiver, a renewed effort to sell should be made. Once again this presents a case of a temporary closing with the power of sale remaining available within time limits and on conditions fashioned or approved by the judge.

This last example is somewhat the case here. Sale was authorized by a judge under § 72R, but the receiver, due to the delay in the appeal, and, perhaps, other circumstances, was unable to find a suitable buyer.[FN26] Now that the receiver has prevailed on this appeal, may he not seek to sell for a reasonable time if a judge approves? This is the position of the Commonwealth in this case. As it states in its brief: “Union Square's residents were transferred to other facilities in December of 1999. Efforts are being made to determine the health status of these residents, and whether a voluntary relocation to Union Square, assuming the facility is reopened, would be feasible or desirable. Whether Union Square is still viable as a long term care facility, or whether its continued operation is desirable to protect residents is a matter which the Superior Court may decide.” This position on the part of the Commonwealth is not unreasonable.

As has been stated, the general purpose of the Act is to protect the residents of a long term care facility from adverse health effects resulting from abrupt or unsuitable transfers. In her findings, the judge recognized certain unique characteristics of the resident population of Union Square. The home's residents had a significantly higher incidence of psychiatric diagnoses, as well as a higher incidence of cognitive impairment, than the average nursing home residents in the Commonwealth. The home's residents also had a longer average length of stay than nursing home residents generally. In addition, the home's residents were statistically different from the average nursing home resident in their racial and ethnic diversity. While the population of most nursing homes is ninety-eight per cent white, the population of Union Square was sixty-seven per cent white. Union Square was one of only two nursing homes in the Boston area with a substantial Chinese-speaking population. The home attracted residents from the Chinese population because language is the single most important factor in choosing a nursing home for Chinese-speaking families, and Union Square employed both nursing and social services staff that spoke, collectively, three Chinese dialects. The home also offered special dietary, cultural, and social activities for Chinese residents. Further, Union Square was an urban facility, accessible by public transportation, an essential need for many of the home's residents and their families. These characteristics made the home's residents particularly vulnerable to the effects of relocation.

The judge further found that, because of the unique characteristics of Union Square's resident population, suitable placement options did not exist for all residents. At the date of the hearing, there was no nursing facility in the relevant geographical area that had committed to taking the Chinese-speaking residents of Union Square as a group, or to taking Chinese-speaking staff. In addition, care of the high percentage of the home's residents who had psychiatric diagnoses or were cognitively impaired required skills (that) were not available in the average facility. The judge found that Union Square's residents were at an increased risk of illness and death from involuntary transfers that would result from the closing of Union Square.

The judge determined that Union Square was a viable nursing facility, and that the statutory scheme and purposes of the Act would best be effectuated by its sale. The question whether Union Square can, and should be, preserved as a viable facility is one that cannot be satisfactorily resolved on this record, but is one which should be explored further.[FN28]

4. The case is remanded to the Superior Court to reconsider the conflicting orders in effect regarding Union Square. In accordance with this opinion, the receiver and the Commonwealth may, if they chose, apply to a judge to vacate the order closing the facility, to vacate the order to sell the facility, or both. The judge may, at his or her discretion, enter a new order directing Union Square to be sold on appropriate terms and conditions, and within a time limit, as the judge may decide. If a sale is not allowed, or cannot be effectuated, then the judge should reenter the order closing the facility, pursuant to G.L. c. 111, § 72R, and take such further action as is necessary or appropriate to terminate the receivership and to allow the Commonwealth to recover its costs and expenses.

So ordered.

Introduction to Closely Held Corporations

Now that you've got a firm grip on the distinctions between partnership and corporations, it's time to muddy the waters a bit by introducing you to a special subspecies of corporation, the closely held corporation (sometimes called the "close" or "closed" corporation). Closely held refers to the stock. It's not Microsoft. It's a corporation with a few shareholders, no ready market for the shares (its not publicly traded on any stock exchange), and the shareholders are actively involved in the management of the corporation. Some jurisdictions have statutory definitions of what constitutes a closely held corporation.

Think about your 10 shares of Microsoft for a second You know that you have no right to manage the corporation as a result of your ownership of a very small piece of the corporation. You bought the stock as an investment. You trusted the directors and officers to make money for you. It is a passive investment. You intend to buy low, and sell high.

Now think about going into business with a few of your college buddies. There are four of you, and each of you owns 25% of the stock. This isn't a passive investment for you. You are all going to apply your talents and work to make this company a success. All profits from the enterprise are going to pay salaries. There will be no dividends, and any money left over will be plowed back into the business.

The differences between the two corporations are profound. The expectations of the shareholders are equally different in these two cases, and these differences are just as profound. As a matter of fact, when you go into business with your college buddies, you don't think of them as fellow shareholders, you think of them as your partners. Talk about a huge hint.

Discussion points for Donahue v. Rodd Electrotype

Understand how Harry Rodd came to be the dominant shareholder of Royal of New England, since he only bought 200 shares of the 1,000 shares which were issued, and never bought any more. And you are presented with the Massachusetts definition of a "close" corporation. Please memorize all three elements. The court correctly states that many close corporations are really partnerships between two or three people. And, finally, note all of the ways the majority owners can use their voting power to benefit themselves but not the other shareholders (and, if equality of treatment is the standard, benefitting one set of shareholders but not others means that you are harming the other shareholders). Would the same result occur in a non-close corporation? Could the Rodds have done things differently to get the result they wanted?

Donahue v. Rodd Electrotype

Supreme Judicial Court of Massachusetts, Middlesex.

Argued Oct. 8, 1974.

Decided May 2, 1975.

TAURO, Chief Justice.

The plaintiff, Euphemia Donahue, a minority stockholder in the Rodd Electrotype Company of New England, Inc. (Rodd Electrotype), a Massachusetts corporation, brings this suit against the directors of Rodd Electrotype, Charles H. Rodd, Frederick I. Rodd and Mr. Harold E. Magnuson, against Harry C. Rodd, a former director, officer, and controlling

stockholder of Rodd Electrotype and against Rodd Electrotype (hereinafter called defendants). The plaintiff seeks to rescind Rodd Electrotype's purchase of Harry Rodd's shares in Rodd Electrotype and to compel Harry Rodd 'to repay to the corporation the purchase price of said shares, $36,000, together with interest from the date of purchase.' The plaintiff alleges that the defendants caused the corporation to purchase the shares in violation of their fiduciary duty to her, a minority stockholder of Rodd Electrotype.

The trial judge, after hearing oral testimony, dismissed the plaintiff's bill on the merits. He found that the purchase was without prejudice to the plaintiff and implicitly found that the transaction had been carried out in good faith and with inherent fairness. The Appeals Court affirmed with costs. Donahue v. Rodd Electrotype Co. of New England, Inc., --- Mass.App. ---,[FNa], 307 N.E.2d 8 (1974).
The case is before us on the plaintiff's application for further appellate review.

[1][2] The trial judge entered voluntary findings of fact which do not appear to state the complete ground for his decision. The evidence is reported. Accordingly, it is the duty of this court to examine the evidence and to form an independent judgment on the facts in the case. Due weight must be given to the fidings of the trial judge, who has heard the witnesses and has had an opportunity to gauge their credibility and reliability. His findings of fact based on oral testimony will not be reversed unless they are plainly wrong. Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 407, 8 N.E.2d 895 (1937); Seder v. Gibbs, 333 Mass. 445, 446, 131 N.E.2d 376 (1956). However, all inferences to be drawn from the facts are open on this appeal.

The evidence may be summarized as follows: In 1935, the defendant, Harry C. Rodd, began his employment with Rodd Electrotype, then styled the Royal Electrotype Company of New England, Inc. (Royal of New England). At that time, the company was a wholly-owned subsidiary of a Pennsylvania corporation, the Royal Electrotype Company (Royal Electrotype). Mr. Rodd's advancement within the company was rapid. The following year he was elected a director, and, in 1946, he succeded to the position of general manager and treasurer.

In 1936, the plaintiff's husband, Joseph Donahue (now deceased), was hired by Royal of New England as a 'finisher' of electrotype plates. His duties were confined to operational matters within the plant. Although he ultimately achieved the positions of plant superintendent (1946) and corporate vice president (1955), Donahue never participated in the 'management' aspect of the business.

In the years preceding 1955, the parent company, Royal Electrotype, made available to Harry Rodd and Joseph Donahue shares of the common stock in its subsidiary, Royal of New England. Harry Rodd took advantage of the opportunities offered to him and acquired 200 shares for $20 a share. Joseph Donahue, at the suggestion of Harry Rodd, who hoped to interest Donahue in the business, eventually obtained fifty shares in two twenty-five share lots priced at $20 a share. The parent company at all times retained 725 of the 1,000 outstanding shares. One Lawrence W. Kelley owned the remaining twenty-five shares.

In June of 1955, Royal of New England purchased all 725 of its shares owned by its parent company. The total price amounted to $135,000. Royal of New England remitted $75,000 of this total in cash and executed five promissory notes of $12,000 each, due in each of the succeeding five years. Lawrence W. Kelley's twenty-five shares were also purchased at this time for $1,000. A substantial portion of Royal of New England's cash expenditures was loaned to the company by Harry Rodd, who mortgaged his house to obtain some of the necessary funds.

The stock purchases left Harry Rodd in control of Royal of New England. Early in 1955, before the purchases, he had assumed the presidency of the company. His 200 shares gave him a dominant eighty per cent interest. Joseph Donahue, at this time, was the only minority stockholder.

Subsequent events reflected Harry Rodd's dominant influence. In June, 1960, more than a year after the last obligation to Royal Electrotype had been discharged, the company was renamed the Rodd Electrotype Company of New England, Inc. In 1962, Charles H. Rodd, Harry Rodd's son (a defendant here), who had long been a company employee working in the plant, became corporate vice president. In 1963, he joined his father on the board of directors. In 1964, another son, Frederick I. Rodd (also a defendant), replaced Joseph Donahue as plant superintendent. By 1965, Harry Rodd had evidently decided to reduce his participation in corporate management. That year Charles Rodd succeeded him as president and general manager of Rodd Electrotype.

From 1959 to 1967, Harry Rodd pursued what may fairly be termed a gift program by which he distributed the majority of his shares equally among his two sons and his daughter, Phyllis E. Mason. Each child received thirty-nine shares. Two shares were returned to the corporate treasury in 1966.

We come now to the events of 1970 which form the grounds for the plaintiff's complaint. In May of 1970, Harry Rodd was seventy-seven years old. The record indicates that for some time he had not enjoyed the best of health and that he had undergone a number of operations. His sons wished him to retire. Mr. Rodd was not averse to this suggestion. However, he insisted that some financial arrangements be made with respect to his remaining eighty-one shares of stock. A number of conferences ensued. Harry Rodd and Charles Rodd (representing the company) negotiated terms of purchase for forty-five shares which, Charles Rodd testified, would reflect the book value and liquidating value of the shares.

A special board meeting convened on July 13, 1970. As the first order of business, Harry Rodd resigned his directorship of Rodd Electrotype. The remaining incumbent directors, Charles Rodd and Mr. Harold E. Magnuson (clerk of the company and a defendant and defense attorney in the instant suit), elected Frederick Rodd to replace his father. The three directors then authorized Rodd Electrotype's president (Charles Rodd) to execute an agreement between Harry Rodd and the company in which the company would purchase forty- five shares for $800 a share ($36,000).

The stock purchase agreement was formalized between the parties on July 13, 1970. Two days later, a sale pursuant to the July 13 agreement was consummated. At approximately the same time, Harry Rodd resigned his last corporate office, that of treasurer.

Harry Rodd completed divestiture of his Rodd Electrotype stock in the following year. As was true of his previous gifts, his later divestments gave equal representation to his children. Two shares were sold to each child on July 15, 1970, for $800 a share. Each was given ten shares in March, 1971. Thus, in March, 1971, the shareholdings in Rodd Electrotype were apportioned as follows: Charles Rodd, Frederick Rodd and Phyllis Mason each held fifty-one shares; the Donahues held fifty shares.

A special meeting of the stockholders of the company was held on March 30, 1971. At the meeting, Charles Rodd, company president and general manager, reported the tenative results of an audit conducted by the company auditors and reported generally on the company events of the year. For the first time, the Donahues learned that the corporation had purchased Harry Rodd's shares. According to the minutes of the meeting, following Charles Rodd's report, the Donahues raised questions about the purchase. They then voted against a resolution, ultimately adopted by the remaining stockholders, to approve Charles Rodd's report. Although the minutes of the meeting show that the stockholders unanimously voted to accept a second resolution ratifying all acts of the company president (he executed the stock purchase agreement) in the preceding year, the trial judge found, and there was evidence to support his finding, that the Donahues did not ratify the purchase of Harry Rodd's shares. Cf. Braunstein v. Devine, 337 Mass. 408, 413, 149 N.E.2d 628 (1958).

A few weeks after the meeting, the Donahues, acting through their attorney, offered their shares to the corporation on the same terms given to Harry Rodd. Mr. Harold E. Magnuson replied by letter that the corporation would not purchase the shares and was not in a financial position to do so.[FN10] This suit followed.

> FN10. Between 1965 and 1969, the company offered to purchase the Donahue shares for amounts between $2,000 and $10,000 ($40 to $200 a share). The Donahues rejected these offers.

In her argument before this court, the plaintiff has characterized the corporate purchase of Harry Rodd's shares as an unlawful distribution of corporate assets to controlling stockholders. She urges that the distribution constitutes a breach of the fiduciary duty owed by the Rodds, as controlling stockholders, to her, a minority stockholder in the enterprise, because the Rodds failed to accord her an equal opportunity to sell her shares to the corporation. The defendants reply that the stock purchase was within the powers of the corporation and met the requirements of good faith and inherent fairness imposed on a fiduciary in his dealings with the corporation. They assert that there is no right to equal opportunity in corporate stock purchases for the corporate treasury. For the reasons hereinafter noted, we agree with the plaintiff and reverse the decree of the Superior Court. However, we limit the applicability of our holding to 'close corporations,' as hereinafter

defined. Whether the holding should apply to other corporations is left for decision in another case, on a proper record.

A. Close Corporations. In previous opinions, we have alluded to the distinctive nature of the close corporation (e.g., Brigham v. M. & J. Corp., 352 Mass. 674, 678, 227 N.E.2d 915 (1967); see Samia v. Central Oil Co. of Worcester, 339 Mass. 101, 112--113, 158 N.E.2d 469 (1959)), but have never defined precisely what is meant by a close corporation. There is no single, generally accepted definition. Some commentators emphasize an 'integration of ownership and management' ****. Others focus on the number of stockholders and the nature of the market for the stock. In this view, close corporations have few stockholders; there is little market for corporate stock. The Supreme Court of Illinois adopted this latter view in Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1965): 'For our purposes, a close corporation is one in which the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, dealt in by buying or selling.' Id. at 27, 203 N.E.2d at 583. Accord, Brooks v. Willcuts, 78 F.2d 270, 273 (8th Cir. 1935). See, generally, F. H. O'Neal, Close Corporations: Law and Practice, s 1.02 (1971). We accept aspects of both definitions. We deem a close corporation to the typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation.

[3] As thus defined, the close corporation bears striking resemblance to a partnership. Commentators and courts have noted that the close corporation is often little more than an 'incorporated' or 'chartered' partnership. Ripin v. United States Woven Label Co., 205 N.Y. 442, 447, 98 N.E. 855, 856 (1912) ('little more (though not quite the same as) than chartered partnerships'). The stockholders 'clothe' their partnership 'with the benefits peculiar to a corporation, limited liability, perpetuity and the like.' In the Matter of Surchin v. Approved Bus. Mach. Co., Inc., 155 Misc.,2d 888, 889, 286 N.Y.S.2d 580, 581 (Sup.Ct.1967). In essence, though, the enterprise remains one in which ownership is limited to the original parties or transferees of their stock to whom the other stockholders have agreed, in which ownership and management are in the same hands, and in which the owners are quite dependent on one another for the success of the enterprise. Many close corporations are 'really partnerships, between two or three people who contribute their capital, skills, experience and labor.' Kruger v. Gerth, 16 N.Y.2d 802, 805, 263 N.Y.S.2d 1, 3, 210 N.E.2d 355, 356 (1965) (Desmond, C.J., dissenting). Just as in a partnership, the relationship among the stockholders must be one of trust, confidence and absolute loyalty if the enterprise is to succeed. Close corporations with substantial assets and with more numerous stockholders are no different from smaller close corporations in this regard. All participants rely on the fidelity and abilities of those stockholders who hold office. Disloyalty and self-seeking conduct on the part of any stockholder will engender bickering, corporate stalemates, and, perhaps, efforts to achieve dissolution.

[4] Although the corporate form provides the above-mentioned advantages for the stockholders (limited liability, perpetuity, and so forth), it also supplies an opportunity for the majority stockholders to oppress or disadvantage minority stockholders. The minority is vulnerable to a variety of oppressive devices, termed 'freezeouts,' which the majority may

employ. See, generally, Note, Freezing Out Minority Shareholders, 74 Harv.L.Rev. 1630 (1961). An authoritative study of such 'freeze-outs' enumerates some of the possibilities: 'The squeezers (those who employ the freeze-out techniques) may refuse to declare dividends; they may drain off the corporation's earnings in the form of exorbitant salaries and bonuses to the majority shareholder-officers and perhaps to their relatives, or in the form of high rent by the corporation for property leased from majority shareholders . . .; they may deprive minority shareholders of corporate offices and of employment by the company; they may cause the corporation to sell its assets at an inadequate price to the majority shareholders . . ..' F. H. O'Neal and J. Derwin, Expulsion or Oppression of Business Associates, 42 (1961). In particular, the power of the board of directors, controlled by the majority, to declare or withhold dividends and to deny the minority employment is easily converted to a device to disadvantage minority stockholders.

The minority can, of course, initiate suit against the majority and their directors. Self-serving conduct by directors is proscribed by the director's fiduciary obligation to the corporation. Elliott v. Baker, 194 Mass. 518, 523, 80 N.E. 450 (1907). However, in practice, the plaintiff will find difficulty in challenging dividend or employment policies. Such policies are considered to be within the judgment of the directors. This court has said: 'The courts prefer not to interfere . . . with the sound financial management of the corporation by its directors, but declare as general rule that the declaration of dividends rests within the sound discretion of the directors, refusing to interfere with their determination unless a plain abuse of discretion is made to appear.

Thus, when these types of 'freeze-outs' are attempted by the majority stockholders, the minority stockholders, cut off from all corporation- related revenues, must either suffer their losses or seek a buyer for their shares. Many minority stockholders will be unwilling or unable to wait for an alteration in majority policy. Typically, the minority stockholder in a close corporation has a substantial percentage of his personal assets invested in the corporation. Galler v. Galler, 32 Ill.2d 16, 27, 203 N.E.2d 577 (1965). The stockholder may have anticipated that his salary from his position with the corporation would be his livelihood. Thus, he cannot afford to wait passively. He must liquidate his investment in the close corporation in order to reinvest the funds in income-producing enterprises.

[5] At this point, the true plight of the minority stockholder in a close corporation becomes manifest. He cannot easily reclaim his capital. In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation. In a partnership, a partner who feels abused by his fellow partners may cause dissolution by his 'express will . . . at any time' By contrast, the stockholder in the close corporation or 'incorporated partnership' may achieve dissolution and recovery of his share of the enterprise assets only by compliance with the rigorous terms of the applicable chapter of the General Laws. To secure dissolution of the ordinary close corporation subject to G.L. c. 156B, the stockholder, in the absence of corporate deadlock, must own at least fifty per cent of the shares (G.L. c. 156B, s 99(a)) or have the advantage of a favorable provision in the articles of organization (G.L. c. 156B, s 100(a)(2)). The minority stockholder, by definition

lacking fifty per cent of the corporate shares, can never 'authorize' the corporation to file a petition for dissolution under G.L. c. 156B, s 99(a), by his own vote. He will seldom have at his disposal the requisite favorable provision in the articles of organization.

Thus, in a close corporation, the minority stockholders may be trapped in a disadvantageous situation. No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties. To cut losses, the minority stockholder may be compelled to deal with the majority. This is the capstone of the majority plan. Majority 'freeze-out' schemes which withhold dividends are designed to compel the minority to relinquish stock at inadequate prices.

[6] Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders[FN17] in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined the standard of duty owed by partners to one another as the 'utmost good faith and loyalty.' Cardullo v. Landau, 329 Mass. 5, 8, 105 N.E.2d 843 (1952); DeCotis v. D'Antona, 350 Mass. 165, 168, 214 N.E.2d 21 (1966). Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.

> FN17. We do not limit our holding to majority stockholders. In the close corporation, the minority may do equal damage through unscrupulous and improper 'sharp dealings' with an unsuspecting majority. See Helms v. Duckworth, 101 U.S.App.D.C. 390, 249 F.2d 482 (1957).

The more rigorous duty of partners and participants in a joint adventure, here extended to stockholders in a close corporation, was described by then Chief Judge Cardozo of the New York Court of Appeals in Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928): 'Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. . . . Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.' Id. at 463--464, 164 N.E. at 546.

Application of this strict standard of duty to stockholders in close corporations is a natural outgrowth of the prior case law. In a number of cases involving close corporations, we have held stockholders participating in management to a standard of fiduciary duty more exacting than the traditional good faith and inherent fairness standard because of the trust and confidence reposed in them by the other stockholders. In Silversmith v. Sydeman, 305 Mass. 65, 25 N.E.2d 215 (1940), the plaintiff brought suit for an accounting of the liquidation of a close corporation which he and the defendant had owned. In assessing their relative rights in the discount of a note, we had occasion to consider the defendant's fiduciary duty with

respect to the financial affairs of the company. We implied that, in addition to the fiduciary duty owed by an officer to the corporation, a more rigorous standard of fiduciary duty applied to the defendant by virtue of the relationship between the stockholders: '. . . it could be found that the plaintiff and the defendant were acting as partners in the conduct of the company's business and in the liquidation of its property even though they had adopted a corporate form as the instrumentality by which they should associate in the furtherance of their joint venture.' Id. at 68, 25 N.E.2d at 217.

The strict standard of duty is plainly applicable to the stockholders in Rodd Electrotype. Rodd Electrotype is a close corporation. Members of the Rodd and Donahue families are the sole owners of the corporation's stock. In actual numbers, the corporation, immediately prior to the corporate purchase of Harry Rodd's shares, had six stockholders. The shares have not been traded, and no market for them seems to exist. Harry Rodd, Charles Rodd, Frederick Rodd, William G. Mason (Phyllis Mason's husband), and the plaintiff's husband all worked for the corporation. The Rodds have retained the paramount management positions.

Through their control of these management positions and of the majority of the Rodd Electrotype stock, the Rodds effectively controlled the corporation. In testing the stock purchase from Harry Rodd against the applicable strict fiduciary standard, we treat the Rodd family as a single controlling group. We reject the defendants' contention that the Rodd family cannot be treated as a unit for this purpose. From the evidence, it is clear that the Rodd family was a close-knit one with strong community of interest. See Samia v. Central Oil Co. of Worcester, 339 Mass. 101, 112, 158 N.E.2d 469 (1959). Harry Rodd had hired his sons to work in the family business, Rodd Electrotype. As he aged, he transferred portions of his stock holdings to his children.[FN26] Charles Rodd and Frederick Rodd were given positions of responsibility in the business as he withdrew from active management. In these circumstances, it is realistic to assume that appreciation, gratitude, and filial devotion would prevent the younger Rodds from opposing a plan which would provide funds for their father's retirement.

On its face, then, the purchase of Harry Rodd's shares by the corporation is a breach of the duty which the controlling stockholders, the Rodds, owed to the minority stockholders, the plaintiff and her son. The purchase distributed a portion of the corporate assets to Harry Rodd, a member of the controlling group, in exchange for his shares. The plaintiff and her son were not offered an equal opportunity to sell their shares to the corporation. In fact, their efforts to obtain an equal opportunity were rebuffed by the corporate representative. As the trial judge found, they did not, in any manner, ratify the transaction with Harry Rodd.

[19][20] Because of the foregoing, we hold that the plaintiff is entitled to relief. Two forms of suitable relief are set out hereinafter. The judge below is to enter an appropriate judgment. The judgment may require Harry Rodd to remit $36,000 with interest at the legal rate from July 15, 1970, to Rodd Electrotype in exchange for forty-five shares of Rodd Electrotype treasury stock. This, in substance, is the specific relief requested in the plaintiff's bill of complaint. Interest is manifestly appropriate. A stockholder, who, in violation of his fiduciary duty to the other stockholders, has obtained assets from his corporation and has had

those assets available for his own use, must pay for that use. See Silversmith v. Sydeman, 305 Mass. 65, 74, 25 N.E.2d 215 (1940). Cf. Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 420, 8 N.E.2d 895 (1937). In the alternative, the judgment may require Rodd Electrotype to purchase all of the plaintiff's shares for $36,000 without interest. In the circumstances of this case, we view this as the equal opportunity which the plaintiff should have received. Harry Rodd's retention of thirty-six shares, which were to be sold and given to his children within a year of the Rodd Electrotype purchase, cannot disguise the fact that the corporation acquired one hundred per cent of that portion of his holdings (forty-five shares) which he did not intend his children to own. The plaintiff is entitled to have one hundred per cent of her forty-five shares similarly purchased.[FN30]

The final decree, in so far as it dismissed the bill as to Harry C. Rodd, frederick I. Rodd, Charles J. Rodd, Mr. Harold E. Magnuson and Rodd Electrotype Company of New England, Inc., and awarded costs, is reversed. The case is remanded to the Superior Court for entry of judgment in conformity with this opinion.

So ordered.

Discussion points for Wilkes v. Springside Nursing Home

This case seems to be a watering down of the Donahue standard, even though the Donahue case was decided by this same court less than a year earlier. Why? This case gives you a balancing test, and seemingly borrows a little from constitutional law in its logic. Ask yourself how Wilkes could have better protected himself at the outset of this arrangement. If I have a close corporation, with an employee at will who owns 5% of the stock and whose agreement calls for redemption of the stock upon termination of employment, can I fire him for any reason?

Stanley J. WILKES
v.
SPRINGSIDE NURSING HOME, INC., et al.

Supreme Judicial Court of Massachusetts, Berkshire.

Argued March 2, 1976.

Decided Aug. 20, 1976.

HENNESSEY, Chief Justice.

On August 5, 1971, the plaintiff (Wilkes) filed a bill in equity for declaratory judgment in the Probate Court for Berkshire County, naming as defendants T. Edward Quinn (Quinn),

Leon L. Riche (Riche), the First Agricultural National Bank of Berkshire County and Frank Sutherland MacShane as executors under the will of Lawrence R. Connor (Connor), and the Springside Nursing Home, Inc. (Springside or the corporation). Wilkes alleged that he, Quinn, Riche and Dr. Hubert A. Pipkin (Pipkin) entered into a partnership agreement in 1951, prior to the incorporation of Springside, which agreement was breached in 1967 when Wilkes's salary was terminated and he was voted out as an officer and director of the corporation. Wilkes sought, among other forms of relief, damages in the amount of the salary he would have received had he continued as a director and officer of Springside subsequent to March, 1967.

A judge of the Probate Court referred the suit to a master, who, after a lengthy hearing, issued his final report in late 1973. Wilkes's objections to the master's report were overruled after a hearing, and the master's report was confirmed in late 1974. A judgment was entered dismissing Wilkes's action on the merits. We granted direct appellate review. Mass.R.A.P. 11, 365 Mass. --- (1974). On appeal, Wilkes argued in the alternative that (1) he should recover damages for breach of the alleged partnership agreement; and (2) he should recover damages because the defendants, as majority stockholders in Springside, breached their fiduciary duty to him as a minority stockholder by their action in February and March, 1967.

We conclude that the master's findings were warranted by the evidence and that his report was properly confirmed. However, we reverse so much of the judgment as dismisses Wilkes's complaint and order the entry of a judgment substantially granting the relief sought by Wilkes under the second alternative set forth above.

A summary of the pertinent facts as found by the master is set out in the following pages. It will be seen that, although the issue whether there was a breach of the fiduciary duty owed to Wilkes by the majority stockholders in Springside was not considered by the master, the master's report and the designated portions of the transcript of the evidence before him supply us with a sufficient basis for our conclusion.

In 1951 Wilkes acquired an option to purchase a building and lot located on the corner of Springside Avenue and North Street in Pittsfield, Massachusetts, the building having previously housed the Hillcrest Hospital. Though Wilkes was principally engaged in the roofing and siding business, he had gained a reputation locally for profitable dealings in real estate. Riche, an acquaintance of Wilkes, learned of the option, and interested Quinn (who was known to Wilkes through membership on the draft board in Pittsfield) and Pipkin (an acquaintance of both Wilkes and Riche) in joining Wilkes in his investment. The four men met and decided to participate jointly in the purchase of the building and lot as a real estate investment which, they believed, had good profit potential on resale or rental.

The parties later determined that the property would have its greatest potential for profit if it were operated by them as a nursing home. Wilkes consulted his attorney, who advised him that if the four men were to operate the contemplated nursing home as planned, they would be partners and would be liable for any debts incurred by the partnership and by each other. On the attorney's suggestion, and after consultation among themselves, ownership of the

property was vested in Springside, a corporation organized under Massachusetts law.

Each of the four men invested $1,000 and subscribed to ten shares of $100 par value stock in Springside. At the time of incorporation it was understood by all of the parties that each would be a director of Springside and each would participate actively in the management and decision making involved in operating the corporation.[FN7] It was, further, the understanding and intention of all the parties that, corporate resources permitting, each would receive money from the corporation in equal amounts as long as each assumed an active and ongoing responsibility for carrying a portion of the burdens necessary to operate the business.

FN7. Wilkes testified before the master that, when the corporate officers were elected, all four men 'were . . . guaranteed directorships.' Riche's understanding of the parties' intentions was that they all wanted to play a part in the management of the corporation and wanted to have some 'say' in the risks involved; that, to this end, they all would be directors; and that 'unless you (were) a director and officer you could not participate in the decisions of (the) enterprise.'

The work involved in establishing and operating a nursing home was roughly apportioned, and each of the four men undertook his respective tasks.[FN8] Initially, Riche was elected president of Springside, Wilkes was elected treasurer, and Quinn was elected clerk. Each of the four was listed in the articles of organization as a director of the corporation.

FN8. Wilkes took charge of the repair, upkeep and maintenance of the physical plant and grounds; Riche assumed supervision over the kitchen facilities and dietary and food aspects of the home; Pipkin was to make himself available if and when medical problems arose; and Quinn dealt with the personnel and administrative aspects of the nursing home, serving informally as a managing director. Quinn further coo rdinated the activities of the other parties and served as a communication link among them when matters had to be discussed and decisions had to be made without a formal meeting.

FN9. Riche held the office of president from 1951 to 1963; Quinn served as president from 1963 on, as clerk from 1951 to 1967, and as treasurer from 1967 on; Wilkes was treasurer from 1951 to 1967.

At some time in 1952, it became apparent that the operational income and cash flow from the business were sufficient to permit the four stockholders to draw money from the corporation on a regular basis. Each of the four original parties initially received $35 a week from the corporation. As time went on the weekly return to each was increased until, in 1955, it totalled $100.

In 1959, after a long illness, Pipkin sold his shares in the corporation to Connor, who was known to Wilkes, Riche and Quinn through past transactions with Springside in his capacity as president of the First Agricultural National Bank of Berkshire County. Connor received a weekly stipend from the corporation equal to that received by Wilkes, Riche and Quinn. He

was elected a director of the corporation but never held any other office. He was assigned no specific area of responsibility in the operation of the nursing home but did participate in business discussions and decisions as a director and served additionally as financial adviser to the corporation.

In 1965 the stockholders decided to sell a portion of the corporate property to Quinn who, in addition to being a stockholder in Springside, possessed an interest in another corporation which desired to operate a rest home on the property. Wilkes was successful in prevailing on the other stockholders of Springside to procure a higher sale price for the property than Quinn apparently anticipated paying or desired to pay. After the sale was consummated, the relationship between Quinn and Wilkes began to deteriorate.

The bad blood between Quinn and Wilkes affected the attitudes of both Riche and Connor. As a consequence of the strained relations among the parties, Wilkes, in January of 1967, gave notice of his intention to sell his shares for an amount based on an appraisal of their value. In February of 1967 a directors' meeting was held and the board exercised its right to establish the salaries of its officers and employees.[FN10] A schuedle of payments was established whereby Quinn was to receive a substantial weekly increase and Riche and Connor were to continue receiving $100 a week. Wilkes, however, was left off the list of those to whom a salary was to be paid. The directors also set the annual meeting of the stockholders for March, 1967.

> FN10. The by-laws of the corporation provided that the directors, subject to the approval of the stockholders, had the power to fix the salaries of all officers and employees. This power, however, up until February, 1967, had not been exercised formally; all payments made to the four participants in the venture had resulted from the informal but unanimous approval of all the parties concerned.

At the annual meeting in March, Wilkes was not reelected as a director, nor was he ree lected as an officer of the corporation. He was further informed that neither his services nor his presence at the nursing home was wanted by his associates.

The meetings of the directors and stockholders in early 1967, the master found, were used as a vehicle to force Wilkes out of active participation in the management and operation of the corporation and to cut off all corporate payments to him. Though the board of directors had the power to dismiss any officers or employees for misconduct or neglect of duties, there was no indication in the minutes of the board of directors' meeting of February, 1967, that the failure to establish a salary for Wilkes was based on either ground. The severance of Wilkes from the payroll resulted not from misconduct or neglect of duties, but because of the personal desire of Quinn, Riche and Connor to prevent him from continuing to receive money from the corporation. Despite a continuing deterioration in his personal relationship with his associates, Wilkes had consistently endeavored to carry on his responsibilities to the corporation in the same satisfactory manner and with the same degree of competence he had previously shown. Wilkes was at all times willing to carry on his responsibilities and participation if permitted so to do and provided that he receive his weekly stipend.

1. We turn to Wilkes's claim for damages based on a breach of the fiduciary duty owed to him by the other participants in this venture. In light of the theory underlying this claim, we do not consider it vital to our approach to this case whether the claim is governed by partnership law or the law applicable to business corporations. This is so because, as all the parties agree, Springside was at all times relevant to this action, a close corporation as we have recently defined such an entity in Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505 (1975).

[1] In Donahue, we held that 'stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another.' Id. at --- - --- (footnotes omitted),[FNb] 328 N.E.2d at 515. As determined in previous decisions of this court, the standard of duty owed by partners to one another is one of 'utmost good faith and loyalty.' Cardullo v. Landau, 329 Mass. 5, 8, 105 N.E.2d 843 (1952), and cases cited. DeCotis v. D'Antona, 350 Mass. 165, 168, 214 N.E.2d 21 (1966), qyuoting from Mendelsohn v. Leather Mfg. Corp., 326 Mass. 226, 233, 93 N.E.2d 537 (1950). Thus, we concluded in Donahue, with regard to 'their actions relative to the operations of the enterprise and the effects of that operation on the rights and investments of other stockholders,' '(s)tockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self- interest in derogation of their duty of loyalty to the other stockholders and to the corporation.' --- Mass. at n. 18, ---,[FNc] 328 N.E.2d at 515.

In the Donahue case we recognized that one peculiar aspect of close corporations was the opportunity afforded to majority stockholders to oppress, disadvantage or 'freeze out' minority stockholders. In Donahue itself, for example, the majority refused the minority an equal opportunity to sell a ratable number of shares to the corporation at the same price available to the majority. The net result of this refusal, we said, was that the minority could be forced to 'sell out at less than fair value,' --- Mass. at ---,[FNd] 328 N.E.2d at 515, since there is by definition no ready market for minority stock in a close corporation.

'Freeze outs,' however, may be accomplished by the use of other devices. One such device which has proved to be particularly effective in accomplishing the purpose of the majority is to deprive minority stockholders of corporate offices and of employment with the corporation. F. H. O'Neal, 'Squeeze-Outs' of Minority Shareholders 59, 78--79 (1975). See --- Mass. at ---, ---, [FNe] 328 N.E.2d 505. This 'freeze-out' technique has been successful because courts fairly consistently have been disinclined to interfere in those facets of internal corporate operations, such as the selection and retention or dismissal of officers, directors and employees, which essentially involve management decisions subject to the principle of majority control. See Note, 35 N.C.L.Rev. 271, 277 (1957). As one authoritative source has said, '(M)any courts apparently feel that there is a legitimate sphere in which the controlling (directors or) shareholders can act in their own interest even if the minority suffers.' F. H. O'Neal, supra at 59 (footnote omitted). Comment, 1959 Duke L.J. 436, 437.

The denial of employment to the minority at the hands of the majority is especially

pernicious in some instances. A guaranty of employment with the corporation may have been one of the 'basic reason(s) why a minority owner has invested capital in the firm.' Symposium--The Close Corporation, 52 Nw.U.L.Rev. 345, 392 (1957). See F. H. O'Neal, supra at 78--79; Hancock, Minority Interests in Small Business Entities, 17 Clev.-Mar.L.Rev. 130, 132--133 (1968); 89 Harv.L.Rev. 423, 427 (1975). The minority stockholder typically depends on his salary as the principal return on his investment, since the 'earnings of a close corporation . . . are distributed in major part in salaries, bonuses and retirement benefits.' 1 F. H. O'Neal, Close Corporations s 1.07 (1971). Other noneconomic interests of the minority stockholder are likewise injuriously affected by barring him from corporate office. See F. H. O'Neal, 'Squeeze-Outs' of Minority Shareholders 79 (1975). Such action severely restricts his participation in the management of the enterprise, and he is relegated to enjoying those benefits incident to his status as a stockholder. See Symposium--The Close Corporation, 52 Nw.U.L.Rev. 345, 386 (1957). In sum, by terminating a minority stockholder's employment or by severing him from a position as an officer or director, the majority effectively frustrate the minority stockholder's purposes in entering on the corporate venture and also deny him an equal return on his investment.

[2] The Donahue decision acknowledged, as a 'natural outgrowth' of the case law of this Commonwealth, a strict obligation on the part of majority stockholders in a close corporation to deal with the minority with the utmost good faith and loyalty. On its face, this strict standard is applicable in the instant case. The distinction between the majority action in Donahue and the majority action in this case is more one of form than of substance. Nevertheless, we are concerned that untempered application of the strict good faith standard enunciated in Donahue to cases such as the one before us will result in the imposition of limitations on legitimate action by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned. The majority, concededly, have certain rights to what has been termed 'selfish ownership' in the corporation which should be balanced against the concept of their fiduciary obligation to the minority.

[3] Therefore, when minority stockholders in a close corporation bring suit against the majority alleging a breach of the strict good faith duty owed to them by the majority, we must carefully analyze the action taken by the controlling stockholders in the individual case. It must be asked whether the controlling group can demonstrate a legitimate business purpose for its action. In asking this question, we acknowedge the fact that the controlling group in a close corporation must have some room to maneuver in establishing the business policy of the corporation. It must have a large measure of discretion, for example, in declaring or withholding dividends, deciding whether to merge or consolidate, establishing the salaries of corporate officers, dismissing directors with or without cause, and hiring and firing corporate employees.

When an asserted business purpose for their action is advanced by the majority, however, we think it is open to minority stockholders to demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest. If called on to settle a dispute, our courts must weigh the legitimate

business purpose, if any, against the practicability of a less harmful alternative.

[4] Applying this approach to the instant case it is apparent that the majority stockholders in Springside have not shown a legitimate business purpose for severing Wilkes from the payroll of the corporation or for refusing to ree lect him as a salaried officer and director. The master's subsidiary findings relating to the purpose of the meetings of the directors and stockholders in February and March, 1967, are supported by the evidence. There was no showing of misconduct on Wilkes's part as a director, officer or employee of the corporation which would lead us to approve the majority action as a legitimate response to the disruptive nature of an undesirable individual bent on injuring or destroying the corporation. On the contrary, it appears that Wilkes had always accomplished his assigned share of the duties competently, and that he had never indicated an unwillingness to continue to do so.

It is an inscapable conclusion from all the evidence that the action of the majority stockholders here was a designed 'freeze out' for which no legitimate business purpose has been suggested. Furthermore, we may infer that a design to pressure Wilkes into selling his shares to the corporation at a price below their value well may have been at the heart of the majority's plan.[FN14]

FN14. This inference arises from the fact that Connor, acting on behalf of the three controlling stockholders, offered to purchase Wilkes's shares for a price Connor admittedly would not have accepted for his own shares.

[5] In the context of this case, several factors bear directly on the duty owed to Wilkes by his associates. At a minimum, the duty of utmost good faith and loyalty would demand that the majority consider that their action was in disregard of a long-standing policy of the stockholders that each would be a director of the corporation and that employment with the corporation would go hand in hand with stock ownership; that Wilkes was one of the four originators of the nursing home venture; and that Wilkes, like the others, had invested his capital and time for more than fifteen years with the expectation that he would continue to participate in corporate decisions. Most important is the plain fact that the cutting off of Wilkes's salary, together with the fact that the corporation never declared a dividend (see note 13 supra), assured that Wilkes would receive no return at all from the corporation.

[6] 2. The question of Wilkes's damages at the hands of the majority has not been thoroughly explored on the record before us. Wilkes, in his original complaint, sought damages in the amount of the $100 a week he believed he was entitled to from the time his salary was terminated up until the time this action was commenced. However, the record shows that, after Wilkes was severed from the corporate payroll, the schedule of salaries and payments made to the other stockholders varied from time to time. In addition, the duties assumed by the other stockholders after Wilkes was deprived of his share of the corporate earnings appear to have changed in significant respects. Any resolution of this question must take into account whether the corporation was dissolved during the pendency of this litigation.

Therefore our order is as follows: So much of the judgment as dismisses Wilkes's complaint and awards costs to the defendants is reversed. The case is remanded to the Probate Court for Berkshire County for further proceedings concerning the issue of damages. Thereafter a judgment shall be entered declaring that Quinn, Riche and Connor breached their fiduciary duty to Wilkes as a minority stockholder in Springside, and awarding money damages therefor. Wilkes shall be allowed to recover from Riche, the estate of T. Edward Quinn and the estate of Lawrence R. Connor, ratably, according to the inequitable enrichment of each, the salary he would have received had he remained an officer and director of Springside. In considering the issue of damages the judge on remand shall take into account the extent to which any remaining corporate funds of Springside may be diverted to satisfy Wilkes's claim.

So ordered.

Merola v. Exergen

Steven MEROLA
v.
EXERGEN CORPORATION

Supreme Judicial Court of Massachusetts, Middlesex.

Argued April 2, 1996.
Decided Aug. 8, 1996.

The plaintiff, a former vice president of Exergen Corporation (Exergen) and a former minority stockholder of that corporation, brought suit in the Superior Court against Exergen and the president and majority stockholder, Francesco Pompei, because of his termination as an officer and employee of Exergen. Count I of the complaint was dismissed prior to trial; count II (deceit) alleged that the plaintiff had been induced to work for the corporation by Pompei's knowingly false representations of continuing employment; and count III (breach of fiduciary duty) alleged that the corporation was a “close corporation,” and that Pompei, as the majority stockholder, violated his fiduciary obligations to the plaintiff as a minority stockholder by terminating his employment without cause.

The trial judge ruled that the jury would hear evidence on both counts, but that she would make findings of fact and conclusions of law on count III, the equity count, following the verdict of the jury. The jury rendered a verdict, answering special questions regarding count II and providing advisory answers regarding count III. The jury found that, on count II, there had been no deceit by Pompei.

On count III the judge found that the corporation was a “close corporation” and that Pompei had breached his fiduciary obligations to the plaintiff by failing to give him an opportunity to become a major stockholder and by terminating his employment. She adopted the jury's

advisory conclusion that he had been damaged only by the termination of employment to the extent of $50,000.

The Appeals Court affirmed the judgment as to Pompei, but modified it as to the corporation, holding that there was no basis for liability by Exergen to the plaintiff. 38 Mass.App.Ct. 462, 471-472 (1995). We granted the defendants' application for further appellate review [FN2] and now reverse the judgment of the Superior Court.

> FN2. Both Pompei and Exergen were the named defendants in the complaint, however, as the allegations relating to the breach of fiduciary duty apply only to Pompei, we refer only to him regarding this issue.

We summarize the facts found by the judge. Exergen was formed in May, 1980, as a corporation in the business of developing and selling infrared heat detection devices. From Exergen's inception to the date of trial, Pompei, the founder, was the majority shareholder in the corporation, as well as its president, owning over sixty per cent of the shares issued. At all relevant times, Pompei actively participated in and controlled the management of Exergen and, as the majority shareholder, had power to elect and change Exergen's board of directors.

The plaintiff began working for Exergen on a part-time basis in late 1980 while he was also employed full time by Analogic Corporation. In the course of conversations with Pompei in late 1981, and early 1982, the plaintiff was offered full-time employment with Exergen, and he understood that, if he came to work there and invested in Exergen stock, he would have the opportunity to become a major shareholder of Exergen and for continuing employment with Exergen.

As of March 1, 1982, the plaintiff resigned from Analogic and began working full time for Exergen. He also then began purchasing shares in Exergen when the company made periodic offerings to its employees. From March, 1982, through June, 1982, the plaintiff purchased 4,100 shares at $2.25 per share, for a total of $9,225. Exergen announced at the Exergen shareholders meeting in September, 1982, another option program to purchase shares at $5 per share within one year. By late 1983, the plaintiff had exercised his option to purchase an additional 1,200 shares. The plaintiff was not offered additional stock options after late 1983.

In response to special questions the jury made the following findings which were adopted by the judge: (1) the plaintiff did not receive an opportunity to become a major shareholder of Exergen; (2) there was a legitimate business purpose for not providing the plaintiff an opportunity to become a major shareholder of Exergen; (3) this business purpose could have been accomplished through an alternative course of action less harmful to the plaintiff's interests; and (4) the plaintiff suffered no damages by not being able to become a major shareholder of Exergen.

With regard to the alleged breach of fiduciary duty for terminating the plaintiff's employment with Exergen, the judge adopted the following findings by the jury: (1) the plaintiff was terminated by Pompei on April 16, 1987, and therefore did not receive continuing

employment by Exergen; (2) there was no legitimate business purpose for not continuing the plaintiff's employment by Exergen; and (3) the plaintiff suffered damages in lost wages, reduced by income from other employment, in the total amount of $50,000.

Findings of fact, made by the jury on issues to be decided by the judge, shall be viewed as the findings of the judge, if adopted, and therefore shall not be set aside unless clearly erroneous. See *Starr v. Fordham,* 420 Mass. 178, 182, 648 N.E.2d 1261 (1995). See also Mass.R.Civ.P. 52(a), 365 Mass. 816 (1974). Based on these findings, the judge ruled that, as matter of law, Pompei breached a fiduciary duty to the plaintiff to honor the reasonable expectations that the plaintiff had concerning investments of time and resources in Exergen,[FN3] and awarded the plaintiff $50,000 in damages.

> FN3. Although the judge ruled that Exergen and Pompei shall be jointly and severally liable for the judgment, the claim for breach of fiduciary duty lies only against the majority shareholder, not against the corporation. 38 Mass.App.Ct. 462, 471-472, 648 N.E.2d 1301 (1995).

Breach of fiduciary duty. In *Donahue v. Rodd Electrotype Co.,* 367 Mass. 578, 593, 328 N.E.2d 505 (1975), this court recognized a fiduciary duty by a majority shareholder of “utmost good faith and loyalty” toward shareholders of a close corporation. A claim based on this duty is an equitable claim against individual stockholders. *Zimmerman v. Bogoff,* 402 Mass. 650, 660-661, 524 N.E.2d 849 (1988). The determination whether a breach of this fiduciary duty has occurred is a matter of law for the court, as is the remedy for such breach. *Id.* at 661, 524 N.E.2d 849.

We agree with the judge's conclusion that Exergen was a close corporation, and that stockholders in a close corporation owe one another a fiduciary duty of “utmost good faith and loyalty.” *Donahue v. Rodd Electrotype Co., supra* at 593, 328 N.E.2d 505. We, therefore, look to see whether the plaintiff has established a breach of that duty under the principles of *Donahue.* Even in close corporations, the majority interest “must have a large measure of discretion, for example, in declaring or withholding dividends, deciding whether to merge or consolidate, establishing the salaries of corporate officers, dismissing directors with or without cause, and hiring and firing corporate employees.” *Wilkes v. Springside Nursing Home, Inc.,* 370 Mass. 842, 851, 353 N.E.2d 657 (1976).

Principles of employment law permit the termination of employees at will, with or without cause excepting situations within a narrow public policy exception. *King v. Driscoll,* 418 Mass. 576, 581-582, 638 N.E.2d 488 (1994), and cases cited. However, the termination of a minority shareholder's employment may present a situation where the majority interest has breached its fiduciary duty to the minority interest. *Id.* at 586, 638 N.E.2d 488. *Wilkes v. Springside Nursing Home, Inc., supra* at 852-853, 353 N.E.2d 657. There the court concluded that the majority stockholders had attempted unfairly to “freeze out” a minority stockholder by terminating his employment, in part because their policy and practice was to divide the available resources of the corporation equally by way of salaries to the shareholders who all participated in the operation of the enterprise. *Id.* at 846, 353 N.E.2d

657. As the investment became more profitable, the salaries were increased. *Id.* The court recognized that "[t]he minority stockholder typically depends on his salary as the principal return on his investment, since the 'earnings of a close corporation ... are distributed in major part in salaries, bonuses and retirement benefits.' " *Id.* at 850, 353 N.E.2d 657, quoting 1 F.H. O'Neal, Close Corporations § 1.07 (1971). Given those facts, this court concluded that the other shareholders did not show a legitimate business purpose for terminating the minority stockholder and that the other parties acted "in disregard of a long-standing policy of the stockholders that each would be a director of the corporation and that employment with the corporation would go hand in hand with stock ownership." *Id.* at 853, 353 N.E.2d 657.

Here, although the plaintiff invested in the stock of Exergen with the reasonable expectation of continued employment, there was no general policy regarding stock ownership and employment, and there was no evidence that any other stockholders had expectations of continuing employment because they purchased stock. The investment in the stock was an investment in the equity of the corporation which was not tied to employment in any formal way. The plaintiff acknowledged that he could have purchased 5,000 shares of stock while he was working part time before resigning from his position at Analogic Corporation and accepting full-time employment at Exergen. He testified that he was induced to work for Exergen with the promise that he could become a major stockholder. There was no testimony that he was ever required to buy stock as a condition of employment.

Unlike the *Wilkes* case, there was no evidence that the corporation distributed all profits to shareholders in the form of salaries. On the contrary, the perceived value of the stock increased during the time that the plaintiff was employed. The plaintiff first purchased his stock at $2.25 per share and, one year later, he purchased more for $5 per share. This indicated that there was some increase in value to the investment independent of the employment expectation. Neither was the plaintiff a founder of the business, his stock purchases were made after the business was established, and there was no suggestion that he had to purchase stock to keep his job.

The plaintiff testified that, when he sold his stock back to the corporation in 1991, he was paid $17 per share. This was a price that had been paid to other shareholders who sold their shares to the corporation at a previous date, and it is a price which, after consulting with his attorney, he concluded was a fair price. With this payment, the plaintiff realized a significant return on his capital investment independent of the salary he received as an employee.

We conclude that this is not a situation where the majority shareholder breached his fiduciary duty to a minority shareholder. "[T]he controlling group in a close corporation must have some room to maneuver in establishing the business policy of the corporation." *Wilkes v. Springside Nursing Home, Inc., supra* at 851, 353 N.E.2d 657. Although there was no legitimate business purpose for the termination of the plaintiff, neither was the termination for the financial gain of Pompei or contrary to established public policy. Not every discharge of an at-will employee of a close corporation who happens to own stock in the corporation gives rise to a successful breach of fiduciary duty claim. The plaintiff was terminated in

accordance with his employment contract and fairly compensated for his stock. He failed to establish a sufficient basis for a breach of fiduciary duty claim under the principles of *Donahue v. Rodd Electrotype Co., supra.*

The plaintiff's cross appeal. The plaintiff argues that it was error to allow evidence regarding the salary of other positions available during the relevant period to show the plaintiff's failure to mitigate his damages. Because we have concluded that, as matter of law, the termination of the plaintiff did not constitute a breach of Pompei's fiduciary duty, evidence concerning damages is irrelevant.

Judgment reversed.

Discussion points for Sugarman v. Sugarman

This is another freeze-out case, with predictable results. What exactly did Leonard do wrong, in Wilkes terms? What would he have to prove to avoid the result in this case? Where do we go from here? How should Leonard determine what his salary should be in the future? Aren't the plaintiffs still frozen out?

Jon SUGARMAN, et al., Plaintiffs, Appellees,
v.
Leonard SUGARMAN and Statler Industries, Inc., Defendants, Appellants.

No. 85-1612.

United States Court of Appeals,
First Circuit.

Argued Feb. 4, 1986.

Decided June 30, 1986.

COFFIN, Circuit Judge.

Leonard Sugarman appeals from a judgment of the United States District Court for the District of Massachusetts, based on a finding that he breached his fiduciary duty to minority shareholders in a close corporation. We conclude that none of the various errors of fact or law alleged by appellant warrant reversal of the district court's judgment as to liability. Because, however, of our differences with the district court as to the appropriate Massachusetts statute governing interest and the allowability of attorney's fees, we must remand for a recalculation of appellees' award, increasing the amount attributable to interest

and deleting the amount attributable to attorney's fees.

I. Factual Background

In 1906, four brothers formed a partnership, Sugarman Brothers, for the purpose of selling paper products. By 1918, the partnership was owned in equal shares and managed by three of the four brothers: Joseph, Samuel and Myer Sugarman. Leonard Sugarman ("Leonard"), defendant-appellant, is the son of Myer, who died in 1983. Plaintiffs-appellees are the grandchildren of Samuel, who died in 1965.

In the 1930's, the principals in Sugarman Brothers organized Leonard Tissue Corporation, owned equally by Joseph, Myer and Samuel. Following World War II, Sugarman Brothers was incorporated, with its stock also owned equally by the three Sugarman branches. In 1964, Leonard Tissue changed its name to Statler Tissue and in 1969, Statler Tissue and Sugarman Brothers merged to create Statler Corporation. Statler's common stock was owned in approximately equal amounts by each of the three Sugarman branches. Leonard, his father Myer, and appellees' father, Hyman, were all officers and directors of the company.

The present difficulties arise from the fact that, after the original equal division which existed until 1974, one branch of the family has controlled a majority of the stock and all of the management. Defendant Leonard Sugarman, president of the company and chairman of the board, owns 61% of the stock; plaintiffs Jon Sugarman, James Sugarman, and Marjorie Sugarman Tyie, Hyman's children, own 21.78%. These disparate holdings result from the fact that Samuel gave some of his stock to his son Hyman, and some to Jon, James and Marjorie, Hyman's children. Hyman, in turn, sold his shares to Leonard in 1974. The stock owned by Joseph Sugarman was ultimately redeemed, and while this did not vary the relative proportion of the stock owned by Leonard vis-a- vis the plaintiffs, it did result in Leonard owning over half of the outstanding shares. When Leonard purchased Hyman's shares in the spring of 1974, Leonard and his immediate family owned 49.6% of the company's outstanding stock. Harris Baseman, the company's lawyer, owned approximately .8%. Because Baseman owed his appointment as company counsel to Leonard, and was Leonard's personal counsel, Leonard effectively controlled the company from that time forward.

Members of the other branches of the family were employed by the company from time to time. The district court found that James Sugarman had never sought to be employed by the company, and that Marjorie Sugarman had sought to be employed, but was not. The court stated that Jon Sugarman was employed from 1974 until his discharge in 1978, but did not rule on whether that discharge was improper, as alleged by Jon.

In 1981, plaintiff-appellees brought suit, alleging that Leonard had abused his fiduciary duty to Statler and to appellees. Count I of the complaint sought a derivative recovery against Leonard on behalf of Statler, alleging that Leonard had caused Statler to pay him excessive salary and bonuses and had engaged in other forms of prohibited self-dealing. Count II sought direct recovery for appellees against Leonard on the theory of "freeze-out" of minority shareholders. This theory was based on allegations that Leonard had deprived Jon and

Marjorie Sugarman of desired employment with the company, had drained off the company's earnings in the form of excessive compensation to Leonard, and had refused to pay dividends.

The district court found that Leonard had given his father, Myer, salary and pension benefits that were not given equally to Hyman, appellees' father. In addition, it found that Leonard had offered to buy Jon and Marjorie's stock at a grossly inadequate price. The court also found that Leonard had received excessive compensation from Statler for the years 1978 to 1984 and that this overcompensation "was effected in bad faith, as part of an attempt to freeze out minority interests". The court concluded that this combination of factors was proof of Leonard's effort to improperly freeze appellees out of the company. Adding annual interest at twelve percent from the dates each of these payments were made, the court concluded that a total amount of $1,353,837 had been improperly paid to Leonard and Myer. The court further found that Leonard had improperly caused Statler to pay on his behalf an additional $82,201 in attorney's fees and $9,836 in expert witness fees in defending this action. The court then awarded damages directly to appellees in an amount equal to 21.78% of these improper payments, a percentage equivalent to the amount of stock owned by appellees. The court also awarded appellees their attorney's fees and costs in the amount of $115,720. The final amount awarded to appellees was $537,925.

II. Freeze-Out

We first examine the legal standard that must be met to establish a "freeze- out" of minority shareholders, and then analyze the evidence and findings of the district court. In Donahue v. Rodd Electrotype Co. of New England, 367 Mass. 578, 328 N.E.2d 505 (1975), the Massachusetts Supreme Judicial Court (SJC) held that shareholders in a close corporation owe one another a fiduciary duty of " 'utmost good faith and loyalty' ". 367 Mass. at 593, 328 N.E.2d 505 (quoting Cardullo v. Landau, 329 Mass. 5, 8, 105 N.E.2d 843 (1952)). According to the court, stockholders in a close corporation "may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation." Id.

The court's decision in Donahue was premised on the rationale that the corporate form of a close corporation "supplies an opportunity for the majority stockholders to oppress or disadvantage minority stockholders". Id. 367 Mass. at 588, 328 N.E.2d 505. Some of these devices to "freeze out" the minority were described by the court:

" 'The squeezers [those who employ the freeze-out technique] may refuse to declare dividends; they may drain off the corporation's earnings in the form of exorbitant salaries, and bonuses to the majority shareholder-officers and perhaps to their relatives ...; they may deprive minority shareholders of corporate offices and of employment by the company; they may cause the corporation to sell its assets at an inadequate price to the majority shareholders.' " Id. at 588-89, 328 N.E.2d 505, (quoting F.H. O'Neal and J. Derwin, Expulsion or Oppression of Business Associates: "Squeeze-Outs" in Small Enterprises 42

(1961)).

All of these devices are designed to ensure that the minority shareholders do not receive any financial benefits from the corporation. When these types of "freeze-outs" are attempted by the majority, "the minority stockholders, cut off from all corporation-related revenues, must either suffer their losses or seek a buyer for their shares". 367 Mass. at 590-91, 328 N.E.2d 505. This, according to the court, is often "the capstone of the majority plan". Because minority shareholders cannot sell their stock on the open market, as can shareholders in public corporations, the minority shareholders may be compelled to deal with the majority and be vulnerable to low offers for their stock. Id. at 592, 328 N.E.2d 505. As the court explained, "[w]hen the minority stockholder agrees to sell out at less than fair value, the majority has won." Id.

In Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976), the SJC held that three directors of a close corporation had improperly "frozen-out" Wilkes, a fourth director when they removed him from the payroll without any "legitimate business interest". 370 Mass. at 852, 353 N.E.2d 657. The court also stated that it could "infer that a design to pressure Wilkes into selling his shares to the corporation at a price below their value well may have been at the heart of the majority's plan." Id. This inference arose from the fact that "Connor [one of the stockholders], acting on behalf of the three controlling stockholders, offered to purchase Wilkes's shares for a price Connor admittedly would not have accepted for his own shares." Id. at 852, n. 14, 353 N.E.2d 657.

In these cases, the SJC has pioneered in developing an effective cause of action for minority shareholders who have been denied their fair share of benefits in close corporations. At the same time, it has carefully set out the contours of that cause of action. First, it is not sufficient for a minority shareholder to prove that the majority shareholder has taken excessive compensation or other payments from the corporation. See Bessette v. Bessette, 385 Mass. 806, 809-10 & n. 5, 434 N.E.2d 206 (1982) (right to recover overcompensation payments belongs to the corporation as a whole; suit must be brought as derivative action unless plaintiffs specifically allege that "defendant's conduct was an attempted 'freeze-out' of the minority stockholders by draining off 'the corporation's earnings in the form of exorbitant salaries and bonuses.' ") (quoting Donahue, 367 Mass. at 588-89, 328 N.E.2d 505). Here, appellees alleged a freeze-out attempt, and the district court found that Leonard's overcompensation was indeed "effected in bad faith, as part of an attempt to freeze out minority interests".

Second, it is not sufficient to allege that the majority shareholder has offered to buy the stock of a minority shareholder at an inadequate price. Majority shareholders have an independent duty to exercise complete candor with minority shareholders when they negotiate stock transactions; they must fully disclose all the material facts and circumstances surrounding or affecting a proposed transaction. Lynch v. Vickers Energy Corporation, 383 A.2d 278, 279 (Del.Sup.1977) (failure to disclose material facts in a tender offer); Ritchie v. McGrath, 1 Kan.App.2d 481, 571 P.2d 17, 22 (1977) (same); Flynn v. Bass Brothers Enterprises, 456 F.Supp. 484, 493 (E.D.Pa.1978) (must prove at trial that material information was withheld

in tender offer). If a majority shareholder breaches this duty, and a minority shareholder sells stock at an inadequate price, the minority shareholder can seek damages based on the difference between the offered price and the fair value of the stock. See, e.g., Lynch, 383 A.2d at 278-79.

In most cases, a stockholder must first sell his or her stock at an inadequate price before seeking damages. In a close corporation, however, a minority shareholder who merely receives an offer from a majority shareholder to sell stock at an inadequate price, but does not accept that offer, can still seek damages if the shareholder can prove that the offer was part of a plan to freeze the minority shareholder out of the corporation. That is, the minority shareholder must first establish that the majority shareholder employed various devices to ensure that the minority shareholder is frozen out of any financial benefits from the corporation through such means as the receipt of dividends or employment, and that the offer to buy stock at a low price is the "capstone of the majority plan" to freeze-out the minority. Donahue, 367 Mass. at 592, 328 N.E.2d 505.

The necessary ingredients of a freeze-out of minority shareholders are present in this case. The district court first had to find that Leonard Sugarman took actions to ensure that appellees would not receive any financial benefits from Statler. As noted, the court did find that Leonard's overcompensation was designed to freeze-out appellees from the company's benefits. The court also took note of the fact that dividends had never been paid by the company, although it concluded that dividends were only indirectly the issue in this case. The court also pointed out that Marjorie had sought and been denied employment with Statler and that Jon had alleged he was improperly discharged from employment at Statler. The court concluded, however, that it did not need to pass on this "doubtful proof" concerning employment in order to find freeze-out of the minority shareholders.

[1] We agree that the district court was not required to find that every possible device for effectuating a freeze-out was employed by Leonard. Rather, the finding that was essential, and that was made by the district court, was that Leonard took some actions that were designed to freeze appellees out of the financial benefits they would ordinarily have received from Statler. Once the court made that finding, it could appropriately conclude that Leonard's offer to buy Jon and Marjorie's stock at an inadequate price was the capstone of a plan to freeze out appellees. See Donahue, 367 Mass. at 592, 328 N.E.2d 505.

III. Payments to Myer

As one of the factors establishing freeze-out, the district court found that Myer, Leonard's father, had received salary and pension benefits in excess of payments made to Hyman, appellees' father. Myer was one of the founding members of the company. From 1975-81, from ages 82-88, Myer received substantial salaries from Statler. In the last two years of his employment, 1980-81, Myer's salary approximately doubled, reaching $85,000. On his retirement in 1982 at age 88, Myer was voted a pension of $75,000. Hyman, while employed by Statler, received a salary similar to Myer's pre-1980 salary. When Hyman's employment

with Statler ended in 1980, however, he was not voted a similar pension payment.

Although the district court found that "soon after 1975 [Myer's] net value to the company declined from relatively little to zero", it went on to conclude that it did "not quarrel seriously with payments to Myer and Hyman, whether for working, or as a pension, as long as neither is favored." Appellants argue that the court made two factual mistakes in its analysis of the payments to Myer and Hyman which require reversal. We find neither of these claims to have merit.

[2] Appellants first note that the court erred when it stated that Hyman died in 1979 and that no pension was voted to his estate. It is true, as appellants point out, that Hyman did not die in 1979, but rather left the company's employ in 1980. Nevertheless, we believe this misstatement on the part of the court to be harmless. If what was improper was the differential treatment between Myer and Hyman, it makes no difference whether the money under consideration was paid to the person himself as a pension or to the person's estate. We believe the district court made the same assumption. At a post-trial hearing on attorney's fees, the court was informed by the parties that, in fact, Hyman was still alive. The court apparently did not believe that fact ultimately changed its analysis, and we agree.

[3] Appellants' second argument is that Hyman and Myer were disparately situated within the company, and that the district court failed to explain why differential treatment of the two was inherently wrong. They point out that Myer was an original founder of the corporation, a stockholder, and had remained in the company's employ until his retirement. In contrast, they note that Hyman was only a son of one of the founders, had not been a stockholder since 1974, and had his employment with the company come to an end in 1980. We believe the district court sufficiently explained its reasoning and was correct in its conclusion based on the evidence. The court noted that Myer's salary was suddenly doubled in 1980, with no evidence that Myer was more valuable than Hyman at that point. The court also stated that this salary, for a person who had "become completely irresponsible, unless possibly viewed as a pension, was blatantly unconscionable". In viewing it as a pension, similar to the $75,000 actually voted to Myer as a pension in 1982, the court noted that Hyman received no such comparable pension benefits. Even if Hyman and Myer were not identically situated within the company, their situations were not so disparate as to preclude the court's finding that the payments to Myer were "a shocking case of special treatment for the majority stockholder's side of the family".

IV. The Stock Offer

[4] As the second factor establishing freeze-out, the district court found that Leonard had offered to buy Jon and Marjorie's stock at a "grossly inadequate price". We have already concluded that such an offer may be viewed as an important component of a freeze-out plan. Appellants argue, however, that the district court made a factual error in its analysis of the stock offer that requires reversal. We do not agree.

The district court found that Leonard had offered to buy Jon and Marjorie's stock in 1980 for

$3.33/share. It also found that, in 1980, the company's accountants, Price Waterhouse, had informed Leonard that the book value of the company's stock was $16.30 a share. The court had to decide whether book value of shares in a close corporation could be considered fair value of the stock. The court noted that it "might have considered that book value is not fair value for shares in a close corporation, but Price Waterhouse set this price for purchases by 'key management personnel' pursuant to the company's stock option plan."

Appellants point out that this comment is a misstatement of fact, because the stock option plan to which the court referred had expired the previous year and the letter from Price Waterhouse had made no mention of the stock option plan. Even if the court's comment reflected a misapprehension of fact , we do not believe this possible misapprehension undermines the basic validity of the court's analysis. The stock option plan was critical for determining whether the book value of the stock, as established by Price Waterhouse in 1980, was to be considered fair value of the stock, and thus whether Leonard's offer of $3.33 to Jon and Marjorie should be viewed as unreasonably low. In the stock option plan, adopted in 1972 and in existence till 1979, the company had stated that because the shares of the company "have no recognized market, are not traded regularly or irregularly by any persons and have not been subject to valuation by any disinterested party," the "book value of the shares" would be considered a fair measure of the stock's value. As stated in the plan: "The book value per share shall be that amount as determined by the independent auditors of the Company at the close of the most recently completed fiscal year. Such book value shall be the fair market value for the purposes of this Plan."

Given the framework of the stock option plan, the district court could legitimately conclude that Leonard's offer of $3.33 to Jon and Marjorie in 1980 was unreasonably low. The fact that the court may have been wrong on a subsidiary factual point regarding the term of the stock option plan does not undermine the validity of the court's essential finding regarding Leonard's offer.

V. Leonard's Compensation

Appellants argue that the district court made a number of errors of fact and law in analyzing Leonard's compensation. We do not believe that any of the alleged errors warrant reversal of the court's findings.

[5] Appellants first argue that the court's determination that Leonard's salary was unreasonable was tainted by its erroneous findings of bad faith and freeze-out, and that a new trial on the compensation issue is warranted. We do not agree. The court stated that "[i]t may also be appropriate to consider Leonard's bad faith in connection with the amount of his compensation. Certainly, at the least, it prevents giving weight to the judgment of a board of directors that he controlled" (emphasis added). We find no error in this statement. While courts often defer to the business judgments of boards of directors in ordinary situations, there is nothing improper in reducing the level of that deference once a court has determined that the director who controls the board has operated in bad faith.

[6] Appellants next point to a series of errors in the court's calculation of Leonard's compensation. We deal with these seriatim. First, appellants argue that the court erred in comparing Leonard's compensation to that of similarly situated company directors when it looked only at Leonard's cash compensation and failed to take into account the non-cash elements of compensation packages often given to other company directors. We do not believe the court erred. The question of what elements in the package should have been considered in analyzing Leonard's compensation was extensively addressed and debated by the expert witnesses for each side. Both witnesses agreed that they had not taken into account the company's pension plan in their analyses, and thus the disputed question revolved around whether other long- term incentive plans, such as stock options, should be included in the comparision. Donald Simpson, appellees' expert witness, testified that he did not include such incentive plans in his analysis because such plans were not common in small companies like Statler, and because his experience was that when an officer already has a major ownership in the company (such as Leonard's 60% ownership), the officer does not participate in long-term incentive plans. Clifford Mitman, Leonard's expert witness, disagreed, stating that he considered Leonard's 60% ownership to be irrelevant in doing a comparative analysis. Faced with this conflicting expert testimony, the district court chose to accept Simpson's testimony, concluding that Leonard's 60% ownership was relevant and that Leonard's compensation was therefore significantly greater than that of other comparable officers. We find that the court was clearly within its discretion in accepting Simpson's testimony.

[7] Second, appellants argue that the court erred in not giving weight to Internal Revenue Service (IRS) audits that found Leonard's compensation to be unreasonable during only two years. We do not agree that the court committed error when it failed to give the IRS audits "any favorable weight". Results of IRS audits may be considered by the trial court in its discretion, but are not conclusive on the reasonableness of salaries. Miller v. Magline Inc., 76 Mich.App. 284, 256 N.W.2d 761, 768 (1977). In this case, the district court heard a great deal of evidence from two expert witnesses on Leonard's compensation and made its factual findings on that basis. In light of this detailed expert testimony, it is understandable that the district court would have felt that the more general IRS audits would not be particularly relevant or helpful. We find no reversible error in the court's approach.

[8] Third, appellants argue that the district court did not fully understand the import of Leonard's testimony regarding sales commissions that Leonard could have received instead of salary. We disagree. Leonard testified that, during 1974-1980, he "acted as an agent" for three of the company's major accounts, and that if he had simply received the usual 2.7% sales commission, he would have earned $378,000 per year "without the problems and burdens of being Chief Executive Officer". The court's response was that "[t]here seems something very peculiar about paying a company president a brokerage fee" and that "[i]f a customer is satisfied to stay without constant nursing, that is to the credit of the company's performance. It is not an independent reason to give a continuing bonus to the president." We conclude that the court understood perfectly the import of Leonard's testimony, and acted well within its discretion in refusing to consider such potential commissions.

[9] Fourth, appellants argue that the district court failed to consider the impact of the bonus plan which substantially contributed to Leonard's salary from 1976 to 1979. We do not find reversible error in the court's calculations. It is true that Statler's returns on equity in the years 1975-77 were above average, and that Leonard's bonuses during that time may have been justified. The court, however, charged Leonard with overcompensation only for the years 1978-84, and used the salary and bonuses given in 1976 and 1977 only to partly discharge catch-up salary obligations. Further, the court's ultimate conclusion of overcompensation was largely based on the fact that, when the company began doing poorly after 1978, Leonard's bonuses significantly dropped while his salary substantially increased.

[10] Fifth, appellants argue that the district court made a significant error of fact when it stated that Leonard's salary comprised a higher percentage of company's sales than had been found legitimate for a company president in Black v. Parker Manufacturing Co., 329 Mass. 105, 115-17, 106 N.E.2d 544 (1952). We do not believe the court's statement constituted reversible error, and indeed, we believe the district court properly applied the basic principle enunciated in Black.

In Black, the court stated that the salary and bonus of a chief executive officer should be approved if they bear "a reasonable relation to the officer's ability and to the quantity and quality of the services he renders. Responsibilities assumed, difficulties involved and success achieved are matters to be considered." 329 Mass. at 116, 106 N.E.2d 544. In Black, the officer's compensation was in the 1%-2% range of the company's net sales; Leonard's percentage ranged between .60% and 1% of sales. The court commented as follows: "Passing the fact here, that Leonard's percentage was higher [than the president in Black), his total compensation often bore an inverse relationship to the company's performance. In three out of the last five years the return on equity was poor, and in 1984 negative, the company actually losing money. Yet in that year, by a process of maximum salary and minimum bonus, Leonard received the greatest compensation ever."

It is clear that the precise ratio that Leonard's compensation held to company sales was not the controlling factor in the district court's analysis. Indeed, appellants would have us construe a disclaimed basis for decision ("passing the fact") as an actual basis. Rather, the essential element for the court was the fact that the company was doing quite poorly in 1980-84, Leonard's bonuses thus fell off significantly, and yet Leonard's salary increased by almost $100,000 each year. Under the principle enunciated in Black, it was appropriate for the court to question the reasonableness of Leonard's salary under these circumstances and to accept expert testimony regarding the excessiveness of that salary. The court's miscalculation regarding percentages was harmless.

[11] Last, appellants argue that the district court's treatment of Leonard's "catch-up" claim was illusory and arbitrary. Leonard claimed that he was underpaid during the years 1969-1974, a period during which Statler performed well. Leonard argued that any possible overcompensation in his salary in later years was "catch-up" pay for those previous years. The district court accepted the principle that Leonard deserved some catch-up pay, and

modified its calculations in light of that principle. Leonard's argument on appeal is that the district court did not give sufficient weight to catch-up pay, and that the modifications the court made were arbitrary.

We disagree, finding that the district court acted within its discretion in making its modifications. The district court was presented with extensive expert testimony on this issue. Plaintiff's expert witness, Simpson, testified that Leonard's salary from 1974-84 was above the average salary for a CEO in a similar type of company. In his analysis, Simpson developed four tables, the highest being for a CEO with stock ownership whose performance was good (Table D). Although Simpson had not taken into account, in his analysis, the fact that Leonard received below average salary for a number of years previous to 1974, he did agree to the principle that a board of directors could increase a CEO's salary for a number of years as "catch-up" pay. Simpson noted, however, that such catch-up pay usually does not go on indefinitely and is dependent on continued good performance. Defendant's expert, by contrast, testified that all of Leonard's higher than usual salaries from 1975 on, including the years in which the company had done very poorly, were justified on the grounds of catch-up pay.

Based on this conflicting expert testimony, the district court made its own factual conclusions. It accepted Simpson's testimony that catch-up pay should play a role in deciding compensation, albeit not indefinitely, and it made adjustments in Simpson's analysis to reflect that. First, it ignored any overcompensation for the years 1976 and 1977. Second, for the years 1978 and 1979, it accepted Simpson's highest salary figures (for a stock-holding CEO whose performance was good, Table D), and added a supplement of 10% to that table. Third, although the court found that Leonard's claim to Table D faltered by relatively poor performance after 1980, it retained Leonard in that table through 1984 (without the 10% additional) as a carry-over bonus for past accomplishments.

It would have been useful if plaintiff's expert had been informed of Leonard's previous low salary years and had made his own adjustments for catch-up pay. Nevertheless, it would still have been the job of the district court to accept those adjustments or not. We conclude that the court's actions, in making its own adjustments, were within its discretion.

VI. Laches

[12] The district court applied laches to bar appellees' claims for damages prior to 1978. Appellants argue that laches should bar recovery for all years prior to 1980, the year before the suit was filed. We disagree. The district court appropriately found that Jon Sugarman, having made his complaint about Leonard's salary at the 1978 and 1979 stockholder meetings, was not unjustified in delaying the suit until 1981. As the court noted, "[l]awsuits are expensive, and it was not unreasonable to await further development." In addition, as the court pointed out, Leonard did not change his behavior even after plaintiffs filed suit. Thus, we cannot say that appellees' delay caused Leonard to take steps to his detriment which he otherwise would not have taken. See Provident Co-Operative Bank v. James Talcott, Inc., 358 Mass. 180, 187, 260 N.E.2d 903 (1970) (to sustain a defense of laches, party must prove

that a plaintiff's delay resulted in prejudice or disadvantage to the defendant).

Discussion point for Keating v. Keating

So maybe it's true. Maybe the acorn doesn't fall far from the tree. Which leads to 2 questions. How would you like to work for these people, either as corporate counsel or as an employee? And, more importantly, what would you, as corporate attorney, have done to prevent this acrimonious family situation from getting to where it did?

Superior Court of Massachusetts.

Paul M. **KEATING**, Jr.
v.
Paul M. **KEATING**, Sr.

Nos. 00749, 00748.

Oct. 3, 2003.

MEMORANDUM OF DECISION

PAUL A. CHERNOFF, Judge.

As Lev Tolstoy aptly observed in the immortal opening lines of *Anna Karenina,* "All happy families are the same, every unhappy family is unhappy after its own fashion." The unhappy fashion of the Keating family pits father and daughter against son and vice versa in a lengthy internecine struggle for control of the administration of the family-run closely held food distribution business. The denouement of the son's involvement was marked by his departure from the family business and his initiation of a competing enterprise. At issue in this jury-waived litigation is, inter alia, whether or not: (1) the son quit or was fired by his father; (2) the son was "frozen out" of his 49% stock ownership; (3) there was a buy-sell or stock restriction agreement that governs disposition of stock; (4) there was a breach of a fiduciary duty by one or both of them. The Court must also determine whether father and/or son engaged in unfair or deceptive trade practices or committed intentional torts while trying to throttle one another in the competitive marketplace of food distribution to military commissaries.

The trial was conducted in an emotionally charged atmosphere. For more than four weeks, this judge heard multiple versions of the same events from 24 witnesses and viewed 88 document exhibits and a number of demonstrative aids. Some witnesses changed their testimony between deposition and trial and, on occasion, during the trial itself. The resolution

of the ultimate controversy involves a number of very close legal calls and their very closeness is reflected in the fashioning of appropriate remedies.

The principal witnesses at trial were the principals in the litigation: the father (Paul M. Keating, Senior, age 70) ["Senior"]; the daughter (Michelle Keating, age 42) ["Michelle"]; and the son (Paul M. Keating, Junior, age 39) ["Junior"]. The Keating family members are blessed with intelligence, a strong work ethic, a keen business sense, and superb organizational skills. However, they are quick-tempered and are not inclined to forgive and forget intra-family slights. The essence of this family tragedy was poignantly expressed by the mother (Bertha Keating, age 69) to her son, Junior, "The whole family is being torn apart ... I love you, but this is killing me."

FINDINGS OF FACT

Some of the facts developed during the multi-week trial are not detailed in these findings because, in retrospect, they turn out to be marginally helpful to the resolution of the issue at bar in that they are probative only of the animosity that fueled the litigation. [FN3] This judge has elected to set out the relevant facts in chronological chunks.

FN3. For example, several witnesses spend several hours casting aspersions on the principals.

1965-1988--It all started in the house and garage of Senior, where Alder Food Distributors' ["Alder"] precursor, Military Sales and Marketing was founded in 1965. Food items were purchased and sold to the military through an outside distributor. The Defense Commissary Agency ["DeCA"] is the military purchaser for the more than two hundred military commissaries located on military bases throughout the world. In 1973, Alder was formed and Military Sales was phased out and exists today only as a shell. In 1988, the sales volume was $2.5 million and in 2003 it will exceed $23 million. Until 1988, the Alder personnel consisted of Senior and a single one-half time employee, Ms. Griffith. By 1988, Senior and his wife Bertha had raised and educated five children, including four daughters and one son, Junior.

1988-1994--Junior graduated from college in 1988 and immediately commenced full-time employment with Alder at Senior's suggestion. Junior was not a total novice to the business as he had worked part time during college for his father calling on customers and visiting plants. Junior's focus for the first few years was calling on customers up and down the east coast. In 1990, Alder relocated to Washington Street in Dedham with its personnel complement remaining at 2 1/2 persons. Junior recognized that DeCA's change from a manual to an automated system would require automation by Alder. Junior recommended the hiring of a computer software literate college friend to develop a computer program at Alder.

Senior, who showed little interest in the computerization of the business, allowed Junior to proceed with it. Also, Junior helped persuade Senior to gradually do away with the middleman distributor by assuming that function. By 1994, Senior had shifted many important responsibilities for the day-to-day running of the business to Junior. However, clashes in their management styles and personalities were becoming noticeable to outsiders. For example, Junior wanted to expand the company at the sacrifice of cutting profit percentages which grated against Senior's business philosophy. Also, Senior perceived more than a note of disrespect in Junior's attitude towards his father and boss. Nevertheless, when Senior passed his sixtieth year, he told Junior that he was planning to turn the business over to him some day. Bertha Keating was concerned that the father/son controversies were having a negative impact on Junior's health and that work-associated anxiety was causing him chest pains. In 1993, about the time when Junior married, his mother wanted him to join another company.

1994-1997--Alder Food expanded its product line by adding the Bel Kaukauna cheese line from Wisconsin and a Rainbow line was created to handle salmon and swordfish in Europe and the mid-west. In 1994, Senior started to distance himself from the business as he primarily lived in his Florida home and returned to Massachusetts for days at a time about once each month. The business was run on a day-to-day basis by Junior and Joan Stockhammer. Senior began to take estate planning seriously and over the ensuing three years he met periodically, about six to seven times, with his estate planning group which included two financial advisors (Charlie Fellows and Charlie Murphy) and an attorney (Alan Almeida of the firm of Connor & Hilliard, P.C. of Walpole) where Junior attended a substantial number of the meetings. Senior expressed his interest in keeping the control and ownership of Alder Food within the family and the group considered contingencies in the case of Senior's death and also in case of Junior's death, divorce, or employment termination. Senior also wanted to insure an income stream to his wife in his absence. There was discussion early on of the issuance and distribution of shares of stock in a manner that would avoid both gift and estate taxes. Even though stock certificates had not yet issued, Junior purchased a $400,000 life insurance policy in October 1995 and Senior purchased a policy for $1,000,000. A number of stock issuance options were discussed over the years including the issuance of stock to a trust. In 1995, an appraisal showed the business worth $700,000 and a conclusion was reached that for gift tax purposes one could discount a minority share by 30% to 35% so that 49% of the stock could be valued at $200,000. In November 1996, Senior was considering drafts of an irrevocable trust to hold 51% of the stock and a second irrevocable trust to hold 49% which would be available to be gifted to Junior.

Although Senior had his differences with Junior and he was not hesitant to criticize Junior's performance, Senior saw few options and felt that Junior was destined to control and own the business. By early 1997, Senior decided to take the first step towards committing the company to Junior. He decided not to use a trust vehicle and that 100 shares of stock should issue and that Junior would receive 49 of the shares as a gift. The estate planning group spent hours discussing the tax ramifications associated with the shares and the mechanisms for ensuring family ownership of the company, including a stock restriction or buy-sell agreement. Such a restriction may have privately grated against Junior, but he had little

bargaining leverage and, according to Attorney Almeida, Junior "nodded" his assent. A death or divorce contingency in a buy-sell agreement might not have irked Junior, but leaving employment at Alder certainly would since Senior was, and would continue to be, resistant to offering Junior a contract with significant tenure terms. In August of 1996, the planning group meeting focused on a discussion of a one-year employment contract for Junior and the position of vice president. An employment agreement was never drafted.

In late 1996 or early 1997, Attorney Almeida produced drafts of stock restriction agreements. There was testimony that the last stock restriction or buy-sell agreement did provide, inter alia, for a payment of $200,000 (with an appreciation provision) to Junior for his stock in the event his employment at Alder was terminated. On April 4, 1997, Senior turned in the initial 100 shares of stock and new certificates issued on that day, 51 shares to Senior and 49 shares to Junior. This Court cannot find that Junior had committed himself to specific terms of a stock restriction or buy-sell agreement when he accepted and signed the stock certificates. Senior may have signed such an agreement and Mr. Almeida may have sent an agreement or the draft of one to Junior, but no one can produce the agreement. Later Junior and his counsel, Attorney Stanzler, made substantial efforts to obtain the document from Attorney Almeida and Attorney Michelmore, Senior's attorney.

The relationship between Senior and Junior survived highs and lows over this three-year period. In May 1996, Senior, in Junior's presence, asked Kevin Snyder, a highly regarded consultant at Alder, if he wanted to be made president of Alder Food. The following day Junior complained to Senior who summarily suspended him for one or two weeks stating that it was Senior who ran the company. By letter of May 8, 1996, Senior further chastised Junior, threatening to let him go if he didn't control his temper and reminding him that his parents had given him, and not his sisters, $40,000 to purchase a house. Yet in 1997 Senior and Junior became jointly involved in two new business ventures, PMK Golf and Keating LLC where the principal asset of the former was a golf driving range and the latter was ownership of the property comprising Alder's office building and the driving range. In order to facilitate the ventures, Junior received a $5,000 bonus from Alder for each investment and Senior contributed a like amount, probably from his personal funds. Both companies were and remain indebted to Alder Food and it appears that Senior and Junior have maintained equal interests in each company.

By the close of 1997, Senior had turned over the running of Alder Food to Junior and intended his primary interests to be the monitoring of financials and his own compensation as president. Junior hired John Whouley, a childhood friend, as Director of Finance. Junior also hired Rob Dennecke who was a former college roommate.

1998-1999--Junior was managing the company on a day-to-day basis in the capacity of vice president of sales and marketing. The business expanded from four to more than one dozen product lines including the addition of Land O'Lakes, Integrated Brands, Kens, and Nestle Quick due to the combined efforts of Senior, Junior, Stockhammer, and Denneke. In mid-1998, Michelle Keating was working on the premises of Alder Food managing Military Data Services ["MDS"], which provided pricing and administrative services to manufacturers.

MDS was losing money and Michelle accepted Junior's invitation to join Alder. Michelle learned a great deal from Junior and she served as an intermediary between Senior and Junior when they were unable or unwilling to communicate with each other. Michelle became vice president of marketing while Junior was vice president of sales, a director along with Senior, and clerk. After an interview with both Junior and Michelle, Dustin Whitney, whose wife was friendly with Junior's wife, was hired by Alder with a $5,000 signing bonus and a two-year non-compete agreement. Greg Sheldon, who knew Whouley's brother, was hired first as a consultant in 1998 and later as a staff person in January 2000 after interviews with Junior, Michelle, and Senior.

Senior made periodic trips from Florida, examined the books and involved himself in Alder's affairs when at the office. On one such occasion, in August 1998, Junior and Cathy Flynn were preparing for a presentation in Europe and Senior wanted Junior to make changes in the documents. Junior passed the documents to Senior and told him to make the changes himself. Senior felt publically insulted and, then and there, suspended Junior for two weeks and announced that he would be arrested if he came on the property over that period. During the suspension, Michelle was instrumental in providing Junior with some funds from a related business in the sum of $2,500.

In September 1998, Senior approached Junior with an offer to sell his 51 shares to him for 4 million dollars, payable over ten years, and that he wanted a quick response. Junior discussed the matter with Michelle who indicated that she wanted an ownership share of the business. Junior suggested that she start with a 25% share and she seemed content. Junior felt this to be a fair allocation based on his ten years at Alder and the fact that she had brought in no capital. Attorney Connor, a cousin to the Keatings who was held in very high esteem by all of the principals, was asked to put together a Memorandum of Understanding concerning the sale of Senior's 51% ownership. Junior, on Connor's advice, retained an attorney, Mr. Stanzler who, on occasion, met with both Junior and Michelle. Attorney Melinda Kwart, an associate in the Connor law firm, drafted a Memorandum of Understanding. She worked primarily with Michelle who was in contact with both Junior and Senior on it. The price was not included in the agreement and was left as "something to work on." The plan discussed was that Junior and Michelle would gradually buy out Senior. The agreement was never signed. Senior was coming to believe that the most preferable result would be equal ownership interests to Junior and Michelle. Michelle agreed, but Junior felt it unfair and he at least contemplated a side agreement with Michelle.

In 1999, Junior brought in a beverage product line named "Mighty Mouse" which lost approximately $90,000. This loss was not revealed to Senior and was covered by money transferred from accrual accounts from other products. Most of these transactions were known to Michelle. In 1999, Michelle, who was in the final stages of a divorce, became romantically involved with Kevin Snyder. Junior bristled at their public displays of affection and told Michelle that he felt the relationship was inappropriate, could cause problems, and that one of them might have to leave Alder if they were to marry. Senior also expressed disapproval of the relationship.

In August 1999, Senior told Junior that he wanted to equalize the inheritance bequests to his five children and, to do so, he needed Junior to release his interests in Keating LLC and PMK Golf to Senior. He presented Junior with release papers which Junior refused to sign or even consider. Senior became infuriated and showed Junior a recent letter from Attorney Michelmore that questioned the viability of the 1997 stock transfer to Junior and said that he would come after those shares. Senior was so outraged that he essentially stopped speaking with Junior from that date to the present. Senior testified that "it was the worst day of his life." Michelle noticed that Junior was shaken by the incident.

Senior's bruised feelings contributed to his new resolve to leave the business. At this point, he was basically willing to accept $4,000,000 over ten years and transportation costs over that period as payment for his 51% of the shares. A letter from Junior to Senior dated September 8, 1999, raised a number of questions including tax consequences, payment schedules, Senior's defined benefit plan, and the status of Rainbow. Senior called upon Attorney Connor to mediate the sale of the business to Junior and Michelle equally. The mediation faced a minefield of fractured feelings and distrust, complex tax snares, and the devilish details. For example, Michelle was present for sessions with the mediator, but Senior and Junior never met together with the mediator because of their refusal to sit in the same room with one another.

As Christmas 1999 approached, Junior came to accept that the purchase of Senior's 51% for about 4 million dollars would net him but one additional share and 50 shares for Michelle. Junior received a Christmas bonus from Alder. On or about December 23, 1999, Junior received a very welcome letter from Michelle addressed to "Dear Wally," a pet name which was not embraced by Junior. In the letter she expressed her love, admiration, and gratitude along with an optimism for success in their cooperative undertaking. She wrote that his success should be measured by his own expectations and not that of "ANYONE else," which might well be a veiled reference to Senior and an appreciation of Junior's delicate situation. Assuming the sincerity of this letter, it represents the zenith of the sibling relationship which started to unravel within hours.

Michelle attended a Christmas party at Junior's home with Kevin Snyder and, according to Junior, she drank to excess and embarrassed herself before family and guests. As the month came to a close, Senior, in a decision supported or recommended by Michelle, cancelled Dustin Whitney's plans for a twelve-day trip to Asia and ordered that Junior go in his stead. Senior said that Whitney would be fired if he went and, in addition, that all bonuses would be held up. Junior unhappily agreed to the order and told Senior by phone that there was no need to make threats.

January 1, 2000-May 2000--Attorney Connor was nominated by the Governor and confirmed by the Executive Council for a District Court judgeship, and with the New Year, he was phasing out of his law practice at Connor & Hilliard. Accompanied by a letter of January 11, 2000, Mr. Connor transmitted to Junior a proposed agreement that was acceptable to Senior. Mr. Connor stated that he had listened to all three parties and that they have an excellent opportunity for success if they make personal goals and feelings secondary

and the interests of Alder first. The Agreement provided for a buyout by Alder of Senior's 51% for the sum of $500,000 per year for five years and $300,000 per year for the succeeding five years plus reimbursement for automobile travel expenses and air travel over ten years. It further provided that Alder would forgive PMK Golf its $1,058,000 loan and that Junior and Michelle would own Keating LLC while Senior would own PMK Golf. Another Agreement was proposed by Junior which addressed Rainbow, MDS, PMK Golf, and Keating LLC with two alternative payment schemes, one for payment of $3,500,000 over time with $2,500,000 taxed at 21% capital gains and the second for payment of $4,000,000 over time taxed as ordinary income.

Junior left on the Asian trip on or about January 22, 2000. Michelle managed the business in his absence. While in Asia, Junior learned of a developing inventory problem in Germany where perishable products (CoffeeMate, Lactalis milk, Nestle Quick) which were near their expiration dates had been shipped to Germany and that Alder would have to repurchase the product. In doing so, Alder would sustain a loss of about $20,000 which would be assessed against the products' accrual accounts which were safety nets or "rainy day funds" put aside from individual product earnings.

Junior returned from Asia on or about January 30, 2000. His relationship with Michelle had seen a downward spiral since Christmas. He resented her Friday absences from the office when she was either tending to her twins or visiting Kevin Snyder in New York. She became very suspicious of Junior's closed-door meetings with "his" management people Whouley, Sheldon, and Whitney which she saw as a budding conspiracy to exclude and isolate her from corporate management decisions. Senior traveled alone from Florida on or about Saturday February 5th in order to attended the taking of the judicial oath by John Connor which occurred on February 8, 2000. [FN4] Michelle arranged for a private breakfast meeting with Senior over his brief visit as he planned to return to Florida following the judicial ceremony. At this meeting, which probably occurred on Sunday, February 6, 2000, Michelle poured her heart out to her father. She told him emphatically that: (1) Junior was not capable of running the company; and (2) Junior was betraying them. She described Junior's "conspiracy" with his management friends at Alder to exclude her from management. She advised Senior not to sell the company to Junior and her because they would both be betrayed by Junior who would look for a formal mechanism for freezing her out. She said that she feared that he might accomplish this by moving the business of Alder into Rainbow. Senior apparently accepted these representations without hesitation and indicated that the plan to sell his shares to them would be put on hold and that he needed some time to think about what to do about what she had said to him. Senior returned to Florida within a day or two without reaching a decision on how else to respond to Michelle's accusations of mismanagement and betrayal.

On Friday, February 11, 2000, Michelle was away on personal business. Junior elected to confront Donna Murphy, a regional sales manager, about the mounting losses in Germany which had accrued to thirty thousand dollars. Junior entered the office of Donna Murphy, a veteran employee of 7 years, who was responsible for monitoring the accounts in Germany.

It appeared that both she and the independent broker shared responsibility for the problem. Junior expressed anger to her, he shouted obscenities (using the "f" word), pounded on the desk, and positioned himself in the room so that she felt physically confined. This meeting lasted about 1 1/2 hours and he had calmed by its end. She offered to come in the following day which was a Saturday and he declined her offer. Nevertheless, the following day, she came to the office with her son and worked for a short time with Junior and Dennecke. The strategy for remediating the problem was to seek some recourse from the broker who shared responsibility. The results of this effort are not known to this Court, although Senior's position is that accrual funds from this account had previously been inappropriately diverted by Junior to cover and cover-up Mighty Mouse losses. On Monday, February 14, 2000, Donna Murphy called in sick with a migraine headache. She stated that she did not want to risk being yelled at. Junior was meeting with DeCA in the Washington, D.C. area when he learned that Donna Murphy had called in sick. He called her at home and offered an apology. Michelle returned to work on Monday and learned of the Donna Murphy incident from staff. Michelle quickly concluded that Junior had acted inappropriately and a phone conversation with him where he minimized the events did nothing to mollify her.

On Tuesday, February 15, 2000, Michelle spoke with Donna Murphy. Ms. Murphy indicated that she wanted to quit and offered two weeks notice. Michelle convinced her to stay and told her that Junior would be suspended because of his treatment of her. Donna Murphy elected not to resign. [FN5] Michelle spoke with Senior about the Donna Murphy incident before the close of business on Tuesday and he formalized her resolve that Junior should be suspended. Tuesday evening Junior called Mr. Whouley and learned that Michelle had said that Junior would be suspended for 30 days.

FN5. After Junior's departure in April 2000, Donna Murphy was promoted to the position of Sales and Distribution Manager and received a very substantial $10,000 pay raise. She resigned two years later on March 13, 2002 after a serious falling out with Michelle who had chastised her over an incident involving spoiled milk to Guantanamo Bay.

On February 17, 2000, Junior received by FedEx a letter from Senior suspending him with pay for 30 days commencing February 17, 2000. The letter acknowledged his contributions, but stated that he was putting Alder at risk with his abusive management practices. He was instructed to keep away from the business premises, have no contact with the day-to-day operations and was advised to engage in self-reflection and contemplation.

On February 28, 2000, Junior responded to Senior with a letter stating that what was brought to Senior's attention was grossly exaggerated, that over the years he had worked well with Donna Murphy, and that he has been a factor in Alder's growth and prosperity. He closed with a request that Senior call him to discuss moving forward.

On March 7, 2000, Junior sent Senior a memorandum calling for a meeting of the board of

directors to discuss, inter alia, "allegations of harassment and the corresponding disciplinary action for all management."

On March 14, 2000, Senior responded to Junior's letter of February 28, 2000 noting that Junior had declined to follow his recommendations in that he denied deficiencies in his management style and failed to address his manner of treating employees. Senior placed Junior on an indefinite suspension without pay with a requirement that Junior: (1) participate in a management training course approved by Senior; (2) meet with Senior to improve their working relationship; and (3) meet with Michelle to resolve how to work together in the future. The letter ended with a warning that a refusal on Junior's part would lead to further disciplinary action including the possibility of termination of his employment.

On March 28, 2000, Junior responded with a memorandum first stating that Senior had failed to attend the Board of Director's meeting that Junior had scheduled for March 20, 2000. In regards to Senior's letter of March 14, 2000, he wrote that: (1) Senior should come to Boston to meet with the attorneys on the buy out; (2) a meeting with Michelle should await their working out a direction for the company; (3) that management training would benefit everyone there including Michelle, Junior and "possibly" Senior; (4) that there was no management problem at Alder and that he had apologized for the use of language; (5) that the suspensions were hurting company morale; (6) that the company has succeeded under him, citing Michelle's "Dear Wally letter"; and (7) that he has received no recognition, but instead threats, and suspensions. He closed with a plea for definitive job descriptions and duties to resolve problems between him and Michelle and a declaration that there can only be one leader, not two, and that he would make the best of Senior's decision.

Shortly after March 28, 2000, probably before March 30, 2000, Senior responded with an undated letter minimizing Junior's accomplishments, stating that Michelle is not his only source of information at Alder, that Junior's last communication shows his "unmitigated arrogance" and that Junior has never thanked him for giving him the opportunity to run the company.

On March 31, 2000, Bertha Keating, by e-mail, implored Junior to compromise because his father would not change. Bertha Keating felt that Junior's employment was still salvageable, but he would have to act immediately to show that he was giving in to his father's demands. He neither acted immediately nor showed any indication of a desire to make concessions. The Court finds that Senior's resolve to terminate Junior was firmly set shortly thereafter, probably on April 1, 2000, and no later than April 2, 2000.

On April 2, 2000, after unsuccessfully trying to reach Senior in Florida on previous days, Junior contacted Senior by phone in Weston. Senior refused to discuss the issues but stated that he would offer to buy him out of Alder, PMK Golf, and Keating LLC for $700,000 and he invited a counteroffer.

On or about April 6, 2000, it became known among Alder employees that it was expected that Junior would not be returning to Alder.

On April 13, 2000, Junior sent a letter to Senior stating that he had been wrongfully terminated and effectively removed from the Board of Directors. The letter then presented two buyout options: (1) that Senior could buy out Junior for 5 million dollars for Alder and 1 million dollars for his interest in PMK Golf and Keating LLC; or (2) that Junior could buy out Senior for 5 million dollars plus 1 million dollars to be gifted to Michelle with Senior to own PMK Golf and Junior to own Keating LLC. On this date, Junior also resigned by letter as a director of Alder.

On April 17, 2000, Whouley left Alder Food and joined Elite Food about two months later. Early in Junior's suspension Whouley was told by Michelle not to communicate with Junior. Junior sent Whouley an e-mail asking him to bring some items including a power report, income statistics, data on Keating LLC, the "Stanzler" file, some papers on his desk, and a Palm Pilot cradle. He claims that he did not take those materials from Alder nor did he delete irretrievable data from computers or transmit any information from Alder computers to anyone. He acknowledges deleting data in his computer, but states that it was retrievable elsewhere in the Alder computer system. This action caused significant inconvenience and an expenditure of time and effort by Alder employees to retrieve the data. Although Whouley's actions may have been designed in part to make matters inconvenient for Alder, this Court cannot find that he either converted data or destroyed irretrievable data.

On April 21, 2000, Greg Sheldon resigned from Alder with the giving of two weeks notice. Michelle asked that he not help Junior until he left and Sheldon maintains that he honored the request. He testified that he was not a friend of Junior when he was at Alder. In July 2000, Sheldon joined Elite. There is a controversy about a compact disk given to Whouley by Sheldon and whether it contained Alder data from Alder computers. Sheldon, a computer expert, had received a computer from Whouley and he maintains that the CD contained personal data belonging to John Whouley. There is an insufficient basis in the evidence for this Court to find that Whouley prevailed upon Sheldon to convey company data to Whouley.

Weeks earlier, Dustin Whitney was told by Michelle to have no business contact with Junior. Whitney, nevertheless, wrote him a letter about the environment at work which he claims was a personal letter. On April 24, 2000, Dustin Whitney gave two weeks notice and wanted to leave on May 5, but was fired by Michelle on May 1, 2000, and escorted from the building. He joined Elite Food almost immediately thereafter.

On April 27, 2000, Junior wrote to Senior that he regretted that Senior would not negotiate concerning Junior's offer. He complained of Senior's slandering him and indicated that he remained a 49% shareholder entitled to a full fiduciary accountability and a 50% owner of PMK Golf and Keating LLC.

On April 28, 2000, the Articles of Organization for Elite Food Company were filed with the Secretary of State. Junior embarked on a new career as the sole owner and president of Elite Food Company. The business of Elite appears identical to that of Alder, the sale of food products to military commissaries throughout the world.

Within days of the incorporation of Elite Food, Junior set out to contact some key customers of Alder with the intention of garnering their business. Four of Alder's accounts left Alder in favor of Elite including Kens, Integrated Brands, Bel Kaukauna, and President's Cheese. Junior drafted the brokerage arrangement change from Alder to Elite for DeCA. It may be that Alder has lost $500,000 in commissions due to these changes.

Wendell Dukes and Associates was Alder's broker in the western part of the country and handled CoffeeMate and other products. Alder, through Michelle and/or Senior, made it clear to Dukes that Dukes could serve Alder or Elite, not both. Dukes chose Alder, one of its largest accounts. Alder claims that it did not want its broker also working for a competitor selling another milk substitute. Alder had made similar exclusivity arrangements with some other brokers over the years. The effect of this action was to compel Elite to use a lesser known and less effective broker out west. It may be that Elite has lost commission opportunities of $500,000 due to these actions.

The story ends with a more recent event where Michelle meets Junior at a trade conference in Norfolk earlier this year and expresses sympathy for the passing of his dog. Junior's response is to tell her that she is the cause of ruining his life. She responds by pouring a glass of wine on him.

Miscellaneous Findings

The defendant has attempted to show that Junior was a very poor manager with an uncontrollable temper who terrorized the staff, causing resignations, that he inappropriately fired good employees and moreover, that he himself would have been fired on several occasions had he not been the owner's son. Junior has attempted to show that he was a modern effective manager who brought success to the business and near tranquility within. Junior was an effective manager who showed human frailties over the years. His temper and occasional crudeness was a matter of some concern; however his devotion to the business and its employees merits recognition. The parade of witnesses at trial rated him as "ones" or "tens" over a twelve-year period and this Court need not discuss the views of these polar witnesses.

Likewise, Senior was characterized with the same polar observations. He too is neither a saint nor a sinner and this Court will not detail the incidents described by the competing witnesses.

The evidence shows that Senior and Junior knew how to "push one another's buttons" and they had no hesitancy to do so, either in public or in private. Sadly, each had no reluctance to demean the other to third persons, sometimes using foul and indiscreet language.

It is also unfortunate that the $30,000 of psychiatric services rendered to Senior and Junior on the sage advice of Attorney/Mediator Connor bore little fruit. The instant dispute from September 1999 to April 2000 is the tip of the iceberg of deep-seated and long-lasting

resentments, slights, insults, and lack of expressions of recognition or gratitude.

There was testimony from two financial experts as to the value of Junior's 49% stock as of April 2000. Junior's expert concluded that the business is valued at more than $9.6 million and the fair value of Junior's interest was $4,704,097. This expert did not opine on the fair market value of Junior's 49% interest because it is Junior's theory that there was a freezeout of his minority interest that was sufficiently grave that the Court should exercise its equitable powers to award "fair value" rather than a discounted "fair market value." This expert also declined to make reductions for the volitility of the business and the dependency on retention of staff and management for a service business. The defense expert made substantial deductions for market volitility, dependence on current management, and the traditional discount for the lack of marketability of a minority share in a closed corporation. This expert opined that the value of Junior's shares is the fair market value which he computes as $800,000.

As set out in the *Discussion,* this judge finds persuasive the lay testimony of the owners, sellers, and prospective owners of the property as they have peculiar insights and knowledge of the property. In particular, this judge relies on the valuations of Senior, the owner and prospective seller of 51% of the stock, Junior, the owner of 49% and prospective purchaser of 1%, and Michelle, the prospective purchaser of 50%. On all of the evidence and the reasonable inferences to be drawn therefrom, this Court finds that the fair market value of the 49% of the stock owned by Junior as of April 2000 was $1,981,334.

DISCUSSION

The case presented ten issues for the Court which are described as follows:

1. Whether there was an enforceable and complete stock restriction or buy-sell agreement in place at the time of employment termination.
2. Whether Junior was fired before he resigned from the two-person board of directors of Alder Food.
3. Whether the termination of Junior was wrongful under the law.
4. Whether a firing of Junior would breach a fiduciary duty to a minority shareholder and constituted a freezeout.
5. Whether the damages for a freezeout would be the fair market value of the minority shares held by Junior.
6. Whether Junior committed a breach of fiduciary duty to Alder when he started a competing enterprise.
7. The most appropriate method here for assessing the value of minority shares.
8. Whether the actions of Junior in regard to "stealing" Alder customers violated the Massachusetts Consumer Protection Act or constituted tortious conduct.
9. Whether the actions of Senior, Michelle, and Alder in "forcing" a West Coast broker Wendell Dukes to elect not to do business with Elite Foods violated the Massachusetts Consumer Protection Act or constituted tortious conduct.
10. Whether the actions of Whouley concerning the denuding of computers and the downloading of unspecified information constituted actionable torts or statutory wrongs.

1. Existence of an Enforceable Stock Restriction or Buy-Sell Agreement

Although the parties may have agreed to the concept of a stock restriction or buy-sell agreement, the evidence was insufficient to prove that a binding agreement had been made with specific terms governing compensation for stock in the event of employment termination. The subject matter of a stock restriction agreement was discussed by the parties and other attendees during the periodic estate planning meetings between 1994 and 1997. Such an agreement was contemplated by the parties and was acceptable to Junior if the gift of stock was dependent upon it. It may be that Senior and Junior did not agree to the final terms of an agreement when the time came to transfer the stock. Senior saw fit not to make it a condition precedent and insist on the conveying of the stock shares only upon the execution of a stock restriction agreement. If there was such an agreement, Senior wasn't thinking of enforcing it when he offered Junior the sum of $700,000 for his shares and invited a counter offer on April 2, 2000.

Assuming, without deciding, that Senior did execute an agreement, the proof fails as to the precise terms of the agreement and whether delivery was in fact made to Junior, and, if so, whether it was reviewed, signed, returned, lost, shredded or disposed of otherwise.

Accordingly, the Court finds that the parties are not bound by either a stock restriction agreement or a buy-sell agreement. Yet, this judge hastens to add that the existence of a buy-sell or stock restriction agreement is not dispositive of the issues in this case. (1) If there was a buy-sell agreement, it would have been trumped by the freezeout. (2) If there was no buy-sell agreement, the freezeout remedy appropriately resolves the issue of compensation for the turnover of Junior's shares. (3) Lastly, if the Court were to make the buy-sell agreement viable by equitably reforming it, the consideration term added for employment termination would be the fair market value of the shares which happens to be the same remedy awarded for the freezeout. Hence, the result is the same under each of the three scenarios.

2. Termination from Alder Food

The events leading up to Junior's termination followed the sad pattern of impulsive and questionable decisions by Senior which were followed by self-serving and disrespectful responses by Junior, a chemistry that constantly stirred the pot and led to the inevitable and predictable outcome. No one suggests that anyone spoke the words "I quit" or "You are fired" and hence the Court must rely on more subtle and inferential evidence on what turns out to be a close call.

In March 2000, father, daughter, and son independently concluded that equal control as well as equal ownership by Junior and Michelle guaranteed ongoing strife which would immobilize the business in time. Michelle perceived that Junior would not relinquish control and would isolate her from management decision making. Junior feared that Michelle and Kevin Snyder would become a joint adversary which could threaten his control. Michelle's mistrust of her brother was so strong that she was willing to give up acquisition of 50% of the

stock in order to deprive him of an additional 1%. Over the years, Senior had gone through periods of praising and decrying his son's management of the business and the ingredient of "betrayal" injected at the February breakfast added a new dimension to his concerns. Like the "Perfect Storm," all of the irritants descended almost at once on Senior who was overtaken by what he saw as: a challenge to his authority; disrespect, arrogance, and lack of gratitude; mismanagement and misconduct worthy of suspension; sibling betrayal; disruption of the family unit threatening Senior's own marriage; greed which thwarted Senior's estate plan to provide for all of his children; and fear for the future of his life's accomplishment, Alder Food. Senior's decision was likely supported by Michelle who saw that she could manage Alder in Junior's absence and feared that Junior's return would signal years if not a lifetime of on-the-job misery. On all of the evidence and the reasonable inferences to be drawn therefrom, this judge finds that Senior decided that Junior was not returning to Alder Food on April 1, 2000 or, the latest, April 2, 2000. His conversation with Junior on April 2, 2000, tested and reinforced this resolve. Also, his preliminary offer to buy Junior's shares for $700,000 on April 2, 2000, was a veiled communication to Junior that he was not returning. Although the Court cannot pinpoint the date when Senior and Michelle met with Alder employees and revealed that Junior was not coming back, this information did become known in the corridors of Alder by April 6, 2000. It may be that the formal meeting with Alder employees occurred at the end of April or the beginning of May.

By letter of April 13, 2000, Junior indicated to Senior that he had been wrongfully terminated and Junior submitted his resignation from the two-person board of directors. Junior probably was aware then of the scuttlebutt at Alder Food about his demise.

The Court's finding that Junior's employment was terminated by discharge rather than resignation is one of the close issues in this case. Junior's letter to Senior of March 28, 2000, reminds Senior of Junior's position that the business should only have one leader for everyday decisions and that it's extremely difficult to have two leaders reporting to Senior. One might see this as an ultimatum, that he must choose between Michelle and him for leader and that if it's Michelle, then he will go elsewhere, in other words, *resign.* [FN7] On all of the evidence, this judge finds that Junior's "ultimatum" was a minor factor in Senior's decision to terminate him and that it did not constitute a meaningful offer to resign.

> FN7. "At best, however, it is extremely difficult to have two leaders running a business with one reporting back to you concerning activities of the other. A final decision has to be made on your part. Regardless of my personal feelings, however, whatever decision you make, I will make the best of it." Conclusion of Junior's March 28, 2000 memorandum to Senior. [Ex. 69.]

3. Freezeout of the Minority Shareholder by the Majority Shareholder

Junior was an at-will employee and, if not for his shareholder status, he could have been terminated by Senior without cause at any time. *Merola v. Exergen, Corp.,* 423 Mass. 461, 464 (1996). However, his significant ownership share of the company raises issues bearing on employment termination. *Id.*

As a majority shareholder in a closed corporation, Senior owed a duty of "utmost good faith and loyalty" to the minority shareholder, Junior. *Donahue v. Rodd Electrotype Co.,* 367 Mass. 578, 593 (1975). In *Donahue,* the Supreme Judicial Court cited numerous possible ways in which the majority might oppress or disadvantage the minority, there violating the duty of utmost good faith and loyalty:

> The squeezers (those who employ the freeze-out techniques) may refuse to declare dividends; they may drain off the corporation's earnings in the form of exorbitant salaries and bonuses to the majority shareholder-officers and perhaps to their relatives, or in the form of high rent by the corporation for property leased from majority shareholders ... they may deprive minority shareholders of corporate offices and of employment by the company; they may cause the corporation to sell its assets at an inadequate price to the majority shareholders ... In particular, the power of the board of directors, controlled by the majority, to declare or withhold dividends and to deny the minority employment is easily converted to a device to disadvantage minority stockholders.

Donahue, 367 Mass. at 588-89. In *Donahue* the Court dealt with a freezeout in the context of the majority's refusal to allow the minority to sell its shares back to the corporation at the same price as the majority received. *Id.* at 598.

One year after *Donahue,* the Supreme Judicial Court issued the seminal freezeout decision with respect to the majority's deprivation of employment within the corporation to the minority. In *Wilkes v. Springside Nursing Home, Inc.,* 370 Mass. 842 (1976), the Court observed that "by terminating a minority stockholder's employment or by severing him from a position as an officer or director, the majority effectively frustrates the minority stockholder's purposes in entering on the corporate venture and also deny him an equal return on his investment." *Wilkes,* 370 Mass. at 850. Specifically, the Court noted that the denial of employment leads to both economic and non-economic consequences for the minority, since: (1) a guarantee of employment may have been one of the basic reasons why a minority owner has invested capital in the firm; (2) the minority stockholder typically depends upon his salary as the principle return on his investment; and (3) denial of employment restricts the minority shareholder's participation in the management of the enterprise, and he is relegated to enjoying those benefits incident to his status as a stockholder. *Id.* at 849-50.

Mindful of the possibility that "untempered application of the strict good faith standard enunciated in *Donahue* will result in the imposition of limitations on legitimate actions by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned," the Court held that the majority can raise a defense to a claim for breach of fiduciary duty by establishing a legitimate business purpose for its action. *Wilkes,* 370 Mass. at 850-51. "When an asserted business purpose for their action is advanced by the majority, however, we think it is open to minority stockholders to demonstrate that the same legitimate objective could have been

achieved through an alternative course of action less harmful to the minority's interest." *Id.* at 851-52 (internal citations omitted).

The *Wilkes* Court concluded that the majority's decision to remove the plaintiff from the corporation's payroll and to refuse to reelect him as a salaried officer and director amounted to a freezeout wholly unsupported by any legitimate business purpose. *Wilkes,* 370 Mass. at 853. Specifically, "[t]here was no showing of misconduct on Wilkes' part as a director, officer or employee of the corporation which would lead us to approve the majority action as a legitimate response to the disruptive nature of an undesirable individual bent on injuring or destroying the corporation." *Id.* Rather, the Court found that the plaintiff minority stockholder "had always accomplished his assigned share of the duties competently, and that he had never indicated an unwillingness to continue to do so." *Id.*

The Court cited several factors as bearing on the extent of the duty owed to the plaintiff in *Wilkes.* First, the Court noted that the stockholders of the defendant corporation had a longstanding policy that each stockholder would be a director of the corporation, and that employment with the corporation would go hand-in-hand with stock ownership. *Wilkes,* 370 Mass. at 852-53. [FN8] Additionally, the Court found it significant that the plaintiff was one of the four originators of the corporation, and that he had invested his capital and time for more than fifteen years with the expectation that he could continue to participate in corporate decisions. *Id.* at 853. The "most important" factor, according to the Court was "the plain fact that the cutting off of Wilkes' salary, together with the fact that the corporation never declared a dividend assured that Wilkes would receive no return at all from the corporation." *Id.*

In *Merola v. Exergen, Corp.,* the Supreme Judicial Court seemed to eschew the *Wilkes* "legitimate business purpose" test in favor of an inquiry based more on fairness and equity. 423 Mass. at 466. The Court held that even where there was no legitimate business purpose for the termination of the plaintiff minority shareholder, the plaintiff failed to establish a sufficient basis for a breach of fiduciary duty claim because "the termination [was not] for the financial gain of [the majority shareholder] or contrary to established public policy ... [the plaintiff] was terminated in accordance with his employment contract and fairly compensated for his stock." *Id.* Although the Court acknowledged, citing *Wilkes, supra,* that the termination of a minority shareholder's employment may present a situation where the majority has committed a breach of fiduciary duty, the Court went on to state that "not every discharge of an at-will employee of a close corporation who happens to own stock in the corporation gives rise to a success breach of fiduciary duty claim." *Id.* at 464, 466.

In the wake of the Supreme Judicial Court's decision in *Merola,* the proper analytical framework for this Court to employ in passing on the merits of Junior's freezeout claim is not entirely clear. [FN9] However, given the facts of this case, it appears that Junior could satisfy either standard. Under the *Wilkes* analysis, Senior has asserted that by February of 2000, Junior had become a liability to Alder because of the abusive manner in which he treated employees, and that accordingly he had a legitimate business purpose for the actions taken in response to the Donna Murphy incident.

FN9. It should be noted that in one post-*Merola* decision, Judge van Gestel applied the *Wilkes* "legitimate business purpose" standard in concluding that the plaintiff minority shareholder had been frozen out by the majority shareholders of the defendant corporation. *Leslie v. Boston Software Collaborative, Inc.,* Civil No. 010268BLS (Suffolk Super. Ct. Feb. 12, 2002) (van Gestel, J.) (14 Mass. L. Rptr. 379).

The notion that Junior had somehow become a liability to Alder is not borne out by the weight of the evidence in this case. After Junior took over the day-to-day operations at Alder in 1997, the company experienced steady growth and, of particular concern to Senior, the profit margin remained at an optimal level. To be sure, Junior made certain business decisions that did not work out, particularly with regard to the Mighty Mouse product line. Likewise, at times Junior could be abrasive in his dealings with other Alder employees. However, the evidence in this case indicates that, on the whole, Junior was an effective leader who got along well with his employees, save for a few isolated incidents. Even Donna Murphy, whose confrontation with Junior in February 2000 served as the basis for the actions taken by Senior and Michelle against Junior, testified that most of the time the employees at Alder were happy working under Junior.

As in *Wilkes,* the actions taken by the majority in this case cannot be condoned as a "legitimate response to the disruptive nature of an undesirable individual bent on injuring or destroying the corporation." *Wilkes,* 370 Mass. at 252. To the contrary, Junior routinely carried out his responsibilities at Alder in a competent manner, with the best interests of the corporation in mind. Even after he was placed on suspension in response to the Donna Murphy incident his written correspondence to Senior indicates a willingness to return to Alder, albeit on terms that were ultimately deemed unacceptable by Senior. See *id.* (Minority stockholder had always accomplished his assigned share of the duties competently, and had never indicated an unwillingness to continue to do so.)

The key factual distinction between *Wilkes* and this case is that whereas the plaintiff in *Wilkes* invested capital in the corporation in exchange for his role as a minority shareholder with input into the managerial decision making process, Junior did not purchase his 49% interest in Alder, but rather it was gifted to him by Senior. Although the issue of whether the lack of a monetary investment in a corporation bars a claim that the minority shareholder has been the victim of a freezeout seems to be one of first impression in Massachusetts, courts in other jurisdictions have held that it does not. See, e.g. *In re Smith,* 546 N.Y.S.2d 83, 86 (App.Div.1985) ("[I]t seems clear that the holders of over 41% of a successful corporation are entitled to have their interests protected, regardless of whether or not those shares were received as gifts"). *Meiselman v. Meisman,* 307 S.E.2d 551, 558-59 (N.C.1983) ("[W]hen a minority shareholder receives his shares in a close corporation from another in the form of a gift or inheritance, as did plaintiff, here, the minority shareholder never had the opportunity to negotiate for any sort of protection with respect to the 'reasonable expectations' he had or

hoped to enjoy in the close corporation").

The circumstances surrounding Senior's gift of stock to Junior strongly support the conclusion that Junior is entitled to have his 49% interest in Alder protected, notwithstanding the fact that he did not purchase Alder shares. As of 1997, Junior had already been working at Alder for nine years. Junior had been instrumental in implementing a computer system that allowed Alder's business to continue to grow and he helped phase Alder out of brokering and into distributing. As Senior began to spend the winters in Florida, Junior gradually assumed more of a day-to-day leadership role within the company. The ultimate disposition of the 49% interest was obviously of great importance to Senior as it was the topic of years of estate planning discussion. By the time Senior gifted the shares to Junior in 1997, Junior could reasonably expect that as a 49% shareholder he would receive benefits from Alder in the form of a role in the management decisions within the company as well as a salary. When Senior and Michelle denied Junior of these benefits by their actions in the spring of 2000, they effectively "assured that [he] would receive no return at all from the corporation," *Wilkes,* 370 Mass. at 853, thereby freezing him out of Alder. [FN10]

> FN10. Even under the standard set forth in *Merola, supra,* Junior would be entitled to recover under a freezeout theory. Although the actions taken by Senior in the Spring of 2000 may not have been for his own financial gain, see *Merola,* 423 Mass. at 466, it is clear that he benefitted by virtue of the end result. Senior felt that the best thing that could happen would be if Junior retired or went his own way and Michelle took over the company. Unlike the plaintiff in *Merola,* Junior was never fairly compensated for his stock. Moreover, the *Merola* Court found that the plaintiff's stock purchase was an investment in the equity of the corporation which was not tied to employment in any formal way, since the plaintiff acknowledged that he could have purchased the shares while he was still only a part-time employee who was also working part-time at another company. *Id.* at 464. In this case, however, it is doubtful that Senior might have sold shares in Alder, the family business, to someone outside the Keating bloodline, and it is even less likely that he would have sold shares in Alder to someone not employed by Alder. It is therefore evident that Junior's receipt of stock in 1997 carried with it some connection to future employment within the company.

Junior indicated in a writing to Senior that the business could have only one leader. One could argue that, faced with this ultimatum, Senior, who was personally comfortable with Michelle's leadership, might well have opted for Michelle over Junior realizing that management by Junior and Michelle or by Junior, Michelle, and Senior was no longer an option. Moreover, Junior had his strengths and weaknesses as a manager, and his performance might have justified a change of leadership, a decision which would likely come under the penumbra of a legitimate business decision. This would have placed the burden on Junior to show that this legitimate objective could have been accomplished through a "less harmful, reasonably practicable, alternative mode of action." *Medical Air Tech. Corp. v.*

Marwan Inv., Inc., 303 F.3d 11, 20 (2002). This Court finds that Junior could have been assigned different duties and placed in a different position on the organizational chart and also assigned physically to a different location in the central office or elsewhere, near or far. Whether or not that would have been satisfactory over time to Junior is not germane to the Court's analysis here. If it were a fair and reasonable attempt to deal with the situation in a non-oppressive manner, then there would not have been a breach of Senior's fiduciary relationship to Junior.

This Court finds that Senior's discharge of Junior was a breach of his fiduciary duty to the minority shareholder. Junior's shares netted him neither dividends nor a share in the profits. Since there had never been a board of directors meeting of this two-director company, Junior's termination by Senior served to disenfranchise and isolate him totally from the company. Being offered by Senior far less than the fair market value for his shares also evidences the resultant freezeout.

7. Junior's Post-termination Actions Regarding Clients of Alder

This Court has found that Junior, after being terminated from Alder and frozen out as a shareholder, engaged in conduct that is the subject of the counterclaim, to wit, he contacted and solicited Alder customers and assisted some with the DeCA paperwork necessary for the customer to cancel their relationship with Alder in favor of Junior's new enterprise, Elite Food. Junior never had a non-compete agreement with Alder nor did the clients have a term contract with Alder. Even though there is no question that Junior's actions were intended to gain at the expense of Alder, there is no evidence that such conduct was afield in the highly competitive food distribution business. Junior, as a frozen-out minority shareholder, did not breach a fiduciary duty to the majority shareholder or the corporation itself. On the facts proven at trial, this Court cannot find that Junior's post-termination actions constituted unfair and deceptive trade practices in regards to activities between businesspeople and hence there is no violation of G.L.c. 93A, § 11. Likewise, the complained-of conduct did not rise to the level of a tortious interference of Alder's contractual relationships with the customers. See *Kurker v. Hill,* 44 Mass.App.Ct. 184, 191 (1998). On these findings, the counterclaims must fail.

9. Legality of the Termination

Junior was an at-will employee and could be terminated from his position without cause. His discharge constituted a freezeout. Even though Senior had an articulable business reason for removing him from the position of vice president in charge of sales, Senior did not seek nor even explore the viability of offering him another position at Alder. The termination led to the freezeout which entitles Junior to the damages discussed above. The Court does not see Senior's conduct as a wrongful or illegal discharge.

RULINGS

1. On the Freezeout Claim, the Court finds for plaintiff Paul M. Keating, Junior, and assesses damages at $1,981,334 in that the plaintiff Paul M. Keating, Junior, is ordered to turn in his stock certificates to the Clerk of Court who will hold them until further order of the Court. Paul M. Keating, Senior, is ordered to purchase the shares of Paul M. Keating, Junior, for the sum of $1,981,334 plus the statutory interests and costs computed by the Clerk. When the judgment has been paid by Paul M. Keating, Senior, the Clerk, upon consultation with the trial judge will release the share certificates to Paul M. Keating, Senior.

2. On the Chapter 93A Claim against Alder and Paul M. Keating, Senior, the Court finds for the defendants.

3. On the Tortious Interference with Contractual and/or Business Relations Claim, the Court finds for the defendants.

4. On the Breach of an Oral Contract Claim against Paul M. Keating, Senior, and Alder, the Court finds for the defendants.

5. On the Chapter 93A Counterclaim, the Court finds for the defendant-in-counterclaim.

6. On the Tortious Interference with Contractual and/or Business Relations Counterclaims against Paul M. Keating, Junior, the Court finds for the defendant-in-counterclaim.

7. On the Misappropriation of Trade Secrets Counterclaim against Junior, the Court finds for the defendant-in-counterclaim.

8. On the Misappropriation of Trade Secrets Counterclaim claim against Whouley, the Court finds for the defendant-in-counterclaim.

9. On the Breach of a Fiduciary Duty Counterclaim against Paul M. Keating, Junior, the Court finds for the defendant-in-counterclaim.

10. On the Breach of a Stock Restriction Agreement Counterclaim against Paul M. Keating, Junior, the Court finds for the defendant-in-counterclaim.

Discussion points for Smith v. Atlantic Properties

After you read this case, ask yourself why the three shareholders are any less blameworthy than Wolfson. Tyranny of the majority, or tyranny of the minority, it's still tyranny. What should Wolfson have done to avoid losing this case?

Paul T. SMITH et al.

v.
ATLANTIC PROPERTIES, INC. et al.

Appeals Court of Massachusetts, Suffolk.

Argued April 10, 1981.

Decided July 6, 1981.

CUTTER, Justice.

In December, 1951, Dr. Louis E. Wolfson agreed to purchase land in Norwood for $350,000, with an initial cash payment of $50,000 and a mortgage note of $300,000 payable in thirty-three months. Dr. Wolfson offered a quarter interest each in the land to Mr. Paul T. Smith, Mr. Abraham Zimble, and William H. Burke. Each paid to Dr. Wolfson $12,500, one quarter of the initial payment. Mr. Smith, an attorney, organized the defendant corporation (Atlantic) in 1951 to operate the real estate. Each of the four subscribers received twenty-five shares of stock. Mr. Smith included, both in the corporation's articles of organization and in its by-laws, a provision reading, "No election, appointment or resolution by the Stockholders and no election, appointment, resolution, purchase, sale, lease, contract, contribution, compensation, proceeding or act by the Board of Directors or by any officer or officers shall be valid or binding upon the corporation until effected, passed, approved or ratified by an affirmative vote of eighty (80%) per cent of the capital stock issued outstanding and entitled to vote." This provision (hereafter referred to as the 80% provision) was included at Dr. Wolfson's request and had the effect of giving to any one of the four original shareholders a veto in corporate decisions.

Atlantic purchased the Norwood land. Some of the land and other assets were sold for about $220,000. Atlantic retained twenty-eight acres on which stood about twenty old brick or wood mill-type structures, which required expensive and constant repairs. After the first year, Altantic became profitable and showed a profit every year prior to 1969, ranging from a low of $7,683 in 1953 to a high of $44,358 in 1954. The mortgage was paid by 1958 and Atlantic has incurred no long-term debt thereafter. Salaries of about $25,000 were paid only in 1959 and 1960. Dividends in the total amount of $10,000 each were paid in 1964 and 1970. By 1961, Atlantic had about $172,000 in retained earnings, more than half in cash.

For various reasons, which need not be stated in detail, disagreements and ill will soon arose between Dr. Wolfson, on the one hand, and the other stockholders as a group. Dr. Wolfson wished to see Atlantic's earnings devoted to repairs and possibly some improvements in its existing buildings and adjacent facilities. The other stockholders desired the declaration of dividends. Dr. Wolfson fairly steadily refused to vote for any dividends. Although it was pointed out to him that failure to declare dividends might result in the imposition by the Internal Revenue Service of a penalty under the Internal Revenue Code, I.R.C. s 531 et seq. (relating to unreasonable accumulation of corporate earnings and profits), Dr. Wolfson

persisted in his refusal to declare dividends. The other shareholders did agree over the years to making at least the most urgent repairs to Atlantic's buildings, but did not agree to make all repairs and improvements which were recommended in a 1962 report by an engineering firm retained by Atlantic to make a complete estimate of all repairs and improvements which might be beneficial.

FN3. At least one cause of ill will on Dr. Wolfson's part may have been the refusal of the other shareholders to consent to his transferring his shares in Atlantic to the Louis E. Wolfson Foundation, a charitable foundation created by Dr. Wolfson.

The fears of an Internal Revenue Service assessment of a penalty tax were soon realized. Penalty assessments were made in 1962, 1963, and 1964. These were settled by Dr. Wolfson for $11,767.71 in taxes and interest. Despite this settlement, Dr. Wolfson continued his opposition to declaring dividends. The record does not indicate that he developed any specific and definitive schedule or plan for a series of necessary or desirable repairs and improvements to Atlantic's properties. At least none was proposed which would have had a reasonable chance of satisfying the Internal Revenue Service that expenditures for such repairs and improvements constituted "reasonable needs of the business," I.R.C. s 534(c), a term which includes (see I.R.C. s 537) "the reasonably anticipated needs of the business." Predictably, despite further warnings by Dr. Wolfson's shareholder colleagues, the Internal Revenue Service assessed further penalty taxes for the years 1965, 1966, 1967, and 1968. These taxes were upheld by the United States Tax Court in Atlantic Properties, Inc. v. Commissioner of Int. Rev., 62 T.C. 644 (1974), and on appeal in 519 F.2d 1233 (1st Cir. 1975). See the discussion of these opinions in Cathcart, Accumulated Earnings Tax: A Trap for the Wary, 62 A.B.A.J. 1197-1199 (1976). An examination of these decisions makes it apparent that Atlantic has incurred substantial penalty taxes and legal expense largely because of Dr. Wolfson's refusal to vote for the declaration of sufficient dividends to avoid the penalty, a refusal which was (in the Tax Court and upon appeal) attributed in some measure to a tax avoidance purpose on Dr. Wolfson's part.

On January 30, 1967, the shareholders, other than Dr. Wolfson, initiated this proceeding in the Superior Court, later supplemented to reflect developments after the original complaint. The plaintiffs sought a court determination of the dividends to be paid by Atlantic, the removal of Dr. Wolfson as a director, and an order that Atlantic be reimbursed by him for the penalty taxes assessed against it and related expenses. The case was tried before a justice of the Superior Court (jury waived) in September and October, 1979.

The trial judge made findings (but in more detail) of essentially the facts outlined above and concluded that Dr. "Wolfson's obstinate refusal to vote in favor of ... dividends was ... caused more by his dislike for other stockholders and his desire to avoid additional tax payments than ... by any genuine desire to undertake a program for improving ... (Atlantic) property." She also determined that Dr. Wolfson was liable to Atlantic for taxes and interest amounting to "$11,767.11 plus interest from the commencement of this action, plus $35,646.14 plus interest from August 11, 1975," the date of the First Circuit decision affirming the second penalty tax assessment. The latter amount includes an attorney's fee of $7,500 in the Federal

tax cases. She also ordered the directors of Atlantic to declare "a reasonable dividend at the earliest practical date and reasonable dividends annually thereafter consistent with good business practice." In addition, the trial judge directed that jurisdiction of the case be retained in the Superior Court "for a period of five years to (e)nsure compliance." Judgment was entered pursuant to the trial judge's order. After the entry of judgment, Dr. Wolfson and Atlantic filed a motion for a new trial and to amend the judge's findings. This motion, after hearing, was denied, and Dr. Wolfson and Atlantic claimed an appeal from the judgment and the former from the denial of the motion. The plaintiffs (see note 1, supra) requested payment of their attorneys' fees in this proceeding and filed supporting affidavits. The motion was denied, and the plaintiffs appealed.

1. The trial judge, in deciding that Dr. Wolfson had committed a breach of his fiduciary duty to other stockholders, relied greatly on broad language in Donahue v. Rodd Electrotype Co., 367 Mass. 578, 586-597, 328 N.E.2d 505 (1975), in which the Supreme Judicial Court afforded to a minority stockholder in a close corporation equality of treatment (with members of a controlling group of shareholders) in the matter of the redemption of shares. The court (at 592-593, 328 N.E.2d 505) relied on the resemblance of a close corporation to a partnership and held that "stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another" (footnotes omitted). That standard of duty, the court said, was the "utmost good faith and loyalty." The court went on to say that such stockholders "may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation." Similar principles were stated in Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 848-852, 353 N.E.2d 657 (1976), but with some modifications, mentioned in the margin, of the sweeping language of the Donahue case.

In the Donahue case, 367 Mass. at 593 n. 17, 328 N.E.2d 505, the court recognized that cases may arise in which, in a close corporation, majority stockholders may ask protection from a minority stockholder. Such an instance arises in the present case because Dr. Wolfson has been able to exercise a veto concerning corporate action on dividends by the 80% provision (in Atlantic's articles or organization and by-laws) already quoted. The 80% provision may have substantially the effect of reversing the usual roles of the majority and the minority shareholders. The minority, under that provision, becomes an ad hoc controlling interest.[FN6]

> FN6. The majority shareholders, in the event of a deadlock, at least may seek dissolution of the corporation if forty percent of the voting power can be mustered, whereas a single stockholder with only twenty-five percent of the stock may not do so. See G.L. c. 156B, s 99(b), as amended by St.1969, c. 392, s 23.

It does not appear to be argued that this 80% provision is not authorized by G.L. c. 156B (inserted by St.1964, c. 723, s 1). See especially s 8(a). See also Seibert v. Milton Bradley Co., --- Mass. ---, --- - ---,[FNa] 405 N.E.2d 131 (1980). Chapter 156B was intended to provide desirable flexibility in corporate arrangements. The provision is only one of several methods which have been devised to protect minority shareholders in close corporations from

being oppressed by their colleagues and, if the device is used reasonably, there may be no strong public policy considerations against its use. See 1 O'Neal, Close Corporations s 4.21 (2d ed. 1971 & Supp.1980). The textbook just cited contains in ss 4.01-4.30 a comprehensive discussion of the business considerations (see especially ss 4.02, 4.03, 4.06, & 4.24) which may recommend use of such a device. See also 2 O'Neal s 8.07 (& Supp. 1980 which, at 84-90, discusses the Massachusetts decisions). In the present case, Dr. Wolfson testified that he requested the inclusion of the 80% provision "in case the people (the other shareholders) whom I knew, but not very well, ganged up on me." The possibilities of shareholder disagreement on policy made the provision seem a sensible precaution. A question is presented, however, concerning the extent to which such a veto power possessed by a minority stockholder may be exercised as its holder may wish, without a violation of the "fiduciary duty" referred to in the Donahue case, 367 Mass. at 593, 328 N.E.2d 505, as modified in the Wilkes case. See note 5, supra.

The decided cases in Massachusetts do little to answer this question. The most pertinent guidance is probably found in the Wilkes case, 370 Mass. at 849- 852, 353 N.E.2d 657, (see note 5, supra), essentially to the effect that in any judicial intervention in such a situation there must be a weighing of the business interests advanced as reasons for their action (a) by the majority or controlling group and (b) by the rival persons or group. It would obviously be appropriate, before a court-ordered solution is sought or imposed, for both sides to attempt to reach a sensible solution of any incipient impasse in the interest of all concerned after consideration of all relevant circumstances. See Helms v. Duckworth, 249 F.2d 482, 485-488 (D.C.Cir.1957).

(1) 2. With respect to the past damage to Atlantic caused by Dr. Wolfson's refusal to vote in favor of any dividends, the trial judge was justified in finding that his conduct went beyond what was reasonable. The other stockholders shared to some extent responsibility for what occurred by failing to accept Dr. Wolfson's proposals with much sympathy, but the inaction on dividends seems the principal cause of the tax penalties. Dr. Wolfson had been warned of the dangers of an assessment under the Internal Revenue Code, I.R.C. s 531 et seq. He had refused to vote dividends in any amount adequate to minimize that danger and had failed to bring forward, within the relevant taxable years, a convincing, definitive program of appropriate improvements which could withstand scrutiny by the Internal Revenue Service. Whatever may have been the reason for Dr. Wolfson's refusal to declare dividends (and even if in any particular year he may have gained slight, if any, tax advantage from withholding dividends) we think that he recklessly ran serious and unjustified risks of precisely the penalty taxes eventually assessed, risks which were inconsistent with any reasonable interpretation of a duty of "utmost good faith and loyalty."

The trial judge (despite the fact that the other shareholders helped to create the voting deadlock and despite the novelty of the situation) was justified in charging Dr. Wolfson with the out-of-pocket expenditure incurred by Atlantic for the penalty taxes and related counsel fees of the tax cases.

Introduction to Mergers

Corporations merge for many reasons - synergy, corporate tax, regulatory reasons even a desire to get rid of a competitor, to name but a few of the driving forces. And they cam effect a merger in many ways – stock for stock, stock for assets, assets for assets, etc. The intricacies of mergers are beyond the scope of this course, and for that I am sure that some of you are thankful. What we will focus on is how mergers can affect the shareholders of both corporations, and to what extent the courts should get involved to protect the interests of shareholders.

Discussion points for Coggins v. New England Patriots

The New England Patriots are one of the most interesting of all professional sports franchise stories. Just listen to local sports talk radio during the football season. The bottom line in this case is that Billy Sullivan, the driving force behind the Patriots, wanted the corporation to assume the debt he incurred to pay to gain control of the voting shares of the corporation. Understand that a corporation cannot just go assuming the debts of one of its owners. That would be a clear cut case of breach of fiduciary duty.

So he hatches a plan to get rid of all the other shareholders, by taking the corporation private. (If he is the sole shareholder, who is going to complain about what he does with corporate assets?) But you need a business purpose for a merger, or else the soon-to-be-frozen-out shareholders will have a cause of action to block the merger, because merging to satisfy your personal creditors is a breach of your fiduciary duty. How could Sullivan have succeeded? What should he have done in advance of the merger? Note that the "business purpose" requirement has not been favorably received by other jurisdictions.

David A. COGGINS et al.

v.

NEW ENGLAND PATRIOTS FOOTBALL CLUB, INC. et al.

Supreme Judicial Court of Massachusetts,
Middlesex.

Argued Jan. 8, 1986.

Decided May 14, 1986.

LIACOS, Justice.

On November 18, 1959, William H. Sullivan, Jr. (Sullivan), purchased an American Football League (AFL) franchise for a professional football team. The team was to be the last of the eight original teams set up to form the AFL (now the American Football Conference of the National Football League). For the franchise, Sullivan paid $25,000. Four months later, Sullivan organized a corporation, the American League Professional Football Team of Boston, Inc. Sullivan contributed his AFL franchise; nine other persons each contributed $25,000. In return, each of the ten investors received 10,000 shares of voting common stock in the corporation. Another four months later, in July, 1960, the corporation sold 120,000 shares of nonvoting common stock to the public at $5 a share.

Sullivan had effective control of the corporation from its inception until 1974. By April, 1974, Sullivan had increased his ownership of shares from 10,000 shares of voting stock to 23,718 shares, and also had acquired 5,499 shares of nonvoting stock. Nevertheless, in 1974 the other voting stockholders ousted him from the presidency and from operating control of the corporation. He then began the effort to regain control of the corporation--an effort which culminated in this and other law suits.

In November, 1975, Sullivan succeeded in obtaining ownership or control of all 100,000 of the voting shares, at a price of approximately $102 a share (adjusted cash value), of the corporation, by that time renamed the New England Patriots Football Club, Inc. (Old Patriots). "Upon completion of the purchase, he immediately used his 100% control to vote out the hostile directors, elect a friendly board and arrange his resumption of the presidency and the complete control of the Patriots. In order to finance this coup, Sullivan borrowed approximately $5,348,000 from the Rhode Island Hospital National Bank and the Lasalle National Bank of Chicago. As a condition of these loans, Sullivan was to use his best efforts to reorganize the Patriots so that the income of the corporation could be devoted to the payment of these personal loans and the assets of the corporation pledged to secure them. At this point they were secured by all of the voting shares held by Sullivan. In order to accomplish in effect the assumption by the corporation of Sullivan's personal obligations, it was necessary, as a matter of corporate law, to eliminate the interest of the nonvoting shares."

On October 20, 1976, Sullivan organized a new corporation called the New Patriots Football Club, Inc. (New Patriots). The board of directors of the Old Patriots and the board of directors of the New Patriots executed an agreement of merger of the two corporations providing that, after the merger, the voting stock of the Old Patriots would be extinguished, the nonvoting stock would be exchanged for cash at the rate of $15 a share, and the name of the New Patriots would be changed to the name formerly used by the Old Patriots. As part of this plan, Sullivan gave the New Patriots his 100,000 voting shares of the Old Patriots in return for 100% of the New Patriots stock.

> FN5. The two boards were identical. Each member of the board of directors of the Old Patriots (as constituted after Sullivan had regained control) was a member of the board of directors of the New Patriots. Each of the officers of the Old Patriots held

the same position with the New Patriots.

General Laws c. 156B, § 78(c)(1)(iii), as amended through St. 1976, c. 327, required approval of the merger agreement by a majority vote of each class of affected stock. Approval by the voting class, entirely controlled by Sullivan, was assured. The merger was approved by the class of nonvoting stockholders at a special meeting on December 8, 1976. On January 31, 1977, the merger of the New Patriots and the Old Patriots was consummated.

Prior to the 1976 amendment of G.L. c. 156B, § 78(c)(1)(iii), that section required a two-thirds vote of approval for a merger from each class of stock. The two-thirds requirement was reinstated in 1981 by St. 1981, c. 298, § 4.

David A. Coggins (Coggins) was the owner of ten shares of nonvoting stock in the Old Patriots. Coggins, a fan of the Patriots from the time of their formation, was serving in Vietnam in 1967 when he purchased the shares through his brother. Over the years, he followed the fortunes of the team, taking special pride in his status as an owner. [FN8] When he heard of the proposed merger, Coggins was upset that he could be forced to sell. Coggins voted against the merger and commenced this suit on behalf of those stockholders, who, like himself, believed the transaction to be unfair and illegal. A judge of the Superior Court certified the class as "stockholders of New England Patriots Football Club, Inc. who have voted against the merger ... but who have neither turned in their shares nor perfected their appraisal rights ... [and who] desire only to void the merger."

FN8. It was, in part, the goal of the Old Patriots, in offering stock to the public, to generate loyal fans.

The trial judge found in favor of the Coggins class but determined that the merger should not be undone. Instead, he ruled that the plaintiffs are entitled to rescissory damages, and he ordered that further hearings be held to determine the amount of damages. After the judge rendered his decision, motions were made to permit intervention by plaintiffs in two related cases, Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227 (1st Cir.1984), and Sarrouf v. New England Patriots Football Club, Inc., 397 Mass. 542, 492 N.E.2d 1122 (1986). The trial judge allowed the motion of the Pavlidis plaintiffs, and allowed the motion of the Sarrouf plaintiffs, but only as to those plaintiffs in the Sarrouf action who were not granted relief in that case. On motion of the defendants in this case, the trial judge reported the case to the Appeals Court. Mass.R.Civ.P. 64, 365 Mass. 831 (1974). We granted applications by both parties for direct appellate review.

We conclude that the trial judge was correct in ruling that the merger was illegal and that the plaintiffs have been wronged. Ordinarily, rescission of the merger would be the appropriate remedy. This merger, however, is now nearly ten years old, and, because an effective and orderly rescission of the merger now is not feasible, we remand the case for proceedings to determine the appropriate monetary damages to compensate the plaintiffs. We conclude further that intervention by the Pavlidis plaintiffs should not have been allowed, and that no

stockholders in the Sarrouf class should be allowed to intervene as plaintiffs in the Coggins case.

Scope of Judicial Review. In deciding this case, we address an important corporate law question: What approach will a Massachusetts court reviewing a cash freeze-out merger employ? This question has been considered by courts in a number of other States. See A.M. Borden, Going Private § 4.09, and cases cited (rev.1986); I.M. Lipton and E.H. Steinberger, Takeovers and Freezeouts § 9.05, and cases cited (rev. 1986).
[1][2] The parties have urged us to consider the views of a court with great experience in such matters, the Supreme Court of Delaware. We note that the Delaware court announced one test in 1977, but recently has changed to another. In Singer v. Magnavox Co., 380 A.2d 969, 980 (Del.1977), the Delaware court established the so-called "business-purpose" test, holding that controlling stockholders violate their fiduciary duties when they "cause a merger to be made for the sole purpose of eliminating a minority on a cash-out basis." Id. at 978. In 1983, Delaware jettisoned the business-purpose test, satisfied that the "fairness" test "long ... applicable to parent- subsidiary mergers, Sterling v. Mayflower Hotel Corp., 33 Del.Ch. 293, 93 A.2d 107, 109-10 (1952), the expanded appraisal remedy now available to stockholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate" provided sufficient protection to the frozen-out minority. Weinberger v. UOP, Inc., 457 A.2d 701, 715 (Del.1983). "The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts." Id. at 710. "The concept of fairness has two basic aspects: fair dealing and fair price." Id. at 711. We note that the "fairness" test to which the Delaware court now has adhered is, as we later show, closely related to the views expressed in our decisions. Unlike the Delaware court, however, we believe that the "business-purpose" test is an additional useful means under our statutes and case law for examining a transaction in which a controlling stockholder eliminates the minority interest in a corporation. Cf. Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 851, 353 N.E.2d 657 (1976). This concept of fair dealing is not limited to close corporations but applies to judicial review of cash freeze-out mergers. See Horizon House-Microwave, Inc. v. Bazzy, 21 Mass.App.Ct. 190, 198 n. 11, 486 N.E.2d 70 (1985).

[3] We have held in regard to so called "close corporations" that the statute does not divest the courts of their equitable jurisdiction to assure that the conduct of controlling stockholders does not violate the fiduciary principles governing the relationship between majority and minority stockholders. Pupecki v. James Madison Corp., 376 Mass. 212, 216-217, 382 N.E.2d 1030 (1978) (when controlling stockholder fails to assure that corporation receives adequate consideration for its assets, transaction is illegal or fraudulent, and G.L. c. 156B, § 98, does not foreclose review). "Where the director's duty of loyalty to the corporation is in conflict with his self-interest the court will vigorously scrutinize the situation." American Discount Corp. v. Kaitz, 348 Mass. 706, 711, 206 N.E.2d 156 (1965). The court is justified in exercising its equitable power when a violation of fiduciary duty is claimed.

[4] The dangers of self-dealing and abuse of fiduciary duty are greatest in freeze-out

situations like the Patriots merger, where a controlling stockholder and corporate director chooses to eliminate public ownership. It is in these cases that a judge should examine with closest scrutiny the motives and the behavior of the controlling stockholder. A showing of compliance with statutory procedures is an insufficient substitute for the inquiry of the courts when a minority stockholder claims that the corporate action "will be or is illegal or fraudulent as to him." G.L. c. 156B, § 98. Leader v. Hycor, Inc., 395 Mass. 215, 221, 479 N.E.2d 173 (1985) (judicial review may be had of claims of breach of fiduciary duty and unfairness).

[5][6] A controlling stockholder who is also a director standing on both sides of the transaction bears the burden of showing that the transaction does not violate fiduciary obligations. "As was said in Geddes v. Anaconda Copper Mining Co. 254 U.S. 590, 599 [41 S.Ct. 209, 212, 65 L.Ed. 425 (1921)]: 'The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and where the fairness of such transactions is challenged the burden is upon those who would maintain them to show their entire fairness and where a sale is involved the full adequacy of the consideration. Especially is this true where a common director is dominating in influence or in character.' This rule is applicable even though no corruption or dishonesty is shown...." Lazenby v. Henderson, 241 Mass. 177, 180, 135 N.E. 302 (1922). Cf. Weinberger v. UOP, Inc., supra (similar standard of review). Judicial inquiry into a freeze-out merger in technical compliance with the statute may be appropriate, and the dissenting stockholders are not limited to the statutory remedy of judicial appraisal where violations of fiduciary duties are found.

[8][9][10][11] Judicial scrutiny should begin with recognition of the basic principle that the duty of a corporate director must be to further the legitimate goals of the corporation. The result of a freeze-out merger is the elimination of public ownership in the corporation. The controlling faction increases its equity from a majority to 100%, using corporate processes and corporate assets. The corporate directors who benefit from this transfer of ownership must demonstrate how the legitimate goals of the corporation are furthered. A director of a corporation violates his fiduciary duty when he uses the corporation for his or his family's personal benefit in a manner detrimental to the corporation. Widett & Widett v. Snyder, 392 Mass. 778, 785-786, 467 N.E.2d 1312 (1984). See Buckman v. Elm Hill Realty Co. of Peabody, 312 Mass. 10, 15, 42 N.E.2d 814 (1942). Because the danger of abuse of fiduciary duty is especially great in a freeze-out merger, the court must be satisfied that the freeze-out was for the advancement of a legitimate corporate purpose. If satisfied that elimination of public ownership is in furtherance of a business purpose, the court should then proceed to determine if the transaction was fair by examining the totality of the circumstances.

[12] The plaintiffs here adequately alleged that the merger of the Old Patriots and New Patriots was a freeze-out merger undertaken for no legitimate business purpose, but merely for the personal benefit of Sullivan. While we have recognized the right to "selfish ownership" in a corporation, such a right must be balanced against the concept of the majority stockholder's fiduciary obligation to the minority stockholders. Wilkes v.

Springside Nursing Home, Inc., 370 Mass. 842, 851, 353 N.E.2d 657 (1976). Consequently, the defendants bear the burden of proving, first, that the merger was for a legitimate business purpose, and, second, that, considering totality of circumstances, it was fair to the minority.

[13] The decision of the Superior Court judge includes a finding that "the defendants have failed to demonstrate that the merger served any valid corporate objective unrelated to the personal interests of the majority shareholders. It thus appears that the sole reason for the merger was to effectuate a restructuring of the Patriots that would enable the repayment of the [personal] indebtedness incurred by Sullivan...." The trial judge considered the defendants' claims that the policy of the National Football League (NFL) requiring majority ownership by a single individual or family made it necessary to eliminate public ownership. He found that "the stock ownership of the Patriots as it existed just prior to the merger fully satisfied the rationale underlying the policy as expressed by NFL Commissioner Pete Rozelle. Having acquired 100% control of the voting common stock of the Patriots, Sullivan possessed unquestionable authority to act on behalf of the franchise at League meetings and effectively foreclosed the possible recurrence of the internal management disputes that had existed in 1974. Moreover, as the proxy statement itself notes, the Old Patriots were under no legal compulsion to eliminate public ownership." Likewise, the defendants did not succeed in showing a conflict between the interests of the league owners and the Old Patriots' stockholders. We perceive no error in these findings. They are fully supported by the evidence. Under the approach we set forth above, there is no need to consider further the elements of fairness of a transaction that is not related to a valid corporate purpose.

[14] Remedy. The plaintiffs are entitled to relief. They argue that the appropriate relief is rescission of the merger and restoration of the parties to their positions of 1976. We agree that the normally appropriate remedy for an impermissible freeze-out merger is rescission. Because Massachusetts statutes do not bar a cash freeze-out, however, numerous third parties relied in good faith on the outcome of the merger. The trial judge concluded that the expectations of those parties should not be upset, and so chose to award damages rather than rescission.

[15][16][17] We recognize that, because rescission is an equitable remedy, the circumstances of a particular case may not favor its employment. The goals of a remedy instituted after a finding that a merger did not serve the corporate purpose should include furthering the interests of the corporation. Ordinarily, we would remand with instructions for the trial judge to determine whether rescission would be in the corporation's best interests, but such a remedy does not appear to be equitable at this time. This litigation has gone on for many years. There is yet at least another related case pending (in the Federal District Court). Furthermore, other factors weigh against rescission. The passage of time has made the 1976 position of the parties difficult, if not impossible, to restore. A substantial number of former stockholders have chosen other courses and should not be forced back into the Patriots corporation. In these circumstances the interests of the corporation and of the plaintiffs will be furthered best by limiting the plaintiffs' remedy to an assessment of damages.

[18][19] We do not think it appropriate, however, to award damages based on a 1976

appraisal value. To do so would make this suit a nullity, leaving the plaintiffs with no effective remedy except appraisal, a position we have already rejected. Rescissory damages must be determined based on the present value of the Patriots, that is, what the stockholders would have if the merger were rescinded. Determination of the value of a unique property like the Patriots requires specialized expertise, cf. Correia v. New Bedford Redevelopment Auth., 375 Mass. 360, 367, 377 N.E.2d 909 (1978) (valuation of unusual property may require unusual approach), and, while the trial judge is entitled to reach his own conclusion as to value, Piemonte v. New Boston Garden Corp., 377 Mass. 719, 731, 387 N.E.2d 1145 (1979), the credibility of testimony on value will depend in part on the familiarity of the witness with property of this kind. On remand, the judge is to take further evidence on the present value of the Old Patriots on the theory that the merger had not taken place. Each share of the Coggins class is to receive, as rescissory damages, its aliquot share of the present assets.

Summary. The freeze-out merger accomplished by William H. Sullivan, Jr., was designed for his own personal benefit to eliminate the interests of the Patriots' minority stockholders. The merger did not further the interests of the corporation and therefore was a violation of Sullivan's fiduciary duty to the minority stockholders, and so was impermissible. In most cases we would turn to rescission as the appropriate remedy. In the circumstances of this case, however, rescission would be an inequitable solution. Therefore, we remand for a determination of the present value of the non-voting stock, as though the merger were rescinded. The claim for waste of corporate assets brought against the individual defendants is reinstated. Those stockholders who voted against the merger, who did not turn in their shares, who did not perfect their appraisal rights, but who are part of the Coggins class, are to receive damages in the amount their stock would be worth today, plus interest at the statutory rate.

Introduction to Takeovers

Mergers tend to be negotiated, and (more or less) friendly. Takeovers tend to be hostile mergers. But it is easy to conceptualize. If you wish to take over a corporation, simply buy enough shares to vote yourself onto the board of directors of the acquired corporation, and vote out the old directors. You now have control. Shareholders of the acquired corporation frequently look to management to advise them on whether to sell to the acquirer. And this is where the conflict comes in. The managers of the target corporation are sure to lose their jobs if the takeover succeeds, so their self-interest (in job security) will likely take precedence over their obligations to the shareholders to provide impartial advice.

Discussion points for Cheff v. Mathes

This case introduces you to the dilemma of corporate executives faced with a

takeover attempt, and introduces you to the concept of "greenmail." Whether greenmail is a good or bad thing depends on your perspective, and your priorities.

P. T. CHEFF, Katharine N. Cheff, Edgar P. Landwehr, Defendants Below, Appellants,
v.
Anne J. MATHES and Harry Lewis, Plaintiffs Below, Appellees,
v.
Robert H. TRENKAMP, George Spatta, Ralph C. Boalt, John D. Ames, Motor Products Corporation and Holland Furnace Company, Defendants Below.
Robert H. TRENKAMP, Defendant Below, Appellant,
v.
Anne J. MATHES and Harry Lewis, Plaintiffs Below, Appellees, and Holland Furnace Company, Defendant Below, Appellee.

Supreme Court of Delaware.

March 17, 1964.

CAREY, Justice.

This is an appeal from the decision of the Vice-Chancellor in a derivative suit holding certain directors of Holland Furnace Company liable for loss allegedly resulting from improper use of corporate funds to purchase shares of the company. Because a meaningful decision upon review turns upon a complete understanding of the factual background, a somewhat detailed summary of the evidence is required.

Holland Furnace Company, a corporation of the State of Delaware, manufactures warm air furnaces, air conditioning equipment, and other home heating equipment. At the time of the relevant transactions, the board of directors was composed of the seven individual defendants. Mr. Cheff had been Holland's Chief Executive Officer since 1933, received an annual salary of $77,400, and personally owned 6,000 shares of the company. He was also a director. Mrs. Cheff, the wife of Mr. Cheff, was a daughter of the founder of Holland and had served as a director since 1922. She personally owned 5,804 shares of Holland and owned 47.9 percent of Hazelbank United Interest, Inc. Hazelbank is an investment vehicle for Mrs. Cheff and members of the Cheff-Landwehr family group, which owned 164,950 shares of the 883,585 outstanding shares of Holland. As a director, Mrs. Cheff received a compensation of $200.00 for each monthly board meeting, whether or not she attended the meeting.

The third director, Edgar P. Landwehr, is the nephew of Mrs. Cheff and personally owned 24.010 shares of Holland and 8.6 percent of the outstanding shares of Hazelbank. He received no compensation from Holland other than the monthly director's fee.

Robert H. Trenkamp is an attorney who first represented Holland in 1946. In May 1953, he

became a director of Holland and acted as general counsel for the company. During the period in question, he received no retainer from the company, but did receive substantial sums for legal services rendered the company. Apart from the above-described payments, he received no compensation from Holland other than the monthly director's fee. He owned 200 shares of Holland Furnace stock. Although he owned no shares of Hazelbank, at the time relevant to this controversy, he was serving as a director and counsel of Hazelbank.

John D. Ames was then a partner in the Chicago investment firm of Bacon, Whipple & Co. and joined the board at the request of Mr. Cheff. During the periods in question, his stock ownership varied between ownership of no shares to ownership of 300 shares. He was considered by the other members of the Holland board to be the financial advisor to the board. He received no compensation from Holland other than the normal director's fee.

Mr. Ralph G. Boalt was the Vice President of J. R. Watkins Company, a manufacturer and distributor of cosmetics. In 1953, at the request of Mr. Cheff, he became a member of the board of directors. Apart from the normal director's fee, he received no compensation from Holland for his services.

Mr. George Spatta was the President of Clark Equipment Company, a large manufacturer of earth moving equipment. In 1951, at the request of Mr. Cheff, he joined the board of directors of Holland. Apart from the normal director's fee, he received no compensation from the company.

The board of directors of Hazelbank included the five principal shareholders: Mrs. Cheff; Leona Kolb, who was Mrs. Cheff's daughter; Mr. Landwehr; Mrs. Bowles, who was Mr. Landwehr's sister; Mrs. Putnam, who was also Mr. Landwehr's sister; Mr. Trenkamp; and Mr. William DeLong, an accountant.

Prior to the events in question, Holland employed approximately 8500 persons and maintained 400 branch sales offices located in 43 states. The volume of sales had declined from over $41,000,000 in 1948 to less than $32,000,000 in 1956. Defendants contend that the decline in earnings is attributable to the artificial post-war demand generated in the 1946-1948 period. In order to stabilize the condition of the company, the sales department apparently was reorganized and certain unprofitable branch offices were closed. By 1957 this reorganization had been completed and the management was convinced that the changes were manifesting beneficial results. The practice of the company was to directly employ the retail salesman, and the management considered that practice--unique in the furnace business--to be a vital factor in the company's success.

During the first five months of 1957, the monthly trading volume of Holland's stock on the New York Stock Exchange ranged between 10,300 shares to 24,200 shares. In the last week of June 1957, however, the trading increased to 37,800 shares, with a corresponding increase in the market price. In June of 1957, Mr. Cheff met with Mr. Arnold H. Maremont, who was President of Maremont Automotive Products, Inc. and Chairman of the boards of Motor Products Corporation and Allied Paper Corporation. Mr. Cheff testified, on deposition, that

Maremont generally inquired about the feasibility of merger between Motor Products and Holland. Mr. Cheff testified that, in view of the difference in sales practices between the two companies, he informed Mr. Maremont that a merger did not seem feasible. In reply, Mr. Maremont stated that, in the light of Mr. Cheff's decision, he had no further interest in Holland nor did he wish to buy any of the stock of Holland.

None of the members of the board apparently connected the interest of Mr. Maremont with the increased activity of Holland stock. However, Mr. Trenkamp and Mr. Staal, the Treasurer of Holland, unsuccessfully made an informal investigation in order to ascertain the identity of the purchaser or purchasers. The mystery was resolved, however, when Maremont called Ames in July of 1957 to inform the latter that Maremont then owned 55,000 shares of Holland stock. At this juncture, no requests for change in corporate policy were made, and Maremont made no demand to be made a member of the board of Holland.

Ames reported the above information to the board at its July 30, 1957 meeting. Because of the position now occupied by Maremont, the board elected to investigate the financial and business history of Maremont and corporations controlled by him. Apart from the documentary evidence produced by this investigation, which will be considered infra, Staal testified, on deposition, that 'leading bank officials' had indicated that Maremont 'had been a participant, or had attempted to be, in the liquidation of a number of companies.' Staal specifically mentioned only one individual giving such advice, the Vice President of the First National Bank of Chicago. Mr. Cheff testified, at trial, of Maremont's alleged participation in liquidation activities. Mr. Cheff testified that: 'Throughout the whole of the Kalamazoo-Battle Creek area, and Detroit too, where I spent considerable time, he is well known and not highly regarded by any stretch.' This information was communicated to the board.

On August 23, 1957, at the request of Maremont, a meeting was held between Mr. Maremont and Cheff. At this meeting, Cheff was informed that Motor Products then owned approximately 100,000 shares of Holland stock. Maremont then made a demand that he be named to the board of directors, but Cheff refused to consider it. Since considerable controversy has been generated by Maremont's alleged threat to liquidate the company or substantially alter the sales force of Holland, we believe it desirable to set forth the testimony of Cheff on this point: 'Now we have 8500 men, direct employees, so the problem is entirely different. He indicated immediately that he had no interest in that type of distribution, that he didn't think it was modern, that he felt furnaces could be sold as he sold mufflers, through half a dozen salesmen in a wholesale way.'

Testimony was introduced by the defendants tending to show that substantial unrest was present among the employees of Holland as a result of the threat of Maremont to seek control of Holland. Thus, Mr. Cheff testified that the field organization was considering leaving in large numbers because of a fear of the consequences of a Maremont acquisition; he further testified that approximately '25 of our key men' were lost as the result of the unrest engendered by the Maremont proposal. Staal, corroborating Cheff's version, stated that a number of branch managers approached him for reassurances that Maremont was not going to be allowed to successfully gain control. Moreover, at approximately this time, the

company was furnished with a Dun and Bradstreet report, which indicated the practice of Maremont to achieve quick profits by sales or liquidations of companies acquired by him. The defendants were also supplied with an income statement of Motor Products, Inc., showing a loss of $336,121.00 for the period in 1957.

On August 30, 1957, the board was informed by Cheff of Maremont's demand to be placed upon the board and of Maremont's belief that the retail sales organization of Holland was obsolete. The board was also informed of the results of the investigation by Cheff and Staal. Predicated upon this information, the board authorized the purchase of company stock on the market with corporate funds, ostensibly for use in a stock option plan.

Subsequent to this meeting, substantial numbers of shares were purchased and, in addition, Mrs. Cheff made alternate personal purchases of Holland stock. As a result of purchases by Maremont, Holland and Mrs. Cheff, the market price rose. On September 13, 1957, Maremont wrote to each of the directors of Holland and requested a broad engineering survey to be made for the benefit of all stockholders. During September, Motor Products released its annual report, which indicated that the investment in Holland was a 'special situation' as opposed to the normal policy of placing the funds of Motor Products into 'an active company'. On September 4th, Maremont proposed to sell his current holdings of Holland to the corporation for $14.00 a share. However, because of delay in responding to this offer, Maremont withdrew the offer. At this time, Mrs. Cheff was obviously quite concerned over the prospect of a Maremont acquisition, and had stated her willingness to expend her personal resources to prevent it.

On September 30, 1957, Motor Products Corporation, by letter to Mrs. Bowles, made a buy-sell offer to Hazelbank. At the Hazelbank meeting of October 3, 1957, Mrs. Bowles presented the letter to the board. The board took no action, but referred the proposal to its finance committee. Although Mrs. Bowles and Mrs. Putnam were opposed to any acquisition of Holland stock by Hazelbank, Mr. Landwehr conceded that a majority of the board were in favor of the purchase. Despite this fact, the finance committee elected to refer the offer to the Holland board on the grounds that it was the primary concern of Holland.

Thereafter, Mr. Trenkamp arranged for a meeting with Maremont, which occurred on October 14-15, 1957, in Chicago. Prior to this meeting, Trenkamp was aware of the intentions of Hazelbank and Mrs. Cheff to purchase all or portions of the stock then owned by Motor Products if Holland did not so act. As a result of the meeting, there was a tentative agreement on the part of Motor Products to sell its 155,000 shares at $14.40 per share. On October 23, 1957, at a special meeting of the Holland board, the purchase was considered. All directors, except Spatta, were present. The dangers allegedly posed by Maremont were again reviewed by the board. Trenkamp and Mrs. Cheff agree that the latter informed the board that either she or Hazelbank would purchase part or all of the block of Holland stock owned by Motor Products if the Holland board did not so act. The board was also informed that in order for the corporation to finance the purchase, substantial sums would have to be borrowed from commercial lending institutions. A resolution authorizing the purchase of 155,000 shares from Motor Products was adopted by the board. The price paid was in excess

of the market price prevailing at the time, and the book value of the stock was approximately $20.00 as compared to approximately $14.00 for the net quick asset value. The transaction was subsequently consummated. The stock option plan mentioned in the minutes has never been implemented. In 1959, Holland stock reached a high of $15.25 a share.

FN1. Spatta agreed by telephone.

On February 6, 1958, plaintiffs, owners of 60 shares of Holland stock, filed a derivative suit in the court below naming all of the individual directors of Holland, Holland itself and Motor Products Corporation as defendants. The complaint alleged that all of the purchases of stock by Holland in 1957 were for the purpose of insuring the perpetuation of control by the incumbent directors. The complaint requested that the transaction between Motor Products and Holland be rescinded and, secondly, that the individual defendants account to Holland for the alleged damages. Since Motor Products was never served with process, the initial remedy became inapplicable. Ames was never served nor did he enter an appearance.

After trial, the Vice Chancellor found the following facts: (a) Holland directly sells to retail consumers by means of numerous branch offices. There were no intermediate dealers. (b) Immediately prior to the complained-of transactions, the sales and earnings of Holland had declined and its marketing practices were under investigation by the Federal Trade Commission. (c) Mr. Cheff and Trenkamp had received substantial sums as Chief Executive and attorney of the company, respectively. (d) Maremont, on August 23rd, 1957, demanded a place on the board. (e) At the October 14th meeting between Trenkamp, Staal and Maremont, Trenkamp and Staal were authorized to speak for Hazelbank and Mrs. Cheff as well as Holland. Only Mr. Cheff, Mrs. Cheff, Mr. Landwehr, and Mr. Trenkamp clearly understood, prior to the October 23rd meeting, that either Hazelbank or Mrs. Cheff would have utilized their funds to purchase the Holland stock if Holland had not acted. (g) There was no real threat posed by Maremont and no substantial evidence of intention by Maremont to liquidate Holland. (h) Any employee unrest could have been caused by factors other than Maremont's intrusion and 'only one important employee was shown to have left, and his motive for leaving is not clear.' (1) The Court rejected the stock option plan as a meaningful rationale for the purchase from Maremont or the prior open market purchases.

The Court then found that the actual purpose behind the purchase was the desire to perpetuate control, but because of its finding that only the four above-named directors knew of the 'alternative', the remaining directors were exonerated. No appeal was taken by plaintiffs from that decision.

[1] An examination of the record indicates that a substantial portion of the evidence presented to the Vice Chancellor consisted of deposition testimony and documentary evidence. The only individuals who testified personally (aside from a financial expert) were Mr. Cheff, Trenkamp and Staal. Depositions of the other directors were introduced, but no deposition was taken from Maremont. The standard of review governing this court in such cases was established in Blish v. Thompson Automatic Arms Corp., 30 Del.Ch. 538, 64 A.2d 581, wherein we stated:

'* * * regardless of the state of the evidence below, if there be sufficient oral testimony in the record to support the findings of fact below, such findings should not be disturbed by this Court.' (30 Del.Ch. at page 604, 64 A.2d at page 604).

[2] Under the provisions of 8 Del.C. § 160, a corporation is granted statutory power to purchase and sell shares of its own stock. Such a right, as embodied in the statute, has long been recognized in this State. See In re International Radiator Co., 10 Del.Ch. 358, 92 A. 255. The charge here is not one of violation of statute, but the allegation is that the true motives behind such purchases were improperly centered upon perpetuation of control. In an analogous field, courts have sustained the use of proxy funds to inform stockholders of management's views upon the policy questions inherent in an election to a board of directors, but have not sanctioned the use of corporate funds to advance the selfish desires of directors to perpetuate themselves in office. See Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del.Ch. 78, 171 A. 226. Similarly, if the actions of the board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course. See Kors v. Carey, Del.Ch., 158 A.2d 136. On the other hand, if the board has acted solely or primarily because of the desire to perpetuate themselves in office, the use of corporate funds for such purposes is improper. See Bennett v. Propp, Del., 187 A.2d 405, and Yasik v. Wachtel, 25 Del.Ch. 247, 17 A.2d 309.

Our first problem is the allocation of the burden of proof to show the presence or lack of good faith on the part of the board in authorizing the purchase of shares. Initially, the decision of the board of directors in authorizing a purchase was presumed to be in good faith and could be overturned only by a conclusive showing by plaintiffs of fraud or other misconduct. See Bankers Securities Corp. v. Kresge Department Stores, Inc., D.C., 54 F.Supp. 378. In Kors, cited supra, the court merely indicated that the directors are presumed to act in good faith and the burden of proof to show to the contrary falls upon the plaintiff. However, in Bennett v. Propp, supra, we stated:

'We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult. * * * Hence, in our opinion, the burden should be on the directors to justify such a purchase as one primarily in the corporate interest.' (187 A.2d 409, at page 409).

FN2. See also Andersen v. Albert and J. M. Anderson Manufacturing Co., 325 Mass. 343, 90 N.E.2d 541.

The case of Martin v. American Potash and Chemical Corp., 33 Del.Ch. 234, 92 A.2d 295, 35 A.L.R.2d 1140, relied upon by defendants to support their contention that the burden of proof should be on plaintiffs, is inapposite. As noted in Bennett, Martin was concerned with a statutory reduction of capital, which has the additional safeguards of notice to stockholders and shareholder approval.

[3] To say that the burden of proof is upon the defendants is not to indicate, however, that the directors have the same 'self-dealing interest' as is present, for example, when a director sells property to the corporation. The only clear pecuniary interest shown on the record was held by Mr. Cheff, as an executive of the corporation, and Trenkamp, as its attorney. The mere fact that some of the other directors were substantial shareholders does not create a personal pecuniary interest in the decisions made by the board of directors, since all shareholders would presumably share the benefit flowing to the substantial shareholder. See Smith v. Good Music Station, Inc., 36 Del.Ch. 262, 129 A.2d 242. Accordingly, these directors other than Trenkamp and Cheff, while called upon to justify their actions, will not be held to the same standard of proof required of those directors having personal and pecuniary interest in the transaction.

[4][5] As noted above, the Vice Chancellor found that the stock option plan, mentioned in the minutes as a justification for the purchases, was not a motivating reason for the purchases. This finding we accept, since there is evidence to support it; in fact, Trenkamp admitted that the stock option plan was not the motivating reason. The minutes of October 23, 1957 dealing with the purchase from Maremont do not, in fact, mention the option plan as a reason for the purchase. While the minutes of the October 1, 1957 meeting only indicated the stock option plan as the motivating reason, the defendants are not bound by such statements and may supplement the minutes by oral testimony to show that the motivating reason was genuine fear of an acquisition by Maremont. See Bennett v. Propp, cited supra.

Plaintiffs urge that the sale price was unfair in view of the fact that the price was in excess of that prevailing on the open market. However, as conceded by all parties, a substantial block of stock will normally sell at a higher price than that prevailing on the open market, the increment being attributable to a 'control premium'. Plaintiffs argue that it is inappropriate to require the defendant corporation to pay a control premium, since control is meaningless to an acquisition by a corporation of its own shares. However, it is elementary that a holder of a substantial number of shares would expect to receive the control premium as part of his selling price, and if the corporation desired to obtain the stock, it is unreasonable to expect that the corporation could avoid paying what any other purchaser would be required to pay for the stock. In any event, the financial expert produced by defendant at trial indicated that the price paid was fair and there was no rebuttal. Ames, the financial man on the board, was strongly of the opinion that the purchase was a good deal for the corporation. The Vice Chancellor made no finding as to the fairness of the price other than to indicate the obvious fact that the market price was increasing as a result of open market purchases by Maremont, Mrs. Cheff and Holland.

[6][7] The question then presented is whether or not defendants satisfied the burden of proof of showing reasonable grounds to believe a danger to corporate policy and effectiveness existed by the presence of the Maremont stock ownership. It is important to remember that the directors satisfy their burden by showing good faith and reasonable investigation; the directors will not be penalized for an honest mistake of judgment, if the judgment appeared reasonable at the time the decision was made. See Karasik v. Pacific Eastern Corp., 21

Del.Ch. 81, 180 A. 604.

In holding that employee unrest could as well be attributed to a condition of Holland's business affairs as to the possibility of Maremont's intrustion, the Vice Chancellor must have had in mind one or both of two matters: (1) the pending proceedings before the Federal Trade Commission concerning certain sales practices of Holland; (2) the decrease in sales and profits during the preceding several years. Any other possible reason would be pure speculation. In the first place, the adverse decision of the F.T.C. was not announced until after the complained-of transaction. Secondly, the evidence clearly shows that the downward trend of sales and profits had reversed itself, presumably because of the reorganization which had then been completed. Thirdly, everyone who testified on the point said that the unrest was due to the possible threat presented by Maremont's purchases of stock. There was, in fact, no testimony whatever of any connection between the unrest and either the F.T.C. proceedings or the business picture.

[8] The Vice Chancellor found that there was no substantial evidence of a liquidation posed by Maremont. This holding overlooks an important contention. The fear of the defendants, according to their testimony, was not limited to the possibility of liquidation; it included the alternate possibility of a material change in Holland's sales policies, which the board considered vital to its future success. The unrebutted testimony before the court indicated: (1) Maremont had deceived Cheff as to his original intentions, since his open market purchases were contemporaneous with his disclaimer of interest in Holland; (2) Maremont had given Cheff some reason to believe that he intended to eliminate the retail sales force of Holland; (3) Maremont demanded a place on the board; (4) Maremont substantially increased his purchases after having been refused a place on the board; (5) the directors had good reason to believe that unrest among key employees had been engendered by the Maremont threat; (6) the board had received advice from Dun and Bradstreet indicating the past liquidation or quick sale activities of Motor Products; (7) the board had received professional advice from the firm of Merril Lynch, Fenner & Beane, who recommended that the purchase from Motor Products be carried out; (8) the board had received competent advice that the corporation was over-capitalized; (9) Staal and Cheff had made informal personal investigations from contacts in the business and financial community and had reported to the board of the alleged poor reputation of Maremont. The board was within its rights in relying upon that investigation, since 8 Del.C. § 141(f) allows the directors to reasonably rely upon a report provided by corporate officers. See Graham v. Allis-Chalmers Manufacturing Co., Del., 188 A.2d 125.

[9][10] Accordingly, we are of the opinion that the evidence presented in the court below leads inevitably to the conclusion that the board of directors, based upon direct investigation, receipt of professional advice, and personal observations of the contradictory action of Maremont and his explanation of corporate purpose, believed, with justification, that there was a reasonable threat to the continued existence of Holland, or at least existence in its present form, by the plan of Maremont to continue building up his stock holdings. We find no evidence in the record sufficient to justify a contrary conclusion. The opinion of the Vice Chancellor that employee unrest may have been engendered by other factors or that the board had no grounds to suspect Maremont is not supported in any manner by the evidence.

[11][12] As noted above, the Vice-Chancellor found that the purpose of the acquisition was the improper desire to maintain control, but, at the same time, he exonerated those individual directors whom he believed to be unaware of the possibility of using non-corporate funds to accomplish this purpose. Such a decision is inconsistent with his finding that the motive was improper, within the rule enunciated in Bennett. If the actions were in fact improper because of a desire to maintain control, then the presence or absence of a non- corporate alternative is irrelevant, as corporate funds may not be used to advance an improper purpose even if there is no non-corporate alternative available. Conversely, if the actions were proper because of a decision by the board made in good faith that the corporate interest was served thereby, they are not rendered improper by the fact that some individual directors were willing to advance personal funds if the corporation did not. It is conceivable that the Vice Chancellor considered this feature of the case to be of significance because of his apparent belief that any excess corporate funds should have been used to finance a subsidiary corporation. That action would not have solved the problem of Holland's over-capitalization. In any event, this question was a matter of business judgment, which furnishes no justification for holding the directors personally responsible in this case.

Accordingly, the judgment of the court below is reversed and remanded with instruction to enter judgment for the defendants.

Introduction to Shareholder Derivative Suits

Shareholders are shareholders. They shouldn't be allowed to meddle with the everyday business decisions of the corporate directors and officers. This is just another way to recognize the divorce between ownership of corporate shares and running the corporation. But there do need to be some checks, both on corporate managers who act solely for their own selfish interests in running the corporation, and shareholders who file "nuisance" suits against the corporation in order to get paid a lot of money to go away. It is the attempt to strike a balance between these competing interests that have led to the adoption, and the constant evolution, of the Shareholder Derivative Suit.

When a corporation has been "wronged," it has been wronged either by an outside party, such as the other party to a contract who breaches the contract, or it has been wronged by an inside party, such as a member of the Board of Directors. In the vast majority of cases, if a wrong by an outside party occurs, the Board of Directors will authorize a lawsuit against the breaching party, to recover its losses. But what about wrongs committed by insiders? Will the Board of Directors authorize the corporation to sue one of its own members? Given human nature and the most likely response to that question, the courts have struggled to fine tune an approach to ensuring that the corporation's bests interests are promoted, while allowing the directors leeway about how to run the company (which includes deciding whether to sue).

M.R.C.P. 23.1

Discussion points for Cohen v. Beneficial Industrial

If a corporation wrongs a shareholder, the shareholder files suit. This is known as a direct suit. If the corporation is the party who is wronged, then the shareholder is only indirectly harmed, and the shareholder sues on behalf of the corporation, which will get any recovery under this shareholder derivative suit. You can see the potential for blackmail in these cases (As a shareholder, allege some form of wrongdoing, and get the directors to pay your significant attorneys' fees to walk away. Does it surprise you that many attorneys buy one share of a company?). And now you get to see how the courts struggle to find a middle ground balancing all (legitimate) competing interests.

COHEN et al.
v.
BENEFICIAL INDUSTRIAL LOAN CORPORATION
v.
SMITH et al.

Nos. 442, 512.
Supreme Court of the United States

Argued April 18, 1949.

Decided June 20, 1949.

Mr. Justice JACKSON delivered the opinion of the Court.

The ultimate question here is whether a federal court, having jurisdiction of a stockholder's derivative action only because the parties are of diverse citizenship, must apply a statute of the forum state which makes the plaintiff, if unsuccessful, liable for all expenses, including attorney's fees, of the defense and requires security for their payment as a condition of prosecuting the action.

Petitioners' decedent as plaintiff, brought in the United States District Court for New Jersey an action in the right of the Beneficial Industrial Loan Corporation, a Delaware corporation doing business in New Jersey. The defendants were the corporation and certain of its managers and directors. The complaint alleged generally that since 1929 the individual defendants engaged in a continuing and successful conspiracy to enrich themselves at the expense of the corporation. Specific charges of mismanagement and fraud extended over a period of eighteen years and the assets allegedly wasted or diverted thereby were said to

exceed $100,000,000. The stockholder had demanded that the corporation institute proceedings for its recovery but, by their control of the corporation, the individual defendants prevented it from doing so. This stockholder, therefore, sought to assert the right of the corporation. One of 16,000 stockholders, he owned 100 of its more than two million shares, so that his holdings, together with 150 shares held by the intervenor, approximated 0.0125% of the outstanding stock and had a market value that had never exceeded $9,000.

The action was brought in 1943, and various proceedings had been taken therein when, in 1945, New Jersey enacted the statute which is here involved. Its general effect is to make a plaintiff having so small an interest liable for all expenses and attorney's fees of the defense if he fails to make good his complaint and to entitle the corporation to indemnity before the case can be prosecuted. These conditions are made applicable to pending actions. The corporate defendant therefore moved to require security, pointed to its by-laws by which it might be required to indemnify the individual defendants, and averred that a bond of $125,000 would be appropriate.

Constitutionality.

[6] Petitioners deny the validity of the statute under both Federal and New Jersey Constitutions. The latter question is ultimately for the state courts, and since they have made no contrary determination, we shall presume in the circumstances of this case that the statute conforms with the State constitution.

[7] Federal Constitutional questions we must consider, because a federal court would not give effect, in either a diversity or nondiversity case, to a state statute that violates the Constitution of the United States.

The background of stockholder litigation with which this statute deals requires no more than general notice. As business enterprise increasingly sought the advantages of incorporation, management became vested with almost uncontrolled discretion in handling other people's money. The vast aggregate of funds committed to corporate control came to be drawn to a considerable extent from numerous and scattered holders of small interests. The director was not subject to an effective accountability. That created strong temptation for managers to profit personally at expense of their trust. The business code became all too tolerant of such practices. Corporate laws were lax and were not self-enforcing, and stockholders, in face of gravest abuses, were singularly impotent in obtaining redress of abuses of trust.

Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own. It required him first to demand that the corporation vindicate its own rights but when, as was usual, those who perpetrated the wrongs also were able to obstruct any remedy, equity would hear and adjudge the corporation's cause through its stockholder with the corporation as a defendant, albeit a rather nominal one. This remedy born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not

without reason, that without it there would be little practical check on such abuses.

Unfortunately, the remedy itself provided opportunity for abuse which was not neglected. Suits sometimes were brought not to redress real wrongs, but to realize upon their nuisance value. They were bought off by secret settlements in which any wrongs to the general body of share owners were compounded by the suing stockholder, who was mollified by payments from corporate assets. These litigations were aptly characterized in professional slang as 'strike suits.' And it was said that these suits were more commonly brought by small and irresponsible than by large stockholders, because the former put less to risk and a small interest was more often within the capacity and readiness of management to compromise than a large one.

We need not determine the measure of these abuses or the evils they produced on the one hand or prevented and redressed on the other. The Legislature of New Jersey, like that of other states, considered them sufficient to warrant some remedial measures.

[8][9][10] The very nature of the stockholder's derivative action makes it one in the regulation of which the legislature of a state has wide powers. Whatever theory one may hold as to the nature of the corporate entity, it remains a wholly artificial creation whose internal relations between management and stockholders are dependent upon state law and may be subject to most complete and penetrating regulation, either by public authority or by some form of stockholder action. Directors and managers, if not technically trustees, occupy positions of a fiduciary nature, and nothing in the Federal Constitution prohibits a state from imposing on them the strictest measure of responsibility, liability and accountability, either as a condition of assuming office or as a consequence of holding it.

[11][12][13] Likewise, a stockholder who brings suit on a cause of action derived from the corporation assumes a position, not technically as a trustee perhaps, but one of a fiduciary character. He sues, not for himself alone, but as representative of a class comprising all who are similarly situated. The interests of all in the redress of the wrongs are taken into his hands, dependent upon his diligence, wisdom and integrity. And while the stockholders have chosen the corporate director or manager, they have no such election as to a plaintiff who steps forward to represent them. He is a self-chosen representative and a volunteer champion. The Federal Constitution does not oblige the State to place its litigating and adjudicating processes at the disposal of such a representative, at least without imposing standards of responsibility, liability and accountability which it considers will protect the interests he elects himself to represent. It is not without significance that this Court has found it necessary long ago in the Equity Rules and now in the Federal Rules of Civil Procedure to impose procedural regulations of the class action not applicable to any other. We conclude that the state has plenary power over this type of litigation.

[14][15][16][17] In considering specific objections to the way in which the State has exercised its power in this particular statute, it should be unnecessary to say that we are concerned only with objections which go to constitutionality. The wisdom and the policy of this and similar statutes are involved in controversies amply debated in legal literature but

not for us to judge, and, hence not for us to remark upon. The Federal Constitution does not invalidate state legislation because it fails to embody the highest wisdom or provide the best conceivable remedies. Nor can legislation be set aside by courts because of the fact, if it be such, that it has been sponsored and promoted by those who advantage from it. In dealing with such difficult and controversial subjects, only experience will verify or disclose weaknesses and defects of any policy and teach lessons which may be applied by amendment. Within the area of constitutionality, the states should not be restrained from devising experiments, even those we might think dubious, in the effort to preserve the maximum good which equity sought in creating the derivative stockholder's action and at the same time to eliminate as much as possible its defects and evils.

[21][22] The contention that the statute denies equal protection of the laws is based upon the fact that it enables a stockholder who owns 5% of a corporation's outstanding shares, or $50,000 in market value, to proceed without either security or liability and imposes both upon those who elect to proceed with a smaller interest. We do not think the state is forbidden to use the amount of one's financial interest, which measures his individual injury from the misconduct to be redressed, as some measure of the good faith and responsibility of one who seeks at his own election to act as custodian of the interests of all stockholders, and as an indication that he volunteers for the large burdens of the litigation from a real sense of grievance and is not putting forward a claim to capitalize personally on its harassment value. These may not be the best ways of precluding 'strike lawsuits,' but we are unable to say that a classification for these purposes, based upon the percentage or market value of the stock alleged to be injured by the wrongs, is an unconstitutional one. Where any classification is based on a percentage or an amount, it is necessarily somewhat arbitrary. It is difficult to say of many lines drawn by legislation that they give those just above and those just below the line a perfectly equal protection. A taxpayer with $10,000.01 of income does not think it is equality to tax him at a different rate than one who has $9,999.99, or to require returns from one just above and not from one just below a certain figure. It is difficult to say that a stockholder who has 49.99% of a company's stock should be unable to elect any representative to its Board of Directors while one who owns 50.01% may name the entire Board. If there is power, as we think there is, to draw a line based on considerations of proportion or amount, it is a rare case, of which this is not one, that a constitutional objection may be made to the particular point which the legislature has chosen.

[23][24] The contention also is made that the provision which applies this statute to actions pending upon its enactment, in which no final judgment has been entered, renders it void under the Due Process Clause for retroactivity. While by its terms the statute applies to pending cases, it does not provide the manner of application; nor do the New Jersey courts appear to have settled what its effect is to be. Its terms do not appear to require an interpretation that it creates new liability against the plaintiff for expenses incurred by the defense previous to its enactment. The statute would admit of a construction that plaintiff's liability begins only from the time when the Act was passed or perhaps when the corporation's application for security is granted and that security for expenses and counsel fees which 'may be incurred' does not include those which have been incurred before one or the other of these periods. We would not, for the purpose of considering constitutionality,

construe the statute in absence of a state decision to impose liability for events before its enactment. On this basis its alleged retroactivity amounts only to a stay of further proceedings unless and until security is furnished for expense incurred in the future, and does not extend either to destruction of an existing cause of action or to creation of a new liability for past events.

We hold that the New Jersey statute applies in federal courts and that the District Court erred in declining to fix the amount of indemnity reasonably to be exacted as a condition of further prosecution of the suit.

The judgment of the Court of Appeals is affirmed.

Discussion points for Heineman v. Datapoint

Do you think that demand on the board of directors should be excused, because it was futile? On all four counts? Did a majority of the board of directors have a conflict of interest which would obviate the need for a demand on the board? What do you think a board would say when a demand is required? Isn't that the end of the suit right there?

Stanley HEINEMAN, Plaintiff Below, Appellant,
v.
DATAPOINT CORPORATION, Asher B. Edelman, Edward P. Gistaro, Doris D. Bencsik,
Raymond French, Daniel R. Kail, Clark P. Mandigo, Charles P. Stevenson, Jr., and Dwight D. Sutherland, Defendants Below, Appellees.

Supreme Court of Delaware.

WALSH, Justice:

This is an appeal from the Court of Chancery's dismissal of a stockholder's derivative suit alleging corporate waste and breach of fiduciary duty. The court dismissed the plaintiff's amended complaint for failure to allege with particularity facts sufficient to excuse demand that the corporation's board of directors prosecute this action. The court also denied the stockholder permission to amend his complaint a second time. We reverse the Court of Chancery's dismissal of the amended complaint and remand for further proceedings, to include the opportunity to further amend the complaint.

I

The corporate defendant, Datapoint Corporation ("Datapoint"), is a Delaware corporation

engaged in the design and manufacture of computer, computer software and related office communications equipment. Its stock is publicly held by approximately five thousand investors and is traded on the New York Stock Exchange. The individual defendants are the eight directors comprising Datapoint's board during the period of time relevant to the events underlying this case. This suit was initiated by a Datapoint shareholder, Stanley Heineman ("Heineman"). Heineman alleged that four separate transactions, each approved by Datapoint's board, constituted corporate waste and self- dealing by the directors and that Datapoint was entitled to rescission of the transactions, as well as an accounting and damages.

The claims of director misconduct are directed against what Heineman calls "the Edelman Group," named after its alleged leader, Asher B. Edelman ("Edelman"). In 1985 Edelman, currently Chairman of the Board of Datapoint and its largest shareholder, led an insurgent group of shareholders in a proxy contest for control of Datapoint. Pursuant to a settlement of litigation related to that contest, Edelman and four other individuals were named to Datapoint's board. These directors, with Edelman, make up the so-called "Edelman Group" and constitute a majority of the board.

FN2. Edelman allegedly owns roughly 15 percent of Datapoint's outstanding common stock.

Heineman contends in his complaint that these directors, as well as two other Datapoint directors, were controlled by Edelman and that Edelman used this control to cause Datapoint to enter into certain transactions which were beneficial to Edelman at the expense of Datapoint. He also contends that the individual defendants, constituting Datapoint's board, caused Datapoint to enter into certain other transactions with business entities in which various directors held interests and that these transactions benefitted those entities (and therefore, indirectly, the directors) at the expense of Datapoint. This control by Edelman and the self-interest of a majority of the directors, Heineman claims, made it unlikely that the board would pursue the claims, thus rendering demand futile.

In this appeal, Heineman argues that the Court of Chancery abused its discretion in concluding that allegations of the amended complaint did not raise a reasonable doubt that a majority of Datapoint's directors were disinterested in approving four separate corporate transactions. In the interest of clarity and because the configuration of alleged director interest varies, we will address each transaction. Preliminarily, we note that the parties do not dispute the legal standards which govern the demand requirement but part company on the question of whether the Court of Chancery properly applied those standards. Thus, it is not amiss to review the relevant law concerning presuit demand before addressing the specific allegations of the amended complaint.

[1] As we have previously stated, "[a] shareholder derivative suit is a uniquely equitable remedy in which a shareholder asserts on behalf of a corporation a claim belonging not to the shareholder, but to the corporation." Levine v. Smith, Del.Supr., 591 A.2d 194, 200 (1991). In the usual case, a shareholder's remedy for a perceived wrong against the corporation is limited to a demand upon the board that the corporation pursue redress. The board, in the

exercise of its statutorily conferred managerial powers, see 8 Del.C. § 141(a), then makes the ultimate decision of whether or not to prosecute the claim. Spiegel v. Buntrock, Del.Supr., 571 A.2d 767, 772-73 (1990); Zapata Corp. v. Maldonado, Del.Supr., 430 A.2d 779, 782 (1981).

Equity will not require a useless act, however. Where demand upon the board would be "futile," the demand requirement will be excused. See Aronson v. Lewis, Del.Supr., 473 A.2d 805 (1984). In this context, futility does not mean that there is no likelihood that a board will agree to the demand. Rather, demand is futile where a reasonable doubt exists that the board has the ability to exercise its managerial power, in relation to the decision to prosecute, within the strictures of its fiduciary obligations. Levine, 591 A.2d at 200. If a board's disability as to a particular transaction is attributable to self-interest or lack of independence, then presuit demand is not required. The standard for pleading such futility as set forth in Aronson is "whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." 473 A.2d at 814. Furthermore, this determination "involves essentially a discretionary ruling on a predominantly factual issue." Grobow v. Perot, Del.Supr., 539 A.2d 180, 186 (1988). We therefore review such rulings only for abuse of that discretion. Id.

III

Heineman's amended complaint refers to four separate transactions allegedly entered into by Datapoint with the approval of the defendant directors and which are claimed to be improper. We address them separately.

A. The Reimbursement Transaction

The first such transaction involved payments from Datapoint to a number of directors as reimbursement of expenses related to the successful attempt to acquire control of Datapoint in the proxy contest led by Edelman. Paragraphs 12 and 18 of the amended complaint specifically allege:

> 12. In the months following his assumption of control of Datapoint, Edelman caused the company to pay to himself and the other members of the Edelman Group more than $1,150,000 as reimbursement for costs associated with Edelman's assumption of control over Datapoint. Said payments were received by and/or for the benefit of Edelman and the Edelman group, who constituted a majority of the board of directors.
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> * * * * * *
>
> 18. In May 1986, Edelman abandoned a plan announced in late 1985 to take Datapoint private in a leveraged buy-out transaction. Edelman and the Edelman group caused Datapoint to agree to pay their expenses in connection with the proposal in the amount of $72,000, notwithstanding the fact that the proposed transaction conferred no benefit on Datapoint.

The "assumption of control" language above refers to Edelman's successful proxy contest for

control of Datapoint in 1985.

The Vice Chancellor did not address this claim specifically but in summary fashion ruled:

> From a review of the entire complaint, it is clear that plaintiff has not alleged facts which, if true, reasonably permit the Court to infer that a majority of directors were not independent or did not exercise their own business judgment. Nor has plaintiff plead facts which, if true, raise a reasonable doubt that the challenged transactions were not the product of a valid exercise of business judgment.

[2] This conclusory treatment does not satisfy the "highly factual nature of the inquiry" in which the Court of Chancery must engage when a demand defense is raised. Perot, 539 A.2d at 186. We read the complaint to allege that a majority of the board, after assuming their positions through a successful proxy contest, reimbursed themselves for the costs incurred in that battle by voting funds from the corporate treasury in excess of $1 million. It may be that this reimbursement never occurred or, if so, was justified for some as yet undisclosed reason. No answer has been filed contesting the allegations of the amended complaint, and they must accordingly be viewed as true in this procedural posture, Id. In our view the "well pleaded" allegation of paragraphs 18 and 19 of the amended complaint recite sufficient facts of apparent self-dealing to raise a reasonable doubt concerning director- disinterest. The complaint alleges a successful contest for corporate control, with the victors in that contest using their newly acquired positions to cause the corporation to reimburse the costs of waging that contest. Proof of these facts at trial would represent a prima facia case of director self-dealing. Weinberger v. UOP, Inc., Del.Supr., 457 A.2d 701, 710 (1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."). While countervailing evidence might incline the fact finder to discredit the allegations, at this juncture the Court is not engaged in a weighing of evidence. The plaintiff need only raise a reasonable doubt that the business judgment rule applies. And though he is not required to plead a prima facia case of breach of fiduciary duty in order to avoid the demand requirement, once he does make such allegations he has carried his burden and demand is excused. We conclude, therefore, that the court's dismissal of this claim was an abuse of its discretion.

B. The Arbitrage Transaction

Heineman next alleges that a substantial investment made by Datapoint, at the direction of the individual defendants, in a firm titled Arbitrage Securities Company ("Arbitrage Securities") inured to the financial benefit of a majority of the board of directors. Paragraphs 14, 15 and 16 of the Amended Complaint read as follows:

> 14. Not content with the cash extracted from Datapoint pursuant to the transactions set forth above, Edelman caused Datapoint in February 1986 to enter into an agreement with Edelman-controlled Arbitrage Securities pursuant to which Datapoint formed an investment partnership with Arbitrage Securities. Under the terms of this arrangement, Datapoint would provide cash, which Arbitrage Securities would invest in its sole discretion. Net profits would be divided 75% to Datapoint and 25% to Arbitrage

Securities. Net losses would be allocated 100% to Datapoint. The amount of cash invested in this partnership was determined by the Datapoint board of directors.

15. Pursuant to the foregoing arrangement with Arbitrage Securities, Datapoint, with the approval and/or acquiescence of the defendant directors, made available to Arbitrage Securities more than $20,000,000 for the latter to utilize in risk arbitrage transactions as it deemed appropriate. Under this arrangement, Datapoint's cash was invested by Arbitrage, in conjunction with one or more of its affiliated investment partnerships. Defendants Edelman, Gistara, French, Kail, Mandigo, Stevenson and Sutherland were investors in one or more of said partnerships.

16. Pursuant to the aforesaid arrangement, Edelman has shifted to Datapoint the entire risk of loss, while retaining for himself and his affiliates the ability to employ Datapoint's assets in arbitrage transactions on a completely risk-free basis with enormous and unreasonable profits for himself and his affiliates.

[3] Again, there is no specific treatment of this claim by the Court of Chancery other than the stated conclusion that Heineman has failed to allege sufficient facts to support a finding of reasonable doubt of director disinterest. We disagree.

Apart from the hyperbole, the factual assertions allege an "arrangement" by a majority of Datapoint's board to divert a substantial amount of the corporation's assets to an arbitrage pool whose participants include entities in which a majority of the directors hold an interest. That Datapoint entered into this arrangement with the approval of its board and the specifics of the agreement are assertions of fact. That particular members of Datapoint's board have interests in partnerships which have risk-free access to Datapoint's contribution to the arbitrage panel is also a statement of fact.

These allegations paint a picture of directors funneling corporate assets to their private use, a practice at clear variance with the directors' fiduciary obligation. Mills Acquisition Co. v. Macmillan, Inc., Del.Supr., 559 A.2d 1261 (1989); Weinberger v. UOP, Inc., Del.Supr., 457 A.2d 701 (1983); Sterling v. Mayflower Hotel Corp., Del.Supr., 93 A.2d 107 (1952); Guth v. Loft, Inc., Del.Supr., 5 A.2d 503 (1939). The claims of director self- dealing supported by particularized facts raise a reasonable doubt as to director disinterest to the extent that the challenged transaction may result in a benefit to the affected directors "which is not equally shared by the stockholders." Pogostin v. Rice, Del.Supr., 480 A.2d 619, 624 (1984). Dismissal of this claim for failure to make demand represents a too stringent application of the standards governing demand and, in our view, constitutes an abuse of discretion.

C. The United Stockyards Transaction

The amended complaint also alleges that Datapoint, at the direction of the individual defendants, entered into an agreement with the United Stockyards Corporation ("United Stockyards") under which United Stockyards would provide "consulting" to Datapoint for a fee of $300,000 per year. The complaint recites that United Stockyards is a corporation engaged primarily in the business of operating public stockyards and that it has no expertise in the computer business.

The amended complaint asserts that this transaction was effected by Edelman, for his benefit, through his control and domination of a majority of the Datapoint board. To support this allegation, it is claimed that Edelman is the controlling shareholder of Datapoint and that its directors held their positions "at his pleasure." It is alleged that six members of Datapoint's board occupy board positions in various Edelman-controlled business entities and do so "at the pleasure of Edelman." It is further alleged that those same directors have substantial business dealings with Edelman through investments in numerous Edelman-controlled concerns. Finally, it is alleged that Edelman is the controlling shareholder of United Stockyards and that four members of Datapoint's board also sit on the board of United Stockyards.

The nub of this claim is that a majority of Datapoint's board were dominated by Edelman through his control of their positions as Datapoint directors coupled with his control of business organizations in which they were investors. This domination, it is claimed, has caused Datapoint to enter into a self-dealing transaction. The claim thus attacks the board's independence.

[4] An allegation of controlling stock ownership does not raise, per se, a reasonable doubt as to the board's independence. Kaplan v. Centex Corp., Del.Ch., 284 A.2d 119, 122 (1971). Nor does a solitary claim of interlocking directorships. Id. at 123. To raise such a doubt a party attacking a corporate transaction must advance particularized factual allegations from which the Court of Chancery can reasonably infer that the board members who approved the transaction are acting at the direction of the allegedly dominating individual or entity. Id.

[5] We recognize that an allegation that directors are dominated and controlled, standing alone, does not meet the demand futility standard. Aronson v. Lewis, 473 A.2d at 816. There must be some alleged nexus between the domination and the resulting personal benefit to the controlling party. Id. at 815.

In the present case, Heineman has alleged control of various business entities through stock ownership on the part of certain directors affiliated with Edelman. He has also alleged that among those entities there exist extensive interlocking business relationships "at the pleasure of Edelman." Finally, Heineman asserts that transactions between Datapoint and certain of the entities have resulted in substantial payments by Datapoint.

[6] We believe these allegations present a close question as to the board's independence. It is at least arguable that Heineman has failed to allege that Edelman directed a majority of Datapoint's board to support the transaction and to that extent the factual allegations of the amended complaint may be deemed inadequate. However, in view of our reversal of the Court of Chancery dismissal of the Reimbursement and Arbitrage transactions, further proceedings will be required at the trial level. We therefore deem the better course to be a remand of this claim with direction to permit Heineman to file a second amended complaint to further articulate the assertion of self-interest and lack of independence regarding the United Stockyards transaction.

We emphasize that in permitting a further amendment of this complaint regarding the United Stockyards transaction we are not directly passing upon the Vice Chancellor's denial of Heineman's motion to further amend the entire complaint. In this case the plaintiff had been given two opportunities and three years, see note 1, supra, to articulate adequate claims and further delay for that purpose would have been prejudicial to the defendants. Cf. Atlantis Plastics Corp. v. Sammons, Del.Ch., 558 A.2d 1062 (1989); see also Bowl-Mor Co. v. Brunswick Corp., Del.Ch., 297 A.2d 61 (1972), appeal dismissed, Del.Supr., 297 A.2d 67 (1972). The context has changed however with our reversal of the dismissal of the first two claims. The defendants are still "in court" and subject to the possibility of further proceedings on the merits, including discovery. Thus, delay is no longer an overriding consideration because the defendants will experience no prejudice by the allowance of an amendment. Boileu v. Bethlehem Steel Corp., 3rd Cir., 730 F.2d 929 (1984). Moreover, if United Stockyards claims were to be dismissed with prejudice and upon remand Heineman were to discover additional facts of self-dealing relating to this transaction, he would be barred from asserting those claims against the defendants even though he was then prosecuting other claims of self-interest. Such a result would be inefficient and inequitable. We therefore vacate the dismissal of this claim and remand with directions to allow Heineman a second amendment.

D. The Jetstar Transaction

Finally, the amended complaint contains allegations that Edelman, through his control of the board of Datapoint, caused Datapoint to enter into an agreement with AAA Jetstar, a corporation whose sole shareholder is Edelman. The agreement allegedly contemplates Datapoint's paying AAA Jetstar $245,000 in exchange for "transportation services." It is alleged that this transaction is simply another device whereby Edelman siphons cash from Datapoint for his personal benefit.

Because Heineman has not alleged that a majority of the board holds an interest in AAA Jetstar, he again relies on the allegation of board domination to show that the decision to enter into Jetstar transaction is not entitled to the protection of the business judgment rule. Aronson, 473 A.2d at 814. Again, the claim of lack of independence is arguably insufficient but since it is part of a larger dispute which must receive further judicial attention at the trial level we decline to affirm its dismissal in the present posture of this litigation. This claim also will be remanded for the opportunity to enlarge upon the allegation of domination through the filing of a second amended complaint.

The amended complaint pleads in sufficient particularized detail claims of interlocking directorships, domination by Edelman and shared investments between Edelman and a majority of the Datapoint board to raise a reasonable doubt concerning the disinterest and independence of the Datapoint board. The level of doubt is clearly sufficient as to the reimbursement and arbitrage claims as to excuse presuit demand as futile. The Court of Chancery's holding to the contrary represents an abuse of discretion. The remaining claims involving United Stockyards and Jetstar should be subject to amended pleading in the context

of ongoing litigation as to related claims.

REVERSED AND REMANDED.

Discussion points for Alford v. Shaw

More on the attempt to find a middle ground. How effective do you think a litigation committee is? Or better, how unbiased do you think it really is? Does it depend on who is on the committee?

Frank O. **ALFORD**, Wilkie P. Beatty, as Executrix of the Estate of Paul B. Beatty, Carson Insurance Agency, Inc., Patricia A. Edlund, Stanley Edlund, James M. Gilfillin, Larry G. Goldberg, Raquel T. Goldberg, Betty F. Rhyne, Robert R. Rhyne and Norman V. Swenson, derivatively in the right of All American Assurance Company, Plaintiffs,
v.
Robert T. **SHAW**, American Commonwealth Financial Corporation, Great Commonwealth Life Insurance Company, ICH Corporation, Charles E. Black, S.J. Campisi, Roy J. Broussard, Truman D. Cox, Fred M. Hurst, C. Fred Rice and Peggy P. Wiley, Defendants,
and
All American Assurance Company, Beneficial Party.

No. 132PA85.

Supreme Court of North Carolina.

July 28, 1987.

MARTIN, Justice.

The sole issue raised by this appeal is whether a special litigation committee's decision to terminate plaintiff minority shareholders' derivative action against defendant corporate directors is binding upon the courts. In our earlier opinion in this case, 318 N.C. 289, 349 S.E.2d 41 (1986), we stated that the "business judgment rule," a doctrine shielding the good faith actions of disinterested corporate directors from judicial inquiry on the merits, required deference to the decisions of independent special litigation committees. Consequently we held that summary judgment had been properly granted for defendants. Upon this rehearing we have elected to reconsider our prior holding and to redetermine the question raised by the

appeal.

Briefly summarized, the record discloses the following: In response to charges of mismanagement asserted by plaintiff minority shareholders, the board of directors of All American Assurance Company (AAA) voted to appoint a committee to conduct an investigation. The board then elected Marion G. Follin, a retired insurance executive, and Frank M. Parker, a former judge of the North Carolina Court of Appeals, to board membership and designated them as a special investigative committee. The committee was authorized to determine whether it would be in the best interest of AAA and its shareholders to initiate legal action against those implicated in any wrongdoing uncovered by the investigation.

Before the committee had completed its investigation, plaintiffs filed a shareholders' derivative action in superior court, naming as defendants the controlling shareholders of AAA and a majority of its directors. The complaint alleged inter alia that in a series of transactions involving corporations affiliated with AAA, defendants had violated fiduciary obligations by engaging in a pattern of fraud, self-dealing, and negligent acquiescence which amounted to a "looting" of corporate assets for defendants' own benefit.

Upon completion of its investigation, the committee filed a report in the trial court recommending that the majority of plaintiffs' claims be dismissed with prejudice and that two remaining claims be settled in accordance with an attached settlement agreement. Based on the committee's report, defendants moved for summary judgment and approval of the settlement agreement. The trial court held that the business judgment rule controlled the disposition of the case and granted the motions. The Court of Appeals reversed, 72 N.C.App. 537, 324 S.E.2d 878 (1985), holding that corporate directors who are parties to a derivative action may not confer upon a special committee the power to bind the corporation as to the derivative litigation. We affirm the Court of Appeals, subject to the modifications discussed below.

We deem it unnecessary for the purposes of this opinion to review the development of the basic principles of derivative litigation. For a general discussion of derivative suits, see D. DeMott, Shareholder Derivative Actions Law and Practice §§ 1:01-:05 (1987); R. Robinson, North Carolina Corporate Law and Practice §§ 14-1, -2 (3d ed. 1983).

In determining the proper role, if any, of special corporate litigation committees in the termination of derivative shareholders' actions, three basic approaches have been adopted by other jurisdictions:

1. Auerbach. In Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), the Court of Appeals of New York extended the business judgment rule to the decisions of special litigation committees, precluding judicial review of the merits of those decisions. Under Auerbach, judicial review of committee decisions is limited to the issues of good faith, independence, and sufficiency of the investigation.

2. Miller. In Miller v. Register and Tribune Syndicate, Inc., 336 N.W.2d 709 (Iowa 1983), the Iowa Supreme Court adopted a prophylactic rule as a means of circumventing the "structural bias" inherent in the committee appointment process. Under Miller, directors charged with misconduct are prohibited from participating in the selection of special litigation committees.

3. Zapata. In Zapata Corp. v. Maldonado, 430 A.2d 779 (Del.1981), the Delaware Supreme Court promulgated a two-step test for judicial review of the decisions of special litigation committees. The first step requires an inquiry as to the independence, good faith, and investigative techniques of the committee, expressly placing the burden of proof as to these matters on the corporation. The second step, as a safeguard against structural bias, provides for an additional, discretionary level of scrutiny on the merits in which trial courts may exercise their own "independent business judgment" in deciding whether derivative actions should be dismissed. The report of the special litigation committee may be considered along with all the other evidence before the court.

The recent trend among courts which have been faced with the choice of applying an Auerbach-type rule of judicial deference or a Zapata-type rule of judicial scrutiny has been to require judicial inquiry on the merits of the special litigation committee's report. See Note, Derivative Actions--Presumed Good Faith Deliberations By Special Litigation Committees: A Major Hurdle For Minority Shareholders--Alford v. Shaw, 22 Wake Forest L.Rev. 127, 139-44 (1987).

In our previous decision in this case, we applied a modified Auerbach rule. We interpret the trend away from Auerbach among other jurisdictions as an indication of growing concern about the deficiencies inherent in a rule giving great deference to the decisions of a corporate committee whose institutional symbiosis with the corporation necessarily affects its ability to render a decision that fairly considers the interest of plaintiffs forced to bring suit on behalf of the corporation. See generally Cox & Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, 48 Law and Contemporary Problems, Summer 1985 at 83 (1985). Such concerns are legitimate ones and, upon further reflection, we find that they must be resolved not by slavish adherence to the business judgment rule, but by careful interpretation of the provisions of our own Business Corporation Act. We conclude from our analysis of the pertinent statutes that a modified Zapata rule, requiring judicial scrutiny of the merits of the litigation committee's recommendation, is most consistent with the intent of our legislature and is therefore the appropriate rule to be applied in our courts. While we affirm the holding of the Court of Appeals reversing summary judgment for defendants, we reject that court's application of the Miller rule.

In 1973 the General Assembly enacted N.C.G.S. § 55-55 which expressly authorizes shareholders' derivative actions and prescribes the rules governing all such actions brought in the state courts of North Carolina. Section 55- 55 contains liberal provisions which do not impose many of the restrictions upon derivative actions encountered in other jurisdictions.

The legislature has placed the minority shareholder in North Carolina "in a more favorable position to seek redress on behalf of his corporation for wrongs allegedly done to it by the majority shareholders, the directors and officers, or outside third parties." R. Robinson, North Carolina Corporation Law and Practice § 14-1 at 214 (3d ed. 1983).

The plain language of the statute requires thorough judicial review of suits initiated by shareholders on behalf of a corporation: the court is directed to determine whether the interest of any shareholder will be substantially affected by the discontinuance, dismissal, compromise, or settlement of a derivative suit. Although the statute does not specify what test the court must apply in making this determination, it would be difficult for the court to determine whether the interests of shareholders or creditors would be substantially affected by such discontinuance, dismissal, compromise, or settlement without looking at the proposed action substantively.

[1] To make the required assessment under section 55-55, the court must of necessity evaluate the adequacy of materials prepared by the corporation which support the corporation's decision to settle or dismiss a derivative suit along with the plaintiff's forecast of evidence. If it appears likely that plaintiff could prevail on the merits, but that the amount of the recovery would not be sufficient to outweigh the detriment to the corporation, the court could still allow discontinuance, dismissal, compromise, or settlement.

Although the recommendation of the special litigation committee is not binding on the court, in making this determination the court may choose to rely on such recommendation. To rely blindly on the report of a corporation-appointed committee which assembled such materials on behalf of the corporation is to abdicate the judicial duty to consider the interests of shareholders imposed by the statute. This abdication is particularly inappropriate in a case such as this one, where shareholders allege serious breaches of fiduciary duties owed to them by the directors controlling the corporation.

[2][3] Section 55-55(c) is a broadening of the Zapata approach. As in other jurisdictions, exhaustion of intracorporate remedies (that is, "demand") is a procedural prerequisite to the filing of a derivative action in North Carolina. Section 55-55(b), codifying prior case law, makes this explicit:

> The complaint shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort.

An equitable exception to the demand requirement may be invoked when the directors who are in control of the corporation are the same ones (or under the control of the same ones) as were initially responsible for the breaches of duty alleged. In such case, the demand of a shareholder upon directors to sue themselves or their principals would be futile and as such is not required for the maintenance of the action. Hill v. Erwin Mills, Inc., 239 N.C. 437, 80 S.E.2d 358 (1954); Swenson v. Thibaut, 39 N.C.App. 77, 250 S.E.2d 279 (1978), cert. denied and appeal dismissed, 296 N.C. 740, 254 S.E.2d 181 (1979). Here plaintiffs alleged that defendant shareholders, who were responsible for the fraudulent transactions, used their

control of AAA to nominate and elect defendant directors and that defendant directors permitted the fraudulent transactions to occur. This establishes a demand-excused situation and sufficiently complies with the procedural requirement of section 55-55(b).

[4] The Zapata Court limited its two-step judicial inquiry to cases in which demand upon the corporation was futile and therefore excused. However, we find no justification for such limitation in our statutes. The language of section 55-55(c) is inclusive and draws no distinctions between demand- excused and other types of cases. Cf. ALI Principles of Corporate Governance: Analysis and Recommendations § 7.08 & Reporter's Notes 2 & 4 at 135-139 (Council Draft No. 6, Oct. 10, 1986) (issue of demand of minimal importance in determining scope of review; demand-excused/demand-required distinction not determinative). Thus, court approval is required for disposition of all derivative suits, even where the directors are not charged with fraud or self- dealing, or where the plaintiff and the board agree to discontinue, dismiss, compromise, or settle the lawsuit.

Another expression of legislative intent may be found in N.C.G.S. § 55-30 relating to a director's adverse interest. It provides, inter alia:

> (b) No corporate transaction in which a director has an adverse interest is either void or voidable, if:
>
> (3) The adversely interested party proves that the transaction was just and reasonable to the corporation at the time when entered into or approved. In the case of compensation paid or voted for services of a director as director or as officer or employee the standard of what is "just and reasonable" is what would be paid for such services at arm's length under competitive conditions.

[5][6] When N.C.G.S. §§ 55-55 and 55-30(b)(3) are read in pari materia, they indicate that when a stockholder in a derivative action seeks to establish self-dealing on the part of a majority of the board, the burden should be upon those directors to establish that the transactions complained of were just and reasonable to the corporation when entered into or approved. The fact that a special litigation committee appointed by those directors charged with self-dealing recommends that the action should not proceed, while carrying weight, is not binding upon the trial court. Rather, the court must make a fair assessment of the report of the special committee, along with all the other facts and circumstances in the case, in order to determine whether the defendants will be able to show that the transaction complained of was just and reasonable to the corporation. If this appears evident from the materials before the court, then in a proper case summary judgment may be allowed in favor of the defendants.

[7] Upon remand plaintiffs shall be permitted to develop and present evidence on this issue, such as: (1) that the committee, though perhaps disinterested and independent, may not have been qualified to assess intricate and allegedly false tax and accounting information supplied to it by those within the corporate structure who would benefit from decisions not to proceed with litigation, (2) that, in fact, false and/or incomplete information was supplied to the committee because of the nonadversarial way in which it gathered and evaluated information, and therefore (3) in light of these and other problems which arise from the structural bias

inherent in the use of board-appointed special litigation committees, that the committee's decision with respect to the litigation eviscerates plaintiffs' opportunities as minority shareholders to vindicate their rights under North Carolina law. Cf. Dent, The Power of Directors to Terminate Shareholder Litigations: The Death of The Derivative Suit, 75 Nw. U.L.Rev. 96 (1981).

The trial court in this case adopted the erroneous

> opinion that the business judgment rule controls the disposition of this case and, therefore, that the only issues before it are whether the Special Committee was composed of disinterested, independent directors who acted in good faith, and whether the scope of the investigation and the procedures adopted and followed were appropriate.

(Emphasis added.) By so doing, the trial court failed to fulfill its duties under N.C.G.S. § 55-55(c) and the rationale of Zapata.

In view of the foregoing, we withdraw our decision reported in 318 N.C. 289, 349 S.E.2d 41 (1986). That decision is no longer authoritative and this opinion now becomes the law of the case. See Investment Properties v. Allen, 283 N.C. 277, 196 S.E.2d 262 (1973).

The decision of the Court of Appeals as modified by this opinion is affirmed. This cause is remanded to the Court of Appeals with direction to remand to the Superior Court of Mecklenburg County for further proceedings not inconsistent with this opinion.

MODIFIED AND AFFIRMED.

Food & Allied Service v. Wal-Mart Stores

Court of Chancery of Delaware.

The **FOOD AND ALLIED SERVICE TRADES DEPARTMEN**T, AFL-CIO, Plaintiff,
v.
WAL-MART STORES, INC., Defendant.

CIV. A. No. 12551.

Submitted: May 18, 1992.
Decided: May 20, 1992.

MEMORANDUM OPINION

ALLEN, Chancellor.

This is an action under Section 220 of the Delaware General Corporation law for an order compelling defendant to permit plaintiff to inspect defendant's stockholder list and related materials.

Plaintiff "Food and Allied Service Trades Department, AFL-CIO" ("FAST") is an unincorporated labor organization. It was established as a department of the AFL-CIO [FN1] by that organization's sixteen, affiliated labor unions for the purpose of addressing the affiliates' common concerns by means of research, public relations and, apparently, litigation. Significantly, it also is the owner of 23 shares of the defendant's common stock.

Defendant Wal-Mart Stores, Inc. ("Wal-Mart"), a Delaware corporation, is the largest retailer in the United States.

* * *

Section 220 provides

any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose the corporation's ... list of stockholders ... and to make copies or extracts therefrom.

On April 24 of this year, FAST delivered to Wal-Mart a written demand [FN2] under oath for a list of the corporation's shareholders and other related documents customarily demanded in connection with such inspection requests. That demand stated the purpose of the inspection request to be:

to permit the undersigned to communicate with other stockholders of the Company on matters relating to their interest as stockholders, including communicating with such stockholders regarding a solicitation of proxies to be conducted by the undersigned in connection with the Company's 1992 Annual Meeting of Shareholders, scheduled for June 5, 1992, in support of an independent shareholders' resolution recommending that the Board of Directors establish a Special Committee to study and report to the Board of Directors and to the shareholders on the Company's buying policies and practices in China, with special attention to ensuring that no products purchased directly and/or indirectly from sources in China are produced wholly or in part by forced labor. The purpose of this demand for a stocklist is also to permit the undersigned to furnish the Company's stockholders with copies of proxy materials relating to that resolution and to solicit proxies from those stockholders.

Wal-Mart does not contend that the demand does not satisfy the formal requirements of Section 220. FAST, Wal-Mart concedes, owns twenty three shares of Wal-Mart common stock and has submitted a demand under oath which includes a statement of the purpose for the inspection.

Wal-Mart does contend that the stated purpose is not "proper" as required by Section 220 because it is not "reasonably related to [FAST's] interest as a stockholder," 8 *Del.C.* § 220,

as required by that section. Thus, the only question requiring an answer is whether FAST's purpose in seeking the shareholder list is proper.

Under Section 220, the burden of proof is on Wal-Mart. [FN3] In other words, FAST will be permitted inspection unless Wal-Mart establishes that FAST's purpose is *not* proper.

* * *

Following Wal-Mart's refusal to comply with FAST's demand, FAST filed this suit on May 5, 1992. On May 18, a trial was held at which the court heard the direct and cross-examination testimony of plaintiff's witness, FAST's president, Robert F. Harbrant, and received documentary evidence from both parties.

Mr. Harbrant described the events leading up to FAST's proposal of its resolution in the following manner. Sometime during 1991, particularly following the massacre in Tianamen Square and the related government arrests of students and workers, FAST grew concerned about the abuse of civil rights by the government of the People's Republic of China. FAST then heard that the Chinese government was using forced prison labor in the manufacture of goods for export. Mr. Harbrant testified that the sale of goods produced by forced labor is not only morally repugnant, but a violation of United States law. He added that FAST, as a labor organization, sympathizes with workers throughout the world and thus has an interest in eliminating the worldwide purchase of goods produced by forced labor. Accordingly, FAST began to investigate the use of forced labor in China.

A FAST board member, Jeffrey Fiedler, travelled to China once during 1991 as part of a Congressional fact finding mission and has travelled there twice subsequently in search of more information about the production of goods by forced labor. In his capacity as a FAST board member, Fiedler testified on the subject of Chinese forced labor before various Congressional committees in September, October and November of 1991.

In late 1991, FAST helped organize a boycott of toys made in China and allegedly sold in the United States by "Toys R Us" and defendant Wal-Mart.

Also in 1991, FAST took issue with announcements by Wal-Mart, as part of its "Buy American" campaign, suggesting that its products were made in America. According to Harbrant, FAST did not believe Wal-Mart in fact acted consistently with its own public statements. FAST thus circulated to consumers leaflets explaining how to determine where a product is made from the "RN" number displayed on its label.

Finally, Harbrant testified that the impetus for the resolution now proposed by FAST came during Wal-Mart's 1991 shareholders' meeting where, in response to a question from a FAST representative, Wal-Mart's president, now chief executive officer, appeared to be too little concerned, in FAST's opinion, with the possibility that Wal-Mart was importing and selling in the United States a significant number of products that were produced by captive laborers in China. According to Harbrant, Wal-Mart had and still has no system in place for

determining which, if any, of the Chinese products it sells are produced by forced labor. FAST believes that its proposed resolution calling, as it does, for a report to the shareholders by a special board committee, will rectify this situation.

The principal argument of defendant is factual. It is that the proxy solicitation purpose is a pretext to get the shareholder list for an inappropriate purpose (organizing) and that, in all events, the purpose is to injure Wal-Mart, to the advantage of competitors who employ union workers.

Defendant has not met its burden of proof on this assertion. The willingness of the plaintiff to agree to the restrictions on use of the list and the limitation of the names to be disclosed makes defendant's first supposition unlikely. But, even if those proposals had not been made, too little has been shown to justify that inference. The second explanation advanced is equally unsupported in the record. On cross-examination, Mr. Harbrant's testimony did not establish that FAST's largest union sponsor, the United Food and Commercial Workers International Union ("UFCW"), would have a motive to harm Wal-Mart. It did establish that the UFCW and FAST have been urging consumers to "buy American" and have been teaching them, as Harbrant also noted on direct, how to identify foreign made goods. Finally, Harbrant's testimony established that some of the efforts of FAST and the UFCW in this regard have been targeted at Wal-Mart. However, in my opinion, Wal-Mart has not met its burden of proof in establishing that FAST is seeking to harm Wal-Mart.

The more plausible explanation is the one that FAST offers: that it is motivated by a desire to try to combat the importation of goods made with forced labor both as a matter of international labor solidarity and as a self- interested effort to keep low-price foreign goods out of competitive American markets. Thus, I accept as truthful Mr. Harbrant's testimony that FAST's principal purpose in seeking the stockholder list is to facilitate its solicitation of proxies from Wal-Mart stockholders so that it more easily can get its proposed resolution adopted at the June 5 stockholders' meeting or, if unsuccessful then, at some later date. As the owner of just 23 shares which it purchased for about $300, FAST cannot persuasively argue that its effort to see the resolution adopted is pursued in order to benefit its interest as a stockholder.

* * *

This leaves the question whether Section 220 permits a stockholder to inspect a corporation's stockholder list if that stockholder's purpose in seeking such inspection is to solicit proxies in support of a resolution that it has proposed solely for moral and political reasons.

While as a matter of public policy interesting arguments could be made on either side of this question, such an exercise, by this court, is no longer useful. The question is not an open one. It once was held that shareholders have no right to inspect their corporation's stockholder list unless their ultimate aim is the enhancement of the economic value of the corporation. *See Pillsbury v. Honeywell, Inc.,* Minn.Supr., 191 N.W.2d 406 (1971) (applying Delaware law). However, this result was disapproved by the Delaware Supreme Court. In

Credit Bureau Reports, Inc. v. Credit Bureau of St. Paul, Inc., Del.Supr., 290 A.2d 691 (1972), the Supreme Court of Delaware affirmed this court's order requiring the defendant corporation to permit inspection of its stockholder list by a stockholder whose purpose in seeking the list was to solicit proxies with the ultimate aim of inducing the corporation to deal more generously with its suppliers of which the stockholder was one.

I believe *Credit Bureau Reports* is controlling here. There, as here, the plaintiff sought the stockholder list for the immediate purpose of soliciting proxies to be voted at an annual meeting. And there, as here, plaintiff's ultimate aim was not to enhance the value of the corporation's shares. In fact, in that case, the plaintiff's ultimate aim was even further removed from enhancement of share value than is FAST's aim which on some attenuated basis might arguably be said to foster corporate profit. Rather than seeking to benefit itself and certain nonshareholders at the expense of the corporation, FAST seeks to ensure that the corporation complies with its legal obligations in the interest of forced laborers in China. This purpose, while principally directed towards other interests, is consistent with management's conception of the corporation's long-term interest. I therefore conclude that FAST's purpose in seeking inspection is no less proper than was that of the plaintiff in the *Credit Bureau* case.

Judgment for plaintiff is entered hereby. Defendant shall produce the stockholder list materials, as modified herein, by the close of business tomorrow. It is so ordered.

In Re Paxson Communication

Court of Chancery of Delaware.

In re **PAXSON COMMUNICATION** CORPORATION SHAREHOLDERS LITIGATION

No. CIV.A. 17568.

Submitted: April 25, 2001.
Decided: July 10, 2001.
July 12, 2001.

MEMORANDUM OPINION

CHANDLER, Chancellor.

This action arises out of the alleged rejection of a cash offer for Paxson Communications Corporation ("Pax" or the "Company") from Fox Network ("Fox") and the later acceptance by Pax of a series of agreements (the "NBC Transactions") with the National Broadcasting

Company, Inc. ("NBC"). The plaintiffs allege that Fox made an all cash offer of $20 per share for Pax common stock (the "Fox Offer") that was summarily rejected by the directors and/or senior officers of Pax. [FN1] Shortly after the alleged Fox Offer, NBC invested $415 million in Pax in exchange for convertible preferred stock, certain warrants, and the right to purchase certain shares owned by Pax's controlling stockholder, Lowell W. Paxson.

Plaintiffs first assert a direct claim, arguing that the defendants abdicated their duty to evaluate and fairly respond to the Fox Offer with a view towards maximizing shareholder value and thereby depriving the Company's shareholders of a substantial premium that Fox (or perhaps another potential bidder) might have been willing to provide ("Claim I").

I. FACTUAL BACKGROUND

Defendant Pax is a Delaware corporation with its headquarters in West Palm Beach, Florida. Pax is a network television broadcasting company that owns and operates the largest group of broadcast television stations in the United States. Pax is a publicly traded company whose Class A common stock trades on the American Stock Exchange. Pax's capital structure also includes Class B common stock. The Class B stock, beneficially owned entirely by Pax Chairman Lowell Paxson, is identical to the Class A stock except that each Class B share possesses ten votes per share. Class A shares possess one vote per share.

The Individual Defendants were the six members of the Pax Board at the time of the challenged NBC Transactions. Lowell Paxson, Jeffrey Sagansky, and James Bocock were also officers of the Company during the period in question. Through his ownership of 39.2% of the Pax Class A stock and 100% of the Pax Class B stock, Mr. Paxson controls approximately 75% of Pax's voting power.

On or about August 9, 1999, Pax issued a press release announcing that it had formally retained Salomon Smith Barney ("Salomon") to explore potential strategic alternatives for the Company. In this press release, Pax stated that the Pax Board had decided to pursue this course of action in anticipation that the Federal Communications Commission would loosen ownership restrictions affecting the broadcasting industry.

The plaintiffs contend that shortly after issuing this press release, Pax received an unsolicited offer from Fox to acquire Pax for approximately $20.00 per share. They further allege that Pax responded to the Fox Offer with a counter-offer of $26.00 per share, but failed to enter into a genuine negotiating process with Fox aimed at selling the Company. As Pax common stock had traded between $6.00 and $17.4375 over the preceding twelve months, the plaintiffs conclude that this aborted attempt to sell Pax deprived them as Pax shareholders of a substantial premium.

On September 15, 1999, Pax entered into the NBC Transactions. These three agreements included an investment agreement (the "Investment Agreement"), a call option agreement (the "Call Agreement"), and a stockholder agreement (the "Stockholder Agreement"). In the aggregate, NBC and its affiliates paid approximately $415 million for the rights they received

in the NBC transactions.

In the first of these transactions, the Investment Agreement, Pax agreed to: (i) sell 41,500 shares of newly created preferred stock in Pax to a wholly owned subsidiary of NBC ("NBC Sub I"), convertible at any time into 31,896,032 shares of Pax Class A common stock for an initial conversion price of $13.01 per share; (ii) issue a warrant ("Warrant A") to another wholly owned subsidiary of NBC ("NBC Sub II") to purchase up to 13,065,507 shares of Pax common stock at an exercise price of $12.60 per share; and, (iii) issue a warrant ("Warrant B") to NBC Sub II to purchase another 18,966,620 shares of Pax common stock at an exercise price equal to the average closing prices of the Class A common stock for the 45 consecutive trading days before the warrant exercise date, subject to a minimum exercise price of $22.50 per share during the three years after September 15, 1999. Subject to certain conditions and limitations, Warrants A and B are exercisable for ten years from September 15, 1999.

Concurrently with the Investment Agreement, a wholly owned subsidiary of NBC entered into the Call Agreement with Lowell Paxson, personally, and certain entities controlled by him. By the terms of the Call Agreement, the NBC subsidiary was granted the right (the "Call Right") to purchase all, but not less than all, of Mr. Paxson's 8,311,639 shares of Pax's Class B common stock (the "Call Shares"). Under the Call Agreement, the NBC subsidiary may purchase the Call Shares at a price equal to the greater of (i) the average of the closing sale prices of the Class A common stock for the 45 consecutive trading days ending on the trading date immediately preceding the date of exercise of the Call Right; and (ii) $22.50 per share for any exercise of the Call Right within three years of September 15, 1999, or $20.00 per share if the Call Right is exercised thereafter.

The third of the NBC transactions, the Stockholder Agreement, provided, among other things, for NBC to have representation on the Pax Board if permitted by applicable law. The Stockholder Agreement also requires NBC's consent for Pax to take certain actions, including the adoption of a shareholder's rights plan, amendments to Pax's organizational documents, and issuances of stock or other securities.

If NBC converts the newly created preferred shares, exercises both warrants, and purchases Lowell Paxson's Class B shares, NBC would own approximately 49% of the equity in Pax and control almost 70% of its voting power.

II. ANALYSIS

B. Claim I

Claim I purports to be a class action claim for breach of fiduciary duty. The defendants insist that Claim I is in fact a derivative claim that can be brought only on the Company's behalf and, therefore, must be dismissed for failure to state a direct claim.

The Delaware courts are often faced with the complex task of distinguishing derivative claims from individual claims. The distinction between the rights of the corporation as opposed to the individual rights of shareholders is often "a narrow one" that can have extremely important consequences for litigation. Among these consequences are:

> the possible dismissal for an unjustified failure to demand that the board institute litigation; the general inability of a derivative plaintiff to engage in discovery relevant to the demand issue when dismissal on such grounds is sought; [and,] the ability of a special litigation committee of the board to terminate even a properly instituted derivative action as to which demand has been shown to be futile. (cite omitted).

In determining whether a given claim is derivative or direct in nature, this Court must look to " 'the nature of the wrong alleged' and the relief, if any, which could result if plaintiff were to prevail." In determining the nature of the wrong alleged, the Court will not be bound by the plaintiff's characterization of the claim in the complaint, but rather must look to "the body of the complaint." [FN8]

To have standing to sue directly rather than derivatively on behalf of the corporation, the plaintiff must have been injured "*directly* or *independently* of the corporation." [FN9] In other words, the plaintiff needs to have sustained a "special injury," defined as "a wrong inflicted upon [a shareholder] alone or a wrong affecting any particular right which [that shareholder] is asserting,--such as his preemptive rights as a stockholder, rights involving the control of the corporation, or a wrong affecting the stockholders and not the corporation." [FN10]

Although there is no standard test that shall be mechanistically applied in all cases to determine whether a given claim is derivative or direct, probably the most-cited formulation is that of former Chancellor Brown in *Moran v. Household International Inc.:*

> To set out an individual action, the plaintiff must allege either 'an injury which is separate and distinct from that suffered by other shareholders,' ... or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert majority control, which exists independently of any right of the corporation. (cite omitted).

The Supreme Court has made clear that although Chancellor Brown's *Moran* formulation may serve as "a quite useful guide," that test is not conclusive. [FN12] Rather, Delaware courts must ultimately look "to whether the plaintiff has alleged 'special' injury, in whatever form."

In this case, the plaintiffs assert that they have suffered two distinct, direct injuries that each bestow standing on the plaintiffs to bring direct claims against the defendants. Plaintiffs point to the dilution of their ownership interest, earnings per share and voting power due to the effect of the NBC Transactions. Additionally, plaintiffs argue that the Pax Board's failure to pursue the Fox Offer in favor of the NBC Transactions resulted in the loss of the opportunity for the shareholders to receive optimum value for their investment in Pax. I address each of these contentions in turn.

First, the plaintiffs argue that "it is well-settled that equity dilution and diminution of one's voting power constitutes a direct injury to the shareholders and not the corporation." They contend that the NBC Transactions will dilute the equity and voting power of the plaintiff shareholders should NBC Sub I convert its 41,500 shares of preferred stock into 31,896,032 shares of common stock and NBC Sub II exercise its warrants to purchase a total of 32,032,127 shares of Pax common stock.

> Plaintiffs point to two cases, *In re Tri-Star Pictures, Inc. Litigation* and *Oliver, et al. v. Boston University, et al.* to support the proposition that their dilution claim is direct rather than derivative. Their reliance on these two cases, however, is misplaced. In *Tri-Star,* the plaintiffs, former stockholders of Tri-Star Pictures, Inc. ("Tri-Star"), challenged an assets for stock transaction between Tri-Star and Coca-Cola Company ("Coca-Cola"), a 36.8% stockholder of Tri-Star before the transaction. The complaint alleged that Coca-Cola had wrongfully manipulated the transaction to receive an excessive amount of Tri-Star shares in exchange for assets having a lower value. As a result of the transaction, Coca-Cola obtained an 80% stock interest in Tri-Star and the public shareholders, who had formerly owned 43.4% of the common equity, now owned only 20% of Tri-Star's equity. [FN18] Because Coca-Cola, a significant stockholder of Tri-Star before the transaction, did not suffer a similar dilution of their percentage ownership or their voting power as compared to the plaintiffs, the Supreme Court held that the plaintiffs had suffered a special injury not shared equally by all shareholders. This rendered the plaintiffs' claims direct and not derivative in nature.

Similarly, in *Boston University,* plaintiffs, investors in Seragen, Inc. ("Seragen"), argued that the defendants, controlling shareholders, directors, and officers of Seragen, unfairly took advantage of their controlling position to dilute the minority's interests, engage in self-dealing, and effect a merger that resulted in a disproportionate amount of consideration to be paid to the controlling shareholders. [FN21] The Court held that for the purposes of a motion to dismiss, the plaintiffs had adequately alleged a direct claim, noting that "the defendants engaged in self-dealing that resulted in reduced voting power and stock dilution." [FN22]

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Together, *Tri-Star* and *Boston University* stand for the proposition that dilution claims are individual in nature where a significant stockholder's interest is increased "at the sole expense of the minority." [FN23] *Tri- Star* and *Boston University* have no application, in my opinion, where the entity benefiting from the allegedly diluting transaction, NBC, is a third party rather than an existing significant or controlling stockholder. This identical distinction was also made by Vice Chancellor Jacobs in *Turner v. Bernstein.* In that case, Vice Chancellor Jacobs noted that a claim of stock dilution and a corresponding reduction in a stockholder's voting power states a direct claim only in transactions where a significant stockholder sells its assets to the corporation in exchange for the corporation's stock, and influences the transaction terms so that the result is (i) a decrease (or 'dilution') of the asset value and voting power of the stock held by the public stockholders and (ii) a corresponding increase (or benefit) to the shares held by the significant stockholder.

Under this principle, to the extent that any alleged decrease in the asset value and voting power of plaintiffs' shares of Pax results from the issuance of new equity to a third party (NBC), plaintiff's dilution theory as a basis for a direct claim fails and any individual claim for dilution must be dismissed.

In the plaintiffs' second attempt to support a direct claim, they allege that the defendants' failure to properly explore the Fox Offer, and later engage in serious negotiations with Fox, deprived the plaintiffs of the opportunity to realize the optimum value for their Pax stock. This, according to the plaintiffs, caused them to suffer individual injury. In substance, the plaintiffs argue that as soon as the Pax Board announced that Pax had retained Salomon to "explore strategic alternatives," the plaintiffs were entitled to a reasonable inference that the individual defendants had engaged in an active bidding process seeking to sell Pax and were under a fiduciary obligation to maximize value for the Pax shareholders in accordance with *Revlon, Inc. v. McAndrews & Forbes Holdings, Inc.* [FN29] This argument fails for at least two reasons.

First, the plaintiffs have failed to distinguish these facts from the numerous cases that have previously held that allegations that directors wrongfully failed to pursue business combinations are derivative in nature. Vice Chancellor Hartnett's opinion in *Sumers v. Beneficial Corporation* is representative of this line of authority. [FN30] In *Sumers,* the plaintiff alleged that directors of Beneficial Corporation announced that the corporation was for sale and then "summarily and arbitrarily rejected, without timely disclosure to the public shareholders," acquisition offers made at substantial premiums over the market price. [FN31] The Court held that

> [t]he complaint in the present suit ... does not state any claim of breach of contractual rights, nor any facts which, if true, would constitute a special or individual cause of action. Plaintiffs' injury, if any, is the same as the injury to all other stockholders of [the corporation].

In the present case, the plaintiffs have represented to the Court that "[t]he Class B stock is identical to the Class A stock except for voting power. The economic attributes are identical." [FN33] They have failed to identify any significant difference between the facts in this matter and those found in the *Sumers* line of cases.

Cuker v. Mikalauskas

Supreme Court of Pennsylvania.

Albert **CUKER** and Sabina Cuker, and Stanley Katzman and Sidney J. Silver, Trustees for the Irrevocable Trust for the Descendants of Howard and Pearl Katzman, derivatively, on behalf of PECO Energy Company, Respondents,
v.
Albert G. **MIKALAUSKAS**, Joseph F. Paquette, Jr., Corbin A. McNeill, Jr., John H. Austin, Jr., James L. Everett, Richard G. Gilmore, Kenneth G. Lawrence, Morton W. Rimmerman, Thomas P. Hill, Jr., Raymond F. Holman and PECO Energy Company, Petitioners.

Argued Jan. 27, 1997.
Decided April 21, 1997.
Reargument Denied June 18, 1997.

OPINION OF THE COURT

FLAHERTY, Chief Justice.

PECO Energy Company filed a motion for summary judgment seeking termination of minority shareholder derivative actions. When the motion was denied by the court of common pleas, PECO sought extraordinary relief in this court pursuant to Pa.R.A.P. 3309. We granted the petition, limited to the issue of "whether the 'business judgment rule' permits the board of directors of a Pennsylvania corporation to terminate derivative lawsuits brought by minority shareholders."

PECO is a publicly regulated utility incorporated in Pennsylvania which sells electricity and gas to residential, commercial, and industrial customers in Philadelphia and four surrounding counties. PECO is required to conform to PUC regulations which govern the provision of service to residential customers, including opening, billing, and terminating accounts. PECO is required to report regularly to the PUC on a wide variety of statistical and performance information regarding its compliance with the regulations as interpreted by the PUC. Like other utilities, PECO is required to undergo a comprehensive management audit at the direction of the PUC approximately every ten years. The most recent audit was

conducted by Ernst & Young. The report issued in 1991 recommended changes in twenty-two areas, including criticisms and recommendations regarding PECO's credit and collection function.

Two trustees, on behalf of a group of minority shareholders, made a demand on PECO, alleging wrongdoing by some PECO directors and officers. This Katzman demand, made in May, 1993, asserted that the delinquent officers had damaged PECO by mismanaging the credit and collection function, particularly as to the collection of overdue accounts. The shareholders demanded that PECO authorize litigation against the wrongdoers to recover monetary damages sustained by PECO. At its meeting of June 28, 1993, PECO's board responded by creating a special litigation committee to investigate the Katzman allegations.

Less than a month later, a second group of minority shareholders filed a complaint against PECO officers and directors. *Cuker v. Mikalauskas,* July Term, 1993, No. 3470 (C.P.Phila.). The *Cuker* complaint, filed in July, 1993, made the same allegations as those in the Katzman demand, with extensive references to the Ernst & Young audit report. The *Cuker* complaint was filed before the special litigation committee had begun its substantive work of investigating and evaluating the Katzman demand, so the committee's work encompassed both the Katzman and Cuker matters. Only the twelve nondefendant members of the PECO board acted to create the special committee, which consisted of three outside directors who had never been employed by PECO and who were not named in the Katzman demand or the *Cuker* complaint.

The work of the special committee was aided by the law firm of Dilworth, Paxson, Kalish & Kauffman, as well as PECO's regular outside auditor, Coopers & Lybrand, selected to assist in accounting matters because Coopers was knowledgeable about the utility industry and was familiar with PECO's accounting practices. The special committee conducted an extensive investigation over many months while maintaining a separate existence from PECO and its board of directors and keeping its deliberations confidential. The special committee held its final meeting on January 26, 1994, whereupon it reached its conclusions and prepared its report.

The report of the special committee concluded that there was no evidence of bad faith, self-dealing, concealment, or other breaches of the duty of loyalty by any of the defendant officers. It also concluded that the defendant officers "exercised sound business judgment in managing the affairs of the company" and that their actions "were reasonably calculated to further the best interests of the company." The three-hundred-page report identified numerous factors underlying the conclusions of the special committee. Significant considerations included the utility's efforts before the PUC to raise electricity rates in consequence of the expense of new nuclear generating plants. Other factors were the impact of PUC regulations limiting wintertime termination of residential service and other limitations on the use of collection techniques such as terminations of overdue customers, particularly with a large population of poverty level users among PECO's customer base. These considerations were supported by PUC documents which criticized PECO for aggressive and excessive terminations in recent years. The report of the special litigation

committee also described how PECO's management had been attentive to the credit and collection function, with constant efforts to improve performance in that area. According to the report, limiting the use of terminations as a collection technique was a sound business judgment, reducing antagonism between the PUC and PECO and resulting in rate increases which produced revenue far in excess of the losses attributed to nonaggressive collection tactics. The report concluded that proceeding with a derivative suit based largely on findings of the Ernst & Young audit would not be in the best interests of PECO.

When it received the report of the special litigation committee with appendices containing the documents and interviews underlying the report, the board debated the recommendations at two meetings early in 1994. The twelve nondefendant members of the PECO board voted unanimously on March 14, 1994 to reject the Katzman demand and to terminate the *Cuker* action.

In the *Cuker* action, the court of common pleas rejected PECO's motion for summary judgment. The court stated that "the 'business judgment rule' [has been] adopted in some states but never previously employed in Pennsylvania." The court held that as a matter of Pennsylvania public policy, a corporation lacks power to terminate pending derivative litigation. On PECO's motion, the court certified four controlling questions of law to the Superior Court, pursuant to 42 Pa.C.S. § 702(b), including the question presented in this appeal. [FN1] The Superior Court denied interlocutory review, on January 31, 1996, after the *Cuker* plaintiffs argued that unresolved factual issues precluded review.

When the PECO board, following the recommendation of the special litigation committee, rejected the Katzman demand, the Katzman claimants filed a shareholder derivative action. *Katzman v. Mikalauskas,* August Term 1995, No. 1278 (C.P.Phila.). After the Superior Court denied interlocutory review of *Cuker,* the two cases were consolidated by the court of common pleas on February 20, 1996.

PECO then filed a petition to terminate the consolidated actions which raised issues of fact regarding the independence of the special committee and the adequacy of its investigation. The plaintiffs responded that the court of common pleas could not resolve the factual issues because of the earlier decision in the same court that a Pennsylvania corporation lacks the power to terminate pending derivative litigation. This decision presumably precluded another judge of the same court from hearing the factual disputes. The court denied PECO's petition to terminate on May 21, 1996.

The decisions of the Superior Court on January 31, 1996 and the court of common pleas on May 21, 1996 were irreconcilably inconsistent. The Superior Court refused to consider the legal questions regarding the business judgment rule because there were unresolved factual questions pertaining to the independence of the board and the adequacy of its investigation. The court of common pleas then refused to consider the same factual disputes due to its prior holding that the business judgment rule is not the law of Pennsylvania. Because of this inconsistency, PECO sought extraordinary relief in this court under our King's Bench powers, which we granted.

The issue is whether the business judgment rule permits the board of directors of a Pennsylvania corporation to terminate derivative lawsuits brought by minority shareholders. The business judgment rule insulates an officer or director of a corporation from liability for a business decision made in good faith if he is not interested in the subject of the business judgment, is informed with respect to the subject of the business judgment to the extent he reasonably believes to be appropriate under the circumstances, and rationally believes that the business judgment is in the best interests of the corporation. 1 ALI, *Principles of Corporate Governance: Analysis and Recommendations,* (1994) ("*ALI Principles* ") § 4.01(c). The Delaware Supreme Court has written a widely quoted formulation of the rule:

> It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Aronson v. Lewis, 473 A.2d 805, 812 (Del.1984) (citations omitted). The Ohio Supreme Court expressed the rule as follows: "The rule is a rebuttable presumption that directors are better equipped than the courts to make business judgments and that the directors acted without self-dealing or personal interest and exercised reasonable diligence and acted with good faith." *Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co.,* 26 Ohio St.3d 15, 20, 496 N.E.2d 959, 963-64 (1986).

Most American jurisdictions employ the business judgment rule, but there is no uniform expression of the rule. It is sometimes referred to as a doctrine. Regardless of the precise terminology, the doctrine serves several significant public policies. It encourages competent individuals to become directors by insulating them from liability for errors in judgment. *See, e.g., Briggs v. Spaulding,* 141 U.S. 132, 149, 11 S.Ct. 924, 929-30, 35 L.Ed. 662 (1891); *Weiss v. Temporary Investment Fund, Inc.,* 692 F.2d 928 (3d Cir.1982), *vacated on other grounds,* 465 U.S. 1001, 104 S.Ct. 989, 79 L.Ed.2d 224 (1984). The doctrine also recognizes that business decisions frequently entail some degree of risk and consequently provides directors broad discretion in setting policies without judicial or shareholder second-guessing. *See e.g., Cramer v. General Telephone & Electronics Corp.,* 582 F.2d 259, 274 (3d Cir.1978), *cert. denied,* 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979). Finally, the doctrine prevents courts from becoming enmeshed in complex corporate decision-making, a task they are ill-equipped to perform.

This has been the policy of Pennsylvania for over a century, as reflected in the decisions of this court as early as 1872. Ironically, this court has never used the term "business judgment rule" in a corporate context nor has it explicitly adopted the business judgment rule. Nevertheless, a review of Pennsylvania decisions establishes that the business judgment doctrine or rule is the law of Pennsylvania.

The business judgment rule should insulate officers and directors from judicial intervention in the absence of fraud or self-dealing, if challenged decisions were within the scope of the

directors' authority, if they exercised reasonable diligence, and if they honestly and rationally believed their decisions were in the best interests of the company. It is obvious that a court must examine the circumstances surrounding the decisions in order to determine if the conditions warrant application of the business judgment rule. If they do, the court will never proceed to an examination of the merits of the challenged decisions, for that is precisely what the business judgment rule prohibits. In order to make the business judgment rule meaningful, the preliminary examination should be limited and precise so as to minimize judicial involvement when application of the business judgment rule is warranted.

To achieve these goals, a court might stay the derivative action while it determines the propriety of the board's decision. The court might order limited discovery or an evidentiary hearing to resolve issues respecting the board's decision. Factors bearing on the board's decision will include whether the board or its special litigation committee was disinterested, whether it was assisted by counsel, whether it prepared a written report, whether it was independent, whether it conducted an adequate investigation, and whether it rationally believed its decision was in the best interests of the corporation (i.e., acted in good faith). If all of these criteria are satisfied, the business judgment rule applies and the court should dismiss the action.

These considerations and procedures are all encompassed in Part VII, chapter 1 of the *ALI Principles* (relating to the derivative action), which provides a comprehensive mechanism to address shareholder derivative actions. A number of its provisions are implicated in the action at bar. Sections 7.02 (standing), 7.03 (the demand rule), 7.04 (procedure in derivative action), 7.05 (board authority in derivative action), 7.06 (judicial stay of derivative action), 7.07, 7.08, and 7.09 (dismissal of derivative action), 7.10 (standard of judicial review), and 7.13 (judicial procedures) are specifically applicable to this case. [FN3] These sections set forth guidance which is consistent with Pennsylvania law and precedent, which furthers the policies inherent in the business judgment rule, and which provides an appropriate degree of specificity to guide the trial court in controlling the proceedings in this litigation.

We specifically adopt § § 7.02-7.10, and § 7.13 of the *ALI Principles.* [FN4], [FN5] In doing so we have weighed many considerations. First, the opinion of the trial court, the questions certified to the Superior Court, and the inability of PECO to obtain a definitive ruling from the lower courts all demonstrate the need for specific guidance from this court on how such litigation should be managed; the ALI principles provide such guidance in specific terms which will simplify this litigation. Second, we have often found ALI guidance helpful in the past, most frequently in adopting or citing sections of various Restatements; the scholarship reflected in work of the American Law Institute has been consistently reliable and useful. Third, the principles set forth by the ALI are generally consistent with Pennsylvania precedent. Fourth, although the *ALI Principles* incorporate much of the law of New York and Delaware, other states with extensive corporate jurisprudence, the *ALI Principles* better serve the needs of Pennsylvania. Although New York law parallels Pennsylvania law in many respects, it does not set forth any procedures to govern the review

of corporate decisions relating to derivative litigation, and this omission would fail to satisfy the needs evident in this case. Delaware law permits a court in some cases ("demand excused" cases) to apply its own business judgment in the review process when deciding to honor the directors' decision to terminate derivative litigation. In our view, this is a defect which could eviscerate the business judgment rule and contradict a long line of Pennsylvania precedents. Delaware law also fails to provide a procedural framework for judicial review of corporate decisions under the business judgment rule.

Brehm v. Eisner

Supreme Court of Delaware.

William **BREHM**,
v.
Michael D. **EISNER**, Michael S. Ovitz,
and
The Walt Disney Company, Nominal Defendant Below, Appellee.

No. 469, 1998.

Submitted: Sept. 14, 1999.
Decided: Feb. 9, 2000.

VEASEY, Chief Justice:

In this appeal from the Court of Chancery, we agree with the holding of the Court of Chancery that the stockholder derivative Complaint [FN1] was subject to dismissal for failure to set forth particularized facts creating a reasonable doubt that the director defendants were disinterested and independent or that their conduct was protected by the business judgment rule. [FN2] Our affirmance, however, is in part based on a somewhat different analysis than that of the Court below or the parties. Accordingly, in the interests of justice, we reverse only to the extent of providing that one aspect of the dismissal shall be without prejudice, and we remand to the Court of Chancery to provide plaintiffs a reasonable opportunity to file a further amended complaint consistent with this opinion.

The claims before us are that: (a) the board of directors of The Walt Disney Company ("Disney") as it was constituted in 1995 (the "Old Board") breached its fiduciary duty in approving an extravagant and wasteful Employment Agreement of Michael S. Ovitz as president of Disney; (b) the Disney board of directors as it was constituted in 1996 (the "New Board") breached its fiduciary duty in agreeing to a "non-fault" termination of the Ovitz Employment Agreement, a decision that was extravagant and wasteful; and (c) the

directors were not disinterested and independent. [FN3]

The Complaint, consisting of 88 pages and 285 paragraphs, is a pastiche of prolix invective. It is permeated with conclusory allegations of the pleader and quotations from the media, mostly of an editorial nature (even including a cartoon).

This is potentially a very troubling case on the merits. On the one hand, it appears from the Complaint that: (a) the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz' value to the Company; and (b) the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory. On the other hand, the Complaint is so inartfully drafted that it was properly dismissed under our pleading standards for derivative suits. From what we can ferret out of this deficient pleading, the processes of the Old Board and the New Board were hardly paradigms of good corporate governance practices. Moreover, the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions. Therefore, both as to the processes of the two Boards and the waste test, this is a close case.

But our concerns about lavish executive compensation and our institutional aspirations that boards of directors of Delaware corporations live up to the highest standards of good corporate practices do not translate into a holding that these plaintiffs have set forth particularized facts excusing a pre-suit demand under our law and our pleading requirements.

This appeal presents several important issues, including: (1) the scope of review that this Court applies to an appeal from the dismissal of a derivative suit; (2) the extent to which the pleading standards required by Chancery Rule 23.1 exceed those required by Rule 8 of that Court; and (3) the scope of the business judgment rule as it interacts with the relevant pleading requirements. To some extent, the principles enunciated in this opinion restate and clarify our prior jurisprudence.

Facts

This statement of facts is taken from the Complaint. We have attempted to summarize here the essence of Plaintiffs' factual allegations on the key issues before us, disregarding the many conclusions that are not supported by factual allegations.

A. The 1995 Ovitz Employment Agreement

By an agreement dated October 1, 1995, Disney hired Ovitz as its president. He was a long-time friend of Disney Chairman and CEO Michael Eisner. At the time, Ovitz was an important talent broker in Hollywood. Although he lacked experience managing a diversified public company, other companies with entertainment operations had been interested in hiring him for high-level executive positions. The Employment Agreement was unilaterally negotiated by Eisner and approved by the Old Board. Their judgment was that Ovitz was a valuable person to hire as president of Disney, and they agreed ultimately with

Eisner's recommendation in awarding him an extraordinarily lucrative contract.

Ovitz' Employment Agreement had an initial term of five years and required that Ovitz "devote his full time and best efforts exclusively to the Company," with exceptions for volunteer work, service on the board of another company, and managing his passive investments. [FN5] In return, Disney agreed to give Ovitz a base salary of $1 million per year, a discretionary bonus, and two sets of stock options (the "A" options and the "B" options) that collectively would enable Ovitz to purchase 5 million shares of Disney common stock.

The "A" options were scheduled to vest in three annual increments of 1 million shares each, beginning on September 30, 1998 (*i.e.,* at the end of the third full year of employment) and continuing for the following two years (through September 2000). The agreement specifically provided that the "A" options would vest immediately if Disney granted Ovitz a non-fault termination of the Employment Agreement. The "B" options, consisting of 2 million shares, differed in two important respects. Although scheduled to vest annually starting in September 2001 (*i.e.,* the year *after* the last "A" option would vest), the "B" options were conditioned on Ovitz and Disney first having agreed to extend his employment beyond the five-year term of the Employment Agreement. Furthermore, Ovitz would forfeit the right to qualify for the "B" options if his initial employment term of five years ended prematurely for any reason, even if from a non-fault termination.

The Employment Agreement provided for three ways by which Ovitz' employment might end. He might serve his five years and Disney might decide against offering him a new contract. If so, Disney would owe Ovitz a $10 million termination payment. [FN6] Before the end of the initial term, Disney could terminate Ovitz for "good cause" only if Ovitz committed gross negligence or malfeasance, or if Ovitz resigned voluntarily. Disney would owe Ovitz no additional compensation if it terminated him for "good cause." Termination without cause (non-fault termination) would entitle Ovitz to the present value of his remaining salary payments through September 30, 2000, a $10 million severance payment, an additional $7.5 million for each fiscal year remaining under the agreement, and the immediate vesting of the first 3 million stock options (the "A" Options).

Plaintiffs allege that the Old Board knew that Disney needed a strong second- in-command. Disney had recently made several acquisitions, and questions lingered about Eisner's health due to major heart surgery. The Complaint further alleges that "Eisner had demonstrated little or no capacity to work with important or well-known subordinate executives who wanted to position themselves to succeed him," citing the departures of Disney executives Jeffrey Katzenberg, Richard Frank, and Stephen Bollenbach as examples. Thus, the Board knew that, to increase the chance for long-term success, it had to take extra care in reviewing a decision to hire Disney's new president.

But Eisner's decision that Disney should hire Ovitz as its president was not entirely well-received. When Eisner told three members of the Old Board in mid-August 1995 that he had decided to hire Ovitz, all three "denounced the decision." Although not entirely clear from

the Complaint, the vote of the Old Board approving the Ovitz Employment Agreement two months later appears to have been unanimous. Aside from a conclusory attack that the Old Board followed Eisner's bidding, the Complaint fails to allege any particularized facts that the three directors changed their initial reactions through anything other than the typical process of further discussion and individual contemplation.

The Complaint then alleges that the Old Board failed properly to inform itself about the total costs and incentives of the Ovitz Employment Agreement, especially the severance package. This is the key allegation related to this issue on appeal. Specifically, plaintiffs allege that the Board failed to realize that the contract gave Ovitz an incentive to find a way to exit the Company via a non-fault termination as soon as possible because doing so would permit him to earn more than he could by fulfilling his contract. The Complaint alleges, however, that the Old Board had been advised by a corporate compensation expert, Graef Crystal, in connection with its decision to approve the Ovitz Employment Agreement. Two public statements by Crystal form the basis of the allegation that the Old Board failed to consider the incentives and the total cost of the severance provisions, but these statements by Crystal were not made until after Ovitz left Disney in December 1996, approximately 14 1/2 months after being hired.

The first statement, published in a December 23, 1996 article in the web-based magazine *Slate,* quoted Crystal as saying, in part, "Of course, the overall costs of the package would go up sharply in the event of Ovitz's termination (*and I wish now that I'd made a spreadsheet showing just what the deal would total if Ovitz had been fired at any time*)." [FN7] The second published statement appeared in an article about three weeks later in the January 13, 1997 edition of *California Law Business.* The article appears first to paraphrase Crystal: "With no one expecting failure, the sleeper clauses in Ovitz's contract seemed innocuous, Crystal says, explaining that no one added up the total cost of the severance package." The article then quotes Crystal as saying that the amount of Ovitz' severance was "shocking" and that "*[n]obody quantified this and I wish we had.*"]

One of the charging paragraphs of the Complaint concludes:

> As has been conceded by Graef Crystal, the executive compensation consultant who advised the Old Board with respect to the Ovitz Employment Agreement, the Old Board *never* considered the costs that would be incurred by Disney in the event Ovitz was terminated from the Company for a reason other than cause prior to the natural expiration of the Ovtiz Employment Agreement.

Although repeated in various forms in the Complaint, these quoted admissions by Crystal constitute the extent of the factual support for the allegation that the Old Board failed properly to consider the severance elements of the agreement. This Court, however, must juxtapose these allegations with the legal presumption that the Old Board's conduct was a proper exercise of business judgment. That presumption includes the statutory protection for a board that relies in good faith on an expert advising the Board. [FN9] We must decide whether plaintiffs' factual allegations, if proven, would rebut that presumption.

B. The New Board's Actions in Approving the Non-Fault Termination

Soon after Ovitz began work, problems surfaced and the situation continued to deteriorate during the first year of his employment. To support this allegation, the plaintiffs cite various media reports detailing internal complaints and providing external examples of alleged business mistakes. The Complaint uses these reports to suggest that the New Board had reason to believe that Ovitz' performance and lack of commitment met the gross negligence or malfeasance standards of the termination-for-cause provisions of the contract.

The deteriorating situation, according to the Complaint, led Ovitz to begin seeking alternative employment and to send Eisner a letter in September 1996 that the Complaint paraphrases as stating his dissatisfaction with his role and expressing his desire to leave the Company. [FN10] The Complaint also admits that Ovitz would not actually resign before negotiating a non-fault severance agreement because he did not want to jeopardize his rights to a lucrative severance in the form of a "non-fault termination" under the terms of the 1995 Employment Agreement.

On December 11, 1996, Eisner and Ovitz agreed to arrange for Ovitz to leave Disney on the non-fault basis provided for in the 1995 Employment Agreement. Eisner then "caused" the New Board [FN11] "to rubber-stamp his decision (by 'mutual consent')." This decision was implemented by a December 27, 1996 letter to Ovitz from defendant Sanford M. Litvack, an officer and director of Disney. That letter stated:

> This will confirm the terms of your agreement with the Company as follows:
> 1. The Term of your employment under your existing Employment Agreement with The Walt Disney Company will end at the close of business today. Consequently, your signature confirms the end of your service as an officer, and your resignation as a director, of the Company and its affiliates.
> 2. This letter will for all purposes of the Employment Agreement be treated as a "Non-Fault Termination." By our mutual agreement, the total amount payable to you under your Employment Agreement, including the amount payable under Section 11(c) in the event of a "Non-Fault Termination," is $38,888,230.77, net of withholding required by law or authorized by you. By your signature on this letter, you acknowledge receipt of all but $1,000,000 of such amount. Pursuant to our mutual agreement, this will confirm that payment of the $1,000,000 balance has been deferred until February 5, 1997, pending final settlement of accounts.
> 3. This letter will further confirm that the option to purchase 3,000,000 shares of the Company's Common Stock granted to you pursuant to Option A described in your Employment Agreement will vest as of today and will expire in accordance with its terms on September 30, 2002.

Although the non-fault termination left Ovitz with what essentially was a very lucrative

severance agreement, it is important to note that Ovitz and Disney had negotiated for that severance payment at the time they initially contracted in 1995, and in the end the payout to Ovitz did not exceed the 1995 contractual benefits. Consequently, Ovitz received the $10 million termination payment, $7.5 million for part of the fiscal year remaining under the agreement and the immediate vesting of the 3 million stock options (the "A" options). As a result of his termination Ovitz would not receive the 2 million "B" options that he would have been entitled to if he had completed the full term of the Employment Agreement and if his contract were renewed. [FN12]

The Complaint charges the New Board with waste, computing the value of the severance package agreed to by the Board at over $140 million, consisting of cash payments of about $39 million and the value of the immediately vesting "A" options of over $101 million. The Complaint quotes Crystal, the Old Board's expert, as saying in January 1997 that Ovitz' severance package was a "shocking amount of severance."

The allegation of waste is based on the inference most favorable to plaintiffs that Disney owed Ovitz nothing, either because he had resigned (*de facto*) or because he was unarguably subject to firing for cause. These allegations must be juxtaposed with the presumption that the New Board exercised its business judgment in deciding how to resolve the potentially litigable issues of whether Ovitz had actually resigned or had definitely breached his contract. We must decide whether plaintiffs' factual allegations, if proven, would rebut that presumption.

Scope of Review

Our view is that in determining demand futility the Court of Chancery *in the proper exercise of its discretion* must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.

The view we express today, however, is designed to make clear that our review of decisions of the Court of Chancery applying Rule 23.1 is *de novo* and plenary. We apply the law to the allegations of the Complaint as does the Court of Chancery. Our review is not a deferential review that requires us to find an abuse of discretion. We see no reason to perpetuate the concept of discretion in this context. The nature of our analysis of a complaint in a derivative suit is the same as that applied by the Court of Chancery in making its decision in the first instance.

Analyzing a pleading for legal sufficiency is not, for example, the equivalent of the deferential review of certain discretionary rulings, such as: an administrative agency's findings of fact; [FN14] a trial judge's evaluation of witness credibility; [FN15] findings of the Court of Chancery in a statutory stock appraisal; [FN16] a decision whether to grant or deny injunctive relief or the scope of that relief; [FN17] or what rate of interest to apply.

[FN18] In a Rule 23.1 determination of pleading sufficiency, the Court of Chancery, like this Court, is merely reading the English language of a pleading and applying to that pleading statutes, case law and Rule 23.1 requirements. To that extent, our scope of review is analogous to that accorded a ruling under Rule 12(b)(6).

Therefore, our scope of review must be *de novo.* To the extent *Aronson* and its progeny contain dicta expressing or suggesting an abuse of discretion scope of review, that language is overruled. We now proceed to decide *de novo* whether the Complaint was properly dismissed for failure to set forth particularized facts to support the plaintiffs' claim that demand is excused.

Pleading Requirements in Derivative Suits

Pleadings in derivative suits are governed by Chancery Rule 23.1, [FN19] just as pleadings alleging fraud are governed by Chancery Rule 9(b). [FN20] Those pleadings must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a). [FN21] Rule 23.1 is not satisfied by conclusory statements or mere notice pleading. On the other hand, the pleader is not required to plead evidence. [FN22] What the pleader must set forth are particularized factual statements that are essential to the claim. Such facts are sometimes referred to as "ultimate facts," "principal facts" or "elemental facts." [FN23] Nevertheless, the particularized factual statements that are required to comply with the Rule 23.1 pleading rules must also comply with the mandate of Chancery Rule 8(e) that they be "simple, concise and direct." [FN24] A prolix complaint larded with conclusory language, like the Complaint here, does not comply with these fundamental pleading mandates.

Chancery Rule 23.1 requires, in part, that the plaintiff must allege with particularity facts raising a reasonable doubt that the corporate action being questioned was properly the product of business judgment. [FN25] The rationale of Rule 23.1 is two-fold. On the one hand, it would allow a plaintiff to proceed with discovery and trial if the plaintiff complies with this rule and can articulate a reasonable basis to be entrusted with a claim that belongs to the corporation. On the other hand, the rule does not permit a stockholder to cause the corporation to expend money and resources in discovery and trial in the stockholder's quixotic pursuit of a purported corporate claim based solely on conclusions, opinions or speculation. As we stated in *Grimes v. Donald:*

> The demand requirement serves a salutary purpose. First, by requiring exhaustion of intracorporate remedies, the demand requirement invokes a species of alternative dispute resolution procedure which might avoid litigation altogether. Second, if litigation is beneficial, the corporation can control the proceedings. Third, if demand is excused or wrongfully refused, the stockholder will normally control the proceedings.
> The jurisprudence of *Aronson* and its progeny is designed to create a balanced environment which will: (1) on the one hand, deter costly, baseless suits by creating a screening

> mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms; and (2) on the other hand, permit suit by a stockholder who is able to articulate particularized facts showing that there is a reasonable doubt either that (a) a majority of the board is independent for purposes of responding to the demand, or (b) the underlying transaction is protected by the business judgment rule. [FN26]

In setting up its analysis of the amended complaint, the Court of Chancery in this case stated that the standard by which the Complaint is to be tested is as follows: "Where under any set of facts consistent with the facts alleged in the complaint the plaintiff *would not be entitled* to judgment, the complaint *may be dismissed* as legally defective." [FN27] The Court attempted to paraphrase the Court of Chancery decision in *Lewis v. Vogelstein* for this formulation. The *Vogelstein* quote is that "[w]here under any state of facts consistent with the factual allegations of the complaint the plaintiff *would be entitled* to a judgment, the complaint *may not be dismissed* as legally defective." [FN28]

Plaintiffs argue that the formulation used by the Court of Chancery was error in that it is the opposite of the *Vogelstein* formulation. Defendants, on the other hand, argue that the formulations are identical. We need not resolve what is essentially a semantic debate. In our view, the formulation by the Court of Chancery here is confusing and unhelpful, but not reversible error, particularly in light of our *de novo* review. The issue is whether plaintiffs have alleged particularized facts creating a reasonable doubt that the actions of the defendants were protected by the business judgment rule. Plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged, but conclusory allegations are not considered as expressly pleaded facts or factual inferences.

Principles of Corporation Law Compared with Good Corporate Governance Practices

This is a case about whether there should be personal liability of the directors of a Delaware corporation to the corporation for lack of due care in the decisionmaking process and for waste of corporate assets. This case is not about the failure of the directors to establish and carry out ideal corporate governance practices.

[7] All good corporate governance practices include compliance with statutory law and case law establishing fiduciary duties. But the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability.

The inquiry here is not whether we would disdain the composition, behavior and decisions of Disney's Old Board or New Board as alleged in the Complaint if we were Disney stockholders. In the absence of a legislative mandate, [FN30] that determination is not for

the courts. That decision is for the stockholders to make in voting for directors, urging other stockholders to reform or oust the board, or in making individual buy-sell decisions involving Disney securities. The sole issue that this Court must determine is whether the particularized facts alleged in this Complaint provide a reason to believe that the conduct of the Old Board in 1995 and the New Board in 1996 constituted a violation of their fiduciary duties.

Independence of the Disney Board

[8] The test of demand futility is a two-fold test under *Aronson* and its progeny. The first prong of the futility rubric is "whether, under the particularized facts alleged, a reasonable doubt is created that ... the directors are disinterested and independent." [FN31] The second prong is whether the pleading creates a reasonable doubt that "the challenged transaction was otherwise the product of a valid exercise of business judgment." [FN32] These prongs are in the disjunctive. Therefore, if either prong is satisfied, demand is excused. [FN33]

In this case, the issues of disinterestedness and independence involved in the first prong of *Aronson* are whether a majority of the New Board, which presumably was in office when plaintiffs filed this action, was disinterested and independent. That is, were they incapable, due to personal interest or domination and control, of objectively evaluating a demand, if made, that the Board assert the corporation's claims that are raised by plaintiffs or otherwise remedy the alleged injury? [FN34] This rule is premised on the principle that a claim of the corporation should be evaluated by the board of directors to determine if pursuit of the claim is in the corporation's best interests. [FN35] That is the analysis the Court of Chancery brought to bear on the matter, [FN36] and it is that analysis we now examine to the extent necessary for appropriate appellate review.

The facts supporting plaintiffs' claim that the New Board was not disinterested or independent turn on plaintiffs' central allegation that a majority of the Board was beholden to Eisner. It is not alleged that they were beholden to Ovitz. Plaintiffs' theory is that Eisner was advancing Ovitz' interests primarily because a lavish contract for Ovtiz would redound to Eisner's benefit since Eisner would thereby gain in his quest to have his own compensation increased lavishly. This theory appears to be in the nature of the old maxim that a "high tide floats all boats." But, in the end, this theory is not supported by well-pleaded facts, only conclusory allegations. Moreover, the Court of Chancery found that these allegations were illogical and counterintuitive:

> Plaintiffs' allegation that Eisner was interested in maximizing his compensation at the expense of Disney and its shareholders cannot reasonably be inferred from the facts alleged in Plaintiffs' amended complaint. At all times material to this litigation, Eisner owned several million options to purchase Disney stock. Therefore, it would not be in Eisner's economic interest to cause the Company to issue millions of additional options unnecessarily and at considerable cost. Such a gesture would not, as Plaintiffs suggest, "maximize" Eisner's own compensation package. Rather, it would dilute the value of Eisner's own very substantial holdings. Even if the impact on Eisner's option value were relatively small, such a large compensation package would, and did, draw largely negative

> attention to Eisner's own performance and compensation. Accordingly, no reasonable doubt can exist as to Eisner's disinterest in the approval of the Employment Agreement, as a matter of law. Similarly, the Plaintiffs have not demonstrated a reasonable doubt that Eisner was disinterested in granting Ovitz a Non-Fault Termination, thus allowing Ovitz to receive substantial severance benefits under the terms of the Employment Agreement. Nothing alleged by Plaintiffs generates a reasonable inference that Eisner would benefit personally from allowing Ovitz to leave Disney without good cause. [FN37]

The Complaint then proceeds to detail the various associations that each member of the New Board had with Eisner. In an alternative holding, the Court of Chancery proceeded meticulously to analyze each director's ties to Eisner to see if they could have exercised business judgment independent of Eisner. [FN39] Because we hold that the Complaint fails to create a reasonable doubt that Eisner was disinterested in the Ovitz Employment Agreement, we need not reach or comment on the analysis of the Court of Chancery on the independence of the other directors for this purpose. [10] In this case, therefore, that part of plaintiffs' Complaint raising the first prong of *Aronson,* even though not pressed by plaintiffs in this Court, [FN41] has been dismissed with prejudice. Our affirmance of that dismissal is final and dispositive of the first prong of *Aronson.* [FN42] We now turn to the primary issues in this case that implicate the second prong of *Aronson:* whether the Complaint sets forth particularized facts creating a reasonable doubt that the decisions of the Old Board and the New Board were protected by the business judgment rule.

Plaintiffs' Contention that the Old Board Violated the Process Duty of Care in Approving the Ovitz Employment Agreement

[14] Certainly in this case the economic exposure of the corporation to the payout scenarios of the Ovitz contract was material, particularly given its large size, for purposes of the directors' decisionmaking process. [FN49] And those dollar exposure numbers were reasonably available because the logical inference from plaintiffs' allegations is that Crystal or the New Board could have calculated the numbers. Thus, the objective tests of reasonable availability and materiality were satisfied by this Complaint. But that is not the end of the inquiry for liability purposes.

The Court of Chancery interpreted the Complaint to allege that only Crystal (the Board's expert)--and *not the Board itself* --failed to bring to bear all the necessary information because he (Crystal) did not quantify for the Board the maximum payout to Ovitz under the non-fault termination scenario. Alternatively, the Court of Chancery reasoned that even if the Old Board failed to make the calculation, that fact does not raise a reasonable doubt of due care because *Crystal* did not consider it critical to ascertain the potential costs of Ovitz' severance package. The Court's language is as follows:

> With regard to the alleged breach of the duty of care, Plaintiffs claim that the directors were not properly informed before they adopted the Employment Agreement because they did

not know the value of the compensation package offered to Ovitz. To that end, Plaintiffs offer several statements made by Graef Crystal, the financial expert who advised the Board on the Employment Agreement, including his admission that "[n]obody quantified the total cost of the severance package and I wish we had."

The fact that *Crystal* did not quantify the potential severance benefits to Ovitz for terminating early without cause (under the terms of the Employment Agreement) does not create a reasonable inference that *the Board* failed to consider the potential cost to Disney in the event that they decided to terminate Ovitz without cause. But, even if the Board did fail to calculate the potential cost to Disney, I nevertheless think that this allegation fails to create a reasonable doubt that the former Board exercised due care. Disney's expert did not consider an inquiry into the potential cost of Ovitz's severance benefits to be critical or relevant to the Board's consideration of the Employment Agreement. Merely because Crystal *now* regrets not having calculated the package is not reason enough to overturn the judgment of the Board *then.* It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision, except "in rare cases [where] a transaction may be so egregious on its face that the board approval cannot meet the test of business judgment." Because the Board's reliance on Crystal and his decision not to fully calculate the amount of severance lack "egregiousness," this is not that rare case. I think it a correct statement of law that the duty of care is still fulfilled even if a Board does not know the exact amount of a severance payout but nonetheless is fully informed about the manner in which such a payout would be calculated. A board is not required to be informed of every fact, but rather is required to be reasonably informed. Here the Plaintiffs have failed to plead facts giving rise to a reasonable doubt that the Board, as a matter of law, was reasonably informed on this issue. [FN50]

We believe, however, that the Complaint, fairly read, charges that Crystal admitted that "nobody"--not Crystal *and* not the directors--made that calculation, although all the necessary information presumably was at hand to do so. Thus the reading given by the Court of Chancery to this aspect of the amended complaint was too restrictive because the Court's reading fails to appreciate the breadth of the allegation--*i.e.,* that neither Crystal nor the Old Board made the calculations that Crystal--the expert--*now* believes he should have made. Moreover, the Court's alternative analysis that "Disney's expert did not consider an inquiry into the potential costs ... to be critical or relevant to the board's consideration" is inappropriately simplistic at the pleading stage to state a comprehensive analysis of the issue.

We regard the Court's language as harmless error, however, for the following reason. The Complaint, fairly construed, admits that the directors were advised by Crystal as an expert and that they relied on his expertise. Accordingly, the question here is whether the directors are to be "fully protected" (*i.e.,* not held liable) on the basis that they relied in good faith on a qualified expert under Section 141(e) of the Delaware General Corporation Law. [FN51] The Old Board is entitled to the presumption [FN52] that it exercised proper business judgment, including proper reliance on the expert. In fact, the Court of Chancery refers to the "Board's reliance on Crystal and his decision not to fully calculate the amount of severance." [FN53] The Court's invocation here of the concept of the protection accorded directors who rely on experts, even though no reference is made to the statute itself, is on the

right track, but the Court's analysis is unclear and incomplete. [FN54]

Although the Court of Chancery did not expressly predicate its decision on Section 141(e), Crystal is presumed to be an expert on whom the Board was entitled to rely in good faith under Section 141(e) in order to be "fully protected." [FN55] Plaintiffs must rebut the presumption that the directors properly exercised their business judgment, including their good faith reliance on Crystal's expertise. What Crystal *now* believes *in hindsight* that he and the Board *should have done* in 1995 does not provide that rebuttal. That is not to say, however, that a rebuttal of the presumption of proper reliance on the expert under Section 141(e) cannot be pleaded consistent with Rule 23.1 in a properly framed complaint setting forth particularized facts creating reason to believe that the Old Board's conduct was grossly negligent.

To survive a Rule 23.1 motion to dismiss in a due care case where an expert has advised the board in its decisionmaking process, the complaint must allege particularized facts (not conclusions) that, if proved, would show, for example, that: (a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; (c) they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject matter (in this case the cost calculation) that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) that the decision of the Board was so unconscionable as to constitute waste or fraud. [FN56] This Complaint includes no particular allegations of this nature, and therefore it was subject to dismissal as drafted. Plaintiffs also contend that Crystal's latter-day admission is "valid and binding" on the Old Board. This argument is without merit. Crystal was the Board's expert *ex ante* for purposes of advising the directors on the Ovitz Employment Agreement. He was not their agent *ex post* to make binding admissions.

We conclude that, although the language of the Court of Chancery was flawed in formulating the proper legal test to be used and in its reading of the Complaint, that pleading, as drafted, fails to create a reasonable doubt that the Old Board's decision in approving the Ovitz Employment Agreement was protected by the business judgment rule. Plaintiffs will be provided an opportunity to replead on this issue.

Class #28

Introduction to Insider Trading

Take a simple hypothetical. You are in your mid-level financial/management position at Megacorp. You make a decent living, but there really is precious little job security in this company, and you have no chance of advancing up the corporate ladder any further. To do so would require getting another degree, maybe going to law school or something, and that is simply not going to happen.

Remember when you and your spouse decided to have kids, oh so many years ago, and remember when you thought it would be a good idea to have those kids close together, so that they could grow up together? That was a good idea, then. Now, they've grown up, and one is in college, and the other will be going next year. Two kids in college. How in God's good name are you going to afford it?

Well, here's one idea. You've just gotten from senior management in the company a copy of Megacorp's latest, highly confidential, Five Year Plan. It is truly ambitious, and it lists all of the excellent technological breakthroughs management realistically expects to occur within the next year at Megacorp, which will really help the company snap out of its doldrums. You scan the financial projections, and realize that if only half of management's expectations come to fruition, Megacorp stock will skyrocket.

So the devil on your left shoulder appears out of nowhere and tells you that opportunity knocks very seldom in this life, and when it does knock, you damn well better answer the door. So you call your broker and quickly put down $15,000 of your hard earned nest egg to obtain options to purchase 100,000 shares of Megacorp stock within the next 8 months at $50 per share (it currently is trading at $47 per share).

Let me do the math for you. First, if the stock goes nowhere in the next months, you let the option expire without being exercised. You have lost $15,000, the price you paid to obtain the option. Second, if the stock goes up to $51 per share, you will exercise the option to buy 100,000 shares of Megacorp at $50 per share, and immediately sell at $51 per share, making $100,000. You will net $85,000 after all is said and done ($100,000 profit less the $15,000 you paid to purchase the option).

And third, let us do the math assuming that the stock does take off within the next 8 months, rising from its current price of $47 per share, to a high of $83 per share, which is when you exercise the option to purchase 100,000 shares at $50 per share. Shortcut math will tell you that you will be making a profit of $33 for each share you buy at $50, and sell at $83. Multiply that by the 100,000 shares you buy, and you have a tidy little profit of $3,300,000. That ought to be enough to pay for college for the kids, and still leave you with enough money to play lavishly for the rest of your life.

Congratulations. My hat is off to you.
Just remember one thing, though. It's tough to enjoy that money while you spend the NEXT TEN YEARS IN JAIL, YOU FELON!!!

http://www.sec.gov/about/laws.shtml

Discussion points for Goodwin v. Agassiz

Back in the old days, when men were men, it was much more of a rough and tumble, *caveat emptor* type of world. Insiders were allowed to profit from their superior knowledge, even if someone else got harmed. Why? Because the concepts of duty of loyalty were more narrowly circumscribed back then. Note to whom the court says the defendants have a duty of loyalty.

GOODWIN
v.
AGASSIZ et al.

Supreme Judicial Court of Massachusetts, Suffolk.

June 29, 1933.

Appeal from Superior Court, Suffolk County; Donahue, Judge.

Suit by Homer Goodwin against Rodolphe L. Agassiz and another. From a decree dismissing plaintiff's bill, plaintiff appeals.

RUGG, Chief Justice.

A stockholder in a corporation seeks in this suit relief for losses suffered by him in selling shares of stock in Cliff Mining Company by way of accounting, rescission of sales, or redelivery of shares. The named defendants are MacNaughton, a resident of Michigan not served or appearing, and Agassiz, a resident of this commonwealth, the active party defendant.

[1] The trial judge made findings of fact, rulings, and an order dismissing the bill. There is no report of the evidence. The case must be considered on the footing that the findings are

true. The facts thus displayed are these: The defendants, in May, 1926, purchased through brokers on the Boston stock exchange seven hundred shares of stock of the Cliff Mining Company which up to that time the plaintiff had owned. Agassiz was president and director and MacNaughton a director and general manager of the company. They had certain knowledge, material as to the value of the stock, which the plaintiff did not have. The plaintiff contends that such purchase in all the circumstances without disclosure to him of that knowledge was a wrong against him. That knowledge was that an experienced geologist had formulated in writing in March, 1926, a theory as to the possible existence of copper deposits under conditions prevailing in the region where the property of the company was located. That region was known as the mineral belt in Northern Michigan, where are located mines of several copper mining companies. Another such company, of which the defendants were officers, had made extensive geological surveys of its lands. In consequence of recommendations resulting from that survey, exploration was started on property of the Cliff Mining Company in 1925. That exploration was ended in May, 1926, because completed unsuccessfully, and the equipment was removed. The defendants discussed the geologist's theory shortly after it was formulated. Both felt that the theory had value and should be tested, but they agreed that, before starting to test it, options should be obtained by another copper company of which they were officers on land adjacent to or nearby in the copper belt, that if the geologist's theory were known to the owners of such other land there might be difficulty in securing options, and that that theory should not be communicated to any one unless it became absolutely necessary. Thereafter, options were secured which, if taken up, would involve a large expenditure by the other company. The defendants both thought, also that, if there was any merit in the geologist's theory, the price of Cliff Mining Company stock in the market would go up. Its stock was quoted and bought and sold on the Boston Stock Exchange. Pursuant to agreement, they bought many shares of that stock through agents on joint account. The plaintiff first learned of the closing of exploratory operations on property of the Cliff Mining Company from an article in a paper on May 15, 1926, and immediately sold his shares of stock through brokers. It does not appear that the defendants were in any way responsible for the publication of that article. The plaintiff did not know that the purchase was made for the defendants and they did not know that his stock was being bought for them. There was no communication between them touching the subject. The plaintiff would not have sold his stock if he had known of the geologist's theory. The finding is express that the defendants were not guilty of fraud, that they committed no breach of duty owed by them to the Cliff Mining Company, and that that company was not harmed by the nondisclosure of the geologist's theory, or by their purchases of its stock, or by shutting down the exploratory operations.

The contention of the plaintiff is that the purchase of his stock in the company by the defendants without disclosing to him as a stockholder their knowledge of the geologist's theory, their belief that the theory was true, had value, the keeping secret the existence of the theory, discontinuance by the defendants of exploratory operations begun in 1925 on property of the Cliff Mining Company and their plan ultimately to test the value of the theory, constitute actionable wrong for which he as stockholder can recover.

The trial judge ruled that conditions may exist which would make it the duty of an officer of

a corporation purchasing its stock from a stockholder to inform him as to knowledge possessed by the buyer and not by the seller, but found, on all the circumstances developed by the trial and set out at some length by him in his decision, that there was no fiduciary relation requiring such disclosure by the defendants to the plaintiff before buying his stock in the manner in which they did.

The question presented is whether the decree dismissing the bill rightly was entered on the facts found.
[2][3] The directors of a commercial corporation stand in a relation of trust to the corporation and are bound to exercise the strictest good faith in respect to its property and business. Elliott v. Baker, 194 Mass. 518, 523, 80 N. E. 450; Beaudette v. Graham, 267 Mass. 7, 165 N. E. 671; L. E. Fosgate Co. v. Boston Market Terminal Co., 275 Mass. 99, 107, 175 N. E. 86. The contention that directors also occupy the position of trustee toward individual stockholders in the corporation is plainly contrary to repeated decisions of this court and cannot be supported. In Smith v. Hurd, 12 Metc. 371, 384, 46 Am. Dec. 690, it was said by Chief Justice Shaw: 'There is no legal privity, relation, or immediate connexion, between the holders of shares in a bank, in their individual capacity, on the one side, and the directors of the bank on the other. The directors are not the bailees, the factors, agents or trustees of such individual stockholders.' In Stewart v. Joyce, 201 Mass. 301, 311, 312, 87 N. E. 613, and Lee v. Fisk, 222 Mass. 424, 426, 109 N. E. 835, the same principle was reiterated. In Blabon v. Hay, 269 Mass. 401, 407, 169 N. E. 268, 271, occurs this language with reference to sale of stock in a corporation by a stockholder to two of its directors: 'The fact that the defendants were directors created no fiduciary relation between them and the plaintiff in the matter of the sale of his stock.'

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[4][5][6][7] While the general principle is as stated, circumstances may exist requiring that transactions between a director and a stockholder as to stock in the corporation be set aside. The knowledge naturally in the possession of a director as to the condition of a corporation places upon him a peculiar obligation to observe every requirement of fair dealing when directly buying or selling its stock. Mere silence does not usually amount to a breach of duty, but parties may stand in such relation to each other that an equitable responsibility arises to communicate facts. Wellington v. Rugg, 243 Mass. 30, 35, 136 N. E. 831. Purchases and sales of stock dealt in on the stock exchange are commonly impersonal affairs. An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules. Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud. On the other hand, directors cannot rightly be allowed to indulge with impunity in

practices which do violence to prevailing standards of upright business men. Therefore, where a director personally seeks a stockholder for the purpose of buying his shares without making disclosure of material facts within his peculiar knowledge and not within reach of the stockholder, the transaction will be closely scrutinized and relief may be granted in appropriate instances. Strong v. Repide, 213 U. S. 419, 29 S. Ct. 521, 53 L. Ed. 853; Allen v. Hyatt, 30 T. L. R. 444; Gammon v. Dain, 238 Mich. 30, 212 N. W. 957; George v. Ford, 36 App. D. C. 315. See, also, Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159, 194, 195, 89 N. E. 193, 40 L. R. A. (N. S.) 314. The applicable legal principles 'have almost always been the fundamental ethical rules of right and wrong.' Robinson v. Mollett, L. R. 7 H. L. 802, 817.

[8][9][10] The precise question to be decided in the case at bar is whether on the facts found the defendants as directors had a right to buy stock of the plaintiff, a stockholder. Every element of actual fraud or misdoing by the defendants is negatived by the findings. Fraud cannot be presumed; it must be proved. Brown v. Little, Brown & Co., Inc., 269 Mass. 102, 117, 168 N. E. 521, 66 A. L. R. 1284. The facts found afford no ground for inferring fraud or conspiracy. The only knowledge possessed by the defendants not open to the plaintiff was the existence of a theory formulated in a thesis by a geologist as to the possible existence of copper deposits where certain geological conditions existed common to the property of the Cliff Mining Company and that of other mining companies in its neighborhood. This thesis did not express an opinion that copper deposits would be found at any particular spot or on property of any specified owner. Whether that theory was sound or fallacious, no one knew, and so far as appears has never been demonstrated. The defendants made no representations to anybody about the theory. No facts found placed upon them any obligation to disclose the theory. A few days after the thesis expounding the theory was brought to the attention of the defendants, the annual report by the directors of the Cliff Mining Company for the calendar year 1925, signed by Agassiz for the directors, was issued. It did not cover the time when the theory was formulated. The report described the status of the operations under the exploration which had been begun in 1925. At the annual meeting of the stockholders of the company held early in April, 1926, no reference was made to the theory. It was then at most a hope, possibly an expectation. It had not passed the nebulous stage. No disclosure was made of it. The Cliff Mining Company was not harmed by the nondisclosure. There would have been no advantage to it, so far as appears, from a disclosure. The disclosure would have been detrimental to the interests of another mining corporation in which the defendants were directors. In the circumstances there was no duty on the part of the defendants to set forth to the stockholders at the annual meeting their faith, aspirations and plans for the future. Events as they developed might render advisable vadical changes in such views. Disclosure of the theory, if it ultimately was proved to be erroneous or without foundation in fact, might involve the defendants in litigation with those who might act on the hypothesis that it was correct. The stock of the Cliff Mining Company was bought and sold on the stock exchange. The identity of buyers and seller of the stock in question in fact was not known to the parties and perhaps could not readily have been ascertained. The defendants caused the shares to be bought through brokers on the stock exchange. They said nothing to anybody as to the reasons actuating them. The plaintiff was no novice. He was a member of the Boston stock exchange and had kept a record of sales of Cliff Mining Company stock. He acted upon his

own judgment in selling his stock. He made no inquiries of the defendants or of other officers of the company. The result is that the plaintiff cannot prevail.

Decree dismissing bill affirmed with costs.

The Securities Act of 1933

The Securities and Exchange Act of 1934

Class #29

Discussion points for SEC v. Texas Gulf Sulphur

Still not convinced about the evils of insider trading? Well, think on a larger, grander scale. Forget about being the insider, and picture yourself as the blue haired lady on her porch in the middle of Kansas, wondering how to invest her life savings of $50,000. Would you, as her only child, advise her to invest in the stock market, knowing that there are people who are just waiting to take advantage of her without fear of civil or criminal liability? Stated another way, corporations depend on money to grow, and that money will dry up if people think the game is rigged. Can you spell G-r-e-a-t D-e-p-r-e-s-s-i-o-n?

The question now becomes one of "materiality." Can this be adequately defined? Should it be?

SECURITIES AND EXCHANGE COMMISSION, Plaintiff-Appellant,
v.
TEXAS GULF SULPHUR CO., a Texas Corporation, Charles F. Fogarty, Richard D.

No. 296, Docket 30882.

United States Court of Appeals Second Circuit.

Argued March 20, 1967, Submitted to in Banc Court May 2, 1968.

Decided Aug. 13, 1968.

WATERMAN, Circuit Judge:

This action was commenced in the United States District Court for the Southern District of New York by the Securities and Exchange Commission (the SEC) pursuant to Sec. 21(e) of the Securities Exchange Act of 1934 (the Act), 15 U.S.C. § 78u(e), against Texas Gulf Sulphur Company (TGS) and several of its officers, directors and employees, to enjoin certain conduct by TGS and the individual defendants said to violate Section 10(b) of the Act, 15 U.S.C. Section 78j(b), and Rule 10b-5 (17 CFR 240.10b-5) (the Rule), promulgated thereunder, and to compel the rescission by the individual defendants of securities transactions assertedly conducted contrary to law. The complaint alleged (1) that defendants

Fogarty, Mollison, Darke, Murray, Huntington, O'Neill, Clayton, Crawford, and Coates had either personally or through agents purchased TGS stock or calls thereon from November 12, 1963 through April 16, 1964 on the basis of material inside information concerning the results of TGS drilling in Timmins, Ontario, while such information remained undisclosed to the investing public generally or to the particular sellers; (2) that defendants Darke and Coates had divulged such information to others for use in purchasing TGS stock or calls or recommended its purchase while the information was undisclosed to the public or to the sellers; that defendants Stephens, Fogarty, Mollison, Holyk, and Kline had accepted options to purchase TGS stock on Feb. 20, 1964 without disclosing the material information as to the drilling progress to either the Stock Option Committee or the TGS Board of Directors; and (4) that TGS issued a deceptive press release on April 12, 1964. The case was tried at length before Judge Bonsal of the Southern District of New York, sitting without a jury. Judge Bonsal in a detailed opinion decided, inter alia, that the insider activity prior to April 9, 1964 was not illegal because the drilling results were not 'material' until then; that Clayton and Crawford had traded in violation of law because they traded after that date; that Coates had committed no violation as he did not trade before disclosure was made; and that the issuance of the press release was not unlawful because it was not issued for the purpose of benefiting the corporation, there was no evidence that any insider used the release to his personal advantage and it was not 'misleading, or deceptive on the basis of the facts then known,' 258 F.Supp. 262, at 292- 296 (SDNY 1966). Defendants Clayton and Crawford appeal from that part of the decision below which held that they had violated Sec. 10 (b) and Rule 10b-5 and the SEC appeals from the remainder of the decision which dismissed the complaint against defendants TGS, Fogarty, Mollison, Holyk, Darke, Stephens, Kline, Murray, and Coates.

For reasons which appear below, we decide the various issues presented as follows:

(1) As to Clayton and Crawford, as purchasers of stock on April 15 and 16, 1964, we affirm the finding that they violated 15 U.S.C. § 78j(b) and Rule 10b-5 and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(2) As to Murray, we affirm the dismissal of the complaint.

(3) As to Mollison and Holyk, as recipients of certain stock options, we affirm the dismissal of the complaint.

(4) As to Stephens and Fogarty, as recipients of stock options, we reverse the dismissal of the complaint and remand for a further determination as to whether an injunction, in the exercise of the trial court's discretion, should issue.

(5) As to Kline, as a recipient of a stock option, we reverse the dismissal of the complaint and remand with directions to issue an order rescinding the option and for a determination of any other appropriate remedy in connection therewith.

(6) As to Fogarty, Mollison, Holyk, Darke, and Huntington, as purchasers of stock or calls

thereon between November 12, 1963, and April 9, 1964, we reverse the dismissal of the complaint and find that they violated 15 U.S.C. § 78j(b) and Rule 10b-5, and remand, pursuant to the agreement of all the parties, for a determination of the appropriate remedy.

(7) As to Clayton, although the district judge did not specify that the complaint be dismissed with respect to his purchases of TGS stock before April 9, 1964, such a dismissal is implicit in his treatment of the individual appellees who acted similarly. Consequently, although Clayton is named only as an appellant our decision with respect to the materiality of K- 55-1 renders it necessary to treat him also as an appellee. Thus, as to him, as one who purchased stock between November 12, 1963 and April 9, 1964, we reverse the implicit dismissal of the complaint, find that he violated § 78j(b) and Rule 10b-5, and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(8) As to Darke, as one who passed on information to tippees, we reverse the dismissal of the complaint and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(9) As to Coates, as one who on April 16th purchased stock and gave information on which his son-in-law broker and the broker's customers purchased shares, we reverse the dismissal of the complaint, find that he violated 15 U.S.C. § 78j(b) and Rule 10b-5, and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(10) As to Texas Gulf Sulphur, we reverse the dismissal of the complaint and remand for a further determination by the district judge in the light of the approach taken in this opinion.

The occurrences out of which this litigation arose are not set forth hereafter in as detailed a manner as they are set out in the published opinion of the court below, but are stated sufficiently, we believe, for the exposition of the issues raised by the several appeals to us.

THE FACTUAL SETTING

This action derives from the exploratory activities of TGS begun in 1957 on the Canadian Shield in eastern Canada. In March of 1959, aerial geophysical surveys were conducted over more than 15,000 square miles of this area by a group led by defendant Mollision, a mining engineer and a Vice President of TGS. The group included defendant Holyk, TGS's chief geologist, defendant Clayton, an electrical engineer and geophysicist, and defendant Darke, a geologist. These operations resulted in the detection of numerous anomalies, i.e., extraordinary variations in the conductivity of rocks, one of which was on the Kidd 55 segment of land located near Timmins, Ontario.

On October 29 and 30, 1963, Clayton conducted a ground geophysical survey on the northeast portion of the Kidd 55 segment which confirmed the presence of an anomaly and indicated the necessity of diamond core drilling for further evaluation. Drilling of the initial hole, K-55-1, at the strongest part of the anomaly was commenced on November 8 and terminated on November 12 at a depth of 655 feet. Visual estimates by Holyk of the core of

K-55-1 indicated an average copper content of 1.15% And an average zinc content of 8.64% Over a length of 599 feet. This visual estimate convinced TGS that it was desirable to acquire the remainder of the Kidd 55 segment, and in order to facilitate this acquisition TGS President Stephens instructed the exploration group to keep the results of K-55-1 confidential and undisclosed even as to other officers, directors, and employees of TGS. The hole was concealed and a barren core was intentionally drilled off the anomaly. Meanwhile, the core of K-55-1 had been shipped to Utah for chemical assay which, when received in early December, revealed an average mineral content of 1.18% Copper, 8.26% Zinc, and 3.94% Ounces of silver per ton over a length of 602 feet. These results were so remarkable that neither Clayton, an experienced geophysicist, nor four other TGS expert witnesses, had ever seen or heard of a comparable initial exploratory drill hole in a base metal deposit. So, the trial court concluded, 'There is no doubt that the drill core of K-55-1 was unusually good and that it excited the interest and speculation of those who knew about it.' Id. at 282. By March 27, 1964, TGS decided that the land acquisition program had advanced to such a point that the company might well resume drilling, and drilling was resumed on March 31.

During this period, from November 12, 1963 when K-55-1 was completed, to March 31, 1964 when drilling was resumed, certain of the individual defendants listed in fn. 2, supra, and persons listed in fn. 4, supra, said to have received 'tips' from them, purchased TGS stock or calls thereon. Prior to these transactions these persons had owned 1135 shares of TGS stock and possessed no calls; thereafter they owned a total of 8235 shares and possessed 12,300 calls.

On February 20, 1964, also during this period, TGS issued stock options to 26 of its officers and employees whose salaries exceeded a specified amount, five of whom were the individual defendants Stephens, Fogarty, Mollison, Holyk, and Kline. Of these, only Kline was unaware of the detailed results of K-55-1, but he, too, knew that a hole containing favorable bodies of copper and zinc ore had been drilled in Timmins. At this time, neither the TGS Stock Option Committee nor its Board of Directors had been informed of the results of K-55- 1, presumably because of the pending land acquisition program which required confidentiality. All of the foregoing defendants accepted the options granted them.

When drilling was resumed on March 31, hole K-55-3 was commenced 510 feet west of K-55-1 and was drilled easterly at a 45 degrees angle so as to cross K-55-1 in a vertical plane. Daily progress reports of the drilling of this hole K-55-3 and of all subsequently drilled holes were sent to defendants Stephens and Fogarty (President and Executive Vice President of TGS) by Holyk and Mollison. Visual estimates of K-55-3 revealed an average mineral content of 1.12% Copper and 7.93% Zinc over 641 of the hole's 876-foot length. On April 7, drilling of a third hole, K-55-4, 200 feet south of and parallel to K-55-1 and westerly at a 45 degrees angle, was commenced and mineralization was encountered over 366 of its 579-foot length. Visual estimates indicated an average content of 1.14% Copper and 8.24% Zinc. Like K-55-1, both K-55-3 and K-55-4 established substantial copper mineralization on the eastern edge of the anomaly. On the basis of these findings relative to the foregoing drilling results, the trial court concluded that the vertical plane created by the intersection of K-55-1 and K-55-3, which measured at least 350 feet wide by 500 feet deep extended southward 200 feet to

its intersection with K-55-4, and that 'There was real evidence that a body of commercially mineable ore might exist.' Id. at 281- 82.

On April 8 TGS began with a second drill rig to drill another hole, K-55-6, 300 feet easterly of K-55-1. This hole was drilled westerly at an angle of 60 degrees and was intended to explore mineralization beneath K-55-1. While no visual estimates of its core were immediately available, it was readily apparent by the evening of April 10 that substantial copper mineralization had been encountered over the last 127 feet of the hole's 569-foot length. On April 10, a third drill rig commenced drilling yet another hole, K-55-5, 200 feet north of K-55-1, parallel to the prior holes, and slanted westerly at a 45 degrees angle. By the evening of April 10 in this hole, too, substantial copper mineralization had been encountered over the last 42 feet of its 97-foot length.

Meanwhile, rumors that a major ore strike was in the making had been circulating throughout Canada. On the morning of Saturday, April 11, Stephens at his home in Greenwich, Conn. read in the New York Herald Tribune and in the New York Times unauthorized reports of the TGS drilling which seemed to infer a rich strike from the fact that the drill cores had been flown to the United States for chemical assay. Stephens immediately contacted Fogarty at his home in Rye, N.Y., who in turn telephoned and later that day visited Mollison at Mollison's home in Greenwich to obtain a current report and evaluation of the drilling progress. The following morning, Sunday, Fogarty again telephoned Mollison, inquiring whether Mollison had any further information and told him to return to Timmins with Holyk, the TGS Chief Geologist, as soon as possible 'to move things along.' With the aid of one Carroll, a public relations consultant, Fogarty drafted a press release designed to quell the rumors, which release, after having been channeled through Stephens and Huntington, a TGS attorney, was issued at 3:00 P.M. on Sunday, April 12, and which appeared in the morning newspapers of general circulation on Monday, April 13. It read in pertinent part as follows:

NEW YORK, April 12-- The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fogarty said:

'During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.

'The facts are as follows. TGS has been exploring in the Timmins area for six years as part of its overall search in Canada and elsewhere for various minerals-- lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-

drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.

'Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.

'Recent drilling on one property near Timmins has led to preliminary indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

'The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project.'

The release purported to give the Timmins drilling results as of the release date, April 12. From Mollison Fogarty had been told of the developments through 7:00 P.M. on April 10, and of the remarkable discoveries made up to that time, detailed supra, which discoveries, according to the calculations of the experts who testified for the SEC at the hearing, demonstrated that TGS had already discovered 6.2 to 8.3 million tons of proven ore having gross assay values from $26 to $29 per ton. TGS experts, on the other hand, denied at the hearing that proven or probable ore could have been calculated on April 11 or 12 because there was then no assurance of continuity in the mineralized zone.

The evidence as to the effect of this release on the investing public was equivocal and less than abundant. On April 13 the New York Herald Tribune in an article head-noted 'Copper Rumor Deflated' quoted from the TGS release of April 12 and backtracked from its original April 11 report of a major strike but nevertheless inferred from the TGS release that 'recent mineral exploratory activity near Timmins, Ontario, has provided preliminary favorable results, sufficient at least to require a step-up in drilling operations.' Some witnesses who testified at the hearing stated that they found the release encouraging. On the other hand, a Canadian mining security specialist, Roche, stated that 'earlier in the week (before April 16) we had a Dow Jones saying that they (TGS) didn't have anything basically' and a TGS stock specialist for the Midwest Stock Exchange became concerned about his long position in the stock after reading the release. The trial court stated only that 'While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known.' Id. at 296.

Meanwhile, drilling operations continued. By morning of April 13, in K-55-5, the fifth drill hole, substantial copper mineralization had been encountered to the 580 foot mark, and the hole was subsequently drilled to a length of 757 feet without further results. Visual estimates revealed an average content of 0.82% Copper and 4.2% Zinc over a 525-foot section. Also by

7:00 A.M. on April 13, K-55-6 had found mineralization to the 946-foot mark. On April 12 a fourth drill rig began to drill K-55-7, which was drilled westerly at a 45 degrees angle, at the eastern edge of the anomaly. The next morning the 137 foot mark had been reached, fifty feet of which showed mineralization. By 7:00 P.M. on April 15, the hole had been completed to a length of 707 feet but had only encountered additional mineralization during a 26-foot length between the 425 and 451-foot marks. A mill test hole, K-55-8, had been drilled and was complete by the evening of April 13 but its mineralization had not been reported upon prior to April 16. K-55-10 was drilled westerly at a 45 degrees angle commencing April 14 and had encountered mineralization over 231 of its 249-foot length by the evening of April 15. It, too, was drilled at the anomaly's eastern edge.

While drilling activity ensued to completion, TGC officials were taking steps toward ultimate disclosure of the discovery. On April 13, a previously-invited reporter for The Northern Miner, a Canadian mining industry journal, visited the drillsite, interviewed Mollison, Holyk and Darke, and prepared an article which confirmed a 10 million ton ore strike. This report, after having been submitted to Mollison and returned to the reporter unamended on April 15, was published in the April 16 issue. A statement relative to the extent of the discovery, in substantial part drafted by Mollison, was given to the Ontario Minister of Mines for release to the Canadian media. Mollison and Holyk expected it to be released over the airways at 11 P.M. on April 15th, but, for undisclosed reasons, it was not released until 9:40 A.M. on the 16th. An official detailed statement, announcing a strike of at least 25 million tons of ore, based on the drilling data set forth above, was read to representatives of American financial media from 10:00 A.M. to 10:10 or 10:15 A.M. on April 16, and appeared over Merrill Lynch's private wire at 10:29 A.M. and, somewhat later than expected, over the Dow Jones ticker tape at 10:54 A.M.

Between the time the first press release was issued on April 12 and the dissemination of the TGS official announcement on the morning of April 16, the only defendants before us on appeal who engaged in market activity were Clayton and Crawford and TGS director Coates. Clayton ordered 200 shares of TGS stock through his Canadian broker on April 15 and the order was executed that day over the Midwest Stock Exchange. Crawford ordered 300 shares at midnight on the 15th and another 300 shares at 8:30 A.M. the next day, and these orders were executed over the Midwest Exchange in Chicago at its opening on April 16. Coates left the TGS press conference and called his broker son-in-law Haemisegger shortly before 10:20 A.M. on the 16th and ordered 2,000 shares of TGS for family trust accounts of which Coates was a trustee but not a beneficiary; Haemisegger executed this order over the New York and Midwest Exchanges, and he and his customers purchased 1500 additional shares.

During the period of drilling in Timmins, the market price of TGS stock fluctuated but steadily gained overall. On Friday, November 8, when the drilling began, the stock closed at 17 3/8 ; on Friday, November 15, after K- 55-1 had been completed, it closed at 18. After a slight decline to 16 3/8 by Friday, November 22, the price rose to 20 7/8 by December 13, when the chemical assay results of K-55-1 were received, and closed at a high of 24 1/8 on February 21, the day after the stock options had been issued. It had reached a price of 26 by March 31, after the land acquisition program had been completed and drilling had been

resumed, and continued to ascend to 30 1/8 by the close of trading on April 10, at which time the drilling progress up to then was evaluated for the April 12th press release. On April 13, the day on which the April 12 release was disseminated, TGS opened at 30 1/8 , rose immediately to a high of 32 and gradually tapered off to close at 30 7/8 . It closed at 30 1/4 the next day, and at 29 3/8 on April 15. On April 16, the day of the official announcement of the Timmins discovery, the price climbed to a high of 37 and closed at 36 3/8 . By May 15, TGS stock was selling at 58 1/4.

I. THE INDIVIDUAL DEFENDANTS

A. Introductory

Rule 10b-5, 17 CFR 240.10b-5, on which this action is predicated, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[1][2][3][4][5] Rule 10b-5 was promulgated pursuant to the grant of authority given the SEC by Congress in Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b). By that Act Congress purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges, see 3 Loss, Securities Regulation 1455-56 (2d ed. 1961). The Act and the Rule apply to the transactions here, all of which were consummated on exchanges. See List v. Fashion Park, Inc., 340 F.2d 457, 461- 62 (2 Cir.), cert. denied, 382 U.S. 811, 86 S.Ct. 23, 15 L.Ed.2d 60 (1965); Cochran v. Channing Corp., 211 F.Supp. 239, 243 (SDNY 1962). Whether predicated on traditional fiduciary concepts, see, e.g., Hotchkiss v. Fisher, 136 Kan. 530, 16 P.2d 531 (Kan.1932), or on the 'special facts' doctrine, see, e.G., Strong v. Repide, 213 U.S. 419, 29 S.Ct. 521, 53 L.Ed. 853 (1909), the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information, see Cary, Insider Trading in Stocks, 21 Bus.Law. 1009, 1010 (1966), Fleischer, Securities Trading and Corporation Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va.L.Rev. 1271, 1278-80 (1965). The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of

anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.E., the investing public. Matter of Cady, Roberts & Co., 40 SEC 907, 912 (1961). Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an 'insider' within the meaning of Sec. 16(b) of the Act. Cady, Roberts, supra. Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site; if the information was, as the SEC contends, material, its possessors should have kept out of the market until disclosure was accomplished. Cady, Roberts, supra at 911.

B. Material Inside Information

[6] An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in 'those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if (the extraordinary situation is) disclosed.' Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va.L.Rev. 1271, 1289.

[7] Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions. 3 Loss, op. cit. supra at 1463. The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.

[8][9][10] This is not to suggest, however, as did the trial court, the 'the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight,'258 F.Supp. 262 at 280, in the sense that the materiality of facts is to be assessed solely by measuring the effect the knowledge of the facts would have upon prudent or conservative investors. As we stated in List v. Fashion Park, Inc., 340 F.2d 457, 462, 'The basic test of materiality * * * is whether a reasonable man would attach importance * * * in determining his choice of action in the transaction in question. Restatement, Torts § 538(2)(a); accord Prosser, Torts 554-55; I Harper & James, Torts 565-66.' This, of course, encompasses any fact '* * * which in reasonable and objective contemplation might affect the value of the corporation's stock or securities * * *.' List v. Fashion Park, Inc., supra at 462, quoting from Kohler v. Kohler Co., 319 F.2d 634, 642, 7 A.L.R.3d 486 (7 Cir. 1963). Such a fact is a material fact and must be effectively disclosed to

the investing public prior to the commencement of insider trading in the corporation's securities. The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders. Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.

[11][12] In each case, then, whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. Here, notwithstanding the trial court's conclusion that the results of the first drill core, K-55-1, were 'too 'remote' * * * to have had any significant impact on the market, i.e., to be deemed material,' 258 F.Supp. at 283, knowledge of the possibility, which surely was more than marginal, of the existence of a mine of the vast magnitude indicated by the remarkably rich drill core located rather close to the surface (suggesting mineability by the less expensive openpit method) within the confines of a large anomaly (suggesting an extensive region of mineralization) might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold. After all, this first drill core was 'unusually good and * * * excited the interest and speculation of those who knew about it.' 258 F.Supp. at 282.

[13] Our disagreement with the district judge on the issue does not, then, go to his findings of basic fact, as to which the 'clearly erroneous' rule would apply, but to his understanding of the legal standard applicable to them. See Baranow v. Gibralter Factors Corp., 366 F.2d 584, 587-589 (2 Cir. 1966), and cases cited in footnote 11 supra. Our survey of the facts found below conclusively establishes that knowledge of the results of the discovery hole, K-55-1, would have been important to a reasonable investor and might have affected the price of the stock. On April 16, The Northern Miner, a trade publication in wide circulation among mining stock specialists, called K- 55-1, the discovery hole, 'one of the most impressive drill holes completed in modern times.' Roche, a Canadian broker whose firm specialized in mining securities, characterized the importance to investors of the results of K-55-1. He stated that the completion of 'the first drill hole' with 'a 600 foot drill core is very very significant * * * anything over 200 feet is considered very significant and 600 feet is just beyond your wildest imagination.' He added, however, that it 'is a natural thing to buy more stock once they give you the first drill hole.' Additional testimony revealed that the prices of stocks of other companies, albeit less diversified, smaller firms, had increased substantially solely on the basis of the discovery of good anomalies or even because of the proximity of their lands to the situs of a potentially major strike.

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. Finally, a major factor in determining whether the K-55-1 discovery was a material fact is the importance attached to the drilling results by those who knew about it. In view of other unrelated recent developments favorably affecting TGS, participation by an informed person

in a regular stock-purchase program, or even sporadic trading by an informed person, might lend only nominal support to the inference of the materiality of the K-55-1 discovery; nevertheless, the timing by those who knew of it of their stock purchases and their purchases of short-term calls-- purchases in some cases by individuals who had never before purchased calls or even TGS stock-- virtually compels the inference that the insiders were influenced by the drilling results. This insider trading activity, which surely constitutes highly pertinent evidence and the only truly objective evidence of the materiality of the K-55-1 discovery, was apparently disregarded by the court below in favor of the testimony of defendants' expert witnesses, all of whom 'agreed that one drill core does not establish an ore body, much less a mine,' 258 F.Supp. at 282- 283. Significantly, however, the court below, while relying upon what these defense experts said the defendant insiders ought to have thought about the worth to TGS of the K-55-1 discovery, and finding that from November 12, 1963 to April 6, 1964 Fogarty, Murray, Holyk and Darke spent more than $100,000 in purchasing TGS stock and calls on that stock, made no finding that the insiders were motivated by any factor other than the extraordinary K-55-1 discovery when they bought their stock and their calls. No reason appears why outside investors, perhaps better acquainted with speculative modes of investment and with, in many cases, perhaps more capital at their disposal for intelligent speculation, would have been less influenced, and would not have been similarly motivated to invest if they had known what the insider investors knew about the K-55-1 discovery.

Our decision to expand the limited protection afforded outside investors by the trial court's narrow definition of materiality is not at all shaken by fears that the elimination of insider trading benefits will deplete the ranks of capable corporate managers by taking away an incentive to accept such employment. Such benefits, in essence, are forms of secret corporate compensation, see Cary, Corporate Standards and Legal Rules, 50 Calif.L.Rev. 408, 409-10 (1962), derived at the expense of the uninformed investing public and not at the expense of the corporation which receives the sole benefit from insider incentives. Moreover, adequate incentives for corporate officers may be provided by properly administered stock options and employee purchase plans of which there are many in existence. In any event, the normal motivation induced by stock ownership, i.e., the identification of an individual with corporate progress, is ill-promoted by condoning the sort of speculative insider activity which occurred here; for example, some of the corporation's stock was sold at market in order to purchase short-term calls upon that stock, calls which would never be exercised to increase a stockholder equity in TGS unless the market price of that stock rose sharply.

[14] The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks,-- which market risks include, of course the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital. The insiders here were not trading on an equal footing with the outside investors. They alone were in a position to evaluate the probability and magnitude of what seemed from the outset to be a major ore strike; they alone could invest safely, secure in the expectation that the price of TGS stock would rise substantially in the event such a major strike should materialize, but would decline little, if at all, in the event of failure, for the public, ignorant at

the outset of the favorable probabilities would likewise be unaware of the unproductive exploration, and the additional exploration costs would not significantly affect TGS market prices. Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.

[15] We hold, therefore, that all transactions in TGS stock or calls by individuals apprised of the drilling results of K-55-1 were made in violation of Rule 10b-5. Inasmuch as the visual evaluation of that drill core (a generally reliable estimate though less accurate than a chemical assay) constituted material information, those advised of the results of the visual evaluation as well as those informed of the chemical assay traded in violation of law. The geologist Darke possessed undisclosed material information and traded in TGS securities. Therefore we reverse the dismissal of the action as to him and his personal transactions. The trial court also found, 258 F.Supp. at 284, that Darke, after the drilling of K-55-1 had been completed and with detailed knowledge of the results thereof, told certain outside individuals that TGS 'was a good buy.' These individuals thereafter acquired TGS stock and calls. The trial court also found that later, as of March 30, 1964, Darke not only used his material knowledge for his own purchases but that the substantial amounts of TGS stock and calls purchased by these outside individuals on that day, see footnote 4, supra, was 'strong circumstantial evidence that Darke must have passed the word to one or more of his 'tippees' that drilling on the Kidd 55 segment was about to be resumed.' 258 F.Supp. at 284. Obviously if such a resumption were to have any meaning to such 'tippees,' they must have previously been told of K-55-1.

[16] Unfortunately, however, there was no definitive resolution below of Darke's liability in these premises for the trial court held as to him, as it held as to all the other individual defendants, that this 'undisclosed information' never became material until April 9. As it is our holding that the information acquired after the drilling of K-55-1 was material, we, on the basis of the findings of direct and circumstantial evidence on the issue that the trial court has already expressed, hold that Darke violated Rule 10b-5(3) and Section 10(b) by 'tipping' and we remand, pursuant to the agreement of the parties, for a determination of the appropriate remedy. As Darke's 'tippees' are not defendants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible.

[17] With reference to Huntington, the trial court found that he 'had no detailed knowledge as to the work' on the Kidd-55 segment, 258 F.Supp. 281. Nevertheless, the evidence shows that he knew about and participated in TGS's land acquisition program which followed the receipt of the K-55-1 drilling results, and that on February 26, 1964 he purchased 50 shares of TGS stock. Later, on March 16, he helped prepare a letter for Dr. Holyk's signature in which TGS made a substantial offer for lands near K-55-1, and on the same day he, who had never before purchased calls on any stock, purchased a call on 100 shares of TGS stock. We are satisfied that these purchases in February and March, coupled with his readily inferable and probably reliable, understanding of the highly favorable nature of preliminary operations

on the Kidd segment, demonstrate that Huntington possessed material inside information such as to make his purchase violative of the Rule and the Act.

C. When May Insiders Act?

[18] Appellant Crawford, who ordered the purchase of TGS stock shortly before the TGS April 16 official announcement, and defendant Coates, who placed orders with and communicated the news to his broker immediately after the official announcement was read at the TGS-called press conference, concede that they were in possession of material information. They contend, however, that their purchases were not proscribed purchases for the news had already been effectively disclosed. We disagree.

[19][20][21] Crawford telephoned his orders to his Chicago broker about midnight on April 15 and again at 8:30 in the morning of the 16th, with instructions to buy at the opening of the Midwest Stock Exchange that morning. The trial court's finding that 'he sought to, and did, 'beat the news,'' 258 F.Supp. at 287, is well documented by the record. The rumors of a major ore strike which had been circulated in Canada and, to a lesser extent, in New York, had been disclaimed by the TGS press release of April 12, which significantly promised the public an official detailed announcement when possibilities had ripened into actualities. The abbreviated announcement to the Canadian press at 9:40 A.M. on the 16th by the Ontario Minister of Mines and the report carried by The Northern Miner, parts of which had sporadically reached New York on the morning of the 16th through reports from Canadian affiliates to a few New York investment firms, are assuredly not the equivalent of the official 10-15 minute announcement which was not released to the American financial press until after 10:00 A.M. Crawford's orders had been placed before that. Before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availibility to the investing public. Particularly here, where a formal announcement to the entire financial news media had been promised in a prior official release known to the media, all insider activity must await dissemination of the promised official announcement.

[22] Coates was absolved by the court below because his telephone order was placed shortly before 10:20 A.M. on April 16, which was after the announcement had been made even though the news could not be considered already a matter of public information. 258 F.Supp. at 288. This result seems to have been predicated upon a misinterpretation of dicta in Cady, Roberts, where the SEC instructed insiders to 'keep out of the market until the established procedures for public release of the information are carried out instead of hastening to execute transactions in advance of, and in frustration of, the objectives of the release,' 40 SEC at 915. The reading of a news release, which prompted Coates into action, is merely the first step in the process of dissemination required for compliance with the regulatory objective of providing all investors with an equal opportunity to make informed investment judgments. Assuming that the contents of the official release could instantaneously be acted upon, at the minimum Coates should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his broker son-in-law.

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C. Did the Issuance of the April 12 Release Violate Rule 10b-5?

[36] Turning first to the question of whether the release was misleading, i.e., whether it conveyed to the public a false impression of the drilling situation at the time of its issuance, we note initially that the trial court did not actually decide this question. Its conclusion that 'the Commission has failed to demonstrate that it was false, misleading or deceptive,' 258 F.Supp. at 294, seems to have derived from its views that 'The defendants are to be judged on the facts known to them when the April 12 release was issued,' 258 F.Supp. at 295, (emphasis supplied), that the draftsmen 'exercised reasonable business judgment under the circumstances,' 258 F.Supp. at 296, and that the release was not 'misleading or deceptive on the basis of the facts then known,' 258 F.Supp. at 296 (emphasis supplied) rather than from an appropriate primary inquiry into the meaning of the statement to the reasonable investor and its relationship to truth. While we certainly agree with the trial court that 'in retrospect, the press release may appear gloomy or incomplete,' [FN28] 258 F.Supp. at 296, we cannot, from the present record, by applying the standard Congress intended, definitively conclude that it was deceptive or misleading to the reasonable investor, or that he would have been misled by it. Certain newspaper accounts of the release viewed the release as confirming the existence of preliminary favorable developments, and this optimistic view was held by some brokers, so it could be that the reasonable investor would have read between the lines of what appears to us to be an inconclusive and negative statement and would have envisioned the actual situation at the Kidd segment on April 12. On the other hand, in view of the decline of the market price of TGS stock from a high of 32 on the morning of April 13 when the release was disseminated to 29 3/8 by the close of trading on April 15, and the reaction to the release by other brokers, it is far from certain that the release was generally interpreted as a highly encouraging report or even encouraging at all. Accordingly, we remand this issue to the district court that took testimony and heard and saw the witnesses for a determination of the character of the release in the light of the facts existing at the time of the release, by applying the standard of whether the reasonable investor, in the exercise of due care, would have been misled by it.

In the event that it is found that the statement was misleading to the reasonable investor it will then become necessary to determine whether its issuance resulted from a lack of due diligence. The only remedy the Commission seeks against the corporation is an injunction, see footnote 26, supra, and therefore we do not find it necessary to decide whether just a lack of due diligence on the part of TGS, absent a showing of bad faith, would subject the Corporation to any liability for damages. We have recently stated in a case involving a private suit under Rule 10b-5 in which damages and an injunction were sought, "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547, quoting from SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963)

[37] We hold only that, in an action for injunctive relief, the district court has the

discretionary power under Rule 10b-5 and Section 10(b) to issue an injunction, if the misleading statement resulted from a lack of due diligence on the part of TGS. The trial court did not find it necessary to decide whether TGS exercised such diligence and has not yet attempted to resolve this issue. While the trial court concluded that TGS had exercised 'reasonable business judgment under the circumstances,' 258 F.Supp. at 296 (emphasis supplied) it applied an incorrect legal standard in appraising whether TGS should have issued its April 12 release on the basis of the facts known to its draftsmen at the time of its preparation, 258 F.Supp. at 295, and in assuming that disclosure of the full underlying facts of the Timmins situation was not a viable alternative to the vague generalities which were asserted. 258 F.Supp. at 296.

It is not altogether certain from the present record that the draftsmen could, as the SEC suggests, have readily obtained current reports of the drilling progress over the weekend of April 10-12, but they certainly should have obtained them if at all possible for them to do so. However, even if it were not possible to evaluate and transmit current data in time to prepare the release on April 12, it would seem that TGS could have delayed the preparation a bit until an accurate report of a rapidly changing situation was possible. See 258 F.Supp. at 296. At the very least, if TGS felt compelled to respond to the spreading rumors of a spectacular discovery, it would have been more accurate to have stated that the situation was in flux and that the release was prepared as of April 10 information rather than purporting to report the progress 'to date.' Moreover, it would have obviously been better to have specifically described the known drilling progress as of April 10 by stating the basic facts. Such an explicit disclosure would have permitted the investing public to evaluate the 'prospect' of a mine at Timmins without having to read between the lines to understand that preliminary indications were favorable-- in itself an understatement.

[38][39][40] The choice of an ambiguous general statement rather than a summary of the specific facts cannot reasonably be justified by any claimed urgency. The avoidance of liability for misrepresentation in the event that the Timmins project failed, a highly unlikely event as of April 12 or April 13, did not forbid the accurate and truthful divulgence of detailed results which need not, of course, have been accompanied by conclusory assertions of success. Nor is it any justification that such an explicit disclosure of the truth might have 'encouraged the rumor mill which they were seeking to allay.' 258 F.Supp. at 296.

We conclude, then, that, having established that the release was issued in a manner reasonably calculated to affect the market price of TGS stock and to influence the investing public, we must remand to the district court to decide whether the release was misleading to the reasonable investor and if found to be misleading, whether the court in its discretion should issue the injunction the SEC seeks.

CONCLUSION

In summary, therefore, we affirm the finding of the court below that appellants Richard H. Clayton and David M. Crawford have violated 15 U.S.C. § 78j(b) and Rule 10b-5; we reverse the judgment order entered below dismissing the complaint against appellees Charles

F. Fogarty, Richard H. Clayton, Richard D. Mollison, Walter Holyk, Kenneth H. Darke, Earl L. Huntington, and Francis G. Coates, as we find that they have violated 15 U.S.C. § 78j(b) and Rule 10b-5. As to these eight individuals we remand so that in accordance with the agreement between the parties the Commission may notice a hearing before the court below to determine the remedies to be applied against them. We reverse the judgment order dismissing the complaint against Claude O. Stephens, Charles F. Fogarty, and Harold B. Kline as recipients of stock options, direct the district court to consider in its discretion whether to issue injunction orders against Stephens and Fogarty, and direct that an order issue rescinding the option granted Kline and that such further remedy be applied against him as may be proper by way of an order of restitution; and we reverse the judgment dismissing the complaint against Texas Gulf Sulphur Company, remand the cause as to it for a further determination below, in the light of the approach explicated by us in the foregoing opinion, as to whether, in the exercise of its discretion, the injunction against it which the Commission seeks should be ordered.

Discussion points for Carpenter v. United States

Scams come in all shapes and sizes, but greed only comes in one color – green. Can you really trust your fellow conspirators?

David CARPENTER, Kenneth P. Felis, and R. Foster Winans, Petitioners
v.
UNITED STATES.
No. 86-422.
Supreme Court of the United States
Argued Oct. 7, 1987.
Decided Nov. 16, 1987.

Justice WHITE delivered the opinion of the Court.
Petitioners Kenneth Felis and R. Foster Winans were convicted of violating s 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. s 78j(b), and Rule 10b-5, 17 CFR s 240.10b-5 (1987). United States v. Winans, 612 F.Supp. 827 (SDNY 1985). They were also found guilty of violating the federal mail and wire fraud statutes, 18 U.S.C. ss 1341, 1343, and were convicted for conspiracy under 18 U.S.C. s 371. Petitioner David Carpenter, Winans' roommate, was convicted for aiding and abetting. With a minor exception, the Court of Appeals for the Second Circuit affirmed, 791 F.2d 1024 (1986); we granted certiorari, 479 U.S. 1016, 107 S.Ct. 666, 93 L.Ed.2d 718 (1986).

FN1. Section 10(b) provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange–

** * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

FN2. Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,"in connection with the purchase or sale of any security."

FN3. Section 1341 provides:

"Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both."

FN4. Section 1343 provides:

"Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined not more than $1,000 or imprisoned not more than five years, or both."

FN5. Section 371 provides:

"If two or more persons conspire either to commit any offense against the United States,

or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000 or imprisoned not more than five years, or both."

I

In 1981, Winans became a reporter for the Wall Street Journal (the Journal) and in the summer of 1982 became one of the two writers of a daily column, "Heard on the Street." That column discussed selected stocks or groups of stocks, giving positive and negative information about those stocks and taking "a point of view with respect to investment in the stocks that it reviews." 612 F.Supp., at 830. Winans regularly interviewed corporate executives to put together interesting perspectives on the stocks that would be highlighted in upcoming columns, but, at least for the columns at issue here, none contained corporate inside information or any "hold for release" information. Id., at 830, n. 2. Because of the "Heard" column's perceived quality and integrity, it had the potential of affecting the price of the stocks which it examined. The District Court concluded on the basis of testimony presented at trial that the "Heard" column "does have an impact on the market, difficult though it may be to quantify in any particular case." Id., at 830.

The official policy and practice at the Journal was that prior to publication, the contents of the column were the Journal's confidential information. Despite the rule, with which Winans was familiar, he entered into a scheme in October 1983 with Peter Brant and petitioner Felis, both connected with the Kidder Peabody brokerage firm in New York City, to give them advance information as to the timing and contents of the "Heard" column. This permitted Brant and Felis and another conspirator, David Clark, a client of Brant, to buy or sell based on the probable impact of the column on the market. Profits were to be shared. The conspirators agreed that the scheme would not affect the journalistic purity of the "Heard" column, and the District Court did not find that the contents of any of the articles were altered to further the profit potential of petitioners' stock-trading scheme. Id., at 832, 834-835. Over a 4-month period, the brokers made prepublication trades on the basis of information given them by Winans about the contents of some 27 "Heard" columns. The net profits from these trades were about $690,000.

In November 1983, correlations between the "Heard" articles and trading in the Clark and Felis accounts were noted at Kidder Peabody and inquiries began. Brant and Felis denied knowing anyone at the Journal and took steps to conceal the trades. Later, the Securities and Exchange Commission began an investigation. Questions were met by denials both by the brokers at Kidder Peabody and by Winans at the Journal. As the investigation progressed, the conspirators quarreled, and on March 29, 1984, Winans and Carpenter went to the SEC and revealed the entire scheme. This indictment and a bench trial followed. Brant, who had pleaded guilty under a plea agreement, was a witness for the Government.

The District Court found, and the Court of Appeals agreed, that Winans had knowingly breached a duty of confidentiality by misappropriating prepublication information regarding the timing and contents of the "Heard" column, information that had been gained in the course of his employment under the understanding that it would not be revealed in advance of publication and that if it were, he would report it to his employer. It was this

appropriation of confidential information that underlay both the securities laws and mail and wire fraud counts. With respect to the s 10(b) charges, the courts below held that the deliberate breach of Winans' duty of confidentiality and concealment of the scheme was a fraud and deceit on the Journal. Although the victim of the fraud, the Journal, was not a buyer or seller of the stocks traded in or otherwise a market participant, the fraud was nevertheless considered to be "in connection with" a purchase or sale of securities within the meaning of the statute and the rule.

The courts reasoned that the scheme's sole purpose was to buy and sell securities at a profit based on advance information of the column's contents. The courts below rejected petitioners' submission, which is one of the two questions presented here, that criminal liability could not be imposed on petitioners under Rule 10b-5 because "the newspaper is the only alleged victim of fraud and has no interest in the securities traded."

In affirming the mail and wire fraud convictions, the Court of Appeals ruled that Winans had fraudulently misappropriated "property" within the meaning of the mail and wire fraud statutes and that its revelation had harmed the Journal. It was held as well that the use of the mail and wire services had a sufficient nexus with the scheme to satisfy ss 1341 and 1343. The petition for certiorari challenged these conclusions.

[1] The Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts. For the reasons that follow, we also affirm the judgment with respect to the mail and wire fraud convictions.

II

Petitioners assert that their activities were not a scheme to defraud the Journal within the meaning of the mail and wire fraud statutes; and that in any event, they did not obtain any "money or property" from the Journal, which is a necessary element of the crime under our decision last Term in McNally v. United States, 483 U.S. 350, 107 S.Ct. 2875, 97 L.Ed.2d 292 (1987). We are unpersuaded by either submission and address the latter first.

FN6. The mail and wire fraud statutes share the same language in relevant part, and accordingly we apply the same analysis to both sets of offenses here.

We held in McNally that the mail fraud statute does not reach "schemes to defraud citizens of their intangible rights to honest and impartial government," id., at 355, 107 S.Ct., at 2879, and that the statute is "limited in scope to the protection of property rights." Id., at 360, 107 S.Ct., at 2882. Petitioners argue that the Journal's interest in prepublication confidentiality for the "Heard" columns is no more than an intangible consideration outside the reach of s 1341; nor does that law, it is urged, protect against mere injury to reputation. This is not a case like McNally, however. The Journal, as Winans' employer, was defrauded of much more than its contractual right to his honest and faithful service, an interest too ethereal in itself to fall within the protection of the mail fraud statute, which "had its origin in the desire to protect individual property rights." McNally, supra, at 359, n. 8, 107 S.Ct., at 2881, n. 8.

Here, the object of the scheme was to take the Journal's confidential business information--the publication schedule and contents of the "Heard" column--and its intangible nature does not make it any less "property" protected by the mail and wire fraud statutes. McNally did not limit the scope of s 1341 to tangible as distinguished from intangible property rights.

[2] Both courts below expressly referred to the Journal's interest in the confidentiality of the contents and timing of the "Heard" column as a property right, 791 F.2d, at 1034-1035; 612 F.Supp., at 846, and we agree with that conclusion. Confidential business information has long been recognized as property. See Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1001-1004, 104 S.Ct. 2862, 2874, 81 L.Ed.2d 815 (1984); Dirks v. SEC, 463 U.S. 646, 653, n. 10, 103 S.Ct. 3255, 3260, n. 10, 77 L.Ed.2d 911 (1983); Board of Trade of Chicago v. Christie Grain & Stock Co., 198 U.S. 236, 250- 251, 25 S.Ct. 637, 639-40, 49 L.Ed. 1031 (1905); cf. 5 U.S.C. s 552(b)(4). "Confidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right and benefit, and which a court of equity will protect through the injunctive process or other appropriate remedy." 3 W. Fletcher, Cyclopedia of Law of Private Corporations s 857.1, p. 260 (rev. ed. 1986) (footnote omitted). The Journal had a property right in keeping confidential and making exclusive use, prior to publication, of the schedule and contents of the "Heard" column. Christie Grain, supra. As the Court has observed before: "[N]ews matter, however little susceptible of ownership or dominion in the absolute sense, is stock in trade, to be gathered at the cost of enterprise, organization, skill, labor, and money, and to be distributed and sold to those who will pay money for it, as for any other merchandise." International News Service v. Associated Press, 248 U.S. 215, 236, 39 S.Ct. 68, 71, 63 L.Ed. 211 (1918).

[3] Petitioners' arguments that they did not interfere with the Journal's use of the information or did not publicize it and deprive the Journal of the first public use of it, see Reply Brief for Petitioners 6, miss the point. The confidential information was generated from the business, and the business had a right to decide how to use it prior to disclosing it to the public. Petitioners cannot successfully contend based on Associated Press that a scheme to defraud requires a monetary loss, such as giving the information to a competitor; it is sufficient that the Journal has been deprived of its right to exclusive use of the information, for exclusivity is an important aspect of confidential business information and most private property for that matter.

[4] We cannot accept petitioners' further argument that Winans' conduct in revealing prepublication information was no more than a violation of workplace rules and did not amount to fraudulent activity that is proscribed by the mail fraud statute. Sections 1341 and 1343 reach any scheme to deprive another of money or property by means of false or fraudulent pretenses, representations, or promises. As we observed last Term in McNally, the words "to defraud" in the mail fraud statute have the "common understanding" of " 'wronging one in his property rights by dishonest methods or schemes,' and 'usually signify the deprivation of something of value by trick, deceit, chicane or overreaching.' " 483 U.S., at 358, 107 S.Ct., at 2881 (quoting Hammerschmidt v. United States, 265 U.S. 182, 188, 44 S.Ct. 511, 512, 68 L.Ed. 968 (1924)). The concept of "fraud" includes the

act of embezzlement, which is " 'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.' " Grin v. Shine, 187 U.S. 181, 189, 23 S.Ct. 98, 102, 47 L.Ed. 130 (1902).

The District Court found that Winans' undertaking at the Journal was not to reveal prepublication information about his column, a promise that became a sham when in violation of his duty he passed along to his co-conspirators confidential information belonging to the Journal, pursuant to an ongoing scheme to share profits from trading in anticipation of the "Heard" column's impact on the stock market. In Snepp v. United States, 444 U.S. 507, 515, n. 11, 100 S.Ct. 763, 768, n. 11, 62 L.Ed.2d 704 (1980) (per curiam), although a decision grounded in the provisions of a written trust agreement prohibiting the unapproved use of confidential Government information, we noted the similar prohibitions of the common law, that "even in the absence of a written contract, an
employee has a fiduciary obligation to protect confidential information obtained during the course of his employment." As the New York courts have recognized: "It is well established, as a general proposition, that a person who acquires special knowledge or
information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom." Diamond v. Oreamuno, 24 N.Y.2d 494, 497, 301 N.Y.S.2d 78, 80, 248 N.E.2d 910, 912 (1969); see also Restatement (Second) of Agency ss 388, Comment c, 396(c) (1958).

We have little trouble in holding that the conspiracy here to trade on the Journal's confidential information is not outside the reach of the mail and wire fraud statutes, provided the other elements of the offenses are satisfied. The Journal's business information that it intended to be kept confidential was its property; the declaration to that effect in the employee manual merely removed any doubts on that score and made the finding of specific intent to defraud that much easier. Winans continued in the employ of the Journal, appropriating its confidential business information for his own use, all the while pretending to perform his duty of safeguarding it. In fact, he told his editors twice about leaks of confidential information not related to the stock-trading scheme, 612 F.Supp., at 831, demonstrating both his knowledge that the Journal viewed information concerning the "Heard" column as confidential and his deceit as he played the role of a loyal employee. Furthermore, the District Court's conclusion that each of the petitioners acted with the required specific intent to defraud is strongly supported by the evidence.
Id., at 847-850.

[5] Lastly, we reject the submission that using the wires and the mail to print and send the Journal to its customers did not satisfy the requirement that those mediums be used to execute the scheme at issue. The courts below were quite right in observing that circulation of the "Heard" column was not only anticipated but an essential part of the scheme. Had the column not been made available to Journal customers, there would have been no effect on stock prices and no likelihood of profiting from the information leaked by Winans.

The judgment below is Affirmed.

Discussion points for United States v. Chestman

Under 10(b)-5 analysis, there is no wrongdoing unless there is a fiduciary duty owed. Chestman owes no fiduciary to anybody, so he should be clear on this one. But the law evolves, and the SEC has broad rule-making authority. So which rule did he violate?

UNITED STATES of America, Appellee,
v.
Robert CHESTMAN, Defendant-Appellant.

No. 309, Docket 89-1276.

United States Court of Appeals,
Second Circuit.

Argued Nov. 9, 1990.

Decided Oct. 7, 1991.

MESKILL, Circuit Judge, joined by CARDAMONE, PRATT, MINER and ALTIMARI, Circuit Judges:

BACKGROUND

Robert Chestman is a stockbroker. Keith Loeb first sought Chestman's services in 1982, when Loeb decided to consolidate his and his wife's holdings in Waldbaum, Inc. (Waldbaum), a publicly traded company that owned a large supermarket chain. During their initial meeting, Loeb told Chestman that his wife was a granddaughter of Julia Waldbaum, a member of the board of directors of Waldbaum and the wife of its founder. Julia Waldbaum also was the mother of Ira Waldbaum, the president and controlling shareholder of Waldbaum. From 1982 to 1986, Chestman executed several transactions involving Waldbaum restricted and common stock for Keith Loeb. To facilitate some of these trades, Loeb sent Chestman a copy of his wife's birth certificate, which indicated that his wife's mother was Shirley Waldbaum Witkin.

On November 21, 1986, Ira Waldbaum agreed to sell Waldbaum to the Great Atlantic and

Pacific Tea Company (A & P). The resulting stock purchase agreement required Ira to tender a controlling block of Waldbaum shares to A & P at a price of $50 per share. Ira told three of his children, all employees of Waldbaum, about the pending sale two days later, admonishing them to keep the news quiet until a public announcement. He also told his sister, Shirley Witkin, and nephew, Robert Karin, about the sale, and offered to tender their shares along with his controlling block of shares to enable them to avoid the administrative difficulty of tendering after the public announcement. He cautioned them "that [the sale was] not to be discussed," that it was to remain confidential.

In spite of Ira's counsel, Shirley told her daughter, Susan Loeb, on November 24 that Ira was selling the company. Shirley warned Susan not to tell anyone except her husband, Keith Loeb, because disclosure could ruin the sale. The next day, Susan told her husband about the pending tender offer and cautioned him not to tell anyone because "it could possibly ruin the sale."

The following day, November 26, Keith Loeb telephoned Robert Chestman at 8:59 a.m. Unable to reach Chestman, Loeb left a message asking Chestman to call him "ASAP." According to Loeb, he later spoke with Chestman between 9:00 a.m. and 10:30 a.m. that morning and told Chestman that he had "some definite, some accurate information" that Waldbaum was about to be sold at a "substantially higher" price than its market value. Loeb asked Chestman several times what he thought Loeb should do. Chestman responded that he could not advise Loeb what to do "in a situation like this" and that Loeb would have to make up his own mind.

That morning Chestman executed several purchases of Waldbaum stock. At 9:49 a.m., he bought 3,000 shares for his own account at $24.65 per share. Between 11:31 a.m. and 12:35 p.m., he purchased an additional 8,000 shares for his clients' discretionary accounts at prices ranging from $25.75 to $26.00 per share. One of the discretionary accounts was the Loeb account, for which Chestman bought 1,000 shares.

Before the market closed at 4:00 p.m., Loeb claims that he telephoned Chestman a second time. During their conversation Loeb again pressed Chestman for advice. Chestman repeated that he could not advise Loeb "in a situation like this," but then said that, based on his research, Waldbaum was a "buy." Loeb subsequently ordered 1,000 shares of Waldbaum stock.

Chestman presented a different version of the day's events. Before the SEC and at trial, he claimed that he had purchased Waldbaum stock based on his own research. He stated that his purchases were consistent with previous purchases of Waldbaum stock and other retail food stocks and were supported by reports in trade publications as well as the unusually high trading volume of the stock on November 25. He denied having spoken to Loeb about Waldbaum stock on the day of the trades.

At the close of trading on November 26, the tender offer was publicly announced. Waldbaum stock rose to $49 per share the next business day. In December 1986 Loeb

learned that the National Association of Securities Dealers had started an investigation concerning transactions in Waldbaum stock. Loeb contacted Chestman who, according to Loeb, "reassured" him that Chestman had bought the stock for Loeb's account based on his research. Loeb called Chestman again in April 1987 after learning of an SEC investigation into the trading of Waldbaum stock. Chestman again stated that he bought the stock based on research. Similar conversations ensued. After one of these conversations, Chestman asked Loeb what his "position" was, Loeb replied, "I guess it's the same thing." Loeb subsequently agreed, however, to cooperate with the government. The terms of his cooperation agreement required that he disgorge the $25,000 profit from his purchase and sale of Waldbaum stock and pay a $25,000 fine.

A grand jury returned an indictment on July 20, 1988, charging Chestman with the following counts of insider trading and perjury: ten counts of fraudulent trading in connection with a tender offer in violation of Rule 14e-3(a), ten counts of securities fraud in violation of Rule 10b-5, ten counts of mail fraud, and one count of perjury in connection with his testimony before the SEC. The district court thereafter denied Chestman's motion to dismiss the indictment. 704 F.Supp. 451 (S.D.N.Y.1989). After a jury trial, Chestman was found guilty on all counts.

Chestman appealed. He claimed that Rule 14e-3(a) was invalid because the SEC had exceeded its statutory authority in promulgating a rule that dispensed with one of the common law elements of fraud. He also argued that there was insufficient evidence to sustain his Rule 10b-5, mail fraud and perjury convictions.

A panel of this Court reversed Chestman's convictions on all counts, issuing three separate opinions on the Rule 14e-3(a) charges. 903 F.2d 75 (2d Cir.1990). Familiarity with the panel's opinions is assumed.

A majority of the active judges of the Court voted to rehear in banc the panel's decision with respect to the Rule 14e-3(a), Rule 10b-5, and mail fraud convictions. We directed the parties to file additional briefs on these issues and heard oral argument on November 9, 1990.

DISCUSSION

A. Rule 14e-3(a)

Chestman challenges his Rule 14e-3(a) convictions on three grounds. He first contends that the SEC exceeded its rulemaking authority when it promulgated Rule 14e-3(a). He then argues that the government presented insufficient evidence to support these convictions. Finally, he contends that his convictions should be overturned on due process notice grounds. We begin with his facial attack on the validity of Rule 14e-3(a).

1. Validity of Rule 14e-3(a)

[1] Chestman's first challenge concerns the validity of a rule prescribed by the SEC pursuant to a congressional delegation of rulemaking authority. The question presented is whether Rule 14e-3(a) represents a proper exercise of the SEC's statutory authority. While we have

not heretofore addressed this question, several district court judges in this Circuit have concluded that Rule 14e-3(a) represents a valid exercise of rulemaking authority.

****

In sum, the language and legislative history of section 14(e), as well as congressional inactivity toward it since the SEC promulgated Rule 14e-3(a), all support the view that Congress empowered the SEC to prescribe a rule that extends beyond the common law.

Chestman points to nothing in the language or legislative history of section 14(e) to refute our construction of the statute. Instead he relies principally on Chiarella v. United States, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980), and Schreiber, 472 U.S. 1, 105 S.Ct. 2458, to advance his argument that section 14(e) parallels common law fraud. That reliance is misplaced.

Chiarella considered whether trading stock on the basis of material nonpublic information in the absence of a fiduciary breach constitutes fraud under section 10(b). Confronted with both congressional and SEC silence on the issue, see section 10(b) and Rule 10b-5, the Court applied common law principles of fraud. It concluded, based on those principles, that liability under section 10(b) requires a fiduciary breach.

Several factors limit Chiarella's precedential value in this case. First, Chiarella of course concerns section 10(b), not section 14(e). Section 10(b) is a general antifraud statute, while section 14(e) is an antifraud provision specifically tailored to the field of tender offers, an area of the securities industry that, the Williams Act makes clear, deserves special regulation.

[4] That leaves Chestman with the dubious argument that, while he had notice that Rule 14e-3(a) prohibited his activity, he could not have known whether a court would find the rule valid. Due process does not extend this far. When statutory language provides notice that conduct is illegal, the notice requirements of due process have been met. The government need not await every conceivable challenge to a law's validity before it prosecutes conduct covered by a statute. Chestman "treaded closely enough along proscribed lines ... to find that [he] had adequate notice of the illegality of [his] acts." United States v. Carpenter, 791 F.2d 1024, 1034 (2d Cir.1986), aff'd, 484 U.S. 19, 108 S.Ct. 316, 98 L.Ed.2d 275 (1987).

B. Rule 10b-5

Chestman's Rule 10b-5 convictions were based on the misappropriation theory, which provides that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5." SEC v. Materia, 745 F.2d 197, 203 (2d Cir.1984), cert. denied, 471 U.S. 1053, 105 S.Ct. 2112, 85 L.Ed.2d 477 (1985). With respect to the shares Chestman purchased on behalf of Keith Loeb, Chestman was convicted of aiding and abetting Loeb's misappropriation of nonpublic information in breach of a duty Loeb owed to the Waldbaum family and to his wife Susan. As to the shares Chestman purchased for himself and his other clients,

Chestman was convicted as a "tippee" of that same misappropriated information. Thus, while Chestman is the defendant in this case, the alleged misappropriator was Keith Loeb. The government agrees that Chestman's convictions cannot be sustained unless there was sufficient evidence to show that (1) Keith Loeb breached a duty owed to the Waldbaum family or Susan Loeb based on a fiduciary or similar relationship of trust and confidence, and (2) Chestman knew that Loeb had done so. We have heretofore never applied the misappropriation theory--and its predicate requirement of a fiduciary breach--in the context of family relationships. As a prologue to that analysis, we canvass past Rule 10b-5 jurisprudence.

Section 10(b) prohibits the use "in connection with the purchase or sale of any security ... [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j(b). Pursuant to that mandate, the SEC promulgated Rule 10b-5, which, in pertinent part, makes it unlawful "[t]o employ any device, scheme, or artifice to defraud" or "[t]o engage in any act ... which operates ... as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1988). While more than one interpretation has been given to this expansive language, fraud has remained the centerpiece of a Rule 10b-5 criminal violation. At this juncture, two general theories of Rule 10b-5 fraud have emerged to fill the interstitial gaps of the rule.

1. Traditional Theory of Rule 10b-5 Liability

[5] The traditional theory of insider trader liability derives principally from the Supreme Court's holdings in Chiarella, 445 U.S. 222, 100 S.Ct. 1108, and Dirks v. SEC, 463 U.S. 646, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983). A securities trader commits Rule 10b-5 fraud, the Chiarella Court held, only if he "fails to disclose material information prior to the consummation of a transaction ... when he is under a duty to do so." Chiarella, 445 U.S. at 228, 100 S.Ct. at 1114. The Chiarella Court then delineated when a person possessing material nonpublic information owes such a duty--what it called "[t]he obligation to disclose or abstain" from trading. Id. at 227, 100 S.Ct. at 1114. It held that this duty "does not arise from the mere possession of nonpublic market information." Id. at 235, 100 S.Ct. at 1118. That is, the duty inquiry does not turn on whether the parties to the transaction have "equal information." Dirks, 463 U.S. at 657, 103 S.Ct. at 3263 (construing Chiarella). Rather, a duty to disclose or abstain arises only from " 'a fiduciary or other similar relation of trust and confidence between [the parties to the transaction].' " Chiarella, 445 U.S. at 228, 100 S.Ct. at 1114 (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

In Dirks, an action concerning the liability of a tippee of material nonpublic information, the Court built on its holding in Chiarella. Dirks again rejected a parity of information theory of Rule 10b-5 liability, reiterating the "requirement of a specific relationship between the shareholders and the individual trading on inside information." Dirks, 463 U.S. at 655, 103 S.Ct. at 3261. It then examined when a tippee inherits a fiduciary duty to the corporation's shareholders to disclose or refrain from trading. Noting the "derivative" nature of tippee liability, id. at 659, 103 S.Ct. at 3264, the Court held that tippee liability attaches only when

an "insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." Id. at 660, 103 S.Ct. at 3264.

Dirks established, in dictum, an additional means by which erstwhile outsiders become fiduciaries of a corporation's shareholders. Justice Powell explained:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.... For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

Id. at 655 n. 14, 103 S.Ct. at 3262 n. 14 (citations omitted). This theory clothes an outsider with temporary insider status when the outsider obtains access to confidential information solely for corporate purposes in the context of "a special confidential relationship." The temporary insider thereby acquires a correlative fiduciary duty to the corporation's shareholders.

[6] Binding these strands of Rule 10b-5 liability are two principles-- one, the predicate act of fraud must be traceable to a breach of duty to the purchasers or sellers of securities, two, a fiduciary duty does not run to the purchasers or sellers solely as a result of one's possession of material nonpublic information.

> FN2. The insider's fiduciary duties, it should be noted, run to a buyer (a shareholder-to-be) and to a seller (a pre-existing shareholder) of securities, even though the buyer technically does not have a fiduciary relationship with the insider prior to the trade. As the Court explained in Chiarella:
> The transaction in Cady, Roberts involved sale of stock to persons who previously may not have been shareholders in the corporation. The Commission embraced the reasoning of Judge Learned Hand that "the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one."

2. Misappropriation Theory

[7] The second general theory of Rule 10b-5 liability, the misappropriation theory, has not yet been the subject of a Supreme Court holding, but has been adopted in the Second, Third, Seventh and Ninth Circuits. See, e.g., SEC v. Cherif, 933 F.2d 403 (7th Cir.1991); SEC v. Clark, 915 F.2d 439 (9th Cir.1990); Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir.1985), rev'd on other grounds after remand, 808 F.2d 252 (3d Cir.1986), cert. denied, 481 U.S. 1017, 107 S.Ct. 1895, 95 L.Ed.2d 501 (1987); United States v. Newman, 664 F.2d 12 (2d

Cir.1981), aff'd after remand, 722 F.2d 729 (2d Cir.1983), cert. denied, 464 U.S. 863, 104 S.Ct. 193, 78 L.Ed.2d 170 (1983). Under this theory, a person violates Rule 10b-5 when he misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction. See, e.g., Carpenter, 791 F.2d at 1028-29; Materia, 745 F.2d at 201; Newman, 664 F.2d at 17-18. In contrast to Chiarella and Dirks, the misappropriation theory does not require that the buyer or seller of securities be defrauded. Newman, 664 F.2d at 17. Focusing on the language "fraud or deceit upon any person" (emphasis added), we have held that the predicate act of fraud may be perpetrated on the source of the nonpublic information, even though the source may be unaffiliated with the buyer or seller of securities. See Carpenter, 791 F.2d at 1032. To date we have applied the theory only in the context of employment relationships. See Carpenter, 791 F.2d at 1032 (financial columnist breached duty to his newspaper); Materia, 745 F.2d at 202 (copyholder breached duty to his printing company); Newman, 664 F.2d at 17 (investment banker breached duty to his firm). District courts in this Circuit have applied the theory in other settings as well as in the employment context. See, e.g., United States v. Willis, 737 F.Supp. 269 (S.D.N.Y.1990) (denying motion to dismiss indictment of psychiatrist who traded on the basis of information obtained from patient, in breach of duty arising from relationship of trust and confidence); United States v. Reed, 601 F.Supp. 685 (S.D.N.Y.), rev'd on other grounds, 773 F.2d 477 (2d Cir.1985) (allegation that son breached fiduciary duty to father, a corporate director, withstood motion to dismiss indictment); SEC v. Musella, 578 F.Supp. 425 (S.D.N.Y.1984) (office services manager of law firm breached duty to law firm and its clients by trading on the basis of material nonpublic information acquired in the course of his employment).

FN3. In Carpenter v. United States, 484 U.S. 19, 24, 108 S.Ct. 316, 320, 98 L.Ed.2d 275 (1987), an "evenly divided" Court affirmed the securities fraud convictions brought pursuant to the misappropriation theory. An affirmance by an evenly divided court is "not entitled to precedential weight." See Neil v. Biggers, 409 U.S. 188, 192, 93 S.Ct. 375, 379, 34 L.Ed.2d 401 (1972). Thus, Supreme Court support for the misappropriation theory is still unclear.

One point at which the misappropriation theory and the traditional theory of insider trading merge warrants brief consideration. Our first applications of the misappropriation theory, in Newman and Materia, concerned conduct that occurred before the Supreme Court's holding in Dirks. Dirks noted that an outsider could obtain temporary insider status by gaining access to confidential information through certain relationships with a corporation--as, for example, an underwriter, lawyer or consultant. 463 U.S. at 655 n. 14, 103 S.Ct. at 3262 n. 14. A temporary insider theory of prosecution might well have covered the activities of the investment banker in Newman and the printer in Materia. In Newman and Materia, the defendants appeared to have "entered into a special confidential relationship in the conduct of the business of the enterprise and [were] given access to information solely for corporate purposes." Dirks, 463 U.S. at 655 n. 14, 103 S.Ct. at 3262 n. 14. In view of the overlap between Newman and Materia on the one hand and the Dirks concept of temporary insiders on the other, we arguably did not break ranks with the traditional theory of insider trading until our holding in Carpenter. In Carpenter none of the prongs of liability under the

traditional theory applied. That is, the defendants did not owe the people with whom they traded a duty to disclose or abstain from trading--absent resurrection of the twice- rejected parity of information theory. Carpenter, then, represents the first fact pattern we have considered that is clearly beyond the pale of the traditional theory of insider trading.

After Carpenter, the fiduciary relationship question takes on special importance. This is because a fraud-on-the-source theory of liability extends the focus of Rule 10b-5 beyond the confined sphere of fiduciary/shareholder relations to fiduciary breaches of any sort, a particularly broad expansion of 10b-5 liability if the add-on, a "similar relationship of trust and confidence," is construed liberally. One concern triggered by this broadened inquiry is that fiduciary duties are circumscribed with some clarity in the context of shareholder relations but lack definition in other contexts. See generally Reed, 601 F.Supp. 685 (and authorities cited therein). Tethered to the field of shareholder relations, fiduciary obligations arise within a narrow, principled sphere. The existence of fiduciary duties in other common law settings, however, is anything but clear. Our Rule 10b-5 precedents under the misappropriation theory, moreover, provide little guidance with respect to the question of fiduciary breach, because they involved egregious fiduciary breaches arising solely in the context of employer/employee associations. See Carpenter, 791 F.2d at 1028 ("It is clear that defendant Winans ... breached a duty of confidentiality to his employer"); Newman, 664 F.2d at 17 ("we need spend little time on the issue of fraud and deceit"); Materia, 745 F.2d at 201 (same). For these reasons we tread cautiously in extending the misappropriation theory to new relationships, lest our efforts to construe Rule 10b-5 lose method and predictability, taking over "the whole corporate universe." United States v. Chiarella, 588 F.2d 1358, 1377 (2d Cir.1978) (Meskill, J., dissenting) (quoting Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 480, 97 S.Ct. 1292, 1304, 51 L.Ed.2d 480 (1977)), rev'd, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980).

3. Fiduciary Duties and Their Functional Equivalent

[8] Against this backdrop, we turn to our central inquiry--what constitutes a fiduciary or similar relationship of trust and confidence in the context of Rule 10b-5 criminal liability? We begin by noting two factors that do not themselves create the necessary relationship.

[9] First, a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information. Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir.1980) (applying Delaware law). Walton concerned the conduct of an investment bank, Morgan Stanley. While investigating possible takeover targets for one of its clients, Morgan Stanley obtained unpublished material information (internal earnings reports) on a confidential basis from a prospective target, Olinkraft. After its client abandoned the planned takeover, Morgan Stanley was charged with trading in Olinkraft's stock on the basis of the confidential information. Observing that the parties had bargained at "arm's length" and that there had not been a pre-existing agreement of confidentiality between Morgan Stanley and Olinkraft, we rejected the argument that

> Morgan Stanley became a fiduciary of Olinkraft by virtue of the receipt of the confidential information.... [T]he fact that the information was confidential did nothing, in and of itself,

> to change the relationship between Morgan Stanley and Olinkraft's management. Put bluntly, although, according to the complaint, Olinkraft's management placed its confidence in Morgan Stanley not to disclose the information, Morgan Stanley owed no duty to observe that confidence.

Walton, 623 F.2d at 799. See also Dirks, 463 U.S. at 662 n. 22, 103 S.Ct. at 3265 n. 22 (citing Walton approvingly as "a case turning on the court's determination that the disclosure did not impose any fiduciary duties on the recipient of the inside information"). Reposing confidential information in another, then, does not by itself create a fiduciary relationship.

[10][11] Second, marriage does not, without more, create a fiduciary relationship. " '[M]ere kinship does not of itself establish a confidential relation.' ... Rather, the existence of a confidential relationship must be determined independently of a preexisting family relationship." Reed, 601 F.Supp. at 706 (quoting G.G. Bogert, The Law of Trusts and Trustees § 482, at 300-11 (Rev. 2d ed. 1978)) (other citations omitted). Although spouses certainly may by their conduct become fiduciaries, the marriage relationship alone does not impose fiduciary status. In sum, more than the gratuitous reposal of a secret to another who happens to be a family member is required to establish a fiduciary or similar relationship of trust and confidence.

We take our cues as to what is required to create the requisite relationship from the securities fraud precedents and the common law. See Chiarella, 445 U.S. at 227-30, 100 S.Ct. at 1114-16. The common law has recognized that some associations are inherently fiduciary. Counted among these hornbook fiduciary relations are those existing between attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder. Reed, 601 F.Supp. at 704 (citing Coffee, From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics, 19 Am.Crim.L.Rev. 117, 150 (1981); and Scott, The Fiduciary Principle, 37 Cal.L.Rev. 539, 541 (1949)); Black's Law Dictionary 564 (5th ed. 1979). While this list is by no means exhaustive, it is clear that the relationships involved in this case--those between Keith and Susan Loeb and between Keith Loeb and the Waldbaum family--were not traditional fiduciary relationships.

[12] That does not end our inquiry, however. The misappropriation theory requires us to consider not only whether there exists a fiduciary relationship but also whether there exists a "similar relationship of trust and confidence." As the term "similar" implies, a "relationship of trust and confidence" must share the essential characteristics of a fiduciary association. Absent reference to the adjective "similar," interpretation of a "relationship of trust and confidence" becomes an exercise in question begging. Consider: when one entrusts a secret (read confidence) to another, there then exists a relationship of trust and confidence. Walton, however, instructs that entrusting confidential information to another does not, without more, create the necessary relationship and its correlative duty to maintain the confidence. A "similar relationship of trust and confidence," therefore, must be the functional equivalent of a fiduciary relationship. To determine whether such a relationship exists, we must ascertain the characteristics of a fiduciary relationship.

"[A]t the heart of the fiduciary relationship" lies "reliance, and de facto control and dominance." United States v. Margiotta, 688 F.2d 108, 125 (2d Cir.1982) (citations omitted) (nonpublic office holder found to owe a fiduciary duty to general citizenry, breach of which created predicate for violation of mail fraud statute) (construing New York law), cert. denied, 461 U.S. 913, 103 S.Ct. 1891, 77 L.Ed.2d 282 (1983). The relation "exists when confidence is reposed on one side and there is resulting superiority and influence on the other." Mobil Oil Corp. v. Rubenfeld, 72 Misc.2d 392, 400, 339 N.Y.S.2d 623, 632 (Civ.Ct.1972) (discussing fiduciary duty in the franchisee context), aff'd, 77 Misc.2d 962, 357 N.Y.S.2d 589 (Sup.Ct.App.1974), rev'd on other grounds, 48 A.D.2d 428, 370 N.Y.S.2d 943 (2d Dep't 1975), aff'd, 40 N.Y.2d 936, 390 N.Y.S.2d 57, 358 N.E.2d 882 (1976)). One acts in a "fiduciary capacity" when

> the business which he transacts, or the money or property which he handles, is not his own or for his own benefit, but for the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part.

Black's Law Dictionary 564 (5th ed. 1979). See also 29 U.S.C. § 1002(21)(A) (defining a fiduciary for purposes of ERISA as one "who exercises any discretionary authority or discretionary control").

[13][14] A fiduciary relationship involves discretionary authority and dependency: One person depends on another--the fiduciary--to serve his interests. In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use. What has been said of an agent's duty of confidentiality applies with equal force to other fiduciary relations: "an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency." Restatement (Second) of Agency § 395 (1958). These characteristics represent the measure of the paradigmatic fiduciary relationship. A similar relationship of trust and confidence consequently must share these qualities.

In Reed, 601 F.Supp. 685, the district court confronted the question whether these principal characteristics of a fiduciary relationship--dependency and influence--were necessary factual prerequisites to a similar relationship of trust and confidence. There a member of the board of directors of Amax, Gordon Reed, disclosed to his son on several occasions confidential information concerning a proposed tender offer for Amax. Allegedly relying on this information, the son purchased Amax stock call options. The son was subsequently indicted for violating, among other things, Rule 10b-5 based on breach of a fiduciary duty arising between the father and son. The son then moved to dismiss the indictment, contending that he did not breach a fiduciary duty to his father. The district court sustained the indictment.

[15] Both the government and Chestman rely on Reed. The government draws on Reed's application of the misappropriation theory in the family context and its expansive construction of relationships of trust and confidence. Chestman, without challenging the

holding in Reed, argues that Reed cannot sustain his Rule 10b-5 convictions because, unlike Reed senior and junior, Keith and Susan Loeb did not customarily repose confidential business information in one another. Neither party challenges the holding of Reed. And we decline to do so sua sponte. To remain consistent with our interpretation of a "similar relationship of trust and confidence," however, we limit Reed to its essential holding: the repeated disclosure of business secrets between family members may substitute for a factual finding of dependence and influence and thereby sustain a finding of the functional equivalent of a fiduciary relationship. We note, in this regard, that Reed repeatedly emphasized that the father and son "frequently discussed business affairs." Id. at 690; see also id. at 705, 709, 717-18.

We recognize, as Reed did, that equity has occasionally established a less rigorous threshold for a fiduciary-like relationship in order to right civil wrongs arising from non-compliance with the statute of frauds, statute of wills and parol evidence rule. See Bogert, supra § 482, at 286 (explaining that equity's flexible treatment of confidential relationships has been particularly useful in evading the harsh consequences of the statute of frauds). Commenting on the boundless nature of relations of trust and confidence, one scholar observed:

> Equity has never bound itself by any hard and fast definition of the phrase "confidential relation" and has not listed all the necessary elements of such a relation, but has reserved discretion to apply the doctrine whenever it believes that a suitable occasion has arisen.

Reed, 601 F.Supp. at 712 n. 38 (quoting G.G. Bogert, The Law of Trusts and Trustees § 482, at 284-86 (Rev. 2d ed. 1978)). Useful as such an elastic and expedient definition of confidential relations, i.e., relations of trust and confidence, may be in the civil context, it has no place in the criminal law. A "suitable occasion" test for determining the presence of criminal fraud would offend not only the rule of lenity but due process as well. See Chiarella, 445 U.S. at 235 n. 20, 100 S.Ct. at 1118 n. 20 ("a judicial holding that certain undefined activities 'generally are prohibited' by § 10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity"). See also Dirks, 463 U.S. at 658 n. 17, 103 S.Ct. at 3263 n. 17 (In rejecting an SEC variation on the parity of information theory, the Court wrote: "[T]his rule is inherently imprecise, and imprecision prevents parties from ordering their actions in accord with legal requirements."). More than a perfunctory nod at the rule of lenity, then, is required. We will not apply outer permutations of chancery relief in addressing what is frequently the core inquiry in a Rule 10b-5 criminal conviction--whether a fiduciary duty has been breached.

4. Application of the Law of Fiduciary Duties

[16] The alleged misappropriator in this case was Keith Loeb. According to the government's theory of prosecution, Loeb breached a fiduciary duty to his wife Susan and the Waldbaum family when he disclosed to Robert Chestman information concerning a pending tender offer for Waldbaum stock. Chestman was convicted as an aider and abettor of the misappropriation and as a tippee of the misappropriated information. Convictions under both theories, the government concedes, required the government to establish two critical elements--Loeb breached a fiduciary duty to Susan Loeb or to the Waldbaum family and Chestman knew that Loeb had done so.

Chestman challenges the sufficiency of the evidence to establish each of these elements of the convictions. Although such a challenge carries a "heavy burden," United States v. Chang An-Lo, 851 F.2d 547, 553 (2d Cir.), cert. denied, 488 U.S. 966, 109 S.Ct. 493, 102 L.Ed.2d 530 (1988), that burden was carried here.

We have little trouble finding the evidence insufficient to establish a fiduciary relationship or its functional equivalent between Keith Loeb and the Waldbaum family. The government presented only two pieces of evidence on this point. The first was that Keith was an extended member of the Waldbaum family, specifically the family patriarch's (Ira Waldbaum's) "nephew-in-law." The second piece of evidence concerned Ira's discussions of the business with family members. "My children," Ira Waldbaum testified, "have always been involved with me and my family and they know we never speak about business outside of the family." His earlier testimony indicates that the "family" to which he referred were his "three children who were involved in the business."

Lending this evidence the reasonable inferences to which it is entitled, United States v. Zabare, 871 F.2d 282, 286 (2d Cir.), cert. denied, 493 U.S. 856, 110 S.Ct. 161, 107 L.Ed.2d 119 (1989), it falls short of establishing the relationship necessary for fiduciary obligations. Kinship alone does not create the necessary relationship. The government proffered nothing more to establish a fiduciary-like association. It did not show that Keith Loeb had been brought into the family's inner circle, whose members, it appears, discussed confidential business information either because they were kin or because they worked together with Ira Waldbaum. Keith was not an employee of Waldbaum and there was no showing that he participated in confidential communications regarding the business. The critical information was gratuitously communicated to him. The disclosure did not serve the interests of Ira Waldbaum, his children or the Waldbaum company. Nor was there any evidence that the alleged relationship was characterized by influence or reliance of any sort. Measured against the principles of fiduciary relations, the evidence does not support a finding that Keith Loeb and the Waldbaum family shared either a fiduciary relation or its functional equivalent.

[17] The government's theory that Keith breached a fiduciary duty of confidentiality to Susan suffers from similar defects. The evidence showed: Keith and Susan were married; Susan admonished Keith not to disclose that Waldbaum was the target of a tender offer; and the two had shared and maintained confidences in the past.

Keith's status as Susan's husband could not itself establish fiduciary status. Nor, absent a pre-existing fiduciary relation or an express agreement of confidentiality, could the coda--"Don't tell." That leaves the unremarkable testimony that Keith and Susan had shared and maintained generic confidences before. The jury was not told the nature of these past disclosures and therefore it could not reasonably find a relationship that inspired fiduciary, rather than normal marital, obligations.

[18] In the absence of evidence of an explicit acceptance by Keith of a duty of confidentiality, the context of the disclosure takes on special import. While acceptance may

be implied, it must be implied from a pre-existing fiduciary-like relationship between the parties. Here the government presented the jury with insufficient evidence from which to draw a rational inference of implied acceptance. Susan's disclosure of the information to Keith served no purpose, business or otherwise. The disclosure also was unprompted. Keith did not induce her to convey the information through misrepresentation or subterfuge. Superiority and reliance, moreover, did not mark this relationship either before or after the disclosure of the confidential information. Nor did Susan's dependence on Keith to act in her interests for some purpose inspire the disclosure. The government failed even to establish a pattern of sharing business confidences between the couple. The government, therefore, failed to offer sufficient evidence to establish the functional equivalent of a fiduciary relation.

In sum, because Keith owed neither Susan nor the Waldbaum family a fiduciary duty or its functional equivalent, he did not defraud them by disclosing news of the pending tender offer to Chestman. Absent a predicate act of fraud by Keith Loeb, the alleged misappropriator, Chestman could not be derivatively liable as Loeb's tippee or as an aider and abettor. Therefore, Chestman's Rule 10b-5 convictions must be reversed.

CONCLUSION

Accordingly, we affirm the Rule 14e-3(a) convictions and reverse the Rule 10b-5 and mail fraud convictions. The reversal of these convictions does not warrant reconsideration of the sentence since the sentences on the Rule 10b-5 and mail fraud convictions are concurrent with the sentences in the Rule 14(e)-3(a) counts. The panel's reversal of the perjury conviction remains intact.

United States v. O'Hagan

Supreme Court of the United States

UNITED STATES, Petitioner,
v.
James Herman **O'HAGAN**.

No. 96-842.

Argued April 16, 1997.
Decided June 25, 1997.

Justice GINSBURG delivered the opinion of the Court.

This case concerns the interpretation and enforcement of § 10(b) and § 14(e) of the Securities Exchange Act of 1934, and rules made by the Securities and Exchange Commission pursuant to these provisions, Rule 10b-5 and Rule 14e- 3(a). Two prime questions are presented. The first relates to the misappropriation of material, nonpublic information for securities trading; the second concerns fraudulent practices in the tender offer setting. In particular, we address and resolve these issues: (1) Is a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, guilty of violating § 10(b) and Rule 10b-5? (2) Did the Commission exceed its rulemaking authority by adopting Rule 14e-3(a), which proscribes trading on undisclosed information in the tender offer setting, even in the absence of a duty to disclose? Our answer to the first question is yes, and to the second question, viewed in the context of this case, no.

I

Respondent James Herman O'Hagan was a partner in the law firm of Dorsey & Whitney in Minneapolis, Minnesota. In July 1988, Grand Metropolitan PLC (Grand Met), a company based in London, England, retained Dorsey & Whitney as local counsel to represent Grand Met regarding a potential tender offer for the common stock of the Pillsbury Company, headquartered in Minneapolis. Both Grand Met and Dorsey & Whitney took precautions to protect the confidentiality of Grand Met's tender offer plans. O'Hagan did no work on the Grand Met representation. Dorsey & Whitney withdrew from representing Grand Met on September 9, 1988. Less than a month later, on October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock.

On August 18, 1988, while Dorsey & Whitney was still representing Grand Met, O'Hagan began purchasing call options for Pillsbury stock. Each option gave him the right to purchase 100 shares of Pillsbury stock by a specified date in September 1988. Later in August and in September, O'Hagan made additional purchases of Pillsbury call options. By the end of September, he owned 2,500 unexpired Pillsbury options, apparently more than any other individual investor. See App. 85, 148. O'Hagan also purchased, in September 1988, some 5,000 shares of Pillsbury common stock, at a price just under $39 per share. When Grand Met announced its tender offer in October, the price of Pillsbury stock rose to nearly $60 per share. O'Hagan then sold his Pillsbury call options and common stock, making a profit of more than $4.3 million.

The Securities and Exchange Commission (SEC or Commission) initiated an investigation into O'Hagan's transactions, culminating in a 57-count indictment. The indictment alleged that O'Hagan defrauded his law firm and its client, Grand Met, by using for his own trading purposes material, nonpublic information regarding Grand Met's planned tender offer. *Id.,* at 8. [FN1] According to the indictment, O'Hagan used the profits he gained through this trading to conceal his previous embezzlement and conversion of unrelated client trust funds. *Id.,* at 10. [FN2] O'Hagan was charged with 20 counts of mail fraud, in violation of 18

U.S.C. § 1341; 17 counts of securities fraud, in violation of § 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 48 Stat. 891, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 CFR § 240.10b-5 1996); 17 counts of fraudulent trading in connection with a tender offer, in violation of § 14(e) of the Exchange Act, 15 U.S.C. § 78n(e), and SEC Rule 14e-3(a), 17 CFR § 240.14e-3(a) (1996); and 3 counts of violating federal money laundering statutes, 18 U.S.C. § § 1956(a)(1)(B)(i), 1957. See App. 13-24. A jury convicted O'Hagan on all 57 counts, and he was sentenced to a 41-month term of imprisonment.

FN1. As evidence that O'Hagan traded on the basis of nonpublic information misappropriated from his law firm, the Government relied on a conversation between O'Hagan and the Dorsey & Whitney partner heading the firm's Grand Met representation. That conversation allegedly took place shortly before August 26, 1988. See Brief for United States 4. O'Hagan urges that the Government's evidence does not show he traded on the basis of nonpublic information. O'Hagan points to news reports on August 18 and 22, 1988, that Grand Met was interested in acquiring Pillsbury, and to an earlier, August 12, 1988, news report that Grand Met had put up its hotel chain for auction to raise funds for an acquisition. See Brief for Respondent 4 (citing App. 73-74, 78-80). O'Hagan's challenge to the sufficiency of the evidence remains open for consideration on remand.

FN2. O'Hagan was convicted of theft in state court, sentenced to 30 months' imprisonment, and fined. See *State v. O'Hagan,* 474 N.W.2d 613, 615, 623 (Minn.App.1991). The Supreme Court of Minnesota disbarred O'Hagan from the practice of law. See *In re O'Hagan,* 450 N.W.2d 571 (1990).

A divided panel of the Court of Appeals for the Eighth Circuit reversed all of O'Hagan's convictions. 92 F.3d 612 (1996). Liability under § 10(b) and Rule 10b-5, the Eighth Circuit held, may not be grounded on the "misappropriation theory" of securities fraud on which the prosecution relied. *Id.,* at 622. The Court of Appeals also held that Rule 14e-3(a)-- which prohibits trading while in possession of material, nonpublic information relating to a tender offer--exceeds the SEC's § 14(e) rulemaking authority because the Rule contains no breach of fiduciary duty requirement. *Id.,* at 627. The Eighth Circuit further concluded that O'Hagan's mail fraud and money laundering convictions rested on violations of the securities laws, and therefore could not stand once the securities fraud convictions were reversed. *Id.,* at 627-628. Judge Fagg, dissenting, stated that he would recognize and enforce the misappropriation theory, and would hold that the SEC did not exceed its rulemaking authority when it adopted Rule 14e-3(a) without requiring proof of a breach of fiduciary duty. *Id.,* at 628.

Decisions of the Courts of Appeals are in conflict on the propriety of the misappropriation theory under § 10(b) and Rule 10b-5, see *infra* this page and n. 3, and on the legitimacy of Rule 14e-3(a) under § 14(e), see *infra,* at 25. We granted certiorari, 519 U.S. 1087, 117

S.Ct. 759, 136 L.Ed.2d 695 (1997), and now reverse the Eighth Circuit's judgment.

II

We address first the Court of Appeals' reversal of O'Hagan's convictions under § 10(b) and Rule 10b-5. Following the Fourth Circuit's lead, see *United States v. Bryan,* 58 F.3d 933, 943-959 (1995), the Eighth Circuit rejected the misappropriation theory as a basis for § 10(b) liability. We hold, in accord with several other Courts of Appeals, [FN3] that criminal liability under § 10(b) may be predicated on the misappropriation theory. [FN4]

A

In pertinent part, § 10(b) of the Exchange Act provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--

.....

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b).

The statute thus proscribes (1) using any deceptive device (2) in connection with the purchase or sale of securities, in contravention of rules prescribed by the Commission. The provision, as written, does not confine its coverage to deception of a purchaser or seller of securities, see *United States v. Newman,* 664 F.2d 12, 17 (C.A.2 1981); rather, the statute reaches any deceptive device used "in connection with the purchase or sale of any security."

[3] Pursuant to its § 10(b) rulemaking authority, the Commission has adopted Rule 10b-5, which, as relevant here, provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud, [or]

.....

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security." 17 CFR § 240.10b-5 (1996).

Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)'s prohibition. See *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 214, 96 S.Ct. 1375, 1391, 47 L.Ed.2d 668 (1976) (scope of Rule 10b-5 cannot exceed power

Congress granted Commission under § 10(b)); see also *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N. A.,* 511 U.S. 164, 173, 114 S.Ct. 1439, 1446, 128 L.Ed.2d 119 (1994) ("We have refused to allow [private] 10b-5 challenges to conduct not prohibited by the text of the statute.").

[4][5][6] Under the "traditional" or "classical theory" of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under § 10(b), we have affirmed, because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." *Chiarella v. United States,* 445 U.S. 222, 228, 100 S.Ct. 1108, 1114, 63 L.Ed.2d 348 (1980). That relationship, we recognized, "gives rise to a duty to disclose [or to abstain from trading] because of the 'necessity of preventing a corporate insider from ... tak[ing] unfair advantage of ... uninformed ... stockholders.' " *Id.,* at 228-229, 100 S.Ct., at 1115 (citation omitted). The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation. See *Dirks v. SEC,* 463 U.S. 646, 655, n. 14, 103 S.Ct. 3255, 3262, 77 L.Ed.2d 911 (1983).

[7][8] The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. See Brief for United States 14. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.

[9] The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is thus designed to "protec [t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders." *Ibid.*

In this case, the indictment alleged that O'Hagan, in breach of a duty of trust and confidence he owed to his law firm, Dorsey & Whitney, and to its client, Grand Met, traded on the basis of nonpublic information regarding Grand Met's planned tender offer for Pillsbury common stock. App. 16. This conduct, the Government charged, constituted a fraudulent device in

connection with the purchase and sale of securities.

B

We agree with the Government that misappropriation, as just defined, satisfies § 10(b)'s requirement that chargeable conduct involve a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities. We observe, first, that misappropriators, as the Government describes them, deal in deception. A fiduciary who "[pretends] loyalty to the principal while secretly converting the principal's information for personal gain," Brief for United States 17, "dupes" or defrauds the principal. See Aldave, Misappropriation: A General Theory of Liability for Trading on Nonpublic Information, 13 Hofstra L.Rev. 101, 119 (1984).

We addressed fraud of the same species in *Carpenter v. United States,* 484 U.S. 19, 108 S.Ct. 316, 98 L.Ed.2d 275 (1987), which involved the mail fraud statute's proscription of "any scheme or artifice to defraud," 18 U.S.C. § 1341. Affirming convictions under that statute, we said in *Carpenter* that an employee's undertaking not to reveal his employer's confidential information "became a sham" when the employee provided the information to his co-conspirators in a scheme to obtain trading profits. 484 U.S., at 27, 108 S.Ct., at 321. A company's confidential information, we recognized in *Carpenter,* qualifies as property to which the company has a right of exclusive use. *Id.,* at 25-27, 108 S.Ct., at 320-321. The undisclosed misappropriation of such information, in violation of a fiduciary duty, the Court said in *Carpenter,* constitutes fraud akin to embezzlement-- " 'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.' " *Id.,* at 27, 108 S.Ct., at 317 (quoting *Grin v. Shine,* 187 U.S. 181, 189, 23 S.Ct. 98, 101-102, 47 L.Ed. 130 (1902)); see Aldave, 13 Hofstra L.Rev., at 119. *Carpenter* 's discussion of the fraudulent misuse of confidential information, the Government notes, "is a particularly apt source of guidance here, because [the mail fraud statute] (like Section 10(b)) has long been held to require deception, not merely the breach of a fiduciary duty." Brief for United States 18, n. 9 (citation omitted).

Deception through nondisclosure is central to the theory of liability for which the Government seeks recognition. As counsel for the Government stated in explanation of the theory at oral argument: "To satisfy the common law rule that a trustee may not use the property that [has] been entrusted [to] him, there would have to be consent. To satisfy the requirement of the Securities Act that there be no deception, there would only have to be disclosure." Tr. of Oral Arg. 12; see generally Restatement (Second) of Agency § § 390, 395 1958) (agent's disclosure obligation regarding use of confidential information). [FN6]

The misappropriation theory advanced by the Government is consistent with *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977), a decision underscoring that § 10(b) is not an all-purpose breach of fiduciary duty ban; rather, it trains on conduct involving manipulation or deception. See *id.,* at 473-476, 97 S.Ct., at 1300-1302. In contrast to the Government's allegations in this case, in *Santa Fe Industries,* all pertinent facts were disclosed by the persons charged with violating § 10(b) and Rule 10b-5, see *id.,* at 474, 97 S.Ct., at 1301; therefore, there was no deception through nondisclosure to

which liability under those provisions could attach, see *id.,* at 476, 97 S.Ct., at 1302. Similarly, full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no "deceptive device" and thus no § 10(b) violation--although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty. [FN7]

We turn next to the § 10(b) requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of [a] security." This element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information. See Aldave, 13 Hofstra L.Rev., at 120 ("a fraud or deceit can be practiced on one person, with resultant harm to another person or group of persons"). A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public. See *id.,* at 120-121, and n. 107.

The misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities. Should a misappropriator put such information to other use, the statute's prohibition would not be implicated. The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions.

The Government notes another limitation on the forms of fraud § 10(b) reaches: "The misappropriation theory would not ... apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities." Brief for United States 24, n. 13. In such a case, the Government states, "the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained." *Ibid.* In other words, money can buy, if not anything, then at least many things; its misappropriation may thus be viewed as sufficiently detached from a subsequent securities transaction that § 10(b)'s "in connection with" requirement would not be met. *Ibid.*

Justice THOMAS' charge that the misappropriation theory is incoherent because information, like funds, can be put to multiple uses, see *post,* at 2221-2223 (opinion concurring in judgment in part and dissenting in part), misses the point. The Exchange Act was enacted in part "to insure the maintenance of fair and honest markets," 15 U.S.C. § 78b, and there is no question that fraudulent uses of confidential information fall within § 10(b)'s prohibition if the fraud is "in connection with" a securities transaction. It is hardly

remarkable that a rule suitably applied to the fraudulent uses of certain kinds of information would be stretched beyond reason were it applied to the fraudulent use of money.

Justice THOMAS does catch the Government in overstatement. Observing that money can be used for all manner of purposes and purchases, the Government urges that confidential information of the kind at issue derives its value *only* from its utility in securities trading. See Brief for United States 10, 21; *post,* at 2222-2223 (several times emphasizing the word "only"). Substitute "ordinarily" for "only," and the Government is on the mark. [FN8]

Our recognition that the Government's "only" is an overstatement has provoked the dissent to cry "new theory." See *post,* at 2224-2225. But the very case on which Justice THOMAS relies, *Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co.,* 463 U.S. 29, 103 S.Ct. 2856, 77 L.Ed.2d 443 (1983), shows the extremity of that charge. In *State Farm,* we reviewed an agency's rescission of a rule under the same "arbitrary and capricious" standard by which the promulgation of a rule under the relevant statute was to be judged, see *id.,* at 41-42, 103 S.Ct., at 2865-2866; in our decision concluding that the agency had not adequately explained its regulatory action, see *id.,* at 57, 103 S.Ct., at 2873-2874, we cautioned that a "reviewing court should not attempt itself to make up for such deficiencies," *id.,* at 43, 103 S.Ct., at 2867. Here, by contrast, Rule 10b-5's promulgation has not been challenged; we consider only the Government's charge that O'Hagan's alleged fraudulent conduct falls within the prohibitions of the Rule and § 10(b). In this context, we acknowledge simply that, in defending the Government's interpretation of the Rule and statute in this Court, the Government's lawyers have pressed a solid point too far, something lawyers, occasionally even judges, are wont to do.

The misappropriation theory comports with § 10(b)'s language, which requires deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller. The theory is also well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence. See 45 Fed.Reg. 60412 (1980) (trading on misappropriated information "undermines the integrity of, and investor confidence in, the securities markets"). Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-á-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill. See Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L.Rev. 322, 356 (1979) ("If the market is thought to be systematically populated with ... transactors [trading on the basis of misappropriated information] some investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors or corruptly to overcome their unerodable informational advantages."); Aldave, 13 Hofstra L.Rev., at 122-123.

In sum, considering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying § 10(b), it makes scant sense to hold a lawyer like O'Hagan a § 10(b) violator if he works for a law firm

representing the target of a tender offer, but not if he works for a law firm representing the bidder. The text of the statute requires no such result. [FN9] The misappropriation at issue here was properly made the subject of a § 10(b) charge because it meets the statutory requirement that there be "deceptive" conduct "in connection with" securities transactions.

C

The Court of Appeals rejected the misappropriation theory primarily on two grounds. First, as the Eighth Circuit comprehended the theory, it requires neither misrepresentation nor nondisclosure. See 92 F.3d, at 618. As we just explained, however, see *supra,* at 2208-2209, deceptive nondisclosure is essential to the § 10(b) liability at issue. Concretely, in this case, "it [was O'Hagan's] failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that ma[de] his conduct 'deceptive' within the meaning of [§]10(b)." Reply Brief 7.

Second and "more obvious," the Court of Appeals said, the misappropriation theory is not moored to § 10(b)'s requirement that "the fraud be 'in connection with the purchase or sale of any security.' " 92 F.3d, at 618 (quoting 15 U.S.C. § 78j(b)). According to the Eighth Circuit, three of our decisions reveal that § 10(b) liability cannot be predicated on a duty owed to the source of nonpublic information: *Chiarella v. United States,* 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980); *Dirks v. SEC,* 463 U.S. 646, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983); and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N. A.,* 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994). "[O]nly a breach of a duty to parties to the securities transaction," the Court of Appeals concluded, "or, at the most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability." 92 F.3d, at 618. We read the statute and our precedent differently, and note again that § 10(b) refers to "the purchase or sale of any security," not to identifiable purchasers or sellers of securities.

Chiarella involved securities trades by a printer employed at a shop that printed documents announcing corporate takeover bids. See 445 U.S., at 224, 100 S.Ct., at 1112. Deducing the names of target companies from documents he handled, the printer bought shares of the targets before takeover bids were announced, expecting (correctly) that the share prices would rise upon announcement. In these transactions, the printer did not disclose to the sellers of the securities (the target companies' shareholders) the nonpublic information on which he traded. See *ibid.* For that trading, the printer was convicted of violating § 10(b) and Rule 10b-5. We reversed the Court of Appeals judgment that had affirmed the conviction. See *id.,* at 225, 100 S.Ct., at 1113.

The jury in *Chiarella* had been instructed that it could convict the defendant if he willfully failed to inform sellers of target company securities that he knew of a takeover bid that would increase the value of their shares. See *id.,* at 226, 100 S.Ct., at 1113-1114. Emphasizing that the printer had no agency or other fiduciary relationship with the sellers, we held that liability could not be imposed on so broad a theory. See *id.,* at 235, 100 S.Ct., at 1118. There is under § 10(b), we explained, no "general duty between all participants in market transactions

to forgo actions based on material, nonpublic information." *Id.,* at 233, 100 S.Ct., at 1117. Under established doctrine, we said, a duty to disclose or abstain from trading "arises from a specific relationship between two parties." *Ibid.*

The Court did not hold in *Chiarella* that the *only* relationship prompting liability for trading on undisclosed information is the relationship between a corporation's insiders and shareholders. That is evident from our response to the Government's argument before this Court that the printer's misappropriation of information from his employer for purposes of securities trading--in violation of a duty of confidentiality owed to the acquiring companies--constituted fraud in connection with the purchase or sale of a security, and thereby satisfied the terms of § 10(b). *Id.,* at 235-236, 100 S.Ct., at 1118-1119. The Court declined to reach that potential basis for the printer's liability, because the theory had not been submitted to the jury. See *id.,* at 236-237, 100 S.Ct., at 1118-1119. But four Justices found merit in it. See *id.,* at 239, 100 S.Ct., at 1120 (Brennan, J., concurring in judgment); *id.,* at 240-243, 100 S.Ct., at 1120-1122 (Burger, C. J., dissenting); *id.,* at 245, 100 S.Ct., at 1123 (Blackmun, J., joined by Marshall, J., dissenting). And a fifth Justice stated that the Court "wisely le[ft] the resolution of this issue for another day." *Id.,* at 238, 100 S.Ct., at 1120 (STEVENS J., concurring).

Chiarella thus expressly left open the misappropriation theory before us today. Certain statements in *Chiarella,* however, led the Eighth Circuit in the instant case to conclude that § 10(b) liability hinges exclusively on a breach of duty owed to a purchaser or seller of securities. See 92 F.3d, at 618. The Court said in *Chiarella* that § 10(b) liability "is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction,*" 445 U.S., at 230, 100 S.Ct., at 1115 (emphasis added), and observed that the printshop employee defendant in that case "was not a person in whom the sellers had placed their trust and confidence," see *id.,* at 232, 100 S.Ct., at 1117. These statements rejected the notion that § 10(b) stretches so far as to impose "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information," *id.,* at 233, 100 S.Ct., at 1117, and we confine them to that context. The statements highlighted by the Eighth Circuit, in short, appear in an opinion carefully leaving for future resolution the validity of the misappropriation theory, and therefore cannot be read to foreclose that theory.

Dirks, too, left room for application of the misappropriation theory in cases like the one we confront. [FN10] *Dirks* involved an investment analyst who had received information from a former insider of a corporation with which the analyst had no connection. See 463 U.S., at 648-649, 103 S.Ct., at 3258-3259. The information indicated that the corporation had engaged in a massive fraud. The analyst investigated the fraud, obtaining corroborating information from employees of the corporation. During his investigation, the analyst discussed his findings with clients and investors, some of whom sold their holdings in the company the analyst suspected of gross wrongdoing. See *id.,* at 649, 103 S.Ct., at 3258-3259.

The SEC censured the analyst for, *inter alia,* aiding and abetting § 10(b) and Rule 10b-5

violations by clients and investors who sold their holdings based on the nonpublic information the analyst passed on. See *id.,* at 650-652, 103 S.Ct., at 3259-3260. In the SEC's view, the analyst, as a "tippee" of corporation insiders, had a duty under § 10(b) and Rule 10b-5 to refrain from communicating the nonpublic information to persons likely to trade on the basis of it. See *id.,* at 651, 655-656, 103 S.Ct., at 3261- 3262. This Court found no such obligation, see *id.,* at 665-667, 103 S.Ct., at 3266-3268, and repeated the key point made in *Chiarella:* There is no " 'general duty between all participants in market transactions to forgo actions based on material, nonpublic information.' " 463 U.S., at 655, 103 S.Ct., at 3261 (quoting *Chiarella,* 445 U.S., at 233, 100 S.Ct., at 1117); see Aldave, 13 Hofstra L.Rev., at 122 (misappropriation theory bars only "trading on the basis of information that the wrongdoer converted to his own use in violation of some fiduciary, contractual, or similar obligation to the owner or rightful possessor of the information").

No showing had been made in *Dirks* that the "tippers" had violated any duty by disclosing to the analyst nonpublic information about their former employer. The insiders had acted not for personal profit, but to expose a massive fraud within the corporation. See 463 U.S., at 666-667, 103 S.Ct., at 3267-3268. Absent any violation by the tippers, there could be no derivative liability for the tippee. See *id.,* at 667, 103 S.Ct., at 3267- 3268. Most important for purposes of the instant case, the Court observed in *Dirks:* "There was no expectation by [the analyst's] sources that he would keep their information in confidence. Nor did [the analyst] misappropriate or illegally obtain the information...." *Id.,* at 665, 103 S.Ct., at 3267. *Dirks* thus presents no suggestion that a person who gains nonpublic information through misappropriation in breach of a fiduciary duty escapes § 10(b) liability when, without alerting the source, he trades on the information.

Last of the three cases the Eighth Circuit regarded as warranting disapproval of the misappropriation theory, *Central Bank* held that "a private plaintiff may not maintain an aiding and abetting suit under § 10(b)." 511 U.S., at 191, 114 S.Ct., at 1455. We immediately cautioned in *Central Bank* that secondary actors in the securities markets may sometimes be chargeable under the securities Acts: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) *on which a purchaser or seller of securities relies* may be liable as a primary violator under 10b-5, assuming ... the requirements for primary liability under Rule 10b-5 are met." *Ibid.* (emphasis added). The Eighth Circuit isolated the statement just quoted and drew from it the conclusion that § 10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely. See 92 F.3d, at 619. It is evident from the question presented in *Central Bank,* however, that this Court, in the quoted passage, sought only to clarify that secondary actors, although not subject to aiding and abetting liability, remain subject to primary liability under § 10(b) and Rule 10b-5 for certain conduct.

Furthermore, *Central Bank* 's discussion concerned only private civil litigation under § 10(b) and Rule 10b-5, not criminal liability. *Central Bank* 's reference to purchasers or sellers of securities must be read in light of a longstanding limitation on private § 10(b) suits. In *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539

(1975), we held that only actual purchasers or sellers of securities may maintain a private civil action under § 10(b) and Rule 10b-5. We so confined the § 10(b) private right of action because of "policy considerations." *Id.,* at 737, 95 S.Ct., at 1926. In particular, *Blue Chip Stamps* recognized the abuse potential and proof problems inherent in suits by investors who neither bought nor sold, but asserted they would have traded absent fraudulent conduct by others. See *id.,* at 739-747, 95 S.Ct., at 1927-1931; see also *Holmes v. Securities Investor Protection Corporation,* 503 U.S. 258, 285, 112 S.Ct. 1311, 1326-1327, 117 L.Ed.2d 532 1992) (O'CONNOR, J., concurring in part and concurring in judgment); *id.,* at 289-290, 112 S.Ct., at 1328-1329 (SCALIA, J., concurring in judgment). Criminal prosecutions do not present the dangers the Court addressed in *Blue Chip Stamps,* so that decision is "inapplicable" to indictments for violations of § 10(b) and Rule 10b-5. *United States v. Naftalin,* 441 U.S. 768, 774, n. 6, 99 S.Ct. 2077, 99 S.Ct., at 2082, 60 L.Ed.2d 624 (1979); see also *Holmes,* 503 U.S., at 281, 112 S.Ct., at 1324-1325 (O'CONNOR, J., concurring in part and concurring in judgment) ("[T]he purchaser/seller standing requirement for private civil actions under § 10(b) and Rule 10b-5 is of no import in criminal prosecutions for willful violations of those provisions.").

In sum, the misappropriation theory, as we have examined and explained it in this opinion, is both consistent with the statute and with our precedent. [FN11] Vital to our decision that criminal liability may be sustained under the misappropriation theory, we emphasize, are two sturdy safeguards Congress has provided regarding scienter. To establish a criminal violation of Rule 10b-5, the Government must prove that a person "willfully" violated the provision. See 15 U.S.C. § 78ff(a). [FN12] Furthermore, a defendant may not be imprisoned for violating Rule 10b-5 if he proves that he had no knowledge of the Rule. See *ibid.* [FN13] O'Hagan's charge that the misappropriation theory is too indefinite to permit the imposition of criminal liability, see Brief for Respondent 30-33, thus fails not only because the theory is limited to those who breach a recognized duty. In addition, the statute's "requirement of the presence of culpable intent as a necessary element of the offense does much to destroy any force in the argument that application of the [statute]" in circumstances such as O'Hagan's is unjust. *Boyce Motor Lines, Inc. v. United States,* 342 U.S. 337, 342, 72 S.Ct. 329, 331-332, 96 L.Ed. 367 (1952).

The Eighth Circuit erred in holding that the misappropriation theory is inconsistent with § 10(b). The Court of Appeals may address on remand O'Hagan's other challenges to his convictions under § 10(b) and Rule 10b-5.

III

[13] We consider next the ground on which the Court of Appeals reversed O'Hagan's convictions for fraudulent trading in connection with a tender offer, in violation of § 14(e) of the Exchange Act and SEC Rule 14e-3(a). A sole question is before us as to these convictions: Did the Commission, as the Court of Appeals held, exceed its rulemaking authority under § 14(e) when it adopted Rule 14e-3(a) without requiring a showing that the

trading at issue entailed a breach of fiduciary duty? We hold that the Commission, in this regard and to the extent relevant to this case, did not exceed its authority.

The governing statutory provision, § 14(e) of the Exchange Act, reads in relevant part:

"It shall be unlawful for any person ... to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer.... The [SEC] shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 78n(e).

Section 14(e)'s first sentence prohibits fraudulent acts in connection with a tender offer. This self-operating proscription was one of several provisions added to the Exchange Act in 1968 by the Williams Act, 82 Stat. 454. The section's second sentence delegates definitional and prophylactic rulemaking authority to the Commission. Congress added this rulemaking delegation to § 14(e) in 1970 amendments to the Williams Act. See § 5, 84 Stat. 1497.

Through § 14(e) and other provisions on disclosure in the Williams Act, [FN14] Congress sought to ensure that shareholders "confronted by a cash tender offer for their stock [would] not be required to respond without adequate information." *Rondeau v. Mosinee Paper Corp.,* 422 U.S. 49, 58, 95 S.Ct. 2069, 2076, 45 L.Ed.2d 12 (1975); see *Lewis v. McGraw,* 619 F.2d 192, 195 (C.A.2 1980) *(per curiam)* "very purpose" of Williams Act was "informed decisionmaking by shareholders"). As we recognized in *Schreiber v. Burlington Northern, Inc.,* 472 U.S. 1, 105 S.Ct. 2458, 86 L.Ed.2d 1 (1985), Congress designed the Williams Act to make "disclosure, rather than court imposed principles of 'fairness' or 'artificiality,' ... the preferred method of market regulation." *Id.,* at 9, n. 8, 105 S.Ct., at 2463 n. 8. Section 14(e), we explained, "supplements the more precise disclosure provisions found elsewhere in the Williams Act, while requiring disclosure more explicitly addressed to the tender offer context than that required by § 10(b)." *Id.,* at 10-11, 105 S.Ct., at 2464.

FN14. In addition to § 14(e), the Williams Act and the 1970 amendments added

Relying on § 14(e)'s rulemaking authorization, the Commission, in 1980, promulgated Rule 14e-3(a). That measure provides:

"(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the 'offering person'), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the [Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

"(1) The offering person,

"(2) The issuer of the securities sought or to be sought by such tender offer, or

"(3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly

disclosed by press release or otherwise." 17 CFR § 240.14e- 3(a) (1996).

As characterized by the Commission, Rule 14e-3(a) is a "disclose or abstain from trading" requirement. 45 Fed.Reg. 60410 (1980). [FN15] The Second Circuit concisely described the Rule's thrust:

"One violates Rule 14e-3(a) if he trades on the basis of material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired 'directly or indirectly' from an insider of the offeror or issuer, or someone working on their behalf. Rule 14e-3(a) is a disclosure provision. It creates a duty in those traders who fall within its ambit to abstain or disclose, *without regard to whether the trader owes a pre-existing fiduciary duty* to respect the confidentiality of the information." *United States v. Chestman,* 947 F.2d 551, 557 (1991) (en banc) (emphasis added), cert. denied, 503 U.S. 1004, 112 S.Ct. 1759, 118 L.Ed.2d 422 (1992).

See also *SEC v. Maio,* 51 F.3d 623, 635 (C.A.7 1995) ("Rule 14e-3 creates a duty to disclose material non-public information, or abstain from trading in stocks implicated by an impending tender offer, *regardless of whether such information was obtained through a breach of fiduciary duty.*" (emphasis added)); *SEC v. Peters,* 978 F.2d 1162, 1165 (C.A.10 1992) (as written, Rule 14e-3(a) has no fiduciary duty requirement).

In the Eighth Circuit's view, because Rule 14e-3(a) applies whether or not the trading in question breaches a fiduciary duty, the regulation exceeds the SEC's § 14(e) rulemaking authority. See 92 F.3d, at 624, 627. Contra, *Maio,* 51 F.3d, at 634-635(CA7); *Peters,* 978 F.2d, at 1165-1167 (C.A.10); *Chestman,* 947 F.2d, at 556-563(CA2) (all holding Rule 14e-3(a) a proper exercise of SEC's statutory authority). In support of its holding, the Eighth Circuit relied on the text of § 14(e) and our decisions in *Schreiber* and *Chiarella.* See 92 F.3d, at 624-627.

The Eighth Circuit homed in on the essence of § 14(e)'s rulemaking authorization: "[T]he statute empowers the SEC to 'define' and 'prescribe means reasonably designed to prevent' 'acts and practices' which are 'fraudulent.' " *Id.,* at 624. All that means, the Eighth Circuit found plain, is that the SEC may "identify and regulate," in the tender offer context, "acts and practices" the law already defines as "fraudulent"; but, the Eighth Circuit maintained, the SEC may not "create its own definition of fraud." *Ibid.* (internal quotation marks omitted).

This Court, the Eighth Circuit pointed out, held in *Schreiber* that the word "manipulative" in the § 14(e) phrase "fraudulent, deceptive, or manipulative acts or practices" means just what the word means in § 10(b): Absent misrepresentation or nondisclosure, an act cannot be indicted as manipulative. See 92 F.3d, at 625 (citing *Schreiber,* 472 U.S., at 7-8, and n. 6, 105 S.Ct., at 2462 n. 6). Section 10(b) interpretations guide construction of § 14(e), the Eighth Circuit added, see 92 F.3d, at 625, citing this Court's acknowledgment in *Schreiber* that § 14(e)'s " 'broad antifraud prohibition' ... [is] modeled on the antifraud provisions of § 10(b) ... and Rule 10b-5," 472 U.S., at 10, 105 S.Ct., at 2463 (citation omitted); see *id.,* at 10-11, n. 10, 105 S.Ct., at 2464 n. 10.

For the meaning of "fraudulent" under § 10(b), the Eighth Circuit looked to *Chiarella.* See 92 F.3d, at 625. In that case, the Eighth Circuit recounted, this Court held that a failure to disclose information could be "fraudulent" under § 10(b) only when there was a duty to speak arising out of " 'a fiduciary or other similar relation of trust and confidence.' " *Chiarella,* 445 U.S., at 228, 100 S.Ct., at 1114 (quoting Restatement (Second) of Torts § 551(2)(a) (1976)). Just as § 10(b) demands a showing of a breach of fiduciary duty, so such a breach is necessary to make out a § 14(e) violation, the Eighth Circuit concluded.

As to the Commission's § 14(e) authority to "prescribe means reasonably designed to prevent" fraudulent acts, the Eighth Circuit stated: "Properly read, this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." 92 F.3d, at 627.

The United States urges that the Eighth Circuit's reading of § 14(e) misapprehends both the Commission's authority to define fraudulent acts and the Commission's power to prevent them. "The 'defining' power," the United States submits, "would be a virtual nullity were the SEC not permitted to go beyond common law fraud (which is separately prohibited in the first [self-operative] sentence of Section 14(e))." Brief for United States 11; see *id.,* at 37.

In maintaining that the Commission's power to define fraudulent acts under § 14(e) is broader than its rulemaking power under § 10(b), the United States questions the Court of Appeals' reading of *Schreiber.* See Brief for United States at 38-40. Parenthetically, the United States notes that the word before the *Schreiber* Court was "manipulative"; unlike "fraudulent," the United States observes, " 'manipulative' ... is 'virtually a term of art when used in connection with the securities markets.' " Brief for United States at 38, n. 20 (quoting *Schreiber,* 472 U.S., at 6, 105 S.Ct., at 2461). Most tellingly, the United States submits, *Schreiber* involved acts alleged to violate the self-operative provision in § 14(e)'s first sentence, a sentence containing language similar to § 10(b). But § 14(e)'s second sentence, containing the rulemaking authorization, the United States points out, does not track § 10(b), which simply authorizes the SEC to proscribe "manipulative or deceptive device[s] or contrivance[s]." Brief for United States 38. Instead, § 14(e)'s rulemaking prescription tracks § 15(c)(2)(D) of the Exchange Act, 15 U.S.C. § 78o(c)(2)(D), which concerns the conduct of broker-dealers in over-the-counter markets. See Brief for United States 38-39. Since 1938, see 52 Stat. 1075, § 15(c)(2) has given the Commission authority to "define, and prescribe means reasonably designed to prevent, such [broker-dealer] acts and practices as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 78o(c)(2)(D). When Congress added this same rulemaking language to § 14(e) in 1970, the Government states, the Commission had already used its § 15(c)(2) authority to reach beyond common-law fraud. See Brief for United States 39, n. 22. [FN16]

We need not resolve in this case whether the Commission's authority under § 14(e) to "define ... such acts and practices as are fraudulent" is broader than the Commission's fraud-defining authority under § 10(b), for we agree with the United States that Rule 14e-3(a), as applied to cases of this genre, qualifies under § 14(e) as a "means reasonably designed to

prevent" fraudulent trading on material, nonpublic information in the tender offer context. [FN17] A prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited. As we noted in *Schreiber,* § 14(e)'s rulemaking authorization gives the Commission "latitude," even in the context of a term of art like "manipulative," "to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself." 472 U.S., at 11, n. 11, 105 S.Ct., at 2464 n. 11. We hold, accordingly, that under § 14(e), the Commission may prohibit acts not themselves fraudulent under the common law or § 10(b), if the prohibition is "reasonably designed to prevent ... acts and practices [that] are fraudulent." 15 U.S.C. § 78n(e). [FN18]

Because Congress has authorized the Commission, in § 14(e), to prescribe legislative rules, we owe the Commission's judgment "more than mere deference or weight." *Batterton v. Francis,* 432 U.S. 416, 424-426, 97 S.Ct. 2399, 2406, 53 L.Ed.2d 448 (1977). Therefore, in determining whether Rule 14e-3(a)'s "disclose or abstain from trading" requirement is reasonably designed to prevent fraudulent acts, we must accord the Commission's assessment "controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute." *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837, 844, 104 S.Ct. 2778, 2782, 81 L.Ed.2d 694 (1984). In this case, we conclude, the Commission's assessment is none of these. [FN19]

In adopting the "disclose or abstain" rule, the SEC explained:

> "The Commission has previously expressed and continues to have serious concerns about trading by persons in possession of material, nonpublic information relating to a tender offer. This practice results in unfair disparities in market information and market disruption. Security holders who purchase from or sell to such persons are effectively denied the benefits of disclosure and the substantive protections of the Williams Act. If furnished with the information, these security holders would be able to make an informed investment decision, which could involve deferring the purchase or sale of the securities until the material information had been disseminated or until the tender offer had been commenced or terminated." 45 Fed.Reg. 60412 (1980) (footnotes omitted).

The Commission thus justified Rule 14e-3(a) as a means necessary and proper to assure the efficacy of Williams Act protections.

The United States emphasizes that Rule 14e-3(a) reaches trading in which "a breach of duty is likely but difficult to prove." Reply Brief 16. "Particularly in the context of a tender offer," as the Tenth Circuit recognized, "there is a fairly wide circle of people with confidential information," *Peters,* 978 F.2d, at 1167, notably, the attorneys, investment bankers, and accountants involved in structuring the transaction. The availability of that information may lead to abuse, for "even a hint of an upcoming tender offer may send the price of the target company's stock soaring." *SEC v. Materia,* 745 F.2d 197, 199 (C.A.2 1984). Individuals entrusted with nonpublic information, particularly if they have no long-term loyalty to the issuer, may find the temptation to trade on that information hard to resist

in view of "the very large short-term profits potentially available [to them]." *Peters,* 978 F.2d, at 1167.

"[I]t may be possible to prove circumstantially that a person [traded on the basis of material, nonpublic information], but almost impossible to prove that the trader obtained such information in breach of a fiduciary duty owed either by the trader or by the ultimate insider source of the information." *Ibid.* The example of a "tippee" who trades on information received from an insider illustrates the problem. Under Rule 10b-5, "a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." *Dirks,* 463 U.S., at 660, 103 S.Ct., at 3264. To show that a tippee who traded on nonpublic information about a tender offer had breached a fiduciary duty would require proof not only that the insider source breached a fiduciary duty, but that the tippee knew or should have known of that breach. "Yet, in most cases, the only parties to the [information transfer] will be the insider and the alleged tippee." *Peters,* 978 F.2d, at 1167. [FN20]

In sum, it is a fair assumption that trading on the basis of material, nonpublic information will often involve a breach of a duty of confidentiality to the bidder or target company or their representatives. The SEC, cognizant of the proof problem that could enable sophisticated traders to escape responsibility, placed in Rule 14e-3(a) a "disclose or abstain from trading" command that does not require specific proof of a breach of fiduciary duty. That prescription, we are satisfied, applied to this case, is a "means reasonably designed to prevent" fraudulent trading on material, nonpublic information in the tender offer context. See *Chestman,* 947 F.2d, at 560 ("While dispensing with the subtle problems of proof associated with demonstrating fiduciary breach in the problematic area of tender offer insider trading, [Rule 14e-3(a)] retains a close nexus between the prohibited conduct and the statutory aims."); accord, *Maio,* 51 F.3d, at 635, and n. 14; *Peters,* 978 F.2d, at 1167. [FN21] Therefore, insofar as it serves to prevent the type of misappropriation charged against O'Hagan, Rule 14e-3(a) is a proper exercise of the Commission's prophylactic power under § 14(e). [FN22]

> FN21. Justice THOMAS insists that even if the misappropriation of information from the bidder about a tender offer is fraud, the Commission has not explained why such fraud is "in connection with" a tender offer. *Post,* at 2229. What else, one can only wonder, might such fraud be "in connection with"?

As an alternate ground for affirming the Eighth Circuit's judgment, O'Hagan urges that Rule 14e-3(a) is invalid because it prohibits trading in advance of a tender offer--when "a substantial step ... to commence" such an offer has been taken--while § 14(e) prohibits fraudulent acts "in connection with any tender offer." See Brief for Respondent 41-42.

O'Hagan further contends that, by covering pre-offer conduct, Rule 14e-3(a) "fails to comport with due process on two levels": The Rule does not "give fair notice as to when, in advance of a tender offer, a violation of § 14(e) occurs," *id.,* at 42; and it "disposes of any scienter requirement," *id.,* at 43. The Court of Appeals did not address these arguments, and O'Hagan did not raise the due process points in his briefs before that court. We decline to consider these contentions in the first instance. [FN23] The Court of Appeals may address on remand any arguments O'Hagan has preserved.

IV

Based on its dispositions of the securities fraud convictions, the Court of Appeals also reversed O'Hagan's convictions, under 18 U.S.C. § 1341, for mail fraud. See 92 F.3d, at 627-628. Reversal of the securities convictions, the Court of Appeals recognized, "d[id] not as a matter of law require that the mail fraud convictions likewise be reversed." *Id.,* at 627 (citing *Carpenter,* 484 U.S., at 24, 108 S.Ct., at 319-320, in which this Court unanimously affirmed mail and wire fraud convictions based on the same conduct that evenly divided the Court on the defendants' securities fraud convictions). But in this case, the Court of Appeals said, the indictment was so structured that the mail fraud charges could not be disassociated from the securities fraud charges, and absent any securities fraud, "there was no fraud upon which to base the mail fraud charges." 92 F.3d, at 627-628. [FN24]

The United States urges that the Court of Appeals' position is irreconcilable with *Carpenter:* Just as in *Carpenter,* so here, the "mail fraud charges are independent of [the] securities fraud charges, even [though] both rest on the same set of facts." Brief for United States 46-47. We need not linger over this matter, for our rulings on the securities fraud issues require that we reverse the Court of Appeals judgment on the mail fraud counts as well. [FN25]

O'Hagan, we note, attacked the mail fraud convictions in the Court of Appeals on alternate grounds; his other arguments, not yet addressed by the Eighth Circuit, remain open for consideration on remand.

* * *

The judgment of the Court of Appeals for the Eighth Circuit is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

APPENDIX A

MASSACHUSETTS GENERAL LAWS ANNOTATED
PART I. ADMINISTRATION OF THE GOVERNMENT
TITLE XV. REGULATION OF TRADE

CHAPTER 108A. PARTNERSHIPS
GENERAL PROVISIONS

§ 1. Citation of chapter

This chapter may be cited as the Uniform Partnership Act.

§ 2. Definitions

In this chapter, "court" includes every court and judge having jurisdiction in the case.

"Business" includes every trade, occupation, or profession.

"Bankrupt" includes bankrupt under the Federal Bankruptcy Act or insolvent under any state insolvent law.

"Conveyance" includes every assignment, lease, mortgage or encumbrance.

"Foreign registered limited liability partnership", a registered limited liability partnership or a limited liability partnership formed pursuant to an agreement governed by the laws of another jurisdiction.

"Real property", includes land or any interest or estate in land.

"Registered limited liability partnership", a partnership registered under section forty-five and complying with section forty-six.

§ 3. Knowledge and notice; definition

(1) A person has "knowledge" of a fact within the meaning of this chapter, not only when he has actual knowledge thereof, but also when he has knowledge of such other facts as in the circumstances show bad faith.

(2) A person has "notice" of a fact within the meaning of this chapter when the person who

claims the benefit of the notice.

(a) States the fact to such person, or

(b) Delivers through the mail, or by other means of communication, a written statement of the fact to such person or to a proper person at his place of business or residence.

§ 4. Interpretation and construction

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

(2) The law of estoppel shall apply under this chapter.

(3) The law of agency shall apply under this chapter.

(4) This chapter shall be so interpreted and construed as to effect its general purpose to make uniform the law of those states which enact it.

(5) This chapter shall not be construed so as to impair the obligations of any contract existing on January first, nineteen hundred and twenty-three, nor to affect any action or proceedings begun or right accrued before said date.

§ 5. Application of rules of law and equity

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

§ 6. Partnership, defined; application to prior associations; limited partnerships

(1) A partnership is an association of two or more persons to carry on as co- owners a business for profit and includes, for all purposes of the laws of the commonwealth, a registered limited liability partnership.

(2) But any association formed under any other statute of this state, or any statute adopted by authority, other than the authority of this state, is not a partnership under this chapter, unless such association would have been a partnership in this state prior to January first, nineteen hundred and twenty- three; but this chapter shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith.

§ 7. Rules for determining existence of partnership

In determining whether a partnership exists, these rules shall apply:

(1) Except as provided by section sixteen persons who are not partners as to each other are

not partners as to third persons.

(2) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property.

(3) The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.

(4) The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:

(a) Of a debt by instalments or otherwise,

(b) As wages of an employee or rent to a landlord,

(c) As an annuity to a widow or representative of a deceased partner,

(d) As interest on a loan, though the amount of payment vary with the profits of the business,

(e) As the consideration for the sale of the good will of a business or other property by instalments or otherwise.

§ 8. Partnership property; acquisition and conveyance

(1) All property originally brought into the partnership stock or subsequently acquired, by purchase or otherwise, on account of the partnership is partnership property.

(2) Unless the contrary intention appears, property acquired with partnership funds is partnership property.

(3) Any estate in real property may be acquired in the partnership name. Title so acquired can be conveyed only in the partnership name.

(4) A conveyance to a partnership in the partnership name, though without words of inheritance, passes the entire estate of the grantor unless a contrary intent appears.

§ 9. Partner as agent of partnership; authority

(1) Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a

member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

(2) An act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners.

(3) Unless authorized by the other partners or unless they have abandoned the business, one or more but less than all the partners have no authority to:

(a) Assign the partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership,

(b) Dispose of the good will of the business,

(c) Do any other act which would make it impossible to carry on the ordinary business of the partnership,

(d) Confess a judgment,

(e) Submit a partnership claim or liability to arbitration or reference.

(4) No act of a partner in contravention of a restriction on his authority shall bind the partnership to persons having knowledge of the restriction.

§ 10. Conveyance to title to realty

(1) Where title to real property is in the partnership name, any partner may convey title to such property by a conveyance executed in the partnership name; but the partnership may recover such property unless the partner's act binds the partnership under the provisions of paragraph (1) of section nine, or unless such property has been conveyed by the grantee or a person claiming through such grantee to a holder for value without knowledge that the partner, in making the conveyance, has exceeded his authority.

(2) Where title to real property is in the name of the partnership, a conveyance executed by a partner, in his own name, passes the equitable interest of the partnership, provided the act is one within the authority of the partner under the provisions of paragraph (1) of section nine.

(3) Where title to real property is in the name of one or more but not all the partners, and the record does not disclose the right of the partnership, the partners in whose name the title stands may convey title to such property, but the partnership may recover such property if the partners' act does not bind the partnership under the provisions of paragraph (1) of section nine, unless the purchaser or his assignee is a holder for value, without knowledge.

(4) Where the title to real property is in the name of one or more of all the partners, or in a third person in trust for the partnership, a conveyance executed by a partner in the partnership name, or in his own name, passes the equitable interest of the partnership, provided the act is one within the authority of the partner under the provisions of paragraph (1) of section nine.

(5) Where the title to real property is in the names of all the partners a conveyance executed by all the partners passes all their rights in such property.

§ 11. Admissions and representations

An admission or representation made by any partner concerning partnership affairs within the scope of his authority as conferred by this chapter is evidence against the partnership.

§ 12. Notice to and knowledge of partner; imputation to partnership

Notice to any partner of any matter relating to partnership affairs, and the knowledge of the partner acting in the particular matter, acquired while a partner or then present to his mind, and the knowledge of any other partner who reasonably could and should have communicated it to the acting partner operate as notice to or knowledge of the partnership, except in the case of a fraud on the partnership committed by or with the consent of that partner.

§ 13. Liability of partnership for wrongful acts of partners

Where, by any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership, or with the authority of his co- partners, loss or injury is caused to any person, not being a partner in the partnership, or any penalty is incurred, the partnership is liable therefor to the same extent as the partner so acting or omitting to act.

§ 14. Liability of partnership for partner's misapplication of money or property

The partnership is bound to make good the loss:

(a) Where one partner acting within the scope of his apparent authority receives money or property of a third person and misapplies it; and

(b) Where the partnership in the course of its business receives money or property of a third person and the money or property so received is misapplied by any partner while it is in the custody of the partnership.

§ 15. Joint and several liability of partners

(1) Except as provided in paragraph (2), all partners are liable:

(a) Jointly and severally for everything chargeable to the partnership under sections thirteen

and fourteen.

(b) Jointly for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract.

(2) Subject to the provisions of paragraph (3), a partner in a registered limited liability partnership shall not be personally liable directly or indirectly, including, without limitation, by way of indemnification, contribution, assessment or otherwise, for debts, obligations and liabilities of or chargeable to such partnership, whether in tort, contract or otherwise arising while the partnership is a registered limited liability partnership.

(3) Paragraph (2) shall not affect (a) the liability of a partner in a registered limited liability partnership arising in whole or in part from such partner's own negligence, wrongful acts, errors or omissions, (b) the availability of partnership property to satisfy debts, obligations and liabilities of the partnership or (c) the persons on whom process may be served in an action against the partnership.

(4) Notwithstanding paragraphs (2) and (3), the personal liability of a partner in a limited liability partnership engaged in the rendering of professional services shall not be less than the personal liability of a shareholder of a professional corporation organized under chapter one hundred and fifty-six A engaged in the rendering of the same professional services.

§ 16. Misrepresentation of self as partner; liability

(1) When a person, by words spoken or written or by conduct, represents himself, or consents to another representing him to any one, as a partner in an existing partnership or with one or more persons not actual partners, he is liable to any such person to whom such representation has been made, who has, on the faith of such representation, given credit to the actual or apparent partnership, and if he has made such representation or consented to its being made in a public manner he is liable to such person, whether the representation has or has not been made or communicated to such person so giving credit by or with the knowledge of the apparent partner making the representation or consenting to its being made.

(a) When a partnership liability results he is liable as though he were an actual member of the partnership.

(b) When no partnership liability results he is liable jointly with the other persons, if any, so consenting to the contract or representation as to incur liability, otherwise separately.

(2) When a person has been thus represented to be a partner in an existing partnership, or with one or more persons not actual partners, he is an agent of the persons consenting to such representation to bind them to the same extent and in the same manner as though he were a partner in fact, with respect to persons who rely upon the representation. Where all the members of the existing partnership consent to the representation, a partnership act or obligation results; but in all other cases it is the joint act or obligation of the person acting

and the persons consenting to the representation.

§ 17. Liability of new partner for partnership obligations

A person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, except that this liability shall be satisfied only out of partnership property.

§ 18. Rights and duties of partners

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 share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied; and except as provided in section fifteen, each partner 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, or for the preservation of its business or property.

(c) A partner, who in aid of the partnership makes any payment or advance beyond the amount of capital which he agreed to contribute, shall be paid interest from the date of the payment or advance.

(d) A partner shall receive interest on the capital contributed by him only from the date when repayment should be made.

(e) All partners have equal rights in the management and conduct of the partnership business.

(f) No partner is entitled to remuneration for acting in the partnership business, except that a surviving partner is entitled to reasonable compensation for his services in winding up the partnership affairs.

(g) No person can become a member of a partnership without the consent of all the partners.

(h) Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners.

§ 19. Partnership books; right of inspection

The partnership books shall be kept, subject to any agreement between the partners, at the principal place of business of the partnership, and every partner shall at all times have access to and may inspect and copy any of them.

§ 20. Disclosure of information on demand

Partners shall render on demand true and full information of all things affecting the partnership to any partner or the legal representative of any deceased partner or partner under legal disability.

§ 21. Accounting of partner to partnership; profits; personal representative of deceased partner

(1) Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct or liquidation of the partnership or from any use by him of its property.

(2) This section applies also to the representatives of a deceased partner engaged in the liquidation of the affairs of the partnership as the personal representatives of the last surviving partner.

§ 22. Partner's right to formal accounting

Any partner shall have the right to a formal account as to partnership affairs:

(a) If he is wrongfully excluded from the partnership business or possession of its property by his co-partners,

(b) If the right exists under the terms of any agreement,

(c) As provided by section twenty-one,

(d) Whenever other circumstances render it just and reasonable.

§ 23. Continuation of partnership beyond time fixed for termination

(1) When a partnership for a fixed term or particular undertaking is continued after the termination of such term or particular undertaking without any express agreement, the rights and duties of the partners remain the same as they were at such termination, so far as is consistent with a partnership at will.

(2) A continuation of the business by the partners or such of them as habitually acted therein during the term, without any settlement or liquidation of the partnership affairs, is prima facie

evidence of a continuation of the partnership.

§ 24. Property rights

The property rights of a partner are (1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management.

§ 25. Ownership of specific partnership property; tenancy in partnership; incidents of tenancy

(1) A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership.

(2) The incidents of this tenancy are such that:

(a) A partner, subject to the provisions of this chapter and to any agreement between the partners, has an equal right with his partners to possess specific partnership property for partnership purposes; but he has no right to possess such property for any other purpose without the consent of his partners.

(b) A partner's right in specific partnership property is not assignable except in connection with the assignment of the rights of all the partners in the same property.

(c) A partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership. When partnership property is attached for a partnership debt the partners, or any of them, or the representatives of a deceased partner, cannot claim any right under the homestead or exemption laws.

(d) On the death of a partner his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when his right in such property vests in his legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.

(e) A partner's right in specific partnership property is not subject to dower, curtesy, or allowances to widows, heirs, or next of kin.

§ 26. Interest in partnership; profits

A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property.

§ 27. Conveyance of interest in partnership; rights of assignee

(1) A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the

assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.

(2) In case of a dissolution of the partnership, the assignee is entitled to receive his assignor's interest and may require an account from the date only of the last account agreed to by all the partners.

§ 28. Creditor's remedy to reach partner's interest in partnership

(1) On due application to the superior court by any judgment creditor of a partner, such court may charge the interest of the debtor partner with payment of the unsatisfied amount of such judgment debt with interest thereon; and may then or later appoint a receiver of his share of the profits, and of any other money due or to fall due to him in respect of the partnership, and make all other orders, directions, accounts and inquiries which the debtor partner might have made, or which the circumstances of the case may require.

(2) The interest charged may be redeemed at any time before foreclosure, or in case of a sale being directed by the court may be purchased without thereby causing a dissolution:

(a) With separate property, by any one or more of the partners, or

(b) With partnership property, by any one or more of the partners with the consent of all the partners whose interests are not so charged or sold.

(3) Nothing in this chapter shall be held to deprive a partner of his right, if any, under the exemption laws, as regards his interest in the partnership.

§ 29. Dissolution and winding up; definition

The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.

§ 30. Effect of dissolution

On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed.

§ 31. Causes of dissolution

Dissolution is caused:

(1) Without violation of the agreement between the partners,

(a) By the termination of the definite term or particular undertaking specified in the agreement,

(b) By the express will of any partner when no definite term or particular undertaking is specified,

(c) By the express will of all the partners who have not assigned their interests or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking,

(d) By the expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners;

(2) In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time;

(3) By any event which makes it unlawful for the business of the partnership to be carried on or for the members to carry it on in partnership;

(4) By the death of any partner;

(5) By the bankruptcy of any partner or the partnership;

(6) By decree of court under section thirty-two.

§ 32. Decree of dissolution

(1) On application by or for a partner the court shall decree a dissolution whenever:

(a) A partner has been declared a lunatic in any judicial proceeding or is shown to be of unsound mind,

(b) A partner becomes in any other way incapable of performing his part of the partnership contract,

(c) A partner has been guilty of such conduct as tends to affect prejudicially the carrying on of the business,

(d) A partner wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him,

(e) The business of the partnership can only be carried on at a loss,

(f) Other circumstances render a dissolution equitable.

(2) On the application of the purchaser of a partner's interest under section twenty-seven or twenty-eight:

(a) After the termination of the specified term or particular undertaking,

(b) At any time if the partnership was a partnership at will when the interest was assigned or when the charging order was issued.

§ 33. Effect of dissolution on partner's authority

Except so far as may be necessary to wind up partnership affairs or to complete transactions begun but not then finished, dissolution terminates all authority of any partner to act for the partnership,

(1) With respect to the partners,

(a) When the dissolution is not by the act, bankruptcy or death of a partner; or

(b) When the dissolution is by such act, bankruptcy or death of a partner, in cases where section thirty-four so requires;

(2) With respect to persons not partners, as declared in section thirty-five.

§ 34. Dissolution by act, death or bankruptcy; liability to copartners

Where the dissolution is caused by the act, death or bankruptcy of a partner, each partner is liable to his co-partners for his share of any liability created by any partner acting for the partnership as if the partnership had not been dissolved unless

(a) The dissolution being by act of any partner, the partner acting for the partnership had knowledge of the dissolution; or

(b) The dissolution being by the death or bankruptcy of a partner, the partner acting for the partnership had knowledge or notice of the death or bankruptcy.

(c) The liability is for a debt, obligation, or liability for which the partner is not liable as provided in section fifteen.

§ 35. Authority and liability after dissolution

(1) After dissolution a partner can bind the partnership except as provided in paragraph (3)

(a) By any act appropriate for winding up partnership affairs or completing transactions unfinished at dissolution;

(b) By any transaction which would bind the partnership if dissolution had not taken place, provided the other party to the transaction

(I) Had extended credit to the partnership prior to dissolution and had no knowledge or notice of the dissolution; or

(II) Though he had not so extended credit, had nevertheless known of the partnership prior to dissolution, and, having no knowledge or notice of dissolution, the fact of dissolution has not been advertised in a newspaper of general circulation in the place (or in each place if more than one) at which the partnership business was regularly carried on.

(2) The liability of a partner under paragraph (1b) shall be satisfied out of partnership assets alone when such partner had been prior to dissolution

(a) Unknown as a partner to the person with whom the contract is made; and

(b) So far unknown and inactive in partnership affairs that the business reputation of the partnership could not be said to have been in any degree due to his connection with it.

(3) The partnership is in no case bound by any act of a partner after dissolution

(a) Where the partnership is dissolved because it is unlawful to carry on the business, unless the act is appropriate for winding up partnership affairs; or

(b) Where the partner has become bankrupt; or

(c) Where the partner has no authority to wind up partnership affairs, except by a transaction with one who

(I) Had extended credit to the partnership prior to dissolution and had no knowledge or notice of his want of authority; or

(II) Had not extended credit to the partnership prior to dissolution, and, having no knowledge or notice of his want of authority, the fact of his want of authority has not been advertised in the manner provided for advertising the fact of dissolution in paragraph (1 b II).

(4) Nothing in this section shall affect the liability under section sixteen of any person who after dissolution represents himself or consents to another representing him as a partner in a partnership engaged in carrying on business.

§ 36. Discharge of partner's liability; assumption of partnership obligations; deceased partner

(1) The dissolution of the partnership does not of itself discharge the existing liability of any partner.

(2) A partner is discharged from any existing liability upon dissolution of the partnership by an agreement to that effect between himself, the partnership creditor and the person or partnership continuing the business; and such agreement may be inferred from the course of dealing between the creditor having knowledge of the dissolution and the person or partnership continuing the business.

(3) Where a person agrees to assume the existing obligations of a dissolved partnership, the partners whose obligations have been assumed shall be discharged from any liability to any creditor of the partnership who, knowing of the agreement, consents to a material alteration in the nature or time of payment of such obligations.

(4) The individual property of a deceased partner shall be liable for those obligations of the partnership incurred while he was a partner and for which he was liable under section fifteen but subject to the prior payment of his separate debts.

§ 37. Right to wind up partnership affairs

Unless otherwise agreed the partners who have not wrongfully dissolved the partnership or the legal representative of the last surviving partner, not bankrupt, has the right to wind up the partnership affairs; provided, that any partner, his legal representative, or his assignee, upon cause shown, may obtain winding up by the court.

§ 38. Rights of partners upon dissolution

(1) When dissolution is caused in any way, except in contravention of the partnership agreement, each partner, as against his co-partners and all persons claiming through them in respect of their interests in the partnership, unless otherwise agreed, may have the partnership property applied to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners. But if dissolution is caused by expulsion of a partner bona fide under the partnership agreement, and if the expelled partner is discharged from all partnership liabilities, either by payment or agreement under section thirty-six (2), he shall receive in cash only the net amount due him from the partnership.

(2) When dissolution is caused in contravention of the partnership agreement the rights of the partners shall be as follows:
(a) Each partner who has not caused dissolution wrongfully shall have--

I. All the rights specified in paragraph (1) of this section, and

II. The right, as against each partner who has caused the dissolution wrongfully, to damages for breach of the agreement.

(b) The partners who have not caused the dissolution wrongfully, if they all desire to continue the business in the same name, either by themselves or jointly with others, may do so during the agreed term for the partnership, and for that purpose may possess the partnership property, provided they secure the payment by bond approved by the court, or pay to any partner who has caused the dissolution wrongfully the value of his interest in the partnership at the dissolution, less any damages recoverable under clause (2 a II) of this section, and in like manner indemnify him against all present or future partnership liabilities.

(c) A partner who has caused the dissolution wrongfully shall have--

I. If the business is not continued under the provisions of paragraph (2b), all the rights of a partner under paragraph (1), subject to clause (2 a II) of this section.

II. If the business is continued under paragraph (2b) of this section, the right as against his co-partners and all claiming through them in respect of their interests in the partnership, to have the value of his interest in the partnership, less any damages caused to his co partners by the dissolution, ascertained and paid to him in cash, or the payment secured by bond approved by the court, and to be released from all existing liabilities of the partnership; but in ascertaining the value of the partner's interest the value of the good will of the business shall not be considered.

§ 39. Rights of partner entitled to rescind partnership

Where a partnership contract is rescinded on the ground of the fraud or misrepresentation of one of the parties thereto, the party entitled to rescind is, without prejudice to any other right, entitled--

(a) To a lien on, or right of retention of, the surplus of the partnership property after satisfying the partnership liabilities to third persons for any sum of money paid by him for the purchase of an interest in the partnership and for any capital or advances contributed by him; and

(b) To stand, after all liabilities to third persons have been satisfied, in the place of the creditors of the partnership for any payments made by him in respect of the partnership liabilities; and

(c) To be indemnified by the person guilty of the fraud or making the representation against all debts and liabilities of the partnership.

§ 40. Rules for settling accounts between partners

In settling accounts between the partners after dissolution, the following rules shall be observed, subject to any agreement to the contrary:

(a) The assets of the partnership are--

I. The partnership property.

II. The contributions of the partners specified in clause (d) of this section.

(b) The liabilities of the partnership shall rank in order of payment, as follows:

I. Those owing to creditors other than partners.

II. Those owing to partners other than for capital and profits.

III. Those owing to partners in respect of capital.

IV. Those owing to partners in respect of profits.

(c) The assets shall be applied in the order of their declaration in clause (a) of this section to the satisfaction of the liabilities.

(d) The partners shall contribute, as provided by section eighteen (a), except as provided in section fifteen: (i) the amount necessary to satisfy the liabilities and (ii) if any, but not all, of the partners are insolvent, or, not being subject to process, refuse to contribute, the other partners shall contribute their share of the liabilities, and, in the relative proportions in which they share the profits, the additional amount necessary to pay the liabilities.

(e) An assignee for the benefit of creditors or any person appointed by the court shall have the right to enforce the contributions specified in clause (d) of this section.

(f) Any partner or his legal representative shall have the right to enforce the contributions specified in clause (d) of this section, to the extent of the amount which he has paid in excess of his share of the liability.

(g) The individual property of a deceased partner shall be liable for the contributions specified in clause (d) of this section.

(h) When partnership property and the individual properties of the partners are in the possession of a court for distribution, partnership creditors shall have priority on partnership property and separate creditors on individual property, saving the rights of lien or secured creditors as heretofore.

(i) Where a partner has become bankrupt or his estate is insolvent, the claims against his separate property shall rank in the following order:

I. Those owing to separate creditors.

II. Those owing to partnership creditors.

III. Those owing to partners by way of contribution.

§ 41. Creditors' rights; continuing business of dissolved partnership

(1) When any new partner is admitted into an existing partnership, or when any partner retires and assigns, or dies and his representative assigns, his rights in partnership property to two or more of the partners, or to one or more of the partners, and one or more third persons, if the business is continued without liquidation of the partnership affairs, creditors of the first or dissolved partnership are also creditors of the partnership so continuing the business.

(2) When all but one partner retire and assign, or die and their representatives assign, their rights in partnership property to the remaining partner, who continues the business without liquidation of partnership affairs, either alone or with others, creditors of the dissolved partnership are also creditors of the person or partnership so continuing the business.

(3) When any partner retires or dies and the business of the dissolved partnership is continued as set forth in paragraph (1) or (2) of this section, with the consent of the retired partners or the representative of the deceased partner, but without any assignment of his right in partnership property, rights of creditors of the dissolved partnership and of the creditors of the person or partnership continuing the business shall be as if such assignment had been made.

(4) When all the partners or their representatives assign their rights in partnership property to one or more third persons, who promise to pay the debts and who continue the business of the dissolved partnership, creditors of the dissolved partnership are also creditors of the person or partnership continuing the business.

(5) When any partner wrongfully causes a dissolution and the remaining partners continue the business under the provisions of section thirty-eight (2b), either alone or with others, and without liquidation of the partnership affairs, creditors of the dissolved partnership are also creditors of the person or partnership continuing the business.

(6) When a partner is expelled and the remaining partners continue the business either alone or with others, without liquidation of the partnership affairs, creditors of the dissolved partnership are also creditors of the person or partnership continuing the business.

(7) The liability of a third person becoming a partner in the partnership continuing the business, under this section, to the creditors of the dissolved partnership shall be satisfied out of partnership property only.

(8) When the business of a partnership after dissolution is continued under any conditions set forth in this section, the creditors of the dissolved partnership, as against the separate creditors of the retiring or deceased partner or the representative of the deceased partner, have a prior right to any claim of the retired partner or the representative of the deceased

partner against the person or partnership continuing the business, on account of the retired or deceased partner's interest in the dissolved partnership or on account of any consideration promised for such interest or for his right in partnership property.

(9) Nothing in this section shall be held to modify any right of creditors to set aside any assignment on the ground of fraud.

(10) The use by the person or partnership continuing the business of the partnership name, or the name of a deceased partner as part thereof, shall not of itself make the individual property of the deceased partner liable for any debts contracted by such person or partnership.

§ 42. Rights of retiring or deceased partner against person or partnership continuing business

When any partner retires or dies, and the business is continued under any of the conditions set forth in section forty-one (1)(2)(3)(5)(6), or section thirty-eight (2b), without any settlement of accounts as between him or his estate and the person or partnership continuing the business, unless otherwise agreed, he or his legal representative as against such persons or partnership may have the value of his interest at the date of dissolution ascertained, and shall receive as an ordinary creditor an amount equal to the value of his interest in the dissolved partnership with interest, or, at his option or at the option of his legal representative, in lieu of interest, the profits attributable to the use of his right in the property of the dissolved partnership; provided, that the creditors of the dissolved partnership as against the separate creditors, or the representative of the retired or deceased partner, shall have priority on any claim arising under this section, as provided by section forty-one (8).

§ 43. Right to an account

The right to an account of his interest shall accrue to any partner, or his legal representative, as against the winding up partners or the surviving partners or the person or partnership continuing the business, at the date of dissolution, in the absence of any agreement to the contrary.

§ 44. Actions to reach and apply corporate shares and interests

Nothing in this chapter shall effect clause seven of section three of chapter two hundred and fourteen.

MASSACHUSETTS GENERAL LAWS ANNOTATED
PART I. ADMINISTRATION OF THE GOVERNMENT
TITLE XV. REGULATION OF TRADE

CHAPTER 109. LIMITED PARTNERSHIP

GENERAL PROVISIONS

§ 1. Definitions

As used in this chapter, the following words shall, unless the context clearly requires otherwise, have the following meanings:----

(1) "Certificate of limited partnership", the certificate referred to in section eight, and the certificate as amended or restated.

(2) "Contribution", any cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to perform services, which a partner contributes to a limited partnership in his capacity as a partner.

(3) "Event of withdrawal of a general partner", an event that causes a person to cease to be a general partner as provided in section twenty-three.

(4) "Foreign limited partnership", a partnership formed under the laws of any state other than the commonwealth and having as partners one or more general partners and one or more limited partners.

(5) "General partner", a person who has been admitted to a limited partnership as a general partner in accordance with the partnership agreement and named in the certificate of limited partnership as a general partner.

(6) "Limited partner", a person who has been admitted to a limited partnership as a limited partner in accordance with the partnership agreement.

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

(8) "Partner", a limited or general partner.

(9) "Partnership agreement", any valid agreement, written or oral, of the partners as to the affairs of a limited partnership and the conduct of its business.

(10) "Partnership interest", a partner's share of the profits and losses of a limited partnership and the right to receive distributions of partnership assets.

(11) "Person", a natural person, partnership, limited partnership (domestic or foreign), trust, estate, association, or corporation.

(12) "State", a state, territory, or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico.

§ 1A. Short title

This chapter may be cited as the Uniform Limited Partnership Act.

§ 2. Name of limited partnership; requirements

The name of each limited partnership as set forth in its certificate of limited partnership:

(1) shall contain without abbreviation the words "limited partnership";

(2) may not contain the name of a limited partner unless (i) it is also the name of a general partner or the corporate name of a corporate general partner, or (ii) the business of the limited partnership had been carried on under that name before the admission of that limited partner;

(3) may not contain any word or phrase indicating or implying that it is organized other than for a purpose stated in its certificate of limited partnership;

(4) may not be the same as, or deceptively similar to, the name of any corporation or limited partnership organized under the laws of the commonwealth or licensed or registered as a foreign corporation or limited partnership in the commonwealth, except with the written consent of said corporation or limited partnership previously filed with the secretary of state.

§ 3. Reservation of name

(a) The exclusive right to the use of a name may be reserved by:

(1) any person intending to organize a limited partnership under this chapter and to adopt such name;

(2) any domestic limited partnership or any foreign limited partnership registered in the commonwealth which, in either case, intends to adopt such name;

(3) any foreign limited partnership intending to register in the commonwealth and adopt such name; and

(4) any person intending to organize a foreign limited partnership and intending to have it registered in the commonwealth and adopt such name.

(b) The reservation shall be made by filing with the secretary of state an application,

executed by the applicant and accompanied by the requisite fee, to reserve a specified name. If the secretary of state finds such name is available for use by a domestic or foreign limited partnership, he shall reserve the name for the exclusive use of the applicant for a period of thirty days. The secretary of state may extend the reservation for an additional thirty days upon written request of the applicant accompanied by the requisite fee. The right to the exclusive use of a reserved name may be transferred to any other person by filing in the office of the secretary of state a notice of the transfer, executed by the applicant for whom the name was reserved, specifying the name and the address of the transferee and accompanied by the requisite fee.

§ 4. Office and agent for service of process

Each limited partnership shall continuously maintain in the commonwealth:

(1) an office, which may, but need not be a place of its business in the commonwealth, at which shall be kept the records required by section five to be maintained; and

(2) an agent for service of process on the limited partnership, which agent must be an individual resident of the commonwealth, a domestic corporation, or a foreign corporation authorized to do business in the commonwealth.

§ 5. Records

(a) Each limited partnership shall keep at the office referred to in clause (1) of section four the following:

(1) a current list of the full name and last known business address of each partner, separately identifying in alphabetical order the general partners and the limited partners;

(2) a copy of the certificate of limited partnership and all certificates of amendment thereto, together with executed copies of any powers of attorney pursuant to which any certificate has been executed;

(3) copies of the limited partnership's federal, state, and local income tax returns and reports, if any, for the three most recent years;

(4) copies of any then effective written partnership agreements and of any financial statements of the limited partnership for the three most recent years; and

(5) unless contained in a written partnership agreement, a writing setting out:

(i) the amount of cash and a description and statement of the agreed value of the other property or services contributed by each partner and which each partner has agreed to contribute;
(ii) the times at which or events on the happening of which any additional contributions

agreed to be made by each partner are to be made;

(iii) any right of a partner to receive, or of a general partner to make distributions to a partner which include a return of all or any part of the partner's contribution; and

(iv) any events upon the happening of which the limited partnership is to be dissolved and its affairs closed.

(b) Records kept under this section shall be subject to inspection and copying at the reasonable request and at the expense of any partner during ordinary business hours.

(c) The current list of names and addresses of the limited partners shall be made available to the secretary of state within five business days of receipt of a written request by said secretary or by the director of the securities division of the secretary of state's office stating that such information is required in connection with an investigatory or enforcement proceeding.

§ 6. Business of partnership

A limited partnership may carry on any business that a partnership without limited partners may carry on.

§ 7. Partners transacting business with partnership

Except as provided in the partnership agreement, a partner may lend money to and transact other business with the limited partnership and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a partner.

§ 8. Certificate

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

(1) the name of the limited partnership;

(2) the general character of its business;

(3) the address of the office and the name and address of the agent for service of process required to be maintained by section four;

(4) the name and the business address of each general partner;

(5) the latest date upon which the limited partnership is to dissolve; and
(6) any other matters the general partners determine to include therein.

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

§ 9. Amendment to certificate

(a) A certificate of limited partnership is amended by filing a certificate of amendment thereto in the office of the secretary of state. The certificate of amendment shall set forth:

(1) the name of the limited partnership;

(2) the date of filing the certificate; and

(3) the amendment to the certificate.

(b) Within thirty days after the happening of any of the following events, an amendment to a certificate of limited partnership reflecting the occurrence of the event or events shall be filed:

(1) the admission of a new general partner;

(2) the withdrawal of a general partner; or

(3) the continuation of the business under section forty-four after an event of withdrawal of a general partner.

(c) A general partner who becomes aware that any statement in a certificate of limited partnership was false when made or that any arrangements or other facts described have changed, making the certificate inaccurate in any respect, shall promptly amend the certificate.

(d) A certificate of limited partnership may be amended at any time for any other proper purpose the general partners determine.

(e) No person has any liability because an amendment to a certificate of limited partnership has not been filed to reflect the occurrence of any event referred to in subsection (b) if the amendment is filed within the thirty-day period specified in subsection (b).

(f) A restated certificate of a limited partnership may be executed and filed in the same manner as a certificate of amendment.

§ 10. Cancellation of certificate

A certificate of limited partnership shall be cancelled upon the dissolution and the

commencement of winding up of the partnership or at any other time there are no limited partners. A certificate of cancellation shall be filed in the office of the secretary of state and set forth:

(1) the name of the limited partnership;

(2) the date of filing of its certificate of limited partnership;

(3) the reason for filing the certificate of cancellation;

(4) the effective date, which shall be a date certain, of cancellation if it is not to be effective upon the filing of the certificate; and

(5) any other information the general partners filing the certificate determine.

§ 11. Execution of certificates

(a) Each certificate required by sections eight to sixteen, inclusive, to be filed in the office of the secretary of state shall be executed in the following manner:

(1) an original certificate of limited partnership must be signed by all general partners;

(2) a certificate of amendment must be signed by at least one general partner and by each other general partner designated in the certificate as a new general partner; and

(3) a certificate of cancellation must be signed by all general partners.

(b) Any person may sign a certificate by an attorney-in-fact, but a power of attorney to sign a certificate relating to the admission of a general partner must specifically describe the admission.

(c) The execution of a certificate by a general partner constitutes an affirmation under the penalties of perjury that the facts stated therein are true.

§ 12. Execution of certificate ordered by court

If a person required by section eleven to execute a certificate fails or refuses to do so, any other person who is adversely affected by the failure or refusal may petition the superior court department of the trial court to direct the execution of the certificate. If the court finds that it is proper for the certificate to be executed and that any person so designated has failed or refused to execute the certificate, it shall order the secretary of state to record an appropriate certificate.

§ 13. Filing of certificates

(a) Two signed copies of the certificate of limited partnership and of any certificates of

amendment or cancellation, or of any judicial decree of amendment or cancellation, shall be delivered to the secretary of state. A person who executes a certificate as an agent or fiduciary need not exhibit evidence of his authority as a prerequisite to filing. Unless the secretary of state finds that any certificate does not conform to law, upon receipt of all filing fees required by law he shall:

(1) endorse on each duplicate original the word "filed" and the day, month and year of the filing thereof;

(2) file one duplicate original in his office; and

(3) return the other duplicate original to the person who filed it or his representative.

(b) Upon the filing of a certificate of amendment, or judicial decree of amendment, in the office of the secretary of state, the certificate of limited partnership shall be amended as set forth therein, and upon the effective date of a certificate of cancellation, or a judicial decree thereof, the certificate of limited partnership is cancelled.

§ 14. False statements in certificates; damages

If any certificate of limited partnership or certificate of amendment or cancellation contains a false statement, one who suffers loss by reliance on the statement may recover damages for the loss from:

(1) any person who executes the certificate, or causes another to execute it on his behalf, and knew, and any general partner who knew or should have known, the statement to be false at the time the certificate was executed; and

(2) any general partner who thereafter knows or should have known that any arrangement or other fact described in the certificate has changed, making the statement inaccurate in any respect within a sufficient time before the statement was relied upon reasonably to have enabled that general partner to cancel or amend the certificate, or to file a petition for its cancellation or amendment under section twelve.

§ 15. Notice

The fact that a certificate of limited partnership is on file in the office of the secretary of state is notice that the partnership is a limited partnership and the persons designated therein as general partners are general partners, but it is not notice of any other fact.

§ 16. Delivery of certificates to limited partners

Upon the return by the secretary of state pursuant to section thirteen of a certificate marked "filed", the general partners shall promptly deliver or mail a copy of the certificate of limited partnership and each certificate to each limited partner unless the partnership agreement

provides otherwise.

§ 16A. Consolidation or merger

(a) As used in this section, other business entity shall mean a corporation to which the provisions of clause (a) of section three of chapter one hundred and fifty-six B apply, a foreign corporation as defined in section one of chapter one hundred and eighty-one, a professional corporation as defined in section two of chapter one hundred and fifty-six A, a foreign professional corporation as defined in section two of chapter one hundred and fifty-six A, an association or a trust as defined in section one of chapter one hundred and eighty-two, a limited liability company, whether domestic or foreign, as defined in section two of chapter one hundred and fifty-six C, and a partnership, whether general, registered limited liability or limited and whether domestic or foreign; as defined, respectively, in sections six and two of chapter one hundred and eight A and section one of chapter one hundred and nine, but excluding a domestic limited partnership.

(b) Pursuant to an agreement of consolidation or merger, a domestic limited partnership may consolidate or merge with or into one or more domestic limited partnerships or other business entities with such domestic limited partnership or other business entity as the agreement shall provide being the resulting or surviving domestic limited partnership or other business entity.

(c) Unless otherwise provided in the partnership agreement, a consolidation or merger shall be approved by each domestic limited partnership which is to consolidate or merge (1) by all general partners, and (2) by the limited partners or, if there is more than one class or group of limited partners, then by each class or group of limited partners, in either case, by limited partners who own more than fifty percent of the then current percentage or other interest in the profits of the domestic limited partnership owned by all of the limited partners or by the limited partners in each class or group, as appropriate.

(d) In connection with a consolidation or merger hereunder, rights or securities of, or interests in, a domestic limited partnership or other business entity which is a constituent party to the consolidation or merger may be exchanged for or converted into cash, property, rights or securities of, or interests in, the surviving or resulting domestic limited partnership or other business entity or, in addition to or in lieu thereof, may be exchanged for or converted into cash, property, rights or securities of, or interests in, a limited partnership or other business entity which is not the surviving or resulting limited partnership or other business entity in the consolidation or merger. Notwithstanding prior approval, an agreement of consolidation or merger may be terminated or amended pursuant to a provision for such termination or amendment contained in the agreement of consolidation or merger.

(e) If a domestic limited partnership is consolidating or merging under this section, the domestic limited partnership or other business entity resulting or surviving from or in the consolidation or merger shall file in the manner described in section thirteen a certificate of consolidation or merger in the office of the state secretary. The certificate of consolidation or merger shall be executed in the manner described in section eleven and shall state:

(1) the name and jurisdiction of formation or organization of each of the domestic limited partnerships or other business entities which is to consolidate or merge;

(2) that an agreement of consolidation or merger has been approved and executed by each of the domestic limited partnerships or other business entities which is to consolidate or merge;

(3) the name of the resulting or surviving domestic limited partnership or other business entity;

(4) the future effective date or time, which shall be a date or time certain, of the consolidation or merger if it is not to be effective upon the filing of the certificate of consolidation or merger;

(5) that the agreement of consolidation or merger is on file at a place of business of the resulting or surviving domestic limited partnership or other business entity, and shall state the address thereof;

(6) that a copy of the agreement of consolidation or merger will be furnished by the surviving or resulting domestic limited partnership or other business entity, on request and without cost, to any member of any domestic limited partnership or any person holding an interest in any other business entity which is to consolidate or merge; and

(7) if the resulting or surviving entity is not an entity organized under the laws of the commonwealth, a statement that such resulting or surviving entity agrees that, if such entity does not continuously maintain an agent for service of process in the commonwealth, to appoint irrevocably the state secretary and his successor in office to be its true and lawful attorney upon whom all lawful process in any such action, suit or proceeding in the commonwealth may be served in the manner set forth in section fifteen of chapter one hundred and eighty-one, relative to foreign corporations; provided, however, that if service of process is made upon the state secretary, he shall follow the procedures set forth in section fifteen of chapter one hundred and eighty-one with respect thereto, except that the plaintiff in any such action, suit or proceeding shall furnish the state secretary with the address specified in the certificate of consolidation or merger provided for in this section and the state secretary shall notify such resulting or surviving entity at such address in accordance with the procedures set forth in section fifteen of chapter one hundred and eighty-one.

(f) Unless a future effective date or time is provided in a certificate of consolidation or merger, in which event a consolidation or merger shall be effective at any such future effective date or time, a consolidation or merger shall be effective upon the filing in the office of the state secretary of a certificate of consolidation or merger.

(g) A certificate of consolidation or merger shall act (1) as a certificate of cancellation for a domestic limited partnership, and (2) as a certificate of withdrawal for a registered foreign partnership, which is not the resulting or surviving entity in the consolidation or merger.

(i) Notwithstanding anything to the contrary contained in the partnership agreement, a partnership agreement containing a specific reference to this subsection may provide that an agreement of consolidation or merger approved in accordance with subsection (b) may (1) effect any amendment to the partnership agreement or (2) effect the adoption of a new partnership agreement, for a limited partnership if it is the resulting or surviving limited partnership in the consolidation or merger. Any amendment to a partnership agreement or adoption of a new partnership agreement made pursuant to the foregoing sentence shall be effective at the effective time or date of the consolidation or merger. The provisions of this subsection shall not be construed to limit the accomplishment of a merger or of any of the matters referred to herein by any other means provided for in a partnership agreement or other agreement or as otherwise permitted by law, including that the partnership agreement of any constituent limited partnership to the consolidation or merger, including a limited partnership formed for the purpose of consummating a consolidation or merger, shall be the partnership agreement of the resulting or surviving limited partnership.

(ii) When any consolidation or merger shall have become effective under this section, for all purposes of the laws of the commonwealth, all of the rights, privileges and powers of each of the domestic limited partnerships and other business entities that have consolidated or merged and all property, real, personal and mixed, and all debts due to any of said domestic limited partnerships and other business entities, as well as all other things and causes of action belonging to each of such domestic limited partnerships and other business entities, shall be vested in the resulting or surviving domestic limited partnership or other business entity, and shall thereafter be the property of the resulting or surviving domestic limited partnership or other business entity as they were of each of the domestic limited partnerships and other business entities that have consolidated or merged, and the title to any real property vested by deed or otherwise under the laws of the commonwealth, in any of such domestic limited partnerships and other business entities shall not revert or be in anyway impaired by reason of this chapter; but all rights of creditors and all liens upon any property of any of said domestic limited partnerships and other business entities shall be preserved unimpaired, and all debts, liabilities and duties of each of the said domestic limited partnerships and other business entities that have consolidated or merged shall thenceforth attach to the resulting or surviving domestic limited partnership or other business entity, and may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it. Unless otherwise agreed, a consolidation or merger of a domestic limited partnership, including a domestic limited partnership which is not the resulting or surviving entity in the consolidation or merger, shall not require such domestic limited partnership to wind up its affairs under section forty-six or pay its liabilities and distribute its assets under section forty-seven.

§ 17. Limited partners

(a) A person becomes a limited partner on the later of:

(1) the date the original certificate of limited partnership is filed; or

(2) the date stated in the records of the limited partnership as the date that person becomes a limited partner.

(b) After the filing of a limited partnership's original certificate of limited partnership, a person may be admitted as an additional limited partner:

(1) in the case of a person acquiring a partnership interest directly from the limited partnership, upon compliance with the partnership agreement or, if the partnership agreement does not so provide, upon the written consent of all partners; and

(2) in the case of an assignee of a partnership interest of a partner who has the power, as provided in section forty-two, to grant the assignee the right to become a limited partner, upon the exercise of that power and compliance with any conditions limiting the grant or exercise of the power.

§ 18. Right to vote of limited partners

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

(b) When the limited partnership is an investment company registered under the Investment Company Act of 1940, 15 USC 80a, the limited partner shall have the right to vote (i) in the election of general partners, directors, or trustees of the investment company, (ii) to approve or terminate investment advisory or underwriting contracts, (iii) for approval of auditors, and (iv) on any matters that the said Investment Company Act of 1940, or rules and regulations promulgated thereunder, requires to be approved by the holders of beneficial interests in the investment company.

§ 19. Liability of limited partners

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

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

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

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

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

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

(5) requesting or attending a meeting of partners;

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

(i) the dissolution and closing of the limited partnership;

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

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

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

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

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

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

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

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

(7) closing of the affairs of the limited partnership pursuant to the provisions of section forty-six; or

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

(c) The enumeration in subsection (b) shall not mean that the possession or exercise of any

other powers by a limited partner constitutes participation by him in the control of the business of the limited partnership.

(d) A limited partner who knowingly permits his name to be used in the name of the limited partnership, except under circumstances permitted by subclause (i) of clause (2) of section two, is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.

§ 20. Person erroneously believing himself limited partner

(a) Except as provided in subsection (b), a person who makes a contribution to a business enterprise and erroneously but in good faith believes that he has become a limited partner in the enterprise is not a general partner in the enterprise and is not bound by its obligations by reason of making the contribution, receiving distributions from the enterprise, or exercising any rights of a limited partner, if, on ascertaining the mistake, he:

(1) causes an appropriate certificate of limited partnership or a certificate of amendment to be executed and filed; or

(2) withdraws from future equity participation in the enterprise by executing and filing in the office of the state secretary a certificate declaring withdrawal under this section.

(b) A person who makes a contribution of the kind described in subsection (a) is liable as a general partner to any third party who transacts business with the enterprise (i) before the person withdraws and an appropriate certificate is filed to show withdrawal, or (ii) before an appropriate certificate is filed to show that he is not a general partner, but in either case only if the third party actually believed in good faith that the person was a general partner at the time of the transaction.

§ 21. Records; rights of limited partners

Each limited partner has the right to:

(1) inspect and copy any of the partnership records required to be maintained by section five, and

(2) obtain from the general partners from time to time upon reasonable demand (i) true and full information regarding the state of the business and financial condition of the limited partnership, (ii) promptly after becoming available, a copy of the limited partnership's federal, state and local income tax returns for each year, and (iii) other information regarding the affairs of the limited partnership as is just and reasonable.

§ 22. Additional general partners

After the filing of a limited partnership's original certificate of limited partnership, additional general partners may be admitted as provided in the partnership agreement or, if the

partnership agreement does not provide for the admission of additional general partners, with the written consent of all partners.

§ 23. Cessation of general partner status

Except as approved by the specific written consent of all partners at the time, a person ceases to be a general partner of a limited partnership upon the happening of any of the following events:

(1) the general partner withdraws from the limited partnership as provided in section thirty-two;

(2) the general partner ceases to be a member of the limited partnership as provided in section forty;

(3) the general partner is removed as a general partner in accordance with the partnership agreement;

(4) Unless otherwise provided in writing in the partnership agreement the general partner: (i) makes an assignment for the benefit of creditors, (ii) files a voluntary petition in bankruptcy; (iii) is adjudicated a bankrupt or insolvent; (iv) files a petition or answer seeking for himself any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law or regulation; (v) files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against him in any proceeding of this nature; or (vi) seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the general partner or of all or any substantial part of his properties;

(5) unless otherwise provided in writing in the partnership agreement one hundred and twenty days after the commencement of any proceeding against the general partner seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law, or regulation, the proceeding has not been dismissed, or if within ninety days after the appointment without his consent or acquiescence of a trustee, receiver, or liquidator of the general partner or of all or any substantial part of his properties, the appointment is not vacated or stayed or within ninety days after the expiration of any such stay, the appointment is not vacated;

(6) in the case of a general partner who is a natural person:

(i) his death; or

(ii) the entry by a court of competent jurisdiction adjudicating him incompetent to manage his person or his estate;

(7) in the case of a general partner who is acting as a general partner by virtue of being a

trustee of a trust, the termination of the trust but not merely the substitution of a new trustee;

(8) in the case of a general partner that is a separate partnership, the dissolution and commencement of winding up of the separate partnership;

(9) in the case of a general partner that is a corporation, the filing of a certificate of dissolution, or its equivalent, for the corporation or the revocation of its charter; or

(10) in the case of an estate, the distribution by the fiduciary of the estate's entire interest in the partnership.

§ 24. Rights, powers and liabilities of general partners

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

§ 25. Contributions by general partner

A general partner of a limited partnership may make contributions to the partnership and share in the profits and losses of, and in distributions from, the limited partnership as a general partner. A general partner also may make contributions to and share in profits, losses, and distributions as a limited partner. A person who is both a general partner and a limited partner has the rights and powers, and is subject to the restrictions and liabilities, of a general partner and, except as provided in the partnership agreement, also has the powers, and is subject to the restrictions, of a limited partner to the extent of his participation in the partnership as a limited partner.

§ 26. Right to vote of general partners

The partnership agreement may grant to all or certain identified general partners the right to vote, on a per capita or any other basis, separately or with all or any class of the limited partners, on any matter.

§ 27. Form of partner's contribution

The contribution of a partner may be in cash, property, or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.

§ 28. Obligation to contribute

(a) No promise by a limited partner to contribute to the limited partnership is enforceable unless set out in a writing signed by the limited partner.

(b) Except as provided in the partnership agreement, a partner is obligated to the limited

partnership to perform any enforceable promise to contribute cash or property or to perform services, even if he is unable to perform because of death, disability or any other reason. If a partner does not make the required contribution of property or services, he is obligated at the option of the limited partnership to contribute cash equal to that portion of the value, as stated in the partnership records required to be kept pursuant to section five, of the stated contribution that has not been made.

(c) Unless otherwise provided in the partnership agreement, the obligation of a partner to make a contribution or return money or other property paid or distributed in violation of this chapter may be compromised only by consent of all the partners. Notwithstanding the compromise, a creditor of a limited partnership who extends credit, or otherwise acts in reliance on that obligation after the partner signs a writing which reflects the obligation, and before the amendment or cancellation thereof to reflect the compromise, may enforce the original obligation.

§ 29. Allocation of profits and losses

The profits and losses of a limited partnership shall be allocated among the partners, and among classes of partners, in the manner provided in writing in the partnership agreement. If the partnership agreement does not so provide in writing, profits and losses shall be allocated on the basis of the value, as stated in the partnership records to be kept pursuant to section five, of the contributions made by each partner to the extent they have been received by the partnership and have not been returned.

§ 30. Distributions of cash or other assets

Distributions of cash or other assets of a limited partnership shall be allocated among the partners, and among classes of partners, in the manner provided in writing in the partnership agreement. If the partnership agreement does not so provide in writing, distributions shall be made on the basis of the value, as stated in the partnership records to be kept pursuant to section five, of the contributions made by each partner to the extent they have been received by the partnership and have not been returned.

§ 31. Interim distributions

Except as provided in sections thirty-one to thirty-eight, inclusive, a partner is entitled to receive distributions from a limited partnership before his withdrawal from the limited partnership and before the dissolution and closing of its affairs to the extent and at the times or upon the happening of the events specified in the partnership agreement.

§ 32. Withdrawal of general partner

A general partner may withdraw from a limited partnership at any time by giving written notice to the other partners, but if the withdrawal violates the partnership agreement, the limited partnership may recover from the withdrawing general partner damages for breach of the partnership agreement and offset the damages against the amount otherwise distributable

to him.

§ 33. Withdrawal of limited partner

A limited partner may withdraw from a limited partnership at the time or upon the happening of events specified in writing in the partnership agreement. If the agreement does not specify the time or the events upon the happening of which the limited partner may withdraw or a definite time for the dissolution and closing of the affairs of the limited partnership, a limited partner may withdraw upon not less than six months' prior written notice to each general partner at his address on the books of the limited partnership at its office in the commonwealth.

§ 34. Distribution to partner upon withdrawal

Except as provided in sections thirty-one to thirty-eight, inclusive, upon withdrawal any withdrawing partner is entitled to receive any distribution to which he is entitled under the partnership agreement and, if not otherwise provided in the agreement, he is entitled to receive, within a reasonable time after withdrawal, the fair value of his interest in the limited partnership as of the date of withdrawal based upon his right to share in distributions from the limited partnership.

§ 35. Distribution in kind

Except as provided in writing in the partnership agreement, a partner, regardless of the nature of his contribution, has no right to demand and receive any distribution from a limited partnership in any form other than cash. Except as provided in writing in the partnership agreement, a partner may not be compelled to accept a distribution of any asset in kind from a limited partnership to the extent that the percentage of the asset distributed to him exceeds a percentage of that asset which is equal to the percentage in which he shares in distributions from the limited partnership.

§ 36. Right to distribution

At the time a partner becomes entitled to receive a distribution, he has the status of, and is entitled to all remedies available to, a creditor of the limited partnership with respect to the distribution.

§ 37. Limitations on distribution

A partner may not receive a distribution from a limited partnership to the extent that, after giving effect to the distribution, all liabilities of the limited partnership, other than liabilities to partners on account of their partnership interests, exceed the fair value of the partnership assets.

§ 38. Liability upon return of contribution

(a) If a partner has received the return of any part of his contribution without violation of the partnership agreement or this chapter, he is liable to the limited partnership for a period of one year thereafter for the amount of the returned contribution, but only to the extent necessary to discharge the limited partnership's liabilities to creditors who extended credit to the limited partnership during the period the contribution was held by the partnership.

(b) If a partner has received the return of any part of his contribution in violation of the partnership agreement or this chapter, he is liable to the limited partnership for a period of six years thereafter for the amount of the contribution wrongfully returned.

(c) A partner receives a return of his contribution to the extent that a distribution to him reduces his shares of the fair value of the net assets of the limited partnership below the value, as set forth in the partnership records required to be kept pursuant to section five, of his contribution which has not been distributed to him.

§ 39. Nature of partnership interest

A partnership interest is personal property.

§ 40. Assignment of partnership interest

Except as provided in the partnership agreement, a partnership interest is assignable in whole or in part. An assignment of a partnership interest shall not dissolve a limited partnership or entitle the assignee to become or to exercise any rights of a partner. An assignment entitles the assignee to receive, to the extent assigned, only the distribution to which the assignor would be entitled. Except as provided in the partnership agreement, a partner ceases to be a partner upon assignment of all his partnership interest.

§ 41. Rights of judgment creditor

On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This chapter shall not deprive any partner of the benefit of any exemption laws applicable to his partnership interest.

§ 42. Assignee becoming limited partner

(a) An assignee of a partnership interest, including an assignee of a general partner, may become a limited partner if and to the extent that (1) the assignor gives the assignee that right in accordance with authority described in the partnership agreement, or (2) all other partners consent.

(b) An assignee who has become a limited partner has, to the extent assigned, the rights and

powers, and is subject to the restrictions and liabilities, of a limited partner under the partnership agreement and this chapter. An assignee who becomes a limited partner also is liable for the obligations of his assignor to make and return contributions as provided in sections twenty-seven to thirty-eight, inclusive; provided, however, that the assignee is not obligated for liabilities unknown to the assignee at the time he became a limited partner.

(c) If an assignee of a partnership interest becomes a limited partner, the assignor is not released from his liability to the limited partnership under sections fourteen and twenty-eight.

§ 43. Death or incompetency of partner; power to settle estate or administer property

If a partner who is an individual dies or a court of competent jurisdiction adjudges him to be incompetent to manage his person or his property, the partner's executor, administrator, guardian, conservator, or other legal representative may exercise all the partner's rights for the purpose of settling his estate or administering his property, including any power the partner had to give an assignee the right to become a limited partner. If a partner is a corporation, trust, or other entity and is dissolved or terminated, the powers of that partner may be exercised by its legal representative or successor.

§ 44. Nonjudicial dissolution

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

(1) at the time specified in writing in the partnership agreement;

(2) upon the happening of events specified in writing in the partnership agreement;

(3) written consent of all partners;

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

(5) entry of a decree of judicial dissolution under section forty-five.

§ 45. Judicial dissolution

On application by or for a partner the superior court department of the trial court may decree dissolution of a limited partnership whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement.

§ 46. Winding up partnership affairs

Except as provided in the partnership agreement, the general partners who have not wrongfully dissolved a limited partnership or, if none, the limited partners, may wind up the limited partnership's affairs; provided, however, that the superior court department of the trial court may wind up the limited partnership's affairs upon application of any partner, his legal representative, or assignee.

§ 47. Distribution of assets following winding up

Upon the winding up of a limited partnership, the assets shall be distributed as follows:

(1) to creditors, including partners who are creditors, to the extent permitted by law, in satisfaction of liabilities of the limited partnership other than liabilities for distributions to partners under sections thirty-one and thirty-four;

(2) except as provided in the partnership agreement, to partners and former partners in satisfaction of liabilities for distributions under sections thirty-one and thirty-four; and

(3) except as provided in the partnership agreement, to partners (i) for the return of their contributions and (ii) respecting their partnership interests, in the proportions in which the partners share in distributions.

§ 48. Nature of business; liability of partners and agents; law governing

A foreign limited partnership shall not do any business in the commonwealth which is prohibited to a limited partnership organized under this chapter. A general partner or other agent of a foreign limited partnership shall be subject to such liabilities, and shall have such defenses, with respect to such foreign limited partnership, as officers, directors and the other agents of a foreign corporation have under sections ten, eleven, twelve, thirteen and fourteen of chapter one hundred and eighty-one relative to such foreign corporation. Subject to the constitution of the commonwealth, its organization and internal affairs and the liability of its limited partners shall be governed by the laws of the state under which it is organized.

§ 49. Registration

A foreign limited partnership shall be considered to be doing business in the commonwealth for the purposes of this section if it would be considered to be doing business in the commonwealth for the purposes of chapter one hundred and eighty-one if it were a foreign corporation. Every foreign limited partnership doing business in the commonwealth shall submit to the secretary of state, within ten days after it commences doing business in the commonwealth, an application for registration as a foreign limited partnership, which shall be signed and sworn to by the general partner. The application shall be in such form as the secretary of state shall require, and shall be accompanied by a certificate of legal existence of the foreign limited partnership, issued by an officer or agency properly authorized in the

jurisdiction in which the foreign limited partnership is organized, or such other evidence of legal existence as the secretary of state shall approve. If the certificate or such evidence is in a foreign language, a translation thereof, under oath of the translator, shall be attached thereto.

The application for registration shall set forth the following information:--

(1) the name of the foreign limited partnership and, if different, the name under which it proposes to do business in the commonwealth;

(2) the jurisdiction where such partnership was organized and the date of its organization;

(3) the general character of the business it proposes to do in the commonwealth;

(4) the business address of its principal office;

(5) the names, business addresses and residence addresses of its general partners;

(6) the business address of its principal office in the commonwealth, if any;

(7) the name and business address of its resident agent; and

(8) the address of the office at which is kept a list of the names and addresses of the limited partners and their capital contributions, together with an undertaking by the foreign limited partnership to keep those records until the foreign limited partnership's registration in the commonwealth is cancelled.

If the foreign limited partnership's certificate of partnership from its jurisdiction of organization sets forth any part of the information required to be set forth in the application for registration in the commonwealth, the foreign limited partnership may submit a certified copy of such certificate, with a sworn translation, if necessary, in lieu of such part of the application for registration.

§ 50. Approval of registration; fee; records

The secretary of state shall examine and endorse his approval on the application for registration if the business of the foreign limited partnership is not prohibited by law to a limited partnership formed under this chapter and if the secretary of state determines that the application complies with this section. Upon such approval and payment of the required fee, the application shall be deemed to be filed with the secretary of state and the foreign limited partnership shall be deemed to be registered to do business in the commonwealth. The secretary of state shall keep such records and have such other duties with respect to foreign limited partnerships as are provided in section six of chapter one hundred and eighty-one relative to foreign corporations.

§ 51. Name

A foreign limited partnership may register with the secretary of state and do business in the commonwealth under any name, whether or not it is the name under which it is registered in its jurisdiction of organization, that could be assumed by a limited partnership.

§ 52. Resident agent

Each foreign limited partnership doing business in the commonwealth shall appoint a resident agent as its true and lawful attorney upon whom all lawful processes in any action or proceeding against such foreign limited partnership in the commonwealth may be served. The provisions of section forty-nine of chapter one hundred and fifty-six B relative to the appointment and qualifications of a resident agent for a corporation shall be applicable to the appointment of a resident agent pursuant to this section. A foreign limited partnership may revoke any such appointment or appoint a new resident agent, and any such resident agent may change his or its business address or resign in substantially the manner set forth in said section forty-nine; provided that each certificate required or permitted to be filed with the secretary of state by the officers of a corporation under said section forty-nine shall be signed on behalf of a foreign limited partnership by a general partner thereof, and each action required or permitted to be taken by the directors of a corporation under said section forty-nine shall be required or permitted in the manner provided in the foreign limited partnership's governing instrument. Compliance with this section shall be deemed compliance with the provisions of section five of chapter two hundred and twenty-seven.

§ 53. Correction or amendment of false or changed statements in application for registration

If any statement in the application for registration of a foreign limited partnership was false when made or any arrangements or other facts described have changed, making the application inaccurate in any respect, the foreign limited partnership shall promptly file in the office of the secretary of state a certificate, signed and sworn to by a general partner, correcting or amending such statement.

§ 54. Cancellation of registration; certificate of withdrawal

The registration of a foreign limited partnership doing business in the commonwealth shall be cancelled in the manner and at such times as are provided in section ten except that the cancellation shall be signed by a general partner. A foreign limited partnership doing business in this commonwealth may withdraw from the commonwealth by submitting to the secretary of state a certificate of withdrawal, in such form as the secretary of state shall require, signed and sworn to by a general partner, stating:

(1) the name of the foreign limited partnership and, if different, the name under which it is registered and doing business in the commonwealth;

(2) the business address of its principal office;

(3) the business address of its principal office in the commonwealth, if any, and the name and business address of its resident agent in the commonwealth;

(4) that the foreign limited partnership is not doing business in the commonwealth; and

(5) that all taxes and fees owed the commonwealth have been paid or provided for.

The secretary of state shall examine and endorse his approval on the certificate of withdrawal if he determines that the certificate complies with this section. Upon such approval and payment of the required fee, the certificate of withdrawal shall be deemed to be filed with the secretary of state.

§ 55. Failure to register; capacity to sue and be sued; secretary of state as attorney of unregistered or withdrawn partnerships

(a) A foreign limited partnership doing business in the commonwealth which fails to register with the secretary of state shall, for each year that such failure shall continue, be fined not more than five hundred dollars. No such failure shall affect the validity of any contract involving the foreign limited partnership, nor is a limited partner of a foreign limited partnership liable as a general partner thereof solely by reason of such failure, but no action shall be maintained or recovery had by the foreign limited partnership in any of the courts of the commonwealth as long as such failure continues. Fines provided for under this section shall be recovered as provided under section nine of chapter one hundred and eighty-one.

(b) Foreign limited partnership shall be liable to be sued and to have their property attached in the same manner and to the same extent as individuals who are residents of other jurisdictions. Every foreign limited partnership doing business in the commonwealth without having registered as prescribed in this section, and every foreign limited partnership which shall have withdrawn from the commonwealth shall be deemed to have appointed the secretary of state and his successor in office to be its true and lawful attorney upon whom all lawful process in any action or proceeding in the commonwealth may be served, in the manner set forth in section fourteen of chapter one hundred and eighty-one relative to foreign corporations.

§ 56. Right of action by limited partner

A limited partner may bring an action in the right of a limited partnership to recover a judgment in its favor if general partners with authority to do so have refused to bring the action or if an effort to cause those general partners to bring the action is not likely to succeed.

§ 57. Proper plaintiff

In a derivative action, the plaintiff must be a partner at the time of bringing the action and (1) at the time of the transaction of which he complains or (2) his status as a partner had

devolved upon him by operation of law or pursuant to the terms of the partnership agreement from a person who was a partner at the time of the transaction.

§ 58. Pleading

In a derivative action, the complaint shall set forth with particularity the effort of the plaintiff to secure initiation of the action by a general partner or the reasons for not making the effort.

§ 59. Expenses in successful action

If a derivative action is successful, in whole or in part, or if anything is received by the plaintiff as a result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff reasonable expenses, including reasonable attorney's fees, and shall direct him to remit to the limited partnership the remainder of those proceeds received by him.

§ 60. Construction and application of chapter

This chapter shall apply and be construed to effectuate its general purpose to make uniform the law with respect to the subject of this chapter among states enacting it.

§ 61. Fees

The fee for filing in the office of the secretary of state of any original certificate of limited partnership or application for registration as a foreign limited partnership shall be one hundred and fifty dollars. The fee for filing a certificate of amendment, cancellation or withdrawal shall be seventy-five dollars. The fee for the reservation of a name or the extension of a reservation shall be ten dollars.

§ 62. Cases not provided for by chapter

In any case not provided for in this chapter, the provisions of the Uniform Partnership Act as provided in chapter one hundred and eight A shall control.

MASSACHUSETTS GENERAL LAWS ANNOTATED
PART I. ADMINISTRATION OF THE GOVERNMENT
TITLE XV. REGULATION OF TRADE

CHAPTER 108A. §§ 45 ET SEQ LIMITED LIABILITY PARTNERSHIPS

§ 45. Registration as limited liability partnership; annual report; withdrawal; revocation

(1) To become a registered limited liability partnership, a partnership shall file with the state secretary a registration stating the name of the partnership, the street address of its principal office in the commonwealth, the federal employer identification number of the partnership, a brief statement of the business or profession in which the partnership engages and, if desired, the names of one or more partners authorized to execute, acknowledge, deliver and record any recordable instrument purporting to affect an interest in real property, whether to be recorded with a registry of deeds or a district office of the land court. The registration shall be executed by one or more partners authorized by a majority of the partners. The registration shall be accompanied by a fee of five hundred dollars.

(2) An annual report shall be filed by the partnership with the state secretary on or before the last day of February in each year following the year of registration. The annual report shall state the name of the partnership, the street address of its principal office in the commonwealth, the federal employer identification number of the partnership, and a brief statement of the business or profession in which the partnership engages.

(3) Each annual report shall be accompanied by a fee of five hundred dollars.

(4) The status of the partnership as a registered limited liability partnership shall be effective upon filing of the registration and the required fee, and such status shall remain effective, regardless of changes in the partnership, until the registration is voluntarily withdrawn pursuant to paragraph (5) or revoked pursuant to paragraph (6). Withdrawal or revocation shall not affect the personal liability of any partner with respect to debts, obligations and liabilities of or chargeable to the partnership which arose prior to the effective date of such withdrawal or revocation. The status of a partnership as a registered limited liability partnership and the liability of the partners thereof shall not be affected by errors or subsequent changes in the information stated in a registration under paragraph (1).

(5) The registration of a registered limited liability partnership may be voluntarily withdrawn by filing with the state secretary a written notice of withdrawal executed by one or more partners authorized by two-thirds of the partners.

(6) If a partnership fails to file an annual report when due or to pay the required fee, the state secretary may revoke the registration of the partnership. The state secretary shall give the partnership at least sixty days notice of his intention to revoke the registration of the partnership. The notice shall be given by mail to the partnership at the address of its principal office as shown in the records of the state secretary. The notice shall specify the annual reports which have not been filed, the fees which have not been paid and the effective date of revocation. The revocation shall not be effective if the specified annual reports are filed and the specified fees are paid prior to specified effective date of revocation.

(7) In the case of a partnership which renders professional services as defined in chapter one hundred and fifty-six A, (a) the registration and each annual report shall contain the names of each of the partners who renders a professional service on behalf of the partnership in the commonwealth at the time of filing and their business addresses, if different from that of the partnership, (b) the registration shall be accompanied by a certificate of the appropriate regulating board or boards that each of the partners who renders a professional service on behalf of the partnership in the commonwealth at the time of filing is duly licensed to render such service, and (c) each annual report contains a certification that each of the partners who renders professional services on behalf of the partnership in the commonwealth at the time of filing is duly licensed to render such services.

(8) (a) A registered limited liability partnership which renders professional services as defined in chapter one hundred and fifty-six A shall carry at least the designated amount of liability insurance of a kind that is designed to cover negligence, wrongful acts, errors and omissions and that insures the partnership and its partners. The term designated amount shall mean the amount designated by the regulating board which regulates the professional service rendered. The regulating boards for each professional service shall adopt regulations requiring such a designated amount of liability insurance.

(b) If a registered limited liability partnership is in compliance with the requirements of subsection (a), the requirements of this section shall not be admissible or in any way be made known to a jury in determining an issue of liability for or extent of the debt or obligation or damages in question.

(c) A registered limited liability partnership is considered to be in compliance with said subsection (a) if the partnership provides the designated amount of funds specifically designated and segregated for the satisfaction of judgments against the partnership or its partners based on negligence, wrongful acts, errors and omissions by:

(1) deposit in trust or in bank escrow of cash, bank certificates of deposit, or United States Treasury obligations; or

(2) a bank letter of credit or insurance company bond.

§ 46. Name of registered limited liability partnership

The name of every registered limited liability partnership shall end with words "registered limited liability partnership", "limited liability partnership" or the abbreviation "L.L.P." or "LLP".

§ 47. Recognition outside commonwealth

(1) A partnership, including a registered limited liability partnership, formed and existing under an agreement governed by the laws of this commonwealth, may conduct its business, carry on its operations, and have and exercise the powers granted by this act in any state, territory, district, or possession of the United States or in any foreign country.

(2) It is the intent of this section that the legal existence of registered limited liability partnerships be recognized outside the boundaries of this commonwealth and that the laws of this commonwealth governing such registered limited liability partnerships doing business outside this commonwealth be granted the protection of full faith and credit under the Constitution of the United States.

(3) The internal affairs of partnerships, including registered limited liability partnerships, formed and existing under an agreement governed by the laws of this commonwealth, including the liability of partners for debts, obligations and liabilities of or chargeable to the partnership, shall be subject to and governed by the laws of this commonwealth.

(4) Subject to any statutes for the regulation and control of specific types of business, foreign registered limited liability partnerships may do business in this commonwealth and shall be required to register with the state secretary under this chapter in the same manner as a registered limited liability partnership.

(5) The name of a foreign registered limited liability partnership doing business in this commonwealth shall contain the words "registered limited liability partnership" or "limited liability partnership" or the abbreviation "L.L.P." or "LLP" as the last words or letters of its name or such other similar words or abbreviation as may be required or authorized by the laws of the state where the partnership is registered.

(6) The internal affairs of foreign registered limited liability partnerships, including the liability of partners for debts, obligations and liabilities of or chargeable to the partnership, shall be subject to and governed by the laws of the jurisdiction in which the foreign registered limited liability partnership is registered.

§ 48. Recordable instruments binding on partnership

Any recordable instrument purporting to affect an interest in real property, including without limitation, any deed, lease, notice of lease, mortgage, discharge or release of mortgage, assignment of mortgage, easement, and certificate of fact, executed in the name of a registered limited liability partnership by any partner who is identified on the registration of the limited liability partnership, as amended, filed with the secretary of the commonwealth as

authorized to execute, acknowledge, deliver and record recordable instruments affecting interests in real property, shall be binding on the registered limited liability partnership in favor of a seller, purchaser, lessor, lessee, mortgagor, mortgagee, or other person relying in good faith on such instrument, notwithstanding any inconsistent provisions of the partnership agreement, side agreements among the partners, by-laws or rules, resolutions or votes of the registered liability partnership.

§ 49. Certificate of good standing

A registered limited liability partnership shall be deemed to be in good standing with the secretary of the commonwealth if such registered limited liability partnership appears from the records of said secretary to have been duly registered and has filed all annual reports and paid all fees then due to the secretary of the commonwealth, and the registration of the registered limited liability partnership has not been withdrawn or revoked pursuant to subsection (5) or (6) of section forty-five. Upon the request of any person and payment of such fee as may be prescribed by law, the state secretary shall issue a certificate stating, in substance, as to any registered limited liability partnership meeting the requirements of this section, that such registered limited liability partnership appears from the records in his office to exist and to be in good standing, and the identity of any and all partners authorized to act with respect to real property instruments who are named in the registration of the registered limited liability partnership, as amended.

MASSACHUSETTS GENERAL LAWS ANNOTATED
PART I. ADMINISTRATION OF THE GOVERNMENT
TITLE XXII. CORPORATIONS

CHAPTER 156C. LIMITED LIABILITY COMPANY ACT

§1 Short title

This chapter may be cited as the Massachusetts Limited Liability Company Act.

§2 Definitions

As used in this chapter, the following words shall unless the context clearly otherwise requires have the following meanings:--

(1) "***Bankruptcy***", the occurrence of any of the following events:

(a) a member:

(1) makes an assignment for the benefit of creditors;

(2) files a voluntary petition in bankruptcy;

(3) is adjudged a bankrupt or insolvent, or has entered against him an order for relief, in any bankruptcy or insolvency proceeding;

(4) files a petition or answer seeking for himself any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law or regulation;

(5) files an answer or other pleading, admitting or failing to contest the material allegations of a petition filed against him in any proceeding of this nature;

(6) seeks, consents to or acquiesces in the appointment of a trustee, receiver or liquidator of the member or of all or any substantial part of his properties; or

(b) one hundred and twenty days after the commencement of any proceeding against the member seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law or regulation, if the proceeding has not been dismissed, or if within ninety days after the appointment without his consent or acquiescence of a trustee, receiver or liquidator of the member or of all or any substantial part of his properties, the appointment is not vacated or stayed, or within ninety days after the expiration of any such stay, the appointment is not vacated.

(2) "***Certificate of organization***", the certificate referred to in section twelve, and the certificate as amended.

(3) "***Contribution***", any cash, property, services rendered or a promissory note or other obligation to contribute cash or property or to perform services, which a person contributes to a limited liability company in his capacity as a member.

(4) "***Foreign limited liability company***", a limited liability company formed under the laws of any state other than the commonwealth or under the laws of any foreign country or other foreign jurisdiction and denominated as such under the laws of such state or foreign country or other foreign jurisdiction.

(5) "***Limited liability company***" and "domestic limited liability company", an unincorporated organization formed under this chapter and having two or more members.

(6) "***Limited liability company interest***", a member's share of the profits and losses of a limited liability company and the member's right to receive distributions of the limited liability company's assets.
(7) "***Manager***", a person who is designated as a manager of a limited liability company pursuant to the operating agreement.
(8) "***Member***", a person who has been admitted to a limited liability company as a member as provided in section twenty or, in the case of a foreign limited liability company, in accordance with the laws of the state or foreign country or other foreign jurisdiction under which the foreign limited liability company is organized, and whose membership has not been terminated pursuant to the operating agreement or the operation of law.
(9) "***Operating agreement***", any written or oral agreement of the members as to the affairs of a limited liability company and the conduct of its business.
(10) "***Person***", a natural person, partnership, whether general or limited and whether domestic or foreign, limited liability company, foreign limited liability company, trust, estate, association, corporation, custodian, nominee or any other individual or entity in its own or any representative capacity.
(11) "***State***", the District of Columbia or the Commonwealth of Puerto Rico or any state, territory, possession, or other jurisdiction of the United States other than the commonwealth.

§3 Name of limited liability company

The name of each limited liability company as set forth in its certificate of organization:
(1) shall contain the words "limited liability company", "limited company", or the abbreviation "L.L.C.", "L.C.", "LLC" or "LC";
(2) may contain the name of a member or manager; and
(3) may not be the same as, or deceptively similar to the name of any corporation, limited partnership or limited liability company reserved or organized under the laws of the commonwealth or licensed or registered as a foreign corporation, foreign limited partnership or foreign limited liability company in the commonwealth, except with the written consent of said corporation, limited partnership or limited liability company previously filed with the state secretary.

§4 Reservation of exclusive right to name

(a) The exclusive right to the use of a name may be reserved by:
(1) any person intending to organize a limited liability company under this chapter and to adopt such name;
(2) any domestic limited liability company or any foreign limited liability company registered in the commonwealth which, in either case, intends to adopt such name;
(3) any foreign limited liability company intending to register in the commonwealth and adopt such name; and
(4) any person intending to organize a foreign limited liability company and intending to have it register in the commonwealth and adopt such name.
(b) The reservation of a specified name shall be made by filing with the state secretary, an application, executed by the applicant, specifying the name to be reserved and the

name and address of the applicant. If the state secretary finds that the name is available for use by a domestic or foreign limited liability company, he shall reserve the name for the exclusive use of the applicant for a period of thirty days. The state secretary may extend the reservation for an additional thirty days upon written request of the applicant. The right to the exclusive use of a reserved name may be transferred to any other person by filing in the office of the state secretary a notice of the transfer, executed by the applicant for whom the name was reserved, specifying the name to be transferred and the name and address of the transferee.

§5 Office and agent for service of process in commonwealth

Each limited liability company shall have and maintain in the commonwealth:

(1) an office, which may but need not be a place of its business in the commonwealth at which shall be kept the records required by section nine to be maintained; and

(2) a resident agent for service of process on the limited liability company, which agent must be an individual resident of the commonwealth, a domestic corporation, or a foreign corporation authorized to do business in the commonwealth.

§6 Powers and privileges of limited liability company; information to be provided on certificate of organization or application for registration

(a) Except as otherwise expressly provided by law, a limited liability company may carry on any lawful business, trade, profession, purpose or activity.

(b) A limited liability company shall possess and may exercise all the powers and privileges granted by this chapter or by any other law or by the operating agreement, together with any powers incidental thereto, so far as such powers and privileges are necessary or convenient to the conduct, promotion or attainment of the business, trade, profession, purposes or activities of the limited liability company.

(c) A limited liability company or foreign limited liability company which is organized to render a professional service as defined in section two of chapter one hundred and fifty-six A shall (i) indicate in its certificate of organization or application for registration the specific professional services which it shall render, (ii) be subject to any conditions or limitations established by any applicable regulating boards as defined in said section two, including the provision of liability insurance required by section sixty-five, and (iii) include with its certificate of organization or application for registration a certificate by the applicable regulating board which indicates compliance as of the date of organization or registration by the members and managers with any eligibility standards established by such regulating board.

§7 Transaction of business between member or manager and limited liability company

Except as provided in a written operating agreement, a member or manager may lend money to, borrow money from, act as a surety, guarantor or endorser for, guarantee or assume one or more specific obligations of, provide collateral for, and transact other business with a limited liability company and, subject to other applicable law, has the same rights and obligations with respect to any such matter as a person who is not a member or manager.

§8 Indemnification of member or manager

(a) Subject to such standards and restrictions, if any, as are set forth in its certificate of organization or a written operating agreement, a limited liability company may, and shall have the power to, indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever. Such indemnification may include payment by the limited liability company of expenses incurred in defending a civil or criminal action or proceeding in advance of the final disposition of such action or proceeding, upon receipt of an undertaking by the person indemnified to repay such payment if he shall be adjudicated to be not entitled to indemnification under this section which undertaking may be accepted without reference to the financial ability of such person to make repayment. Any such indemnification may be provided although the person to be indemnified is no longer a member or manager.

No indemnification shall be provided for any person with respect to any matter as to which he shall have been adjudicated in any proceeding not to have acted in good faith in the reasonable belief that his action was in the best interest of the limited liability company.

(b) The certificate of organization or a written operating agreement may eliminate or limit the personal liability of a manager for breach of any duty to the limited liability company.

§9 Records and documents

(a) Each limited liability company shall keep at the office referred to in clause (1) of section five the following:

(1) a current list of the full name and last known address of each member and manager;

(2) a copy of the certificate of organization and all certificates of amendment thereto, together with executed copies of any powers of attorney pursuant to which any certificate has been executed;

(3) copies of the limited liability company's federal, state, and local income tax returns and reports, if any, for the three most recent years;

(4) copies of any then effective written operating agreements and of any financial statements of the limited liability company for the three most recent years; and

(5) unless contained in a written operating agreement, a writing setting out:

(i) the amount of cash and a description and statement of the agreed value of the other property or services contributed by each member and which each member has agreed to contribute;

(ii) the times at which or events on the happening of which any additional contributions agreed to be made by each member are to be made;

(iii) any right of a member to receive, or of a manager to make, distributions to a member; and

(iv) any events upon the happening of which the limited liability company is to be dissolved and its affairs wound up.

(b) Records kept under this section shall be subject to inspection and copying at the reasonable request and at the expense of any member or manager during ordinary business hours.

(c) The current list of names and addresses of the members shall be made available to the state secretary within five business days of receipt of a written request by said state secretary or by the director of the securities division of the state secretary's office stating that such information is required in connection with an investigatory or enforcement proceeding.

§10 Furnishing of documents and information to members and managers

Each member or manager of a limited liability company has the right, subject to such reasonable standards, including standards governing what information and documents are to be furnished at what time and location and at whose expense, as may be set forth in the operating agreement or otherwise established by the manager or, if there is no manager, then by the members, to obtain from the limited liability company from time to time upon reasonable demand in writing for any purpose reasonably related to the member's or manager's interest as a member or manager of the limited liability company (i) true and full information regarding the state of the business and financial condition of the limited liability company, (ii) promptly after becoming available, a copy of the limited liability company's federal, state and local income tax returns for each year, and (iii) other information regarding the affairs of the limited liability company as is just and reasonable.

§11 Reliance on records and documents

A member or manager of a limited liability company shall be fully protected in relying in good faith upon the provisions of a written operating agreement and the records of the limited liability company and upon such information, opinions, reports or statements presented to the limited liability company by any of its other managers, members, officers, employees, or committees or by any other person, as to matters the member or manager reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the limited liability company, including information, opinions, reports or statements as to the value and amount of the assets, liabilities, profits or losses of the limited liability company or any other facts pertinent to the existence and amount of assets from which distributions to members might properly be paid.

§12 Certificate of organization

(a) In order to form a limited liability company, one or more authorized persons must execute a certificate of organization. The certificate of organization shall be filed in the office of the state secretary and set forth:

(1) the name of the limited liability company;

(2) the address of the office in the commonwealth required to be maintained by section five;

(3) the name and address of the resident agent for service of process for the limited liability company required to be maintained by section five;

(4) if the limited liability company is to have a specific date of dissolution, the latest date on which the limited liability company is to dissolve;

(5) if the limited liability company has managers at the time of its formation, the name and address of each manager;

(6) the name of any other person in addition to any manager who is authorized to execute any documents to be filed with the office of the state secretary and at least one such person shall be named if there are no managers;
(7) the general character of the limited liability company's business;
(8) if desired, the names of one or more persons authorized to execute, acknowledge, deliver and record any recordable instrument purporting to affect an interest in real property, whether to be recorded with a registry of deeds or a district office of the land court; and
(9) any other matters the authorized persons determine to be included therein.

(b) A limited liability company is formed at the time of the filing of the initial certificate of organization in the office of the state secretary or at any later date specified in the certificate of organization if, in either case, there has been substantial compliance with the requirements of this section. A limited liability company formed under this chapter shall be a separate legal entity, the existence of which as a separate legal entity shall continue until cancellation of the limited liability company's certificate of organization.

(c) All limited liability companies formed under this chapter shall also file an annual report with the state secretary setting forth the information required in subsection (a).

(d) The fee for the filing of the certificate of organization required by subsection (a) shall be five hundred dollars. The fee for the filing of the annual report required by subsection (c) shall be five hundred dollars. Such fees shall be paid to the state secretary at the time the certificate of organization or the annual report is filed.

§13 Amendment of certificate of organization

(a) A certificate of organization may be amended by filing a certificate of amendment thereto in the office of the state secretary. The certificate of amendment shall set forth:
(1) the name of the limited liability company;
(2) the date of filing of its certificate of organization; and
(3) the amendment to the certificate of organization.

(b) A manager or, it there is no manager, then any member, who becomes aware that any statement in a certificate of organization was false when made, or that any matter described in the certificate of organization has changed, making the certificate of organization false in any material respect, shall promptly amend the certificate of organization to correct such matter.

(c) A certificate of organization shall be amended to reflect (i) the designation of managers of a limited liability company which theretofore did not have managers or (ii) any change in the managers of a limited liability company or other authorized signatories.

(d) A certificate of organization may be amended at any time for any other proper purpose.

(e) Unless otherwise provided in this chapter or unless a later effective date, which shall be a date certain, is provided for in the certificate of amendment, a certificate of amendment shall be effective at the time of its filing with the state secretary.

§14 Cancellation of certificate of organization

A certificate of organization shall be cancelled upon the dissolution and the completion of winding up of a limited liability company, or at any other time there are fewer than two

members, or upon the filing of a certificate of consolidation or merger if the limited liability company is not the resulting or surviving entity in a consolidation or merger. A certificate of cancellation shall be filed in the office of the state secretary to accomplish the cancellation of a certificate of organization upon the dissolution and the completion of winding up of a limited liability company or at any other time there are not two members and shall set forth:

(1) the name of the limited liability company;

(2) the date of filing of its certificate of organization;

(3) the reason for filing the certificate of cancellation;

(4) the effective date, which shall be a date certain, of cancellation if it is not to be effective upon the filing of the certificate; and

(5) any other information the person filing the certificate of cancellation determines.

§15 Execution of certificate by authorized person

(a) Each certificate required by this chapter to be filed in the office of the state secretary shall be executed:

(1) by any manager if the limited liability company has managers or by any other authorized person set forth in the certificate of organization or any amendment thereto;

(2) if the limited liability company has not been formed, by the person or persons forming the limited liability company; or

(3) if the limited liability company is in the hands of a receiver, trustee, or other court-appointed fiduciary, by such receiver, trustee or fiduciary.

(b) Unless otherwise provided in the operating agreement, any person may sign any certificate or amendment thereto or enter into the operating agreement or amendment thereto by an agent, including an attorney-in-fact. An authorization, including a power of attorney, to sign any certificate or amendment thereto or to enter into the operating agreement or amendment thereto need not be in writing, need not be sworn to, verified or acknowledged, and need not be filed in the office of the state secretary, but if in writing, must be retained by the limited liability company.

(c) The execution of a certificate by an authorized person constitutes an affirmation, under the penalties of perjury, that the facts stated therein are true.

§16 Failure or refusal to execute certificate

(a) If a person required to execute a certificate required by this chapter fails or refuses to do so, any other person who is adversely affected by the failure or refusal may petition the superior court department of the trial court to direct the execution of the certificate. If the court finds that the execution of the certificate is proper and that any person so designated has failed or refused to execute the certificate, it shall order the state secretary to record an appropriate certificate.

(b) If a person required to execute an operating agreement or amendment thereto fails or refuses to do so, any person who is adversely affected by the failure or refusal may petition the superior court department of the trial court to direct the execution of the operating agreement or amendment thereto. If the court finds that the operating agreement or amendment thereto should be executed and that any person required to execute the operating agreement or amendment thereto has failed or refused to do so, it

shall enter an order granting appropriate relief.

§17 Filing of certificate with state secretary

(a) The original signed copy of the certificate of organization and of any certificates of amendment or cancellation or of any judicial decree of amendment or cancellation, and of any certificate of consolidation or merger and of any restated certificate shall be delivered to the state secretary, together with a duplicate copy which may be a photocopy or a duplicate original. A person who executes a certificate as an attorney-in-fact or fiduciary shall not be required to exhibit evidence of his authority as a prerequisite to filing. Any certificate authorized to be filed with the state secretary under any provision of this chapter shall be originally signed except as otherwise required by this chapter or permitted from time to time by the state secretary. Unless the state secretary finds that any certificate does not conform to law, he shall:

(1) confirm that the certificate of organization, the certificate of amendment, the certificate of cancellation or of any judicial decree of amendment or cancellation, the certificate of consolidation or merger or the restated certificate has been filed in his office by endorsing upon the original certificate and the duplicate certificate the word "filed", and the date and time of the filing. Said endorsement shall be conclusive of the date and time of its filing in the absence of actual fraud;

(2) file the endorsed certificate; and

(3) return to the person who filed it or his representative the duplicate copy of the original signed instrument, similarly endorsed.

(b) Upon the filing of a certificate of amendment or judicial decree of amendment or restated certificate in the office of the state secretary, or upon the effective date of a certificate of amendment or judicial decree thereto or restated certificate, as provided for therein, the certificate of organization shall be amended or restated as set forth therein. Upon the filing of a certificate of cancellation or a judicial decree thereof, or a certificate of consolidation or merger which acts as a certificate of cancellation, or upon the effective date of a certificate of cancellation or a judicial decree thereof or of a certificate of consolidation or merger which acts as a certificate of cancellation, as provided for therein, said certificate of organization shall be cancelled.

§18 Filing of certificate as notice

The fact that a certificate of organization is on file in the office of the state secretary shall be notice that the entity formed in connection with the filing of the certificate of organization is a limited liability company formed under the laws of the commonwealth and shall be notice of all other facts set forth therein which are required to be set forth in a certificate of organization by section twelve.

§19 Restated certificates of organization

(a) A limited liability company may at any time, integrate into a single instrument all of the provisions of its certificate of organization which are then in effect and operative as a result of there having theretofore been filed with the state secretary one or more certificates or other instruments pursuant to any of the sections referred to in this chapter and it may at the same time also further amend its certificate of organization by adopting

a restated certificate of organization.
(b) If a restated certificate of organization merely restates and integrates but does not further amend the initial certificate of organization, as theretofore amended or supplemented by any instrument that was executed and filed pursuant to any of the sections in this chapter, it shall be specifically designated in its heading as a "restated certificate of organization" together with such other words as the limited liability company may deem appropriate and shall be executed by an authorized person and filed as provided in section seventeen in the office of the state secretary. If a restated certificate restates and integrates and also further amends in any respect the certificate of organization, as theretofore amended or supplemented, it shall be specifically designated in its heading as an "amended and restated certificate of organization" together with such other words as the limited liability company may deem appropriate and shall be executed by at least one authorized person, and filed as provided in section seventeen in the office of the state secretary.
(c) A restated certificate of organization shall state, either in its heading or in an introductory paragraph, the limited liability company's present name, and, if such name has been changed, the name under which it was originally filed, the date of filing of its original certificate of organization with the state secretary, and the effective date, which shall be a date certain, of the restated certificate if it is not to be effective upon the filing of the restated certificate. A restated certificate shall also state that it was duly executed and is being filed in accordance with this section. If a restated certificate only restates and integrates and does not further amend a limited liability company's certificate of organization as theretofore amended or supplemented and there is no difference between the provisions of such certificate of organization and the provisions contained in the restated certificate, it shall state the fact of such difference.
(d) Upon the filing of a restated certificate of organization with the state secretary, or upon the future effective date of a restated certificate of organization as provided for therein, the initial certificate of organization, as theretofore amended or supplemented, shall be superseded by such restated certificate; thereafter, the restated certificate of organization, including any further amendment or changes made thereby, shall be the certificate of organization of the limited liability company, but the original effective date of organization shall remain unchanged.
(e) Any amendment or change effected in connection with the restatement and integration of the certificate of organization shall be subject to any other provision of this chapter, not inconsistent with this section, which would apply if a separate certificate of amendment were filed to effect such amendment or change.

§20 Admission as member of limited liability company

(a) In connection with the formation of a limited liability company, a person acquiring a limited liability company interest is admitted as a member of the limited liability company upon the later to occur of:
(1) the formation of the limited liability company; or
(2) the time provided in and upon compliance with the operating agreement or, if the operating agreement does not so provide, when the person's admission is reflected in the records of the limited liability company.

(b) After the formation of a limited liability company, a person acquiring a limited liability company interest is admitted as a member of the limited liability company:

(1) in the case of a person acquiring a limited liability company interest directly from the limited liability company, at the time provided in and upon compliance with a written operating agreement or, if a written operating agreement does not so provide, upon the consent of all members; or

(2) in the case of an assignee of a limited liability company interest, as provided in section forty-one.

(c) A person may be admitted to a limited liability company as a member and may receive an interest in the limited liability company without making a contribution or being obligated to make a contribution to the limited liability company.

§21 Rights, powers and duties of classes or groups of members

(a) An operating agreement may provide for classes or groups of members having such relative rights, powers and duties as the operating agreement may provide, and may make provision for the future creation in the manner provided in the operating agreement of additional classes or groups of members having such relative rights, powers and duties as may from time to time be established, including rights, powers and duties senior to existing classes and groups of members. An operating agreement may provide for the taking of an action, including the amendment of the operating agreement, without the vote or approval of any member or class or group of members, including an action to create under the provisions of the operating agreement a class or group of limited liability company interests that was not previously outstanding.

(b) An operating agreement may grant to all or certain identified members or a specified class or group of the members the right to vote separately or with all or any class or group of the members or managers, on any matter. Voting by members may be on a per capita, number, financial interest, class group or any other basis.

(c) An operating agreement which grants members a right to vote may set forth provisions relating to notice of the time, place or purpose of any meeting at which any matter is to be voted on by any members, waiver of any such notice, action by consent without a meeting, the establishment of a record date, quorum requirements, voting in person or by proxy, or any other matter with respect to the exercise of any such right to vote.

(d) If an operating agreement does not provide for the voting rights of members, the decision of members who own more than fifty percent of the unreturned contributions to the limited liability company determined in accordance with section twenty-nine shall be controlling.

§22 Debts, obligations and liabilities of limited liability company

Except as otherwise provided by this chapter, the debts, obligations and liabilities of a limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company; and no member or manager of a limited liability company shall be obligated personally for any such debt, obligation or liability of the limited liability company solely by reason of being a member or acting as a manager of the limited liability company.

§23 Designation of manager

A person may be named or designated as a manager of the limited liability company as defined in clause seven of section two.

§24 Management of limited liability company

Unless otherwise provided in the operating agreement, the management of a limited liability company shall be vested in its members. An operating agreement may provide for the management, in whole or in part, of a limited liability company by one or more managers, who shall hold office and have the duties set forth in the operating agreement. Subject to section thirty-seven, a manager shall cease to be a manager as provided in the operating agreement.

§25 Manager's membership in company

A manager need not be a member of the limited liability company.

§26 Relative rights, duties and powers of classes or groups of managers

(a) An operating agreement may provide for classes or groups of managers having such relative rights, powers and duties as the operating agreement may provide, and may make provision for the future creation in the manner provided in the operating agreement of additional classes or groups of managers having such relative rights, powers and duties as may from time to time be established, including rights, powers and duties senior to existing classes and groups of managers. An operating agreement may provide for the taking of an action, including the amendment of the operating agreement, without the vote or approval of any manager or class or group of managers.

(b) The operating agreement may grant to all or certain identified managers or a specified class or group of the managers the right to vote, separately or with all or any class or group of managers or members, on any matter. Voting by managers may be on a per capita, number, financial interest, class, group or any other basis.

(c) An operating agreement which grants managers a right to vote may set forth provisions relating to notice of the time, place or purpose of any meeting at which any matter is to be voted on by any manager or class or group of managers, waiver of any such notice, action by consent without a meeting, the establishment of a record date, quorum requirements, voting in person or by proxy, or any other matter with respect to the exercise of any such right to vote.

(d) If an operating agreement does not provide for the voting rights of managers, the decision of a majority in number of the managers shall be controlling.

§27 Contributions of members

The contribution of a member to a limited liability company may be in cash, property or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.

§28 Members' obligations to limited liability company

(a) Except as provided in a written operating agreement, a member is obligated to a limited liability company to perform any promise to contribute cash or property or to

perform services, even if he is unable to perform because of death, disability or any other reason. If a member does not make the required contribution of property or services, he is obligated at the option of the limited liability company to contribute cash equal to that portion of the agreed value as stated in the records of the limited liability company of the contribution that has not been made. The foregoing option shall be in addition to, and not in lieu of, any other rights, including the right to specific performance, that the limited liability company may have against such member under an operating agreement or applicable law.

(b) Unless otherwise provided in a written operating agreement, the obligation of a member to make a contribution or return money or other property paid or distributed in violation of this chapter may be compromised only by consent of all the members. Notwithstanding the compromise, a creditor of a limited liability company who extends credit, after the entering into of the operating agreement or an amendment thereto which, in either case, reflects the obligation, and before the amendment thereof to reflect the compromise, may enforce the original obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation of a member to make a contribution or return. A conditional obligation of a member to make a contribution or return money or other property to a limited liability company may not be enforced unless the conditions of the obligation have been satisfied or waived as to or by such member. Conditional obligations include contributions payable upon a discretionary call of a limited liability company prior to the time the call occurs.

(c) An operating agreement may provide that the interest of a member who fails to make any contribution or other payment that the member is required to make shall be subject to specified remedies for, or specified consequences of, the failure. The remedy or consequence may take the form of reducing the defaulting member's interest in the limited liability company, subordinating the defaulting member's interest in the limited liability company to that of the nondefaulting members, a forced sale of the interest in the limited liability company, forfeiture of the interest in the limited liability company, the lending by the nondefaulting members of the amount necessary to meet the commitment, a fixing of the value of the member's interest in the limited liability company by appraisal or by formula and redemption and sale of the member's interest in the limited liability company at that value, or other remedy or consequences.

§29 Allocation of profits and losses

(a) The profits and losses of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in the operating agreement. If an operating agreement does not so provide, profits and losses shall be allocated on the basis of the agreed value as stated in the records of the limited liability company of the contributions of each member to the extent they have been received by the limited liability company and have not been returned.

(b) For purposes of this chapter, a member receives a return of his contribution to the extent that a distribution to him reduces his share of the fair value of the net assets of the limited liability company below the value, as set forth in the records required to be kept under this chapter, of his contribution which has not been distributed to him.

§30 Distributions of cash or other assets

Distributions of cash or other assets of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in the operating agreement. If the operating agreement does not so provide, distributions shall be made on the basis of the agreed value as stated in the records of the limited liability company of the contributions of each member to the extent they have been received by the limited liability company and have not been returned.

§31 Entitlement to distributions

Except as provided in sections thirty-two and forty-six, a member is entitled to receive distributions from a limited liability company only to the extent and at the times or upon the happening of the events specified in the operating agreement or, if the operating agreement does not so specify, as determined by the members or managers pursuant to section twenty-one or section twenty-six.

§32 Distribution to resigning member

Upon resignation, a resigning member is entitled to receive any distribution to which he is entitled upon resignation under a written operating agreement. If not otherwise provided in a written operating agreement, a resigning member is entitled to receive, within a reasonable time after resignation, the fair value of his limited liability company interest as of the date of resignation based upon his right to share in distributions from the limited liability company.

§33 Form of distribution on demand; acceptance of distribution of assets

Except as provided in a written operating agreement, a member, regardless of the nature of his contribution, has no right to demand and receive any distribution from a limited liability company in any form other than cash. Except as provided in a written operating agreement, a member may not be compelled to accept a distribution of any asset in kind from a limited liability company to the extent that the percentage of the asset distributed to him exceeds a percentage of the asset which is equal to the percentage in which he shares in distributions from the limited liability company

§34 Entitlement to creditor remedies

Except as provided in the operating agreement, and subject to section forty- six, at the time a member becomes entitled to receive a distribution, he has the status of, and is entitled to all remedies available to, a creditor of the limited liability company with respect to the distribution. An operating agreement may provide for the establishment of a record date with respect to allocations and distributions by a limited liability company.

§35 Liability for distribution in excess of terms of operating agreement

(a) A member or manager who votes for or assents to a distribution in violation of the operating agreement shall be personally liable to the limited liability company for the amount of the distribution that exceeds what could have been distributed without violating the operating agreement.

(b) Each member or manager held liable under subsection (a) for an unlawful distribution

is entitled to contribution:

(1) from each other member or manager who could be held liable under said subsection (a) for the unlawful distribution; and

(2) from each member for the amount the member received knowing that the distribution was made in violation of the operating agreement.

(c) A proceeding under this section is barred unless it is commenced within two years after the date of the distribution.

§36 Resignation of member

A member may resign as a member of a limited liability company at the time or upon the happening of events specified in the operating agreement and in accordance with the operating agreement. An operating agreement may provide that a member shall not have the right to resign as a member of a limited liability company. Regardless of whether an operating agreement provides that a member does not have the right to resign as a member of a limited liability company, a member may resign as a member of a limited liability company upon not less than six months' prior written notice to the limited liability company at its office in the commonwealth as set forth in the certificate of organization filed in the office of the state secretary and to each other member and each manager at each other member's and each manager's address as set forth on the records of the limited liability company as of the date of the notice. If the resignation of a member violates the operating agreement, in addition to any remedies otherwise available under applicable law, a limited liability company may recover from the resigning member damages for breach of the operating agreement and offset the damages against any amounts otherwise distributable to the resigning member.

§37 Resignation of manager

A manager may resign as a manager of a limited liability company at the time or upon the happening of events specified in the operating agreement and in accordance with the operating agreement. An operating agreement may provide that a manager shall not have the right to resign as a manager of a limited liability company. Regardless of whether the operating agreement provides that a manager does not have the right to resign as a manager of a limited liability company, a manager may resign as a manager of a limited liability company at any time upon prior written notice to each member and each other manager at each member's and each other manager's address as set forth on the records of the limited liability company as of the date of the notice. If the resignation of a manager violates the operating agreement, in addition to any remedies otherwise available under applicable law, a limited liability company may recover from the resigning manager damages for breach of the operating agreement and offset the damages against any amounts otherwise distributable to the resigning manager.

§38 Personal property

A limited liability company interest is personal property. A member has no interest in specific limited liability company property.

§39 Assignment of interest

(a) A limited liability company interest is assignable in whole or in part except as provided in the operating agreement. The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except:

(1) upon the approval of all of the members of the limited liability company other than the member assigning the limited liability company interest; or

(2) upon compliance with any procedure provided for in a written operating agreement.

(b) Unless otherwise provided in the operating agreement:

(1) an assignment entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar items to which the assignor was entitled, to the extent assigned; and

(2) a member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of his limited liability company interest. Unless otherwise provided in the operating agreement, the pledge of, or granting of a security interest, lien or other encumbrance in or against, any or all of the limited liability company interest of a member shall not cause the member to cease to be a member or to have the power to exercise any rights or powers of a member.

(c) An operating agreement may provide that a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company.

(d) Unless otherwise provided in the operating agreement and except to the extent assumed by agreement, until an assignee of a limited liability company interest becomes a member, the assignee shall have no liability as a member solely as the result of the assignment.

§40 Judgment against member payable with interest in limited liability company

On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the limited liability company interest of the member with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the limited liability company interest. This chapter does not deprive any member of the benefit of any exemption laws applicable to his limited liability company interest.

§41 Membership of assignee

(a) An assignee of a limited liability company interest may become a member:

(1) upon the approval of all of the members of the limited liability company other than the member assigning the limited liability company interest; or

(2) upon compliance with any procedure provided for in a written operating agreement.

(b) An assignee who has become a member has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member under the operating agreement and this chapter. Notwithstanding the foregoing, unless otherwise provided in the operating agreement, an assignee who becomes a member is liable for the obligations

of his assignor to make contributions as provided in section twenty-eight, but shall not be liable for the obligations of his assignor under section thirty-five. However, the assignee is not obligated for liabilities, including the obligations of his assignor to make contributions as provided in section twenty-eight, unknown to the assignee at the time he became a member and which could not be ascertained from the operating agreement.

(c) Whether or not an assignee of a limited liability company interest becomes a member, the assignor is not released from his liability to a limited liability company under sections thirty-one to thirty-seven, inclusive.

§42 Death or incompetence of member

Unless otherwise provided in the operating agreement, if a member who is an individual dies or a court of competent jurisdiction adjudges him to be incompetent to manage his person or his property, the member's executor, administrator, guardian, conservator or other legal representative may exercise all of the member's rights for the purpose of settling his estate or administering his property, including any power under the operating agreement of an assignee to become a member. Unless otherwise provided in an operating agreement, if a member is a corporation, trust or other entity and is dissolved or terminated, the powers of that member may be exercised by its legal representative or successor.

§43 Dissolution of limited liability company

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

(1) the time specified in the operating agreement;

(2) the happening of an event as specified in the operating agreement;

(3) the written consent of all members;

(4) except as provided in a written operating agreement, the death, insanity, retirement, resignation, expulsion, bankruptcy or dissolution of a member or the occurrence of any other event which terminates the membership of a member in the limited liability company unless the business of the limited liability company is continued either by the consent of all the remaining members within ninety days following the occurrence of any such event or pursuant to a right to continue stated in a written operating agreement; or

(5) the entry of a decree of judicial dissolution under section forty-four.

§44 Court-decreed dissolution

On application by or for a member or manager the superior court department of the trial court may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on its business in conformity with the certificate of organization or the operating agreement.

§45 Winding up affairs of dissolved limited liability company

(a) Unless otherwise provided in an operating agreement, a manager who has not wrongfully dissolved a limited liability company or, if none, the members or a person approved by the members pursuant to the operating agreement, or if there is no operating agreement, pursuant to section twenty-one, may wind up the limited liability company's affairs; but the superior court department of the trial court, upon cause shown, may wind

up the limited liability company's affairs upon application of any member or manager, his legal representative or assignee, and in connection therewith, may appoint a liquidating trustee.

(b) Upon dissolution of a limited liability company and until the filing of a certificate of cancellation as provided in section fourteen, the persons winding up the limited liability company's affairs may, in the name of, and for and on behalf of, the limited liability company, prosecute and defend suits, whether civil, criminal or administrative, gradually settle and close the limited liability company's business, dispose of and convey the limited liability company's property, discharge or make reasonable provision for the limited liability company's liabilities, and distribute to the members any remaining assets of the limited liability company, all without affecting the liability of members and managers and without imposing liability on a liquidating trustee.

§46 Distribution of assets of limited liability company following dissolution

(a) Upon the winding up of a limited liability company, the assets shall be distributed as follows:

(1) to creditors, including members and managers who are creditors, to the extent otherwise permitted by law, in satisfaction of liabilities of the limited liability company, whether by payment or the making of reasonable provision for payment thereof, other than liabilities for which reasonable provision for payment has been made and liabilities for distributions to members under section thirty-one or section thirty-two;

(2) unless otherwise provided in the operating agreement, to members and former members in satisfaction of liabilities for distributions under section thirty-one or section thirty-two; and

(3) unless otherwise provided in the operating agreement, to members first for the return of their contributions and second respecting their limited liability company interests, in the proportions in which the members share in distributions.

(b) A limited liability company which has dissolved shall pay or make reasonable provision to pay all claims and obligations, including all contingent, conditional or unmatured claims and obligations, known to the limited liability company and all claims and obligations which are known to the limited liability company but for which the identity of the claimant is unknown. If there are sufficient assets, such claims and obligations shall be paid in full and any such provision for payment made shall be made in full. If there are insufficient assets, such claims and obligations shall be paid or provided for according to their priority and, among claims and obligations of equal priority, ratably to the extent of assets available therefor. Unless otherwise provided in an operating agreement, any remaining assets shall be distributed as provided in this chapter. Any liquidating trustee winding up a limited liability company's affairs who has complied with this section shall not be personally liable to the claimants of the dissolved limited liability company by reason of such person's actions in winding up the limited liability company.

§47 Laws applicable to foreign limited liability company

A foreign limited liability company shall not do any business in the commonwealth

which is prohibited to a limited liability company organized under this chapter. A member, manager or other agent of a foreign limited liability company shall be subject to such liabilities, and shall have such defenses, with respect to such limited liability company, as officers, directors and the other agents of a foreign corporation have under sections ten, eleven, twelve, thirteen and fourteen of chapter one hundred and eighty-one relative to such foreign corporation. Subject to the constitution of the commonwealth, a foreign limited liability company's organization and internal affairs and the liability of its members and managers shall be governed by the laws of the jurisdiction under which it is organized. A foreign limited liability company may not be denied registration by reason of any difference between such laws and the laws of the commonwealth.

§48 Registration of foreign limited liability company

A foreign limited liability company shall be considered to be doing business in the commonwealth for the purposes of this section if it would be considered to be doing business in the commonwealth for the purposes of chapter one hundred and eighty-one if it were a foreign corporation. Every foreign limited liability company doing business in the commonwealth shall submit to the state secretary, within ten days after it commences doing business in the commonwealth, an application for registration as a foreign limited liability company, which shall be signed and sworn to by an authorized person. The application shall be in such form as the state secretary shall require and shall be accompanied by a certificate of legal existence or comparable certificate of the foreign limited liability company, issued by an officer or agency properly authorized in the jurisdiction in which the foreign limited liability company is organized, or such other evidence of legal existence as the state secretary shall approve. If the certificate or such evidence is in a foreign language, a translation thereof, under oath of the translator, shall be attached thereto.

The application for registration shall set forth the following information:

(1) the name of the foreign limited liability company and, if different, the name under which it proposes to do business in the commonwealth;

(2) the jurisdiction where such limited liability company was organized and the date of its organization;

(3) the general character of the business the foreign limited liability company proposes to do in the commonwealth;

(4) the address of the principal office of the foreign limited liability company;

(5) if the foreign limited liability company has managers, the name and address of each manager;

(6) the address of the principal office of the foreign limited liability company in the commonwealth, if any;

(7) the name and address of the resident agent of the foreign limited liability company;

(8) if the foreign limited liability company has a specific date of dissolution, the latest date on which the foreign limited liability company is to dissolve; and

(9) if desired, the name of one or more persons authorized to execute, acknowledge, deliver and record any recordable instrument purporting to affect an interest in real property, whether to be recorded with a registry of deeds or a district office of the land court.

If the foreign limited liability company's certificate of organization from its jurisdiction

of organization sets forth any part of the information required to be set forth in the application for registration in the commonwealth, the foreign limited liability company may submit a certified copy of such certificate, with a sworn translation, if necessary, in lieu of such part of the application for registration.

Each foreign limited liability company formed under this chapter shall also file with the state secretary an annual report setting forth, in updated form, the information contained in the application for registration.

The fee for the filing of the application of registration and each annual report shall be five hundred dollars payable to the state secretary and due at the time of filing.

§49 Duties of state secretary with respect to foreign limited liability companies

The state secretary shall examine and endorse his approval on the application for registration if the business of the foreign limited liability company is not prohibited by law to a limited liability company formed under this chapter and if the state secretary determines that the application complies with section forty-eight. Upon such approval, the application shall be deemed to be filed with the state secretary and the foreign limited liability company shall be deemed to be registered to do business in the commonwealth. The state secretary shall keep such records and have such other duties with respect to foreign limited liability companies as are provided in section six of chapter one hundred and eighty-one relative to foreign corporations.

§50 Name of foreign limited liability company

A foreign limited liability company may register with the state secretary and do business in the commonwealth under any name, whether or not it is the name under which it is registered in its jurisdiction of organization, that could be assumed by a limited liability company organized under this chapter.

§51 Agent for service of process on foreign limited liability company

Each foreign limited liability company doing business in the commonwealth shall appoint a resident agent as its true and lawful attorney upon whom all lawful processes in any action or proceeding against such foreign limited liability company in the commonwealth may be served. Such resident agent shall be either an individual who is a resident of and has a business address in the commonwealth, a domestic corporation, or a corporation organized under the laws of any other state, which has complied with the provisions of section four A of chapter one hundred and eighty-one and which has an office in the commonwealth. Such appointment shall become effective upon the filing in the office of the state secretary of a certificate, signed under the penalties of perjury by an authorized person, setting forth the name and business address of the resident agent. Such foreign limited liability company may revoke any such appointment or appoint a new resident agent, which revocation shall become effective upon filing with the state secretary of a certificate setting forth the fact of such revocation or the appointment of a new resident agent and, in the case of the appointment of a new resident agent, the name and business address of such agent. In the event of any change in the business address of the resident agent of any foreign limited liability company, a certificate setting forth the new business address of such resident agent, signed under the penalties of perjury by such resident agent, shall be filed with the state secretary within five

days of such change. Any resident agent of a foreign limited liability company may resign as such agent by filing with the state secretary a certificate signed under the penalties of perjury by such agent setting forth the fact of his resignation and the effective date thereof, which shall be not less than thirty days after the date of the filing of such certificate, and stating that a copy of such certificate has been mailed, postage prepaid, to the foreign limited liability company at the address of the principal office of the foreign limited liability company in the commonwealth currently on file with the state secretary or, if that office is also the office of the resident agent, at the address most recently furnished to such agent by the foreign limited liability company as the address to which copies of all process served upon him as such agent are to be forwarded. Compliance with this section shall be deemed compliance with the provisions of section five of chapter two hundred and twenty-seven.

§52 Correction or amendment of application for registration of foreign limited liability company

If any statement in the application for registration of a foreign limited liability company was false when made or any arrangements or other facts described have changed, making the application inaccurate in any respect, the foreign limited liability company shall promptly file in the office of the state secretary a certificate, signed and sworn to by an authorized person, correcting or amending such statement.

§53 Cancellation of registration of foreign limited liability company

The registration of a foreign limited liability company doing business in the commonwealth shall be canceled in the manner and at such times as are provided in section fourteen, except that the certificate of cancellation required under section fourteen shall, in addition to the information required thereunder, set forth either that all taxes and fees owed the commonwealth have been paid or provided for or that such foreign limited liability company has no assets. A foreign limited liability company doing business in this commonwealth may withdraw from the commonwealth by submitting to the state secretary a certificate of withdrawal, in such form as said state secretary shall require, signed and sworn to by an authorized person, stating:

(1) the name of such foreign limited liability company and, if different, the name under which it is registered and doing business in the commonwealth;

(2) the address of the principal office of such foreign limited liability company;

(3) the address of the principal office in the commonwealth of such foreign limited liability company, if any, and the name and business address of its resident agent in the commonwealth;

(4) that such foreign limited liability company is not doing business in the commonwealth; and

(5) that all taxes and fees owed the commonwealth have been paid or provided for.

The state secretary shall examine and endorse his approval on the certificate of withdrawal if he determines that the certificate complies with this section. Upon such approval, the certificate of withdrawal shall be deemed to be filed with the state secretary.

§54 Failure to register; penalty; service of process

(a) A foreign limited liability company doing business in the commonwealth which fails

to register with the state secretary shall, for each year that such failure shall continue, be fined not more than five hundred dollars. No such failure shall affect the validity of any contract involving the foreign limited liability company, nor is a member or a manager of a foreign limited liability company liable for the obligations of the foreign limited liability company solely by reason of such failure, but no action shall be maintained or recovery had by the foreign limited liability company in any of the courts of the commonwealth as long as such failure continues. The failure of a foreign limited liability company to register with the state secretary shall not prevent the foreign limited liability company from defending any action, suit or proceeding in any of the courts of the commonwealth.

(b) A foreign limited liability company shall be liable to be sued and to have its property attached in the same manner and to the same extent as persons who are residents of other jurisdictions. Every foreign limited liability company doing business in the commonwealth without having registered as prescribed in this chapter, and every foreign limited liability company having registered as prescribed in this chapter but whose resident agent cannot after a diligent search by an officer authorized to serve legal process be found at the business address of such resident agent stated in its most recent certificate filed with the state secretary pursuant to this chapter, and every foreign limited liability company whose resident agent refuses to act as such, shall be deemed to have appointed the state secretary to be its true and lawful attorney upon whom all process in any action or proceeding may be served so long as any liability incurred in the commonwealth while it was doing business shall remain outstanding.

Service of process in all actions and proceedings in the commonwealth against such a foreign limited liability company may be made upon the state secretary. Service of process in all actions and proceedings in the commonwealth against a foreign limited liability company formerly doing business in the commonwealth that has not complied with the provisions of section forty-eight or against a foreign limited liability company formerly doing business in the commonwealth that has withdrawn from the commonwealth pursuant to this chapter, may be made upon the state secretary if the action or proceeding involves a liability alleged to have been incurred by the foreign limited liability company while it was doing business in the commonwealth.

When lawful process in any action or proceeding against any foreign limited liability company which pursuant to this section may be made upon the state secretary is served upon the state secretary, he shall immediately forward the process by mail, postage prepaid, directed to such foreign limited liability company at its last known principal office or, in the case of a foreign limited liability company established in a foreign country, to the resident manager, if any, in the United States. The state secretary shall keep a record of all such process, which shall show the date of service.

In the case of service of process on a foreign limited liability company that has not complied with the provisions of section forty-eight, the notice herein provided for shall be mailed by the state secretary to the proper address of the foreign limited liability company furnished to him by the plaintiff or his attorney.

Service of process upon a foreign limited liability company for violation of any criminal law of the commonwealth may be made in the manner hereinabove provided.

§55 Suits by or against limited liability company

Suit may be brought by or against a limited liability company in its own name.

§56 Suits on behalf of limited liability company

Except as otherwise provided in a written operating agreement, suit on behalf of the limited liability company may be brought in the name of the limited liability company by:

(a) any member or members of a limited liability company, whether or not the operating agreement vests management of the limited liability company in one or more managers, who are authorized to sue by the vote of members who own more than fifty percent of the unreturned contributions to the limited liability company determined in accordance with section twenty-nine; provided, however, that in determining the vote so required, the vote of any member who has an interest in the outcome of the suit that is adverse to the interest of the limited liability company shall be excluded; or

(b) any manager or managers of a limited liability company, if the operating agreement vests management of the limited liability company in one or more managers, who are authorized to sue by the vote of a majority in number of the managers; provided, however, that, in determining the vote so required, the vote of any manager who has an interest in the outcome of the suit that is adverse to the interest of the limited liability company shall be excluded.

§57 Court orders on termination of derivative suit

On termination of the derivative suit, the court may:

(a) order the limited liability company to pay the plaintiff's reasonable expenses, including counsel fees, incurred in the proceeding if it finds that the suit has resulted in a substantial benefit to the limited liability company; or

(b) order the plaintiff to pay any defendant's reasonable expenses, including counsel fees, incurred in defending the suit if it finds that the suit was commenced or maintained without reasonable cause or for an improper purpose.

§58 Lack of authority to sue

The lack of authority of a member or manager to sue on behalf of the limited liability company may not be asserted as a defense to an action by the limited liability company or by the limited liability company as a basis for bringing a subsequent suit on the same cause of action.

§59 Consolidation or merger

(a) As used in sections fifty-nine to sixty-three, inclusive, the phrase "other business entity" shall mean a corporation to which paragraph (a) of section three of chapter one hundred and fifty-six B applies, a professional corporation and a foreign professional corporation, as defined in section two of chapter one hundred and fifty-six A, a foreign corporation, as defined in section one of chapter one hundred and eighty-one, an association or a trust, as defined in section one of chapter one hundred and eighty-two, and as having filed a copy of its instrument or declaration with the state secretary in compliance with, chapter one hundred and eighty-two, a partnership whether general or limited and whether domestic or foreign, as defined, respectively, in section six of

chapter one hundred and eight A and section one of chapter one hundred and nine, and a foreign limited liability company as defined in this chapter.

(b) Pursuant to an agreement of consolidation or merger, a domestic limited liability company may consolidate or merge with or into one or more domestic limited liability companies or other business entities formed or organized under the law of the commonwealth or any other state of the United States or any foreign country or other foreign jurisdiction, with such domestic limited liability company or other business entity as the agreement shall provide being the resulting or surviving domestic limited liability company or other business entity.

(c) In connection with a consolidation or merger under this chapter, rights or securities of, or interests in, a domestic limited liability company or other business entity which is a constituent party to the consolidation or merger may be exchanged for or converted into cash, property, rights or securities of, or interests in, the resulting or surviving domestic limited liability company or other business entity or, in addition to or in lieu thereof, may be exchanged for or converted into cash, property, rights or securities of, or interests in, a domestic limited liability company or other business entity which is not the resulting or surviving limited liability company or other business entity in the consolidation or merger.

§59 Consolidation or merger

(a) As used in sections fifty-nine to sixty-three, inclusive, the phrase "other business entity" shall mean a corporation to which paragraph (a) of section three of chapter one hundred and fifty-six B applies, a professional corporation and a foreign professional corporation, as defined in section two of chapter one hundred and fifty-six A, a foreign corporation, as defined in section one of chapter one hundred and eighty-one, an association or a trust, as defined in section one of chapter one hundred and eighty-two, and as having filed a copy of its instrument or declaration with the state secretary in compliance with, chapter one hundred and eighty-two, a partnership whether general or limited and whether domestic or foreign, as defined, respectively, in section six of chapter one hundred and eight A and section one of chapter one hundred and nine, and a foreign limited liability company as defined in this chapter.

(b) Pursuant to an agreement of consolidation or merger, a domestic limited liability company may consolidate or merge with or into one or more domestic limited liability companies or other business entities formed or organized under the law of the commonwealth or any other state of the United States or any foreign country or other foreign jurisdiction, with such domestic limited liability company or other business entity as the agreement shall provide being the resulting or surviving domestic limited liability company or other business entity.

(c) In connection with a consolidation or merger under this chapter, rights or securities of, or interests in, a domestic limited liability company or other business entity which is a constituent party to the consolidation or merger may be exchanged for or converted into cash, property, rights or securities of, or interests in, the resulting or surviving domestic limited liability company or other business entity or, in addition to or in lieu thereof, may be exchanged for or converted into cash, property, rights or securities of, or interests in, a domestic limited liability company or other business entity which is not the resulting or

surviving limited liability company or other business entity in the consolidation or merger.

§60 Approval of consolidation or merger; objection; termination or amendment

(a) Unless otherwise provided in a written operating agreement, a consolidation or merger shall be approved by each domestic limited liability company which is to consolidate or merge by the members or, if there is more than one class or group of members, then by each class or group of members, in either case, by members who own more than fifty percent of the unreturned contributions to the domestic limited liability company, determined in accordance with section twenty-nine, owned by all of the members or by the members in each class or group, as appropriate.

(b) The exclusive remedy of a member of a domestic limited liability company, which has voted to consolidate or to merge with another entity under the provisions of sections fifty-nine to sixty-three, inclusive, who objects to such consolidation or merger, shall be the right to resign as a member and to receive any distribution with respect to his limited liability company interest, as provided in sections thirty-one to thirty-seven, inclusive. Such members and the resulting or surviving entity shall have the rights and duties, and shall follow the procedure set forth in said sections.

(c) Notwithstanding prior approval, an agreement of consolidation or merger may be terminated or amended pursuant to a provision for such termination or amendment contained in the agreement of consolidation or merger.

§61 Certificate of consolidation or merger

(a) If a domestic limited liability company is consolidating or merging under this chapter, the domestic limited liability company or other business entity resulting from or surviving in the consolidation or merger shall file in the manner described in section seventeen a certificate of consolidation or merger in the office of the state secretary. The certificate of consolidation or merger shall be executed in the manner described in section fifteen and shall state:

(1) the name and jurisdiction of formation or organization of each of the domestic limited liability companies or other business entities which is to consolidate or merge;

(2) that an agreement of consolidation or merger has been approved and executed by each of the domestic limited liability companies or other business entities which is to consolidate or merge;

(3) the name of the resulting or surviving domestic limited liability company or other business entity;

(4) the future effective date or time, which shall be a date or time certain, of the consolidation or merger if it is not to be effective upon the filing of the certificate of consolidation or merger;

(5) that the agreement of consolidation or merger is on file at a place of business of the resulting or surviving domestic limited liability company or other business entity, and shall state the address thereof;

(6) that a copy of the agreement of consolidation or merger will be furnished by the resulting or surviving domestic limited liability company or other business entity, on request and without cost, to any member of any domestic limited liability company or

any person holding an interest in any other business entity which is to consolidate or merge; and

(7) if the resulting or surviving entity is not an entity organized under the laws of the commonwealth, a statement that such resulting or surviving entity agrees that, if such entity does not continuously maintain an agent for service of process in the commonwealth, to appoint irrevocably the state secretary to be its true and lawful attorney upon whom all lawful process in any action or proceeding in the commonwealth may be served in the manner set forth in section fifteen of chapter one hundred and eighty-one, relative to foreign corporations; provided, however, that if service of process is made upon the state secretary, he shall follow the procedures set forth in section fifteen of chapter one hundred and eighty-one with respect thereto.

(b) Unless a future effective date or time is provided in a certificate of consolidation or merger, in which event a consolidation or merger shall be effective at any such future effective date or time, a consolidation or merger shall be effective upon the filing in the office of the state secretary of a certificate of consolidation or merger.

(c) A certificate of consolidation or merger shall act

(1) as a certificate of cancellation for a domestic limited liability company which is not the resulting or surviving entity in the consolidation or merger and

(2) as a final annual report for an association or trust, as defined in section one of chapter one hundred and eighty-two.

(d) An agreement of consolidation or merger approved in accordance with section sixty may (1) effect any amendment to the operating agreement or (2) effect the adoption of a new operating agreement, for a domestic limited liability company if it is the resulting or surviving entity in the consolidation or merger. Any amendment to an operating agreement or adoption of a new operating agreement made pursuant to the foregoing sentence shall be effective at the effective time or date of the consolidation or merger. The provisions of this subsection shall not be construed to limit the accomplishment of a merger or of any of the matters referred to herein by any other means provided for in the operating agreement, or other agreement, or as otherwise permitted by law; the operating agreement of any constituent limited liability company to the consolidation or merger including a limited liability company formed for the purpose of consummating a consolidation or merger may be the operating agreement of the resulting or surviving limited liability company.

§62 Rights, privileges, powers, property and debts of consolidated or merged business entity

When any consolidation or merger becomes effective as hereinbefore provided, for all purposes of the laws of the commonwealth, all of the rights, privileges and powers of each of the domestic limited liability companies and other business entities that have consolidated or merged, and all property, real, personal and mixed, and all debts due to any of said domestic limited liability companies and other business entities, as well as all other things and causes of action belonging to each of such domestic limited liability companies and other business entities, shall be vested in the resulting or surviving domestic limited liability company or other business entity, and shall thereafter be the property of the resulting or surviving domestic limited liability company or other business entity as they were of each of the

domestic limited liability companies and other business entities that have consolidated or merged, and the title to any real property vested by deed or otherwise, under the laws of the commonwealth, in any of such domestic limited liability companies and other business entities, shall not revert or be in any way impaired by reason of this chapter; but all rights of creditors and all liens upon any property of any of said domestic limited liability companies and other business entities shall be preserved unimpaired, and all debts, liabilities and duties of each of the said domestic limited liability companies and other business entities that have consolidated or merged shall thenceforth attach to the resulting or surviving domestic limited liability company or other business entity, and may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it. Unless otherwise agreed, a consolidation or merger of a domestic limited liability company, including a domestic limited liability company which is not the resulting or surviving entity in the consolidation or merger, shall not require such domestic limited liability company to wind up its affairs under section forty-five or pay its liabilities and distribute its assets under section forty-six.

§63 Duties and liabilities of members and managers

(a) Unless the provisions of this chapter or the context indicate otherwise, each reference in the General Laws to a "person", where such reference includes any partnership, whether general or limited and whether domestic or foreign, shall be deemed to include a limited liability company.

(b) To the extent that, at law or in equity, a member or manager has duties, including fiduciary duties, and liabilities relating thereto to a limited liability company or to another member or manager, (1) any such member or manager acting under the operating agreement shall not be liable to the limited liability company or to any such other member or manager for the member's or manager's good faith reliance on the provision of the operating agreement, and (2) the member's or manager's duties and liabilities may be expanded or restricted by provisions in the operating agreement.

§64 Reorganization of limited liability company

(a) Any limited liability company, a plan of reorganization of which, pursuant to the provisions of any applicable statute of the United States relating to reorganizations of corporations or limited liability companies, has been or shall be confirmed by the decree or order of a court of competent jurisdiction, may put into effect and carry out the plan and the decrees and orders of the court relative thereto and may take any proceeding and do any act provided in the plan or directed by such decrees and orders, without further action by its members or managers. Such power and authority may be exercised, and such proceedings and acts may be taken, as may be directed by such decrees or orders, by the trustee or trustees of such limited liability company appointed by the court in the reorganization proceedings or a majority thereof or if none be appointed and acting, by designated members or managers of the limited liability company, or by a master or other representative appointed by the court, with like effect as if exercised and taken by unanimous action of the members and managers of the limited liability company.

(b) The provisions of this section shall cease to apply to such limited liability company upon the entry of a final decree in the reorganization proceedings closing the case and

discharging the trustee or trustees, if any.

§65 Liability insurance

The regulating boards, as defined in subsection (c) of section two of chapter one hundred and fifty-six A, shall adopt regulations requiring the designated amount of required liability insurance to be maintained by limited liability companies and members subject to their jurisdiction pursuant to subsection (c) of section six. The term designated amount shall be the amount deemed appropriate by the regulating board to cover negligence, wrongful acts, errors and omissions and that insures the company and its members.

§66 Recordable instruments affecting real property binding on limited liability company

Any recordable instrument purporting to affect an interest in real property, including without limitation, any deed, lease, notice of lease, mortgage, discharge or release of mortgage, assignment of mortgage, easement and certificate of fact, executed in the name of a limited liability company by any person who is identified on the certificate of organization, as amended, of a domestic limited liability company, or on the application for registration, as amended, of a foreign limited liability company, as a manager or as a person authorized to execute, acknowledge, deliver and record recordable instruments affecting interests in real property, shall be binding on the limited liability company in favor of a seller, purchaser, grantor, grantee, lessor, lessee, mortgagor, mortgagee, and any other person relying in good faith on such instrument, notwithstanding any inconsistent provisions of the operating agreement, side agreements among the members or managers, by-laws or rules, resolutions or votes of the limited liability company.

§67 Certification of authority to act for limited liability company

Any person who is identified on the certificate of organization, as amended, of a domestic limited liability company, or on the application for registration, as amended, of a foreign limited liability company, as a manager or as a person who is authorized to execute any documents to be filed with the office of the state secretary, may certify as to the incumbency of any manager or member and as to the authority of any person, whether or not such person is identified on the certificate of organization or on the application for registration, to act for the limited liability company, including without limitation with respect to the matters referred to in section sixty-six, and any such certification shall be binding on the limited liability company in favor of a person relying in good faith on such certification, notwithstanding any inconsistent provisions of the operating agreement, side agreements among the members, the managers or both, by-laws or rules, resolutions or votes of the limited liability company.

§68 Good standing

A limited liability company shall be deemed to be in good standing with the secretary of the commonwealth if such limited liability company appears from the records of the said secretary to exist and has paid all fees then due to the secretary, and no certificate of cancellation has been filed by or with respect to the limited liability company. Upon the request of any person and payment of such fee as may be prescribed by law, the secretary of

the commonwealth shall issue a certificate stating, in substance, as to any limited liability company meeting the requirements of this section, that such limited liability company appears from the records in his office to exist and to be in good standing and the identity of any and all managers and persons authorized to act with respect to real property instruments who are named in the certificate of organization of the limited liability company, as amended,

MASSACHUSETTS GENERAL LAWS
PART I. ADMINISTRATION OF THE GOVERNMENT
TITLE XXII. CORPORATIONS
CHAPTER 156D. BUSINESS CORPORATIONS

§ 1.01 SHORT TITLE

This chapter shall be known and may be cited as the "Massachusetts Business Corporation Act".

§ 1.02. RESERVATION OF POWER TO AMEND OR REPEAL

The General Court of the commonwealth has power to amend or repeal all or part of this Act at any time and all domestic and foreign corporations subject to this Act are governed by the amendment or repeal.

§ 1.20. FILING REQUIREMENTS

(a) To be entitled to filing with the secretary of state, a document shall satisfy the requirements of this section, any other section of this chapter that adds to or varies from these requirements, any applicable forms or regulations promulgated by the secretary of state hereunder, and any other relevant laws or regulations of the commonwealth.

(b) This chapter shall require or permit the filing of the document in the office of the secretary of state.

(c) The document shall contain the information required by this chapter. The document may contain other information as well that is relevant to the business or affairs of the corporation.

(d) The document shall be typewritten, printed or in such other form as the secretary of state shall prescribe.

(e) The document shall be in the English language. A corporate name need not be in English if written in English letters or Arabic or Roman numerals, and the certificate of existence required of foreign corporations need not be in English if accompanied by a reasonably authenticated English translation.

(f) The document shall be executed:

(1) by the chairman of the board of directors of a domestic or foreign corporation, by its president, or by another of its officers;

(2) if directors have not been selected or the corporation has not been formed, by the incorporator or incorporators; or
(3) if the corporation is in the hands of a receiver, trustee, or other court-appointed fiduciary, by that fiduciary.

(g) The person executing the document shall sign it and state beneath or opposite his signature his name and the capacity in which he signs. The document may but need not contain any of: (1) the corporate seal, (2) an attestation, and (3) an acknowledgment or verification.

(h) The document shall be delivered to the office of the secretary of state for filing and shall be accompanied by one exact or conformed copy, except that no copy is required for filings under sections 5.02, 15.03, 15.08, 15.09 and 16.22, the correct filing fee and any payment or penalty required by this chapter or other law. The secretary of state may waive the requirement that an exact or conformed copy accompany any document submitted for filing, including documents submitted electronically.

(i) Electronic documents or transmissions may be filed with the secretary of state if and to the extent permitted by the secretary. The secretary of state may promulgate regulations regarding the procedures for electronic filings which shall supersede any inconsistent provisions of this chapter with respect to such filings.

§ 1.21. FORMS

(a) The secretary of state may prescribe and furnish on request forms for any documents to be filed under this chapter. If the secretary of state so requires, use of these forms is mandatory.

(b) The secretary of state may accept for filing a document that contains the information required by this chapter but that does not conform to a prescribed form, whether or not use of the form is mandatory.

§ 1.22. FILING, SERVICE AND COPYING FEES

The commissioner of administration shall issue regulations prescribing fees for the filing and copying of documents, the issuance of certificates and the handling of service of process under this Act.

§ 1.23. EFFECTIVE TIME AND DATE OF DOCUMENT

(a) Except as provided in subsection (b) and in subsection (c) of section 1.24, a document that is filed by the secretary of state pursuant to section 1.25 is effective:

(1) at the time and on the date when it was approved for filing by the secretary of state; or

(2) in the case of articles of organization, amendment or merger, at the time and on the date when the articles were received for filing by the secretary of state if the articles are not rejected by the secretary within such time after their filing as is specified in regulations promulgated by the secretary.

(b) A filed document may specify a delayed effective time and date, and if it does so the document will become effective at the time and date specified. If a delayed effective date but no time is specified, the document is effective at the close of business on that date. A delayed effective date for a document may not be later than the ninetieth day after the date when it is

received for filing by the secretary of state.

§ 1.24. CORRECTING FILED DOCUMENT

(a) A domestic or foreign corporation may correct a document filed by the secretary of state if the document (1) contains a typographical error or an incorrect statement or (2) was defectively executed, attested, sealed, verified, or acknowledged.

(b) A document is corrected:

(1) by preparing articles of correction that (i) describe the document, including its filing date, or attach a copy of it to the articles; (ii) specify the typographical error, the incorrect statement and the reason it is incorrect or the manner in which the execution was defective; and (iii) correct the typographical error, incorrect statement or defective execution; and

(2) by delivering the articles of correction to the secretary of state for filing.

(c) Articles of correction are effective on the effective date of the document they correct except as to persons relying on the uncorrected document and adversely affected by the correction. As to those persons, articles of correction are effective when filed.

(d) Articles of correction cannot be used to change the effective date of a filed document; provided, however, that if a document has been filed with a delayed effective date, articles of correction may be filed prior to said date (1) to accelerate the effective date to a date not earlier than the date of the articles of correction, or (2) to abandon a merger or amendment to the articles of organization if authority to do so is granted by the merger agreement or the persons approving the amendment.

(e) If the secretary of state permits electronic filings, defects in the electronic recording or transmission of documents may be corrected under this section to the extent permitted by regulations promulgated by the secretary.

§ 1.25. FILING DUTY OF SECRETARY OF STATE

(a) Upon receipt of a document for filing, the secretary of state shall record the date and time of receipt on or with the document and, if the person submitting the document or his representative so requests, furnish evidence of the date and time of receipt to such person or his representative in such form as the secretary of state shall determine.

(a) Upon receipt of a document for filing, except an annual report filed pursuant to section 16.22, the secretary of state shall record the date and time of receipt on or with the document and, if the person submitting the document or his representative so requests, furnish evidence of the date and time of receipt to the person or his representative in a form as the secretary of state shall determine.

(b) The secretary of state shall examine each document received by him for filing. If he finds that the relevant provisions of law have been satisfied, he shall evidence his approval on or

with the document. Upon such approval and the payment of the fee authorized by section 1.22, the document shall be deemed to be filed with the secretary of state.

(c) If the secretary of state refuses to file a document, he shall notify the person or his representative in writing of the refusal and his reasons therefor within 90 days after receipt in the case of annual reports under section 16.22 or within 5 days after receipt in the case of other documents.

(d) The secretary of state shall keep a record of each document received, of the date and time of its receipt for filing, and of the date and, if requested, the time of his approval for filing, and shall keep the document and such records on file in his office in a manner convenient for public inspection.

§ 1.26. APPEAL FROM SECRETARY OF STATE'S REFUSAL TO FILE DOCUMENT

If the secretary of state refuses to file a document delivered to his office for filing, the person attempting to file may appeal that refusal. Such an appeal must be commenced within 90 days after the return of the document to the superior court of the county where the corporation's principal office or, if none in the commonwealth, its registered office, is or will be located. Such an appeal is commenced by petitioning the court to compel the filing of the document and by attaching to the petition the document and the explanation of the secretary of state for his refusal to file.

§ 1.27. EVIDENTIARY EFFECT OF COPY OF FILED DOCUMENT

A certified copy of a document filed by the secretary of state is conclusive evidence that the original document is on file with the secretary of state.

§ 1.28. CERTIFICATES REGARDING CORPORATIONS

(a) Anyone may apply to the secretary of state to furnish a certificate of legal existence for a domestic corporation. A certificate of legal existence shall set forth:

(1) the corporate name;

(2) that the corporation was organized under the General Laws of the commonwealth and the date of its incorporation;

(3) that the corporation has legal existence so far as it appears of record with the secretary of state;

(4) if requested, a listing of all amendments to the articles of organization on file with the secretary of state; and

(5) if requested, that the corporation is in good standing with the secretary of state, meaning that the corporation has filed all annual reports required under section 16.22 and has paid all

fees due with respect to the reports and that no proceedings are pending before the secretary of state to dissolve the corporation and no articles of dissolution have been filed with the secretary of state.

A certificate of legal existence issued by the secretary of state may be relied upon as conclusive evidence that the domestic corporation has legal existence in the commonwealth on the date of the certificate.

(b) The secretary of state shall issue, upon request, such other certificates regarding facts of record in his office concerning corporations upon payment of the fees as may be specified in regulations promulgated by the commissioner of administration, including without limitation, certificates of merger, certificates of dissolution, and certificates regarding the authority of a foreign corporation to do business in the commonwealth. The certificates may be relied upon as conclusive evidence of the facts stated herein.

§ 1.28. CERTIFICATES REGARDING CORPORATIONS.

(a) Anyone may apply to the secretary of state to furnish a certificate of legal existence for a domestic corporation. A certificate of legal existence shall set forth:

(1) the name of the corporation;

(2) the date the corporation was organized under the laws of the commonwealth; and

(3) that the corporation has legal existence so far as it appears in the records of the state secretary.

(b) Anyone may apply to the secretary of state to furnish a certificate of good standing. A certificate of good standing shall set forth:

(1) the name of the corporation;

(2) the date the corporation was organized under the laws of the commonwealth;

(3) that the corporation has filed all annual reports required by section 16.22 to be filed by it and paid all fees due with respect to such reports;

(4) that no proceedings are pending under section 14.21 for the dissolution of the corporation;

(5) that no articles of dissolution have been filed by the corporation; and

(6) that the corporation appears from the records of the state secretary to be in good standing.

(c) The secretary of state shall issue, upon request, such other certificates regarding facts of record in his office concerning corporations upon payment of the fees as may be specified in regulations promulgated by the commissioner of administration including, without limitation, certificates of merger, certificates of dissolution and certificates regarding the authority of a foreign corporation to do business in the commonwealth.

(d) The certificates may be relied upon as conclusive evidence of the facts stated therein.

§ 1.29. PENALTY FOR SIGNING FALSE DOCUMENT

(a) A person commits an offense if he signs a document that he knows is false in any material respect with intent that the document be delivered to the secretary of state for filing.

(b) The secretary of state shall refer to the attorney general for action evidence of offenses under this section.

(c) An offense under this section is a civil misdemeanor punishable by a fine not to exceed $100,000.

§ 1.30. POWERS

The secretary of state has the power reasonably necessary to perform the duties required of him by this chapter, including the power to promulgate regulations, prescribe forms and fees and adopt policies in order to implement this chapter.

§ 1.40. ACT DEFINITIONS

(a) As used in this chapter the following words shall have the following meanings, unless the context requires otherwise:

"Articles of organization", means the original and any amended and restated articles of organization and articles of merger, and special acts of incorporation, as amended from time to time by various articles and certificates provided for by this chapter.

"Authorized shares", means the shares of all classes a domestic or foreign corporation is authorized to issue.

"Conspicuous", written so that a reasonable person against whom the writing is to operate should have noticed it.

"Corporation", "domestic corporation" or "domestic business corporation", a corporation for profit, which is not a foreign corporation, incorporated under or subject to this chapter.
"Deliver", any method of delivery used in conventional commercial practice, including mailing, delivery by hand, messenger or delivery service and delivery by electronic transmission; however the secretary of state is not required to accept delivery of electronic documents or transmissions unless he adopts regulations authorizing this practice.

"Distribution", a direct or indirect transfer of money or other property, except its own shares,

or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution includes a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; and a distribution in voluntary or involuntary liquidation.

"Domestic other entity", an other entity organized under the laws of the commonwealth.

"Effective date of notice", as defined in section 1.41.

"Electronic document" or "electronic transmission", any process of communication not directly involving the physical transfer of paper that is suitable for the retention, retrieval and reproduction of information by the recipient.

"Employee", includes an officer but not a director. A director may accept duties that make him also an employee.

"Entity", a corporation and a foreign corporation; a nonprofit corporation; a profit and a nonprofit unincorporated association; a limited liability company; a business trust; an estate; a partnership; a registered limited liability partnership; a trust, and two or more persons having a joint or common economic interest; and a state, the United States, and a foreign government.

"Filing entity", an other entity that is of a type created by filing a public organic document.

"Foreign business corporation", a corporation for profit incorporated under a law other than the law of the commonwealth.

"Foreign corporation", a corporation for profit or a nonprofit corporation incorporated under a law other than the laws of the commonwealth.

"Foreign nonprofit corporation", a corporation incorporated under a law other than the laws of the commonwealth, which if incorporated under the laws of the commonwealth would be a nonprofit corporation.

"Foreign other entity", an other entity organized under a law other than the laws of the commonwealth.

"Governmental subdivision", includes authority, county, district, and municipality.
"Individual", includes the estate of an incompetent or deceased individual.

"Interest holder", a person who holds of record:

(i) a right to receive distributions from an other entity either in the ordinary course of business or upon liquidation, other than as an assignee; or

(ii) a right to vote on issues involving its internal affairs, other than as an agent, assignee, proxy or person responsible for managing its business and affairs.

"Interests", the interests in an other entity held by its interest holders.

"Membership", the rights of a member in a nonprofit corporation.

"Nonfiling entity", an other entity that is of a type that is not created by filing a filed organizational document.

"Nonprofit corporation" or "domestic nonprofit corporation", a corporation incorporated under the laws of the commonwealth and subject to chapter 180.

"Notice", as defined in section 1.41.

"Organic document", a public organic document or a private organic document.

"Organic law", the law governing the internal affairs of an entity.

"Other entity", any association or entity other than a domestic or foreign business corporation, a domestic or foreign nonprofit corporation or a governmental or quasi-governmental organization. The term includes, without limitation, limited partnerships, general partnerships, limited liability partnerships, limited liability companies, joint ventures, joint stock companies, business trusts and profit and not-for-profit unincorporated associations.

"Owner liability", personal liability for a debt, obligation or liability of an entity that is imposed on a person:

(i) solely by reason of the person's status as a shareholder or interest holder; or

(ii) by the articles of organization, bylaws or an organic document under a provision of the organic law of an entity authorizing the articles of organization, bylaws or an organic document to make one or more specified shareholders, members or interest holders liable in their capacity as shareholders, members or interest holders for all or specified debts, obligations or liabilities of the entity.

"Person", includes individual and entity.

"Principal office", the office, within or without the commonwealth, so designated in the annual report where the principal executive offices of a domestic or foreign corporation are located.

"Private organic document", any document, other than the public organic document, if any, that determines the internal governance of an other entity.

"Proceeding", includes civil suit and criminal, administrative, and investigatory action.

"Public corporation", any corporation to which this chapter apply to, and which has a class of voting stock registered under the Securities Exchange Act of 1934, as amended; provided, that if a corporation is subject to paragraph (b) of section 8.06 at the time it ceases to have any class of voting stock so registered, such corporation shall nonetheless be deemed to be a public corporation for a period of twelve months following the date it ceased to have such stock registered.

"Public organic document", the document, if any, that is filed of public record to create an other entity, including amendments and restatements thereof.

"Record date", the date established under PART 6 or PART 7 hereof on which a corporation determines the identity of its shareholders for purposes of this chapter.

"Secretary", the corporate officer to whom the board of directors has delegated responsibility under subsection (c) of section 8.40 for custody of the minutes of the meetings of the board of directors and of the shareholders and for authenticating records of the corporation, and includes a "clerk" appointed under chapter 156B unless the corporation has also appointed a "secretary" or the context otherwise requires.

"Secretary of state", the state secretary.

"Shares", the units into which the proprietary interests in a corporation are divided.

"Shareholder", the person in whose name shares are registered in the records of a corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with a corporation.

"Sign" or "signature", includes any manual, facsimile, conformed or electronic signature.

"State", when referring to a part of the United States, includes a state and commonwealth, and their agencies and governmental subdivisions, and a territory and insular possession, and their agencies and governmental subdivisions, of the United States.

"Subscriber", a person who subscribes for shares in a corporation, whether before or after incorporation.

"United States", includes a district, authority, bureau, commission, department, and any other agency of the United States.

"Voting group", all shares of one or more classes or series that under the articles of organization or this chapter are entitled to vote and to be counted together collectively on a matter at a meeting of shareholders. All shares entitled by the articles of organization or this

chapter to vote generally on the matter are for that purpose a single voting group.

(b) In this chapter, use of the masculine gender includes the feminine gender or, where the context permits, an entity.

§ 1.41. NOTICE

(a) Notice under this chapter shall be in writing unless oral notice is reasonable under the circumstances. Notice by electronic transmission is written notice.

(b) Notice may be communicated in person; by telephone, voice mail, telegraph, teletype, or other electronic means; by mail; by electronic transmission; or by messenger or delivery service. If these forms of personal notice are impracticable, notice may be communicated by a newspaper of general circulation in the area where published; or by radio, television, or other form of public broadcast communication.

(c) Written notice, other than notice by electronic transmission, by a domestic or foreign corporation to any of its shareholders, if in a comprehensible form, is effective upon deposit in the United States mail, if mailed postpaid and correctly addressed to the shareholder's address shown in the corporation's current record of shareholders.

(d) Written notice by electronic transmission by a domestic or foreign corporation to any of its shareholders, if in comprehensible form, is effective:

(1) if by facsimile telecommunication, when directed to a number furnished by the shareholder for the purpose;

(2) if by electronic mail, when directed to an electronic mail address furnished by the shareholder for the purpose;

(3) if by a posting on an electronic network together with separate notice to the shareholder of such specific posting, directed to an electronic mail address furnished by the shareholder for the purpose, upon the later of (i) such posting and (ii) the giving of such separate notice; and

(4) if by any other form of electronic transmission, when directed to the shareholder in such manner as the shareholder shall have specified to the corporation.

An affidavit of the secretary or an assistant secretary of the corporation, the transfer agent or other agent of the corporation that the notice has been given by a form of electronic transmission shall, in the absence of fraud, be prima facie evidence of the facts stated therein.

(e) Written notice, including notice by electronic transmission, to a domestic or foreign corporation, authorized to transact business in the commonwealth, may be addressed to its registered agent at its registered office or to the corporation at its principal office shown in its most recent annual report or, in the case of a foreign corporation that has not yet delivered an

annual report, in its application for a certificate of qualification.

(f) Except as provided in subsection (c), written notice, other than notice by electronic transmission, if in a comprehensible form, is effective at the earliest of the following:

(1) when received;

(2) five days after its deposit in the United States mail, if mailed postpaid and correctly addressed;

(3) on the date shown on the return receipt, if sent by registered or certified mail, return receipt requested; or if sent by messenger or delivery service, on the date shown on the return receipt signed by or on behalf of the addressee; or

(4) on the date of publication if notice by publication is permitted.

(g) Oral notice is effective when communicated if communicated in a comprehensible manner.

(h) If this chapter or any other General Law prescribes notice requirements for particular circumstances, those requirements shall govern. If articles of organization or bylaws prescribe notice requirements, which are not inconsistent with this chapter, those requirements shall govern.

§ 1.42. NUMBER OF SHAREHOLDERS
(a) For purposes of this chapter, except as provided in subsection (c), the following identified as a shareholder in a corporation's current record of shareholders constitutes one shareholder:

(1) three or fewer co-owners;

(2) a corporation, partnership, trust, estate, or other entity;

(3) the trustees, guardians, custodians, or other fiduciaries of a single trust, estate, or account.

(b) For purposes of this chapter, shareholders registered in substantially similar names constitute one shareholder if it is reasonable to believe that the names represent the same person.
(c) For purposes of this chapter, each beneficial owner of shares registered in the name of a nominee in a corporation's current record of shareholders constitutes one shareholder.

§ 1.50. INTERPRETATION OF ACT
In interpreting this chapter, in the absence of controlling Massachusetts precedent on any matter, consideration shall be given to the following:

Inasmuch as predictability is important in the conduct of the affairs of Massachusetts

corporations and in their relations with corporations organized under the laws of other jurisdictions, significant weight shall be given to the interpretations of courts of other jurisdictions of substantially equivalent provisions of the corporate laws of such other jurisdictions.

§ 2.01. INCORPORATORS

One or more persons may act as the incorporator or incorporators of a corporation by signing articles of organization and delivering them to the secretary of state for filing. Before the initial issuance of shares by the corporation, the incorporators may exercise all powers of shareholders and take any action required or permitted by law, the articles of organization or the bylaws to be taken by shareholders.

§ 2.02. ARTICLES OF ORGANIZATION

(a) The articles of organization shall set forth:

(1) a corporate name for the corporation that satisfies the requirements of section 4.01;

(2) the number of shares the corporation is authorized to issue, and any required description of additional classes or series of shares, in conformity with section 6.01; and

(3) the name and address of each incorporator.

(b) The articles of organization may set forth:

(1) provisions not inconsistent with law regarding:

(i) the purpose or purposes for which the corporation is organized;

(ii) managing the business and regulating the affairs of the corporation;

(iii) defining, limiting, and regulating the powers of the corporation, its board of directors, and shareholders or any class thereof;

(iv) a par value for authorized shares or classes of shares;

(v) the imposition of personal liability on shareholders for the debts of the corporation to a specified extent and upon specified conditions; or

(vi) the voluntary dissolution of the corporation; and

(2) any provision that under this chapter is required to be set forth in the articles of organization in order for the subject matter of the provision to be effective or is permitted to be set forth in such articles;

(3) any provision that under this chapter is required or permitted to be set forth in the bylaws;

and

(4) a provision eliminating or limiting the personal liability of a director to the corporation for monetary damages for breach of fiduciary duty as a director notwithstanding any provision of law imposing such liability; but the provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its shareholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) for improper distributions under section 6.40, or (iv) for any transaction from which the director derived an improper personal benefit.

(c) The articles of organization need not set forth any of the corporate powers enumerated in this chapter.

(d) The form on which articles of organization are filed shall also include the following supplemental information, which is not to be considered a part of the articles:

(1) the street address of the initial registered office of the corporation;

(2) the names and addresses of the individuals who will serve as the initial directors, president, treasurer and secretary of the corporation;

(3) the name of its initial registered agent at its registered office;

(4) the fiscal year of the corporation that is initially adopted; and

(5) such other supplemental information as the secretary of state may require, including (i) a brief description of the type of business in which the corporation intends to engage or its SIC code, and (ii) the federal tax identification number of the corporation.

§ 2.03. INCORPORATION

(a) Corporate existence begins when the articles of organization become effective pursuant to section 1.23.

(b) The filing of the articles of organization with the state secretary shall be conclusive evidence that the incorporators satisfied all conditions precedent to incorporation and that the corporation has been incorporated under this chapter, except in a proceeding by the commonwealth to challenge the validity of the corporation.

§ 2.04. LIABILITY FOR PRE-INCORPORATION TRANSACTIONS

All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this chapter shall be jointly and severally liable for all liabilities created while so acting.

§ 2.05. ORGANIZATION OF CORPORATION

(a) The organization of the corporation shall be completed as follows:

(1) The incorporator or incorporators may hold an organizational meeting before or after incorporation at the call of a majority of the incorporators at which by-laws shall be adopted and the initial directors, a president, treasurer and secretary, shall be elected.

(2) If no organizational meeting of the incorporators is held, the initial directors named in the articles of organization shall hold an organizational meeting after incorporation at the call of a majority of the directors at which by-laws shall be adopted and a president, treasurer and secretary shall be elected.

(3) At the organization meeting of the incorporators or the directors, additional officers may be appointed and any other business may be transacted which is properly brought before the meeting.

(b) Action required or permitted by this chapter to be taken by incorporators at an organizational meeting may be taken without a meeting if the action taken is evidenced by one or more written consents describing the action taken and signed by each incorporator.

(c) An organizational meeting may be held within and without the commonwealth.

§ 2.06. BYLAWS

(a) The incorporators or board of directors of a corporation shall adopt initial bylaws for the corporation.

(b) The bylaws of a corporation may contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with law or the articles of organization.

§ 2.07. EMERGENCY BYLAWS

(a) Unless the articles of organization provide otherwise, the board of directors of a corporation may adopt bylaws to be effective only in an emergency defined in subsection (d). The emergency bylaws, which are subject to amendment or repeal by the shareholders, may make all provisions necessary for managing the corporation during the emergency, including:

(1) appointment of successors to any of the officers, directors, employees or agents;

(2) relocation of the principal office or designation of alternative officers;
(3) procedures for calling and giving notice of a meeting of the board of directors;

(4) quorum requirements for the meeting; and

(5) designation of additional or substitute directors.

(b) All provisions of the regular bylaws consistent with the emergency bylaws remain effective during the emergency. The emergency bylaws are not effective after the emergency

ends.

(c) Corporate action taken in good faith in accordance with the emergency bylaws:

(1) binds the corporation; and

(2) may not be used to impose liability on a corporate director, officer, employee, or agent.

(d) An emergency exists for purposes of this section if a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event.

§ 3.01. PURPOSES

Every corporation incorporated under this chapter has the purpose of engaging in any lawful business unless a more limited purpose is set forth in its articles of organization.

§ 3.02. GENERAL POWERS

(a) Unless its articles of organization provide otherwise, every corporation shall have perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including without limitation power:

(1) to sue and be sued, complain and defend in its corporate name;

(2) to have a corporate seal, which may be altered at will, and to use it, or a facsimile of it, by impressing or affixing it or in any other manner reproducing it;

(3) to make and amend bylaws, not inconsistent with its articles of organization or with the laws of the commonwealth, for managing the business and regulating the affairs of the corporation;

(4) to purchase, receive, borrow, lease or otherwise acquire, to own, hold, lend, improve, use, transfer and otherwise deal with, and to sell, convey, mortgage, pledge, lease, exchange and otherwise dispose of, all or any part of its real or personal property, or any legal or equitable interest in such property, wherever located;

(5) to purchase, receive, borrow or otherwise acquire, to use, own, hold, sell, lend, transfer and otherwise dispose of, and to pledge, exchange and otherwise deal in and with, its own shares;

(6) to purchase, receive, subscribe for, or otherwise acquire, to own, hold, vote, use, sell, mortgage, lend, pledge, or otherwise dispose of; and deal in and with shares or other interests in, or obligations of, any other entity;

(7) to make contracts and guarantees, incur liabilities, borrow money, issue its notes, bonds,

and other obligations, which may be convertible into or include the option to purchase other securities of the corporation, and secure any of its obligations by mortgage or pledge of any of its property, franchises, or income;

(8) to lend money, invest and reinvest its funds, and receive and hold real and personal property as security for repayment;

(9) to be a promoter, partner, member, associate, or manager of any partnership, joint venture, trust, or other entity;

(10) to conduct its business, locate offices, and exercise the powers granted by this chapter within or without the commonwealth or the United States;

(11) to elect directors and appoint officers, employees, and agents of the corporation, define their duties, fix their compensation, and lend them money and credit;

(12) to pay pensions and establish pension plans, pension trusts, profit sharing plans, share bonus plans, share option plans, and benefit or incentive plans for any or all of the current or former directors, officers, employees, and agents of the corporation or any other corporation or entity in which it has an interest;

(13) to make donations for the public welfare or for charitable, religious, scientific, civic or educational purposes;

(14) to transact any lawful business that will aid governmental policy; and

(15) to make payments or donations, or do any other act, not inconsistent with law, that furthers the business and affairs of the corporation.

(b) Unless its articles of organization provide otherwise, a contract of guarantee or suretyship made by a corporation with respect to the obligation of another entity, (i) all of the equity interest in which is owned, directly or indirectly, by the contracting corporation, or (ii) which owns, directly or indirectly, all of the outstanding stock of the contracting corporation, or (iii) all of the equity interest in which is owned, directly or indirectly, by an entity which owns, directly or indirectly, all of the outstanding stock of the contracting corporation, shall be deemed necessary or convenient to carry out the business and affairs of the contracting corporation.

§ 3.03. EMERGENCY POWERS

(a) In anticipation of or during an emergency defined in subsection (d), unless emergency bylaws or other bylaws that specifically refer to this section provide otherwise, the board of directors of a corporation may:

(1) modify lines of succession to accommodate the incapacity of any director, officer, employee, or agent; and

(2) relocate the principal office, designate alternative principal offices or regional offices, or authorize the officers to do so.

(b) During an emergency defined in subsection (d), unless emergency bylaws or other bylaws that specifically refer to this section provide otherwise:

(1) notice of a meeting of the board of directors need be given only to those directors whom it is practicable to reach and may be given in any practicable manner, including by publication and radio; and

(2) those directors present may reduce the quorum requirement and/or treat one or more officers of the corporation present at such a meeting as directors for the meeting, in order of rank and within the same rank in order of seniority, as necessary to achieve a quorum.

(c) Corporate action taken in good faith during an emergency under this section to further the ordinary business affairs of the corporation:

(1) binds the corporation; and

(2) may not be used to impose liability on a corporate director, officer, employee, or agent.

(d) An emergency exists for purposes of this section if a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event.

§ 3.04. ULTRA VIRES
(a) Except as provided in subsection (b), the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act.

(b) A corporation's power to act may be challenged:

(1) in a proceeding by a shareholder against the corporation to enjoin the act;

(2) in a proceeding by the corporation, directly, derivatively, or through a receiver, trustee, or other legal representative, against an incumbent or former director, officer, employee, or agent of the corporation; or

(3) in a proceeding by the attorney general under section 14.30.

§ 4.01. CORPORATE NAME
(a) A corporate name:

(1) shall contain the word "corporation, "incorporated," "company," or "limited" or the abbreviation "corp.," "inc., or ltd.," or words or abbreviations of like import in another language; and

(2) may not contain language stating or implying that the corporation is organized for a purpose other than that permitted by section 301. and its articles of organization.

(b) Except as authorized by subsections (c) and (d), a corporate name may not be the same as, or so similar that it is likely to be mistaken for:

(1) the corporate name or trade name of a corporation organized, authorized to transact business or otherwise lawfully conducting business in the commonwealth;

(2) a corporate name reserved under section 4.02;

(3) the fictious name adopted by a foreign corporation or entity authorized to transact business or otherwise lawfully conducting business in the commonwealth because its real or trade name is unavailable;

(4) the corporate name or trade name of a not-for-profit corporation organized, authorized to conduct its activities or otherwise lawfully conducting its activities in the commonwealth;

(5) the name or trade name of a partnership, business trust or other entity organized, authorized to transact business or otherwise lawfully conducting business in the commonwealth; or

(6) a trademark or service mark registered with the secretary of state under chapter 110B.

(c) A person may apply to the secretary of state for authorization to use a corporate name that does not comply with the requirements of subsection (b). The secretary of state shall authorize use of the name applied for if:

(1) the other user consents to the use in writing and, if required by the secretary of state, submits an undertaking in form satisfactory to the secretary of state to change its name or mark to a name or mark that is not the same as or so similar that it is likely to be mistaken for the name of the applicant; or

(2) the applicant delivers to the secretary of state a certified copy of the final judgment of a court of competent jurisdiction establishing the applicant's right to use the name applied for in the commonwealth.
(d) A corporation may use the name, including the fictitious name, or mark of another entity that is used in the commonwealth if the other entity is organized, authorized to transact business or otherwise lawfully conducting business in the commonwealth and the proposed user corporation:

(1) has merged with the other entity; or

(2) has been formed by reorganization of the other entity; or

(3) has acquired all or substantially all of the assets, including the name and marks, of the other entity.

(e) Within 90 days after articles of organization or articles of amendment affecting a change in the name of a corporation are filed with the secretary of state, any person who is registered, qualified or carrying on business in the commonwealth at the time or who has reserved a name under section 4.02 may protest in writing to the secretary of state that the name assumed by the corporation is the same as or so similar that it is likely to be mistaken for the name of such person in violation of this section. In such event, if the secretary of state decides to conduct a hearing regarding the dispute, he shall give notice thereof as soon as possible to the protesting party and the corporation which assumed the name. If as a result of the hearing or otherwise, the secretary of state determines that the assumption of the corporate name violates this section, he shall file a statement withdrawing his approval of the articles of organization or articles of amendment insofar as they relate to the name assumed by the corporation and shall give written notice thereof to the protesting party and the corporation. The withdrawal of approval shall take effect on the date specified by the secretary of state, which shall be not later than 180 days after the filing which was protested. After the effective date of the withdrawal of approval, the corporation shall have no right to use its assumed name and may be enjoined from doing business under such name by the superior court upon application of any interested person.

§ 4.02. RESERVED NAME

(a) A person may reserve the exclusive use of a corporate name, including a fictitious name for a foreign corporation whose corporate name is not available, by delivering an application to the secretary of state for filing. The application shall set forth the name and address of the applicant and the name proposed to be reserved. If the secretary of state finds that the corporate name applied for is available, he shall reserve the name for the applicant's exclusive use for a 60-day period and, upon the applicant's written request within the 60-day period, extend the reservation for an additional 60- day period.

(b) The holder of a reserved corporate name may transfer the reservation to another person by delivering to the secretary of state a signed notice of the transfer that states the name and address of the transferee.

§ 5.01. REGISTERED OFFICE AND REGISTERED AGENT

Each corporation shall continuously maintain in the commonwealth:

(1) a registered office that may, but need not be, the same as any of its places of business; and

(2) a registered agent who may be any of the following individuals or entities whose business office is also the registered office of the corporation:

(i) an individual, including the secretary or another officer of the corporation;

(ii) a domestic corporation or not-for-profit domestic corporation; or

(iii) a foreign corporation or not-for-profit foreign corporation qualified to do business in this commonwealth.

§ 5.02. CHANGE OF REGISTERED OFFICE OR REGISTERED AGENT

(a) A corporation may change its registered office or registered agent by delivering to the secretary of state for filing a statement of change that sets forth:

(1) the name of the corporation;

(2) the street address of its current registered office;

(3) if the current registered office is to be changed, the street address of the new registered office;

(4) the name of its current registered agent;

(5) if the current registered agent is to be changed, the name of the new registered agent and the new agent's written consent, either on the statement or attached to it, to the appointment; and

(6) that after the change or changes are made, the street addresses of its registered office and the business office of its registered agent will be identical.

(b) If a registered agent changes the street address of his business office, he may change the street address of the registered office of any corporation for which he is the registered agent by notifying the corporation in writing of the change and signing (either manually or in facsimile) and delivering to the secretary of state for filing a statement of change that complies with the requirements of subsection (a) and recites that corporation has been notified of the change. If the street addresses of more than one corporation are being changed at the same time, there may be included in a single statement the names of all corporations

the street addresses of the registered office of which are being changed.

§ 5.03. RESIGNATION OF REGISTERED AGENT

(a) The registered agent of a corporation may resign his agency appointment by signing and delivering to the secretary of state for filing a statement of resignation. The registered agent shall furnish a copy of such statement to the corporation. The statement of resignation may include a statement that the registered office is also discontinued.

(b) The agency appointment is terminated, and the registered office discontinued if so provided, on the thirty-first day after the date on which the statement was filed.

§ 5.04. SERVICE ON CORPORATION

(a) A corporation's registered agent is the corporation's agent for service of process, notice, or demand required or permitted by law to be served on the corporation.

(b) Service on a corporation shall be effected and shall be perfected in accordance with the Massachusetts Rules of Civil Procedure and applicable provisions of the General Laws.

§ 6.01. AUTHORIZED SHARES

(a) The articles of organization shall prescribe the total number of shares the corporation is authorized to issue. The articles of organization also shall, before the issuance of any shares of a class or series, prescribe the number of authorized shares of the class or series, the distinguishing designation thereof and the preferences, limitations and relative rights identical with those of other shares of the same class or series, except that if a class consists of more than 1 series, all shares of each series within the class shall have identical preferences, limitations and relative rights with those of other shares within such series and may, but need not, have some or all preferences, limitations and relative rights which are identical with those of shares of other series within the class or any other class.

(b) The articles of organization shall authorize 1 or more classes or series of shares that together have unlimited voting rights, and 1 or more classes or series of shares, which may be the same class or series or classes and series as those with voting rights, that together are entitled to receive the net assets of the corporation upon dissolution.

(c) The articles of organization may authorize 1 or more classes or series of shares that:

(1) have special, conditional, or limited voting rights, or no right to vote, except to the extent prohibited by this chapter;

(2) are redeemable or convertible as specified in the articles of organization (i) at the option of the corporation, the shareholder, or another person or upon the occurrence of a designated event; (ii) for cash, indebtedness, securities, or other property; (iii) in a designated amount or in an amount determined in accordance with a designated formula or by reference to extrinsic

data or events;
(3) entitle the holders to distributions calculated in any manner, including dividends that may be cumulative, noncumulative, or partially cumulative;

(4) have preference over any other class or series of shares with respect to distributions, including dividends and distributions upon the dissolution of the corporation.

(d) The description of the designations, preferences, limitations, and relative rights of share classes and series in subsection (c) is not exhaustive.

§ 6.02. DETERMINATION OF TERMS OF CLASS OR SERIES
(a) The number of authorized shares of any class or series, the distinguishing designation thereof and the preferences, limitations and relative rights applicable thereto shall be set forth in the articles of organization or any amendment thereto approved by the shareholders or, if the articles of organization so permit, by the board of directors, provided that the board of directors may not approve an aggregate number of authorized shares of all classes and series which exceeds the total number of authorized shares specified in the articles of organization approved by the shareholders. Any such action with respect to any class or series may be amended or rescinded by the shareholders or, if initially taken by it, by the board of directors at any time prior to, but, except as provided in the next following subsection with respect to unissued shares, not after, the initial issuance of shares of such class or series.

(b) At any time after the initial issuance of shares of any class or series the shareholders or, if the articles of organization so permit, the board of directors may reclassify any unissued shares of the class or series into 1 or more existing or new classes or series.

(c) Before issuing any shares of a class or series, the number, preferences, limitations or relative rights of which have been determined by the board of directors, the corporation must deliver to the secretary of state for filing articles of amendment, which are effective without shareholder action, that set forth:

(1) the name of the corporation;

(2) the text of the amendment determining the terms of the class or series of shares;

(3) the date it was adopted; and

(4) a statement that the amendment was duly adopted by the board of directors.

(d) If the shareholders or board of directors shall, before the issuance of any shares of any class or series of which the number, preferences, limitations or relative rights are contained in articles of amendment filed with the secretary of state pursuant to subsection (c), amend or rescind any terms applicable to such class or series, or if the shareholders or board of directors shall reclassify any unissued shares of any class or series pursuant to subsection (b), the corporation shall deliver to the secretary of state for filing articles of amendment, which

in the case of any amendment effected by the board of directors are effective without shareholder action, reflecting such amendment, recision or reclassification and setting forth the information required by clauses (1) and (4) of subsection (c) and, in the case of an amendment, the text of the amendment or, in the case of a reclassification, the number and existing class or series of the shares to be reclassified and the text of the amendment determining the terms of any new class or classes or series into which the shares are to be reclassified.

§ 6.03. ISSUED AND OUTSTANDING SHARES

(a) A corporation may issue the number of shares of each class or series authorized by the articles of organization. Shares that are issued are outstanding shares until they are reacquired, redeemed, converted or canceled.

(b) The reacquisition, redemption or conversion of outstanding shares is subject to the limitations of subsection (c) and to section 6.40.

(c) At all times that shares of the corporation are outstanding, 1 or more shares that together have unlimited voting rights and 1 or more shares that together are entitled to receive the net assets of the corporation upon dissolution shall be outstanding.

§ 6.04. FRACTIONAL SHARES

(a) A corporation may:

(1) issue fractions of a share or pay in money or property the value of fractions of a share;

(2) arrange for disposition of fractional shares by the shareholders;

(3) issue scrip in registered or bearer form entitling the holder to receive a full share upon surrendering enough scrip to equal a full share.

(b) Each certificate representing scrip must be conspicuously labeled "scrip" and must contain the information required by subsection (b) of section 6.25.

(c) The holder of a fractional share is entitled to exercise the rights of a shareholder, including the right to vote, to receive dividends, and to participate in the assets of the corporation upon liquidation. The holder of scrip is not entitled to any of these rights unless the scrip provides for them.

(d) The board of directors may authorize the issuance of scrip subject to any condition considered desirable, including:

(1) that the scrip will become void if not exchanged for full shares before a specified date; and

(2) that the shares for which the scrip is exchangeable may be sold and the proceeds paid to

the scripholders.

§ 6.20. SUBSCRIPTION FOR SHARES BEFORE INCORPORATION

(a) A subscription for shares entered into before incorporation is irrevocable for 6 months unless the subscription agreement provides a longer or shorter period or all the subscribers agree to revocation or extension. The subscription agreement shall not be binding on the corporation until it is accepted by the board of directors.

(b) The board of directors may determine the payment terms of subscriptions for shares that were entered into before incorporation, unless the subscription agreement specifies them. A call for payment by the board of directors shall be uniform so far as practicable as to all shares of the same class or series, unless the subscription agreement specifies otherwise.

(c) Shares issued pursuant to subscriptions entered into before incorporation are fully paid and nonassessable when the corporation receives the consideration specified in the subscription agreement.

(d) If a subscriber defaults in payment of money or property under a subscription agreement entered into before incorporation, the corporation may collect the amount owed as any other debt. Alternatively, unless the subscription agreement provides otherwise, the corporation may rescind the agreement and may sell the shares if the debt remains unpaid more than 20 days after the corporation sends written demand for payment to the subscriber. The rescission shall not affect the status of any shares theretofore issued pursuant thereto.

(e) A subscription agreement entered into after incorporation is a contract between the subscriber and the corporation subject to section 6.21.

§ 6.21. ISSUANCE OF SHARES

(a) The powers granted in this section to the board of directors may be reserved to the shareholders, either exclusively or concurrently with the powers of the directors, by the articles of organization.

(b) The board of directors may authorize shares to be issued for consideration consisting of any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation.

(c) Before the corporation issues shares, the board of directors must determine that the consideration received or to be received for shares to be issued is adequate. That determination by the board of directors is conclusive insofar as the adequacy of consideration for the issuance of shares relates to whether the shares are validly issued, fully paid, and nonassessable.

(d) The articles of organization may limit the type or specify the minimum amount of

consideration for which the shares of any class or series may be issued. A reference in the articles of organization to par value shall not, by itself, be deemed to be a specification of the minimum amount.

(e) Notwithstanding subsection (d), when the corporation receives the consideration for which the board of directors authorized the issuance of shares, the shares issued therefor are fully paid and nonassessable.

(f) The corporation may place in escrow shares issued for a contract for future services or benefits or a promissory note, or make other arrangements to restrict the transfer of the shares, and may credit distributions in respect of the shares against their purchase price, until the services are performed, the note is paid, or the benefits received. If the services are not performed, the note is not paid when due, or the benefits are not received, the shares escrowed or restricted and the distributions credited may be canceled in whole or part.

§ 6.22. LIABILITY OF SHAREHOLDERS

(a) A purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued or specified in the subscription agreement.

(b) Unless otherwise provided in the articles of organization, a shareholder of a corporation shall not be 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.

§ 6.23. SHARE DIVIDENDS

(a) Unless the articles of organization provide otherwise, shares may be issued pro rata and without consideration to the corporation's shareholders or to the shareholders of 1 or more classes or series. An issuance of shares under this subsection is a share dividend.

(b) Shares of 1 class or series shall not be issued as a share dividend in respect of shares of another class or series unless (1) the articles of organization so authorized, (2) the holders of a majority of the outstanding shares of the class of series to be issued approve the issue, or (3) there are no outstanding shares of the class or series to be issued. In addition, shares of a class or series having preference over another class or series with respect to distributions, including dividends and distributions upon the dissolution of the corporation, shall not be issued as a share dividend in respect of shares of such other class or series if there are at the time any outstanding shares of any third class or series as to which the shares then to be issued have a right with respect to distribution which is prior, superior or substantially equal unless (1) the articles of organization so authorize, or (2) the holders of a majority of the outstanding shares of such third class or series approve the issue.

(c) If the board of directors does not fix the record date for determining shareholders entitled to a share dividend, it is the date the board of directors authorized the share dividend.

§ 6.24. SHARE OPTIONS

(a) A corporation may issue rights, options or warrants for the purchase of shares or other securities of the corporation. The board of directors shall determine the terms upon which the rights, options, or warrants are issued and the terms, including the consideration, for which the shares or other securities are to be issued.

(b) The terms and conditions of such rights, options or warrants, including those outstanding on the effective date of the chapter, may include without limitation, restrictions or conditions that:

(1) preclude or limit the exercise, transfer or receipt of the rights, options or warrants by any person owning or offering to acquire a specified number or percentage of the outstanding shares or other securities of the corporation or by any transferee of any person, or that preclude or limit the exercise, transfer or receipt based on such other factors, including the nature or identity of such persons, as the directors determine to be reasonable and in the best interests of the corporation, or

(2) invalidate or void such rights, options or warrants held by any such person or persons or any such transferee or transferees.

§ 6.25. FORM AND CONTENT OF CERTIFICATES

(a) Shares may but need not be represented by certificates. Unless this chapter or another statute expressly provides otherwise, the rights and obligations of shareholders are identical whether or not their shares are represented by certificates.

(b) At a minimum each share certificate shall state on its face:

(1) the name of the issuing corporation and that it is organized under the laws of the commonwealth;

(2) the name of the person to whom issued; and

(3) the number and class of shares and the designation of the series, if any, the certificate represents.

(c) If the issuing corporation is authorized to issue different classes of shares or different series within a class then the variations in rights, preferences and limitations applicable to each class and series, and the authority of the board of directors to determine variations for any future class or series, must be summarized on the front or back of each certificate. Alternatively, each certificate may state conspicuously on its front or back that the corporation will furnish the shareholder this information on request in writing and without charge.

(d) Each share certificate shall be signed, either manually or in facsimile, by 2 officers designated in the bylaws or by the board of directors and shall bear the corporate seal or its facsimile.

(e) If the person who signed, either manually or in facsimile, a share certificate no longer holds office when the certificate is issued, the certificate shall be nevertheless valid.

§ 6.26. SHARES WITHOUT CERTIFICATES

(a) Unless the articles of organization or bylaws provide otherwise, the board of directors of a corporation may authorize the issue of some or all of the shares of any or all of its classes or series without certificates. The authorization shall not affect shares already represented by certificates until they are surrendered to the corporation.

(b) Within a reasonable time after the issue or transfer of shares without certificates, the corporation shall send the shareholder a written statement of the information required on certificates by subsections (b) and (c) of section 6.25, and, if applicable, section 6.27.

§ 6.27. RESTRICTION ON TRANSFER OF SHARES AND OTHER SECURITIES

(a) The articles of organization, bylaws, an agreement among shareholders or an agreement between shareholders and the corporation may impose restrictions on the transfer or registration of transfer of shares of the corporation. A restriction shall not affect shares issued before the restriction was adopted unless the holders of the shares are parties to the restriction agreement or voted in favor of the restriction, or unless the restriction is set forth in an amendment to the articles of organization or bylaws approved by the holders of that percentage of each voting group of the outstanding shares required for the approval of an amendment of the articles of organization containing the restriction.

(b) A restriction on the transfer or registration of transfer of shares is valid and enforceable against the holder or a transfer of the holder if the restriction is authorized by this section and its existence is noted conspicuously on the front or back of the certificate or is contained in the formation statement required by subsection (b) of section 6.26. Unless so noted, a restriction is not enforceable against a person without knowledge of the restriction.

(c) A restriction on the transfer or registration of transfer of shares is authorized:

(1) to maintain the corporation's status when it is dependent on the number or identity of its shareholders;

(2) to preserve exemptions under federal or state securities law;

(3) for any other reasonable purpose.

(d) A restriction on the transfer or registration to transfer of shares may, without limitation:

(1) obligate the shareholder first to offer the corporation or other persons, separately, consecutively, or simultaneously, an opportunity to acquire the restricted shares;

(2) obligate the corporation or other persons, separately, consecutively, or simultaneously, to acquire the restricted shares;

(3) require the corporation, the holders of any class of its shares, or another person to approve the transfer of the restricted shares, if the requirement is not manifestly unreasonable;

(4) prohibit the transfer of the restricted shares to designated persons or classes of persons, if the prohibition is not manifestly unreasonable.

(e) For purposes of this section, "shares" includes a security convertible into or carrying a right to subscribe for or acquire shares.

§ 6.30. SHAREHOLDERS' PREEMPTIVE RIGHTS

(a) The shareholders of a corporation shall not have a preemptive right to acquire the corporation's unissued shares except to the extent the articles of organization or any contract to which the corporation is a party so provides.

(b) For purposes of this section, "share" includes a security convertible into or carrying a right to subscribe for or acquire shares.

§ 6.31. CORPORATION'S ACQUISITION OF ITS OWN SHARES

(a) A corporation may acquire its own shares and shares so acquired constitute authorized but unissued shares.

(b) If the articles of organization prohibit the reissue of acquired shares, the number of authorized shares is reduced by the number of shares acquired.

§ 6.40. DISTRIBUTIONS TO SHAREHOLDERS

(a) A board of directors may authorize and the corporation may make distributions to its shareholders subject to restriction by the articles of organization and the limitations in subsections (c) and (h).

(b) If the board of directors does not fix the record date for determining shareholders entitled to a distribution, other than one involving a purchase, redemption or other acquisition of the corporation's shares, it is the date the board of directors authorizes the distribution.

(c) No distribution may be made by a corporation which is a going concern if, after giving it effect,

(1) the corporation would not be able to pay its existing and reasonably foreseeable debts, liabilities and obligations, whether or not liquidated, matured, asserted or contingent, as they become due in the usual course of business; or

(2) the corporation's total assets would be less than the sum of its total liabilities plus, unless the articles or organization permit otherwise, the amount that would be needed, if the

corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

(d) The board of directors may base a determination that a distribution is not prohibited under subsection (c) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.

(e) Except as provided in subsection (g), the effect of a distribution made in accordance with subsection (c) is measured:

(1) in the case of distribution by purchase, redemption, or other acquisition of the corporation's shares, as of the earlier of (i) the date money or other property is transferred or debt incurred by the corporation, or (ii) the date the shareholder ceases to be a shareholder with respect to the acquired shares;

(2) in the case of any other distribution of indebtedness, as of the date the indebtedness is distributed; and

(3) in all other cases, as of (i) the date the distribution is authorized if the payment occurs within 120 days after the date of authorization or (ii) the date the payment is made if it occurs more than 120 days after the date of authorization.

(f) A corporation's indebtedness to a shareholder incurred by reason of a distribution made in accordance with subsection (c) is at parity with the corporation's indebtedness to its general, unsecured creditors except to the extent subordinated by agreement.

(g) Indebtedness of a corporation, including indebtedness issued as a distribution, is not considered a liability for purposes of determinations under subsection (c) if its terms provide that payment of principal and interest are made only if and to the extent that payment of a distribution to shareholders could than be made under this section. If the indebtedness is issued as a distribution, each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is actually made.

(h) No distribution in liquidation may be made by a corporation unless adequate provision has been made, after giving effect to the provisions of PART 14, to satisfy:

(1) the corporation's existing and reasonably foreseeable debts, liabilities and obligations, whether or not liquidated, matured, asserted or contingent, as they thereafter arise; and
(2) the preferential liquidation rights of shares whose preferential rights are superior to such rights of the shares which would receive the distribution.

A distribution in liquidation means a distribution made by a corporation in dissolution under PART 14, or a distribution, or 1 of a series of related distributions, of all or substantially all

of the corporation's assets.

§ 6.41. LIABILITY FOR IMPROPER DISTRIBUTIONS

(a) A director who votes for or assents to a distribution, including a distribution in liquidation as described in subsection (h) of section 6.40, made in violation of this chapter or the articles of organization, is personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed without violating this chapter or the articles of organization, if it is established that he did not perform his duties in compliance with section 8.30. In any proceeding under this section, a director has all of the defenses ordinarily available to a director.

(b) A director who pays the corporation on account of liability for an improper distribution under subsection (a) is entitled to:

(1) contribution from every other director who could be held liable under subsection (a) for the distribution;

(2) reimbursement from each shareholder who received the distribution knowing it was improper, for the amount that exceeded what could properly have been distributed to him; and

(3) reimbursement from each shareholder who received the distribution without knowing it was improper, to the extent determined appropriate in the circumstances by a court.

(c) Each shareholder who receives a distribution, including one in liquidation, knowing it was made in violation of this chapter or the articles of organization, shall be personally liable to the corporation for the amount of the distribution he received in excess of what could have been distributed to him without violating this chapter or the articles of organization.

(d) If a distribution in liquidation in violation of this chapter is made before 3 years after the effective date of the corporation's dissolution under PART 14, shareholders who receive the distribution without knowing it is improper are personally liable to the corporation on account of any claim against the corporation existing at the end of the 3-year period, to the extent of each shareholder's respective pro rata share of the claim, with pro ration to be determined by reference to the respective amounts distributed to shareholders in excess of what could properly have been distributed to them.

(e) Any shareholder's total liability for all claims under this section on account of distributions in liquidation may not exceed the total amount of assets distributed to the shareholder in liquidation.

(f) A proceeding by or on behalf of the corporation under this section is barred unless it is commenced by:

(1) in the case of a distribution not in liquidation, 2 years after the date on which the effect of the challenged distribution was measured under subsection (e) or (g) of section 6.40;

(2) in the case of a distribution in liquidation by a corporation in dissolution under PART 14, the later of the time specified in the preceding clause (1) and 6 months after the end of the two-year period referred to in subsection (d); or

(3) in the case of a distribution in liquidation by a corporation not in dissolution, as described in the second clause in the last sentence of subsection (h) of section 6.40, three years after the date on which the effect of the challenged distribution was measured under subsection (e) or (g) of section 6.40.

(g) A proceeding under subsection (b) against a director for contribution or against a shareholder for reimbursement is barred unless it is commenced by the later of (1) two years after the date on which the effect of the challenged distribution was measured under subsection (e) or (g) of section 6.40, and (2) 6 months after payment to the corporation on account of liability under subsection (a) of this section by the party seeking contribution or reimbursement.

§ 7.01. ANNUAL MEETING

(a) A corporation shall hold a meeting of shareholders annually at a time stated in or fixed in accordance with the bylaws.

(b) Except as otherwise permitted by section 7.08, annual shareholders' meetings may be held within or without the commonwealth at the place stated in or fixed in accordance with the bylaws. If no place is stated in or fixed in accordance with the bylaws, annual meetings shall be held at the corporation's principal office.

(c) The failure to hold an annual meeting at the time stated in or fixed in accordance with a corporation's bylaws shall not affect the validity of any corporate action.

(d) Unless otherwise provided in the articles of organization, an annual meeting shall be held for the purpose of electing directors and such other purposes as are specified in the notice of the meeting, and only business within such purposes may be conducted at the meeting.

§ 7.02. SPECIAL MEETING

(a) A corporation shall hold a special meeting of shareholders:

(1) on call of its board of directors or the person authorized to do so by the articles of organization or bylaws; or

(2) in the case of a corporation other than a public corporation, if the holders of at least 10 per cent, or such lesser percentage as the articles of organization permit, of all the votes entitled to be cast on any issue to be considered at the proposed special meeting sign, date, and deliver to the corporation's secretary one or more written demands for the meeting describing the purpose for which it is to be held; or

(3) in the case of a public corporation, unless otherwise provided in the articles of

organization or bylaws, if the holders of at least 40 per cent of all the votes entitled to be cast on any issue to be considered at the proposed special meeting sign, date, and deliver to the corporation's secretary one or more written demands for the meeting describing the purposes for which it is to be held.

(b) If not otherwise fixed under section 7.03 or 7.07, the record date for determining shareholders entitled to demand a special meeting is the date the first shareholder signs the demand.

(c) Except for meetings held as permitted by section 7.08, special shareholders' meetings may be held in or out of the commonwealth at the place stated in or fixed in accordance with the bylaws. If no place is stated or fixed in accordance with the bylaws, special meetings shall be held at the corporation's principal office.

(d) Only business within the purpose or purposes described in the meeting notice required by subsection (a) of section 7.05 may be conducted at a special shareholders' meeting.

(e) In the event an annual meeting is not held at the time stated in or fixed in accordance with the bylaws or the time for an annual meeting is not fixed in accordance with the bylaws to be held within 13 months after the last annual meeting was held, the corporation may designate a special meeting held thereafter in accordance with this section 7.02 as a special meeting in lieu of the annual meeting, and the meeting shall have all of the effect of an annual meeting.

§ 7.03. COURT-ORDERED MEETING

(a) The superior court of the county where a corporation's principal office or, if none in the commonwealth, its registered office is located may summarily order a meeting to be held:

(1) on application of any shareholder of the corporation entitled to participate in an annual meeting if an annual meeting was not held within the earlier of 6 months after the end of the corporation's fiscal year or 15 months after its last annual meeting; or

(2) on application of a shareholder who signed a demand for a special meeting valid under section 7.02, if:

(i) notice of the special meeting was not given within 30 days after the date the demand was delivered to the corporation's secretary or within such further time as the court may order under the circumstances; or

(ii) the special meeting was not held in accordance with the notice.

(b) The court may fix the time and place of the meeting, determine the voting groups entitled to participate in the meeting, specify a record date for determining shareholders entitled to notice of and to vote at the meeting, prescribe the form and content of the meeting notice, fix the quorum required for specific matters to be considered at the meeting, or direct that the votes represented at the meeting constitute a quorum for action on those matters, and enter other orders necessary to accomplish the purpose or purposes of the meeting.

§ 7.04. ACTION WITHOUT MEETING

(a) Action required or permitted by this chapter to be taken at a shareholders' meeting may be taken without a meeting if the action is taken either: (1) by all shareholders entitled to vote on the action; or (2) to the extent permitted by the articles of organization, by shareholders having not less than the minimum number of votes necessary to take the action at a meeting at which all shareholders entitled to vote on the action are present and voting. The action shall be evidenced by 1 or more written consents that describe the action taken, are signed by shareholders having the requisite votes, bear the date of the signatures of such shareholders, and are delivered to the corporation for inclusion with the records of meetings within 60 days of the earliest dated consent delivered to the corporation as required by this section.

(b) If not otherwise fixed under section 7.03 or 7.07, the record date for determining shareholders entitled to take action without a meeting is the date the first shareholder signs the consent under subsection (a).

(c) A consent signed under this section has the effect of a vote at a meeting and may be described as such in any document, except that if action is taken by the consent of less than all shareholders entitled to vote on the action, any document required to be filed under this chapter with respect to such action shall state that the action was taken by consent of the required number of shareholders and that any required notice has been given to other shareholders.

(d) If action is to be taken pursuant to the consent of voting shareholders without a meeting, the corporation, at least 7 days before the action pursuant to the consent is taken, shall give notice, which complies in form with the requirements of section 7.05, of the action (1) to nonvoting shareholders in any case where this Act would require such notice if the action is to be taken pursuant to a vote by voting shareholders at a meeting, and (2) if the action is to be taken pursuant to the consent of less than all the shareholders entitled to vote on the matter, to all shareholders entitled to vote who did not consent to the action. The notice shall contain, or be accompanied by, the same material that, under this chapter, would have been required to be sent to shareholders in or with the notice of a meeting at which the action would have been submitted to the shareholders for approval.

§ 7.05. NOTICE OF MEETING

(a) A written notice of the date, time, and place of each annual and special shareholders' meeting describing the purposes of the meeting shall be given to shareholders no fewer than 7 nor more than 60 days before the meeting date. Unless this chapter or the articles of organization require otherwise, the corporation is required to give notice only to shareholders entitled to vote at the meeting.

(b) Unless the bylaws require otherwise, if an annual or special meeting of shareholders is adjourned to a different date, time or place, notice need not be given of the new date, time or place if the new date, time or place, if any, is announced at the meeting before adjournment. If a new record date for the adjourned meeting is or shall be fixed under section 7.07, however, notice of the adjourned meeting shall be given under this section to persons who are shareholders as of the new record date.

§ 7.06. WAIVER OF NOTICE

(a) A shareholder may waive any notice required by this chapter, the articles of organization, or the bylaws before or after the date and time stated in the notice. The waiver shall be in writing, be signed by the shareholder entitled to the notice, and be delivered to the corporation for inclusion with the records of the meeting.

(b) A shareholder's attendance at a meeting:

(1) waives objection to lack of notice or defective notice of the meeting, unless the shareholder at the beginning of the meeting objects to holding the meeting or transacting business at the meeting; and

(2) waives objection to consideration of a particular matter at the meeting that is not within the purpose or purposes described in the meeting notice, unless the shareholder objects to considering the matter when it is presented.

§ 7.07. RECORD DATE

(a) Except as otherwise provided in section 7.03, the bylaws may fix or provide the manner of fixing the record date for one or more voting groups in order to determine the shareholders entitled to notice of a shareholders' meeting, to demand a special meeting, to vote, or to take any other action. If the bylaws do not fix or provide for fixing a record date, the board of directors of the corporation may fix a future date as the record date. If a record date for a specific action is not fixed by the bylaws or the board of directors, and is not supplied by the section of this chapter dealing with that action, the record date shall be the close of business either on the day before the first notice is sent to shareholders, or, if no notice is sent, on the day before the meeting.

(b) A record date fixed under this section may not be more than 70 days before the meeting or action requiring a determination of shareholders.

(c) A determination of shareholders entitled to notice of or to vote at a shareholders' meeting is effective for any adjournment of the meeting unless the board of directors fixes a new record date, which it shall do if the meeting is adjourned to a date more than 120 days after the date fixed for the original meeting.

(d) If a court orders a meeting adjourned to a date more than 120 days after the date fixed for the original meeting, it may provide that the original record date continues in effect or it may fix a new record date.

§ 7.08. MEETINGS BY REMOTE COMMUNICATIONS; REMOTE PARTICIPATION IN MEETINGS

Unless otherwise provided in the articles of organization or bylaws, if authorized by the board of directors: any annual or special meeting of shareholders need not be held at any place but may instead be held solely by means of remote communication, unless the corporation is a public corporation; and subject to such guidelines and procedures as the board of directors may adopt, shareholders and proxyholders not physically present at a meeting of shareholders may, by means of remote communications:

(1) participate in a meeting of shareholders; and

(2) be deemed present in person and vote at a meeting of shareholders whether such meeting is to be held at a designated place or solely by means of remote communication, provided that:

(i) the corporation shall implement reasonable measures to verify that each person deemed present and permitted to vote at the meeting by means of remote communication is a stockholder or proxyholder;

(ii) the corporation shall implement reasonable measures to provide such shareholders and proxyholders a reasonable opportunity to participate in the meeting and to vote on matters submitted to the shareholders, including an opportunity to read or hear the proceedings of the meeting substantially concurrently with such proceedings; and

(iii) if any stockholder or proxyholder votes or takes other action at the meeting by means of remote communication, a record of such vote or other action shall be maintained by the corporation.

§ 7.20. SHAREHOLDERS LIST FOR MEETING

(a) After fixing a record date for a shareholders' meeting, a corporation shall prepare an alphabetical list of the names of all its shareholders who are entitled to notice of the meeting. The list shall be arranged by voting group, and within each voting group by class or series of shares, and show the address of and number of shares held by each shareholder, but need not include an electronic mail address or other electronic contact information for any shareholder.

(b) The shareholders list shall be available for inspection by any shareholder, beginning 2 business days after notice is given of the meeting for which the list was prepared and continuing through the meeting:

(1) at the corporation's principal office or at a place identified in the meeting notice in the city where the meeting will be held; or

(2) on a reasonably accessible electronic network, provided that the information required to gain access to such list is provided with the notice of the meeting.

If the meeting is to be held solely by means of remote communication, the list shall be made available on an electronic network. In the event the corporation determines or is required to make the list available on an electronic network, the corporation may take reasonable steps to ensure that such information is available only to shareholders of the corporation.

(c) A shareholder, his agent, or attorney is entitled on written demand to inspect and, subject to the requirements of section 16.02(c), to copy the list, during regular business hours and at his expense, during the period it is available for inspection.

(d) The corporation shall make the shareholders list available at the meeting, and any shareholder or his agent or attorney is entitled to inspect the list at any time during the meeting or any adjournment.

(e) If the corporation refuses to allow a shareholder or his agent or attorney to inspect the shareholders list before or at the meeting, or copy the list as permitted by subsection (b), the superior court of the county where a corporation's principal office or, if none in the commonwealth, its registered office is located, on application of the shareholder, may summarily order the inspection or copying at the corporation's expense and may postpone the meeting for which the list was prepared until the inspection or copying is complete.

(f) Refusal or failure to prepare or make available the shareholders list shall not affect the validity of action taken at the meeting.

§ 7.21. VOTING ENTITLEMENT OF SHARES

(a) Except as provided in subsections (b) and (c) or unless the articles of organization provide otherwise, each outstanding share, regardless of class, is entitled to 1 vote on each matter voted on at a shareholders' meeting. Pursuant to subsection (c) of section 6.04 each fractional share is entitled to a proportional vote. Only shares are entitled to vote.

(b) Absent special circumstances, the shares of a corporation are not entitled to vote if they are owned, directly or indirectly, by another entity of which the corporation owns, directly or indirectly, a majority of the voting interests.

(c) Subsection (b) shall not limit the power of a corporation to vote any shares, including its

own shares, held by it, directly or indirectly, in a fiduciary capacity.

(d) Unless the articles of organization provide otherwise, redeemable shares are not entitled to vote after notice of redemption is given to the holders and a sum sufficient to redeem the shares has been deposited with a bank, trust company or other financial institution under an irrevocable obligation to pay the holders the redemption price upon surrender of the shares.

§ 7.22. PROXIES

(a) A shareholder may vote his shares in person or by proxy.

(b) A shareholder may appoint a proxy to vote or otherwise act for him by signing an appointment form, either personally or by his attorney-in-fact.

(c) An appointment of a proxy is effective when received by the secretary or other officer or agent authorized to tabulate votes. Unless otherwise provided in the appointment form, an appointment is valid for a period of 11 months from the date the shareholder signed the form or, if it is undated, from the date of its receipt by the officer or agent, or for such shorter period as may be specified in the bylaws.

(d) An appointment of a proxy is revocable by the shareholder unless the appointment form conspicuously states that it is irrevocable and the appointment is coupled with an interest. Appointments coupled with an interest include, without limitation, the appointment of:

(1) a secured party;

(2) a person who purchased or agreed to purchase the shares;

(3) a creditor of the corporation who extended it credit under terms requiring the appointment;

(4) an employee of the corporation whose employment contract requires the appointment; or

(5) a party to a voting agreement created under section 7.31.

(e) The death or incapacity of the shareholder appointing a proxy shall not affect the right of the corporation to accept the proxy's authority unless notice of the death or incapacity is received by the secretary or other officer or agent authorized to tabulate votes before the proxy exercises his authority under the appointment.

(f) An appointment made irrevocable under subsection (d) is revoked when the interest with which it is coupled is extinguished.

(g) A transferee for value of shares subject to an irrevocable appointment may revoke the appointment if he did not know of its existence when he acquired the shares and the existence of the irrevocable appointment was not noted conspicuously on the certificate representing

the shares or on the information statement for shares without certificates.

(h) Subject to section 7.24 and to any express limitation on the proxy's authority appearing on the face of the appointment form, a corporation is entitled to accept the proxy's vote or other action as that of the shareholder making the appointment.

§ 7.23. SHARES HELD BY NOMINEES

(a) A corporation may establish a procedure by which the beneficial owner of shares that are registered in the name of a nominee will be recognized by the corporation as the shareholder, to the extent provided in the procedure.

(b) The procedure may set forth:

(1) the types of nominees to which it applies;

(2) the rights or privileges that the corporation recognizes in a beneficial owner;

(3) the manner in which the procedure is selected by the nominee;

(4) a requirement for the certification by the nominee of the beneficial holders;

(5) the information that must be provided when the procedure is selected;

(6) the period for which selection of the procedure is effective; and

(7) other aspects of the rights and duties created.

§ 7.24. CORPORATION'S ACCEPTANCE OF VOTES

(a) If the name signed on a vote, consent, waiver, or proxy appointment corresponds to the name of a shareholder, the corporation if acting in good faith is entitled to accept the vote, consent, waiver, or proxy appointment and give it effect as the act of the shareholder.

(b) If the name signed on a vote, consent, waiver, or proxy appointment does not correspond to the name of its shareholder, the corporation if acting in good faith is nevertheless entitled to accept the vote, consent, waiver, or proxy appointment and give it effect as the act of the shareholder if:

(1) the shareholder is an entity and the name signed purports to be that of an officer or agent of the entity;

(2) the name signed purports to be that of an administrator, executor, guardian, conservator or other fiduciary representing the shareholder and, if the corporation requests, evidence of fiduciary status acceptable to the corporation has been presented;

(3) the name signed purports to be that of a receiver or trustee in bankruptcy of the

shareholder and, if the corporation requests, evidence of this status acceptable to the corporation has been presented;

(4) the name signed purports to be that of a secured party, beneficial owner, or attorney-in-fact of the shareholder and, if the corporation requests, evidence acceptable to the corporation of the signatory's authority to sign for the shareholder has been presented;

(5) two or more persons are the shareholder as co-owners, demutualization or fiduciaries and the name signed purports to be the name of at least one of the co-owners and the person signing appears to be acting on behalf of all the co-owners; or

(6) the corporation otherwise has a reasonable basis for believing that the signatory is, or has authority to sign for, the shareholder.

(c) The corporation is entitled to reject a vote, consent, waiver, or proxy appointment if the secretary or other officer or agent authorized to tabulate votes, acting in good faith, has reasonable basis for doubting the validity of the signature on it or the signatory's authority to sign for the shareholder.

(d) The corporation and its officer or agent who accepts or rejects a vote, consent, waiver, or proxy appointment in good faith and in accordance with the standards of this section shall not be liable to the shareholder for damages resulting from the acceptance or rejection.

(e) Corporate action based on the acceptance or rejection of a vote, consent, waiver, or proxy appointment under this section is valid unless a court of competent jurisdiction determines otherwise.

§ 7.25. QUORUM AND VOTING REQUIREMENTS FOR VOTING GROUPS

(a) Shares entitled to vote as a separate voting group may take action on a matter at a meeting only if a quorum of those shares exists with respect to that matter. Unless otherwise provided in this Act, or in the articles of organization, the bylaws or a resolution of the board of directors, as permitted by subsection (a) of section 7.27, a majority of the votes entitled to be cast on the matter by the voting group constitutes a quorum of that voting group for action on that matter.

(b) A share once represented for any purpose at a meeting is deemed present for quorum purposes for the remainder of the meeting and for any adjournment of that meeting unless:
(1) the shareholder attends solely to object to lack of notice, defective notice, or the conduct of the meeting on other grounds, and does not vote the shares or otherwise consent that they are to be deemed present; or

(2) in the case of an adjournment, a new record date is or shall be set for that adjourned meeting.

(c) If a quorum of a voting group exists, favorable action on a matter, other than the election

of directors, is taken by a voting group if the votes cast within the group favoring the action exceed the votes cast opposing the action, unless either this chapter, or the articles of organization, the bylaws or a resolution of the board of directors, as permitted by subsection (a) of section 7.27, requires a greater number of affirmative votes.

(d) An amendment of the articles of organization or the bylaws affecting the quorum or voting requirement for a voting group is governed by section 7. 27 or section 10.21 respectively.

(e) The election of directors is governed by section 7.28.

§ 7.26. ACTION BY SINGLE AND MULTIPLE VOTING GROUPS

(a) When a matter is to be voted upon by a single voting group, action on that matter is taken when voted upon by that voting group as provided in section 7.25.

(b) When a matter is to be voted upon by two or more voting groups, favorable action on that matter is taken only by the required vote of each of those voting groups counted separately, as provided in section 7.25. Action may be taken by one voting group on a matter even though no action is taken by another voting group entitled to vote on the matter.

§ 7.27. GREATER OR LESSER QUORUM OR VOTING REQUIREMENTS FOR SHAREHOLDERS

(a) The articles of organization, or a bylaw adopted in conformity to section 10.21, may provide for a greater or lesser quorum requirement for action by any voting group, or for a greater affirmative vote requirement, including additional separate voting groups, than is provided for by this chapter. Whenever authorized by this chapter, the board of directors may require for the approval of a matter submitted to a vote of the shareholders satisfaction of a greater quorum requirement for any voting group, or receipt of a greater affirmative vote of the shareholders, including more separate voting groups, than is required by this chapter or the articles or bylaws.

(b) If any provision of this chapter requires the affirmative vote of more than a majority of the shares in any voting group, the articles of organization may provide that favorable action may be taken by vote of a lesser proportion of shares than the chapter specifies, but not less than a majority of all the shares in the voting group eligible to vote on the matter.
(c) Action to approve an amendment to the articles of organization or bylaws that changes or deletes a quorum or voting requirement for action by shareholders must satisfy both the quorum and voting requirements then applicable for amendment of the articles or bylaws, as the case may be, and also the quorum and voting requirements sought to be changed or deleted.

§ 7.28. VOTING FOR DIRECTORS; CUMULATIVE VOTING

(a) Unless otherwise provided in the articles of organization or bylaws, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at

which a quorum is present.

(b) Shareholders do not have a right to cumulate their votes for directors unless the articles of organization so provide.

(c) A statement included in the articles of organization that "a designated voting group of shareholders are entitled to cumulate their votes for directors", or words of similar import, means that the shareholders designated are entitled to multiply the number of votes they are entitled to cast by the number of directors for whom they are entitled to vote and cast the product for a single candidate or distribute the product among two or more candidates.

§ 7.29. FORM OF SHAREHOLDER ACTION

(a) Any vote, consent, waiver, proxy appointment or other action by a shareholder or by the proxy or other agent of any shareholder pursuant to any section of this chapter shall be considered given in writing, dated and signed as required by this chapter if, in lieu of any other means permitted by this chapter, it consists of an electronic transmission that sets forth or is delivered with information from which the corporation can determine (i) that the electronic transmission was transmitted by the shareholder, proxy or agent or by a person authorized to act for the shareholder, proxy or agent; and (ii) the date on which such shareholder, proxy, agent or authorized person transmitted the electronic transmission. The date on which the electronic transmission is transmitted shall be considered to be the date on which it was signed. The electronic transmission shall be considered received by the corporation if it has been sent to any address specified by the corporation for the purpose or, if no address has been specified, to the principal office of the corporation, addressed to the secretary or other officer or agent having custody of the records of proceedings of shareholders.

(b) Any copy, facsimile or other reliable reproduction of a vote, consent, waiver, proxy appointment or other action by a shareholder or by the proxy or other agent of any shareholder may be substituted or used in lieu of the original writing for any purpose for which the original writing could be used, but the copy, facsimile or other reproduction shall be a complete reproduction of the entire original writing.

§ 7.30. VOTING TRUSTS

(a) One or more shareholders may create a voting trust, conferring on a trustee the right to vote or otherwise act for them, by signing an agreement setting out the provisions of the trust, which may include anything consistent with its purpose, and transferring their shares to the trustee. The trustee shall also sign the voting trust agreement and the shares transferred shall be registered in the name of the trustee. Promptly thereafter, the trustee shall prepare a list of the names and addresses of all owners of beneficial interests in the trust, together with the number and class of shares each transferred to the trust, and deliver copies of the list and agreement to the corporation's principal office.

(b) A voting trust becomes effective on the date the first shares subject to the trust are registered in the trustee's name. A voting trust is valid for the period as is specified in the

trust agreement.

(c) All or some of the parties to a voting trust may extend it for additional terms by signing an extension agreement and obtaining the voting trustee's written consent to the extension. An extension is valid for such period as is specified in the extension agreement. The voting trustee shall deliver copies of the extension agreement and list of beneficial owners to the corporation's principal office. An extension agreement binds only those parties signing it.

§ 7.31. VOTING AGREEMENTS

(a) An agreement between 2 or more shareholders or between 1 or more shareholders and 1 or more other persons, if in writing and signed by the parties to the agreement, whether or not the parties include all of the shareholders of the corporation, may provide for the manner in which the parties who are shareholders will vote their shares. A voting agreement created under this section is not subject to section 7.30.

(b) A voting agreement is valid for such period as is specified in the agreement or in any extension agreement entered into by all or some of the parties to it. An extension agreement binds only those parties signing it.

(c) A voting agreement created under this section is specifically enforceable.

§ 7.32. SHAREHOLDER AGREEMENTS

(a) An agreement among the shareholders of a corporation that complies with this section is effective among the shareholders and the corporation even though it is inconsistent with 1 or more other sections of this chapter in that it:

(1) eliminates the board of directors or restricts the discretion or powers of the board of directors;

(2) governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in section 6.40;

(3) establishes who shall be directors or officers of the corporation, or their terms of office or manner of selection or removal;

(4) governs, in general or in regard to specific matters, the exercise or division of voting power by or between the shareholders and directors or by or among any of them, including use of weighted voting rights or director proxies;

(5) establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation or among any of them;

(6) transfers to 1 or more shareholders or other persons all or part of the authority to exercise corporate powers or to manage the business and affairs of the corporation, including the resolution of any issue about which there exists a deadlock among directors or shareholders;

(7) requires dissolution of the corporation at the request of 1 or more of the shareholders or upon the occurrence of a specified event or contingency; or

(8) otherwise governs exercise of the corporate powers or management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, and is not contrary to public policy.

(b) An agreement authorized by this section shall be:

(1) set forth (i) in the articles of organization or bylaws and approved by all persons who are shareholders at the time of the agreement or (ii) in a written agreement that is signed by all persons who are shareholders at the time of the agreement and is made known to the corporation;

(2) subject to amendment only by all persons who are shareholders at the time of the amendment, unless the agreement provides otherwise; and

(3) valid for 10 years, unless the agreement provides otherwise.

(c) The existence of an agreement authorized by this section shall be noted conspicuously on the front or back of each certificate for outstanding shares or on the information statement required by subsection (b) of section 6.26. If at the time of the agreement the corporation has shares outstanding represented by certificates, the corporation shall recall the outstanding certificates and issue substitute certificates that comply with this subsection. The failure to note the existence of the agreement on the certificate or information statement does not affect the validity of the agreement or any action taken pursuant to it. Any purchaser of shares who, at the time of purchase, did not have knowledge of the existence of the agreement is entitled to rescission of the purchase. A purchaser is considered to have knowledge of the existence of the agreement if its existence is noted on the certificate or information statement for the shares in compliance with this subsection and, if the shares are not represented by a certificate, the information statement is delivered to the purchaser at or prior to the time of purchase of the shares. An action to enforce the right of rescission authorized by this subsection shall be commenced within the earlier of 90 days after discovery of the existence of the agreement or 2 years after the time of purchase of the shares.

(d) An agreement authorized by this section automatically terminates when shares of the corporation are listed on a national securities exchange or are regularly traded in a market maintained by 1 or more members of a national or affiliated securities association. If the agreement so terminates or otherwise ceases to be effective, the board of directors may, if the agreement is contained or referred to in the corporation's articles of organization or bylaws, adopt an amendment to the articles of organization or bylaws, without shareholder action, to delete the agreement and any references to it.

(e) To the extent that an agreement authorized by this section limits the discretion or powers

of the board of directors, liability for acts or omissions otherwise imposed by law on directors shall be imposed instead upon the person or persons in whom the discretion or powers are vested.

(f) If an agreement is authorized by this section, shareholders shall not be personally liable for the acts or debts of the corporation on the ground that the agreement or its performance treats the corporation as if it were a partnership or results in a failure to observe corporate formalities that would otherwise apply.

(g) Incorporators or subscribers for shares may act as shareholders with respect to an agreement authorized by this section if no shares have been issued when the agreement is made.

(h) Nothing contained in this section shall be construed to limit the effectiveness of any agreement or arrangement permitted by or not inconsistent with any other provision of this chapter.

§ 7.40. SUBCHAPTER DEFINITIONS
In this SUBDIVISION the following words shall have the following meanings unless the context requires otherwise:

"Derivative proceeding", a civil suit in the right of a domestic corporation or, to the extent provided in section 7.47, in the right of a foreign corporation.

"Shareholder" includes a beneficial owner whose shares are held in a voting trust or held by a nominee on the beneficial owner's behalf.

§ 7.41. STANDING
A shareholder may not commence or maintain a derivative proceeding unless the shareholder:

(1) was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time; and
(2) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

§ 7.42. DEMAND
No shareholder may commence a derivative proceeding until:

(1) a written demand has been made upon the corporation to take suitable action; and

(2) 90 days have elapsed from the date the demand was made, or, if the decision whether to reject such demand has been duly submitted to a vote of the shareholders, not including the holders of those shares referred to in section 7.44(b)(3), within 60 days from the date when

demand was made, 120 days have elapsed from the date the demand was made, unless in either case the shareholder has earlier been notified that the demand has been rejected by the corporation or irreparable injury to the corporation would result by waiting for the expiration of such 90-day or 120-day period.

§ 7.43. STAY OF PROCEEDINGS

If the corporation commences an inquiry into the allegations made in the demand or complaint, the court may stay any derivative proceeding for a period as the court considers appropriate.

§ 7.44. DISMISSAL

(a) A derivative proceeding commenced after rejection of a demand shall be dismissed by the court on motion by the corporation if the court finds that either: (1) 1 of the groups specified in subsections (b)(1) or (f) has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation; or (2) shareholders specified in subsection (b)(3) have determined that the maintenance of the derivative proceeding is not in the best interests of the corporation.

(b) Unless a panel is appointed pursuant to subsection (f), the determination in subsection (a) shall be made by:

(1) a majority vote of independent directors present at a meeting of the board of directors if the independent directors constitute a quorum;

(2) a majority vote of a committee consisting of 2 or more independent directors appointed by majority vote of independent directors present at a meeting of the board of directors, whether or not the independent directors constituted a quorum; or

(3) the vote of the holders of a majority of the outstanding shares entitled to vote, not including shares owned by or voted under the control of a shareholder or related person who has or had a beneficial financial interest in the act or omission complained of or other interest therein that would reasonably be expected to exert an influence on that shareholder's or related person's judgment if called upon to vote in the determination.

(c) None of the following shall by itself cause a director to be considered not independent for the purposes of this section:

(1) the nomination or election of the director by a person who is a defendant in the derivative proceeding or against whom action is demanded;

(2) the naming of the director as a defendant in the derivative proceeding or as a person against whom action is demanded; or

(3) the approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.

(d) If the corporation moves to dismiss the derivative suit, it shall make a written filing with the court setting forth facts to show (1) whether a majority of the board of directors was independent at the time of the determination by the independent directors and (2) that the independent directors made the determination in good faith after conducting a reasonable inquiry upon which their conclusions are based. Unless otherwise required by subsection (a), the court shall dismiss the suit unless the plaintiff has alleged with particularity facts rebutting the corporation's filing in its complaint or an amended complaint or in a written filing with the court. All discovery proceedings shall be stayed upon the filing by the corporation of the motion to dismiss and the filing required by this subsection until the notice of entry of the order ruling on the motion; but the court, on motion and after a hearing and for good cause shown, may order that specified discovery be conducted.

(e) If a majority of the board of directors does not consist of independent directors at the time the determination by independent directors is made, the corporation shall have the burden of proving that the requirements of subsection (a) have been met. If a majority of the board of directors consists of independent directors at the time the determination is made or if the determination is made by shareholders pursuant to clause (3) of subsection (b) or is made pursuant to subsection (f), the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

(f) The court may appoint a panel of 1 or more independent persons upon motion by the corporation to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

§ 7.45. DISCONTINUANCE OR SETTLEMENT
A derivative proceeding may not be discontinued or settled without the court's approval. If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation's shareholders or a class of shareholders, the court shall direct that notice to be given to the shareholders affected.

§ 7.46. PAYMENT OF EXPENSES
On termination of the derivative proceeding the court may:
(1) order the corporation to pay the plaintiff's reasonable expenses, including counsel fees, incurred in the proceeding if it finds that the proceeding has resulted in a substantial benefit to the corporation; or

(2) order the plaintiff to pay any defendant's reasonable expenses, including counsel fees, incurred in defending the proceeding if it finds that the proceeding was commenced or maintained without reasonable cause or for an improper purpose.

§ 7.47. APPLICABILITY TO FOREIGN CORPORATIONS
In any derivative proceeding in the right of a foreign corporation, the matters covered by this subchapter shall be governed by the laws of the jurisdiction of incorporation of the foreign

corporation except for section 7.43, 7.45 and 7.46.

§ 8.01. REQUIREMENT FOR AND DUTIES OF BOARD OF DIRECTORS

(a) Except as provided in section 7.32, each corporation shall have a board of directors.

(b) All corporate power shall be exercised by or under the authority of, and the business and affairs of the corporation shall be managed under the direction of, its board of directors, subject to any limitation set forth in the articles of organization or in an agreement authorized under section 7.32.

§ 8.02. QUALIFICATIONS OF DIRECTORS

The articles of organization or bylaws may prescribe qualifications for directors. A director need not be a resident of the commonwealth or a shareholder of the corporation unless the articles of organization or bylaws so prescribe.

§ 8.03. NUMBER AND ELECTION OF DIRECTORS

(a) A board of directors shall consist of 1 or more individuals, with the number specified in or fixed in accordance with the articles of organization or bylaws, but, unless otherwise provided in the articles of organization, if the corporation has more than 1 shareholder, the number of directors shall not be less than 3, except that whenever there shall be only 2 shareholders, the number of directors shall not be less than 2.

(b) If a board of directors has power to fix or change the number of directors, the board may increase or decrease the number of directors last approved by the shareholders.

(c) The articles of organization or bylaws may establish a variable range for the size of the board of directors by fixing a minimum and maximum number of directors. If a variable range is established, the number of directors may be fixed or changed from time to time, within the minimum and maximum, by the shareholders or the board of directors. After shares are issued, only the shareholders may change the range for the size of the board or change from a fixed or a variable-range size board to the other.

(d) Directors shall be elected at the first annual shareholders' meeting and at each annual meeting thereafter unless their terms are staggered under section 8.06.

§ 8.04. ELECTION OF DIRECTORS BY CERTAIN CLASSES OF SHAREHOLDERS

If the articles of organization authorize dividing the shares into classes or series, the articles may also authorize the election of all or a specified number of directors by the holders of 1 or more authorized classes or series of shares. A class or series of shares entitled to elect 1 or more directors is a separate voting group for purposes of the election of directors.

§ 8.05. TERMS OF DIRECTORS GENERALLY

(a) The terms of the initial directors of a corporation shall expire at the first shareholders' meeting at which directors are elected.

(b) The terms of all directors shall expire at the next annual shareholders' meeting following their election unless their terms are staggered under section 8.06.

(c) A decrease in the number of directors does not shorten an incumbent director's term.

(d) Unless otherwise provided in the articles of organization or a bylaw adopted by shareholders or required by section 8.06(e), the term of a director elected to fill a vacancy shall expire at the next shareholders' meeting at which directors are elected.

(e) Despite the expiration of a director's term, he shall continue to serve until his successor is elected and qualified or until there is a decrease in the number of directors.

§ 8.06. STAGGERED TERMS FOR DIRECTORS

(a) The articles of organization may provide for staggering the terms of directors by dividing the total number of directors into 2 or 3 groups, with each group containing 1/2 or 1/3 of the total, as near as may be. In that event, the terms of directors in the first group expire at the first annual shareholders' meeting after their election, the terms of the second group expire at the second annual shareholders' meeting after their election, and the terms of the third group, if any, expire at the third annual shareholders' meeting after their election. At each annual shareholders' meeting held thereafter, directors shall be chosen for a term of 2 years or 3 years, as the case may be, to succeed those whose terms expire.

(b) Except as provided in subsection (c) and notwithstanding anything to the contrary in this chapter or in the articles of organization or bylaws of any public corporation, the terms of the directors of a public corporation shall be staggered by dividing the number of directors into 3 groups, as nearly equal in number as possible; the term of office of those of the first group, "Class I Directors", to continue until the first annual meeting following the date such public corporation becomes subject to this subsection and until their successors are elected and qualified; the term of office of those of the second group, "Class II Directors", to continue until the second annual meeting following the date the public corporation becomes subject to this subsection and until their successors are elected and qualified; and the term of office of those of the third group, "Class III Directors", to continue until the third annual meeting following the date such public corporation becomes subject to this subsection and until their successors are elected and qualified. At each annual meeting of a public corporation subject to this subsection, the successors to the class of directors whose term expires at that meeting shall be elected to hold office for a term continuing until the annual meeting held in the third year following the year of their election and until their successors are elected and qualified. On or before the date on which a public corporation first convenes an annual meeting following the time at which the public corporation becomes subject to this subsection, the board of directors of the public corporation shall adopt a vote designating, from among its members, directors to serve as Class I Directors, Class II Directors and Class III Directors. Notwithstanding this subsection, the articles of organization may confer upon holders of any class or series of preference or preferred stock the right to elect 1 or more directors who shall serve for such term, and have such voting powers, as shall be stated in the articles of

organization; provided, however, that no such provision of the articles of organization which confers upon such holders any such right and which is filed with the state secretary after the effective date of this chapter shall become effective unless before its adoption it was approved by a vote of a majority in number of the directors of the public corporation.

(c)(1) Subsection (b) shall apply to every public corporation, whether or not notice of an annual meeting of the public corporation has been given on or prior to the effective date of this chapter, unless the board of directors of the public corporation, or the shareholders of the corporation by a vote of two-thirds of each class of stock outstanding at a meeting duly called for the purpose of the vote, shall adopt a vote providing that the corporation elects to be exempt from the provisions of subsection (b). Upon adoption of the vote, subsection (b) shall, unless otherwise provided in the vote, shall become immediately ineffective with respect to such public corporation and the provisions of section 8.05 shall become immediately effective with respect to the corporation as soon as subsection (b) of this section is no longer effective.

(2) In the event that any public corporation shall so elect by vote of the board of directors to be exempt pursuant to clause (1) the public corporation may at any time thereafter adopt a vote of its board of directors electing to be subject to subsection (b). In the event that any public corporation shall so elect by vote of two-thirds of the shareholders to be exempt pursuant to clause (1) of this subsection the public corporation may at any time thereafter by vote of two-thirds of the shareholders elect to be subject to the provisions of subsection (b). Upon adoption of the vote, subsection (b), unless otherwise provided in the vote, shall immediately become effective.

(3) If a corporation is subject to subsection (b) at the time it ceases to be a public corporation, the corporation shall nonetheless be considered to be a public corporation for purposes of this section for a period of 12 months following the date it ceased to be a public corporation.

(d) Notwithstanding anything to the contrary in this chapter or in the articles of organization or bylaws of any public corporation, in the case of directors of a public corporation whose terms are staggered pursuant to subsection (b), shareholders may effect, by the affirmative vote of a majority of the shares outstanding and entitled to vote in the election of directors, the removal of any director or directors or the entire board of directors only for cause.

(e) Notwithstanding anything to the contrary in this chapter or in the articles of organization or bylaws of any public corporation, in the case of directors of a public corporation whose terms are staggered pursuant to subsection (b):

(1) vacancies and newly created directorships, whether resulting from an increase in the size of the board of directors, from the death, resignation, disqualification or removal of a director or otherwise, shall be filled solely by the affirmative vote of a majority of the remaining directors then in office, even though less than a quorum of the board of directors;

(2) any director elected in accordance with clause (1) shall hold office for the remainder of

the full term of the class of directors in which the vacancy occurred or the new directorship was created and until the director's successor shall have been elected and qualified;

(3) no decrease in the number of directors constituting the board of directors shall shorten the term of any incumbent director; and

(4) the number of directors of a public corporation subject to subsection (b) shall be fixed only by vote of its board of directors.

(f) As used in subsections (b) to (g), inclusive, the following words shall have the following meanings:

(1) "Annual meeting", any annual meeting of shareholders and any special meeting of shareholders in lieu of an annual meeting provided for by law, the articles of organization, bylaws or otherwise.

(2) "Cause", with respect to the removal of any director of a public corporation, only (i) conviction of a felony, (ii) declaration of unsound mind by order of court, (iii) gross dereliction of duty, (iv) commission of an action involving moral turpitude, or (v) commission of an action which constitutes intentional misconduct or a knowing violation of law if such action in either event results both in an improper substantial personal benefit and a material injury to the public corporation.

(g) Nothing elsewhere in this section shall be considered to amend, modify or otherwise effect the validity of any of the articles of organization or bylaws of any corporation during any period that it elects not to be subject to subsection (b), whether or not currently in effect, providing for staggering the terms of directors as contemplated by subsection (a). No provision of the articles of organization or bylaws of any public corporation that is subject to subsection (b), whether or not currently in effect, shall render inapplicable any provision of subsections (b) to (g), inclusive, or require the board of directors of the corporation to adopt any vote pursuant to subsection (c). No vote adopted by a board of directors electing not to be subject to subsection (b) shall render invalid, or prevent adoption of, any amendment to the corporation's articles of organization as contemplated by section 8.05.

§ 8.07. RESIGNATION OF DIRECTORS

(a) A director may resign at any time by delivering written notice of resignation to the board of directors, its chairman, or to the corporation.

(b) A resignation is effective when the notice is delivered unless the notice specifies a later effective date.

§ 8.08. REMOVAL OF DIRECTORS

(a) Subject to subsection (b) of section 8.06 and except as otherwise provided in the articles of organization or bylaws, the shareholders may remove 1 or more directors with or without cause.

(b) If a director is elected by a voting group of shareholders, only the shareholders of that voting group may participate in the vote to remove him.

(c) If cumulative voting is authorized, a director may not be removed by the shareholders if the number of votes sufficient to elect him under cumulative voting is voted against his removal. If cumulative voting is not authorized, a director may be removed by the shareholders only if the number of votes cast to remove him exceeds the number of votes cast not to remove him.

(d) A director may be removed for cause by the directors by vote of the greater of (1) a majority of the directors then in office or (2) the number of directors required by the articles of organization or bylaws to take action under section 8.24, but, if a director is elected by a voting group of shareholders, only the directors elected by that voting group may participate in the vote to remove him.

(e) A director may be removed by the shareholders or the directors only at a meeting called for the purpose of removing him and the meeting notice must state that the purpose, or one of the purposes, of the meeting is removal of the director.

§ 8.10. VACANCY ON BOARD

(a) Unless the articles of organization or section 8.06 provide otherwise, if a vacancy occurs on a board of directors, including a vacancy resulting from an increase in the number of directors:

(1) the shareholders may fill the vacancy;

(2) the board of directors may fill the vacancy; or

(3) if the directors remaining in office constitute fewer than a quorum of the board, they may fill the vacancy by the affirmative vote of a majority of all the directors remaining in office.

(b) If the vacant office was held by a director elected by a voting group of shareholders, only the holders of shares of that voting group or, unless the articles of organization or by-laws provide otherwise, the directors elected by that voting group are entitled to vote to fill the vacancy.

(c) A vacancy that will occur at a specific later date, by reason of a resignation effective at a later date under subsection (b) of section 8.07 or otherwise, may be filled before the vacancy occurs but the new director may not take office until the vacancy occurs.

§ 8.11. COMPENSATION OF DIRECTORS

Unless the articles of organization or bylaws provide otherwise, the board of directors may fix the compensation of directors.

§ 8.20. MEETINGS

(a) The board of directors may hold regular or special meetings within or without the commonwealth.

(b) Unless the articles of organization or bylaws provide otherwise, the board of directors may permit any or all directors to participate in a regular or special meeting by, or conduct the meeting through the use of, any means of communication by which all directors participating may simultaneously hear each other during the meeting. A director participating in a meeting by this means is considered to be present in person at the meeting.

§ 8.21. ACTION WITHOUT MEETING

(a) Unless the articles of organization or bylaws provide that action required or permitted by this chapter to be taken by the directors may be taken only at a meeting, the action may be taken without a meeting if the action is taken by the unanimous consent of the members of the board of directors. The action must be evidenced by 1 or more consents describing the action taken, in writing, signed by each director, or delivered to the corporation by electronic transmission, to the address specified by the corporation for the purpose or, if no address has been specified, to the principal office of the corporation, addressed to the secretary or other officer or agent having custody of the records of proceedings of directors, and included in the minutes or filed with the corporate records reflecting the action taken.

(b) Action taken under this section is effective when the last director signs or delivers the consent, unless the consent specifies a different effective date.

(c) A consent signed or delivered under this section has the effect of a meeting vote and may be described as such in any document.

§ 8.22. NOTICE OF MEETING

(a) Unless the articles of organization or bylaws provide otherwise, regular meetings of the board of directors may be held without notice of the date, time, place or purpose of the meeting.

(b) Unless the articles of organization or bylaws otherwise provide, special meetings of the board of directors must be preceded by at least 2 days' notice of the date, time and place of the meeting. The notice need not describe the purpose of the special meeting unless required by the articles of organization or bylaws.

§ 8.23. WAIVER OF NOTICE

(a) A director may waive any notice required by this chapter, the articles of organization or the bylaws before or after the date and time of the meeting. Except as provided by subsection (b), the waiver shall be in writing, signed by the director entitled to the notice, or in the form of an electronic transmission by the director to the corporation, and filed with the minutes or corporate records.

(b) A director's attendance at or participation in a meeting waives any required notice to him of the meeting unless the director at the beginning of the meeting, or promptly upon his

arrival, objects to holding the meeting or transacting business at the meeting and does not thereafter vote for or assent to action taken at the meeting.

§ 8.24. QUORUM AND VOTING

(a) Subject to subsection (b), unless the articles of organization or bylaws otherwise provide or unless otherwise specifically provided in this chapter, a quorum of a board of directors consists of:

(1) a majority of the fixed number of directors if the corporation has a fixed board size; or

(2) a majority of the number of directors prescribed, or if no number is prescribed the number in office immediately before the meeting begins, if the corporation has a variable-range size board.

(b) The articles of organization or bylaws may authorize a quorum of a board of directors to consist of no fewer than:

(1) one-third of the fixed or prescribed number of directors determined under subsection (a); or

(2) a majority of the directors then in office, without regard to the number of directors determined under subsection (a) of this section.

(c) If a quorum is present when a vote is taken, the affirmative vote of a majority of directors present is the act of the board of directors unless the articles of organization or bylaws require the vote of a greater number of directors.
(d) A director who is present at a meeting of the board of directors or a committee of the board of directors when corporate action is taken is considered to have assented to the action taken unless: (1) he objects at the beginning of the meeting, or promptly upon his arrival, to holding it or transacting business at the meeting; (2) his dissent or abstention from the action taken is entered in the minutes of the meeting; or (3) he delivers written notice of his dissent or abstention to the presiding officer of the meeting before its adjournment or to the corporation immediately after adjournment of the meeting. The right of dissent or abstention is not available to a director who votes in favor of the action taken.

§ 8.25. COMMITTEES

(a) Unless the articles of organization or bylaws provide otherwise, a board of directors may create 1 or more committees and appoint members of the board of directors to serve on them. Each committee may have 1 or more members, who serve at the pleasure of the board of directors.

(b) The creation of a committee and appointment of members to it must be approved by the greater of: (1) a majority of all the directors in office when the action is taken; or (2) the number of directors required by the articles of organization or bylaws to take action under section 8.24.

(c) Sections 8.20 through 8.24, which govern meetings, action without meetings, notice and waiver of notice, and quorum and voting requirements of the board of directors, shall apply to committees and their members.

(d) To the extent specified by the board of directors or in the articles of organization or bylaws, each committee may exercise the authority of the board of directors under section 8.01.

(e) A committee may not, however:

(1) authorize distributions;

(2) approve or propose to shareholders action that this chapter requires be approved by shareholders;

(3) change the number of the board of directors, remove directors from office or fill vacancies on the board of directors;

(4) amend articles of organization pursuant to section 10.02;

(5) adopt, amend or repeal bylaws; or

(6) authorize or approve reacquisition of shares, except according to a formula or method prescribed by the board of directors.
(f) The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in section 8.30.

§ 8.30. GENERAL STANDARDS FOR DIRECTORS

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) in good faith;

(2) with the care that a person in a like position would reasonably believe appropriate under similar circumstances; and

(3) in a manner the director reasonably believes to be in the best interests of the corporation. In determining what the director reasonably believes to be in the best interests of the corporation, a director may consider the interests of the corporation's employees, suppliers, creditors and customers, the economy of the state, the region and the nation, community and societal considerations, and the long-term and short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

(b) In discharging his duties, a director who does not have knowledge that makes reliance unwarranted is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent with respect to the information, opinions, reports or statements presented;

(2) legal counsel, public accountants, or other persons retained by the corporation, as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence; or

(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.

§ 8.31. DIRECTOR CONFLICT OF INTEREST

(a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a material direct or indirect interest. A conflict of interest transaction is not voidable by the corporation solely because of the director's interest in the transaction if any one of the following is true:

(1) the material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction;

(2) the material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction; or

(3) the transaction was fair to the corporation.

(b) For purposes of this section, and without limiting the interests that may create conflict of interest transactions, a director of the corporation has an indirect interest in a transaction if: (1) another entity in which he has a material financial interest or in which he is a general partner is a party to the transaction; or (2) another entity of which he is a director, officer, or trustee or in which he holds another position is a party to the transaction and the transaction is or should be considered by the board of directors of the corporation.

(c) For purposes of clause (1) of subsection (a), a conflict of interest transaction is authorized, approved, or ratified if it receives the affirmative vote of a majority of the directors on the board of directors (or on the committee) who have no direct or indirect

interest in the transaction, but a transaction may not be authorized, approved, or ratified under this section by a single director. If a majority of the directors who have no direct or indirect interest in the transaction vote to authorize, approve, or ratify the transaction, a quorum is present for the purpose of taking action under this section. The presence of, or a vote cast by, a director with a direct or indirect interest in the transaction does not affect the validity of any action taken under clause (1) of subsection (a) if the transaction is otherwise authorized, approved, or ratified as provided in that subsection.

(d) For purposes of clause (2) of subsection (a), a conflict of interest transaction is authorized, approved, or ratified if it receives the vote of a majority of the shares entitled to be counted under this subsection. Shares owned by or voted under the control of a director who has a direct or indirect interest in the transaction, and shares owned by or voted under the control of an entity described in clause (1) of subsection (b), may not be counted in a vote of shareholders to determine whether to authorize, approve, or ratify a conflict of interest transaction under clause (2) of subsection (a). The vote of those shares, however, is counted in determining whether the transaction is approved under other sections of this chapter. A majority of the shares, whether or not present, that are entitled to be counted in a vote on the transaction under this subsection constitutes a quorum for the purpose of taking action under this section.

§ 8.32. LOANS TO DIRECTORS

(a) Except as provided by subsection (c), a corporation may not lend money to, or guarantee the obligation of a director of, the corporation unless:
(1) the specific loan or guarantee is approved by a majority of the votes represented by the outstanding voting shares of all classes, voting as a single voting group, except the votes of shares owned by or voted under the control of the benefited director; or

(2) the corporation's board of directors determines that the loan or guarantee benefits the corporation and either approves the specific loan or guarantee or a general plan authorizing loans and guarantees.

(b) The fact that a loan or guarantee is made in violation of this section shall not affect the borrower's liability on the loan.

(c) This section shall not apply to loans and guarantees authorized by statute regulating any special class of corporations.

§ 8.40. REQUIRED OFFICERS

(a) A corporation shall have a president, a treasurer and a secretary and such other officers described in its bylaws or appointed by the board of directors in accordance with the bylaws.

(b) A duly appointed officer may appoint 1 or more officers or assistant officers if authorized by the bylaws or the board of directors.

(c) Unless the bylaws or the board of directors shall designate another officer, the secretary

or an assistant secretary shall have responsibility for preparing minutes of the directors' and shareholders' meetings and for authenticating records of the corporation.

(d) The same individual may simultaneously hold more than 1 office in a corporation.

§ 8.41. DUTIES OF OFFICERS

Each officer has the authority and shall perform the duties set forth in the bylaws or, to the extent consistent with the bylaws, the duties prescribed by the board of directors or by direction of an officer authorized by the board of directors to prescribe the duties of other officers.

§ 8.42. STANDARDS OF CONDUCT FOR OFFICERS

(a) An officer shall discharge his duties:

(1) in good faith;

(2) with the care that a person in a like position would reasonably exercise under similar circumstances; and

(3) in a manner the officer reasonably believes to be in the best interests of the corporation.

(b) In discharging his duties an officer, who does not have knowledge that makes reliance unwarranted, is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the officer reasonably believes to be reliable and competent with respect to the information, opinions, reports or statements presented; or

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the officer reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence.

(c) An officer shall not be liable to the corporation or its shareholders for any decision to take or not to take any action taken, or any failure to take any action, as an officer, if the duties of the officer are performed in compliance with this section.

§ 8.43. RESIGNATION AND REMOVAL OF OFFICERS

(a) An officer may resign at any time by delivering notice of the resignation to the corporation. A resignation is effective when the notice is delivered unless the notice specifies a later effective date. If a resignation is made effective at a later date and the corporation accepts the future effective date, its board of directors may fill the pending vacancy before the effective date if the board of directors provides that the successor shall not take office until the effective date.

(b) A board of directors may remove any officer at any time with or without cause.

§ 8.44. CONTRACT RIGHTS OF OFFICERS
(a) The appointment of an officer shall not itself create contract rights.

(b) An officer's removal shall not affect the officer's contract rights, if any, with the corporation. An officer's resignation shall not affect the corporation's contract rights, if any, with the officer.

§ 8.45. CERTIFICATE OF CHANGE IN OFFICERS OR DIRECTORS
Whenever any change is made in the directors or in the president, treasurer or secretary of a corporation, the corporation shall forthwith file in the office of the state secretary a certificate of the change signed under the penalties of perjury by the clerk or an assistant clerk. If a corporation fails or refuses to file such a certificate within the 30-day period following a change in the directors or in the officers, any director or officer involved in the change, or the personal representative of any deceased director or office so involved, may evidence the change by filing a certificate thereof with the office of the state secretary, signed under the penalties or perjury, including a statement that a copy of the certificate has been delivered to the corporation or has been mailed to the principal office of the corporation, postage prepaid.

§ 8.46. INSTRUMENTS AFFECTING REAL ESTATE
Any recordable instrument purporting to affect an interest in real estate, executed in the name of a corporation by the president or a vice president and the treasurer or an assistant treasurer, who may be one and the same person, shall be binding on the corporation in favor of a purchaser or other person relying in good faith on the instrument notwithstanding any inconsistent provisions of the articles of organization or bylaws of the corporation, any special act of incorporation governing the corporation or any vote or other action by the shareholders or directors of the corporation.

§ 8.50. SUBCHAPTER DEFINITIONS
In this SUBDIVISION the following words shall have the following meanings unless the context requires otherwise:

"Corporation", includes any domestic or foreign predecessor entity of a corporation in a merger.

"Director" or "officer", an individual who is or was a director or officer, respectively, of a corporation or who, while a director or officer of the corporation, is or was serving at the corporation's request as a director, officer, partner, trustee, employee, or agent of another domestic or foreign corporation, partnership, joint venture, trust, employee benefit plan, or other entity. A director or officer is considered to be serving an employee benefit plan at the corporation's request if his duties to the corporation also impose duties on, or otherwise involve services by, him to the plan or to participants in or beneficiaries of the plan. "Director" or "officer" includes, unless the context requires otherwise, the estate or personal representative of a director or officer.

"Disinterested director", a director who, at the time of a vote referred to in subsection (c) of section 8.53 or a vote or selection referred to in subsection (b) or (c) of section 8.55, is not (i) a party to the proceeding, or (ii) an individual having a familial, financial, professional, or employment relationship with the director whose indemnification or advance for expenses is the subject of the decision being made, which relationship would, in the circumstances, reasonably be expected to exert an influence on the director's judgment when voting on the decision being made.

"Expenses", includes counsel fees.

"Liability", the obligation to pay a judgment, settlement, penalty, fine including an excise tax assessed with respect to an employee benefit plan, or reasonable expenses incurred with respect to a proceeding.

"Party", an individual who was, is, or is threatened to be made, a defendant or respondent in a proceeding.

"Proceeding", any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, arbitrative, or investigative and whether formal or informal.

§ 8.51. PERMISSIBLE INDEMNIFICATION

(a) Except as otherwise provided in this section, a corporation may indemnify an individual who is a party to a proceeding because he is a director against liability incurred in the proceeding if:

(1)(i) he conducted himself in good faith; and

(ii) he reasonably believed that his conduct was in the best interests of the corporation or that his conduct was at least not opposed to the best interests of the corporation; and

(iii) in the case of any criminal proceeding, he had no reasonable cause to believe his conduct was unlawful; or

(2) he engaged in conduct for which he shall not be liable under a provision of the articles of organization authorized by clause (4) of subsection (b) of section 2.02.

(b) A director's conduct with respect to an employee benefit plan for a purpose he reasonably believed to be in the interests of the participants in, and the beneficiaries of, the plan is conduct that satisfies the requirement that his conduct was at least not opposed to the best interests of the corporation.

(c) The termination of a proceeding by judgment, order, settlement, or conviction, or upon a plea of nolo contendere or its equivalent, is not, of itself, determinative that the director did not meet the relevant standard of conduct described in this section.

(d) Unless ordered by a court under clause (3) of subsection (a) of section 8.54, a corporation may not indemnify a director under this section if his conduct did not satisfy the standards set forth in subsection (a) or subsection (b).

§ 8.52. MANDATORY INDEMNIFICATION

A corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he was a director of the corporation against reasonable expenses incurred by him in connection with the proceeding.

§ 8.53. ADVANCE FOR EXPENSES

(a) A corporation may, before final disposition of a proceeding, advance funds to pay for or reimburse the reasonable expenses incurred by a director who is a party to a proceeding because he is a director if he delivers to the corporation:

(1) a written affirmation of his good faith belief that he has met the relevant standard of conduct described in section 8.51 or that the proceeding involves conduct for which liability has been eliminated under a provision of the articles of organization as authorized by clause (4) of subsection (b) of section 2.02; and

(2) his written undertaking to repay any funds advanced if he is not entitled to mandatory indemnification under section 8.52 and it is ultimately determined under section 8.54 or section 8.55 that he has not met the relevant standard of conduct described in section 8.51.

(b) The undertaking required by clause (2) of subsection (a) must be an unlimited general obligation of the director but need not be secured and may be accepted without reference to the financial ability of the director to make repayment.

(c) Authorizations under this section shall be made:

(1) by the board of directors;

(i) if there are 2 or more disinterested directors, by a majority vote of all the disinterested directors, a majority of whom shall for such purpose constitute a quorum, or by a majority of the members of a committee of two or more disinterested directors appointed by the vote; or

(ii) if there are fewer than 2 disinterested directors, by the vote necessary for action by the board in accordance with subsection (c) of section 8.24, in which authorization directors who do not qualify as disinterested directors may participate; or

(2) by the shareholders, but shares owned by or voted under the control of a director who at the time does not qualify as a disinterested director may not be voted on the authorization; or

(3) as otherwise permitted by law.

§ 8.54. COURT-ORDERED INDEMNIFICATION AND ADVANCE FOR EXPENSES
(a) A director who is a party to a proceeding because he is a director may apply for indemnification or an advance for expenses to the court conducting the proceeding or to another court of competent jurisdiction. After receipt of an application and after giving any notice it considers necessary, the court shall:

(1) order indemnification if the court determines that the director is entitled to mandatory indemnification under section 8.52;

(2) order indemnification or advance for expenses if the court determines that the director is entitled to indemnification or advance for expenses pursuant to a provision authorized by subsection (a) of section 8.58; or

(3) order indemnification or advance for expenses if the court determines, in view of all the relevant circumstances, that it is fair and reasonable

(i) to indemnify the director pursuant to section 8.51, or

(ii) to advance expenses to the director, even if he has not met the relevant standard of conduct set forth in subsection (a) or (b) of sections 8.51 or 8.51 or failed to comply with section 8.53.

(b) If the court determines that the director is entitled to indemnification under clause (1) of subsection (a) or to indemnification or advance for expenses under clause (2) of subsection (a), it shall also order the corporation to pay the director's reasonable expenses incurred in connection with obtaining court-ordered indemnification or advance for expenses. If the court determines that the director is entitled to indemnification or advance for expenses under clause (3) of subsection (a), it may also order the corporation to pay the director's reasonable expenses to obtain court-ordered indemnification or advance for expenses.

§ 8.55. DETERMINATION AND AUTHORIZATION OF INDEMNIFICATION
(a) A corporation may not indemnify a director under section 8.51 unless authorized for a specific proceeding after a determination has been made that indemnification of the director is permissible because he has met the relevant standard of conduct set forth in said section 8.51.

(b) The determination shall be made:

(1) if there are 2 or more disinterested directors, by the board of directors by a majority vote of all the disinterested directors, a majority of whom shall for such purpose constitute a quorum, or by a majority of the members of a committee of 2 or more disinterested directors appointed by vote;

(2) by special legal counsel

(i) selected in the manner prescribed in clause (1); or

(ii) if there are fewer than two disinterested directors, selected by the board of directors, in which selection directors who do not qualify as disinterested directors may participate; or

(3) by the shareholders, but shares owned by or voted under the control of a director who at the time does not qualify as a disinterested director may not be voted on the determination.

(c) Authorization of indemnification shall be made in the same manner as the determination that indemnification is permissible, except that if there are fewer than two disinterested directors, authorization of indemnification shall be made by those entitled under subclause (ii) of clause (2) of subsection (b) to select special legal counsel.

§ 8.56. OFFICERS

(a) A corporation may indemnify and advance expenses under this subchapter to an officer of the corporation who is a party to a proceeding because he is an officer of the corporation.

(1) to the same extent as a director; and

(2) if he is an officer but not a director, to such further extent as may be provided by the articles of organization, the bylaws, a resolution of the board of directors, or contract except for liability arising out of acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.

(b) Clause (2) of subsection (a) shall apply to an officer who is also a director if the basis on which he is made a party to the proceeding is an act or omission solely as an officer.

(c) An officer of a corporation who is not a director is entitled to mandatory indemnification under section 8.52, and may apply to a court under section 8.54 for indemnification or an advance for expenses, in each case to the same extent to which a director may be entitled to indemnification or advance under those provisions.

§ 8.57. INSURANCE

A corporation may purchase and maintain insurance on behalf of an individual who is a director or officer of the corporation, or who, while a director or officer of the corporation, serves at the corporation's request as a director, officer, partner, trustee, employee, or agent of another domestic or foreign corporation, partnership, joint venture, trust, employee benefit plan, or other entity, against liability asserted against or incurred by him in that capacity or arising from his status as a director or officer, whether or not the corporation would have power to indemnify or advance expenses to him against the same liability under this subdivision.

§ 8.58. VARIATION BY CORPORATE ACTION; APPLICATION OF SUBCHAPTER

(a) A corporation may, by its articles of organization or bylaws or in a resolution adopted or a contract approved by its board of directors or shareholders, obligate itself in advance of the act or omission giving rise to a proceeding to provide indemnification in accordance with section 8.51 or section 8.56 or advance funds to pay for or reimburse expenses in accordance with section 8.53. Any such obligatory provision shall be deemed to satisfy the requirements for authorization referred to in subsection (c) of section 8.53 and in subsection (c) of section 8.55. Any such provision that obligates the corporation to provide indemnification to the fullest extent permitted by law shall be considered to obligate the corporation to advance funds to pay for or reimburse expenses in accordance with section 8.53 to the fullest extent permitted by law, unless the provision specifically provides otherwise.
(b) Any provision pursuant to subsection (a) shall not obligate the corporation to indemnify or advance expenses to a director of a predecessor of the corporation, pertaining to conduct with respect to the predecessor, unless otherwise specifically provided. Any provision for indemnification or advance for expenses in the articles of incorporation, bylaws, or a resolution of the board of directors or shareholders of a predecessor of the corporation in a merger or in a contract to which the predecessor is a party, existing at the time the merger takes effect, shall be governed by clause (3) of subsection (a) of section 11.06.

(c) A corporation in its articles of organization may, limit any of the rights to indemnification or advance for expenses created by or pursuant to this subchapter.

(d) This subdivision shall not limit a corporation's power to pay or reimburse expenses incurred by a director or an officer in connection with his appearance as a witness in a proceeding at a time when he is not a party.

(e) This subdivision shall not limit a corporation's power to indemnify, advance expenses to or provide or maintain insurance on behalf of an employee or agent.

§ 8.59. EXCLUSIVITY OF SUBCHAPTER
The indemnification and advancement of expenses provided by, or granted pursuant to, this subdivision shall not be considered exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled.

§ 9.20. DOMESTICATION
(a) A foreign business corporation may become a domestic business corporation only if the domestication is permitted by the organic law of the foreign corporation. The laws of the commonwealth shall govern the effect of domesticating in the commonwealth pursuant to this subdivision.

(b) A domestic business corporation may become a foreign business corporation only if the domestication is permitted by the laws of the foreign jurisdiction. Regardless of whether the laws of the foreign jurisdiction require the adoption of a plan of domestication, the domestication shall be approved by the adoption by the corporation of a plan of domestication in the manner provided in this subdivision. The laws of the foreign jurisdiction shall govern the effect of domesticating in that jurisdiction.

(c) The plan of domestication adopted by a domestic business corporation shall include:

(1) a statement of the jurisdiction in which the corporation is to be domesticated;

(2) the terms and conditions of the domestication;

(3) the manner and basis of reclassifying the shares of the corporation into other shares or other securities, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing; and
(4) any amendments to the articles of organization of the corporation following its domestication that may be desired.

The plan of domestication may include any other provisions relating to the domestication that may be desired.

(d) The plan of domestication may also include a provision that the plan may be amended before filing the document required by the laws of the commonwealth or the other jurisdiction to consummate the domestication, except that subsequent to the approval of the plan by the shareholders the plan may not be amended to change:

(1) the amount or kind of shares or other securities, obligations, rights to acquire shares or other securities, cash, or other property to be received by the shareholders under the plan;

(2) the articles of organization as they will be in effect immediately following the domestication, except for changes permitted by section 10.05 or by comparable laws of the other jurisdiction; or

(3) any of the other terms or conditions of the plan if the change would adversely affect any of the shareholders in any material respect.

§ 9.21. ACTION ON A PLAN OF DOMESTICATION
In the case of a domestication of a domestic business corporation in a foreign jurisdiction:

(1) The plan of domestication shall be adopted by the board of directors.

(2) After adopting the plan of domestication the board of directors shall submit the plan to the shareholders for their approval.

(3) The board of directors may condition its submission of the plan of domestication to the shareholders on any basis.

(4) If the approval of the shareholders is to be given at a meeting, the corporation shall notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan of domestication is to be submitted for approval. The notice shall state that the purpose,

or one of the purposes, of the meeting is to consider the plan and shall contain or be accompanied by a copy or summary of the plan. The notice shall include or be accompanied by a copy or a summary of the articles of organization as they will be in effect immediately after the domestication.

(5) Unless (1) a greater percentage vote, or one or more additional separate voting groups, is required by the articles of organization, pursuant to subsection (a) of section 7.27, by the bylaws, pursuant to section 10.21, or by the board of directors, acting pursuant to paragraph (3), or (2) the articles provide for a lesser percentage vote, in accordance with subsection (b) of section 7.27, approval of the plan of domestication requires approval by two-thirds of all the shares entitled generally to vote on the matter by the articles of organization, and in addition two-thirds of the shares in any voting group entitled to vote separately on the matter by this Act, by the articles, by the bylaws, or by action of the board of directors pursuant to subsection (c) of section 9.21.

(6) Separate voting by voting groups is required by each class or series of shares that:

(i) are to be reclassified under the plan of domestication into other securities, obligations, rights to acquire shares or other securities, cash, other property or any combination of the foregoing;

(ii) would be entitled to vote as a separate group on a provision of the plan that, if contained in a proposed amendment to articles of organization, would require action by separate voting groups under section 10.04; or

(iii) is entitled under the articles of organization to vote as a voting group to approve an amendment of the articles.

(7) If the articles of organization, bylaws or an agreement to which any of the directors or shareholders are parties, adopted or entered into before the effective date of this chapter, contains a provision applying to a merger of the corporation that does not refer to a domestication of the corporation, the provision shall be deemed to apply to a domestication of the corporation until such time as the provision is amended subsequent to that date.

§ 9.22. ARTICLES OF DOMESTICATION

(a) After the domestication of a foreign business corporation has been authorized as required by the laws of the foreign jurisdiction, articles of domestication shall be executed by any officer or other duly authorized representative. The articles shall set forth:

(1) the name of the corporation immediately before the filing of the articles of domestication and, if that name is unavailable for use in the commonwealth or the corporation desires to change its name in connection with the domestication, a name that satisfies the requirements of section 4.01;

(2) the jurisdiction of incorporation of the corporation immediately before the filing of the

articles of domestication and the date the corporation was incorporated in that jurisdiction; and

(3) a statement that the domestication of the corporation in the commonwealth was duly authorized as required by the laws of the jurisdiction in which the corporation was incorporated immediately before its domestication in the commonwealth.

(b) The articles of domestication shall either contain all of the provisions that subsection (a) of section 2.02 requires to be set forth in articles of organization and other desired provisions that subsection (b) of section 2.02 permits to be included in articles of organization, or shall have attached articles of organization, except that, in either case, provisions that would not be required to be included in restated articles of organization may be omitted.

(c) The articles of domestication shall be delivered by the corporation to the secretary of state for filing and shall take effect at the effective time provided in section 1.23.

(d) The corporation shall file a copy of the articles of domestication certified by the state secretary in the registry of deeds in each district within the commonwealth in which real property of the corporation is situated. The domestication shall not be affected by this requirement.

(e) If the foreign corporation is authorized to transact business in the commonwealth under chapter 15, its authority shall be cancelled automatically on the effective date of its domestication.

§ 9.23. SURRENDER OF CHARTER UPON DOMESTICATION

(a) Whenever a domestic business corporation has adopted and approved, in the manner required by this chapter, a plan of domestication providing for the corporation to be domesticated in a foreign jurisdiction, articles of charter surrender shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles of charter surrender shall set forth:

(1) the name of the corporation;

(2) a statement that the articles of charter surrender are being filed in connection with the domestication of the corporation in a foreign jurisdiction;

(3) a statement that the domestication was duly approved by the shareholders and, if voting by any separate voting group was required, by each such separate voting group, in the manner required by this chapter and the articles of organization; and

(4) the corporation's new jurisdiction of incorporation.

(b) The articles of charter surrender shall be delivered by the corporation to the secretary of

state for filing. The articles of charter surrender shall take effect on the effective time provided in section 1.23.

§ 9.24. EFFECT OF DOMESTICATION

(a) When a domestication of a foreign business corporation in the commonwealth becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the corporation remains in the corporation without reversion or impairment;
(2) the liabilities of the corporation remain the liabilities of the corporation;

(3) an action or proceeding pending against the corporation continues against the corporation as if the domestication had not occurred;

(4) the articles of domestication, or the articles of organization attached to the articles of domestication, constitute the articles of organization of the corporation;

(5) the shares of the corporation are reclassified into other shares, other securities, obligations, rights to acquire shares or other securities of the corporation or into cash or other property in accordance with the terms of the domestication as approved under the laws of the foreign jurisdiction, and the shareholders are entitled only to the rights provided by those terms and under those laws; and

(6) the corporation is considered to:

(i) be incorporated under the laws of the commonwealth for all purposes;

(ii) be the same corporation without interruption as the corporation that existed under the laws of the foreign jurisdiction; and

(iii) have been incorporated on the date it was originally incorporated in the foreign jurisdiction.

(b) When a domestication of a domestic business corporation in a foreign jurisdiction becomes effective, the foreign business corporation is considered to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders who exercise appraisal rights in connection with the domestication; and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under PART 13.

(c) The owner liability of a shareholder in a foreign corporation that is domesticated in the commonwealth shall be as follows:

(1) The domestication shall not discharge any owner liability under the laws of the foreign jurisdiction to the extent the owner liability arose before the effective time of the articles of domestication.

(2) The shareholder shall not have owner liability under the laws of the foreign jurisdiction for any debt, obligation or liability of the corporation that arises after the effective time of the articles of domestication.

(3) The laws of the foreign jurisdiction shall continue to apply to the collection or discharge of any owner liability preserved by clause (1), as if the domestication had not occurred and the corporation were still incorporated under the laws of the foreign jurisdiction.

(4) The shareholder shall have whatever rights of contribution from other shareholders are provided by the laws of the foreign jurisdiction with respect to any owner liability preserved by clause (1), as if the domestication had not occurred and the corporation were still incorporated under the laws of that jurisdiction.

(d) A shareholder who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the corporation as a result of its domestication in the commonwealth shall be personally liable only for those debts, obligations or liabilities of the corporation that arise after the effective time of the articles of domestication.

§ 9.25. ABANDONMENT OF A DOMESTICATION

(a) Unless otherwise provided in a plan of domestication of a domestic business corporation, after the plan has been adopted and approved as required by this subdivision, and at any time before the domestication has become effective, it may be abandoned by the board of directors without action by the shareholders.

(b) If a domestication is abandoned under subsection (a) after articles of charter surrender have been filed with the secretary of state but before the domestication has become effective, a statement that the domestication has been abandoned in accordance with this section, executed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the domestication. The statement shall take effect upon filing and the domestication shall be deemed abandoned and shall not become effective.

(c) If the domestication of a foreign business corporation into the commonwealth is abandoned in accordance with the laws of the foreign jurisdiction after articles of domestication have been filed with the secretary of state but before their effective date, a statement that the domestication has been abandoned, executed by an officer or other duly authorized representative shall be delivered to the secretary of state for filing. The statement shall take effect upon filing and the domestication shall be considered abandoned and shall not become effective.

§ 9.30. NONPROFIT CONVERSION

(a) A domestic business corporation may become a domestic nonprofit corporation pursuant to a plan of nonprofit conversion.

(b) A domestic business corporation may become a foreign nonprofit corporation if the nonprofit conversion is permitted by the laws of the foreign jurisdiction. Regardless of whether the laws of the foreign jurisdiction require the adoption of a plan of nonprofit conversion, the foreign nonprofit conversion shall be approved by the adoption by the domestic business corporation of a plan of nonprofit conversion in the manner provided in this subchapter. The laws of the foreign jurisdiction govern the effect of the foreign nonprofit conversion.

(c) The plan of nonprofit conversion shall include:

(1) the terms and conditions of the conversion;

(2) the manner and basis of reclassifying the shares of the corporation into memberships, if any, or securities, obligations, rights to acquire memberships or securities, cash, other property, or any combination of the foregoing;

(3) any desired amendments to the articles of organization of the corporation following its conversion; and

(4) if the domestic business corporation is to be converted into a foreign nonprofit corporation, a statement of the jurisdiction in which the corporation will be incorporated after the conversion.

The plan of nonprofit conversion may include any other provisions relating to the conversion that may be desired.

(d) The plan of nonprofit conversion may also include a provision that the plan may be amended before filing articles of nonprofit conversion, except that subsequent to approval of the plan by the shareholders it may not be amended to change:

(1) the amount or kind of memberships or securities, obligations, rights to acquire memberships or securities, cash, or other property to be received by the shareholders under the plan;
(2) the articles of organization as they will be in effect immediately following consummation of the conversion, except for changes permitted by section 10.05; or

(3) any of the other terms or conditions of the plan if the change would adversely affect any of the shareholders in any material respect.

§ 9.31. ACTION ON A PLAN OF NONPROFIT CONVERSION

In the case of a conversion of a domestic business corporation to a domestic or foreign nonprofit corporation:

(1) The plan of nonprofit conversion shall be adopted by the board of directors.

(2) After adopting the plan of nonprofit conversion, the board of directors shall submit the plan to the shareholders for their approval. The board of directors shall also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors shall transmit to the shareholders the basis for that determination.

(3) The board of directors may condition its submission of the plan of nonprofit conversion to the shareholders on any basis.

(4) If the approval of the shareholders is to be given at a meeting, the corporation shall notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan of nonprofit conversion is to be submitted for approval. The notice shall state that the purpose, or one of the purposes, of the meeting is to consider the plan and shall contain or be accompanied by a copy or summary of the plan. The notice shall include or be accompanied by a copy of the articles of organization as they will be in effect immediately after the nonprofit conversion.

(5) Unless (1) a greater percentage vote, or one or more additional separate voting groups, is required by the articles of organization, pursuant to section 7.27(a), by the bylaws, pursuant to section 10.22, or by the board of directors, acting pursuant to paragraph (3), or (2) the articles provide for a lesser percentage vote, in accordance with subsection (b) of section 7.27, approval of the plan of domestication requires approval by two-thirds of all the shares entitled generally to vote on the matter by the articles of organization, and in addition two-thirds of the shares in any voting group entitled to vote separately on the matter by this chapter, by the articles, by the bylaws, or by action of the board of directors pursuant to section 9.31(c).

(6) Separate voting by voting groups is required by each class or series of shares that:

(i) would have a right to vote as a separate group on a provision in the plan that, if contained in a proposed amendment to articles of organization, would require action by separate voting groups under section 10.04; or

(ii) is entitled under the articles of organization to vote as a voting group to approve a plan of merger or amendment of articles.

(7) If any provision of the articles of organization, bylaws or an agreement to which any of the directors or shareholders are parties, adopted or entered into before the effective date of this chapter, applies to a merger of the corporation and does not refer to a nonprofit

conversion of the corporation, the provision shall be deemed to apply to a nonprofit conversion of the corporation until such time as the provision is amended subsequent to that date.

§ 9.32. ARTICLES OF NONPROFIT CONVERSION

(a) After a plan of nonprofit conversion providing for the conversion of a domestic business corporation to a domestic nonprofit corporation has been adopted and approved as required by this chapter, articles of nonprofit conversion shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles shall set forth:

(1) the name of the corporation immediately before the filing of the articles of nonprofit conversion and if that name does not satisfy the requirements of chapter 180 or the corporation desires to change its name in connection with the conversion, a name that satisfies the requirements of said chapter 180; and

(2) a statement that the plan of nonprofit conversion was duly approved by the shareholders and, if voting by any separate voting group was required, by each such separate voting group, in the manner required by this Act and the articles of organization.

(b) The articles of nonprofit conversion shall either contain all of the provisions that chapter 180 requires to be set forth in articles of organization of a domestic nonprofit corporation and any other desired provisions permitted by said chapter 180, or shall have attached articles of organization that satisfy the requirements of said chapter 180, except that in either case provisions that would not be required to be included in restated articles of organization of a domestic nonprofit corporation may be omitted.

(c) The articles of nonprofit conversion shall be delivered to the secretary of state for filing and shall take effect at the effective time provided in section 1.23.

(d) The resulting or surviving corporation shall file a copy of the articles of nonprofit conversion certified by the state secretary in the registry of deeds in each district within the commonwealth in which real property of the corporation is situated. The conversion shall be valid and effective in accordance with the terms of the plan of nonprofit conversion and the articles of nonprofit conversion delivered to the secretary of state pursuant to subsection (c) of section 9.32, notwithstanding any failure to make the filing.

§ 9.33. SURRENDER OF CHARTER UPON FOREIGN NONPROFIT CONVERSION
(a) Whenever a domestic business corporation has adopted and approved, in the manner required by this subdivision, a plan of nonprofit conversion providing for the corporation to be converted to a foreign nonprofit corporation, articles of charter surrender shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles of charter surrender shall set forth:

(1) the name of the corporation;

(2) a statement that the articles of charter surrender are being filed in connection with the conversion of the corporation to a foreign nonprofit corporation;

(3) a statement that the foreign nonprofit conversion was duly approved by the shareholders and, if voting by any separate voting group was required, by each such separate voting group, in the manner required by this chapter and the articles of organization; and

(4) the corporation's new jurisdiction of incorporation.

(b) The articles of charter surrender shall be delivered by the corporation to the secretary of state for filing. The articles of charter surrender shall take effect on the effective time provided in section 1.23.

§ 9.34. EFFECT OF NONPROFIT CONVERSION
(a) When a conversion of a domestic business corporation to a domestic nonprofit corporation becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the corporation remains in the corporation without reversion or impairment;

(2) the liabilities of the corporation remain the liabilities of the corporation;

(3) an action or proceeding pending against the corporation continues against the corporation as if the conversion had not occurred;

(4) the articles of nonprofit conversion, or the articles of organization attached to the articles of nonprofit conversion, constitute the articles of organization of the corporation;

(5) the shares of the corporation are reclassified into memberships, securities, obligations, rights to acquire memberships or securities of the corporation or into cash or other property in accordance with the plan of conversion, and the shareholders are entitled only to the rights provided in the plan of nonprofit conversion or to any rights they may have under PART 13; and

(6) the corporation is considered to:
(i) be a domestic nonprofit corporation for all purposes;

(ii) be the same corporation without interruption as the corporation that existed before the conversion; and

(iii) have been incorporated on the date that it was originally incorporated as a domestic business corporation.

(b) When a conversion of a domestic business corporation to a foreign nonprofit corporation becomes effective, the foreign nonprofit corporation is considered to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders who exercise appraisal rights in connection with the conversion; and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under PART 13.

(c) The owner liability of a shareholder in a domestic business corporation that converts to a domestic nonprofit corporation shall be as follows:

(1) The conversion does not discharge any owner liability of the shareholder with respect to the business corporation to the extent any such owner liability arose before the effective date of the articles of nonprofit conversion.

(2) The shareholder shall not have owner liability for any debt, obligation or liability of the nonprofit corporation that arises after the effective date of the articles of nonprofit conversion.

(3) The laws of the commonwealth shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the conversion had not occurred and the nonprofit corporation were still a business corporation.

(4) The shareholder shall have whatever rights of contribution from other shareholders are provided by the laws of the commonwealth with respect to any owner liability preserved by paragraph (1), as if the conversion had not occurred and the nonprofit corporation were still a business corporation.

(d) A shareholder who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the nonprofit corporation shall be personally liable only for those debts, obligations or liabilities of the nonprofit corporation that arise after the effective time of the articles of nonprofit conversion.

§ 9.35. ABANDONMENT OF A NONPROFIT CONVERSION

(a) Unless otherwise provided in a plan of nonprofit conversion of a domestic business corporation, after the plan has been adopted and approved as required by this chapter, and at

any time before the nonprofit conversion has become effective, it may be abandoned by the board of directors without action by the shareholders.

(b) If a nonprofit conversion is abandoned under subsection (a) after articles of nonprofit conversion or articles of charter surrender have been filed with the secretary of state but before the nonprofit conversion has become effective, a statement that the nonprofit conversion has been abandoned in accordance with this section, executed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing before the effective date of the nonprofit conversion. The statement shall take effect upon filing and the nonprofit conversion shall be deemed abandoned and shall not become effective.

§ 9.40. FOREIGN NONPROFIT DOMESTICATION AND CONVERSION

A foreign nonprofit corporation may become a domestic business corporation if the domestication and conversion is permitted by the organic law of the foreign nonprofit corporation. The laws of the commonwealth shall govern the effect of converting to a domestic business corporation pursuant to this subchapter.

§ 9.41. ARTICLES OF DOMESTICATION AND CONVERSION

(a) After the conversion of a foreign nonprofit corporation to a domestic business corporation has been authorized as required by the laws of the foreign jurisdiction, articles of domestication and conversion shall be executed by any officer or other duly authorized representative. The articles shall set forth:

(1) the name of the corporation immediately before the filing of the articles of domestication and conversion and, if that name is unavailable for use in the commonwealth or the corporation desires to change its name in connection with the domestication and conversion, a name that satisfies the requirements of section 4.01;

(2) the jurisdiction of incorporation of the corporation immediately before the filing of the articles of domestication and conversion and the date the corporation was incorporated in that jurisdiction; and

(3) a statement that the domestication and conversion of the corporation in the commonwealth was duly authorized as required by the laws of the jurisdiction in which the corporation was incorporated immediately before its domestication and conversion in the commonwealth.

(b) The articles of domestication and conversion shall either contain all of the provisions that subsection (a) of section 2.02 requires to be set forth in articles of organization and any other desired provisions that subsection (b) of section 2.02 permits to be included in articles of organization, or shall have attached articles of organization. In either case, provisions that would not be required to be included in restated articles of organization may be omitted.

(c) The articles of domestication and conversion shall be delivered by the corporation to the secretary of state for filing and shall take effect at the effective time provided in section 1.23.

(d) The corporation shall file a copy of the articles of domestication and conversion certified by the state secretary in the registry of deeds in each district within the commonwealth in which real property of the corporation is situated. The domestication and conversion shall be valid and effective in accordance with the terms of the plan of domestication and conversion and the articles of domestication and conversion delivered to the secretary of state pursuant to subsection (c), notwithstanding any failure to make the filing.

(e) If the foreign nonprofit corporation is authorized to transact business in the commonwealth under this chapter, its authority shall be cancelled automatically on the effective date of its domestication and conversion.

§ 9.42. EFFECT OF FOREIGN NONPROFIT DOMESTICATION AND CONVERSION

(a) When a domestication and conversion of a foreign nonprofit corporation to a domestic business corporation becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the corporation remains in the corporation without reversion or impairment;

(2) the liabilities of the corporation remain the liabilities of the corporation;

(3) an action or proceeding pending against the corporation continues against the corporation as if the domestication and conversion had not occurred;

(4) the articles of domestication and conversion, or the articles of organization attached to the articles of domestication and conversion, constitute the articles of organization of the corporation;

(5) shares, other securities, obligations, rights to acquire shares or other securities of the corporation or cash or other property shall be issued or paid as provided pursuant to the laws of the foreign jurisdiction, so long as at least one share is outstanding immediately after the effective time; and

(6) the corporation is considered to:

(i) be a domestic corporation for all purposes;

(ii) be the same corporation without interruption as the corporation that existed under the laws of the jurisdiction in which it was formerly domiciled; and

(iii) have been incorporated on the date it was originally incorporated in the former jurisdiction.

(b) The owner liability of a member of a foreign nonprofit corporation that domesticates and converts to a domestic business corporation shall be as follows:

(1) The domestication and conversion does not discharge any owner liability under the laws of the foreign jurisdiction to the extent any such owner liability arose before the effective time of the articles of domestication and conversion.

(2) The member shall not have owner liability under the laws of the foreign jurisdiction for any debt, obligation or liability of the corporation that arises after the effective time of the articles of domestication and conversion.

(3) The provisions of the laws of the foreign jurisdiction shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the domestication and conversion had not occurred and the corporation were still incorporated under the laws of the foreign jurisdiction.

(4) The member shall have whatever rights of contribution from other members are provided by the laws of the foreign jurisdiction with respect to any owner liability preserved by paragraph (1), as if the domestication and conversion had not occurred and the corporation were still incorporated under the laws of that jurisdiction.

(c) A member of a foreign nonprofit corporation who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the corporation as a result of its domestication and conversion in the commonwealth shall be personally liable only for those debts, obligations or liabilities of the corporation that arise after the effective time of the articles of domestication and conversion.

§ 9.43. ABANDONMENT OF A FOREIGN NONPROFIT DOMESTICATION AND CONVERSION

If the domestication and conversion of a foreign nonprofit corporation to a domestic business corporation is abandoned in accordance with the laws of the foreign jurisdiction after articles of domestication and conversion have been filed with the secretary of state, a statement that the domestication and conversion has been abandoned, executed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing. The statement shall take effect upon filing and the domestication and conversion shall be deemed abandoned and shall not become effective.

§ 9.50. ENTITY CONVERSION AUTHORIZED; DEFINITIONS

(a) A domestic business corporation may become a domestic other entity pursuant to a plan of entity conversion. If the organic law of the other entity does not provide for such a conversion, section 9.55 governs the effect of converting to that form of entity.

(b) A domestic business corporation may become a foreign other entity only if the entity conversion is permitted by the laws of the foreign jurisdiction. The laws of the foreign

jurisdiction governs the effect of converting to an other entity organized in that jurisdiction.

(c) A domestic other entity may become a domestic business corporation. Section 9.55 governs the effect of converting to a domestic business corporation. If the organic law of a domestic other entity does not provide procedures for the approval of an entity conversion, the conversion shall be adopted and approved, and the entity conversion effectuated, in the same manner as a merger of the other entity and its interest holders shall be entitled to appraisal rights if appraisal rights are available upon any type of merger under the organic law of the other entity. If the organic law of a domestic other entity does not provide procedures for the approval of either an entity conversion or a merger, a plan of entity conversion shall be adopted and approved, the entity conversion effectuated, and appraisal rights exercised, in accordance with the procedures in this subdivision and PART 13. Without limiting the provisions of this subsection, a domestic other entity whose organic law does not provide procedures for the approval of an entity conversion shall be subject to subsection (e) of this section and clause (7) of section 9.52. For purposes of applying this subdivision and PART 13:

(1) the other entity, its interest holders, interests and organic documents taken together, shall be deemed to be a domestic business corporation, shareholders, shares and articles of organization, respectively, and vice versa, as the context may require; and

(2) if the business and affairs of the other entity are managed by a group of persons that is not identical to the interest holders, that group shall be deemed to be the board of directors.

(d) A foreign other entity may become a domestic business corporation if the organic law of the foreign other entity authorizes it to become a corporation in another jurisdiction. The laws of the commonwealth shall govern the effect of converting to a domestic business corporation pursuant to this subdivision.

(e) As used in this SUBDIVISION the following words shall have the following meanings unless the context requires otherwise.

"Converting entity", the domestic business corporation or domestic other entity that adopts a plan of entity conversion or the foreign other entity converting to a domestic business corporation.

"Surviving entity", the corporation or other entity that is in existence immediately after consummation of an entity conversion pursuant to this subdivision.

§ 9.51. PLAN OF ENTITY CONVERSION

(a) A plan of entity conversion shall include:

(1) a statement of the type of entity the surviving entity will be and, if it will be a foreign other entity, its jurisdiction of organization;

(2) the terms and conditions of the conversion;

(3) if the surviving entity will be an other entity, the manner and basis of converting the shares of the domestic business corporation into interests or other securities, obligations, rights to acquire interests or other securities, cash, other property, or any combination of the foregoing; and

(4) if the surviving entity will be a domestic business corporation, the manner and basis of converting the interests in the other entity into shares of the domestic business corporation, if any, or other securities, obligations, rights to acquire interests or other securities, cash, other property, or any combination of the foregoing; and

(5) the full text of the organic documents of the surviving entity, as they will be in effect immediately after consummation of the conversion.

The plan of entity conversion may include any other provisions relating to the conversion that may be desired.

(b) The plan of entity conversion may also include a provision that the plan may be amended prior to filing articles of entity conversion, except that subsequent to approval of the plan by the shareholders or by the holders of voting interests in the other entity the plan may not be amended to change:

(1) the amount or kind of shares or other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, or other property to be received by the shareholders or interest holders under the plan;

(2) the organic documents that will be in effect immediately following the conversion, except for changes permitted by a provision of the organic law of the surviving entity comparable to section 10.05; or

(3) any of the other terms or conditions of the plan if the change would adversely affect any of the shareholders or the interest holders in any material respect.

§ 9.52. ACTION ON A PLAN OF ENTITY CONVERSION

In the case of an entity conversion of a domestic business corporation to a domestic or foreign other entity:

(1) The plan of entity conversion shall be adopted by the board of directors.

(2) After adopting the plan of entity conversion, the board of directors shall submit the plan to the shareholders for their approval.

(3) The board of directors may condition its submission of the plan of entity conversion to the shareholders on any basis.

(4) If the approval of the shareholders is to be given at a meeting, the corporation shall notify

each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan of entity conversion is to be submitted for approval. The notice shall state that the purpose, or one of the purposes, of the meeting is to consider the plan and shall contain or be accompanied by a copy or summary of the plan. The notice shall include or be accompanied by a copy or summary of the organizational documents as they will be in effect immediately after the entity conversion.

(5) Unless (i) a greater percentage vote, or one or more additional separate voting groups, is required by the articles of organization, pursuant to section 7.27(a), by the bylaws, pursuant to section 10.21, or by the board of directors, acting pursuant to paragraph (3), or (ii) the articles provide for a lesser percentage vote, in accordance with subsection (b) of section 7.27, approval of the plan of domestication requires approval by two-thirds of all the shares entitled generally to vote on the matter by the articles of organization, and in addition two-thirds of the shares in any voting group entitled to vote separately on the matter by this chapter, by the articles, by the bylaws, or by action of the board of directors pursuant to subsection (c) of this section.

(6) Separate voting by voting groups is required by each class or series of shares that:

(1) would have a right to vote as a separate voting group on a provision in the plan that, if contained in a proposed amendment to articles of organization, would require action by separate voting groups under section 10.04; or

(2) is entitled under the articles of organization to vote as a voting group to approve a plan of merger.

(7) If the articles of organization, bylaws or an agreement to which any of the directors or shareholders are parties, adopted or entered into before the effective date of this chapter, applies to a merger of the corporation and the document does not refer to an entity conversion of the corporation, the provision shall be deemed to apply to an entity conversion of the corporation until such time as the provision is subsequently amended.

(8) If as a result of the conversion one or more shareholders of the corporation would become subject to owner liability for the debts, obligations or liabilities of any other person or entity, approval of the plan of conversion shall require the execution, by each such shareholder who does not assert appraisal rights, of a separate written consent to become subject to such owner liability.

§ 9.53. ARTICLES OF ENTITY CONVERSION

(a) After the conversion of a domestic business corporation to a domestic other entity has been adopted and approved as required by this chapter, articles of entity conversion shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles shall:

(1) set forth the name of the corporation immediately before the filing of the articles of entity

conversion and the name to which the name of the corporation is to be changed, which shall be a name that satisfies the organic law of the surviving entity;

(2) state the type of other entity that the surviving entity will be;

(3) set forth a statement that the plan of entity conversion was duly approved by the shareholders and if voting by any separate voting group was required, by each such separate voting group, in the manner required by this chapter and the articles of organization;

(4) if the surviving entity is a filing entity, either contain all of the provisions required to be set forth in its public organic document and any other desired provisions that are permitted, or have attached a public organic document, except that, in either case, provisions that would not be required to be included in a restated public organic document may be omitted;

(b) After the conversion of a domestic other entity to a domestic business corporation has been adopted and approved as required by the organic laws of the other entity, articles of entity conversion shall be executed on behalf of the other entity by any officer or other duly authorized representative. The articles shall:

(1) set forth the name of the other entity immediately before the filing of the articles of entity conversion and the name to which the name of the other entity is to be changed, which shall be a name that satisfies the requirements of section 4.01;

(2) set forth a statement that the plan of entity conversion was duly approved in accordance with the organic law of the other entity;

(3) either contain all of the provisions that subsection (a) of section 2. 02 requires to be set forth in articles of organization and any other desired provisions that section 2.02 subsection (b) of permits to be included in articles of organization, or have attached articles of organization, except that, in either case, provisions that would not be required to be included in restated articles of organization of a domestic business corporation may be omitted.

(c) After the conversion of a foreign other entity to a domestic business corporation has been authorized as required by the laws of the foreign jurisdiction, articles of entity conversion shall be executed on behalf of the foreign other entity by any officer or other duly authorized representative. The articles shall:

(1) set forth the name of the other entity immediately before the filing of the articles of entity conversion and the name to which the name of the other entity is to be changed, which shall be a name that satisfies the requirements of section 4.01;

(2) set forth the jurisdiction under the laws of which the other entity was organized immediately before the filing of the articles of entity conversion and the date on which the other entity was organized in that jurisdiction;

(3) set forth a statement that the conversion of the other entity was duly approved in the manner required by its organic law; and

(4) either contain all of the provisions that subsection (a) of section 2. 02 requires to be set forth in articles of organization and any other desired provisions that subsection (b) of section 2.02 permits to be included in articles of organizations, or have attached articles of organization, except that, in either case, provisions that would not be required to be included in restated articles of organization of a domestic business corporation may be omitted.

(d) The articles of entity conversion shall be delivered to the secretary of state for filing, and shall take effect at the effective time provided in section 1.23.

(e) The corporation shall file a copy of the articles of entity conversion certified by the state secretary in the registry of deeds in each district within the commonwealth in which real property of the corporation is situated. The entity conversion shall be valid and effective in accordance with the terms of the plan of entity conversion and the articles of entity conversion delivered to the secretary of state pursuant to subsection (d) of section 9.53, notwithstanding any failure to make the filing.

(f) If the converting entity is a foreign other entity that is authorized to transact business in the commonwealth under a provision of law similar to PART 15, its authority or other type of foreign qualification shall be cancelled automatically on the effective date of its conversion.

§ 9.54. SURRENDER OF CHARTER UPON CONVERSION

(a) Whenever a domestic business corporation has adopted and approved, in the manner required by this subdivision, a plan of entity conversion providing for the corporation to be converted to a foreign other entity, articles of charter surrender shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles of charter surrender shall set forth:

(1) the name of the corporation;

(2) a statement that the articles of charter surrender are being filed in connection with the conversion of the corporation to a foreign other entity;

(3) a statement that the conversion was duly approved by the shareholders and, if voting by any separate voting group was required, by each such separate voting group, in the manner required by this chapter and the articles of organization;

(4) the jurisdiction under the laws of which the surviving entity will be organized;

(5) if the surviving entity will be a nonfiling entity, the address of its executive office immediately after the conversion.

(b) The articles of charter surrender shall be delivered by the corporation to the secretary of

state for filing. The articles of charter surrender shall take effect on the effective time provided in section 1.23.

§ 9.55. EFFECT OF ENTITY CONVERSION

(a) When a conversion under this subchapter in which the surviving entity is a domestic business corporation or domestic other entity becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the converting entity remains in the surviving entity without reversion or impairment;

(2) the liabilities of the converting entity remain the liabilities of the surviving entity;

(3) an action or proceeding pending against the converting entity continues against the surviving entity as if the conversion had not occurred;

(4) in the case of a surviving entity that is a filing entity, the articles of conversion, or the articles of organization or public organic document attached to the articles of conversion, constitute the articles of organization or public organic document of the surviving entity;

(5) in the case of a surviving entity that is a nonfiling entity, the private organizational document provided for in the plan of conversion constitutes the private organizational document of the surviving entity;

(6) the shares or interests of the converting entity are reclassified into shares, interests, other securities, obligations, rights to acquire shares, interests or other securities of the surviving entity or into cash or other property in accordance with the plan of conversion, and the shareholders or interest holders of the converting entity are entitled only to the rights provided in the plan of conversion or, in the case of a converting entity that is a domestic business corporation, to any rights they may have under PART 13; and

(7) the surviving entity is considered to:

(i) be a domestic business corporation or other entity for all purposes;

(ii) be the same corporation or other entity without interruption as the converting entity that existed prior to the conversion; and

(iii) have been incorporated or otherwise organized on the date that the converting entity was originally incorporated or organized.

(b) When a conversion of a domestic business corporation to a foreign other entity becomes effective, the surviving entity is considered to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce

the rights of shareholders who exercise appraisal rights in connection with the conversion; and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under PART 13.

(c) A shareholder who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the surviving entity as a result of an entity conversion shall be personally liable only for those debts, obligations or liabilities of the surviving entity that arise after the effective time of the articles of entity conversion.

(d) The owner liability of an interest holder in an other entity that converts to a domestic business corporation shall be as follows:

(1) The conversion does not discharge any owner liability under the organic law of the other entity to the extent any such owner liability arose before the effective time of the articles of entity conversion.

(2) The interest holder shall not have owner liability under the organic law of the other entity for any debt, obligation or liability of the corporation that arises after the effective time of the articles of entity conversion.

(3) The provisions of the organic law of the other entity shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the conversion had not occurred and the surviving entity were still the converting entity.

(4) The interest holder shall have whatever rights of contribution from other interest holders are provided by the organic law of the other entity with respect to any owner liability preserved by paragraph (1), as if the conversion had not occurred and the surviving entity were still the converting entity.

§ 9.56. ABANDONMENT OF AN ENTITY CONVERSION

(a) Unless otherwise provided in a plan of entity conversion of a domestic business corporation, after the plan has been adopted and approved as required by this chapter, and at any time before the entity conversion has become effective, it may be abandoned by the board of directors without action by the shareholders.

(b) If an entity conversion is abandoned after articles of entity conversion or articles of charter surrender have been filed with the secretary of state but before the entity conversion has become effective, a statement that the entity conversion has been abandoned in accordance with this section, executed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing before the effective date of the entity conversion. Upon filing, the statement shall take effect and the entity conversion shall be considered abandoned and shall not become effective.

§ 10.01. AUTHORITY TO AMEND

(a) A corporation may amend its articles of organization at any time to add or change a provision that is required or permitted in the articles of organization as of the effective date of the amendment or to delete a provision not required in the articles of organization.

(b) A shareholder of the corporation shall not have a vested property right resulting from any provision in the articles of organization, including provisions relating to management, control, capital structure, dividend entitlement, or purpose or duration of the corporation.

§ 10.02. AMENDMENT BEFORE ISSUANCE OF SHARES

If a corporation has not yet issued shares, its board of directors, or its incorporators if it has no board of directors, may adopt one or more amendments to the corporation's articles of organization.

§ 10.03. AMENDMENT BY BOARD OF DIRECTORS AND SHAREHOLDERS; EXCEPTION

If a corporation has issued shares, an amendment to the articles of organization shall be adopted in the following manner:

(a) The proposed amendment must be adopted by the board of directors.

(b) Except as provided in sections 10.05, 10.07, and 14.34, after adopting the proposed amendment the board of directors shall submit the amendment to the shareholders for their approval.

(c) The board of directors may condition its submission of the amendment to the shareholders on any basis.

(d) If the amendment is required to be approved by the shareholders, and the approval is to be given at a meeting, the corporation shall notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the amendment is to be submitted for approval. The notice shall state that the purpose, or one of the purposes, of the meeting is to consider the amendment and shall contain or be accompanied by a copy or a summary of the amendment.

(e) Unless (1) a greater percentage vote, or action by 1 or more additional separate voting groups, is required by the articles of organization, pursuant to subsection (a) of section 7.27, by the bylaws, pursuant to section 10.21, or by the board of directors, acting pursuant to subsection (c) of section 10.03, or (2) the articles provide for a lesser percentage vote, in accordance with subsection (b) of section 7.27, approval of the amendment requires:

(1) except as otherwise provided in clause (2), the affirmative vote of two-thirds of all the shares entitled generally to vote on the matter by the articles of organization, and in addition two-thirds of the shares of any voting group entitled to vote separately on the matter by the

chapter, by the articles, by the bylaws, or by action of the board of directors pursuant to subsection (c) of section 10.03, or

(2) if the amendment relates solely to (A) an increase or reduction in the corporation's capital stock of any class or series then authorized, (B) a change in its authorized shares into a different number of shares or the exchange thereof pro rata for a different number of shares of the same class or series, or (C) a change of its corporate name, the required vote shall be a majority rather than two-thirds, except that if the vote of a separate voting group is required under section 10.04, the required vote of that voting group shall remain two-thirds.

If the amendment to the articles of organization changes a quorum or voting requirement for action by the shareholders, approval by the shareholders shall satisfy not only the quorum and voting requirement then applicable for amendment of the articles but also the particular quorum or voting requirement being changed.

(f) The articles of organization of any corporation, a plan of reorganization of which, pursuant to any applicable statute of the United States relating to reorganizations of corporations, has been or shall be confirmed by the decree or order of a court of competent jurisdiction may be amended as provided in section 14.34, notwithstanding the terms of this section.

§ 10.04. VOTING ON AMENDMENTS BY VOTING GROUPS
(a) The holders of the outstanding shares of a class or of a series of a class are entitled to vote as a separate voting group, whether or not shareholder voting is otherwise required by this chapter, on a proposed amendment to the articles of organization if the amendment would:

(1) increase or decrease the aggregate number of authorized shares of the class or the series;

(2) authorize an exchange or effect a reclassification of all or part of the shares of the class or series into shares of another class or series;

(3) authorize an exchange or create a right of exchange, or effect a reclassification, of all or part of the outstanding shares of another class or series into shares of the class or series;

(4) change the designation, or the stated rights, preferences or limitations of all or part of the shares of the class or the series;

(5) change all or part of the shares of the class or series into a different number of shares of the same class or series;

(6) increase the voting rights of the outstanding shares of another class or series relative to the voting rights of the subject class or series;

(7) increase directly the stated rights or preferences of the outstanding shares of another class or series with respect to distributions or to dissolution, to make them prior, superior, or

substantially equal to the rights or preferences of the subject class or series, or do so indirectly by way of implementing an exchange or reclassification of the outstanding shares of the other class or series into shares of a third class or series;

(8) limit or deny an existing preemptive right of all or part of the outstanding shares of the class or series; or

(9) cancel or otherwise affect interests in distributions or dividends that have accumulated but not yet been declared on all or part of the outstanding shares of the class or series.

(b) If a proposed amendment that entitles the holders of 2 or more classes or series of shares to vote as separate voting groups under this section would affect those 2 or more classes or series in the same or a substantially similar way, the holders of shares of all the classes or series so affected shall vote together as a single voting group on the proposed amendment, unless otherwise provided in the articles of organization or required by the board of directors.

(c) A class or series of shares is entitled to the voting rights granted by this section although the articles of organization provide that the shares are nonvoting shares.

§ 10.05. AMENDMENT BY BOARD OF DIRECTORS

Unless the articles of organization provide otherwise, a corporation's board of directors may adopt amendments to the corporation's articles of organization without shareholder approval:

(1) to extend the duration of the corporation if it was incorporated at a time when limited duration was required by law;

(2) if the corporation has only one class of shares outstanding:

(a) to change each issued and unissued authorized share of the class into a greater number of whole shares of that class; or

(b) to increase the number of authorized shares of the class to the extent necessary to permit the issuance of shares as a share dividend;

(3) to change the corporate name by substituting the word "corporation," "incorporated," "company," "limited," or the abbreviation "corp.," "inc.," "co.," or "ltd.," for a similar word or abbreviation in the name, or by adding, deleting, or changing a geographical attribution for the name;

(4) to reflect a reduction in authorized shares, as a result of the operation of subsection (b) of section 6.31, when the corporation has acquired its own shares and the articles of organization prohibit the reissue of the acquired shares;

(5) to delete a class or series of shares from the articles of organization, as a result of the operation of subsection (b) of section 6.31 or of the conversion of the shares, when there are

no remaining shares of the class or series because the corporation has acquired all shares of the class or series, or all shares of the class or series have been converted into other securities, and the articles of organization prohibit the reissue of the acquired or converted shares; or

(6) to make any change expressly permitted by section 6.02 to be made without shareholder approval.

§ 10.06. ARTICLES OF AMENDMENT

After an amendment to the articles of organization has been adopted and approved in the manner required by the chapter and by the articles of organization, the corporation shall deliver to the secretary of state for filing articles of amendment setting forth:

(1) the name of the corporation;

(2) the text of each amendment adopted;

(3) if an amendment authorizes an exchange, or effects a reclassification or cancellation, of issued shares, provisions for implementing that action unless contained in the amendment itself;

(4) the date of each amendment's adoption;

(5) if an amendment:

(a) was adopted by the incorporators or board of directors without shareholder approval, a statement that the amendment was duly approved by the incorporators or by the board of directors, as the case may be, and that shareholder approval was not required;

(b) required approval by the shareholders, a statement that the amendment was duly approved by the shareholders in the manner required by this chapter and by the articles of organization.

§ 10.07. RESTATED ARTICLES OF ORGANIZATION

(a) A corporation's board of directors may restate its articles of organization at any time, with or without shareholder approval, to consolidate all amendments into a single document.

(b) If the restated articles include one or more new amendments that require shareholder approval, the amendments must be adopted and approved as provided in section 10.03.

(c) A corporation that restates its articles of organization shall deliver to the secretary of state for filing articles of restatement setting forth the name of the corporation and the text of the restated articles of organization together with a certificate which states that the restated articles consolidate all amendments into a single document and, if a new amendment is included in the restated articles, which also includes the statements required under section 10.06.

(d) Duly adopted restated articles of organization supersede the original articles of organization and all amendments thereto.

(e) The secretary of state may certify restated articles of organization as the articles of organization currently in effect, without including the certificate information required by subsection (c).

§ 10.08. EFFECT OF AMENDMENT

An amendment to the articles of organization shall not affect a cause of action existing against or in favor of the corporation, a proceeding to which the corporation is a party, or the existing rights of persons other than shareholders of the corporation. An amendment changing a corporation's name shall not abate a proceeding brought by or against the corporation in its former name.

§ 10.20. AMENDMENT BY BOARD OF DIRECTORS OR SHAREHOLDERS

(a) The power to make, amend or repeal bylaws shall be in the shareholders. If authorized by the articles of organization, or by the bylaws pursuant to authorization in the articles, the board of directors may also make, amend or repeal bylaws in whole or in part, except with respect to any provision thereof which by virtue of an express provision in this chapter, the articles of organization, or the bylaws, requires action by the shareholders.

(b) Not later than the time of giving notice of the meeting of shareholders next following the making, amending or repealing by the board of directors of any bylaw, notice stating the substance of the action taken by the board of directors shall be given to all shareholders entitled to vote on amending the bylaws. Any action taken by the board of directors with respect to the bylaws may be amended or repealed by the shareholders.

§ 10.21. BYLAW DEALING WITH QUORUM OR VOTING REQUIREMENTS FOR SHAREHOLDERS

(a) If authorized by the articles of organization, the initial bylaws or a bylaw subsequently adopted by shareholders may provide for a greater or lesser quorum requirement for action by any voting group of shareholders, or for a greater affirmative vote requirement, including additional separate voting groups, than is provided for by this chapter.

(b) Approval of an amendment to the bylaws that changes or deletes a quorum or voting requirement for action by shareholders must satisfy both the applicable quorum and voting requirements for action by shareholders with respect to amendment of the bylaws and also the particular quorum and voting requirements sought to be changed or deleted.

(c) A bylaw dealing with quorum or voting requirements for shareholders, including additional voting groups, may not be adopted, amended or repealed by the board of directors.

§ 10.22. BYLAW DEALING WITH QUORUM OR VOTING REQUIREMENTS FOR BOARD OF DIRECTORS

(a) A bylaw that fixes a greater or lesser quorum requirement for action by the board of directors, or a greater voting requirement, than provided for by this Act may be adopted in the initial bylaws, or thereafter by the shareholders pursuant to subsection (a) of section 10.20, or by the board of directors if authorized by subsection (a) of section 10.20.

(b) A bylaw authorized by subsection (a) may be amended or repealed by the shareholders, or by the board of directors if authorized by subsection (a) of section 10.20;

(c) A bylaw adopted or amended by the shareholders pursuant to subsection (a) may provide that it may be amended or repealed only by a specified vote of the shareholders, or by a specified vote of the board of directors if the board is authorized to act by both subsection (a) of section 10.20 and subsection (b) of this section.

(d) If the board of directors is authorized to amend the bylaws by subsection (a) of section 10.20, approval by the board of directors of an amendment to the bylaws that changes or deletes a quorum or voting requirement for action by the board of directors must satisfy both the applicable quorum and voting requirements for action by the board of directors with respect to amendment of the bylaws, and also the particular quorum and voting requirements sought to be changed or deleted.

§ 11.01. DEFINITIONS

As used in this PART:

"Interests", includes any form of membership in a domestic or foreign nonprofit corporation.

"Merger", a business combination pursuant to section 11.02.

"Other entity", includes a domestic or foreign nonprofit corporation.

"Party to a merger" or "party to a share exchange", any domestic or foreign corporation or other entity that will either:

(1) merger under a plan of merger;

(2) acquire shares or interests of another corporation or an other entity in a share exchange; or

(3) have all of its shares or interests or all of one or more classes or series of its shares or interests acquired in a share exchange.

"Share exchange", a business combination pursuant to section 11.03.

"Survivor", in a merger, the corporation or other entity into which one or more other corporations or other entities are merged. A survivor of a merger may preexist the merger or be created by the merger.

§ 11.02. MERGER
One or more domestic corporations may merge with a domestic or foreign corporation or other entity pursuant to a plan of merger.

(a) A foreign corporation, or a foreign other entity, may be a party to the merger, or may be created by the terms of the plan of merger, only if:

(1) the merger is permitted by the laws under which the corporation or other entity is organized or by which it is governed; and

(2) in effecting the merger, the corporation or other entity complies with such laws and with its articles of organization or organizational documents.

(b) If the law under which a domestic other entity is organized does not provide procedures for the approval of a merger, a plan of merger may be adopted and approved, and the merger effectuated, by the other entity in accordance with the procedures in this PART and PART 13 applicable to domestic business corporations, and for the purposes of applying this chapter:

(1) the other entity, its interest holders, interests and filed organizational document, if any, shall be considered to be a domestic business corporation, shareholders, shares and articles of organization, respectively; and

(2) if the affairs of the other entity are managed by a group of persons that is not identical to the interest holders, that group shall be considered to be the board of directors.
(c) The plan of merger shall include:

(1) the name of each corporation or other entity that will merge and the name of the corporation or other entity that will be the survivor of the merger;

(2) the terms and conditions of the merger;

(3) the manner and basis of converting the shares of each merging corporation and interests of each merging other entity into shares or other securities, interests, obligations, rights to acquire shares or other securities, rights to acquire interests, cash, other property, or any combination of the foregoing;

(4) the articles of organization of any corporation, or the organizational documents of any other entity, to be created by the merger, or if a new corporation or other entity is not to be created by the merger, any amendments to the survivor's articles of organization or organizational documents; and

(5) any other provisions required by the laws under which any party to the merger is organized or by which it is governed, or by the articles of organization or organizational documents of any such party.

(d) The plan of merger may set forth:

(1) to the extent not inconsistent with contractual rights, the manner and basis of converting rights to acquire shares of each corporation into rights to acquire shares, obligations or other securities of the surviving or any other corporation or into cash or other property in whole or in part; and

(2) other provisions relating to the merger.

(e) The plan of merger may also include a provision that the plan may be amended before filing the articles of merger with the secretary of state; but, if the shareholders of a domestic corporation that is a party to the merger are required or permitted to vote on the plan, the plan shall provide that subsequent to approval of the plan by the shareholders the plan may not be amended to:

(1) change the amount or kind of shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, or other property to be received by the shareholders of or owners of interests in any party to the merger upon conversion of their shares or interests under the plan;

(2) change the articles of organization of any corporation, or the organizational documents of any other entity, that will survive or be created as a result of the merger, except for changes permitted by section 10.05 or by comparable provisions of the laws under which the foreign corporation or other entity is organized or governed; or
(3) change any of the other terms or conditions of the plan if the change would adversely affect such shareholders in any material respect.

§ 11.03. SHARE EXCHANGE
(a) Through a share exchange:

(1) a domestic corporation may acquire all of the shares of 1 or more classes or series of shares of another domestic or foreign corporation, or all of the interests of 1 or more classes or series of interests of a domestic or foreign other entity, in exchange for shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, pursuant to a plan of share exchange; or

(2) all of the shares of 1 or more classes or series of shares of a domestic corporation may be acquired by another domestic or foreign corporation or other entity, in exchange for shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, pursuant to a plan of share exchange.

(b) If the law under which a domestic other entity is organized does not provide procedures for the approval of a share exchange, a plan of share exchange may be adopted and approved, and the share exchange effectuated, in accordance with the procedures, if any, for a merger.

If the law under which a domestic other entity is organized does not provide procedures for the approval of either a share exchange or a merger, a plan of share exchange may be adopted and approved, and the share exchange effectuated, by the other entity in accordance with the procedures in this chapter and chapter 13 applicable to domestic business corporations; and for the purposes of applying this PART and PART 13:

(1) the other entity, its interest holders, interests and filed organizational document, if any, shall be considered to be a domestic business corporation, shareholders, shares and articles of organization, respectively; and

(2) if the affairs of the other entity are managed by a group of persons that it is not identical to the interest holders, that group shall be considered to be the board of directors.

(c) A foreign corporation, or a domestic or foreign other entity, may be a party to the share exchange only if:

(1) the share exchange is permitted by the laws under which the corporation or other entity is organized or by which it is governed; and

(2) in effecting the share exchange, the corporation or other entity complies with such laws and with its articles of organization or organizational documents.

(d) The plan of share exchange shall include:

(1) the name of each corporation or other entity whose shares or interests will be acquired and the name of the corporation or other entity that will acquire those shares or interests;

(2) the terms and conditions of the share exchange;

(3) the manner and basis of exchanging shares of a corporation or interests in an other entity whose shares or interests will be acquired under the share exchange into shares or other securities, interests, obligations, rights to acquire shares or other securities, rights to acquire interests, cash, other property, or any combination of the foregoing; and

(4) any other provisions required by the laws under which any party to the share exchange is organized or by the articles of organization or organizational documents of any such party.

(e) The terms described in clauses (2) and (3) of subsection (d) may be made dependent on facts ascertainable outside the plan of share exchange, provided that those facts are objectively ascertainable. The term "facts" shall include, but shall not limited to, the occurrence of any event, including a determination or action by any person or body, including the corporation or other entity.

(f) The plan of share exchange may also include a provision that the plan may be amended prior to filing of the articles of share exchange with the secretary of state, provided that if the

shareholders of a domestic corporation that is a party to the share exchange are required or permitted to vote on the plan, the plan shall provide that subsequent to approval of the plan by such shareholders the plan may not be amended to:

(1) change the amount or kind of shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, or other property to be issued by the corporation or to be received by the shareholders of or owners of interests in any party to the share exchange in exchange for their shares or interests under the plan; or

(2) change any of the terms or conditions of the plan if the change would adversely affect such shareholders in any material respect.

(g) This section shall not limit the power of a domestic corporation to acquire shares of another corporation or interests in another entity in a transaction other than a share exchange.

§ 11.04. ACTION ON A PLAN OF MERGER OR SHARE EXCHANGE

In the case of a domestic corporation that is a party to a merger or share exchange:

(1) The plan of merger or share exchange shall be adopted by the board of directors.

(2) Except as provided in clause (7) and in section 11.05, after adopting the plan of merger or share exchange the board of directors must submit the plan to the shareholders for their approval.

(3) The board of directors may condition its submission of the plan of merger or share exchange to the shareholders on any basis.

(4) If the plan of merger or share exchange is required to be approved by the shareholders, and if the approval is to be given at a meeting, the corporation shall notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan is to be submitted for approval. The notice shall state that the purpose, or one of the purposes, of the meeting is to consider the plan and shall contain or be accompanied by a copy or summary of the plan. If the corporation is to be merged into an existing corporation or other entity, the notice shall also include or be accompanied by a copy or summary of the articles of organization or organizational documents of that corporation or other entity. If the corporation is to be merged into a corporation or other entity that is to be created pursuant to the merger, the notice shall include or be accompanied by a copy or a summary of the articles of organization or organizational documents of the new corporation or other entity.

(5) Unless (i) a greater percentage vote, or one or more additional separate voting groups, is required by the articles of organization, pursuant to subsection (a) of section 7.27, by the bylaws, pursuant to section 10.21, or by the board of directors, acting pursuant to clause (3) of this section, or (ii) the articles provide for a lesser percentage vote, in accordance with subsection (b) of section 7.27, approval of the plan of merger or share exchange requires

approval by two-thirds of all the shares entitled generally to vote on the matter by the articles of organization, and in addition two-thirds of the shares in any voting group entitled to vote separately on the matter by the Act, by the articles, by the bylaws, or by action of the board of directors pursuant to subsection (c) of section 11. 04.

(6) Except as otherwise expressly provided in the article of organization, voting by a class or series of shares as a separate voting group is required on a plan of merger or share exchange if the plan contains a provision that, if contained in a proposed amendment to articles of organization, would entitle such class or series to vote as a separate voting group on the proposed amendment under section 10.04; provided however, that (i) receipt of shares of a class or series of shares in exchange for shares pursuant to a plan of merger or share exchange involving each outstanding class and series shall not, in and of itself, entitle holders of the exchanged class or series to vote as a separate voting group, and (ii) if the proposed provision would, as an amendment, entitle two or more classes or series of shares to vote separately but would affect those classes or series in the same or a substantially similar way, the shares of all such classes or series shall, unless the articles of organization provide otherwise, vote together as a single voting group on the plan.

(7) Unless the articles of organization otherwise provide, approval by the corporation's shareholders of a plan of merger or share exchange is not required if:
(i) the corporation will survive the merger or is the acquiring corporation in a share exchange;

(ii) except for amendments permitted by section 10.05, its articles of organization will not be changed;

(iii) each shareholder of the corporation whose shares were outstanding immediately before the effective date of the merger or share exchange will hold the same number of shares, with identical preferences, limitations, and relative rights, immediately after the effective date of change; and

(iv) the shares of any class or series of stock of such corporation to be issued or delivered pursuant to the plan of merger does not exceed 20 per cent of the shares of such corporation of the same class or series outstanding immediately before the effective date of the merger.

(8) If as a result of a merger or share exchange 1 or more shareholders of a domestic corporation would become subject to owner liability for the obligations or liabilities of any other person or entity, approval of the plan of merger shall require the execution, by each such shareholder, of a separate written consent to become subject to such owner liability.

§ 11.05. MERGER BETWEEN PARENT AND SUBSIDIARY OR BETWEEN SUBSIDIARIES

(a) A domestic parent corporation that owns shares of a domestic or foreign subsidiary corporation that carry at least 90 per cent of the voting power of each class and series of the outstanding shares of the subsidiary that have voting power may merge the subsidiary into

itself or into another such subsidiary, or merge itself into the subsidiary, without the approval of the board of directors or shareholders of the subsidiary, unless the articles of organization of any of the corporations otherwise provide, and unless, in the case of a foreign subsidiary, approval by the subsidiary's board of directors or shareholders is required by the laws under which the subsidiary is organized.

(b) If under subsection (a) approval of a merger by the subsidiary's shareholders is not required, the parent corporation shall, within 10 days after the effective date of the merger, notify each of the subsidiary's shareholders that a merger has become effective.

(c) Except as provided in subsections (a) and (b), a merger between a parent and subsidiary shall be governed by PART 11 applicable to mergers generally.

§ 11.06. ARTICLES OF MERGER OR SHARE EXCHANGE

(a) After a plan of merger or share exchange has been adopted and approved as required by this chapter, articles of merger or share exchange shall be executed on behalf of each party to the merger or share exchange by any officer or other duly authorized representative. The articles shall set forth:
(1) the names of the parties to the merger or share exchange and the date on which the merger or share exchange occurred or is to be effective;

(2) if the articles of organization of the survivor of a merger are amended, or if a new corporation is created as a result of a merger, the amendments to the survivor's articles of organization or the articles of organization of the new corporation;

(3) if the plan of merger or share exchange required approval by the shareholders of a domestic corporation that was a party to the merger or share exchange, a statement that the plan was duly approved by the shareholders and, if voting by any separate voting group was required, by each such separate voting group, in the manner required by this chapter and the articles of organization;

(4) if the plan of merger or share exchange did not require approval by the shareholders of a domestic corporation that was a party to the merger or share exchange, a statement to that effect; and

(5) as to each foreign corporation and each other entity that was a party to the merger or share exchange, a statement that the participation of the foreign corporation or other entity was duly authorized by the laws under which the corporation or other entity is organized or by which it is governed and by all action required by such laws, and by its articles of organization or other organizational documents.

(b) Articles of merger or share exchange shall be delivered to the secretary of state for filing by the survivor of the merger or the acquiring corporation in a share exchange and shall take effect at the effective time provided in section 1.23.

(c) The survivor of the merger or share exchange shall file a copy of the articles of merger or share exchange certified by the state secretary in the registry of deeds in each district within the commonwealth in which real property of any constituent corporation is situated, except that no filing need be made with respect to real property of a constituent corporation which is the survivor. The effectiveness of the merger or share exchange shall not be affected by this requirement.

§ 11.07. EFFECT OF MERGER OR SHARE EXCHANGE

a) When a merger becomes effective:

(1) the corporation or other entity that is designated in the plan of merger as the survivor continues or comes into existence, as the case may be;

(2) the separate existence of every corporation or other entity that is merged into the survivor ceases;

(3) all property owned by, and every contract right possessed by each corporation or other entity that merges into the survivor is vested in the survivor without reversion or impairment;
(4) all liabilities of each corporation or other entity that is merged into the survivor are vested in the survivor;

(5) the name of the survivor may, but need not be, substituted in any pending proceeding for the name of any party to the merger whose separate existence ceased in the merger;

(6) the articles of organization or organizational documents of the survivor are amended to the extent provided in the plan of merger;

(7) the articles of organization or organizational documents of a survivor that is created by the merger become effective; and

(8) the shares of each corporation that is a party to the merger, and the interests in an other entity that is a party to a merger, that are to be converted under the plan of merger into shares, interests, obligations, rights to acquire securities, other securities, cash, other property, or any combination of the foregoing, are converted, and the former holders of such shares or interests are entitled only to the rights provided to them in the plan of merger or to any rights they may have under PART 13.

(b) When a share exchange becomes effective, the shares of each domestic corporation that are to be exchanged for shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, are entitled only to the rights provided to them in the plan of share exchange or to any rights they may have under PART 13.

(c) A person who becomes subject to owner liability for some or all of the debts, obligations

or liabilities of any entity as a result of a merger or share exchange shall have owner liability only to the extent provided in the organic law of the entity and only for those debts, obligations and liabilities that arise after the effective time of the articles of merger or share exchange.

(d) Upon a merger becoming effective, a foreign corporation, or a foreign other entity, that is the survivor of the merger is deemed:

(1) unless, in the case of a foreign corporation, it is qualified as a foreign corporation under PART 15 after the effectiveness of the merger, to revoke the authority of its registered agent to accept service on its behalf and appoint the secretary of state as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in the commonwealth and to appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders of each domestic corporation that is a party to the merger who exercise appraisal rights, and

(2) to agree that it will promptly pay the amount, if any, to which such shareholders are entitled under PART 13.
(e) The effect of a merger or share exchange on the owner liability of a person who had owner liability for some or all of the debts, obligations or liabilities of a party to the plan of merger or share exchange shall be as follows:

(1) The merger or share exchange does not discharge any owner liability under the organic law of the entity in which the person was a shareholder or interest holder to the extent any such owner liability arose before the effective time of the articles of merger or share exchange.

(2) The person shall not have owner liability under the organic law of the entity in which the person was a shareholder or interest holder before the merger or share exchange for any debt, obligation or liability that arises after the effective time of the articles of merger or share exchange.

(3) The organic law of any entity for which the person had owner liability before the merger or share exchange shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the merger or share exchange had not occurred.

(4) The person shall have whatever rights of contribution from other persons are provided by the organic law of the entity for which the person had owner liability with respect to any owner liability preserved by paragraph (1), as if the merger or share exchange had not occurred.

§ 11.08. ABANDONMENT OF A MERGER OR SHARE EXCHANGE

(a) Unless otherwise provided in a plan of merger or share exchange or in the laws under which a foreign corporation or a domestic or foreign other entity that is a party to a merger or

a share exchange is organized or by which it is governed, after the plan has been adopted and approved as required by this chapter, and at any time before the merger or share exchange has become effective, it may be abandoned by any party thereto without action by the party's shareholders or owners of interests, in accordance with any procedures set forth in the plan of merger or share exchange or, if no such procedures are set forth in the plan, in the manner determined by the board of directors of a corporation, or the managers of an other entity, subject to any contractual rights of other parties to the merger or share exchange.

(b) If a merger or share exchange is abandoned under subsection (a) after articles of merger or share exchange have been filed with the secretary of state but before the merger or share exchange has become effective, a statement that the merger or share exchange has been abandoned in accordance with this section, executed on behalf of a party to the merger or share exchange by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the merger or share exchange. Upon filing, the statement shall take effect and the merger or share exchange shall be deemed abandoned and shall not become effective.

§ 12.01. SALE OF ASSETS IN REGULAR COURSE OF BUSINESS AND MORTGAGE OF ASSETS

(a) A corporation may, on the terms and conditions and for the consideration determined by the board of directors:

(1) sell, lease, exchange, or otherwise dispose of all, or substantially all, of its property in the usual and regular course of business;

(2) mortgage, pledge, including any sale upon foreclosure of such pledge, dedicate to the repayment of indebtedness, whether with or without recourse, or otherwise encumber all or substantially all of its property whether or not in the usual and regular course of business;

(3) transfer all, or substantially all, of its property to another corporation all of the shares of which are owned, directly or indirectly, by the corporation; or

(4) distribute assets pro rata to the holders of 1 or more classes or series of the corporation's shares.

(b) Unless the articles of organization require it, approval by the shareholders of a transaction described in subsection (a) is not required.

§ 12.02. SALE OF ASSETS OTHER THAN IN REGULAR COURSE OF BUSINESS

(a) A corporation may sell, lease, exchange, or otherwise dispose of all, or substantially all, of its property, otherwise than in the usual and regular course of business, on the terms and conditions and for the consideration determined by the corporation's board of directors, if the board of directors proposes and the shareholders entitled to vote approve the proposed transaction.

(b) The board of directors may condition its submission of the proposed transaction to the

shareholders on any basis.

(c) When seeking the approval of the shareholders, the corporation shall notify each shareholder, whether or not entitled to vote, of the proposed shareholders' meeting in accordance with section 7.05. The notice shall also state that the purpose, or 1 of the purposes, of the meeting is to consider the sale, lease, exchange or other disposition, as the case may be, of all, or substantially all, the property of the corporation, otherwise than in the usual and regular course of business, and shall contain or be accompanied by a description of the proposed transaction.

(d) The shareholders may approve the terms and conditions of the proposed transaction, and the consideration to be received by the corporation, as previously determined by the board of directors or may fix, or authorize the board of directors to fix, the terms and conditions of the proposed transaction and the consideration to be received by the corporation.
(e) Unless (1) a greater percentage vote, or one or more additional separate voting groups, is required by the articles of organization, pursuant to subsection (a) of section 7.27, by the bylaws, pursuant to section 10.21, or by the board of directors, acting pursuant to subsection (c) of section 12.02, or (2) the articles provide for a lesser percentage vote, in accordance with subsection (b) of section 7.27, approval of the transaction requires the affirmative vote of two-thirds of all the shares entitled generally to vote on the matter by the articles of organization, and in addition two-thirds of the shares in any voting group entitled to vote separately on the matter by the articles, by the bylaws, or by action of the board of directors pursuant to subsection (c) of section 12.02.

(f) After such a transaction is approved by shareholders, but before it has been consummated, it may be abandoned by the corporation without further shareholder action, subject to any contractual rights which may have arisen.

(g) A transaction that constitutes a pro rata distribution of the corporation's property to its shareholders is governed by section 6.40 and not by this section.

§ 13.01. DEFINITIONS
In this PART the following words shall have the following meanings unless the context requires otherwise:

"Affiliate", any person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control of or with another person.

"Beneficial shareholder", the person who is a beneficial owner of shares held in a voting trust or by a nominee as the record shareholder.

"Corporation", the issuer of the shares held by a shareholder demanding appraisal and, for matters covered in sections 13.22 to 13.31, inclusive, includes the surviving entity in a merger.

"Fair value", with respect to shares being appraised, the value of the shares immediately before the effective date of the corporate action to which the shareholder demanding appraisal objects, excluding any element of value arising from the expectation or accomplishment of the proposed corporate action unless exclusion would be inequitable.

"Interest", interest from the effective date of the corporate action until the date of payment, at the average rate currently paid by the corporation on its principal bank loans or, if none, at a rate that is fair and equitable under all the circumstances.

"Marketable securities", securities held of record by, or by financial intermediaries or depositories on behalf of, at least 1,000 persons and which were

(a) listed on a national securities exchange,

(b) designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc., or

(c) listed on a regional securities exchange or traded in an interdealer quotation system or other trading system and had at least 250,000 outstanding shares, exclusive of shares held by officers, directors and affiliates, which have a market value of at least $5,000,000.

"Officer", the chief executive officer, president, chief operating officer, chief financial officer, and any vice president in charge of a principal business unit or function of the issuer.

"Person", any individual, corporation, partnership, unincorporated association or other entity.

"Record shareholder", the person in whose name shares are registered in the records of a corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with a corporation.

"Shareholder", the record shareholder or the beneficial shareholder.

§ 13.02. RIGHT TO APPRAISAL

(a) A shareholder is entitled to appraisal rights, and obtain payment of the fair value of his shares in the event of, any of the following corporate or other actions:

(1) consummation of a plan of merger to which the corporation is a party if shareholder approval is required for the merger by section 11.04 or the articles of organization or if the corporation is a subsidiary that is merged with its parent under section 11.05, unless, in either case, (A) all shareholders are to receive only cash for their shares in amounts equal to what they would receive upon a dissolution of the corporation or, in the case of shareholders already holding marketable securities in the merging corporation, only marketable securities of the surviving corporation and/or cash and (B) no director, officer or controlling shareholder has a direct or indirect material financial interest in the merger other than in his capacity as (i) a shareholder of the corporation, (ii) a director, officer, employee or consultant

of either the merging or the surviving corporation or of any affiliate of the surviving corporation if his financial interest is pursuant to bona fide arrangements with either corporation or any such affiliate, or (iii) in any other capacity so long as the shareholder owns not more than five percent of the voting shares of all classes and series of the corporation in the aggregate;

(2) consummation of a plan of share exchange in which his shares are included unless: (A) both his existing shares and the shares, obligations or other securities to be acquired are marketable securities; and (B) no director, officer or controlling shareholder has a direct or indirect material financial interest in the share exchange other than in his capacity as (i) a shareholder of the corporation whose shares are to be exchanged, (ii) a director, officer, employee or consultant of either the corporation whose shares are to be exchanged or the acquiring corporation or of any affiliate of the acquiring corporation if his financial interest is pursuant to bona fide arrangements with either corporation or any such affiliate, or (iii) in any other capacity so long as the shareholder owns not more than five percent of the voting shares of all classes and series of the corporation whose shares are to be exchanged in the aggregate;

(3) consummation of a sale or exchange of all, or substantially all, of the property of the corporation if the sale or exchange is subject to section 12.02, or a sale or exchange of all, or substantially all, of the property of a corporation in dissolution, unless:

(i) his shares are then redeemable by the corporation at a price not greater than the cash to be received in exchange for his shares; or

(ii) the sale or exchange is pursuant to court order; or

(iii) in the case of a sale or exchange of all or substantially all the property of the corporation subject to section 12.02, approval of shareholders for the sale or exchange is conditioned upon the dissolution of the corporation and the distribution in cash or, if his shares are marketable securities, in marketable securities and/or cash, of substantially all of its net assets, in excess of a reasonable amount reserved to meet unknown claims under section 14.07, to the shareholders in accordance with their respective interests within one year after the sale or exchange and no director, officer or controlling shareholder has a direct or indirect material financial interest in the sale or exchange other than in his capacity as (i) a shareholder of the corporation, (ii) a director, officer, employee or consultant of either the corporation or the acquiring corporation or of any affiliate of the acquiring corporation if his financial interest is pursuant to bona fide arrangements with either corporation or any such affiliate, or (iii) in any other capacity so long as the shareholder owns not more than five percent of the voting shares of all classes and series of the corporation in the aggregate;

(4) an amendment of the articles of organization that materially and adversely affects rights in respect of a shareholder's shares because it:

(i) creates, alters or abolishes the stated rights or preferences of the shares with respect to

distributions or to dissolution, including making non-cumulative in whole or in part a dividend theretofore stated as cumulative;

(ii) creates, alters or abolishes a stated right in respect of conversion or redemption, including any provision relating to any sinking fund or purchase, of the shares;

(iii) alters or abolishes a preemptive right of the holder of the shares to acquire shares or other securities;

(iv) excludes or limits the right of the holder of the shares to vote on any matter, or to cumulate votes, except as such right may be limited by voting rights given to new shares then being authorized of an existing or new class; or
(v) reduces the number of shares owned by the shareholder to a fraction of a share if the fractional share so created is to be acquired for cash under section 6.04;

(5) an amendment of the articles of organization or of the bylaws or the entering into by the corporation of any agreement to which the shareholder is not a party that adds restrictions on the transfer or registration or any outstanding shares held by the shareholder or amends any pre-existing restrictions on the transfer or registration of his shares in a manner which is materially adverse to the ability of the shareholder to transfer his shares;

(6) any corporate action taken pursuant to a shareholder vote to the extent the articles of organization, bylaws or a resolution of the board of directors provides that voting or nonvoting shareholders are entitled to appraisal;

(7) consummation of a conversion of the corporation to nonprofit status pursuant to subdivision B of PART 9; or

(8) consummation of a conversion of the corporation into a form of other entity pursuant to subdivision D of PART 9.

(b) Except as otherwise provided in subsection (a) of section 13.03, in the event of corporate action specified in clauses (1), (2), (3), (7) or (8) of subsection (a), a shareholder may assert appraisal rights only if he seeks them with respect to all of his shares of whatever class or series.

(c) Except as otherwise provided in subsection (a) of section 13.03, in the event of an amendment to the articles of organization specified in clause (4) of subsection (a) or in the event of an amendment of the articles of organization or the bylaws or an agreement to which the shareholder is not a party specified in clause (5) of subsection (a), a shareholder may assert appraisal rights with respect to those shares adversely affected by the amendment or agreement only if he seeks them as to all of such shares and, in the case of an amendment to the articles of organization or the bylaws, has not voted any of his shares of any class or series in favor of the proposed amendment.

(d) The shareholder's right to obtain payment of the fair value of his shares shall terminate upon the occurrence of any of the following events:

(i) the proposed action is abandoned or rescinded; or

(ii) a court having jurisdiction permanently enjoins or sets aside the action; or

(iii) the shareholder's demand for payment is withdrawn with the written consent of the corporation.

(e) A shareholder entitled to appraisal rights under this chapter may not challenge the action creating his entitlement unless the action is unlawful or fraudulent with respect to the shareholder or the corporation.

§ 13.03. ASSERTION OF RIGHTS BY NOMINEES AND BENEFICIAL OWNERS
(a) A record shareholder may assert appraisal rights as to fewer than all the shares registered in the record shareholder's name but owned by a beneficial shareholder only if the record shareholder objects with respect to all shares of the class or series owned by the beneficial shareholder and notifies the corporation in writing of the name and address of each beneficial shareholder on whose behalf appraisal rights are being asserted. The rights of a record shareholder who asserts appraisal rights for only part of the shares held of record in the record shareholder's name under this subsection shall be determined as if the shares as to which the record shareholder objects and the record shareholder's other shares were registered in the names of different record shareholders.

(b) A beneficial shareholder may assert appraisal rights as to shares of any class or series held on behalf of the shareholder only if such shareholder:

(1) submits to the corporation the record shareholder's written consent to the assertion of such rights no later than the date referred to in subclause (ii) of clause (2) of subsection (b) of section 13.22; and

(2) does so with respect to all shares of the class or series that are beneficially owned by the beneficial shareholder.

§ 13.20. NOTICE OF APPRAISAL RIGHTS
(a) If proposed corporate action described in subsection (a) of section 13.02 is to be submitted to a vote at a shareholders' meeting or through the solicitation of written consents, the meeting notice or solicitation of consents shall state that the corporation has concluded that shareholders are, are not or may be entitled to assert appraisal rights under this chapter and refer to the necessity of the shareholder delivering, before the vote is taken, written notice of his intent to demand payment and to the requirement that he not vote his shares in favor of the proposed action. If the corporation concludes that appraisal rights are or may be available, a copy of this chapter shall accompany the meeting notice sent to those record shareholders entitled to exercise appraisal rights.

(b) In a merger pursuant to section 11.05, the parent corporation shall notify in writing all record shareholders of the subsidiary who are entitled to assert appraisal rights that the corporate action became effective. Such notice shall be sent within 10 days after the corporate action became effective and include the materials described in section 13.22.

§ 13.21. NOTICE OF INTENT TO DEMAND PAYMENT

(a) If proposed corporate action requiring appraisal rights under section 13.02 is submitted to vote at a shareholders' meeting, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares:

(1) shall deliver to the corporation before the vote is taken written notice of the shareholder's intent to demand payment if the proposed action is effectuated; and

(2) shall not vote, or cause or permit to be voted, any shares of such class or series in favor of the proposed action.

(b) A shareholder who does not satisfy the requirements of subsection (a) is not entitled to payment under this chapter.

§ 13.22. APPRAISAL NOTICE AND FORM

(a) If proposed corporate action requiring appraisal rights under subsection (a) of section 13.02 becomes effective, the corporation shall deliver a written appraisal notice and form required by clause (1) of subsection (b) to all shareholders who satisfied the requirements of section 13.21 or, if the action was taken by written consent, did not consent. In the case of a merger under section 11.05, the parent shall deliver a written appraisal notice and form to all record shareholders who may be entitled to assert appraisal rights.

(b) The appraisal notice shall be sent no earlier than the date the corporate action became effective and no later than 10 days after such date and must:

(1) supply a form that specifies the date of the first announcement to shareholders of the principal terms of the proposed corporate action and requires the shareholder asserting appraisal rights to certify (A) whether or not beneficial ownership of those shares for which appraisal rights are asserted was acquired before that date and (B) that the shareholder did not vote for the transaction;

(2) state:

(i) where the form shall be sent and where certificates for certificated shares shall be deposited and the date by which those certificates shall be deposited, which date may not be earlier than the date for receiving the required form under subclause (ii);

(ii) a date by which the corporation shall receive the form which date may not be fewer than 40 nor more than 60 days after the date the subsection (a) appraisal notice and form are sent, and state that the shareholder shall have waived the right to demand appraisal with respect to

the shares unless the form is received by the corporation by such specified date;

(iii) the corporation's estimate of the fair value of the shares;

(iv) that, if requested in writing, the corporation will provide, to the shareholder so requesting, within 10 days after the date specified in clause (ii) the number of shareholders who return the forms by the specified date and the total number of shares owned by them; and
(v) the date by which the notice to withdraw under section 13.23 shall be received, which date shall be within 20 days after the date specified in subclause (ii) of this subsection; and

(3) be accompanied by a copy of this chapter.

§ 13.23. PERFECTION OF RIGHTS; RIGHT TO WITHDRAW
(a) A shareholder who receives notice pursuant to section 13.22 and who wishes to exercise appraisal rights shall certify on the form sent by the corporation whether the beneficial owner of the shares acquired beneficial ownership of the shares before the date required to be set forth in the notice pursuant to clause (1) of subsection (b) of section 13.22. If a shareholder fails to make this certification, the corporation may elect to treat the shareholder's shares as after-acquired shares under section 13.25. In addition, a shareholder who wishes to exercise appraisal rights shall execute and return the form and, in the case of certificated shares, deposit the shareholder's certificates in accordance with the terms of the notice by the date referred to in the notice pursuant to subclause (ii) of clause (2) of subsection (b) of section 13.22. Once a shareholder deposits that shareholder's certificates or, in the case of uncertificated shares, returns the executed forms, that shareholder loses all rights as a shareholder, unless the shareholder withdraws pursuant to said subsection (b).

(b) A shareholder who has complied with subsection (a) may nevertheless decline to exercise appraisal rights and withdraw from the appraisal process by so notifying the corporation in writing by the date set forth in the appraisal notice pursuant to subclause (v) of clause (2) of subsection (b) of section 13.22. A shareholder who fails to so withdraw from the appraisal process may not thereafter withdraw without the corporation's written consent.

(c) A shareholder who does not execute and return the form and, in the case of certificated shares, deposit that shareholder's share certificates where required, each by the date set forth in the notice described in subsection (b) of section 13.22, shall not be entitled to payment under this chapter.

§ 13.24. PAYMENT
(a) Except as provided in section 13.25, within 30 days after the form required by subclause (ii) of clause (2) of subsection (b) of section 13.22 is due, the corporation shall pay in cash to those shareholders who complied with subsection (a) of section 13.23 the amount the corporation estimates to be the fair value of their shares, plus interest.

(b) The payment to each shareholder pursuant to subsection (a) shall be accompanied by:

(1) financial statements of the corporation that issued the shares to be appraised, consisting of a balance sheet as of the end of a fiscal year ending not more than 16 months before the date of payment, an income statement for that year, a statement of changes in shareholders' equity for that year, and the latest available interim financial statements, if any;
(2) a statement of the corporation's estimate of the fair value of the shares, which estimate shall equal or exceed the corporation's estimate given pursuant to subclause (iii) of clause (2) of subsection (b) of section 13.22; and

(3) a statement that shareholders described in subsection (a) have the right to demand further payment under section 13.26 and that if any such shareholder does not do so within the time period specified therein, such shareholder shall be deemed to have accepted the payment in full satisfaction of the corporation's obligations under this chapter.

§ 13.25. AFTER-ACQUIRED SHARES

(a) A corporation may elect to withhold payment required by section 13.24 from any shareholder who did not certify that beneficial ownership of all of the shareholder's shares for which appraisal rights are asserted was acquired before the date set forth in the appraisal notice sent pursuant to clause (1) of subsection (b) of section 13.22.

(b) If the corporation elected to withhold payment under subsection (a), it must, within 30 days after the form required by subclause (ii) of clause (2) of subsection (b) of section 13.22 is due, notify all shareholders who are described in subsection (a):

(1) of the information required by clause (1) of subsection (b) of section 13.24;

(2) of the corporation's estimate of fair value pursuant to clause (2) of subsection (b) of said section 13.24;

(3) that they may accept the corporation's estimate of fair value, plus interest, in full satisfaction of their demands or demand appraisal under section 13.26;

(4) that those shareholders who wish to accept the offer shall so notify the corporation of their acceptance of the corporation's offer within 30 days after receiving the offer; and

(5) that those shareholders who do not satisfy the requirements for demanding appraisal under section 13.26 shall be deemed to have accepted the corporation's offer.

(c) Within 10 days after receiving the shareholder's acceptance pursuant to subsection(b), the corporation shall pay in cash the amount it offered under clause (2) of subsection (b) to each shareholder who agreed to accept the corporation's offer in full satisfaction of the shareholder's demand.

(d) Within 40 days after sending the notice described in subsection (b), the corporation must

pay in cash the amount if offered to pay under clause (2) of subsection (b) to each shareholder deserved in clause (5) of subsection (b).

§ 13.26. PROCEDURE IF SHAREHOLDER DISSATISFIED WITH PAYMENT OR OFFER

(a) A shareholder paid pursuant to section 13.24 who is dissatisfied with the amount of the payment shall notify the corporation in writing of that shareholder's estimate of the fair value of the shares and demand payment of that estimate plus interest, less any payment under section 13.24. A shareholder offered payment under section 13.25 who is dissatisfied with that offer shall reject the offer and demand payment of the shareholder's stated estimate of the fair value of the shares plus interest.

(b) A shareholder who fails to notify the corporation in writing of that shareholder's demand to be paid the shareholder's stated estimate of the fair value plus interest under subsection (a) within 30 days after receiving the corporation's payment or offer of payment under section 13.24 or section 13.25, respectively, waives the right to demand payment under this section and shall be entitled only to the payment made or offered pursuant to those respective sections.

§ 13.30. COURT ACTION

(a) If a shareholder makes demand for payment under section 13.26 which remains unsettled, the corporation shall commence an equitable proceeding within 60 days after receiving the payment demand and petition the court to determine the fair value of the shares and accrued interest. If the corporation does not commence the proceeding within the 60-day period, it shall pay in cash to each shareholder the amount the shareholder demanded pursuant to section 13.26 plus interest.

(b) The corporation shall commence the proceeding in the appropriate court of the county where the corporation's principal office, or, if none, its registered office, in the commonwealth is located. If the corporation is a foreign corporation without a registered office in the commonwealth, it shall commence the proceeding in the county in the commonwealth where the principal office or registered office of the domestic corporation merged with the foreign corporation was located at the time of the transaction.

(c) The corporation shall make all shareholders, whether or not residents of the commonwealth, whose demands remain unsettled parties to the proceeding as an action against their shares, and all parties shall be served with a copy of the petition. Nonresidents may be served by registered or certified mail or by publication as provided by law or otherwise as ordered by the court.

(d) The jurisdiction of the court in which the proceeding is commenced under subsection (b) is plenary and exclusive. The court may appoint 1 or more persons as appraisers to receive evidence and recommend a decision on the question of fair value. The appraisers shall have the powers described in the order appointing them, or in any amendment to it. The shareholders demanding appraisal rights are entitled to the same discovery rights as parties in

other civil proceedings.

(e) Each shareholder made a party to the proceeding is entitled to judgment (i) for the amount, if any, by which the court finds the fair value of the shareholder' s shares, plus interest, exceeds the amount paid by the corporation to the shareholder for such shares or (ii) for the fair value, plus interest, of the shareholder's shares for which the corporation elected to withhold payment under section 13.25.

§ 13.31. COURT COSTS AND COUNSEL FEES

(a) The court in an appraisal proceeding commenced under section 13.30 shall determine all costs of the proceeding, including the reasonable compensation and expenses of appraisers appointed by the court. The court shall assess the costs against the corporation, except that the court may assess cost against all or some of the shareholders demanding appraisal, in amounts the court finds equitable, to the extent the court finds such shareholders acted arbitrarily, vexatiously, or not in good faith with respect to the rights provided by this chapter.

(b) The court in an appraisal proceeding may also assess the fees and expenses of counsel and experts for the respective parties, in amounts the court finds equitable:

(1) against the corporation and in favor of any or all shareholders demanding appraisal if the court finds the corporation did not substantially comply with the requirements of sections 13.20, 13.22, 13.24 or 13.25; or

(2) against either the corporation or a shareholder demanding appraisal, in favor of any other party, if the court finds that the party against whom the fees and expenses are assessed acted arbitrarily, vexatiously, or not in good faith with respect to the rights provided by this chapter.

(c) If the court in an appraisal proceeding finds that the services of counsel for any shareholder were of substantial benefit to other shareholders similarly situated, and that the fees for those services should not be assessed against the corporation, the court may award to such counsel reasonable fees to be paid out of the amounts awarded the shareholders who were benefited.

(d) To the extent the corporation fails to make a required payment pursuant to sections 13.24, 13.25, or 13.26, the shareholder may sue directly for the amount owed and, to the extent successful, shall be entitled to recover from the corporation all costs and expenses of the suit, including counsel fees.

§ 14.01. DISSOLUTION BY INCORPORATORS OR INITIAL DIRECTORS

A majority of the incorporators or initial directors of a corporation that has not issued shares or has not commenced business may dissolve the corporation by delivering to the secretary of state for filing articles of dissolution that set forth:

(1) the name of the corporation;

(2) the date of its incorporation;

(3) either (i) that none of the corporation's shares has been issued or (ii) that the corporation has not commenced business;
(4) that no debt of the corporation remains unpaid;

(5) that the net assets of the corporation remaining after winding up have been distributed to the shareholders, if shares were issued; and

(6) that a majority of the incorporators or initial directors authorized the dissolution.

§ 14.02. DISSOLUTION BY BOARD OF DIRECTORS AND SHAREHOLDERS, OR OTHERWISE IN ACCORDANCE WITH ARTICLES OF ORGANIZATION

(a) A corporation may voluntarily authorize dissolution by any method or procedure specified in its articles of organization. The articles of organization may condition the availability of the method or procedure on any basis. Notwithstanding anything else contained in this subsection, any provision in the articles of organization adopted pursuant to this subsection shall cease to be effective when shares of the corporation are listed on a national securities exchange or regularly traded in a market maintained by 1 or more members of a national or affiliated securities association. If a provision of the articles of organization ceases to be effective for any reason, the board of directors may, without shareholder action, adopt an amendment to the articles of organization, and, if appropriate, to the bylaws of the corporation, to delete such a provision and any references to it.

(b) In the absence of any specified methods or procedures in the articles of organization, and in addition to any methods or procedures so specified unless the articles of organization state that the specified methods or procedures are exclusive, a corporation may voluntarily authorize dissolution as follows:

(1) the board of directors shall submit a proposal for and terms of the proposed dissolution to the shareholders; and

(2) the shareholders entitled to vote shall approve the dissolution as provided in subsection (e).

(c) The board of directors may condition any submission to the shareholders of a proposal for dissolution under subsection (b) on any basis.

(d) The corporation shall notify each shareholder, whether or not entitled to vote, of the proposed shareholders' meeting, in connection with any submission of a proposal for dissolution under subsection (b), in accordance with section 7.05. The notice shall also state that the purpose, or one of the purposes, of the meeting is to consider dissolving the corporation.

(e) Unless (1) a greater percentage vote, or the vote of one or more additional separate voting groups, is required by the articles of organization, pursuant to subsection (a) of section 7.27, by the bylaws, pursuant to section 10.21, or by the board of directors, acting pursuant to subsection (c) of this section, or (2) the articles provide for a lesser percentage vote, in accordance with subsection (b) of section 7.27, and subject, except as otherwise permitted by subsection (a) of this section, to the requirement that such lesser percentage be not less than a majority of all the votes entitled to be cast on the proposal, adoption of the proposal to dissolve requires approval by two-thirds of all the votes entitled generally to be cast on the matter by the articles of organization.

§ 14.03. ARTICLES OF DISSOLUTION

(a) At any time after dissolution is authorized, the corporation may dissolve by delivering to the secretary of state for filing articles of dissolution setting forth:

(1) the name of the corporation;

(2) the date dissolution was authorized;

(3) if dissolution was approved by the shareholders under subsection (b) of section 14.02:

(i) the number of votes entitled to be cast on the proposal to dissolve; and

(ii) either the total number of votes cast for and against dissolution or the total number of undisputed votes cast for dissolution and a statement that the number cast for dissolution was sufficient for approval.

(4) If voting by voting groups was required on a dissolution proposal under subsection (b) of section 14.02, the information required by subparagraph (3) of this section shall be separately provided for each voting group entitled to vote separately on the proposal to dissolve.

(5) If dissolution was authorized by a method or procedure specified in the articles of organization pursuant to subsection (a) of section 14.02, the articles of dissolution shall set forth such method or procedure, together with sufficient information to establish that the corporation has complied therewith.

(b) A corporation is dissolved upon the effective date of its articles of dissolution.

§ 14.04. REVOCATION OF DISSOLUTION

(a) A corporation may revoke its dissolution within 120 days of its effective date.

(b) Revocation of a dissolution under subsection (b) of section 14.02 shall be authorized in the same manner as the dissolution was authorized unless that authorization permitted revocation by action of the board of directors alone, in which event the board of directors may revoke the dissolution without shareholder action. Revocation of a dissolution under

subsection (a) of section 14.02 may be authorized only as specifically contemplated by the articles of organization.

(c) After the revocation of dissolution is authorized, the corporation may revoke the dissolution by delivering to the secretary of state for filing articles of revocation of dissolution, together with a copy of its articles of dissolution, that set forth:
(1) the name of the corporation;

(2) the effective date of the dissolution that was revoked;

(3) the date that the revocation of dissolution was authorized;

(4) if the corporation's board of directors, or incorporators, revoked the dissolution, a statement to that effect;

(5) if the corporation's board of directors revoked a dissolution authorized by the shareholders under subsection (b) of section 14.02, a statement that revocation was permitted by action by the board of directors alone pursuant to that authorization;

(6) if shareholder action was required under subsection (b) of section 14. 02 to revoke the dissolution, the information required by clauses (3) or (4) of subsection (a) of section 14.03; and

(7) if the dissolution being revoked was authorized under subsection (a) of section 14.02, sufficient information to establish that the corporation has complied with the provisions of its articles of organization governing such revocation.

(d) Revocation of dissolution is effective upon the effective date of the articles of revocation of dissolution.

(e) When the revocation of dissolution is effective, it relates back to and takes effect as of the effective date of the dissolution and the corporation resumes carrying on its business as if dissolution had never occurred.

§ 14.05. EFFECT OF DISSOLUTION
(a) A dissolved corporation continues its corporate existence but may not carry on any business except such as is necessary in connection with winding up and liquidating its business and affairs, including:

(1) collecting its assets;

(2) disposing of its properties that will not be distributed in kind to its shareholders;

(3) making adequate provision, by payment or otherwise, and after giving effect to the provisions of sections 14.06, 14.07 and 14.08, for all of the corporation's existing and

reasonably foreseeable debts, liabilities, and obligations, whether or not liquidated, matured, asserted, or contingent;

(4) distributing its remaining property among its shareholders according to their interests; and

(5) doing every other act necessary to wind up and liquidate its business and affairs.
(b) Dissolution of a corporation shall not:

(1) transfer title to the corporation's property;

(2) prevent transfer of its shares or securities, although the authorization to dissolve may provide for closing the corporation's share transfer records;

(3) subject its directors or officers to standards of conduct different from those prescribed in PART 8;

(4) change quorum or voting requirements for its board of directors or shareholders; change provisions for selection, resignation, or removal of its directors or officers or both; or change provisions for amending its bylaws;

(5) prevent commencement of a proceeding by or against the corporation in its corporate name;

(6) abate or suspend a proceeding pending by or against the corporation on the effective date of dissolution; or

(7) terminate the authority of the registered agent of the corporation.

§ 14.06. KNOWN NON-CONTINGENT CLAIMS AGAINST DISSOLVED CORPORATION

(a) With respect to any non-contingent claim against the corporation, whether or not matured, known to the corporation at any time prior to the end of the 3- year period specified in clause (3) of subsection (b) of section 14.07, to the extent that the corporation in good faith disputes the claim, a dissolved corporation may, subject to paragraph (f), limit the assets out of which the claim may be satisfied to the assets retained by the corporation plus, to the extent provided in section 6.41, any assets distributed to its shareholders within 3 years after the effective date of the corporation's dissolution, by following the procedure described in this section.

(b) The dissolved corporation may send notice in writing of the dissolution at any time after its effective date to any known claimant whose claim the corporation disputes in whole or in part. The written notice shall:

(1) include a copy or a summary of this section;

(2) state the amount of the claim that is disputed;

(3) state that the assets out of which the claim may be satisfied shall be limited as provided in subsection (c) unless a statement of the claim is received within the deadline specified in the notice by which the dissolved corporation shall receive the statement of the claim, which deadline may not be earlier than 3 years after the effective date of the corporation's dissolution or 120 days after the effective date of the written notice, whichever is later;

(4) describe the information that shall be included in the statement of the claim; and

(5) provide the mailing address to which the statement shall be sent.

(c) To the extent that the corporation in good faith disputes any non-contingent claim against the corporation, whether or not matured, known to the corporation at any time before the end of the 3-year period specified in clause (3) of subsection (b) of section 14.07, and if written notice of the claim was given under subsection (b), the assets out of which the claim may be satisfied shall be limited, except as provided in subsection (a) of section 14.09, to the assets retained by the corporation plus, to the extent provided in section 6.41, any assets distributed to its shareholders within 3 years after the effective date of the corporation's dissolution:

(1) if a claimant does not deliver a statement of the claim to the dissolved corporation by the specified deadline; or

(2) if a claimant, who has delivered a statement of the claim to the dissolved corporation and the claim was rejected in writing by the dissolved corporation, does not furnish notice to the corporation by the later of the specified deadline and 90 days from the effective date of the rejection notice that the holder intends to commence a proceeding to enforce the claim, and does not actually commence the proceeding by the later of the specified deadline and 270 days from the effective date of the rejection notice.

(d) If a claim described in subsection (a) has not been asserted against the dissolved corporation and the corporation has reason to believe that the claimant is unaware of the claim, the claim shall be considered to be unknown and subject to section 14.07 rather than section 14.06, unless the notice described in subsection (b) contains a reasonable description of the claim the corporation believes the claimant may have.

(e) The giving of notice by the dissolved corporation pursuant to section 14.06 is not evidence or admission of the existence or validity of any claim or amount.

§ 14.07. UNKNOWN CLAIMS AGAINST DISSOLVED CORPORATION

(a) With respect to any unknown claim against the corporation, including unknown contingent claims, a dissolved corporation may limit the assets out of which the claim may be satisfied to the assets retained by the corporation plus, to the extent provided in section 6.41, any assets distributed to its shareholders within three years after the effective date of the corporation's dissolution, by following the procedure described in this section.

(b) The dissolved corporation may publish notice of the dissolution at any time after its effective date, and request that any person with a claim against the corporation send a statement of it in accordance with the notice. The notice shall:
(1) be published 1 time in a newspaper of general circulation in the city, town or county where the dissolved corporation's principal office, or, if none in the state, its registered office, is or was last located and, if such dissolved corporation then has a website, posting the notice on the website until the earlier to occur of 30 days or the discontinuance of such website, and, if the dissolved corporation at the time of its dissolution had a class of securities registered under the Securities Exchange Act of 1934, as amended, in addition at least once in a daily newspaper with national circulation;

(2) describe the information that shall be included in the statement of the claim and provide a mailing address where the statement is to be sent; and

(3) state that the assets out of which any unknown claim against the corporation, including unknown contingent claims, may be satisfied will be limited as provided in subsection (c) unless a statement of the claim is received within three years after the publication of the notice.

(c) If the dissolved corporation follows the procedure in subsection (b), except as provided in subsection (a) of section 14.09,

(1) the assets out of which any unknown claim described in paragraph (a) may be satisfied will be limited to the assets retained by the corporation plus, to the extent provided in section 6.41, any assets distributed to its shareholders within three years after the effective date of the corporation's dissolution, if a statement of the claim is not presented to the corporation within the three-year period specified in clause (3) of subsection (b), and

(2) the assets out of which any previously unknown non-contingent claim which has been presented to the corporation and rejected in writing may be satisfied will be limited as provided in clause (1) of subsection (c) if the claimant does not furnish notice to the corporation by the later of the deadline specified in clause (1) of subsection (c) and 90 days from the effective date of the rejection notice that the holder intends to commence a proceeding to enforce the claim, and does not actually commence the proceeding by the later of the specified deadline and 270 days from the effective date of the rejection notice.

§ 14.08. CREATION OF RESERVES AS ADEQUATE PROVISION FOR UNASSERTED PRODUCT LIABILITY CLAIMS AND KNOWN CONTINGENT CLAIMS AGAINST DISSOLVED CORPORATION

(a) At any time after the end of the 3-year period specified in clause (3) of subsection (b) of section 14.07, it shall constitute adequate provision by a dissolved corporation under subsection (h) of section 6.40 and clause (3) of subsection (a) of section 14.05:

(1) for all unasserted claims for personal injury, wrongful death, loss of consortium or

property damage based upon products or services provided by the corporation which may thereafter be asserted against the corporation, if the corporation
(i) sets aside in a reserve a reasonable amount of its assets, including by purchasing paid-up insurance or obtaining an assumption of liability by a responsible third party, to cover such claims, in compliance with subsection (b), and

(ii) publishes a notice as described in clause (1) of subsection (b) of section 14.07 stating that the corporation has complied with this section 14. 08; and

(2) for all remaining known but still contingent claims against the corporation, if it

(i) creates a separate reserve in accordance with subclause (i) of clause (1) of subsection (a) to cover such claims or increases by a reasonable amount the assets set aside in a reserve for unasserted liability claims specified in clause (1) of subsection (a) and makes such reserve also applicable to known but contingent claims, and

(ii) sends written notice to each holder of a known but still contingent claim against the corporation stating that, pursuant to this section 14.08, if such claim thereafter becomes due and payable and is not paid by the corporation, the assets out of which such claim may be satisfied will be limited as provided in subsection (c).

(b) To meet the requirement of subsection (a) that the amount of assets set aside in a reserve be reasonable, the directors or those acting in their place must comply with the applicable standards of conduct under section 8.30 in determining the amount needed to provide for payment of the category or categories of claims to which such reserve is directed, after taking into account any other claims against the corporation for which the assets in such reserve might be reached because of the lack of other adequate provision.

(c) With respect to any claims described in clause (1) and (2) of subsection (a) not paid by the corporation, upon compliance by the dissolved corporation with subsections (a) and (b), except as provided in section 14.09(a), the assets out of which the claims may be satisfied will be limited to the assets retained by the corporation, including the applicable reserve created pursuant to subsection (a), plus, to the extent provided in section 6.41, any assets distributed to shareholders within 3 years after the effective date of the corporation's dissolution.

§ 14.09. ENFORCEMENT OF CLAIMS AGAINST DISSOLVED CORPORATION
(a) A claim against a dissolved corporation described in sections 14.06, 14.07 or 14.08, and which is not barred under the applicable statute of limitations, may be enforced against the dissolved corporation to the extent of any undistributed assets, including any available assets in a reserve created under section 14.08, any available proceeds under an insurance policy, and any applicable assumption of the dissolved corporation's liabilities by a third party.

(b) The giving of notice and/or the setting aside of any reserve hereunder or otherwise by the dissolved corporation is not an admission of the existence or validity of any claim or amount.

(c) No time periods set forth in sections 14.06, 14.07 or 14.08 extend or shorten any applicable statute of limitations.

(d) No liability shall be imposed upon the dissolved corporation's shareholders or directors, or those acting in their place, under section 6.41 or otherwise with respect to any claim described in sections 14.06, 14.07 or 14.08 if the procedures described in those sections are followed.

§ 14.20. GROUNDS FOR ADMINISTRATIVE DISSOLUTION

The secretary of state may commence a proceeding under section 14.21 to dissolve a corporation administratively if:

(a) the corporation has failed to comply with the provisions of law requiring the filing of reports with the secretary of state or the filing of any tax returns or the payment of any taxes under the General Laws for 2 or more consecutive years; or

(b) the secretary of state is satisfied that the corporation has become inactive and that its dissolution would be in the public interest.

§ 14.21. PROCEDURE FOR AND EFFECT OF ADMINISTRATIVE DISSOLUTION

(a) If the secretary of state determines that one or more grounds exist under section 14.20 for dissolving a corporation, he shall notify the corporation's registered agent of his determination. The notice shall be in writing and mailed postage prepaid to the corporation's registered office, or if the registered agent consents, sent by electronic mail to an electronic mail address furnished by the agent for the purpose.

<[Subsection (b) as added by 2003, 127, Sec. 17 effective July 1, 2004. See 2003, 127, Sec. 24. See also, subsection (b) as added by 2004, 178, Sec. 39, below.]>

(b) If the corporation does not correct each ground for dissolution or demonstrate to the reasonable satisfaction of the secretary of state that each ground determined by the secretary of state does not exist within 90 days after service of the notice is perfected under section 5.04, the secretary of state shall administratively dissolve the corporation.

<[Subsection (b) as added by 2004, 178, Sec. 39 effective July 1, 2004. See 2004, 178, Sec. 49. See also, subsection (b) as added by 2003, 127, Sec. 17, above.]>

(b) If the corporation does not correct each ground for dissolution or demonstrate to the reasonable satisfaction of the secretary of state that each ground determined by the secretary of state does not exist within 90 days after notice is given, the secretary of state shall administratively dissolve the corporation.

<[Subsection (c) does not take effect. Deleted by 2004, 178, Sec. 39. See 2003, 127, Secs. 17 and 24 and 2004, 178, Sec. 49.]>

(c) A corporation administratively dissolved continues its corporate existence but may not carry on any business except that necessary to wind up and liquidate its business and affairs under section 14.05 and notify claimants under sections 14.06, 14.07 and 14.08.

(d) The administrative dissolution of a corporation does not terminate the authority of its registered agent.

§ 14.22. REINSTATEMENT FOLLOWING ADMINISTRATIVE DISSOLUTION

(a) A corporation administratively dissolved under section 14.21 may apply to the secretary of state for reinstatement at any time. The application shall:

(1) recite the name of the corporation and the effective date of its administrative dissolution;

(2) state that the ground or grounds for dissolution either did not exist or have been eliminated;

(3) state that the corporation's name satisfies the requirements of section 4.01; and

(4) contain a certificate from the department of revenue reciting that all corporate excise taxes owed by the corporation, and any related penalties, have been paid.

(b) If the secretary of state determines that the application contains the information required by subsection (a) and that the information is correct, he shall reinstate the corporation.

(c) The secretary of state may subject the reinstatement to such terms and conditions, including the payment of reasonable fees, as in his judgment the public interest may require. He may in his discretion make the reinstatement effective for all purposes or for any specified purpose or purposes, in each case with or without limitation of time. When the reinstatement is effective, if by its terms it is effective for all purposes or if the secretary of state specifies that it shall be effective for purposes of this sentence, then the reinstatement relates back to and takes effect as of the effective date of the administrative dissolution and the corporation resumes carrying on its business as if the administrative dissolution had never occurred, with all its original powers and duties and with liability, for all contracts, acts, matters and things made, done or performed in its name and on its behalf prior to reinstatement, as if the administrative dissolution had never occurred, and with all acts and proceedings of its officers, directors and shareholders, acting or purporting to act as such, which would have been legal and valid but for such dissolution, standing ratified and confirmed, in each case except as otherwise specified by the secretary of state.

(d) The certificate of reinstatement, or other equivalent public record, filed by the secretary of state pursuant to this section shall constitute an amendment of the articles of organization of the corporation, effective when filed. Any specification in the certificate of the purpose or purposes of reinstatement, or of a limitation of the time thereof, may, by further certificate filed as aforesaid, be amended by the secretary of state for cause shown to his satisfaction.

§ 14.23. APPEAL FROM DENIAL OF REINSTATEMENT

(a) If the secretary of state denies a corporation's application for reinstatement following administrative dissolution, he shall serve the corporation under section 5.04 with a written notice that explains the reason or reasons for denial.

(b) The corporation may appeal the denial of reinstatement to the superior court for Suffolk county within 30 days after service of the notice of denial is perfected. The corporation appeals by petitioning the court to set aside the dissolution and attaching to the petition copies of the secretary of state's certificate, or other public record, of dissolution, the corporation's application for reinstatement, and the secretary of state's notice of denial.

(c) The court may summarily order the secretary of state to reinstate the dissolved corporation or may take other action the court considers appropriate.

(d) The court's final decision may be appealed as in other civil proceedings.

§ 14.30. GROUNDS FOR JUDICIAL DISSOLUTION

The superior court located in the county set forth in section 14.31 may dissolve a corporation:

(1) in a proceeding by the attorney general if it is established that:

(i) the corporation obtained its articles of organization through fraud; or

(ii) the corporation has continued to exceed or abuse the authority conferred upon it by law;

(2) upon a petition filed by the shareholders holding not less than 40 per cent of the total combined voting power of all the shares of the corporation's stock outstanding and entitled to vote on the question of dissolution, if it is established that:

(i) the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered; or

(ii) the shareholders are deadlocked in voting power and have failed, for a period that includes at least 2 consecutive annual meeting dates, to elect successors to directors whose terms have expired, or would have expired upon the election of their successors, and irreparable injury to the corporation is threatened or being suffered;

(3) in a proceeding by a creditor if it is established that:
(i) the creditor's claim has been reduced to judgment, the execution on the judgment returned unsatisfied, and the corporation is insolvent; or

(ii) the corporation has admitted in writing that the creditor's claim is due and owing and the corporation is insolvent; or

(4) in a proceeding by the corporation to have its voluntary dissolution continued under court supervision.

§ 14.31. PROCEDURE FOR JUDICIAL DISSOLUTION

(a) Venue for a proceeding by the attorney general to dissolve a corporation lies in Suffolk county. Venue for a proceeding brought by any other party named in section 14.30 lies in the county where a corporation's principal office, or, if none in the commonwealth, its registered office, is or was last located.

(b) It is not necessary to make shareholders parties to a proceeding to dissolve a corporation unless relief is sought against them individually.

(c) A court in a proceeding brought to dissolve a corporation may issue injunctions, appoint a receiver or custodian pendente lite with all powers and duties the court directs, take other action required to preserve the corporate assets wherever located, and carry on the business of the corporation until a full hearing can be held.

§ 14.32. RECEIVERSHIP OR CUSTODIANSHIP

(a) A court in a judicial proceeding brought to dissolve a corporation may appoint 1 or more receivers to wind up and liquidate, or one or more custodians to manage, the business and affairs of the corporation. The court shall hold a hearing, after notifying all parties to the proceeding and any interested persons designated by the court, before appointing a receiver or custodian. The court appointing a receiver or custodian has exclusive jurisdiction over the corporation and all of its property wherever located.

(b) The court may appoint an individual or a domestic or foreign corporation, authorized to transact business in the commonwealth, as a receiver or custodian. The court may require the receiver or custodian to post bond, with or without sureties, in an amount the court directs.

(c) The court shall describe the powers and duties of the receiver or custodian in its appointing order, which may be amended from time to time. Among other powers:

(1) the receiver (i) may dispose of all or any part of the assets of the corporation wherever located, at a public or private sale, if authorized by the court; and (ii) may sue and defend in his own name as receiver of the corporation in all courts of the commonwealth;

(2) the custodian may exercise all of the powers of the corporation, through or in place of its board of directors or officers, to the extent necessary to manage the affairs of the corporation in the best interests of its shareholders and creditors.

(d) The court during a receivership may redesignate the receiver a custodian, and during a custodianship may redesignate the custodian a receiver, if doing so is in the best interests of the corporation, its shareholders, and creditors.

(e) The court from time to time during the receivership or custodianship may order

compensation paid and expense disbursements or reimbursements made to the receiver or custodian and his counsel from the assets of the corporation or proceeds from the sale of the assets.

§ 14.33. DECREE OF DISSOLUTION

(a) If after a hearing the court determines that 1 or more grounds for judicial dissolution described in section 14.30 exist, it may enter a decree dissolving the corporation and specifying the effective date of the dissolution, and the clerk of the court shall deliver a certified copy of the decree to the secretary of state, who shall file it.

(b) After entering the decree of dissolution, the court shall direct the winding up and liquidation of the corporation's business and affairs in accordance with section 14.05 and, to the extent not theretofore completed, the notification of claimants in accordance with sections 14.06 and 14.07.

§ 14.34. REORGANIZATION UNDER A STATUTE OF THE UNITED STATES: EFFECTUATION

(a) Any corporation, a plan of reorganization of which, pursuant to any applicable statute of the United States relating to reorganizations of corporations, has been or shall be confirmed by the decree or order of a court of competent jurisdiction, may put into effect and carry out the plan and the decrees and orders of the court or judge relative thereto and may take any proceeding and do any act provided in the plan or directed by the decrees and orders, without further action by its directors or shareholders. The power and authority may be exercised, and the proceedings and acts may be taken, as may be directed by the decrees or orders, by the trustee or trustees of the corporation appointed in the reorganization proceedings, or a majority thereof, or if none be appointed and acting, by designated officers of the corporation, or by a master or other representative appointed by the court or judge, with like effect as if exercised and taken by unanimous action of the directors and shareholders of the corporation.

(b) The corporation may, in the manner provided in subsection (a), but without limiting the generality or effect of the foregoing, alter, amend, or repeal its bylaws; constitute or reconstitute and classify or reclassify its board of directors, and name, constitute or appoint directors and officers in place of or in addition to all or some of the directors or officers then in office; amend its articles of organization, and make any change in its capital or capital stock, or any other amendment, change, or alteration, or provision, authorized by this chapter; be dissolved; sell or otherwise transfer all or part of its assets, merge or consolidate as permitted by this chapter, in any of which cases, however, no shareholder shall have any statutory right of appraisal of his shares pursuant to section 13.02; change the location of its registered office, change its registered agent, and remove or appoint any agent to receive service of process; authorize, fix the terms, manner and conditions of the issuance of, and issue bonds, debentures or other obligations, whether or not convertible into shares of any class or series, or bearing warrants or other evidences of optional rights to purchase or subscribe for shares of any class or series; or lease its property and franchises to any corporation or other party, if permitted by law.

(c) Articles of amendment, merger, share exchange or dissolution effected by the corporation pursuant to the foregoing provisions shall be filed with the secretary of state, and shall become effective, all in accordance with this chapter. The articles shall be made, executed and acknowledged, as may be directed by the decrees or orders, by the trustee or trustees appointed in the reorganization proceedings, or a majority thereof, or, if none be appointed and acting, by the officers of the corporation, or by a master or other representative appointed by the court or judge, and shall certify that provision for the making and filing of the articles is contained in a decree or order of a court or judge having jurisdiction of a proceeding under the applicable statute of the United States for the reorganization of the corporation.

(d) This section shall cease to apply to the corporation upon the entry of a final decree in the reorganization proceedings closing the case and discharging the trustee or trustees, if any.

(e) On filing any articles or other instrument made or executed pursuant to this section, there shall be paid to the secretary of state the same fees as are payable by corporations not in reorganization upon the filing of like articles or instruments.

§ 14.40. DEPOSIT WITH TREASURER OF THE COMMONWEALTH

Assets of a dissolved corporation that should be transferred to a creditor, claimant, or shareholder of the corporation who cannot be found or who is not competent to receive them shall be reduced to cash and deposited with the treasurer of the commonwealth or other appropriate official of the commonwealth for safekeeping. When the creditor, claimant, or shareholder furnishes satisfactory proof of entitlement to the amount deposited, the treasurer or other appropriate official of the commonwealth shall pay him or his representative that amount.

§ 15.01. AUTHORITY TO TRANSACT BUSINESS REQUIRED

(a) A foreign corporation that transacts business or has a usual place of business in the commonwealth shall deliver the certificate required by section 15.03 to the secretary of state for filing.

(b) The following activities, among others, do constitute transacting business within the meaning of subsection (a):

(1) the ownership or leasing of real estate in the commonwealth;

(2) engaging in the construction, alteration or repair of any structure, railway or road; or

(3) engaging in any other activity requiring the performance of labor.

(c) The following activities, among others, without more, do not constitute transacting business within the meaning of subsection (a):

(1) maintaining, defending, or settling any proceeding;

(2) holding meetings of the board of directors or shareholders or carrying on other activities concerning internal corporate affairs;

(3) maintaining bank accounts;

(4) maintaining offices or agencies for the transfer, exchange, and registration of the corporations own securities or maintaining trustees or depositories with respect to those securities;

(5) selling through independent contractors;

(6) soliciting or obtaining orders, whether by mail or through employees or agents or otherwise, if the orders require acceptance outside the commonwealth before they become contracts;

<[Clause (7) of subsection (c) deleted by 2004, 178, Sec. 40 effective July 1, 2004. See 2004, 178, Sec. 49.]>

(7) creating or acquiring indebtedness, mortgages, and security interests in real or personal property;

<[Clause (8) of subsection (c) deleted by 2004, 178, Sec. 40 effective July 1, 2004. See 2004, 178, Sec. 49.]>

(8) securing or collecting debts or enforcing mortgages and security interests in property securing the debts;

(9) conducting an isolated transaction that is not one in the course of repeated transactions of a like nature;

(10) transacting business in interstate commerce; or

(11) performing activities subject to regulation under chapter 167 or chapter 175, if the foreign corporation has complied with applicable chapter.

(d) The list of activities in subsections (b) and (c) is not exhaustive.

§ 15.02. CONSEQUENCES OF TRANSACTING BUSINESS WITHOUT AUTHORITY

(a) A foreign corporation transacting business in the commonwealth without delivering to the secretary of state for filing the certificate required by section 15.03 shall not maintain a proceeding in any court in the commonwealth until the certificate is delivered and filed.

(b) The successor to a foreign corporation that transacted business in the commonwealth without delivering to the secretary of state for filing the certificate required by section 15.03

and the assignee of a cause of action arising out of that business shall not maintain a proceeding based on that cause of action in any court in the commonwealth until the foreign corporation or its successor delivers the certificate and it is filed.

(c) A court may stay a proceeding commenced by a foreign corporation, its successor, or assignee until it determines whether the foreign corporation or its successor is required to deliver to the secretary of state for filing the certificate required by section 15.03. If it so determines, the court may further stay the proceeding until the foreign corporation or its successor delivers the certificate and it is filed.

(d) A foreign corporation is liable to the commonwealth for the years or parts of years during which it transacted business in the commonwealth without delivering to the secretary of state for filing the certificate required by section 15.03, in an amount equal to (1) all late fees which would have been imposed by law had it duly delivered the certificate and (2) all interest and penalties imposed by law for failure to pay the fees. A foreign corporation is further liable to the commonwealth, for each month or part thereof during which it transacted business without delivering the certificate, in an amount determined by the secretary of state, which amount shall in no event exceed the amount established by the commissioner of administration under section 3B of chapter 7, except that a foreign corporation which has delivered such certificate shall not be liable for such monthly penalty for the first 10 days during which it transacted business without delivering such certificate. Such fees and penalties may be levied by the secretary of state. The attorney general may bring an action necessary to recover amounts due to the commonwealth under this subsection including an action to restrain a foreign corporation against which fees and penalties have been imposed pursuant to this subsection from transacting business in the commonwealth until the fees and penalties have been paid.

(e) Notwithstanding subsections (a) and (b), the failure of a foreign corporation to deliver to the secretary of state for filing the certificate required by section 15.03 shall not impair the validity of its corporate acts or prevent it from defending any proceeding in the commonwealth, or affect the validity of any contract entered into by the foreign corporation.

§ 15.03. DELIVERING CERTIFICATE BY FOREIGN CORPORATION

(a) A foreign corporation shall, not later than 10 days after it commences transacting business in the commonwealth, deliver to the secretary of state for filing a certificate setting forth:

(1) the name of the foreign corporation or, if its name is unavailable for use in the commonwealth, a corporate name that satisfies the requirements of section 15.06;

(2) the name of the state or country under whose law it is incorporated;

(3) its date of incorporation and period of duration;

(4) the street address of its principal office;

(5) the address of its registered office in the commonwealth, the name of its registered agent

at that office and the agents written consent, either on the certificate or attached to it, to its appointment as agent;

(6) its fiscal year;

(7) a brief description of the activities to be conducted by the foreign corporation in the commonwealth; and

(8) the names and usual business addresses of its current directors and officers.

(b) The foreign corporation shall deliver with the completed certificate a certificate of existence, or a document of similar import, duly authenticated by the secretary of state or other official having custody of corporate records in the state or country under whose law it is incorporated.

(c) The secretary of state shall examine and endorse his approval on the certificate delivered by the foreign corporation if the business of the foreign corporation is not prohibited by law to a corporation formed under the laws of the commonwealth and if the secretary of state determines that the certificate complies with this section. Upon such approval and payment of the required fee, the certificate shall be filed by the secretary of state and the foreign corporation shall be considered to be registered to transact business in the commonwealth.

§ 15.04. AMENDED CERTIFICATE

(a) A foreign corporation that has delivered to the secretary of state for filing the certificate required by section 15.03 shall deliver an amendment to the certificate if it changes:

(1) its corporate name;

(2) the period of its duration;

(3) the state or country of its incorporation;

(4) the street address of its principal office;

(5) its fiscal year; or

(6) the activities conducted by the foreign corporation in the commonwealth.

(b) A foreign corporation that changes its corporate name or the state or country of its incorporation shall deliver with the completed amendment a certificate evidencing the changes duly authenticated by the secretary of state or other official having custody of corporate records in the state or country under whose law it is incorporated.

(c) A foreign corporation that has delivered to the secretary of state for filing the certificate required by section 15.03 may deliver an amendment to the certificate for any other reason.

(d) The requirements of section 15.03 for delivering to the secretary of state for filing an original certificate apply to delivering any amendment thereto under this section, except that an amendment need not contain any of the information the original certificate that is not being changed and the certificate required by subsection (b) of this section need be delivered only in the circumstances set forth in said subsection (b).

§ 15.05. EFFECT OF FILING OF CERTIFICATE

(a) The delivering by the foreign corporation to the secretary of state for filing of the certificate required by section 15.03 authorizes the foreign corporation to transact business in the commonwealth subject, however, to the right of the commonwealth to revoke the authority as provided in this chapter.

(b) A foreign corporation authorized to do business in the commonwealth has the same but no greater rights and has the same but no greater privileges as, and except as otherwise provided by this chapter is subject to the same duties, restrictions, penalties, and liabilities now or later imposed on, a domestic corporation of like character.

(c) Subject to the constitution of the commonwealth, a foreign corporations organization and internal affairs and the liability of its stockholders and directors shall be governed by the laws of the jurisdiction under which it is organized. A foreign corporation may not be denied the authority to transact business in the commonwealth by reason of any difference between such laws and the laws of the commonwealth.

§ 15.06. CORPORATE NAME OF FOREIGN CORPORATION

(a) If the corporate name of a foreign corporation does not satisfy the requirements of section 4.01, the foreign corporation, to obtain or maintain a certificate of authority to transact business in the commonwealth:

(1) may add the word "corporation", "incorporated", "company", or "limited", or the abbreviation "corp.", "inc.", "co.", or "ltd.", to its corporate name for use in the commonwealth; or

(2) may use a fictitious name to transact business in the commonwealth if its real name is unavailable and it delivers to the secretary of state for filing a copy of the resolution of its board of directors, certified by its secretary, adopting the fictitious name.

(b) Except as authorized by subsections (c) and (d), the corporate name (including a fictitious name) of a foreign corporation may not be the same as, or so similar that it is likely to be mistaken for:

(1) the corporate name or trade name of a corporation organized, authorized to transact business or otherwise lawfully conducting business in the commonwealth;

(2) a corporate name reserved under section 4.02;

(3) the fictitious name of another foreign corporation or entity authorized to transact business

or otherwise lawfully conducting business in the commonwealth because its real or trade name is unavailable;

(4) the corporate name or trade name of a not-for-profit corporation organized, authorized to conduct its activities or otherwise lawfully conducting its activities in the commonwealth;

(5) the name or trade name of a partnership, business trust or other entity organized, authorized to transact business or otherwise lawfully conducting business in the commonwealth; or

(6) a trademark or service mark registered with the secretary of state under chapter 110B.

(c) A foreign corporation may apply to the secretary of state for authorization to use a corporate name that does not comply with the requirements of subsection (b). The secretary of state shall authorize use of the name applied for if:

(1) the other corporation consents to the use in writing and, if required by the secretary of state, submits an undertaking in form satisfactory to the secretary of state to change its name to a name that is not the same as or so similar that it is likely to be mistaken for the name of the applicant; or

(2) the applicant delivers to the secretary of state a certified copy of a final judgment of a court of competent jurisdiction establishing the applicants right to use the name applied for in the commonwealth.

(d) A foreign corporation may use the name, including the fictitious name, or mark of another entity that is used in the commonwealth if the other entity is organized, authorized to transact business or otherwise lawfully conducting business in the commonwealth and the foreign corporation:

(1) has merged with the other entity;

(2) has been formed by reorganization of the other entity; or

(3) has acquired all or substantially all of the assets, including the name and marks, of the other entity.

(e) If a foreign corporation authorized to transact business in the commonwealth changes its corporate name to one that does not satisfy the requirements of section 4.01, it may not transact business in the commonwealth under the changed name until it adopts a name satisfying the requirements of section 4.01 and files with the secretary of state, under section 15.04, an amendment to the certificate required to be filed by it under section 15.03.

(f) Within 90 days after the delivery to the secretary of state for filing of a certificate under section 15.03, or of an amendment to such certificate under section 15.04 that effects an

amendment reflecting a change in the name of a foreign corporation used in the commonwealth, any person who is registered, qualified or carrying on business in the commonwealth at that time or who has reserved or registered a name under sections 4.02, 15.03 or 15.04 may protest in writing to the secretary of state that the name used by the foreign corporation in the commonwealth is the same as or so similar that it is likely to be mistaken for the name of such person in violation of this section. In that event, if the secretary of state decides to conduct a hearing regarding the dispute, he shall give notice thereof as soon as possible to the protesting party and the foreign corporation using the name in the commonwealth. If as a result of the hearing or otherwise, the secretary of state determines that the use in the commonwealth of the corporate name violates this section, he shall file a statement withdrawing his approval of the amendment insofar as it relates to the name used by the foreign corporation and shall give written notice thereof to the protesting party and the foreign corporation. The withdrawal of approval shall take effect on the date specified by the secretary of state, which shall be not later than 180 days after the date of the filing which was protested. After the effective date of the withdrawal of approval, the foreign corporation shall have no right to use the name in the commonwealth and may be enjoined from doing business under the name by the superior court upon application of any interested person.

§ 15.07. REGISTERED OFFICE AND REGISTERED AGENT OF FOREIGN CORPORATION

Each foreign corporation authorized to transact business in the commonwealth shall continuously maintain in the commonwealth:

(1) a registered office that may be the same as any of its places of business; and

(2) a registered agent, who may be:

(i) an individual who resides in the commonwealth and whose business office is identical with the registered office;

(ii) a domestic corporation, not-for-profit domestic corporation or domestic limited liability company whose business office is identical with the registered office; or

(iii) a foreign corporation, foreign not-for-profit corporation or foreign limited liability company authorized to transact business in the commonwealth whose business office is identical with the registered office.

§ 15.08. CHANGE OF REGISTERED OFFICE OR REGISTERED AGENT OF FOREIGN CORPORATION

(a) A foreign corporation authorized to transact business in the commonwealth may change its registered office or registered agent by delivering to the secretary of state for filing a statement of change that sets forth:

(1) its name;

(2) the street address of its current registered office;

(3) if the current registered office is to be changed, the street address of its new registered office;

(4) the name of its current registered agent;

(5) if the current registered agent is to be changed, the name of its new registered agent and the new agent's written consent, either on the statement or attached to it, to the appointment; and

(6) that after the change or changes are made, the street addresses of its registered office and the business office of its registered agent will be identical.

(b) If a registered agent changes the street address of his business office, he may change the street address of the registered office of any foreign corporation for which he is the registered agent by notifying the foreign corporation in writing of the change and signing, either manually or in facsimile, and delivering to the secretary of state for filing a statement of change that complies with the requirements of subsection (a) and recites that the foreign corporation has been notified of the change. If the street addresses of more than one foreign corporation are being changed at the same time, there may be included in a single statement the names of all foreign corporations the street addresses of the registered office of which are being changed.

§ 15.09. RESIGNATION OF REGISTERED AGENT OF FOREIGN CORPORATION
(a) The registered agent of a foreign corporation may resign his agency appointment by signing and delivering to the secretary of state for filing a statement of resignation. The registered agent shall furnish a copy of the statement to the foreign corporation. The statement of resignation may include a statement that the registered office is also discontinued.

(b) The agency appointment is terminated, and the registered office discontinued if so provided, on the thirty-first day after the date on which the statement was filed.

§ 15.10. LIABILITY TO BE SUED; SERVICE ON FOREIGN CORPORATION
(a) Foreign corporations shall be liable to be sued and to have their property attached in the same manner and to the same extent as individuals who are residents of other states.

(b) Every foreign corporation doing business in the commonwealth which has not complied with section 15.03 and every foreign corporation which has complied with said section 15.03 but whose resident agent cannot, after a diligent search by an officer authorized to serve legal process, be found at the business address of such resident agent stated in its most recent certificate filed with the secretary of state pursuant to this chapter or its most recent annual report filed with the secretary of state pursuant to section 16.22 and every foreign corporation

whose resident agent refuses to act as such, shall be deemed to have appointed the secretary of state and his successor in office to be its true and lawful attorney upon whom all lawful process in any action or proceeding may be served so long as any liability incurred in the commonwealth while it was doing business shall remain outstanding.

(c) Service of process in all actions and proceedings in the commonwealth against such a foreign corporation may be made upon the secretary of state. Service of process in all actions and proceedings in the commonwealth against a foreign corporation formerly doing business in the commonwealth that has not complied with the provision of section 15.03, or against a foreign corporation formerly doing business in the commonwealth that has withdrawn from the commonwealth pursuant to this chapter, may be made upon the secretary of state if the action or proceeding involves a liability alleged to have been incurred by the foreign corporation while it was doing business in the commonwealth.

(d) When lawful process in any action or proceeding against any foreign corporation which pursuant to this section may be made upon the secretary of state is served upon the secretary of state, the secretary of state shall immediately forward the process by mail, postage prepaid, directed to such foreign corporation at its last known principal office or, in the case of a foreign corporation established in a foreign country, to the resident manager, if any, in the United States. A fee of $10 shall be paid by the plaintiff to the secretary of state at the time of the service and the fees shall be taxed in his costs, if he prevails in the suit. The secretary of state shall keep a record of all such processes, which shall show the day of service.

(e) In the case of service of process on a foreign corporation that has not complied with section 15.03, the notice herein provided for shall be mailed by the secretary of state to the proper address of the foreign corporation furnished to him by the plaintiff or his attorney.

(f) Service of process upon a foreign corporation for violation of any criminal law of the commonwealth may be made in the manner hereinabove provided except that no fee shall be paid to the secretary of state.
(g) This section does not prescribe the only means, or necessarily the required means, of serving a foreign corporation.

§ 15.11. FALSE REPORTS OR STATEMENTS

(a) An officer of a foreign corporation who signs any statement or report required by this chapter which is false in any material representation and that he knows or has reason to know to be false shall be liable to a creditor of the foreign corporation who has relied upon the false representation to the extent of the actual damage sustained by him by reason of such reliance; but the officer signing the statement or report shall not be liable to creditors for debts contracted or contracts entered into after the filing of a statement or report or a corrected statement or report that is not false in any material representation.

(b) No liability shall be imposed under this section upon any director or officer who shall have discharged the duties of his position in good faith and with the degree of diligence, care

and skill that prudent men would ordinarily exercise under similar circumstances in a like position. In discharging his duties the person, when acting in good faith shall be entitled to rely upon the books of account of the foreign corporation or upon written reports made to the foreign corporation by any of its officers, other than such person, or by an independent public accountant.

(c) Any director or officer who pays on a judgment rendered on a claim asserted under this section shall be entitled to contribution from the other directors and officers against whom judgment has been entered on the same claim or who shall be ascertained to be liable to the plaintiff upon the same claim.

(d) Whoever knowingly makes, executes, delivers or publishes any report or statement required by law to be made, executed, filed or published by a foreign corporation in the commonwealth, or whoever causes the same to be done, which report or statement is false in any material representation, shall be punished by a fine of not more than $5,000 or by imprisonment for not more than 3 years, or both.

(e) Whoever knowingly makes, executes, delivers or publishes any report or statement required by the law of another state or country to be made, executed, or published by a foreign corporation, or whoever causes the same to be done, within the commonwealth, which report or statement is false in any material representation, shall be punished by a fine of not more than $5,000 or by imprisonment for not more than 3 years, or both.

§ 15.20. WITHDRAWAL OF FOREIGN CORPORATION

(a) A foreign corporation authorized to transact business in the commonwealth may not withdraw from the commonwealth until it obtains the consent of the secretary of state.

(b) A foreign corporation authorized to transact business in the commonwealth may apply for withdrawal by delivering an application to the secretary of state for filing. The application shall set forth:
(1) the name of the foreign corporation and the name of the state or country under whose law it is incorporated;

(2) that it is not transacting business in the commonwealth and that it surrenders its authority to transact business in the commonwealth;

(3) that it revokes the authority of its registered agent to accept service on its behalf and appoints the secretary of state as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in the commonwealth;

(4) a mailing address to which the secretary of state may mail a copy of any process served on him under clause (3);

(5) a commitment to notify the secretary of state in the future of any change in its mailing address; and

(6) a certification that all taxes known to the corporation to be due to the commonwealth have been paid or provided for.

(c) After the withdrawal of the corporation is effective, service of process on the secretary of state under this section is service on the foreign corporation. Upon receipt of process, the secretary of state shall mail a copy of the process to the foreign corporation at the mailing address set forth under subsection (b).

§ 15.21. AUTOMATIC WITHDRAWAL UPON CERTAIN CONVERSIONS

A foreign business corporation authorized to transact business in the commonwealth that converts into a domestic nonprofit corporation or any form of domestic filing entity shall be considered to have withdrawn on the effective date of the conversion.

§ 15.22. WITHDRAWAL UPON CONVERSION TO A NONFILING ENTITY

(a) A foreign corporation authorized to transact business in the commonwealth that converts into a form of domestic or foreign nonfiling entity shall apply for withdrawal by delivering an application to the secretary of state for filing. The application shall set forth:

(1) the name of the foreign business corporation and the name of the state or country under whose law it was incorporated before the conversion;

(2) that it surrenders its authority to transact business in the commonwealth as a foreign business corporation;

(3) the type of other entity into which it has been converted and the jurisdiction whose laws govern its internal affairs;

(4) if it has been converted into a foreign other entity:

(i) that it revokes the authority of its registered agent to accept service on its behalf and appoints the secretary of state as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in the commonwealth;

(ii) a mailing address to which the secretary of state may mail a copy of any process served on him under subclause (i); and

(iii) a commitment to notify the secretary of state in the future of any change in its mailing address.

(b) After the withdrawal under this section of a corporation that has converted into a foreign other entity is effective, service of process on the secretary of state is service on the foreign other entity. Upon receipt of process, the secretary of state shall mail a copy of the process to

the foreign other entity at the mailing address set forth under clause (4) of subsection (a).

(c) After the withdrawal under this section of a corporation that has converted into a domestic other entity is effective, service of process shall be made on the other entity in accordance with the regular procedures for service of process on the form of other entity into which the corporation was converted.

§ 15.23. TRANSFER OF AUTHORITY

(a) A foreign business corporation authorized to transact business in the commonwealth that converts into a foreign nonprofit corporation or into any form of foreign other entity that is required to deliver for filing an application for authority to transact business in the commonwealth or make a similar type of delivery with the secretary of state if it transacts business in the commonwealth shall deliver to the secretary of state for filing an application for transfer of authority executed by any officer or other duly authorized representative. The application shall set forth:

(1) the name of the corporation;

(2) the type of other entity into which it has been converted and the jurisdiction whose laws govern its internal affairs;

(3) any other information that would be required in a filing under the laws of the commonwealth by an other entity of the type the corporation has become seeking authority to transact business in the commonwealth.

(b) The application for transfer of authority shall be delivered to the secretary of state for filing and shall take effect on the effective date provided in section 1.23.

(c) Upon the effectiveness of the application for transfer of authority, the authority of the corporation under this chapter to transact business in the commonwealth shall be transferred without interruption to the other entity which shall thereafter hold such authority subject to the provisions of the laws of the commonwealth applicable to that type of other entity.

§ 15.30. GROUNDS FOR REVOCATION

The secretary of state may commence a proceeding under section 15.31 to revoke the authority of a foreign corporation to transact business in the commonwealth if the foreign corporation has failed to comply with laws requiring the filing of reports with the secretary of state or the filing of any tax returns or the payment of any taxes under chapter 62C or chapter 63 for 2 or more consecutive years.

§ 15.31. PROCEDURE FOR AND EFFECT OF REVOCATION

(a) If the secretary of state determines that one or more grounds exist under section 14.20 for dissolving a corporation, he shall notify the corporation's registered agent of his determination. The notice shall be in writing and mailed postage prepaid to the corporation's

registered office, or if the registered agent consents, sent by electronic mail to an electronic mail address furnished by the agent for the purpose.

(b) If the foreign corporation does not correct each ground for revocation or demonstrate to the reasonable satisfaction of the secretary of state that each ground determined by the secretary of state does not exist within 90 days after the notice is given, the secretary of state may revoke the foreign corporations authority to transact business in the commonwealth. The secretary of state shall note the fact of revocation on his records, including the effective date thereof.

(c) The authority of a foreign corporation to transact business in the commonwealth ceases on the date on which the secretary of state makes revocation of such authority effective.

(d) Revocation of a foreign corporations authority to transact business in the commonwealth does not terminate the authority of the registered agent of the corporation until the registered agent resigns his agency pursuant to section 15.09.

§ 15.32. APPEAL FROM REVOCATION

(a) A foreign corporation the authority to transact business in the commonwealth of which has been revoked under section 15.30 may apply to the secretary of state for reinstatement of such authority at any time. The application shall:

(1) recite the name of the foreign corporation and the effective date of the revocation;

(2) state that the ground or grounds for revocation either did not exist or have been eliminated;

(3) state that the foreign corporations name satisfies the requirements of sections 4.01 and 15.06; and

(4) contain a certificate from the department of revenue reciting that all tax returns required to be filed by the foreign corporation under chapters 62C and 63 have been filed and all taxes shown due on such returns and any related penalties have been paid.

(b) If the secretary of state determines that the application contains the information required by subsection (a) and that the information is correct, he shall reinstate the authority of the foreign corporation to transact business in the commonwealth and shall note the fact of reinstatement on his records and the effective date of reinstatement.

(c) The secretary of state may subject such reinstatement to such terms and conditions, including the payment of reasonable fees, as in his judgment the public interest may require. He may in his discretion make the reinstatement effective for all purposes or for any specified purpose or purposes, in each case with or without limitation of time. When the reinstatement is effective, if by its terms it is effective for all purposes or if the secretary of state specifies that it shall be effective for purposes of this sentence, then the reinstatement relates back to and takes effect as of the effective date of the revocation of authority and the

corporation resumes carrying on its business as if the revocation of authority had never occurred, with all its original powers and duties and with liability, for all contracts, acts, matters and things made, done or performed in its name and on its behalf before reinstatement, as if the revocation of authority had never occurred, except as otherwise specified by the secretary of state.

(d) Any limitation in the reinstatement relative to the purpose or purposes of reinstatement, or of a limitation of the time thereof, may be amended by the secretary of state for cause shown to his satisfaction.

§ 16.01. CORPORATE RECORDS

(a) A corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting, and a record of all actions taken by a committee of the board of directors in place of the board of directors on behalf of the corporation.

(b) A corporation shall maintain appropriate accounting records.

(c) A corporation or its agent shall maintain a record of its shareholders, in a form that permits preparation of a list of the names and addresses of all shareholders, in alphabetical order by class of shares showing the number and class of shares held by each.

(d) A corporation shall maintain its records in written form or in another form capable of conversion into written form within a reasonable time.

(e) A corporation shall keep within the commonwealth a copy of the following records at its principal office or an office of its transfer agent or of its secretary or assistant secretary or of its registered agent:

(1) its articles or restated articles of organization and all amendments to them currently in effect;

(2) its bylaws or restated bylaws and all amendments to them currently in effect;

(3) resolutions adopted by its board of directors creating one or more classes or series of shares, and fixing their relative rights, preferences, and limitations, if shares issued pursuant to those resolutions are outstanding;

(4) the minutes of all shareholders' meetings, and records of all action taken by shareholders without a meeting, for the past 3 years;

(5) all written communications to shareholders generally within the past 3 years, including the financial statements furnished under section 16.20 for the past 3 years;

(6) a list of the names and business addresses of its current directors and officers; and

(7) its most recent annual report delivered to the secretary of state under section 16.22.

§ 16.02. INSPECTION OF RECORDS BY SHAREHOLDERS

(a) A shareholder of a corporation is entitled to inspect and copy, during regular business hours at the office where they are maintained pursuant to subsection (e) of section 16.01, copies of any of the records of the corporation described in said subsection (e) of said section 16.01 if he gives the corporation written notice of his demand at least five business days before the date on which he wishes to inspect and copy.

(b) A shareholder of a corporation is entitled to inspect and copy, during regular business hours at a reasonable location specified by the corporation, any of the following records of the corporation if the shareholder meets the requirements of subsection (c) and gives the corporation written notice of his demand at least 5 business days before the date on which he wishes to inspect and copy:

(1) excerpts from minutes reflecting action taken at any meeting of the board of directors, records of any action of a committee of the board of directors while acting in place of the board of directors on behalf of the corporation, minutes of any meeting of the shareholders, and records of action taken by the shareholders or board of directors without a meeting, to the extent not subject to inspection under subsection (a) of section 16.02;

(2) accounting records of the corporation, but if the financial statements of the corporation are audited by a certified public accountant, inspection shall be limited to the financial statements and the supporting schedules reasonably necessary to verify any line item on those statements; and

(3) the record of shareholders described in section 16.01(c).

(c) A shareholder may inspect and copy the records described in subsection (b) only if:

(1) his demand is made in good faith and for a proper purpose;

(2) he describes with reasonable particularity his purpose and the records he desires to inspect;

(3) the records are directly connected with his purpose; and

(4) the corporation shall not have determined in good faith that disclosure of the records sought would adversely affect the corporation in the conduct of its business or, in the case of a public corporation, constitute material non-public information at the time when the shareholder's notice of demand to inspect and copy is received by the corporation.

(d) The right of inspection granted by this section may not be abolished or limited by a corporation's articles of organization or bylaws.

(e) This section shall not affect:

(1) the right of a shareholder to inspect records under section 7.20 or, if the shareholder is in litigation with the corporation, to the same extent as any other litigant; or

(2) the power of a court, independently of this chapter, to compel the production of corporate records for examination, provided that, in the case of production of records described in subsection (b) at the request of a shareholder, the shareholder has met the requirements of subsection (c).

(f) For purposes of this section, "shareholder" includes a beneficial owner whose shares are held in a voting trust or by a nominee on his behalf.

§ 16.03. SCOPE OF INSPECTION RIGHT
(a) A shareholder's agent or attorney has the same inspection and copying rights as the shareholder represented.

(b) The corporation may, if reasonable, satisfy the right of a shareholder to copy records under section 16.02 by furnishing to the shareholder copies by photocopy or other means chosen by the corporation including copies furnished through an electronic transmission.

(c) The corporation may impose a reasonable charge, covering the costs of labor, material, transmission and delivery, for copies of any documents provided to the shareholder. The charge may not exceed the estimated cost of production, reproduction, transmission or delivery of the records.

(d) The corporation may comply at its expense, with a shareholder's demand to inspect the record of shareholders under clause (3) of subsection (b) of section 16.02 by providing the shareholder with a list of shareholders that was compiled no earlier than the date of the shareholder's demand.

(e) The corporation may impose reasonable restrictions on the use or distribution of records by the demanding shareholder.

§ 16.04. COURT-ORDERED INSPECTION
(a) If a corporation does not allow a shareholder who complies with section 16.02(a) to inspect and copy any records required by that subsection to be available for inspection, the superior court of the county where the corporation's principal office or, if none in the commonwealth, its registered office is located may summarily order inspection and copying of the records demanded at the corporation's expense upon application of the shareholder.

(b) If a corporation does not within a reasonable time allow a shareholder to inspect and copy any other record, the shareholder who complies with subsections (b) and (c) of section 16.02 may apply to the superior court in the county where the corporation's principal office or, if

none in the commonwealth, its registered office is located for an order to permit inspection and copying of the records demanded. The court shall dispose of an application under this subsection on an expedited basis.

(c) If the court orders inspection and copying of the records demanded under section 16.02, it shall also order the corporation to pay the shareholder's costs, including reasonable counsel fees, incurred to obtain the order unless the corporation proves that it refused inspection in good faith because it had a reasonable basis for doubt about the right of the shareholder to inspect the records demanded; and the court may order the corporation to pay the shareholder's costs if it orders inspection and copying of records other than under section 16.02.

(d) If the court orders inspection and copying of the records demanded, it may impose reasonable restrictions on the use or distribution of the records by the demanding shareholder.

§ 16.05. INSPECTION OF RECORDS BY DIRECTORS

(a) A director of a corporation is entitled to inspect and copy the books, records and documents of the corporation at any reasonable time to the extent reasonably related to the performance of the director's duties as a director, including duties as a member of a committee, but not for any other purpose or in any manner that would violate any duty to the corporation.

(b) If a corporation does not allow a director who purports to be entitled thereto pursuant to subsection (a) of section 16.05 to inspect and copy any books, records or documents required by that subsection to be available for inspection, the superior court of the county where the corporation's principal office or, if none in the commonwealth, its registered office is located may order inspection and copying of the books, records and documents demanded at the corporation's expense upon application of the director, unless the corporation establishes that the director is not entitled to such inspection rights. The court shall dispose of an application under this subsection on an expedited basis.

(c) If the court orders inspection and copying of the books, records and documents demanded, it may include provisions protecting the corporation from undue burden or expense, and prohibiting the director from using information obtained upon exercise of the inspection rights in a manner that would violate a duty to the corporation, and may also order the corporation to pay the director's costs, including reasonable counsel fees, incurred in connection with the application.

§ 16.06. EXCEPTION TO NOTICE REQUIREMENT; CONSEQUENCES OF INABILITY TO DELIVER NOTICE

(a) Whenever notice is required to be given under any provision of this chapter to any shareholder, the notice shall not be required to be given if:

(1) notice of 2 consecutive annual meetings, and all notices of meetings during the period

between the 2 consecutive annual meetings, have been sent to the shareholder at the shareholder's address as shown on the records of the corporation and have been returned undeliverable; or

(2) all, but not less than 2, payments of dividends on securities during a 12- month period, or 2 consecutive payments of dividends on securities during a period of more than 12 months, have been sent to the shareholder at the shareholder's address as shown on the records of the corporation and have been returned undeliverable.

(b) If the shareholder shall deliver to the corporation a written notice setting forth the shareholder's then-current address, the requirement that notice be given to the shareholder shall be reinstated.

(c) If the corporation is unable to deliver notice to any shareholder to an address furnished by the shareholder for the purpose and the inability becomes known to the secretary or an assistant secretary of the corporation, the transfer agent or other person responsible for the giving of notice, the corporation shall take such action as shall be reasonable in the circumstances to inform the shareholder of the inability and to request the shareholder to furnish a new address for the receipt of notices. Attempting to contact the shareholder at such other address, if any, as the corporation may have for the shareholder is deemed reasonable. The corporation may continue to rely on the address last furnished by the shareholder for notice until it is furnished in writing a new address for notice. The failure of the corporation to take the action required by this subsection shall not invalidate any meeting or other action.

§ 16.20. FINANCIAL STATEMENTS FOR SHAREHOLDERS

(a) A corporation shall furnish to its shareholders upon request annual financial statements, which may be consolidated or combined statements of the corporation and 1 or more of its subsidiaries, as appropriate, that include a balance sheet as at the end of the fiscal year, an income statement for that year and, if available, a statement of changes in shareholder equity for that year unless that information appears elsewhere in the financial statements. If prepared by the corporation, the corporation shall also furnish a statement of cash flows for that year. If financial statements are prepared by the corporation on the basis of generally accepted accounting principles, the annual financial statements must also be prepared on that basis. For purposes of this subsection, financial statements may consist of copies of federal tax returns or other comparable information which is reasonable under the circumstances in the case where the corporation does not prepare financial statements as described above.

(b) If the annual financial statements are reported upon by a public accountant, his report shall accompany those statements. If not, those statements shall be accompanied by a certificate of the president or the person responsible for the corporation's accounting records:

(1) stating his reasonable belief whether the statements were prepared in accordance with generally accepted accounting principles or, if not, describing the basis of preparation; and

(2) describing any respects in which the statements were not prepared on a basis of

accounting consistent with the statements prepared for the preceding year.

(c) A corporation shall deliver the annual financial statements, or a written notice of their availability, to each shareholder before the earlier to occur of the annual meeting of shareholders or 120 days after the close of the fiscal year. Thereafter, the corporation shall deliver its most recent financial statements upon the written request of any shareholder to whom the statements were not delivered.

(d) A corporation shall not be required to furnish its annual financial statements to a shareholder if it can demonstrate a proper corporate purpose for withholding information contained in those statements from that shareholder.

§ 16.21. BY-LAW AMENDMENTS

If the board of directors of a corporation makes, amends or repeals any bylaw, the corporation shall report in writing the substance of the change to the shareholders entitled to vote on amending the bylaws, with or before the notice of the next shareholders meeting. Any bylaw adopted by the board of directors may be amended or repealed by the shareholders.

§ 16.22. ANNUAL REPORT FOR SECRETARY OF STATE

(a) Each domestic corporation, and each foreign corporation authorized to transact business in the commonwealth, shall deliver to the secretary of state for filing an annual report that sets forth:

(1) the name of the corporation and the state or country under whose law it is incorporated;
(2) the address of its registered office and the name of its registered agent at that office in the commonwealth;

(3) the address of its principal office;

(4) the names and business addresses of its directors, officers required by section 8.40(a), and chief executive officer and chief financial officer, if different;

(5) A brief description of its activities in the commonwealth.

(6) the total number of authorized shares, itemized by class and series, if any, within each class;

(7) the total number of issued and outstanding shares, itemized by class and series, if any, within each class; and

(8) the fiscal year of the corporation.

(b) Information in the annual report shall be current as of the date the annual report is executed on behalf of the corporation.

(c) The annual report shall be delivered to the secretary of state within 2 1/2 months after the end of the fiscal year of the corporation.

§ 17.01. APPLICATION TO EXISTING DOMESTIC CORPORATIONS

Except so far as such application may be inconsistent with (i) provisions still in force of any special acts of incorporation, enacted before March 11, 1831, and not subject to amendment, alteration or repeal by the general court, or (ii) chapter 156A applicable to professional corporations incorporated thereunder, this chapter shall apply to:

(1) all domestic corporations having capital stock whether established before or after the effective date of this chapter, either by general or special law, for the purpose of carrying on business for profit except corporations organized for the purpose of carrying on the business of a bank, savings bank, co-operative bank, trust company, credit union, surety or indemnity company, or safe deposit company, or for the purpose of carrying on within the commonwealth the business of an insurance company, railroad, electric railroad, street railway or trolley motor company, telegraph or telephone company, gas or electric light, heat or power company, canal, aqueduct or water company, cemetery or crematory company, any other corporations which on October 1, 1965 have or may thereafter have the right to take land within the commonwealth by eminent domain or to exercise franchises in public ways granted by the commonwealth or by any county, city or town, and corporations subject to chapter 157 and corporations subject to chapter 157A; and

(2) notwithstanding anything to the contrary in clause (1), all other corporations to which this chapter is made applicable by the express provisions of any other general or special law to the extent provided thereby.

§ 17.02. APPLICATION TO QUALIFIED FOREIGN CORPORATIONS

A foreign corporation authorized to transact business in the commonwealth on the effective date of this chapter is subject to this chapter but is not required to apply for new authority to transact business under this chapter.

§ 17.03. SAVING PROVISIONS

(a) Except as provided in subsection (b), the repeal of chapter 181 shall not affect:

(1) the operation of said chapter 181 or any action taken under it before its repeal;

(2) any ratification, right, remedy, privilege, obligation, or liability acquired, accrued, or incurred under said chapter 181 before its repeal;

(3) any violation of said chapter 181, or any penalty, forfeiture, or punishment incurred because of the violation, before its repeal; or

(4) any proceeding commenced under said chapter 181 before its repeal, and the proceeding

may be completed in accordance with said chapter 181 as if it had not been repealed.

(b) If a penalty or punishment imposed for a violation of said chapter 181 is reduced by chapter 156D, the penalty or punishment if not already imposed shall be imposed in accordance with this chapter.

§ 17.04. SEVERABILITY

If any provision of this chapter or its application to any person or circumstance is held invalid by a court of competent jurisdiction, the invalidity shall not affect other provisions or applications of the chapter that can be given effect without the invalid provision or application, and to this end the provisions of the chapter are severable.

RESTATEMENT 2ND OF AGENCY

§ 1. Agency; Principal; Agent

(1) Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.

(2) The one for whom action is to be taken is the principal.

(3) The one who is to act is the agent.

Comment on Subsection (1):
a. The relation of agency is created as the result of conduct by two parties manifesting that one of them is willing for the other to act for him subject to his control, and that the other consents so to act. The principal must in some manner indicate that the agent is to act for him, and the agent must act or agree to act on the principal's behalf and subject to his control. Either of the parties to the relation may be a natural person, groups of natural persons acting for this purpose as a unit such as a partnership, joint undertakers, or a legal person, such as a corporation.

b. Agency a legal concept. Agency is a legal concept which depends upon the existence of required factual elements: the manifestation by the principal that the agent shall act for him, the agent's acceptance of the undertaking and the understanding of the parties that the principal is to be in control of the undertaking. The relation which the law calls agency does not depend upon the intent of the parties to create it, nor their belief that they have done so. To constitute the relation, there must be an agreement, but not necessarily a contract, between the parties; if the agreement results in the factual relation between them to which are attached the legal consequences of agency, an agency exists although the parties did not call it agency and did not intend the legal consequences of the relation to follow. Thus, when one

who asks a friend to do a slight service for him, such as to return for credit goods recently purchased from a store, neither one may have any realization that they are creating an agency relation or be aware of the legal obligations which would result from performance of the service. On the other hand, one may believe that he has created an agency when in fact the relation is that of seller and buyer. See § 14J. The distinction between agency and other relations, such as those of trust, buyer and seller, and others are stated in Sections 14A to 14O. The distinction between the kind of agent called a servant and a non-servant agent is stated in Section 2.

When it is doubtful whether a representative is the agent of one or the other of two contracting parties, the function of the court is to ascertain the factual relation of the parties to each other and in so doing can properly disregard a statement in the agreement that the agent is to be the agent of one rather than of the other, or a statement by the parties as to the legal relations which are thereby created. See § 14L. The agency relation results if, but only if, there is an understanding between the parties which, as interpreted by the court, creates a fiduciary relation in which the fiduciary is subject to the directions of the one on whose account he acts. It is the element of continuous subjection to the will of the principal which distinguishes the agent from other fiduciaries and the agency agreement from other agreements. The characteristics which tend to indicate an agency or a non-agency relation are stated in Sections 12 to 14O.

Illustrations:
1. P and A enter into an agreement which is stated to be a "contract of sale." It provides that for one year A shall purchase a specified amount of goods from P; that the risk of loss of such goods after purchase is upon P, if A uses care in their custody; that A is to pay for and to sell them at prices to be fixed by P from time to time and is to keep the proceeds as a separate account, remitting monthly 90 per cent. and keeping the remainder for himself; that unsold goods can be returned to P; and that P will pay A one-half of A's selling expenses. A is P's agent.
2. B, wishing to borrow money, goes to A, the local representative of an insurance company employed by it to lend money and collect interest, and signs a document which states that A is B's agent for the purpose of borrowing money from the company, for which B is to pay A one per cent. of the money borrowed, and that payments of interest are to be made to A. Both B and A understand that A is primarily to protect the interests of the company. A is not B's agent, and payment of interest by B to A is payment to the insurance company.
3. A, the secretary of the local branch of a fraternal organization, collects money from the members of the branch, remitting it each month to the national body. The rules of the order provide that the members must pay their dues in this manner; that the local secretary is subject to the orders of the national organization as to the collection and disposition of dues, but that in receiving and forwarding dues he is the agent for the members of the local branch. It may be found that, for the collection of dues, he is the agent of the national organization and not of the members of the local branch.

Comment:
c. Confusion of terms. It is sometimes said that agency does not exist until the agent does

something for the principal. In fact, the relation may exist before such time. Reciprocal duties between the parties together with a power of the agent to bind the principal are normally created at the time of the agreement. This is true although there is no binding contract between the parties. See § 16. Thus, where one asks another to purchase property for him which the other gratuitously promises to do, the other immediately has a power to bind the first by the purchase of the property and immediately becomes subject to a fiduciary duty not to buy it on his own account. This is true irrespective of the fact that either can properly terminate the relation at any time.

The agency relation is to be distinguished from other relations sometimes called agency but which do not include the elements here stated. Thus, there is sometimes said to be an "agency by necessity", in cases in which the so-called agent has no duty to respond to the will of the principal. See §§ 14I and 141. Sometimes a power of attorney given for security has been thought to be a form of agency although the power holder has no duty to respond to the will of the one creating the power. See §§ 14H, 138, 139. In such cases the rules of agency as herein stated do not apply.

Comment on Subsection (2):
d. "Principal" is a word used to describe a person who has authorized another to act on his account and subject to his control. It includes, therefore, both a person who has directed another to act on his account in business dealings or to represent him in hearings or proceedings, but who has no control or right of control over the other's physical conduct, and also a person who employs another to act in his affairs, having such control or right to control over his conduct that the other is termed a servant, whether or not he renders merely manual service. The word "master" as defined in Section 2 is not used in contrast to the word "principal," but is included within it. Thus, the owner of a business is a principal not only with regard to brokers who, as to their physical acts, are independent of his supervision, but also with regard to salesmen who conduct business transactions under supervision as to such conduct and who therefore come within the definition of servant. Likewise, the owner of a house is the principal as well as the master of the janitors whom he employs and whose jobs are confined to the performance of manual acts on the premises under the owner's supervision. The word "principal," therefore, includes both persons who are masters and persons who are principals but not masters.

Comment on Subsection (3):
e. "Agent" is a word used to describe a person authorized by another to act on his account and under his control. Included within its meaning are those who, whether or not servants as described in Section 2, act in business transactions and those who perform only manual labor as servants. An agent may be one for whose physical acts the employer is not responsible and who is called an independent contractor in order to distinguish him from a servant, also an agent, for whose physical acts the employer is responsible. Thus, the attorney-at-law, the broker, the factor, the auctioneer, and other similar persons employed either for a single transaction or for a series of transactions, are agents, although as to their physical activities they are independent contractors. These are to be contrasted with others, such as clerks, train conductors, and others who conduct transactions with third persons but who fall within the

category of servants. Likewise, the janitor of a building or the driver of a truck is an agent, as that word is used in the Restatement of this Subject, if he is employed under such circumstances that he becomes a servant. For many purposes it is immaterial whether or not one who is an agent is also a servant. However, the liability of a master for the torts of his servant is greater in extent than the liability of a principal for the torts of an agent who is not a servant (see §§ 219-255), and a master's duties to servants are different from those of a principal to agents who are not servants. See §§ 472-528.

f. Statutory use. Whether the word "agent" as used in a statute corresponds to the meaning here given depends, with other factors, upon the purpose of the statute. Thus, the purpose of statutes providing for substituted service of process on a public official is to satisfy the due process requirement of the United States Constitution. Although such a statute may label the public official an "agent" for receiving service of process, he is not an agent in the sense used herein. He is not in fact designated by the one on whose account he "accepts service", nor does he respond to that person's directions. So, in a statute which fixes the method of payment of all "public officers and agents", the word "agents" may be interpreted in a restricted sense to exclude a clerk employed by the state. The word "agent" in a criminal statute does not normally include other fiduciaries such as receivers, although some statutes may be interpreted to include them.

g. Power holders not agents. The language of agency has been used to describe as agents persons who bind others, or even act in the name of others, but do so for their own purposes. This has resulted from various causes. Thus, at a time when contracts were considered to be purely personal relations between the parties, a contractor could not transfer his right to another. However, one could appoint an agent to collect money due on the contract, the document of agreement being called a power of attorney. When economic reasons made it desirable to recognize assignments, it was not too difficult to hold that one could agree with an "attorney" that the latter should keep the proceeds. In accordance with this point of view, a mortgagee was given a "power of attorney" to sell the mortgagor's interests in the mortgaged property. In doing this the courts created a power for security. Such a power is not an agency power and the holder of one is not an agent of the one who created it. See § 138.

§ 2. Master; Servant; Independent Contractor

(1) A master is a principal who employs an agent to perform service in his affairs and who controls or has the right to control the physical conduct of the other in the performance of the service.

(2) A servant is an agent employed by a master to perform service in his affairs whose physical conduct in the performance of the service is controlled or is subject to the right to control by the master.

(3) An independent contractor is a person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right to control with

respect to his physical conduct in the performance of the undertaking. He may or may not be an agent.

Comment:
a. Servants and non-servant agents. A master is a species of principal, and a servant is a species of agent. The words “master” and “servant” are herein used to indicate the relation from which arises both the liability of an employer for the physical harm caused to third persons by the tort of an employee (see §§ 219-249) and the special duties and immunities of an employer to the employee. See §§ 473-528. Although for brevity the definitions in this Section refer only to the control or right to control the physical conduct of the servant, there are many factors which are considered by the courts in defining the relation. These factors which distinguish a servant from an independent contractor are stated in Section 220. The distinction between servants and agents who are not servants is of importance for the purposes of the Sections referred to. Statements made in the Restatement of this Subject as applicable to principals or agents are, unless otherwise stated, applicable to masters and servants. The rules as to liability of a principal for the torts of agents who are not servants are stated in Sections 250-267, and those with respect to his liability in tort to such agents in Sections 470-472. The duties of servants to masters and their liabilities to third persons are in general the same as those of agents who are not servants. However, servants may have only custody, as distinguished from possession of goods entrusted to them by the master (see § 339, Comment *g* and § 349), and a servant, because of his position, may not be responsible for mistakes made by him as to facts upon which his authority depends, whereas an agent who is not a servant would be responsible. See Comment *c* on § 383.

b. Servant contrasted with independent contractor. The word “servant” is used in contrast with “independent contractor”. The latter term includes all persons who contract to do something for another but who are not servants in doing the work undertaken. An agent who is not a servant is, therefore, an independent contractor when he contracts to act on account of the principal. Thus, a broker who contracts to sell goods for his principal is an independent contractor as distinguished from a servant. Although, under some circumstances, the principal is bound by the broker's unauthorized contracts and representations, the principal is not liable to third persons for tangible harm resulting from his unauthorized physical conduct within the scope of the employment, as the principal would be for similar conduct by a servant; nor does the principal have the duties or immunities of a master towards the broker. Although an agent who contracts to act and who is not a servant is therefore an independent contractor, not all independent contractors are agents. Thus, one who contracts for a stipulated price to build a house for another and who reserves no direction over the conduct of the work is an independent contractor; but he is not an agent, since he is not a fiduciary, has no power to make the one employing him a party to a transaction, and is subject to no control over his conduct.

The word “servant” is thus used to distinguish a group of persons for whose physical conduct the master is responsible to third persons. It is convenient to distinguish this group of persons from other persons for whose physical conduct the employer is not responsible. These latter persons fall into two groups: those who are agents but do not respond to the tests for servants,

and those who are not agents. For the purpose of determining whether or not the employer is responsible for their physical conduct, however, it is immaterial whether such persons are agents or are not agents. For this reason the term “independent contractor” is used to indicate all persons for whose conduct, aside from their use of words, the employer is not responsible except in the performance of nondelegable duties.

c. Servants not necessarily menials. As stated more fully in Section 220, the term servant does not denote menial or manual service. Many servants perform exacting work requiring intelligence rather than muscle. Thus the officers of a corporation or a ship, the interne in a hospital, all of whom give their time to their employers, are servants equally with the janitor and others performing manual labor.

d. Statutory use. The words “master,” and “servant” are frequently used with a limited meaning in statutes. The definitions of these words in this Section are not applicable in the interpretation of such statutes.

The word “employee” is commonly used in current statutes to indicate the type of person herein described as servant. In some of these it is specifically stated that an employee is a servant in the common law meaning. In others, without such statement, the courts have reached a similar result. This has been generally true of Employers' Liability and Workmen's Compensation Acts. In some statutes, however, the term “employee” has been given a much broader meaning than that given herein to the term “servant”. This has been the tendency of the interpretation of both federal and state acts dealing with social security, unemployment insurance, minimum wage, fair labor practices and similar matters. The rules as to these matters are beyond the scope of the Restatement of this Subject. The term “servant” however, is largely used by courts in cases involving the master's liability for acts of the servant in the scope of employment.

§ 3. General Agent; Special Agent

(1) A general agent is an agent authorized to conduct a series of transactions involving a continuity of service.

(2) A special agent is an agent authorized to conduct a single transaction or a series of transactions not involving continuity of service.

Comment:
a. Distinction a matter of degree. The distinction between a general agent and a special agent is one of degree, as is the distinction between a servant and an independent contractor, and the resulting differences in liability of the principal are based in part upon similar grounds of policy. In determining whether an agent is a general agent or a special agent, the number of acts to be performed in accomplishing an authorized result, the number of people to be dealt with, and the length of time needed to accomplish the result are the important considerations.

Continuity of service rather than the extent of discretion or responsibility is the hall-mark of the general agent. The point at which one becomes a general agent can not be marked with exactitude. One who is an integral part of a business organization and does not require fresh authorization for each transaction is a general agent. Thus the manager of a business or the agent in charge of a construction project is clearly a general agent for the one employing him. On the other hand, a person employed only to deliver a promissory note on specified terms is just as clearly a special agent. Between such cases in which the class to which the agent belongs is clear are other cases which require the use of judgment to determine in which class the agent belongs. Thus, one directed by another to purchase two horses, although the purchase may be made from two separate individuals, would ordinarily be a special agent; a person employed to buy one hundred horses in as many transactions as may be necessary to accomplish the total purchase might well be considered a general agent.

b. Area of general agency. One is a general agent only as to those matters in which there is continuity of employment. Thus one who is a general agent with respect to some matters may be a special agent with respect to a particular transaction, as where the owner of a manufacturing business directs his manager to purchase a country estate for him.

c. Extent of discretion not the test. A general agent may have little discretion in regard to the transactions which he is employed to perform, while a special agent may have great discretion in the single transaction which he conducts. Thus, one is a general agent if he is in continuous employment, although the employment consists of purchasing articles as the employer directs with no discretion as to the kinds, amounts, or prices to be paid; whereas one employed to purchase a single article is a special agent although given the widest discretion, as where one is directed to purchase any suitable article for a wedding gift.

A general agent may be a servant. In fact, most general agents are servants, such as managers, sales clerks and persons of that type. However, the fact that they are servants is immaterial in determining the liability of the employer for contracts entered into and representations made by them on his account, except that the intimacy of relations between them and their employer together with the fact that they are continuously dealing solely with the employer's business, is almost conclusive as to their being general agents in the conduct of ordinary affairs. However, as pointed out in Comment *b*, such a servant may be a special agent for a particular purpose, as where a selling clerk is directed by the manager to make particular purchases.

d. Importance of distinction. The distinction between a special agent and a general agent has several important consequences. Thus, the general agent may have a power to bind his principal in excess of his authority or apparent authority in many situations in which the special agent may not have such power. See §§ 161, 161A and 194. Again, the continuity of the employment of the general agent may result in the continuance of apparent authority after the termination of his authority when this would not result in the case of a special agent. See §§ 127-132. Furthermore, manifestations of the principal to a general agent in connection with his authority may be interpreted as merely advice or as instructions not intended to affect the rights of third persons, when similar manifestations made to a special agent would

be interpreted as limiting his authority or power to bind the principal. See Comment *b* on § 34.

e. Colloquial usage. The terms “general agent” and “special agent” have no fixed meaning in the business world. The general agent of an insurance company is ordinarily one who himself employs agents to carry out the business of the company. The “general counsel” of a corporation may or may not be one continuously employed by it. However, the term “general agent” as used in business would almost always include the general agent as described, except for clerks and similar employees.

§ 4. Disclosed Principal; Partially Disclosed Principal; Undisclosed Principal

(1) If, at the time of a transaction conducted by an agent, the other party thereto has notice that the agent is acting for a principal and of the principal's identity, the principal is a disclosed principal.

(2) If the other party has notice that the agent is or may be acting for a principal but has no notice of the principal's identity, the principal for whom the agent is acting is a partially disclosed principal.

(3) If the other party has no notice that the agent is acting for a principal, the one for whom he acts is an undisclosed principal.

Comment:
a. The classification of principals into disclosed, partially disclosed, and undisclosed is for the purpose of simplifying the statement of the rules determining the legal relations of third persons with respect to the principal and the agent, since many of these relations are dependent upon whether or not the third person has notice of the existence and identity of the principal. The other party has notice of the existence or identity of the principal if he knows, has reason to know, or should know of it, or has been given a notification of the fact. See § 9 for the meaning of the word “notice.”

b. Intent of agent. A disclosed principal is a party to a contract made by an authorized agent who purports to act on the principal's account, regardless of the agent's intent. Thus if the principal authorizes him to borrow and he borrows in the principal's name, the principal is liable on the contract even if the agent intended to embezzle money received on account of it. See § 185. However, it is only because the agent intends to act on account of another that the doctrine of undisclosed principal exists. Thus, an agent authorized to buy a specific automobile in his own name who purchases the automobile, causes the principal to be a purchaser only if the agent so intended. The fact that it would be wrongful for him to purchase it for himself and that he would become a constructive trustee of it for the principal, does not make the latter a party to the transaction. See also §§ 194, Comment *b*, and 199.

c. Manifestations at time of transaction. Whether a principal is a disclosed principal, a

partially disclosed principal or an undisclosed principal depends upon the manifestations of the principal or agent and the knowledge of the other party at the time of the transaction. The disclosure of the existence or identity of the principal subsequently has no bearing upon the relations created at the time of the transaction. The non-disclosure of the principal on the face of a document integrating the transaction does not of itself indicate that the principal is undisclosed, although it may affect the liability of the parties to the transaction. Thus, when a simple contract is made in the name of the agent, but the other party knows that the principal is the contracting party and intends to contract with him, the contract is with the principal as a disclosed principal, although his name does not appear in the instrument (see § 149); and this is so even though the agent, in a suit by the other party, may not be able to escape liability. See § 323.

Illustrations:
1. A contracts with T in his own name, T reasonably believing that A is acting for himself. After the execution of the contract, A reveals to T that he was acting as agent for P. P is an undisclosed principal.
2. A, acting as agent for P and so stating to T, executes a memorandum of the contract which he signs with his own name. P is a disclosed principal.

Comment:
d. Sources of third person's knowledge. Ordinarily, the third person derives his knowledge concerning the existence or identity of the principal from the agent or the principal in the transaction with them, but his legal relations with the principal are not affected by the source of his knowledge. The agent may, however, manifest that he contracts only for himself and thereby exclude the principal as a party to the transaction. See § 150.

If the manifestations of the principal or agent are such as reasonably to indicate to the other party the identity or existence of the principal, the latter is disclosed or partially disclosed, and this is true although the other party believes that he is dealing with the agent alone. On the other hand, even though the agent purports to be acting on his own account, if the other party knows that he is acting as agent, the principal is not an undisclosed principal but is either a disclosed principal or a partially disclosed principal, depending upon the nature of the other party's knowledge. If the manifestation as to agency is ambiguous, the belief of the other party, if reasonable, is conclusive.

Illustrations:
3. A and T have correspondence as to the sale of iron by P to T. Negotiations cease, but a few days later A writes to T: “I can now make you a price upon iron castings of $50 per ton f. o. b.” T unreasonably believes that this is A's personal offer and not one from A as agent. He replies: “I will take 100 tons,” specifying sizes. The contract is with P, who is a disclosed principal.
4. A, in dealing with T, does not tell T that he is acting for P. T, however, knows from facts in his possession that A is acting as agent for P, and intends to deal with P through A. P is a party to the contract as a disclosed principal.
5. A, a factor, sells goods sometimes on his own account but usually on account of

consignors, as T knows. A contracts in his own name, as is his usage whether or not selling for consignors, to sell to T goods consigned to A for sale on account of P. T does not inquire whether A is acting for himself or another. P is a partially disclosed principal.

Comment:
e. Disobedience as to concealment or disclosure of principal. The fact that the agent disobeys instructions to conceal the principal's identity or existence does not prevent the principal from being a disclosed or partially disclosed principal, nor prevent the application to the principal of the rules relating to disclosed or partially disclosed principals. See § 163. The fact that the agent disobeys instructions to reveal the existence or identity of the principal does not prevent the latter from being an undisclosed principal if the other party has no notice of his existence; neither does it prevent the application to him of the rules relating to undisclosed principals. See § 197.

f. When principal is or is not identified. Whether a principal is a disclosed principal or a partially disclosed principal depends upon whether or not the third person has sufficient information or other notice as to his identity. This is a question of degree. If the manifestation of the principal or agent to the third person, or the information the third person has, is such that he is able, or should be able, to distinguish the principal from all others, or he otherwise has notice of the principal's identity, the principal is disclosed. If the manifestation is ambiguous and the third person has no reason to know which of two or more principals the agent is representing, the principal is partially disclosed. If the manifestation is ambiguous and the third person is reasonably mistaken as to the person for whom the agent acts, there is no contract with the principal. See the Restatement of Contracts, § 71.

Illustrations:
6. A offers to sell a horse to T, and in reply to T's question concerning the identity of the owner for whom he is acting, A states that he is unable to give his name. The principal is partially disclosed.
7. In contracting for the purchase of a horse, A tells T that he is acting for John Smith, a horse dealer in a neighboring city. There are two John Smiths who are horse dealers in that city. Of these, T knows only one, and erroneously, but reasonably, he believes that A is referring to the dealer who is not A's principal. There is no contract between T and A's principal.

g. Usage of terms. There has been no uniform usage by the courts with respect to the terms here defined. The one here described as a “partially disclosed principal” has been called by some courts an “unidentified principal”, which is a somewhat more accurate description. The term “undisclosed principal” has been used to describe not only a person whose existence is unknown, but also one whose identity has not been revealed and even one whose identity is known but whose name does not appear in the written contract.

§ 7. Authority

Authority is the power of the agent to affect the legal relations of the principal by acts done in accordance with the principal's manifestations of consent to him.

Comment:
a. Authority distinguished from other powers. “Authority” as used in the Restatement of this Subject, is the power of the agent to do an act or to conduct a transaction on account of the principal which, with respect to the principal, he is privileged to do because of the principal's manifestations to him. There is no authority unless there is power to affect the legal relations of the principal. Thus there is no authority unless the principal has capacity to enter into the legal relation sought to be created by the agent. Likewise there is no authority unless, as to the principal, the agent is privileged. Thus, an agent entrusted only with the possession of a negotiable check indorsed in blank, binds the principal by an improper transfer of it to a bona fide purchaser, but not because he had authority. Further, the privilege must come from the manifestations of consent of the principal that the agent should act on account of the principal. An agent who has advanced money to the principal upon the security of goods received by him for sale may be privileged to sell the goods; but if he does so against the orders of the principal, it is not because he is authorized but because he has a right to protect his security interest which is adverse to that of the principal.

Thus authority is distinguished from “apparent authority” (see § 8); from the power which an agent has when he is in a position to estop the principal (see § 8B); from inherent agency power (see § 8A), such as the power which resides in a general agent or one entrusted with property (see §§ 161, 175); and from a power held by one in his own interest. See § 14H.

It should be noted that the term “authority” has been used by the courts in a variety of ways. Sometimes it has been used to denote the factual giving of consent by the principal, without reference to the creation of a legal power; sometimes it has been used broadly to indicate the power which an agent has when there is apparent authority, estoppel or other basis for making the principal a party to the transactions.

b. Manifestation of consent. The word “manifestation” as herein used means the expression of the will to another as distinguished from the undisclosed purpose or intention. Manifestation of consent means conduct from which, in light of the circumstances, it is reasonable for another to infer consent. The giving of consent to the performance of an act may be the only reasonable inference, or it may be one of several reasonable inferences. The agent's conduct is authorized if he is reasonable in drawing an inference that the principal intended him so to act although that was not the principal's intent (see § 44), and although as to a third person such a manifestation might not bind the principal. See § 8.

c. Express and implied authority. The manifestation may be made by words or other conduct, including acquiescence. Sections 26-31 state the manner in which it may be made. The rules for the interpretation of the manifestation are stated in Sections 32-81.

It is possible for a principal to specify minutely what the agent is to do. To the extent that he

does this, the agent may be said to have express authority. But most authority is created by implication. Thus, in the authorization to “sell my automobile”, the only fully expressed power is to transfer title in exchange for money or a promise to give money. In fact, under some circumstances (see § 53), “sell” may not mean “convey”, and there may or may not be power to take or give possession of the automobile or to extend credit or to accept something in partial exchange. These powers are all implied or inferred from the words used, from customs and from the relations of the parties. They are described as “implied authority.” Although frequently used, the phrase “express authority” is usually not adequate to describe the agent's authority, and the use of the adjective “implied” is unnecessary. Both adjectives are to be distinguished sharply from “apparent” as it is used in Section 8, since the latter is distinct in conception, although not in effect as between a principal and third parties. Implied authority as here used is also to be differentiated from a phrase, frequently misused, namely, “authority implied in law,” which refers to situations in which a person has power to bind another although not his agent, for example, the power of a wife to bind her husband to pay for necessaries. See § 14I.

d. Knowledge of third person. The fact that the third person with whom the agent deals on account of the principal has no knowledge of the manifestations of the principal, or even of the principal's existence, does not prevent the agent from having authority to make the principal a party to the transaction in accordance with his instructions. This is true even though the agent acts in accordance with instructions given in error or acts after the principal has withdrawn his consent, if neither the agent nor the third person has notice of such error or withdrawal. If, however, the third person has notice of such error or withdrawal, the agent has no power to bind the principal to him, although the agent, if without notice, is privileged to deal with him.

§ 8. Apparent Authority

Apparent authority is the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons.

See Reporter's Notes.

Comment:
a. Apparent authority results from a manifestation by a person that another is his agent, the manifestation being made to a third person and not, as when authority is created, to the agent. It is entirely distinct from authority, either express or implied. The power to deal with third persons which results from it may, however, be identical with the power created by authority as it is where the principal's statements to the third person are the same as to the agent and are similarly interpreted. On the other hand, the power may be greater or smaller than that resulting from authority. If it exists, the third person has the same rights with reference to the principal as where the agent is authorized. In the relation between principal and agent, however, apparent authority differs from authority, in that the one having it may not be a

fiduciary, may have no privilege to exercise it and may not even know he has it. Although normally it results from a prior relation of principal and agent, this is not necessarily the case. Further, one who is authorized to act for the principal makes the latter a party to the transaction whether or not the third person believes the agent to be authorized or is even aware of the existence of the principal. See §§ 144 and 186. On the other hand, apparent authority exists only with regard to those who believe and have reason to believe that there is authority; there can be no apparent authority created by an undisclosed principal. The rules of interpretation of apparent authority are, however, the same as those for authority, substituting the manifestation to the third person in place of that to the agent. See §§ 27 and 49.

Illustrations:
1. P writes to A directing him to act as his agent for the sale of Blackacre. P sends a copy of this letter to T, a prospective purchaser. A has authority to sell Blackacre and, as to T, apparent authority.
2. Same facts as in Illustration 1, except that in the letter to A, P adds a postscript, not included in the copy to T, telling A to make no sale until after communication with P. A has no authority to sell Blackacre but, as to T, he has apparent authority.
3. Same facts as in Illustration 1, except that after A and T have received the letters, P telegraphs a revocation to A. A has no authority but, as to T, he has apparent authority to sell Blackacre.
4. Same facts as in Illustration 1, except that A never receives the letter directed to him. Nevertheless he has apparent authority as to T.

Comment:
b. The manifestation of the principal may be made directly to a third person, or may be made to the community, by signs, by advertising, by authorizing the agent to state that he is authorized, or by continuously employing the agent. See Sections 27 and 49 for further statements as to its creation and interpretation.

Illustrations:
5. P gives to A a written power of attorney to sell Blackacre and Whiteacre. A shows this to B. A sells Blackacre to B and Whiteacre to C, who has not seen the power of attorney. A had apparent authority to sell to B but not to C.
6. A, with P's acquiescence, advertises in the papers that he is P's local agent and also has a sign put over his place of business to that effect. To those reading the advertisements or the sign, A has apparent authority to act for P; to those not so doing and not otherwise having information, A has no apparent authority.

Comment:
c. Belief by third person. Apparent authority exists only to the extent that it is reasonable for the third person dealing with the agent to believe that the agent is authorized. Further, the third person must believe the agent to be authorized. In this respect apparent authority differs from authority since an agent who is authorized can bind the principal to a transaction with a third person who does not believe the agent to be authorized.

d. Apparent authority distinguished from estoppel. Apparent authority is based upon the principle which has led to the objective theory of contracts, namely, that in contractual relations one should ordinarily be bound by what he says rather than by what he intends, so that the contract which results from the acceptance of an offer is that which the offeree reasonably understands, rather than what the offeror means. It follows, therefore, that when one tells a third person that another is authorized to make a contract of a certain sort, and the other, on behalf of the principal, enters into such a contract with the third person, the principal becomes immediately a contracting party, with both rights and liabilities to the third person, irrespective of the fact that he did not intend to contract or that he had directed the "agent" not to contract, and without reference to any change of position by the third party.

Estoppel on the other hand, as stated in s 8 B, is essentially a principle in the law of torts developed in order to prevent loss to an innocent person. See §§ 872 and 894 of the Restatement of Torts. Like apparent authority, it is based on the idea that one should be bound by what he manifests irrespective of fault; but it operates only to compensate for loss to those relying upon the words and not to create rights in the speaker. It follows, therefore, that one basing his claim upon the rules of estoppel must show not merely reliance, which is required when the claim is based upon apparent authority, but also such a change of position that it would be unjust for the speaker to deny the truth of his words. Estoppel is dealt with as a form of deceit, in which the remedy is to hold the speaker to the truth of his statements instead of creating a tort action for misrepresentation. The one estopped is given no rights thereby.

In the usual agency case, however, little turns upon the distinction. In fact, the elements of estoppel are so frequently present that the courts have repeatedly stated that apparent authority is based upon estoppel. It would be more accurate to say that both are based upon an underlying principle that one should be bound by his words. In the agency cases, the apparent principal can usually ratify in any event; furthermore, it is not irrational to hold that merely entering into a contract is a change of position which would enable the third person to bring an action against the principal. However, it is useful to preserve the distinction. Thus, when a writing is required to authorize an agent to sell land and the agent was authorized only orally, but the principal tells the third person that the agent was authorized, there is no apparent authority, but the principal would be estopped from denying it. See § 31. Further, where a purported principal has not affirmatively misled the third person but has merely carelessly failed to take affirmative steps to deny that another was his agent, the imposition of liability is so extraordinary that it is doubtful whether he should be made liable to a third person who has made a contract with the pretended agent but has not otherwise changed his position.

Illustrations:
7. P authorizes A to contract with T, sending T a copy of the authorization. P telegraphs A not to deal with T and mails a letter to T to the same effect. A receives the telegram, but immediately goes to T, making an apparently authorized contract with him. Just as they finish signing the memorandum, T receives the letter from P. P is subject to liability to T; T is subject to liability to P. Neither has the right of rescission without the consent of the other.

8. P gives A a writing which states that A is authorized to buy Blackacre for P, but at the same time tells A that, before contracting for it, he is to get P's consent. A makes a contract for the purchase of Blackacre from T. Later T contracts to sell it to X. In the competition for Blackacre, P is entitled to it. If the power to bind P were to be based upon estoppel, P would lose. There is no possibility of, and no opportunity for, ratification in any event, since by hypothesis P is bound to the contract.
9. A, with apparent authority, but not authorized by P, contracts for P to buy grain from T. After the transaction, T notifies P that he will not make delivery. P has a cause of action against T. P would have no action against T, if apparent authority were regarded as based wholly upon the principle of estoppel.
10. P orally directs A to sell Blackacre in a state in which written authority is required to effectuate the transfer of real property. Upon an inquiry by T as to A's authority, P says: "I have given A authority to convey it", whereupon T enters into a contract with A on P's behalf for its purchase and makes a partial payment. In an action by T specifically to enforce his agreement, P is estopped to defend on the ground that A was not authorized in writing.

Comment:
e. Authority--apparent, ostensible, inferred, implied. As pointed out in Comment *c* to Section 7, apparent authority has an entirely different meaning from inferred or implied authority. The latter terms are merely descriptive of the way in which authority is created, whereas apparent authority is not necessarily coincidental with authority. In fact, apparent authority is generally inferred or implied from manifestations of the principal to third persons, and hence it is correct to speak of implied or inferred apparent authority in most of the situations where apparent authority exists. Ostensible authority is merely a synonym for apparent authority and is so used by many courts. Apparent authority may coexist with authority either with the same limits, or with larger or smaller limits. When the acts of an agent in dealing with a third person are within the limits of either authority or apparent authority, the principal becomes a party to the transaction. In non-consensual transactions entered into by the agent where there has been no reliance by a third person upon the existence of authority, the presence or absence of an appearance of authority is immaterial. Compare Section 267, which states the liability for acts of apparent servants.

Illustration:
11. The Ace Taxi Company employs no drivers but merely receives orders from prospective passengers and puts "Ace Taxi Company" on cabs owned and operated by independent drivers. One of these drivers collides negligently with another automobile, damaging one of his passengers who reasonably believed the Taxi Company to be the employer. The Taxi Company is liable to the passenger but not to the owner of the other automobile.

Comment:
f. Use by the courts. The term "apparent authority" has been broadly used by the courts to describe the power which agents have in creating liability against their principals, although without authority. Thus, it has been used as a basis for imposing liability upon an undisclosed principal (see § 195), as well as in a variety of other situations dealt with in Chapter 6, where policy considerations require that the principal should be liable for unauthorized conduct. It

is believed that the results reached in such cases are sound and that the only objection to the use of apparent authority is its indefiniteness. In its proper setting, the term enables the courts to exercise a kind of business equity as they have been enabled to do by the use of the term “scope of employment”. In the law of torts, “proximate cause” is similarly used to indicate liability. In the Restatement of this Subject, however, apparent authority is used in the restricted sense, as defined in this Section.

g. Cross References. Section 27 states the way in which apparent authority can be created, and Section 49 states that the rules for interpreting apparent authority are the same as those for interpreting authority, except that the third person's knowledge replaces that of the agent. Sections 159 and 292 state that the principal and the third party are bound to transactions conducted by an agent when acting within his apparent authority. Estoppel is further distinguished from apparent authority in Sections 8B, 49 and 141.

§ 9. Notice

(1) A person has notice of a fact if he knows the fact, has reason to know it, should know it, or has been given notification of it.

(2) A person is given notification of a fact by another if the latter
(a) informs him of the fact by adequate or specified means or of other facts from which he has reason to know or should know the facts: or
(b) does an act which, under the rules applicable to the transaction, has the same effect on the legal relations of the parties as the acquisition of knowledge or reason to know.

(3) A person has notice of a fact if his agent has knowledge of the fact, reason to know it or should know it, or has been given a notification of it, under circumstances coming within the rules applying to the liability of a principal because of notice to his agent.

See Reporter's Notes.

Comment:
a. The legal relations of a person are frequently affected by his knowledge, or by the existence of facts because of which he is treated, for the purpose in question, as if he had knowledge. To express the idea that legal relations may be changed because of knowledge, or something equivalent to it in the particular case, the word “notice” is used. For further discussion and specific applications, see Sections 268-283, comprising Chapter 8. For some purposes, one has notice of a fact only if he has such knowledge concerning it that to act in disregard of it constitutes bad faith; for other purposes one has notice of a fact of which he has reason to know or of which he should know (see Comments *c* and *d*) or if another has done an act amounting to a notification. See Comment *e*. Compare the Uniform Commercial Code, Sections 1-201(25), (26), (27).

b. Use of "notice" in the Restatement. Under the definition in this Section a person has notice of a fact if he has knowledge or reason to know of it, should know of it, or has been given a notification of it; and hence it would be permissible to state that a legal result follows if a person has notice of a fact, although the result would follow only if the person were to have knowledge of the fact, or would follow only if the person were to have reason to know of the fact. In the Restatement, however, for purposes of clarity, where it is stated that a legal result follows if a person has notice of a fact and there is no qualification in the Comment or otherwise, it means that the result follows if such person, in the alternative, has knowledge of the fact, or reason to know of it, or should know of it, or has been given a notification. When only knowledge has the effect stated, the word "knowledge" is used; likewise, where, to constitute notice, it is necessary that the person have reason to know of the fact, that he should know of it, or that he should receive a notification, the particular requirement is stated.

c. Knowledge. Knowledge as the word is herein used, is the belief in a truth. What is the truth is determined by courts for the purpose of the particular case in which the inquiry is made. A person's brain is like a storehouse in which facts are filed for his use; at any given time it contains much more than that of which he is conscious. Thus, one knows that 2 added to 2 amounts to 4, but it is seldom that this mathematical truism is in the consciousness. For the purposes of this Restatement, knowledge means conscious belief. What we know unconsciously becomes conscious only when some event or a train of thought leads to it. The content of the unconscious mind is not knowledge, although it may create reason to know. One does not know all that one once knew or could remember if events called it to his attention. For legal purposes, in contrast with "reason to know" and "should know", knowledge requires awareness of a fact or condition. In the non-agency field this distinction becomes important in a great variety of situations. Thus deceit, in the older common law sense, can be committed only by a person who is conscious that what he is saying is untrue or who knows that he does not know the facts. Another illustration is the situation in which a transferee of a negotiable instrument acquires it with reason to know, but without knowing that the payee obtained it by fraud; if he takes it for value before maturity, he has a valid claim against the maker.

d. Reason to know. A person has reason to know of a fact if he has information from which a person of ordinary intelligence, or of the superior intelligence which such person may have, would infer that the fact in question exists or that there is such a substantial chance of its existence that, if exercising reasonable care with reference to the matter in question, his action would be predicated upon the assumption of its possible existence. The inference drawn need not be that the fact exists; it is sufficient that the likelihood of its existence is so great that a person of ordinary intelligence, or of the superior intelligence which the person in question has, would, if exercising ordinary prudence under the circumstances, govern his conduct as if the fact existed, until he could ascertain its existence or non-existence. The words "reason to know" do not necessarily import the existence of a duty to others to ascertain facts; the words are used both where the actor has a duty to another and where he would not be acting adequately in the protection of his own interests were he not to act with reference to the facts which he has reason to know. One may have reason to know a fact

although he does not make the inference of its existence which would be made by a reasonable person in his position and with his knowledge, whether his failure to make such inference is due to inferior intelligence or to a failure properly to exercise such intelligence as he has. A person of superior intelligence or training has reason to know a fact if a person with his mental capacity and attainments would draw such an inference from the facts known to him. On the other hand, "reason to know" imports no duty to ascertain facts not to be deduced as inferences from facts already known; one has reason to know a fact only if a reasonable person in his position would infer such fact from other facts already known to him.

Further, a person has reason to know facts only if the circumstances are such that any unconscious knowledge would be made conscious if such person were to meet the required standards with reference to memory, consideration for the interests of others, or, in some instances, consideration for one's own interests. Thus, one who had no reason to remember facts once known would not at a later time have reason to know the facts. See Sections 276 and 277, which deal with situations in which this distinction may be crucial in determining the liability of the principal because of what an agent has reason to know.

Illustrations:
1. A, agent for P, with authority to make and endorse checks, improperly makes a check in P's name "by A, agent," payable to himself, and endorses it to his creditor, T, in payment of a personal debt. T has reason to know that A is acting improperly. See § 166.
2. P employs A as manager of his store, and A makes numerous regular purchases from T for P. The store building burns; P does not rebuild. T knows these facts. P discharges all his employees. A makes a purchase from T professedly on P's account. It is permissible for the triers of fact to find that T has reason to know that A is not authorized. See § 125.
3. P, a laborer, suddenly acquiring wealth, purchases a grain business without knowing of business customs. He sends A, one of the employees of the business, to sell some of the grain already on hand. One of the usages of the business in that locality is that the seller of wheat warrants it to keep during any specific voyage for which the seller knows the grain to be purchased. A sells the grain to T for shipment to Calcutta, giving the customary warranty. P has reason to know that business usages may exist and, this being a reasonable usage, he is bound by it. See § 36.

Comment:
e. Should know. A person should know of a fact if a person of ordinary prudence and intelligence, or the intelligence which such person has or professes to have, would ascertain, in the performance of his duty to another, that such fact exists or that there is such a substantial chance of its existence that his action would be predicated upon its possible existence. The words "should know" express the idea that the person of whom they are spoken has a duty to others to ascertain facts or, if he does not ascertain them, to act with reference to the likelihood that such facts exist. In conduct not involving consensual relations, a person is required to ascertain what would be ascertained by a person of ordinary intelligence exercising ordinary care in the protection of his own interests or those of others, unless he has superior attainments, in which case he is required to exercise the intelligence

which he has. In consensual transactions, he should know what a person with the knowledge or skill which he professes would ascertain.

It is to be noted that lack of knowledge alone is not the basis of tort liability. It is only when harm results from it that liability results. On the other hand, a contract may require knowledge. Thus, an ignorant physician, employed to treat workmen, is not liable in tort either to his employer or to the workmen unless, because of his lack of knowledge, he harms an employee by improper treatment, which would not have been given by one with standard knowledge. However, even in the absence of harm, he committed a breach of contract in not having the knowledge and is subject to discharge.

Illustrations:
4. P purchases an outwardly substantial-looking building to be used as a factory and employs a number of workmen. He makes no inspection of it and fails to discover the dangerous condition of the floor which simple tests would have revealed. Several of his workmen are hurt by the fall of the floor. P should know of the dangerous condition of the floor because he had a duty to inspect it. See § 502.
5. P employs A to purchase second-hand automobiles for him. A represents that he is a skilled mechanic, although in fact he knows little. A purchases for P a car which runs smoothly and well and which would have deceived the ordinary car owner, but which an inspection would have shown to have serious defects. A should know of the defects.

Comment:
f. Notification. Knowledge is subjective to one having it; it may be acquired by any means, and it may disappear because of lapse of time and intervening events. Notification, however, is a juristic act which determines the rights of the parties, sometimes irrespective of knowledge by the recipient. It may be given to all persons, as by a statement affixed to a subject matter in the case of trademarks and copyrights, or by filing a writing in a specified place, as the recording of a deed. Such cases ordinarily do not involve any problem of agency, but the situations in which a notification to specific persons is required may involve the rules of agency, since a notification given to the proper agent and only to the proper agent is a notification to the principal. See § 268. The existence of the notification and its effect are often matters of contract between the parties. Thus, it may be provided in a contract with a carrier that notification of the arrival of the goods at their destination shall be given to a specified person. Likewise, the notification between the principal and agent may be made a matter of special contract between the parties. Section 11 states the rules which are applicable when no special contract has been made.

Whether or not the doing of a specific act is a notification in a particular case depends upon the special rules applicable to the situation. Thus, when a partnership is dissolved or an agency relation terminated, effective notification may depend upon whether the person to whom it is addressed has had dealings with the agent. See § 136.

Illustrations:
6. P gives A a formal power of attorney to convey Blackacre, which A records. A statute

provides that a power of attorney which has been recorded is effectively revoked as to all persons if the revocation is also recorded. P revokes the power of attorney and delivers to the recorder's office a writing manifesting it. The recorder fails to file or index it. A, purporting to act under the power of attorney, executes a conveyance of Blackacre to T, who has no knowledge or reason to know of the revocation. The statute may be so interpreted that T has notice of the revocation.
7. P appoints A as his agent, A agreeing to perform P's orders. P mails directions to A which are not received at A's office. In the absence of a special agreement, A has no notice of the directions.
8. Same facts as in Illustration 7, except that P's letter is dropped through the mail slot into A's office, where it is inadvertently swept up and thrown away by a scrub woman employed by the owner of the building. A has notice of the directions.

Comment:
g. In the absence of a special custom, there is notice only in favor of the person giving the notification and his successors in interest or, if given on behalf of another, in favor of such other if the other has authorized or ratified it. As to others, the effect of notification is merely that of information received by the person notified if the notification results in knowledge by him. The acts required for notification by principal or agent to each other are stated in Section 11. The acts required for notification to a third person of a change in the agent's authority are stated in Section 136.

Illustration:
9. A, a friend of P, the assignee of a chose in action, writes to the debtor, T, telling him that P has become the assignee of the chose. T is not bound by this as a notification, but is affected by it if he reads the letter and if he has reason to believe that A is telling the truth.

Comment on Subsection (3):
h. Notice through an agent. By the rules of agency, notice is sometimes attributed to a principal because of knowledge which his agent has, has reason to have, or should have, as well as because of a notification given to the agent. The rules by which a principal is affected with respect to third persons because of the knowledge of or notification to an agent are stated in Sections 268-283. Section 90 states the rule applicable to the ratification of a notification by a purported agent. The rules by which a master is affected in his duties to his servants because of the knowledge of or notification to other servants are stated in Section 496. If the knowledge of or notification to a servant or other agent as to a fact is effective as against the principal, the principal has notice of such fact.

§ 27. Creation Of Apparent Authority: General Rule

Except for the execution of instruments under seal or for the conduct of transactions required by statute to be authorized in a particular way, apparent authority to do an act is created as to a third person by written or spoken words or any other conduct of the principal which, reasonably interpreted, causes the third person to believe that the principal consents to have

the act done on his behalf by the person purporting to act for him.

Comment:
a. Analogy to authority. Apparent authority is created by the same method as that which creates authority, except that the manifestation of the principal is to the third person rather than to the agent. For apparent authority there is the basic requirement that the principal be responsible for the information which comes to the mind of the third person, similar to the requirement for the creation of authority that the principal be responsible for the information which comes to the agent. Thus, either the principal must intend to cause the third person to believe that the agent is authorized to act for him, or he should realize that his conduct is likely to create such belief. The information received by the third person may come directly from the principal by letter or word of mouth, from authorized statements of the agent, from documents or other indicia of authority given by the principal to the agent, or from third persons who have heard of the agent's authority through authorized or permitted channels of communication. Likewise, as in the case of authority, apparent authority can be created by appointing a person to a position, such as that of manager or treasurer, which carries with it generally recognized duties; to those who know of the appointment there is apparent authority to do the things ordinarily entrusted to one occupying such a position, regardless of unknown limitations which are imposed upon the particular agent. So, too, a person who permits another to do an act in such a way as to establish in a community a reputation for having authority to act, either by directing the agent so to represent, or by directing him to act and doing nothing to prevent the spread of such information by the agent or by others, creates apparent authority with respect to those who learn of the reputation. Third persons who are aware of what a continuously employed agent has done are normally entitled to believe that he will continue to have such authority for at least a limited period in the future, and this apparent authority continues until the third person has been notified or learns facts which should lead him to believe that the agent is no longer authorized. As to the circumstances under which apparent authority is terminated, see Sections 125-137.

b. Limited effect. As authority can be created only by the principal's manifestation to the agent, so apparent authority exists only as to those who learn of a manifestation from conduct of the principal for which he is responsible. As in the case of an offer of a contract, the principal does not and cannot make a manifestation "to the world". The utmost he can do is to broadcast the existence of authority and be willing or apparently willing that any person to whose attention the information comes should act upon it. Until there has been a communication to a particular person, and until that person learns facts from which he reasonably infers that the agent is authorized, there is no apparent authority as that word is here used. Thus, if the agent has the reputation in a community of having authority so that as to all the persons in the community he would have apparent authority, he nevertheless has no apparent authority as to a stranger who does not know of the reputation or the past conduct of the agent. If the agent has been given a document by the principal and shows it to a third person, he has apparent authority consistent with the statements in the document, but he does not have apparent authority with respect to a person to whom the document is not shown. This is true even though he truthfully represents the existence and contents of the document, unless he was authorized either to show it or to state its contents.

c. Representation of authority by the agent. Unless directed not to do so, the agent is authorized to represent the extent of his authority, and he has apparent authority to the extent that he reveals his authority. Thus, a person sent to borrow $1,000 has authority to state the extent of his authority; and if he does state this, he has both authority to borrow and apparent authority to borrow. In such a case there is no substantial legal problem involved. However, it should be noted that if, before borrowing, the agent had decided that after borrowing the money, he would embezzle it, he would not be authorized to represent that he could borrow, since authority can exist only to the extent that the agent intends to carry out his principal's purposes. In such a case, however, whatever the technique used, the courts impose liability upon the principal for the money thus borrowed. See § 165. A statement by an agent to a third person with whom he deals, as to the extent of his authority, is admissible in evidence as an operative fact creating apparent authority upon proof that the agent was authorized to make the statement. See § 284, Comment *d*.

d. Third persons who know of agent's employment but not of his authority. The position of those who do not know of the prior conduct or reputation of the agent is to be distinguished from those who know of this but are not familiar with the extent of the powers of the kind of agent he appears to be. As to these the agent has apparent authority. Thus, a manager has apparent authority to do those things which managers in that business at that time and place customarily do, as to persons who know that he is a manager, although they do not know what powers managers in such a business have. In such cases the manifestation is interpreted as meaning that the agent has the powers which such managers have, and those dealing with him are entitled to rely upon this as to the extent of the agent's authority, even though they do not know the powers of such managers. This result is consistent with the interpretation of authority (see § 7), and with the interpretation of an offer which, in the absence of other evidence, is interpreted in light of the business usages of the community. See the Restatement of Contracts, §§ 245-249.

Apparent authority is to be distinguished from estoppel, which is based upon the theory that the principal is bound because of a misrepresentation made to a third person, or under some circumstances because of his failure to reveal relevant facts. The distinction is between the objective theory of contracts and the theory, fundamentally one of torts, in which a party is made responsible for misleading statements. See § 8B.

e. Similarity of authority and apparent authority. The scope of apparent authority in any given case may be different from or identical with the authority which the agent has if the same manifestation is made to both agent and the third person. If these two persons have the same information, or if the manifestation is entirely unambiguous, the apparent authority of the agent is the same as the authority of the agent. To the extent that they are the same, it is immaterial upon what grounds the principal is made a party to a transaction conducted by the agent. If they are different, the transaction is effective if the agent has either authority or apparent authority.

f. See Section 8 for the definition of apparent authority, Section 49 for its interpretation,

Sections 125-137 for its termination, and Section 159 for the liabilities resulting from it.

§ 67. When Authority To Lease Is Inferred

(1) Unless otherwise agreed, authority to lease land or chattels is inferred from authority to manage the subject matter if leasing is the usual method of dealing with it or if, in view of the principal's business and other circumstances, leasing is a reasonable method of dealing with it.

(2) Authority to lease land or chattels is not inferred merely from an authority to sell the subject matter, to take charge of it, or to receive rents from it.

Comment:
a. The authority to lease is the more readily inferred in the case of land or chattels ordinarily devoted to leasing purposes. Authority to manage a business upon land of the principal does not ordinarily justify an inference that the agent can properly lease it or a portion of it.

b. Authority to make conditional sales includes authority to make sales in the form of leases if that is a usual form.

§ 82. Ratification

Ratification is the affirmance by a person of a prior act which did not bind him but which was done or professedly done on his account, whereby the act, as to some or all persons, is given effect as if originally authorized by him.

Comment:
a. Ratification, as the word is here used, represents a legal concept in the law of agency describing the relations between the parties after affirmance by a person of a transaction done or purported to be done for him. Affirmance is a word or act as defined in Section 83. Ratification is to be distinguished from the affirmance of a voidable transaction because of fraud or mistake, and from the affirmance of a transaction, voidable because of partial lack of capacity. It is also to be distinguished from the situation in which an agent, although without authority nevertheless binds the principal because he acted within his apparent authority, scope of employment or other agency power under the rules stated in Sections 159-178, 194-209, 220-267, and in which later the principal, satisfied with the transaction, accepts the proceeds in lieu of a claim against the agent, or otherwise indicates approval. See § 419. In the sense in which the word is used in the Restatement of this Subject, ratification connotes that the act was done or purported to be done for a person who acquired no rights or liabilities because of it, except the right to elect to become a party to it.

b. Ratification is not a form of authorization, but its peculiar characteristic is that ordinarily it

has the same effect as authorization; upon ratification the consequences of the original transaction are the same as if it had been authorized, except in favor of persons who, because of their wrongful conduct, are not entitled to benefit, and against persons who have meanwhile acquired interests with which it would be unjust to interfere. See §§ 100-102.

c. A unique concept. The concept of ratification is not a legal fiction, but denotes the legal consequences which result from a series of events beginning with a transaction inoperative as to the principal, and ending in an act of validation. The statement that there is a relation back to the time of the original act is fictitious in form, but in effect, it is a statement of liabilities. The concept is unique. It does not conform to the rules of contracts, since it can be accomplished without consideration to or manifestation by the purported principal and without fresh consent by the other party. Further, it operates as if the transaction were complete at the time and place of the first event, rather than the last, as in the normal case of offer and acceptance. It does not conform to the rules of torts, since the ratifier may become responsible for a harm which was not caused by him, his property or his agent. It can not be justified on a theory of restitution, since the ratifier may not have received a benefit, nor the third person a deprivation. Nor is ratification dependent upon a doctrine of estoppel, since there may be ratification although neither the agent nor the other party suffer a loss resulting from a statement of affirmance or a failure to disavow. However, in some cases in which ratification is claimed, the principal's liability can be based upon unjust enrichment or estoppel, either in addition to or as alternative to his liability based on ratification. See §§ 103, 104.

d. Justification. That the doctrine of ratification may at times operate unfairly must be admitted, since it gives to the purported principal an election to blow hot or cold upon a transaction to which, in contract cases, the other party normally believes himself to be bound. But this hardship is minimized by denying a power to ratify when it would obviously be unfair. See §§ 88-90. Further, if the transaction is not ratified normally the pseudo-agent is responsible; if not, it is because the third party knew, or agreed to take the risk, of lack of authority by the agent. In many cases, the third person is a distinct gainer as where the purported principal ratifies a tort or a loan for which he was not liable and for which he receives nothing. This result is not, however, unjust, since although the creation of liability against the ratifier may run counter to established tort or contract principles, the liability is self-imposed. Even one who ratifies to protect his business reputation or who retains unwanted goods rather than defend a law suit, chooses ratification as preferable to the alternative. Further, the sometimes-derided doctrine of relation back not only is one used in other parts of the law, but it tends to give the parties what they wanted or said they wanted. If it sometimes happens that a mistaken or over-zealous agent is relieved from liability to the third person, the net result causes no harm to anyone. However, perhaps the best defense of ratification is pragmatic; that it is needed in the prosecution of business. It operates normally to cure minor defects in an agent's authority, minimizing technical defenses and preventing unnecessary law suits. In this aspect, it is a beneficial doctrine, which has been adopted in most systems of law.

e. There is not a change in legal relations as if there had been initial authorization, and hence

there is no ratification unless an act has been done which the purported or intended principal could have authorized (see § 84), by one who purported to act as agent or intended to act as servant (see § 85); and unless the act is affirmed (see §§ 93-99), while still capable of ratification (see §§ 88-90), by a person who, at the time of affirmance, knows the facts (see § 91), who can authorize such an act (see § 86), and who is the person for whom the agent purported or intended to act. See § 87.

§ 100. Effect Of Ratification; In General

Except as stated in Section 101, the liabilities resulting from ratification are the same as those resulting from authorization if, between the time when the original act was performed and when it was affirmed, there has been no change in the capacity of the principal or third person or in the legality of authorizing or performing the original act.

Comment:
a. The affirmance of the act of an unauthorized person by the purported principal, all conditions requisite for ratification being fulfilled, normally has the same effect as if such person had been originally authorized. There are a number of situations, however, in which an affirmance results only in a ratification which the principal or the third person can avoid. Thus, as stated in Section 91, a purported principal can rescind an affirmance made in ignorance of a material fact, with the consequence that no ratification finally results. Also, the third person can elect to avoid an affirmance made under circumstances which would render it inequitable to bind him by it (see § 89) or an affirmance which results only from conduct of the purported principal inconsistent with a repudiation of the transaction by him. See §§ 97-99.

b. Persons affected. The effect of ratification upon the liabilities of the parties to the transaction is stated in subsequent Sections. The liabilities of the principal to the other party are stated in Sections 143, 218, 290; of the other party to the principal in Section 319; of the agent to the principal in Sections 408 and 416; of the principal to the agent in Section 462; of the agent to the third person in Sections 338 and 360.

Except as to interests acquired between the time of the transaction and the time of the affirmance (see § 101), persons not parties to the transaction are affected as if the transaction had been originally authorized, subject to the conditions as to capacity and legality stated in this Section.

Illustrations:
1. A, rendering acts of service as if he were P's servant but not employed by P, operates P's truck. Within the scope of the purported service, A negligently injures T. P, with knowledge of the facts, affirms the service. P is subject to liability to T.
2. A, purporting to act for P, receives possession of Blackacre from T. B trespasses upon Blackacre. P affirms. B is subject to liability to P in an action of trespass.

Comment:

c. Misrepresentation and duress. The effect of misrepresentation or duress by the other party in the original transaction is the same after an affirmance without knowledge of the fraud or duress as if the transaction had been authorized; the effect of misrepresentation or duress in obtaining the affirmance is the same as if an authorization had been similarly obtained. Thus, the principal can rescind a contract, the making of which he has ratified, if it is obtained through a misrepresentation by the third person of an important collateral fact which affects the judgment of the agent or principal; if such fact is material within the meaning of Section 91, the principal can avoid the affirmance because of ignorance of fact at the time of the affirmance. If the other party obtains the affirmance by misrepresentation or duress, the principal can avoid it, as he could an authorization so obtained. In either case, the principal has an election to maintain an action against the third person for the deceit or the duress.

If the agent made misrepresentations to the other party other than as to his power to bind the principal, and this is known to the principal when he affirms, he is affected by the affirmance as if he had authorized the transaction with knowledge that the agent would make untruthful statements. If he is not aware of the statements of the agent, he can disaffirm upon learning the facts. Misrepresentation by the agent as to his power to bind the principal does not prevent the affirmance of the transaction from operating as ratification, and neither the principal nor the agent is liable thereafter to the other party for such misrepresentation. If the agent obtains an affirmance by making misrepresentations to the principal, the liabilities of the parties are the same as if the agent had obtained an authorization by means of similar misrepresentations, except that if misrepresentations made in obtaining affirmance prevent the principal from knowing the material facts of the prior transaction, the principal can disaffirm in accordance with the rule stated in Section 91.

Illustrations:

3. T represents to A, who purports to be acting for P, that a farm which T owns has rich sandy loam, this being untrue as T knows. A purchases in the name of P. P affirms without knowledge of the fraud. P can rescind or maintain an action of deceit against T.
4. Same facts as in Illustration 3, except that T's statements as to the farm are made to P in an effort to persuade him to affirm. P can rescind, or maintain an action of deceit against T.
5. Purporting to act for P but without power to bind him, A contracts to sell corporate shares to T, innocently misrepresenting the assets of the corporation. P receives the proceeds, knowing their source but not knowing of A's statements. Either P or T can rescind.
6. Same facts as in Illustration 5, except that P receives the proceeds knowing of the statements and that they are untrue. T can rescind or, at his election, maintain an action of deceit against P.
7. A, in order to induce ratification by P, knowingly misrepresents to him the facts respecting a contract made for P by A without authority. P states to T, the other party to the contract, that he will stand by the contract, including any statements made by A, and that he doesn't want any information from T. P thereby becomes subject to liability to T. A is subject to liability to P for loss thereby sustained.
8. A, purporting to act for P, makes an unauthorized contract with T which P refuses to affirm. To induce P to affirm, A purports to convey Blackacre to P as indemnity, and P

affirms. A does not own Blackacre, and the transaction between P and A is fraudulent on A's part. P's affirmance is a ratification and there is a contract between P and T. A acquires no rights against P and is subject to liability to P.
9. A, purporting to act for P, contracts with T for the purchase of Blackacre for $10,000, without warranties of title. In order to induce P to ratify the transaction, A represents to P that the contract includes a warranty of title by T. P thereupon writes T that he affirms. Upon discovery of the facts, P is entitled to disaffirm. If P chooses to affirm, A is not entitled to commission.

Comment:
d. Incapacity. If, at the time of the original transaction, the purported principal had only partial capacity so that he could have avoided the appointment of an agent to perform the transaction, an affirmance while such partial incapacity remains is subject to the same power of avoidance. If, however, the partial incapacity has ceased at the time of the affirmance, the principal can affirm the conduct of the purported agent with the same effect as if he had authorized the act when having full capacity. As stated in Comment *c* on Section 84, if, at the time of the original transaction, the purported principal had no capacity to appoint an agent or to enter into the transaction, an affirmance after the disability is removed is ineffective.

If, at the time of the original transaction, the purported principal had full capacity, but he affirms at a time when his capacity is such that he could avoid an authorization or a transaction then authorized by him, he can avoid the affirmance or the transaction.

Illustrations:
10. A, mistakenly believing himself to be authorized by P, twenty years of age, and intending to act for compensation, contracts with T in P's name. P affirms before reaching twenty-one. The transaction can be avoided by P, and P is not liable to A for compensation.
11. While P has full capacity, A, without power to bind him, purports to purchase goods for him. P becomes partially mentally incapacitated. His affirmance has the same effect as if he had authorized the transaction while partially mentally incapacitated.

Comment:
e. Change of law. If, at the time of the original transaction, the appointment of the agent could have been avoided by the purported principal, or the transaction could have been avoided by him or by the other party because of illegality, the appointment and the transaction are equally subject to avoidance after an affirmance made without change of circumstances. If, had the agent been authorized, his appointment or the transaction conducted by him would have been unlawful, and hence could have been avoided by the purported principal or by the other party, the transaction can be similarly avoided after affirmance, although the affirmance takes place when such an appointment or transaction would be lawful, in the absence of retroactive legislation. If, at the time of the original transaction, such an appointment or transaction would have had no legal effect, the affirmance is inoperative (see § 84); if, at the time of the affirmance, such an appointment or transaction would have no legal effect, the affirmance is inoperative, unless the original transaction was lawful and it is not against public policy at the time of affirmance to enforce

rights arising from it. See § 86.

f. Punitive damages. If an act is not within the scope of employment but is of a sort for which punitive damages can properly be awarded against the one doing the act, such damages can properly be awarded against one who with knowledge of the facts ratifies the acts. Likewise, when a servant or other agent does an act within the scope of employment but for which the master would not be subject to punitive damages, the master is subject to an award of punitive damages if he expresses approval. Retention of the servant in his employment is not, however, of itself sufficient evidence of approval. See § 217C.

§ 100A. Relation Back In Time And Place

The liabilities of the parties to a ratified act or contract are determined in accordance with the law governing the act or contract at the time and place it was done or made. Whether the conduct of the purported principal is an affirmance depends upon the law at the time and place when and where the principal consents or acts.

Comment:
a. For expositions of the operation of the rule as to time, see Sections 82, 86, 89.

For a statement of the applicable rules as to the place, see the Restatement of Conflict of Laws.

§ 118. Revocation Or Renunciation

Authority terminates if the principal or the agent manifests to the other dissent to its continuance.

Comment:
a. Such termination by act of the principal is revocation; by act of the agent, it is renunciation.

b. Power to revoke or renounce. The principal has power to revoke and the agent has power to renounce, although doing so is in violation of a contract between the parties and although the authority is expressed to be irrevocable. A statement in a contract that the authority cannot be terminated by either party is effective only to create liability for its wrongful termination.

Illustrations:
1. In consideration of A's agreement to advertise and give his best energies to the sale of Blackacre, its owner, P, grants to A “a power of attorney, irrevocable for one year” to sell it. A advertises and spends time trying to sell Blackacre. At the end of three months P informs

A that he revokes. A's authority is terminated.
2. In consideration of $1000 and A's promise to endeavor to sell, P grants to A for a period of one year a power of attorney to sell property, with compensation at 25 per cent. of the selling price, the power of attorney ending with this phrase: “Hereby intending and agreeing that this power shall be irrevocable during one year, and that during this period A shall have a power coupled with an interest which shall not be affected by my death or other circumstances.” At the end of three months P informs A that he revokes. A's authority is terminated.

Comment:
c. Liabilities. If there is a contract between principal and agent that the authority shall not be revoked or renounced, a party who revokes or renounces, unless privileged by the conduct of the other or by supervening circumstances, is subject to liability to the other. The rules as to the liabilities of the agent to the principal are stated in Section 400; the liabilities of the principal to the agent, in Sections 450-456.

Where an agent has bound himself to the performance of a contract made for the principal with a third person, he is entitled to perform the contract either with his own goods or money or with those of the principal, and to receive indemnity for losses from the principal. See §§ 438, 439. Likewise, if an agent has a lien for advances upon or services in connection with his principal's goods received for sale, he may have not only a right to retain possession of them, but a right to sell them, either by virtue of common law rules or by statute. See § 464.

d. Non-agency powers. A power in the form of an agency authority given for the protection of a person described as an agent, but who is not one, is not an agency authority and cannot be revoked by the power giver; if such a power is held for the benefit of a third person, it can be terminated neither by revocation nor renunciation. See § 139. Likewise, if a statute provides that a person is to be affected by a notification given to another, designated an agent, the power of the person so designated is not terminated by an attempted revocation. In both of these cases, and in analogous situations, there is no agency as that word is used in the Restatement of this Subject.

Illustration:
3. A statute in State X provides that those entering the state in an automobile thereby consent to the appointment of the Secretary of State as their agent for the receipt of a summons by which action may be begun against them for injuries arising from the operation of the car. P enters X and injures T. P notifies the Secretary of State that he is no longer authorized to receive a summons for him. P's notification is ineffective.

Comment:
e. Subagency. The authority of a subagent to act for the principal is terminated by notification to the subagent or such knowledge as would terminate the authority of an agent and also by similar notification to or knowledge of the agent employing him after the latter has had an opportunity of communicating with him. See § 137, Comment *b*.

§ 144. General Rule

A disclosed or partially disclosed principal is subject to liability upon contracts made by an agent acting within his authority if made in proper form and with the understanding that the principal is a party.

Comment:
a. If a contract is made in the name of the principal or by a description sufficient to identify him, the rule stated in this Section is applicable. The principal may also be subject to liability under the rule stated in this Section although the contract is not made in his name or by a description sufficient to identify him. For the purpose of identifying the principal and charging him upon a contract in writing, parol evidence is admissible. See §§ 149, 153. In the case of sealed or negotiable instruments, the contract is not made in proper form unless upon the face of the instrument the principal is named or described. See §§ 151 and 152.

b. Prima facie, an agent is authorized to make contracts which are incidental, usual, or necessary in the making of a contract specifically authorized. See § 51. If the agent is thus authorized, the rule stated in this Section applies.

Sometimes an agent is authorized to make only part of the contract or the series of dependent contracts which he makes with the third person. If the transaction is a unit and the principal is not bound by the unauthorized part, he is not bound by the contract as authorized, except under the circumstances stated in Section 164(2). Compare Section 148 (several principals) and Section 96, which states the rule which applies when a purported principal affirms part of a transaction conducted by him.

c. The liability of the principal can be enforced by any appropriate action whether legal or equitable; it extends to executory as well as to executed contracts.

d. The principal is subject to liability upon a contract made by the agent acting within his authority to the same extent as if the contract had been made by him in person, subject to the rules in relation to knowledge and notice stated in Sections 268-283. As is stated there, the principal is affected by the agent's knowledge where that is relevant, and by his own knowledge if he has notice that the agent is entering into such a transaction.

Illustrations:
1. P authorizes A to sell a horse, which P knows to be unsound, in a market in which, in the absence of specific repudiation, the seller warrants the soundness of the animals sold. A warrants the horse in the belief that it is sound. P is subject to liability upon the warranty. He is liable in an action of deceit if he intended the misrepresentation. See § 256.
2. T sells a horse to A, P's authorized agent. T represents the horse to be sound. A knows the horse to be unsound. P does not have this knowledge. P is subject to liability upon the contract of purchase unless A colluded with T, although had P been acting in person he would not be liable. See § 272.

Comment:
e. The principal is subject to liability upon an authorized contract although the other party does not know that the agent is authorized, or even though the other party believes that the agent is not authorized. It is sufficient that the other party manifests an intention to enter into contractual relations with the principal.

On the other hand, a third person who knows facts unknown to the agent which indicate that the principal does not wish the contract to be entered into or that he no longer wishes the agent to act for him, can acquire no rights against the principal. The agent in ignorance of such facts is privileged to act but he does not have power to bind the principal to such person and hence has no authority as defined in Section 7.

Illustrations:
3. P tells A to sell certain commodities to T. A makes an offer to T on P's behalf. T replies: “I do not believe you are authorized to sell these, but I will chance it and accept your offer.” There is a contract between P and T.
4. P authorizes A to sell P's automobile. Later P obtains a good offer from Y and sells it to him. In ignorance of this A contracts to sell it to T, who has learned of the sale to Y. T has no claim against P.

Comment:
f. A contract made by the agent on account of the principal does not result in a contract between the principal and the third person if the agent and the third person agree that the transaction is only the contract of the agent. See § 146.

g. The fact that the agent commits a breach of duty to the principal in connection with the circumstances involved in the making of a contract does not necessarily prevent the agent from being authorized. Thus, the insulting of a customer during the progress of negotiations, although a breach of the agent's duty to use skill does not prevent the existence of authority to make a contract with the customer.

h. Even though the agent exceeds his authority in making a contract, the principal may become liable upon it because of the rules stated in Sections 159-178.

§ 186. General Rule

An undisclosed principal is bound by contracts and conveyances made on his account by an agent acting within his authority, except that the principal is not bound by a contract which is under seal or which is negotiable, or upon a contract which excludes him.

Comment:
a. Rationale. The rules with reference to undisclosed principals appear to violate one of the basic theories of contracts. The relation between the principal and a person with whom the agent has made an authorized contract is spoken of as contractual, although by definition there has been no manifestation of consent by the third person to the principal or by the

principal to him. In fact, the contract, in the common law sense, is between the agent and the third person. In spite of this, the law of agency finds it expedient to create rights and liabilities between the other party to the transaction and the principal as if the latter were a contracting party. It may be said that the principal becomes a party to the contract by operation of law, without the will of the third party and, in some cases, contrary to the will of the principal. Just as the common law created a pseudo-contract out of the obligation of a husband to pay for his wife's necessaries, so it has created a similar fictitious contractual relation in the case of the undisclosed principal. In the case of the husband, the liability results from restitutional principles. The liability of the undisclosed principal results from the agency relation.

The normal liability of an undisclosed principal as a party to a contract is in accordance with the ordinary principles of agency, even where the agent violates his orders (see §§ 194-202), since the principal, unlike the beneficiary of a trust, is the one who initiated the activities of the agent and has a right to control them. Having created a relation between the third person and the undisclosed principal analogous to that of contract, the law preserves the equities of the situation by protecting the third person from hardship by limiting the principal's rights to those which he had as a contracting party at the time before his existence was discovered. See §§ 203-206, 306, 307. He is given substantially the same rights as if he were an assignee, or a beneficiary, of a contract, upon whom the law has conferred rights in relatively modern times, although violating earlier conceptions as to the necessity of privity between contracting parties. Subject to these equitable defenses, the undisclosed principal is given the normal rights of a disclosed principal to maintain an action at law. See § 302.

However, because of the variation from normal theories of contracts, the courts have had difficulty with the question whether the third person has two rights, one against the agent and one against the principal, or only one right which can be exercised in the alternative against the principal or the agent, but not against both. The English courts hold that there is but one right, so that if the third person obtains a judgment against the agent, he cannot later have one against the principal. The American decisions are illogical, but more equitable, in holding that if the third person with knowledge of the facts obtains judgment against either one, he cannot have judgment against the other, although if he obtains judgment against the agent with no knowledge of the identity of the principal, he can later get judgment against the principal. See § 210. Neither the American nor English courts give reasons, aside from authority, why the third person should not have a right to two judgments, one based on the agreement itself, the other based on the contract created by law upon the agreement.

b. As stated in Section 322, an agent who makes a contract for an undisclosed principal is personally liable upon the contract as a party to it. The rule stated in this Section gives to the other party the election, subject to the exceptions stated, of holding the principal liable when discovered. Although the other party expects the obligation of the agent alone, he has that of the principal also, unless the contract provides against it, as stated in Section 189.

c. The principal becomes a party to the transaction only if it is proved that the agent intended to act upon his account. See § 199. It is not enough that the proof shows that the one

negotiating the contract acted generally for the benefit of the one sought to be charged or because of something initiated by him. The proof must be that the one making the contract was acting as agent in a matter entrusted to him as agent. For the purpose of proving this, parol evidence is admissible, even though the contract is in writing. However, the fact that the agent acts disobediently does not prevent the act from being on account of the principal; the principal may be liable for the agent's unauthorized acts. See §§ 194-202.

Illustrations:
1. P directs A to purchase 100 tons of coal for him. A purchases the coal from T through correspondence, not revealing that he is acting for a principal. P is subject to liability upon the contract.
2. P goes into the bookstore of A and asks for a certain book. A replies: "I am sold out of that book, but I can get a copy for you in a minute if you will wait." P says he will wait. A goes to the bookstore of T next door and obtains the book from T, telling T to charge it to him, and not stating his purpose in buying it. A delivers and charges the book to P. A does not pay T for it and T, discovering that P procured it from A, seeks to hold P as undisclosed principal. P is not so liable because A was not acting as P's agent, but as a seller.
3. P writes to A authorizing him to buy Blackacre. A does not reply, but contracts to buy Blackacre in his own name. Whether P is liable on the contract depends upon whether A intended to act for himself or for P.

Comment:
d. The liability of the principal extends to all usual or reasonably necessary contracts, the making of which is within the authority of the agent as incidental to the main contract. What contracts are incidental, usual, or reasonably necessary is stated in Section 51. Although the agent exceeds his authority in making an incidental contract, the principal may become subject to personal liability or the loss of his property under the rules stated in Sections 194-202.

Sometimes an agent is authorized to make only part of the contract or the series of dependent contracts which he makes with the third person. If the transaction is a unit and the principal is not bound by the unauthorized part, he becomes a party to the transaction only in accordance with the rule stated in Section 198.

e. The rules stated in this Section apply although the agent violates advice given him by the principal under such circumstances that, as between himself and the principal, there is a breach of duty if the agent, in spite of such violation, is authorized to act. See Comment *g* on § 144.

f. Liability extends to executory as well as to executed contracts and can be enforced by any appropriate action, whether legal or equitable.

g. The rule stated in this Section applies although it is unlawful for the principal to be undisclosed in the particular transaction.

Illustration:
4. P appoints A as agent to operate a saloon in A's name in a state in which a statute makes it unlawful to operate such a business except under the name of the owner. A buys goods on credit from T in the course of the business. P is subject to liability to T for the price of the goods.

§ 209. Choice By Third Person To Look Only To Agent

An undisclosed principal is not discharged from liability upon a contract made for him by an agent by the fact that, after the discovery of his existence or identity, the other party looks only to the agent for payment or performance.

Comment:
a. The other party to the transaction has two rights; he does not lose either by determining to utilize only one. Thus, if, with knowledge of the identity of the principal, the other party charges the agent and refuses to charge the principal, or if he takes a note from the agent, not received in satisfaction of the claim, or files a claim in bankruptcy against the agent and refuses to take any action against the principal, the principal's liability is not affected. Since, however, the two rights arise out of one breach of contract, the principal is discharged from liability if the agent gives satisfaction, as stated in Section 211. If the other party contracts with the agent or principal that the principal is not to be held, the principal is discharged from liability.

§ 210. Judgment For Or Against Agent

(1) An undisclosed principal is discharged from liability upon a contract if, with knowledge of the identity of the principal, the other party recovers judgment against the agent who made the contract, for breach of the contract.

(2) The principal is not discharged by a recovery of judgment against the agent by the other party before knowledge of the identity of the principal.

(3) The existence and extent of the liability of an undisclosed principal upon a contract made by an agent may be determined by a judgment for or against the agent in an action between the agent and the other party in accordance with the rules of res judicata stated in the Restatement of Judgments.

See Reporter's Notes.

Comment on Subsections (1) and (2):
a. Inconsistency of the theories of Subsections: The rule stated in Subsection (1), if considered by itself, appears to adopt a theory that a person dealing with an undisclosed

principal has but one claim which is extinguished by getting a judgment against the agent. The rule cannot properly rest upon a normal doctrine of election--that is, a definitive choice between alternatives--since only a judgment against the agent destroys the claim against the principal. See § 209. However, the rule stated in Subsection (2) seems to reject the theory that the other party makes either a joint contract with the agent and principal, which would be destroyed through merger by judgment against one of the parties, or a contract by which the other party is to have the liability of the principal or agent but not both. Either theory would be an explanation of the rule in Subsection (1). The language in the decisions involving Subsection (2) indicates that the courts look upon the problem as involving an election which cannot be made if the third party is not aware of the principal's existence. In fact, Subsection (1) appears to be inconsistent with the basic reason underlying the liability of the undisclosed principal. In actions of tort, the agent is liable because he committed the tort, the principal because of the doctrine of respondeat superior. In the same way, the agent of an undisclosed principal, in making a contract with a third person is liable because of his promise, the principal because of the agency relation, as in the case of tort. From this it is not possible to find a joint promise, and because of the rule stated in Subsection (2) it is difficult to conceive of a promise in the alternative. However, the rule stated in Subsection (1) represents the prevailing judicial viewpoint, although a few states hold otherwise and most of the commentators find it inconsistent and unjust. The rule stated in Subsection (2) has met with universal approval.

b. Amelioration. The hardship created by the rule stated in Subsection (1) may be ameliorated in several respects. Procedurally, it is possible for the third party to join the principal and the agent in one action and make his choice between principal and agent after the evidence is in. In some states, if the defendants do not require him to make an election, judgment against both can be entered, upon the ground that the defendants have waived their right to object to the judgments. Moreover, if the agent is entitled to exoneration or indemnity from the principal, the plaintiff is entitled to reach this asset of the agent as in the other situations in which a defendant is a secondary obligor.

Comment on Subsection (3):
c. The Restatement of Judgments, Section 85, states the rule where the prior action is controlled by the principal. Sections 97-99 state the rules where the prior action is not controlled by the principal but where the principal or agent has a right of indemnity against the other or where the principal's liability is based solely upon the act of the agent, as it must be when the principal is undisclosed.

§ 214. Failure Of Principal To Perform Non-Delegable Duty

A master or other principal who is under a duty to provide protection for or to have care used to protect others or their property and who confides the performance of such duty to a servant or other person is subject to liability to such others for harm caused to them by the failure of such agent to perform the duty.

Comment:
a. Unless one has directed a specific tortious act or result, or has been negligent, he is normally not responsible for the conduct of others, except that of his agents or servants acting within the scope of their employment. By contract, however, or by entering into certain relations with others, a person may become responsible for harm caused to them by conduct of his agents or servants not within the scope of employment; the extent of this liability depends upon the duty assumed. Also, if one contracts for a result to be achieved, in accomplishing which there is a peculiar likelihood of harm to others, he may become liable for the conduct of those not his agents or servants. There are three forms of the duty of protection. First, a person may have a duty to protect another which can be performed either by exercising care personally in protecting the other or by exercising care in the employment of an independent contractor to protect the other. Secondly, there may be a duty to protect another at all hazards, a duty which is not fulfilled unless the other is protected and which is not satisfied by the use of care. This duty normally exists only when undertaken by contract. Thirdly, one may have a duty to see that due care is used in the protection of another, a duty which is not satisfied by using care to delegate its performance to another but is satisfied if, and only if, the person to whom the work of protection is delegated is careful in giving the protection. In this third class, the duty of care is non-delegable. It is beyond the scope of the Restatement of this Subject to do more than state the general rule and indicate the most frequently arising situations in which a master or other principal may be liable, although without personal fault, for conduct of his agents or servants, whether or not they are acting in scope of employment. In fact, a person who has undertaken a specific piece of work is also liable for the failure of those not his servants or agents to carry out the terms of the undertaking.

b. Action illegal unless licensed. When a license is required for the performance of acts, one having a license who delegates performance of the acts to another is subject to liability for the negligence of the other. Thus, a trucking company doing an interstate business requiring a license is liable for the negligence of an independent contractor whom it employs to do some of the work.

c. Highly dangerous activities. A person who directs another to enter upon an undertaking in which the risk of harm to third persons is great unless certain precautions are taken is sometimes liable to persons injured by the work through the failure of those engaging in it to take such precautions. The rule and its applications are stated more fully in the Restatement of Torts, Sections 416-429. It is not within the scope of the Restatement of this Subject to state what undertakings are so intrinsically dangerous that, although it is not negligent to engage in them, one employing another to engage in them is responsible for the incidental negligent conduct of such other in performing the work. Under the rule stated in this Section, liability exists only if some one connected with the undertaking performs it negligently and then only if the negligence is with respect to the element in the undertaking which causes it to be classed as inherently dangerous.

Illustrations:
1. P employs A, a careful and competent person, to dig a hole in the street, instructing him to

protect travelers therefrom, a permit therefor having been obtained from the city authorities. A digs the hole but negligently fails to illuminate it. P is subject to liability to T, a traveler hurt by falling into the hole owing to the absence of a lantern.
2. Same facts as in Illustration 1, except that A places an adequately protected light near the hole, this being due care on his part. The light is stolen by a third person. P is not liable to T.

Comment:
d. Occupiers of land. The possessor of premises is under a duty to have due care used to prevent the premises from harming persons in the vicinity and business visitors upon them. In some instances he can satisfy this duty by being personally careful. In other situations he is subject to liability for the conduct of an independent contractor whom he employs to make repairs. Thus, the landlord, under a duty to a tenant to keep a common stairway in repair, is subject to liability for harm caused the tenant by the negligent repair or failure to repair by one whom he employs either as an independent contractor or as a servant. If the duty is only to be personally careful, as is the duty to a seen trespasser, he is subject to liability only for conduct of a servant or other agent which is within the scope of employment. See §§ 228-267. The rules and their applications are stated in the Restatement of Torts, Sections 410-425. The duty of an employer to employees with respect to the condition of the business premises is stated in Sections 501-503.

e. Voluntary relations. A master or other principal may be in such relation to another that he has a duty to protect, or to see that due care is used to protect, such other from harm although not caused by an enterprise which has been initiated by the master or by things owned or possessed by him. This duty may be created by contract, as where one agrees to protect another, or may be imposed by law as incident to a relation voluntarily entered into, as the relation of carrier and passenger, or by statute. A statement of the situations in which a duty of this sort exists and of the limits of such duty is beyond the scope of the Restatement of this Subject. In situations coming within the rule stated in this Section, the fact that the one to whom the performance of the duty is delegated acts for his own purposes and with no intent to benefit the principal or master is immaterial.

Illustrations:
3. P, a railroad, employs A, a qualified conductor, to take charge of a train. A assaults T, a passenger. P is subject to liability to T.
4. P invites T to his home as a social guest. A, P's butler, steals from T. P is not liable to T, unless P was negligent in the selection of A.
5. The chambermaid at a hotel steals the clothes of a traveler stopping at the hotel. The hotel keeper is subject to liability although he reasonably believed the chambermaid to be honest.

§ 219. When Master Is Liable For Torts Of His Servants

(1) A master is subject to liability for the torts of his servants committed while acting in the scope of their employment.

(2) A master is not subject to liability for the torts of his servants acting outside the scope of their employment, unless:
(a) the master intended the conduct or the consequences, or
(b) the master was negligent or reckless, or
(c) the conduct violated a non-delegable duty of the master, or
(d) the servant purported to act or to speak on behalf of the principal and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation.

Comment on Subsection (1):
a. Rationale of liability. As stated in the Introductory Note to this Title, the relation of master and servant long antedated the modern conception of agency. In early times the servant was a member of the family or of the mercantile household, and intimacy of relation is still the basic idea which today distinguishes the servant from the non-servant. When units were small and the assistants were chosen when young, frequently remaining until death, it was not difficult to regard the household or business as a unit and to deal with the act of any member of it as the responsibility of its head. The father of a family was, as a matter of course, the master of all those rendering services for it, including the minor children. But as England became a mercantile country, and still later entered the machine age, the unity of the family or other organization was frequently lost. It became more and more difficult to apply to all those who participated in the work the fundamental fiction that "he who acts through another acts for himself", although this could still be applied to authorized acts and contracts.

The great mass of persons who act for others but who are not an integral part of the business establishment and who are used as the need arises,--the factor, the broker, the non-resident selling agent, the lawyer--all of such persons who are not under the immediate eye of the head of the business and who normally operate independent enterprises, obviously do not fall within the group of business intimates. Some might, a priori, be put into either the group of servants or the group of independent contractors. Thus, for instance, a person who derives his entire income from the principal and yet who has no duty to act except as he himself desires and who responds to no discipline, such as some traveling salesmen working on commission, or truck owners paid by the ton mile, might be put into either category. So, too, there are casual manual workers, the carpenter and plumber, who come only when needed and remain but for a short period. The modern enterprise utilizes all of these and it is in these marginal situations that during the past century and a half it has become essential to develop tests for distinguishing the servant from the non-servant. These tests have been used to determine whether the employer should be liable for such of the employee's torts as involve harm from physical conduct and to determine the liability of the employer to the employee. Bearing in mind the purpose for fixing the categories, it may be said that a servant is an agent standing in such close relation to the principal that it is just to make the latter respond for some of his physical acts resulting from the performance of the principal's business.

The conception of the master's liability to third persons appears to be an outgrowth of the idea that within the time of service, the master can exercise control over the physical activities of the servant. From this, the idea of responsibility for the harm done by the

servant's activities followed naturally. The assumption of control is a usual basis for imposing tort liability when the thing controlled causes harm. It is true that normally one in control of tangible things is not liable without fault. But in the law of master and servant the use of the fiction that "the act of the servant is the act of the master" has made it seem fair to subject the non-faulty employer to liability for the negligent and other faulty conduct of his servants. It is probably true that before the nineteenth century the master was not normally responsible for the uncommanded acts of the servant, at least for those which did not enure to the master's benefit. However, with the growth of large enterprises, it became increasingly apparent that it would be unjust to permit an employer to gain from the intelligent cooperation of others without being responsible for the mistakes, the errors of judgment and the frailties of those working under his direction and for his benefit. As a result of these considerations, historical and economic, the courts of today have worked out tests which are helpful in predicting whether there is such a relation between the parties that liability will be imposed upon the employer for the employee's conduct which is in the scope of employment. By and large, the same tests are used in determining whether the worker is a servant for the purpose of ascertaining whether the employer has the special duties and immunities of a master to him.

Comment on Subsection (1):
b. The factors which determine whether or not a person is a servant are stated in Sections 220-227. A subservant, as defined in Section 5, is a servant of the master, and the statements in this Chapter apply to such a person. What constitutes conduct within the scope of employment is stated in Sections 228-237. The master's liability to his servants for the torts of other servants is stated in Sections 473-528. The master's liability for the torts of servants to agents who are not servants is stated in Section 472.

c. Defenses. In an action against the master, the latter has all the defenses open to one defending an action of tort, including contributory negligence, the personal immunity which he has, or a privilege which he or the servant has. Likewise the master is not liable for the failures of a servant to perform a duty to him which he had undertaken gratuitously for the benefit of a third person, although the servant may himself be liable for such failure. See § 354.

d. When servant not employed. The relation of master and servant, like that of principal and agent, is a continuing one and may involve continuing duties to the employer. Thus, the duties of the servant not to disclose business secrets and not to compete unfairly continue through the existence of the relation and in some cases even after its termination. However, the master's liability for the servant's tortious conduct ordinarily exists only during certain periods. The servant has power to subject his master to liability for tortious physical conduct only during such times and in such places as he is authorized to perform service, or at times and places reasonably close to them. As pointed out in Section 233, some servants are "on call" at all times and some, like managers, control their own time. But except for such cases, a servant during the period not set apart for his work is his own man, and his acts do not affect his employer as an employer, except as stated in Subsection (2). Likewise, although a particular act is performed at an authorized place and within the working time of the servant,

the master is not affected by it as a master unless the act is one of the kind which he has authorized, or is incidental to it and, in case of physical acts, unless the servant acts to some extent to forward the business for which he is employed. See § 228. As to other conduct, the servant is a stranger to the master.

Comment on Subsection (2):
e. This Subsection enumerates the situations in which a master may be liable for torts of servants acting solely for their own purposes and hence not in the scope of employment. The first three categories are those in which the master is guilty of tortious conduct or is, by law, responsible for the conduct of others not his servants. See §§ 212-214. Clause (d) includes primarily situations in which the principal's liability is based upon conduct which is within the apparent authority of a servant, as where one purports to speak for his employer in defaming another or interfering with another's business. See §§ 247-249. Apparent authority may also be the basis of an action of deceit (§§ 257-264), and even physical harm. See §§ 265-267. In other situations, the servant may be able to cause harm because of his position as agent, as where a telegraph operator sends false messages purporting to come from third persons. See § 261. Again, the manager of a store operated by him for an undisclosed principal is enabled to cheat the customers because of his position. See § 222. The enumeration of such situations is not exhaustive, and is intended only to indicate the area within which a master may be subjected to liability for acts of his servants not in scope of employment.

§ 220. Definition Of Servant

(1) A servant is a person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services is subject to the other's control or right to control.

(2) In determining whether one acting for another is a servant or an independent contractor, the following matters of fact, among others, are considered:
(a) the extent of control which, by the agreement, the master may exercise over the details of the work;
(b) whether or not the one employed is engaged in a distinct occupation or business;
(c) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;
(d) the skill required in the particular occupation;
(e) whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;
(f) the length of time for which the person is employed;
(g) the method of payment, whether by the time or by the job;
(h) whether or not the work is a part of the regular business of the employer;
(i) whether or not the parties believe they are creating the relation of master and servant; and
(j) whether the principal is or is not in business.

Comment on Subsection (1):
a. Servants not performing manual labor. The word “servant” does not exclusively connote a person rendering manual labor, but one who performs continuous service for another and who, as to his physical movements, is subject to the control or to the right to control of the other as to the manner of performing the service. The word indicates the closeness of the relation between the one giving and the one receiving the service rather than the nature of the service or the importance of the one giving it. Thus, ship captains and managers of great corporations are normally superior servants, differing only in the dignity and importance of their positions from those working under them. The rules for determining the liability of the employer for the conduct of both superior servants and the humblest employees are the same; the application differs with the extent and nature of their duties.

b. Non-contractual employment. The word “employed” as used in this Section is not intended to connote a contractual or business relation between the parties. In fact, as pointed out in Section 225, the relation may rest upon the most informal basis, as where the owner of a car invites a guest to drive the car temporarily in his presence or to assist him in making minor repairs.

c. Generality of definition. The relation of master and servant is one not capable of exact definition. It is an important relation in that upon it depends the liability of the master to third persons and to his employees under the provisions of various statutes as well as under the common law; the relation may prevent liability, as in the case of the fellow servant rule. It cannot, however, be defined in general terms with substantial accuracy. The factors stated in Subsection (2) are all considered in determining the question, and it is for the triers of fact to determine whether or not there is a sufficient group of favorable factors to establish the relation. See Comment *g*. If the inference is clear that there is, or is not, a master and servant relation, it is made by the court; otherwise the jury determines the question after instruction by the court as to the matters of fact to be considered.

d. Control or right to control. Although control or right to control the physical conduct of the person giving service is important and in many situations is determinative, the control or right to control needed to establish the relation of master and servant may be very attenuated. In some types of cases which involve persons customarily considered as servants, there may even be an understanding that the employer shall not exercise control. Thus, the full-time cook is regarded as a servant although it is understood that the employer will exercise no control over the cooking. In other types of situations where an emergency creates peril to human lives, as in the case of a ship in a storm, a servant--in this case the captain--might properly refuse to be controlled by the ship owner and still cause his master to be liable for his negligence or other faulty conduct.

When two persons are engaged in a common undertaking, it may be understood that there is to be joint control, as where two men hire an automobile for a vacation trip, alternating in driving. On the other hand, two servants, directed to drive on their master's business and alternating in driving, do not agree to joint control, and one of them would not be liable to a person hurt by the negligent driving of the other.

Where the owner of a vehicle driven by a guest is in the vehicle, there is ordinarily an inference that he is in control, rebuttable only if he agrees with the guest to surrender complete control to him.

e. Independent contractors. It is important to distinguish between a servant and an agent who is not a servant, since ordinarily a principal is not liable for the incidental physical acts of negligence in the performance of duties committed by an agent who is not a servant. See § 250. One who is employed to make contracts may, however, be a servant. Thus, a shop girl is, and a traveling salesman may be, a servant and cause the employer to be liable for negligent injuries to a customer or for negligent driving while traveling to visit prospective customers. The important distinction is between service in which the actor's physical activities and his time are surrendered to the control of the master, and service under an agreement to accomplish results or to use care and skill in accomplishing results. Those rendering service but retaining control over the manner of doing it are not servants. They may be agents, agreeing to use care and skill to accomplish a result and subject to the fiduciary duties of loyalty and obedience to the wishes of the principal; or they may be persons employed to accomplish or to use care to accomplish physical results, without fiduciary obligations, as where a contractor is paid to build a house. An agent who is not subject to control as to the manner in which he performs the acts that constitute the execution of his agency is in a similar relation to the principal as to such conduct as one who agrees only to accomplish mere physical results. For the purpose of determining liability, they are both "independent contractors" and do not cause the person for whom the enterprise is undertaken to be responsible, under the rule stated in Section 219.

Illustrations:
1. P employs A as a broker to sell Blackacre. A, while driving T, a prospective customer, to inspect the premises, negligently injures him. P is not liable to T.
2. The salesman of a real estate broker, while driving T, a prospective customer, to view a house, negligently injures him. The broker, but not the broker's principal, is subject to liability to T.
f. Subservants. A subservant is a servant of the servant who employed him and also of the master for the conduct of whose affairs he was employed. See § 5(2).

Comment on Subsection (1), continued:
g. Statutory interpretation. The word servant has retained its early significance in cases involving the liability of the master to third persons and the common law liability of master and servant. However, in statutes dealing with various aspects of the relation between the two parties, the word "employee" has largely displaced "servant". In general, this word is synonymous with servant. Under the usual Employers' Liability Acts and the Workmen's Compensation Acts the tests given in this Section for the existence of the relation of master and servant are valid. Beyond this there is little uniformity of decision. Under the existing regulations and decisions involving the Federal Labor Relations Act, there is little, if any, distinction between employee and servant as here used. Under the federal and state wages and hours acts, the purpose of which is to raise wages and working conditions, persons

working at home at piece rates and choosing their own time for work have been held to be employees, although clearly not servants as the word is herein used.

Comment on Subsection (2):
h. Factors indicating the relation of master and servant. The relation of master and servant is indicated by the following factors: an agreement for close supervision or de facto close supervision of the servant's work; work which does not require the services of one highly educated or skilled; the supplying of tools by the employer; payment by hour or month; employment over a considerable period of time with regular hours; full time employment by one employer; employment in a specific area or over a fixed route; the fact that the work is part of the regular business of the employer; the fact that the community regards those doing such work as servants; the belief by the parties that there is a master and servant relation; an agreement that the work cannot be delegated.

i. Effect of custom. The custom of the community as to the control ordinarily exercised in a particular occupation is of importance. This, together with the skill which is required in the occupation, is often of almost conclusive weight. Unskilled labor is usually performed by those customarily regarded as servants, and a laborer is almost always a servant in spite of the fact that he may nominally contract to do a specified job for a specified price. If, however, one furnishes unskilled workmen to do work for another, it is not abnormal to find that the workmen remain the servants of the one supplying them. See § 227. Even where skill is required, if the occupation is one which ordinarily is considered as a function of the regular members of the household staff or an incident of the business establishment of the employer, there is an inference that the actor is a servant. Thus, highly skilled cooks or gardeners, who resent and even contract against interference, are normally servants if regularly employed. So too, the skilled artisans employed by a manufacturing establishment, many of whom are specialists, with whose method of accomplishing results the employer has neither the knowledge nor the desire to interfere, are servants. On the other hand, the question of the degree of skill requisite for the job is often determinative where the actor is employed temporarily to enter the household or establishment and render incidental assistance. Thus, one employing a laborer for a specific job is normally, as stated above, his master; whereas one engaging a plumber to repair a boiler is not, in the absence of a special arrangement for supervision. The fact that the state regulates the conduct of an employee through the operation of statutes requiring licenses or specific acts to be done or not to be done does not prevent the employer from having such control over the employee as to constitute him a servant.

Illustrations:
3. P, who knows little of social affairs, employs A as a social secretary to instruct P in her own deportment and the conduct of all social events, it being agreed that A is to live at P's home and to have complete management within her sphere. P is subject to liability for A's conduct within the scope of employment.
4. P employs a woman to open his summer house. It is agreed that she is to come just before his arrival to clean it and put it in order. For this she is to receive thirty dollars. During her presence in the house, she is P's servant.

Comment on Subsection (2), continued:
j. Period of employment and method of payment. The time of employment and the method of payment are important. If the time of employment is short, the worker is less apt to subject himself to control as to details and the job is more likely to be considered his job than the job of the one employing him. This is especially true if payment is to be made by the job and not by the hour. If, however, the work is not skilled, or if the employer supplies the instrumentalities, the workman may be found to be a servant.

k. Ownership of instrumentalities. The ownership of the instrumentalities and tools used in the work is of importance. The fact that a worker supplies his own tools is some evidence that he is not a servant. On the other hand, if the worker is using his employer's tools or instrumentalities, especially if they are of substantial value, it is normally understood that he will follow the directions of the owner in their use, and this indicates that the owner is a master. This fact is, however, only of evidential value.

Illustrations:
5. P employs A to drive him around town in A's automobile at $4.00 per hour. The inference is that A is not P's servant. If P supplies the automobile, the inference is that A is P's servant for whose conduct within the scope of employment P is responsible.
6. P employs a salesman who agrees to give substantially his full time to the employment and who is furnished a car by the employer. On these facts it is inferred that he is a servant.
7. P employs a salesman who agrees to give full time to the work but furnishes his own car, is paid by commission and can call on those whom he pleases. It is inferred that the salesman is not P's servant.

Comment on Subsection (2), continued:
l. Control of the premises. If the work is done upon the premises of the employer with his machinery by workmen who agree to obey general rules for the regulation of the conduct of employees, the inference is strong that such workmen are the servants of the owner, and this inference is not necessarily rebutted by the fact that the workmen are paid by the amount of work performed or by the fact that they supply in part their own tools or even their assistants. If, however, the rules are made only for the general policing of the premises, as where a number of separate groups of workmen are employed in erecting a building, mere conformity to such regulations does not indicate that the workmen are servants of the person making the rules.

Illustrations:
8. P conducts a manufacturing establishment for the manufacture of woolen goods. Certain factory employees normally arrive at eight in the morning and leave at five in the afternoon, but are not required to work a fixed number of hours or during specified periods, provided they accomplish a specified amount of work during the week, for each unit of which they receive compensation. Such employees are servants.
9. P is the owner of a coal mine employing miners. He provides them with the larger units of machinery and the means of ingress and egress. The miners supply their own implements, the

powder necessary, and their own helpers, being paid for each ton mined and brought to the surface. The miners, including the assistants, are the servants of the mine owner. The assistants are servants of the miners and subservants of the owner.

Comment on Subsection (2), continued:
m. Belief as to existence of relation. It is not determinative that the parties believe or disbelieve that the relation of master and servant exists, except insofar as such belief indicates an assumption of control by the one and submission to control by the other. However, community custom in thinking that a kind of service, such as household service, is rendered by servants, is of importance.

Illustrations:
10. A, employed by a taxi company, is sent by P, his employer, to drive B from X to Y, and it is agreed between A, P, and B that for the purposes of the trip A is to be B's servant, although B is to exercise no more control over A's conduct than is normal in the ordinary case of passengers in taxicabs. A is not B's servant.
11. A is employed by P as resident cook for his household under an agreement in which P promises that he will in no way interfere with A's conduct in preparing the food. A is P's servant.

§ 229. Kind Of Conduct Within Scope Of Employment

(1) To be within the scope of the employment, conduct must be of the same general nature as that authorized, or incidental to the conduct authorized.

(2) In determining whether or not the conduct, although not authorized, is nevertheless so similar to or incidental to the conduct authorized as to be within the scope of employment, the following matters of fact are to be considered:
(a) whether or not the act is one commonly done by such servants;
(b) the time, place and purpose of the act;
(c) the previous relations between the master and the servant;
(d) the extent to which the business of the master is apportioned between different servants;
(e) whether or not the act is outside the enterprise of the master or, if within the enterprise, has not been entrusted to any servant;
(f) whether or not the master has reason to expect that such an act will be done;
(g) the similarity in quality of the act done to the act authorized;
(h) whether or not the instrumentality by which the harm is done has been furnished by the master to the servant;
(i) the extent of departure from the normal method of accomplishing an authorized result; and
(j) whether or not the act is seriously criminal.

Comment:
a. As stated in Section 212, a master is responsible for an act or result which he intends the servant to perform or achieve if the servant acts because of his directions. Also, as stated in

Section 215, a master is responsible for authorized but unintended conduct. Thus, a servant is authorized to do anything which is reasonably regarded as incidental to the work specifically directed or which is usually done in connection with such work. The scope of employment includes not only such acts but also other acts which, as between the master and servant, the servant is not privileged to do. The limits of the scope of employment are dependent upon the facts of the particular case, and no more definite statement can profitably be made concerning them than that made in Subsection (2). Since the phrase "scope of the employment," is used for the purpose of determining the liability of the master for the conduct of servants, the ultimate question is whether or not it is just that the loss resulting from the servant's acts should be considered as one of the normal risks to be borne by the business in which the servant is employed.

The factors here stated have primary reference to the physical activities of servants. The special rules which deal with situations in which the master may be liable for deceit, false arrest or attachment and similar matters are stated in Sections 246-264.

Illustrations:
1. P directs his woodchoppers to cut down specific trees, his directions being such that A, a woodchopper, mistakenly cuts an unspecified tree. While cutting, A negligently injures T. P is subject to liability to T.
2. P employs A as a general farm hand, B as a milker of cows. He directs A not to do any mowing until instructed to do so. In the absence of P and thinking that the grass should be cut immediately, A and B cut the grass. If the cutting of grass is within the duties that A is employed to perform, the fact that P forbids cutting temporarily does not prevent it from being within the scope of A's employment. It is not within the scope of B's employment.
3. A has been employed by P as a general assistant in a machine shop to do odd jobs around the place. As he develops more skill, he is assigned to a particular lathe. A assists another operative in this shop upon a difficult piece of work. The fact that A has not been directed to assist the other operative does not prevent his act in doing so from being within the scope of the employment.
4. P operates a small store employing two clerks and a delivery boy. One of the clerks, during the absence of P and of the delivery boy, to oblige a customer, although his ordinary employment does not include such service, delivers a package to a point close to the store, using a bicycle supplied for the delivery boy's use. It may be found that the conduct of the clerk was within the scope of employment.
5. Same facts as in Illustration 4, except that P has no delivery boy, makes no deliveries, and A uses his own bicycle. The act was not within the scope of employment.
6. P is the owner of an apartment house in a district in which the boys constantly annoy the janitor and interfere with his work. P discharges one janitor who had punished a neighbor's boy for such interference and directs A, the new janitor, to leave boys alone. A does not touch the boys but puts broken glass at the place on the wall where boys customarily climb, in order to exclude them. If it is part of his job to prevent intrusions by defensive means and if his purpose is to prevent intrusions, such act is within the scope of his employment.
7. Same facts as in Illustration 6, except that the janitor has in mind chiefly the punishment of a particular boy whom he dislikes. The addition of this element is sufficient to support a

verdict that the act is not within the scope of employment.

Comment:
b. Acts incidental to authorized acts. An act may be incidental to an authorized act, although considered separately it is an entirely different kind of an act. To be incidental, however, it must be one which is subordinate to or pertinent to an act which the servant is employed to perform. It must be within the ultimate objective of the principal and an act which it is not unlikely that such a servant might do. The fact that a particular employer has no reason to expect the particular servant to perform the act is not conclusive. Although an act is a means of accomplishing an authorized result, it may be done in so outrageous or whimsical a manner that it is not within the scope of employment. An assault by one employed to recapture a chattel, while entirely different from the act which he was employed to do, which was merely to take possession of the chattel, may be within the scope of employment, unless committed with such violence that it bears no relation to the simple aggression which was reasonably foreseeable. See § 245.

c. Acts of a personal nature. Although the servant is authorized to act, the master is not liable for his conduct unless the servant is in fact acting in the employment and for his master's purposes. Getting ready to work or clearing away after work may be within the scope of employment. So, even such personal matters as eating and cleaning of the person may be so much a part of the work and under such control that it is part of the employment. This is true if the master assumes control over the general conduct of the servant during such period. If, however, such acts are for the personal convenience of the employees and are merely permitted by the master in order to make the employment more desirable, the acts are not within the scope of employment. As in other situations, the fact that the acts are done upon the master's premises or with his instrumentalities is important but not conclusive.

Illustrations:
8. P, an engraver, requires all servants employed in finishing work to wash their hands in his wash room before beginning work. The washing of the hands by the employees as part of their daily work is within the scope of employment.
9. P, employing ball players, requires them to eat what he directs and under his supervision. The conduct of the players during meals while under P's control is within the scope of employment.
10. P furnishes a lavatory in which employees may wash, if they wish, before or after working hours, P retaining no control over it except with regard to keeping it clean. An employee turns on the water to wash his hands after hours and fails to turn it off. This act is not within the scope of employment.

Comment:
d. Going to and from work. If the master supplies a servant with a vehicle in order that the servant may go to or from work, it is important to ascertain whether the vehicle is supplied primarily for the purpose of assisting the master's work or for the purpose of assisting the employee to perform what is essentially his own job of getting to or from work. The mere fact that the employer supplies a vehicle does not establish that those who avail themselves

of it are within the scope of employment while upon it, especially if the use is merely casual. On the other hand, the fact that the master contracts to supply a vehicle or that the supplying of a means of access to the work is one of the inducements to the employment indicates that the operation of the vehicle is part of the master's work. If employees are required to use a particular vehicle and particularly if they are paid while in it, it would ordinarily be found that the driver of the vehicle is acting as the employer's servant.

Illustrations:
11. P employs A as a chauffeur, requesting him to drive the car to A's own garage for the night at the termination of the day's work, in order that A can arrive early in the morning. In driving to and from the garage to P's place of business, A is within the scope of employment.
12. P employs A, who lives two miles from P's office. Because A has difficulty in getting to the office on time, he persuades P to allow him to use an old car belonging to P. In driving to the office in this car A is not in the scope of employment.
13. P employs men to do logging five miles from the nearest habitation. In order to be certain that they arrive on time, P habitually supplies and keeps in repair a truck which his workmen, who live in the nearest town, use in going to and from work. It is driven usually, but not invariably, by the one acknowledged to be the best driver. These facts will support a verdict that in driving to and from work, the driver is within the scope of employment.

Comment:
e. The fact that the act is done at an unauthorized place or time or is actuated by a purpose not to serve the master indicates that the act is not within the scope of the employment. See §§ 233-235. In determining whether or not the act is beyond the scope of the employment, the fact that the act is unauthorized in more than one respect is considered. Thus, an act which is a slight departure from that authorized as to its nature, place, and time of performance, may be found to be not within the scope of employment, while a similar act done at the required place and time, or an otherwise authorized act done at a slightly different place or time, would be within the scope of employment. Likewise a number of slight departures from the authorized conduct may place the entire activity beyond the scope of employment.

f. The fact that the act done is a serious crime is a factor indicating that it is not in the scope of employment. See § 231.

§ 230. Forbidden Acts

An act, although forbidden, or done in a forbidden manner, may be within the scope of employment.

Comment:
a. This Section does not include consideration of the cases in which an act, otherwise permitted, is done at a forbidden time or place, as to which see Sections 233-234. It deals only with acts which are not within the authorization of the servant wherever or whenever

done.

b. Acts specifically forbidden. A master cannot avoid responsibility for the negligence of a servant by telling him to act carefully. He cannot limit the servant to the pound of flesh and direct him not to spill blood. But the rule stated in this Section goes much further; it includes specifically forbidden acts and forbidden means of accomplishing results. A master cannot direct a servant to accomplish a result and anticipate that he will always use the means which he directs or will refrain from acts which it is natural to expect that servants may do.

Illustrations:
1. P directs his salesman, in selling guns, never to insert a cartridge while exhibiting a gun. A, a salesman, does so. This act is within the scope of employment.
2. P, the owner of a house, directs his janitor to collect the rubbish and deposit it only in barrels provided for the purpose. The janitor, collecting the rubbish, burns it in a vacant lot behind the house. Under normal circumstances and if performed as part of his service, the janitor's act of burning the rubbish is within the scope of employment.

Comment:
c. Acts not within scope of the work. Conduct is not within the scope of employment if it has no connection with the act which the employee is required to perform. An employer can properly divide his work into as many fractions as he pleases, and a direction to a servant to do only certain classes of acts is, negatively, a prohibition of other acts. Prohibition to do any acts except those of a certain class may indicate that the scope of employment extends only to acts of that class. Furthermore, the prohibition by the employer may be a factor in determining whether or not, in an otherwise doubtful case, the act of the employee is incidental to the employment; it accentuates the limits of the servant's permissible action and hence makes it more easy to find that the prohibited act is entirely beyond the scope of employment. Thus, where a person employs another to make collections, a specific direction by such employer that servants shall not use force in seeking to collect debts is a factor tending to show that an assault made by the servant to enforce collection is not within the scope of employment. On the other hand, if the act forbidden is of a sort which would be likely to be done in the performance of the authorized act, the prohibition has little effect in preventing the act from being within the scope of employment, as where one directed to recapture personal property is directed to use no force against the possessor in retaking it. The same rule applies in the use of an instrumentality. In general, a servant is authorized to use an appropriate instrumentality. If there is no authorization to use a particular one, because it is not as appropriate as some other, the master may still be responsible for its use by the servant. If, however, the master has prohibited the use of the particular one, it is more difficult to find that its use is within the class of acts authorized or is performed with the intent to act in the master's behalf. See § 239.

§ 231. Criminal Or Tortious Acts

An act may be within the scope of employment although consciously criminal or tortious.

Comment:
a. The fact that the servant intends a crime, especially if the crime is of some magnitude, is considered in determining whether or not the act is within the employment, since the master is not responsible for acts which are clearly inappropriate to or unforeseeable in the accomplishment of the authorized result. The master can reasonably anticipate that servants may commit minor crimes in the prosecution of the business, but serious crimes are not only unexpectable but in general are in nature different from what servants in a lawful occupation are expected to do.

A chauffeur, driving on an errand for his master, who knowingly drives on the left-hand side of the street or exceeds the speed limit, is still acting within the scope of employment. Likewise, a gardener using a small stick in an assault upon a trespassing child to exclude him from the premises may be found to be acting within the scope of the employment; if, however, the gardener were to shoot the child for the same purpose, it would be difficult to find the act within the scope of employment. So, if a servant is directed to use any lawful means to overcome competition, the bribery of employees of the competitor, or the circulation of malicious stories, might be found to be within the scope of employment, while the murder of the competitor, although actuated solely by zeal for the master, would not be.

A servant selling goods for his master may cause the master to be liable in an action of deceit, although the servant was guilty of obtaining property by false pretences in making the sale. See Sections 257 and 258. As in other cases, it is a matter of degree, the question being whether or not the conduct is so unlike that authorized that it is a substantially different thing.

Illustrations:
1. A, P's chauffeur, to avoid a rough spot in the road while upon an errand for P, unlawfully drives upon the sidewalk. This conduct is within the scope of employment.
2. P employs A as a servant to dig a ditch in his land, near the road. Finding rock present, A, although knowing that there is an ordinance against using dynamite near the highway, unnecessarily uses it to blast the rock, taking no precautions to guard travelers upon the road. If blasting is an abnormal and unexpectable method of executing the work for which A was employed, the blasting is not within the scope of employment.

Comment:
b. The liability of a master to a penalty for minor crimes committed within the scope of employment is stated in Section 217D; his liability for punitive damages in Section 217C.

§ 336. Election By Other Party To Hold Principal; Agency Disclosed

Unless otherwise agreed, the agent of a disclosed or partially disclosed principal who is a party to a contract made by another with such principal is not relieved from liability upon the contract by the determination of the other party to look to the principal alone, nor, unless the agent and the principal are joint contractors, by the fact that the other gets a judgment against

the principal. He is relieved from liability to the extent that he is prejudiced thereby if he changes his position in justifiable reliance upon a manifestation of the other that he will look solely to the principal for performance.

Comment:
a. The effect of obtaining a judgment against one of several joint contractors is stated in the Restatement of Contracts, Section 119.

If the agent is a party to the contract, but is not a joint contractor, the other party to it has two separate claims. In such a situation, there is no reason to invoke a doctrine of election; taking measures to realize upon one claim does not affect the other. Since, however, both claims are dependent upon one performance, if the principal performs or gives the other party compensation for a failure to perform, the agent is thereby discharged from liability.

Illustration:
1. On behalf of P, A contracts to deliver to T certain goods, it being agreed that A, as well as P, should be responsible for the delivery of the goods. Thereafter, T tells A that since he is sure that P will deliver the goods, he will no longer look to A. A is not thereby discharged from liability if no consideration is given for T's promise.

Comment:
b. When agent is discharged from liability. If the other party to the transaction has manifested to the agent that he will look solely to the principal for payment, the agent is discharged from liability to the extent that he has relied on the representation and as the other should have anticipated, has thereby changed his position. Also, as stated in Section 335, an agent, liable as surety for his principal, may be relieved from liability by dealings between the other party and the principal.

Illustration:
2. Same facts as in Illustration 1, except that, upon the strength of T's statement to him and with T's knowledge, A releases a lien on goods of P held by him as security for the performance by P of the transaction. A is relieved from liability upon the transaction to the extent of the value of his lien.

Comment:
c. Partially disclosed principal. The rule stated in this Section applies to contracts with a partially disclosed principal as well as to those with a fully disclosed principal. In making a contract through an agent for an unidentified principal, the other party to the contract has the same opportunity to select his debtors as where the principal is wholly disclosed. Since he knows the facts, he may, at the time of entering the contract, choose either the joint liability of the agent and the unidentified principal or their several liabilities. Unless otherwise agreed, he has cumulative and not alternative rights against agent and principal.

Illustration:
3. A, being authorized to do so, contracts with T on behalf of P, whose identity is not

disclosed to T. Upon discovering P's identity, T tells A that he is satisfied with P's responsibility and will not thereafter look to A. Since A gives no consideration for this assurance, he is not discharged from liability unless thereafter he changes his position is reliance upon T's statement.

Comment:
d. Special agreements. The parties can agree upon any variation of the liability of the agent; the customs of a business or the nature of the transaction may indicate a variation from the normal. Thus, where the agent represents a partially disclosed principal, it may be found that the agent is to remain liable only until he reveals a principal within the description which he gives. Likewise, the undertaking of one known as an agent may be merely to complete arrangements with one of a number of persons to be selected later, in which case his liability ceases upon the allocation of the contract to one of them, as in the case of a person acting for various underwriters.

Illustration:
4. A custom exists by which a broker purchasing shares is liable upon such purchase only until he reveals the name of the person for whom he purchases. A buys shares from T, not revealing the name of P for whom he is acting. A is liable to T for the purchase price. A reveals P's identity. A is now discharged from liability.

Comment:
e. Effect of prior judgment for or against principal. If the principal and agent are joint contractors, a judgment either against the principal, or for the principal on the merits, destroys the cause of action against the agent on the contract. See the Restatement of Contracts, § 119 and the Restatement of Judgments, § 101.

If principal and agent are joint and several contractors, the judgment cannot adversely affect the agent, unless he was in control of the action. See the Restatement of Judgments, Section 84, for the effect of the agent's control of the prior actions. An unsatisfied judgment against the principal does not relieve the agent from liability. However, the rules of res judicata may give him a defense or a partial defense. See the Restatement of Judgments, §§ 97, 99.

§ 393. Competition As To Subject Matter Of Agency

Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency.

Comment:
a. The reasons for the rule stated in this Section are the same as those which prevent an agent from dealing with the principal as an adverse party, and the rule stated in Section 390 as to the duties of disclosure and fair dealing is applicable.

There is no violation of the agent's duty if the principal understands that the agent is to

compete; a course of dealing between the parties may indicate that this is understood. Likewise, an agent can properly act freely on his own account in matters not within the field of his agency and in matters in which his interests are not antagonistic to those of the principal, except that he can not properly thus use confidential information.

b. Principal's interests preferred to agent's. In the usual case, it is the agent's duty to further his principal's interests even at the expense of his own in matters connected with the agency. Thus, an agent to buy or to sell for the principal must not buy or sell in competition with the principal, unless it is so agreed. An agent employed to purchase a particular piece of land must not purchase it on his own account as long as it is possible to purchase it for the principal. However, it is not wrongful for him to purchase such land for himself if he cannot purchase it for the principal on terms which the principal is willing to make after learning the facts. An agent employed to purchase unspecified goods in the open market can properly purchase goods of the same kind for himself or for some one else, if such purchase does not affect the price or prevent the required amount from being purchased for the principal. If it does so affect the price or amount, the agent is not privileged to do this, unless it is agreed that he can act for himself or for some one else.

c. Where no use of principal's facilities. The rule stated in this Section applies although the agent does not use his employer's facilities or time. Unless otherwise understood, an agent employed to acquire information for the use of the principal is under a duty to report to the principal or to use for his benefit any information relevant to the subject matter of the agency which he acquires, unless it is obtained confidentially from another, who restricts its use. Thus, an agent, employed to act exclusively for the benefit of the principal in looking for paying mines or oil wells, who independently and out of business hours discovers one which he purchases for his own account, holds it as constructive trustee for the principal who is entitled to it upon payment of what it cost the agent. As to patentable ideas acquired by the agent, see Section 397.

The agent is entitled to use knowledge which he acquires independently for all purposes except that of competition with the principal in matters entrusted to him.

d. Where unavoidable conflict of interests. If, without the violation of a duty on the part of an agent, a situation arises in which the principal's affairs conflict with those of the agent, the agent has a duty to deal fairly in the protection of the principal's interests. Thus, if an attorney regularly employed to collect claims receives a claim for collection against a personal debtor and there is no opportunity for him to notify the client of his conflict of interests, he must not attach the debtor's goods on account of his debt to the exclusion of the principal. Likewise, if an agent, such as a factor, has a lien on his principal's goods which he can enforce by sale of the subject matter, he should exercise it with due consideration for the interests of the principal and, if reasonably possible, only after giving the principal an opportunity to take remedial action. See § 464.

e. Preparation for competition after termination of agency. After the termination of his agency, in the absence of a restrictive agreement, the agent can properly compete with his

principal as to matters for which he has been employed. See § 396. Even before the termination of the agency, he is entitled to make arrangements to compete, except that he cannot properly use confidential information peculiar to his employer's business and acquired therein. Thus, before the end of his employment, he can properly purchase a rival business and upon termination of employment immediately compete. He is not, however, entitled to solicit customers for such rival business before the end of his employment nor can he properly do other similar acts in direct competition with the employer's business.

The limits of proper conduct with reference to securing the services of fellow employees are not well marked. An employee is subject to liability if, before or after leaving the employment, he causes fellow employees to break their contracts with the employer. On the other hand, it is normally permissible for employees of a firm, or for some of its partners, to agree among themselves, while still employed, that they will engage in competition with the firm at the end of the period specified in their employment contracts. However, a court may find that it is a breach of duty for a number of the key officers or employees to agree to leave their employment simultaneously and without giving the employer an opportunity to hire and train replacements.

Illustration:
1. A is employed by P as manager for a year. Before the end of the year, A decides to go into business for himself; in anticipation of this and without P's knowledge, he contracts with the best of P's employees to work for him at the end of the year. At the end of the year, A engages in a competing business and employs the persons with whom he has previously contracted. A has committed a breach of his duty of loyalty to P.

Comment:
f. Liabilities. The liabilities of an agent for a breach of the duty stated in this Section and the defenses which he may make, are stated in Sections 399-421A.

§ 395. Using Or Disclosing Confidential Information

Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge.

Comment:
a. The relation of principal and agent permits and requires great freedom of communication between the principal and the agent; because of this, the agent is often placed in a position to obtain information of great use in competing with the principal. To permit an agent to use, for his own benefit or for the benefit of others in competition with the principal, information

confidentially given or acquired by him in the performance of or because of his duties as agent would tend to destroy the freedom of communication which should exist between the principal and the agent. The agent also has a duty not to use information acquired by him as agent or by means of opportunities which he has as agent to acquire it, or acquired by him through a breach of duty to the principal, for any purpose likely to cause his principal harm or to interfere with his business, although it is information not connected with the subject matter of his agency. Thus, an agent who is told by the principal of his plans, or who secretly examines books or memoranda of the employer, is not privileged to use such information at his principal's expense.

Illustration:
1. A, a reporter on a newspaper, learns by eavesdropping that his employers are about to renew the lease on the building in which the newspaper is run. He secretly visits the lessor and obtains a lease on his own account. He may be required to hold this lease as constructive trustee for the newspaper.

Comment:
b. Scope of rule. The rule stated in this Section applies not only to those communications which are stated to be confidential, but also to information which the agent should know his principal would not care to have revealed to others or used in competition with him. It applies to unique business methods of the employer, trade secrets, lists of names, and all other matters which are peculiarly known in the employer's business. It does not apply to matters of common knowledge in the community nor to special skill which the employee has acquired because of his employment. As to the obtaining and use of patents in competition with the employer, see Section 397.

c. When principal consents. In obtaining consent of the principal to use or disclose confidential information, the agent is under the duty of disclosure stated in Section 390.

d. Before and after agency. A person who, in view of a prospective agency, invites a confidence from or permits the prospective principal to reveal confidential information to him, is subject to the same duties with respect to such information as if, at the time the confidence was given, he were in fact an agent.

After the termination of the agency, an agent is entitled to use information obtained by him as agent in competition with former principals to the extent stated in Section 396.

e. Where no violation of duty or loss to the principal. Even though the agent properly acquires and uses confidential information concerning his principal's activities in the course of employment, he has a duty to account to the principal for any profits thereby made. See § 388.

f. Protection of interests of others. An agent is privileged to reveal information confidentially acquired by him in the course of his agency in the protection of a superior interest of himself or of a third person. Thus, if the confidential information is to the effect that the principal is

committing or is about to commit a crime, the agent is under no duty not to reveal it. However, an attorney employed to represent a client in a criminal proceeding has no duty to reveal that the client has confessed his guilt.

g. Liabilities. The liabilities of an agent for a breach of the duties stated in this Section, and the defenses which can be made, are stated in Sections 399-421A. The liabilities to the principal of a third person who benefits from the misuse of confidential information are stated in Sections 311-314.

§ 463. General Rule (Remedies Of Agent)

An agent whose principal violates or threatens to violate a contractual or restitutional duty to him has an appropriate remedy. He can, in a proper case:
(a) maintain an action at law;
(b) obtain a decree for an accounting or other equitable relief;
(c) maintain a claim to a set-off or a counterclaim in an action brought by the principal;
(d) refuse to render further services;
(e) exercise the rights of a lien holder; or
(f) stop in transit goods shipped to the principal.

Comment:
a. The rights an an agent to maintain an action at law and his privilege to refuse to continue to serve are stated in Sections 432-462. The Restatement of this Subject does not undertake to state the circumstances under which an agent can obtain a decree for an injunction, an accounting, or other equitable relief, or to state when he is entitled to a set-off or counterclaim. The circumstances under which is he entitled to a lien or to stop goods in transit are stated in Sections 464-466.

b. The remedies of an agent against his principal are not mutually exclusive. Thus, in a proper case, he can refuse to continue to serve and at the same time maintain an action against the principal; he can exhaust his remedies as a lien-holder and then maintain an action for a deficiency.

c. An agent is not entitled to a decree for the specific performance of a contract of employment. The fundamental concept of agency is the performance by the agent of that which the principal desires. Each of the parties to the relation has power to terminate it, even though the exercise of the power constitutes a breach of contract. Compare the rules stated in Sections 14H, 38 and 39 concerning the powers which in form are agency powers but which are powers for security.