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BUSINESS ORGANIZATIONS

Cases, Problems, and Context

Fifth Edition

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To Sue.
For constant support and understanding.

D. Gordon Smith

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Thank you.

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Thank you.

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Introduction: Trends and Challenges in Business Law

With the advent of the digital transformation, increasing focus on social and environmental sustainability, and a renewed emphasis on stakeholder rights, this is a dynamic time to be studying business law. There are trends and challenges within and outside of companies that are having profound effects on the internal organization of business and on the context in which business occurs. In this short introduction, we survey a number of the most significant of these trends.

OVERVIEW

Despite the complexity surrounding business associations, we believe that (with limited exceptions) the legal principles central to the law of business associations are quite straightforward. Most issues in this course arise simply because one person — an agent, such as an employee — has acted on behalf of another person — the principal, such as an employer. Whenever an agency relationship exists, there is a risk that the agent will not behave in accordance with the principal's wishes. Hence the adage, "If you want something done right, do it yourself." But doing everything oneself is an onerous burden to all but the smallest of small business operators. In the business world, therefore, principals attempt to structure their relationships in ways that minimize the risk of having agents deviate from their wishes and best interests. The law relating to business associations may be viewed as providing legal rules to accomplish this goal. Much of business organizations law derives from one of the oldest set of principles in the common-law world, those of “agency law” and the fiduciary obligations of agents to their principals.

Yet, over the past several decades, changes both within and outside the firm are having profound effects on the context in which business law issues arise. New types of business associations that we will study (limited liability companies, limited liability partnerships, and public benefit entities) have been developed and have gained widespread acceptance in the business world. The law relating to corporations underwent a dramatic reconsideration during the hostile takeover era of the 1980s, and the repercussions of those changes continue to be ironed out by courts, legislatures, and regulators. Modern business developments — particularly, the globalization of the economy and the increasing importance of digital currencies, artificial intelligence, venture capital, franchising, supply chains, and cross-border governance structures — inevitably impose stress on legal rules designed to address the problems of a different era. Finally, there has been an explosion in situations involving agency law, as fundamental principles of the common law are adapted to the modern regulatory state, to global supply chains, to franchising arrangements,

and to global enterprises involving hundreds of independently established companies, called subsidiaries, in each country in which the firm does business. The use of artificial intelligence (AI) in business decisions further raises interesting questions about the liability of humans for AI’s actions. Thus, within “the firm,” new pressures are proliferating, as we will see immediately in Chapter One.

Outside of the firm, companies are being buffeted by social trends and challenges that are raising the expectations of society regarding “responsible” business conduct, although definitions of what exactly that may be vary widely. The COVID-19 pandemic and related shutdowns of businesses across the global economy beginning in March of 2020, including the near-total shut down of the airline and hospitality industries, resulted in profound economic dislocation for people and for businesses large and small. It also caused government intervention in the U.S. economy to an extent not seen since the Great Depression of the 1930s. The murder of George Floyd in May of 2020 in Minneapolis, Minnesota, sparked the Black Lives Matter movement in the U.S., which provoked examinations of systemic racism and put pressures on companies to reconsider their policies on equality, diversity, and inclusion (EDI). In 2018 and 2020, California introduced two bills requiring companies based in California to have a specified minimum number of women directors and directors from underrepresented communities, respectively. The events at the Capitol on January 6, 2021, as Congress met to certify the results of the election of 2020, similarly put pressure on companies to declare their support for American constitutional norms. And globally, recognition of climate change as both a financially significant risk to investors and companies and as an existential risk to communities and people has been putting a spotlight on corporate directors’ and officers’ actions to incorporate climate change risks and opportunities into their companies’ strategies, oversight, and disclosures. Dozens of the world’s largest companies have halted or limited their operations in Russia in response to its invasion of Ukraine in February 2022. While each of these profound disruptions may be seen as outside of “the corporation,” they are also reverberating within companies, through the actions of business elites and through the actions of shareholders themselves. We sketch a few of these trends here, and take up the issues in further detail in Chapters Six and Seven.

1. *Shifting Norms for the Responsibilities of Business*

Within the last few years, high-level organizations of CEOs and business elites have issued statements supporting “stakeholder capitalism,” an approach that suggests that companies should be run for the benefit of all of their stakeholders, including customers, employees, suppliers, communities, and shareholders. Such statements were issued by the Business Roundtable in the U.S., an organization of CEOs of the 500 largest companies in the United States, in August of 2019; the British Academy, a highly respected organization led by academics and with business leaders as participants, in November of 2019; and the World Economic Forum in Davos, Switzerland, which issued the Davos Manifesto on Stakeholder Capitalism, in December of 2019. In the U.S., the Business Roundtable explicitly rejected its decades-long support for the view that companies should prioritize shareholder wealth maximization, called “shareholder primacy.” The British Academy made

a more subtle shift from its “enlightened shareholder capitalism” to the position that “the purpose of business is to solve the problems of people and planet profitably.” Has European-style stakeholder capitalism won in the competition between the proper beneficiaries of corporate governance systems, stakeholders versus shareholders? The authors think it is far too early to draw such a conclusion, at least for the U.S. and its corporate law, but the debate over what companies’ social responsibilities are, and should be, is front and center in a way it has not been since the 1980s.

2. *Shareholder Activism and Sustainability*

Another trend is increasing pressure on management and boards to pay attention to environmental and social "sustainability." The term "sustainability" generally means acting with some recognition of global environmental limits, the importance of healthy social foundations for thriving economies, and concern for future generations. Sustainability is increasing in importance not because business leaders have all become environmentalists or social activists, but because it is becoming clear that social and environmental issues have financial implications. A comprehensive review in 2015 of 200 "best in class" studies of the relationships between sustainability as a management practice and financial performance found as follows: 90 percent of these studies showed that sound sustainability standards lower firms' cost of capital, that is, the cost to fund the firm's operations; 80 percent showed that companies' stock prices are positively influenced by good sustainability practices; and 88 percent showed that better environmental, social, or governance practices result in better financial performance.[1]

Concerns for sustainability have been brought into companies most directly through the actions of investors — a development some might find ironic. The world's largest investor, BlackRock, which manages over $10 trillion (USD) of other people's money as of January, 2022, has rhetorically led this charge. Since 2018, BlackRock's CEO Larry Fink has been emphasizing the global financial risks of climate change, growing economic inequality, and social fragmentation, setting out these concerns in an annual letter to the CEOs of the thousands of companies in which BlackRock invests globally. After some pressure from civil society, BlackRock has begun voting with its shares in a manner consistent with these concerns. As we will discuss in Chapter Six, investors who hold shares of stock in companies have voting rights in those companies, and subject to many exclusions, have rights to put proposals for discussion and voting on the agenda of the annual general meeting (AGM) of the shareholders. Increasingly, investors are voting in favor of sustainability proposals. An analysis of shareholder voting trends from 2000 to 2018 by ISS Analytics, the research arm of the major voting (proxy) advisor ISS (Institutional Shareholders' Services), concluded that "[t] he most significant change in investors' voting behavior pertains to environmental and social issues, as these proposals are earning record

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levels of support in recent years. . . ."[2] ISS stated that ESG (environmental, social, and governance) proposals are "increasingly focusing on disclosure, risk assessment, and oversight," seeking key indicators of management's approach to matters such as workforce diversity, climate change, and employee health and safety.[3]

While companies are clearly being buffeted by the sustainability concerns of major institutional investors such as BlackRock and ClimateAction 100+, a global coalition of investors with $65 trillion (USD) of money under management (as of January 2022) engaged in pressuring 167 high-emitting companies worldwide to develop specific plans for greenhouse-gas emissions reductions, this is not to suggest that all shareholders today are prioritizing sustainability matters. For the last fifteen years or more, "hedge fund shareholder activists" have been engaged in pressuring companies to improve their financial returns to shareholders. These investors buy shares of a public company with the intention of putting pressure on those companies to prioritize short-term strategies or transactions to increase share prices and redistribute funds to shareholders. These strategies and transactions include cutting research and development, borrowing money to distribute to shareholders in dividends or share buy-backs, selling divisions of the company, and engaging in mergers and acquisitions. This shareholder activism trend encourages companies to reduce the kinds of research and development that might make contributions to sustainability challenges;[4] to split up companies that might otherwise be able to cross-subsidize or cross-fertilize research ideas between divisions to make significant progress on difficult technological issues; and as a general matter to prioritize short-term shareholder interests, even at the expense of longer-term "permanent shareholders"[5] or stakeholders. Thus, as we will see most specifically in Chapter Six, current trends are bringing about a collision of short-term, shareholder pressures with long-term challenges and asserted corporate responsibilities, both aspects of which companies are somehow expected to accommodate.

3. Digital Transformation and the Shift to a "Metaverse"

Another external trend changing internal firm dynamics is the digital transformation. In ***Digital Transformation*** (2019), Thomas M. Siebel describes the business world as a series of "punctuated equilibria" occurring as a series of bursts of

evolutionary change. Siebel suggests that we are presently in the midst of an evolutionary punctuation, citing to evidence of a mass extinction and a mass speciation of innovative entities with entirely new DNA in the corporate world. According to Siebel, the causal factors of this mass extinction and subsequent speciation is the confluence of four technologies — cloud computing, big data, the internet of things (IoT), and artificial intelligence (AI) — which he collectively refers to as the "digital transformation." It is still early for these changes to be reflected in corporate case law, but they have substantial implications for corporate law and governance.

Another technology that is expected to have a significant impact on corporate governance is distributed ledger technologies (DLTs), such as blockchains. NYU Finance professor David Yermack, who is one of the most widely cited academics in this emerging field, has opined that blockchain technology could change corporate governance as much as any event since the Securities Act of 1933 and the Securities Exchange Act of 1934. Those federal statutes transformed corporate governance by bringing extensive federal disclosure requirements into effect before shares of stock could be sold publicly, or traded on exchanges, or before shareholders in public companies could be asked to vote on any transaction. Thus, what Professor Yermack is suggesting is a quite transformative potential for blockchain technology.

BLOCKCHAIN AND OTHER DISTRIBUTED LEDGER TECHNOLOGIES

The concept of a blockchain was first introduced in a white paper by pseudonymous author Satoshi Nakamoto entitled ***Bitcoin: A Peer-to-Peer Electronic Cash System***. In the paper Nakamoto envisioned a peer-to-peer system that would allow online payments to be sent directly from one party to another without going through an intermediary. While the origins of blockchain were motivated by a vision of a purely peer-to-peer electronic cash system (and indeed, the most well-known application of blockchain is the creation of digital tokens such as Bitcoin), the disintermediated and decentralized nature of the blockchain system has myriad exciting applications for corporate governance as well.

How is such a disintermediated and decentralized system created, and what are some of its advantages? Nakamoto's paper outlines a network that "timestamps transactions by hashing them into an ongoing chain of hash-based proofs-of-work, forming a record that cannot be changed without redoing the proof-of-work." Breaking this definition down into its functional components, blockchain technology is a (1) distributed network that is (2) consensus-based and (3) immutable. First, blockchain technology relies on a network, or a chain, of multiple parties (sometimes referred to as “peers” or “nodes”) to jointly maintain and edit a database. Second, this database is maintained according to a consensus mechanism, such as a “proof-of-work” protocol that requires members of the network to expend effort to solve an arbitrary mathematical puzzle to participate in the network. Third, blockchains are considered to be immutable or non-repudiable, or at least more so than their centralized counterparts. This is because the decentralized (or distributed) nature of the blockchain system makes it much more difficult to modify existing data, which is scattered across a multitude of nodes. This feature of blockchain

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technology ensures the provenance of assets, meaning that for any given asset, one can know with high accuracy not only its current status, but also where it has been and what has happened throughout its existence. Furthermore, trust in the provenance of assets stems from the blockchain’s consensus mechanism, not from any particular individual member, the identities of whom are often unknown, which is why the integrity of the blockchain is sometimes referred to as “trustless trust.”(If you feel this description gives rise to more questions than answers, we agree. While those questions and answers are outside the scope of a course on business law, banking and securities regulators are actively engaged in relevant policy making and regulatory interventions.)

SMART CONTRACTS

The concept of a "smart" contract was first introduced by Nick Szabo, an American cryptographer and George Washington Law graduate, who published an article introducing the concept of a smart contract in 1994.[6] In that article, Szabo defines a smart contract as "a computerized transaction protocol that executes the terms of a contract." To be clear, smart contracts are ***not*** legal documents, they are computer code.

The descriptor "smart" refers to the ability of a smart contract to execute on its own when pre-determined conditions are met. This self-executing feature of the smart contract eliminates the need to involve and rely upon third parties to execute the contract and verify the accuracy of the process. As an example, insurance company Axa is using smart contracts to provide flight delay insurance. The service is set up to automatically provide a refund to a policy holder when air traffic control systems in Europe record a delay of two hours or more, based on consumer protection requirements for air passengers that require compensation for delays under the airlines' control.

Smart contracts require a trustworthy platform that specifies the agreed-upon terms and has the ability to determine and to execute when prespecified conditions have been met. Blockchain and other distributed ledger technologies are some of the technologies available to provide such platforms. Together, smart contracts and distributed ledgers can be used to create a self-executing and immutable record, which can be used to improve accuracy and transparency in many aspects of corporate governance, as discussed below.

CORPORATE GOVERNANCE APPLICATIONS OF BLOCKCHAIN AND SMART CONTRACTS

What are some of the current and projected uses of these emerging technologies in corporate governance? One area of immense interest for blockchain

developers has been corporate voting. As will be discussed in Chapter Six, one of the key rights that a shareholder has is the right to vote. However, the data reveals that fewer than one in three retail investors exercises this right. Broadridge Financial Solutions, a global fintech company that processes shareholder communications and proxy voting in the United States, reported that retail shareholder participation was only 28 percent in the 2018 proxy season.[7] (As you'll learn, shareholders normally vote on an annual basis through giving the power to vote their shares, their "proxy," to others, typically management, based on disclosure from management about how that voting power will be used.) This is in contrast to institutional shareholder participation, which was 91 percent during the same period. Yaron Nili and Kobi Kastiel provide data on the negative impact of shareholders' apathy toward corporate governance, finding that mobilizing non-voters could have had a substantial impact on the outcome of contested corporate elections or shareholder initiatives.[8]

Retail shareholder apathy is a phenomenon that has not gone unnoticed by regulators. The U.S. Securities and Exchange Commission (SEC) has organized a series of roundtables to discuss the low participation rates of retail shareholders in the proxy process, and many of these discussions have focused on how technological advances can be used to enhance the participation of shareholders in the voting process. In particular, blockchain and smart contracts have been discussed as potential alternatives to conventional electronic voting platforms that could reduce shareholder apathy by facilitating and incentivizing shareholder voting.

Specifically, blockchain technology could be used to record and identify shareholders who have voting rights, record the votes of these shareholders, and provide aggregated voting data based on the information recorded on the blockchain. Furthermore, the greater speed, transparency, and accuracy afforded by blockchain-enabled corporate voting could motivate shareholders to participate more directly in corporate governance, such as by providing them with a user-friendly mechanism to demand votes on topics that are of interest to them. By inviting more active and real-time participation in corporate governance, these technologies could further empower the shareholder proposal process, especially on matters like climate change, which is discussed in more detail in Chapter Six.

These ideas have already been tested and operationalized both in the U.S. and abroad. For example, Decentology, a California-based smart contract marketplace, has developed blockchain software for shareholder voting, with one of the key features of its software being that it permits participants to audit the votes. As another example, in February of 2016, NASDAQ (Estonia) announced a pilot program for blockchain voting in shareholder meetings hosted by issuers on the exchange.

However, as we know from our current experience with online voting technologies, technology is not always the answer. Retail investor participation in voting continues to decline even as voting technology continues to improve. Technology can make it easier for shareholders to vote, but that doesn't mean that shareholders will show up to vote unless they believe that their vote matters. What must change,

fundamentally, is shareholder awareness, culture, and incentives, which can begin with but cannot end with technology.

In addition to shareholder voting, corporate books and records have been highlighted as another area that could be improved by blockchain and distributed ledger technologies. In particular, George Geis has written about the key benefits of using blockchain technologies to maintain precise records of share provenance: (1) blockchain technologies significantly narrow the temporal decoupling of governance rights and economic interest; (2) they reduce the need to rely on intermediaries such as brokers or proxy solicitation firms; (3) they reduce errors; and (4) they avert the undesirable consequences of "empty voting," wherein shareholders vote in transactions where they have no (or in some cases, adverse) economic interest in the outcome of the transaction because of countervailing derivatives positions.[9] Professor Geis explains how theory is applied to practice by discussing recent efforts, including The Depository Trust & Clearing Corporation's (DTCC) project with IBM to clear securities through a customized distributed ledger system.

Another proposal comes from Dr. Federico Panisi and co-authors, who have suggested the use of blockchain to resolve inefficiencies related to the complexities of the current shareholding architecture and lack of transparency regarding ownership of shares.[10] Today, because even the largest institutional shareholders hold their shares in brokerage accounts or Cede & Co., a firm dedicated to holding shares, it is difficult for companies to know who their actual shareholders, the "beneficial" shareholders, are. This lack of knowledge becomes an issue in contested votes. Under the Panisi et al. proposal, companies would issue digital shares (or smart securities), which would be settled in real-time, and corporations would be able to maintain a single comprehensive register that would be secure, transparent, and immutably reflective of ownership. As such, there would be no discrepancy between record and beneficial shareholders, and voting rights could be exercised directly by owners.

More generally, new platforms are being developed to allow companies to place key governance documents and procedures on the blockchain. Shareholders can already view this information through the company website, but by making these documents available on a blockchain, these platforms seek to achieve greater transparency. For example, a shareholder would be able to view not only the current version but prior versions of a company's organizational documents or codes of conduct. A shareholder would also have the assurance that these documents are not under the unilateral control of the company, but instead are verified by a consensus mechanism that would be disclosed to them.

While these benefits are impressive and have the potential to democratize corporate governance, blockchain and other DLTs are not without their limitations. As mentioned above, the identities of the individual members who maintain copies

of records on a distributed ledger are not usually known. This pseudonymous nature of transactors makes the distributed ledger technology susceptible to misuse. Another problem is the energy-intensive nature of blockchains and other distributed ledger technologies. While spreading the data across multiple computer nodes is what ensures the immutability of the record, this method also requires duplicate copies of the data, which in turn requires duplicate energy. A 2021 New York Times article reported that Bitcoin uses more electricity than many countries.[11] According to this article, "[t] he process of creating Bitcoin to spend or trade consumes around 91 terawatt-hours of electricity annually, more than is used by Finland, a nation of about 5.5 million."

CORPORATE LAW IMPLICATIONS OF BLOCKCHAIN AND SMART CONTRACTS

There has been a varying degree of receptiveness among states to the use of blockchain technologies in corporate voting and record keeping. As a testament to the expected growth of this field, many states have formed working groups to evaluate blockchain technologies, and a few among them have introduced new laws specifically concerning blockchain.

For example, Arizona's A.R.S. § 44-7061 recognizes smart contracts as valid commercial contracts and recognizes signatures and records on blockchain as valid electronic records. Another approach taken by states (including Oklahoma, Ohio, and Washington) has been to update their Uniform Electronic Transactions Act (UETA) to include blockchain and to recognize blockchain records.

A handful of states have also amended their corporate code to address the increasing use of blockchains for corporate recordkeeping. In Delaware, Senate Bill 69 was enacted in 2017 to recognize the use of corporate records stored in distributed electronic networks or databases. Specifically, the bill amended the definition of "electronic transmission" to include distributed ledger technologies. (As will be discussed, although Delaware is the second smallest state in the United States (by area), it is by far the most important state in the U.S. for corporate law. Every student in a U.S. corporate law class will learn — or should learn — Delaware corporate law.) Nevada recognizes blockchain as a valid and legal form of corporate recordkeeping for various types of business entities, including corporations and partnerships, and also includes a specific provision that prohibits local governments from taxing or charging fees for blockchain use or imposing any licensing or other requirements.

Generally speaking, Delaware has adopted a permissive approach, but with safeguards. As an example of such safeguards, Delaware law requires electronics records to be reproduced in paper form upon request and that the technology be open to inspection. On the other hand, Nevada has adopted a more permissive approach with few safeguards (for example, by undercutting fiduciary duties and

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eliminating taxes), with the clear intent to attract blockchain-based business. This theme of state competition in the market for corporate charters using differentiated degrees of regulation is one that we will return to in later chapters.

* * *

Hopefully this brief overview of some significant trends affecting business enterprises has whetted your appetite to learn more about the law and the context in which businesses operate today. We'll start with agency law, addressing the significant ways in which agency law is affected by many of these trends.

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1. ***See*** Gordon L. Clark, Andreas Feiner & Michael Viehs, ***From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance*** (2015), *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281.*

2. Kosmas Papadopoulos, ISS Analytics, ***The Long View: U.S. Proxy Voting Trends on E&S Issues from 2000 to 2018***, Jan.31, 2019, *https://corpgov.law.harvard.edu/2019/01/31/the-long-view-us-proxy-voting-trends-on-es-issues-from-2000-to-2018/.*

3. ***Id.***

4. ***See*** John C. Coffee, Jr. and Darius Palia, ***The Wolf Is at the Door: The Impact of Hedge Fund Activism on Corporate Governance,*** 41 J. Corp. L. 545 (2016) (presenting data on the decline in R&D spending in companies targeted by shareholder activists between 2009 and 2013: from R&D spending of 17.34% of sales in 2009 to 8.12% of sales in 2013. A control group of firms that had not been targeted by activists showed an increase in R&D expenditures during the same period: from 6.54% of sales in 2009 to 7.65% of sales in 2013.).

5. For an analysis of the possible conflicts between undiversified, hedge fund shareholder activists and diversified, "permanent shareholders" such as BlackRock, Vanguard, and State Street, ***see*** John C. Coffee, Jr., ***The Agency Cost of Activism: Information Leakage, Thwarted Majorities, and the Public Morality,*** Nov. 2017, ***available at*** *www.ssrn.com/abstract_id=3058319.*

6. Nick Szabo (1994), "Smart Contracts," retrieved from *http://www.fon.hum.uva.nl/rob/Courses/InformationInSpeech/CDROM/Literature/LOTwinterschool2006/szabo.best.vwh.net/smart.contracts.html.*

7. Broadridge and PwC, ***2018 Proxy Season Review*** (ProxyPulse, October 2018).

8. Yaron Nili and Kobi Kastiel (2016), ***In Search of the "Absent" Shareholders: A New Solution to Retail Investors' Apathy*** (2016) Del. J. Corp. L. 41(1): 55.

9. George Geis (2018), ***Traceable Shares and Corporate Law,*** Northwest. Univ. L. Rev. 113(2): 267.

10. Federico Panisi, Ross Buckley, and Douglas Arner (2019), ***Blockchain and Public Companies: A Revolution in Share Ownership Transparency, Proxy Voting and Corporate Governance?*** Stanford J. of Blockchain Law & Policy 2:1.

11. *https://www.nytimes.com/interactive/2021/09/03/climate/bitcoin-carbon-footprint-electricity.html.*

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Chapter 1

The Law of Agency

MOTIVATING HYPOTHETICAL

When the first Cloudberry Frozen Yogurt store opened the venture seemed destined to fail. In fact, so few people came to the tiny frozen yogurt shop in New York City, that sales totaled only $70 after the first month. Word spread quickly, however, and soon people from miles around were lining up to sample Cloudberry's unique blend of tangy frozen yogurt and fresh fruit toppings. Within a year, Cloudberry became a local phenomenon. So many people came that New York City forced the shop to post guards at the door to control the massive crowds. Parking problems created by the yogurt-hungry masses prompted the New York Times to dub Cloudberry's product "the taste that launched 1,000 parking tickets." Hordes of Cloudberry fans gave their newfound addiction a different unofficial nickname: Crackberry.

Cloudberry fever soon spread beyond New York to Los Angeles and other major U.S. markets. Cloudberry now had locations nationwide and plans to continue expanding globally, partnering with selected "area developers" to open frozen-yogurt shops in Mexico and the Middle East. Area developers license territories, usually defined by metropolitan statistical areas, and agree to build numerous stores within that area. Area developers must enter into an area development agreement with Cloudberry (which establishes the number of stores to be developed in an area) and a franchise agreement for each store opened.

* * *

Generally speaking, an agent is any person who is authorized to act on behalf of another (known as the principal). The law of agency governs the interactions among principals, agents, and the third parties with whom agents deal on behalf of principals. In the preface to one of the first treatises on the law of agency, William Paley wrote: “The law of Principal and Agent appears at first view to be founded upon principles so few and simple, and in general so easy of application, that a treatise upon such a subject may seem altogether superfluous.” William Paley, ***A Treatise on the Law of Principal and Agent*** at iii. Paley found sufficient justification for his treatise, however, in the “vast extension of modern commerce, [and] the novelty and variety of the channels through which it is carried on.”

Today agency issues are, if anything, more pervasive than in Paley’s day, and they are certainly more complicated than Paley’s skeptics would have been willing to concede. Personal injury law, commercial law, and employment law — not to mention partnership law and corporate law — all involve issues of agency law.

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The following materials do not attempt to cover the entire breadth of agency law, but instead strive to explore the fundamental principles relating to creation of an agency relationship and the potential liabilities flowing from that relationship. These principles are essential to the transaction of business generally and to the understanding of the law of business associations covered in subsequent chapters.

The law of agency developed as part of the common law. In 1812 Paley wrote that “the decisions upon this branch of the law which are to be met with in the older reports are neither numerous nor important." In the 19th century, however, the law of agency came into full flower. As business transactions became increasingly complicated, the law of agency became concomitantly necessary to bring order and equity. Justice Joseph Story published his magnificent ***Commentaries on the Law of Agency*** in 1839, and it quickly became the leading authority on agency law cited by American courts. Although the last edition of Story's treatise (the 9th edition, published in 1882, as revised by Charles P. Greenough) was cited well into the 20th century, it was largely displaced by Floyd R. Mechem's ***A Treatise on the Law of Agency*** in 1888. The second edition of Mechem's treatise, which appeared in 1914, was widely cited by American courts, especially before the publication of the first edition of the Restatement of the Law of Agency by the American Law Institute in 1933, and Mechem is still cited by modern courts.

The 900-pound gorilla in this field, however, is the Restatement. Originally published in 1933, the Restatement was again published in 1958 in the Restatement (Second) of the Law of Agency, and the American Law Institute published Restatement (Third) of the Law of Agency in 2006. Although cases still cite the Restatement (Second), the text and cases in this chapter will highlight the relevant provisions of the Restatement (Third). The Restatement is not binding on courts, but it is cited in many modern decisions invoking agency law. The Restatement has helped to unify the law of agency among different states. Despite the apparent certainty that the Restatement conveys, however, underlying the principles are many challenging legal issues with which business lawyers and courts often struggle.

A. CREATION OF THE AGENCY RELATIONSHIP

Paley's treatise on agency law devoted only a single sentence to the creation of the agency relationship: "The authority of an agent is created either by deed, by simple writing, by parol, or by mere employment, according to the capacity of the parties, or the nature of the act to be done." Paley, ***A Treatise on the Law of Principal and Agent*** at 2. The common law cases offered a more detailed exploration of agency formation, starting from the proposition that an agency relationship is a consensual relationship between a principal and an agent. According to Restatement (Third), an agency relationship is created when (1) the principal "manifests assent" to have the agent act on the principal's behalf and under the principal's control, and (2) the agent "manifests assent or otherwise consents" so to act. Restatement (Third) of Agency §1.01. In Restatement (Third), use of the word "assent" is "intended to emphasize that unexpressed reservations or limitations . . . do not restrict the [party's] expression of consent." Restatement (Third) of Agency §1.01, note d.

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Although the parties must agree to enter into the type of relationship described, no contract is required to form an agency relationship. Restatement (Third) of Agency §1.01, note d (observing, "Many agents act or promise to act gratuitously"). Indeed, the parties need not have an intent to enter into something called an agency relationship. As stated in Restatement (Third) of Agency §1.02, "Whether a relationship is characterized as agency in an agreement between parties or in the context of industry or popular usage is not controlling."

The "legal consequences of agency" will be explored more fully in subsequent sections. For present purposes, suffice it to say that the creation of an agency relationship has — in the words of Restatement (Third) — both "inward-looking" and "outward-looking" consequences. Restatement (Third) of Agency §1.01, note c. Inward-looking consequences relate to the relationship between the principal and the agent and are largely governed by the contracts between the parties and by the law of fiduciary duties. Outward-looking consequences relate to the relationship among the principal, the agent, and a third party and are governed by the various "principles of attribution" examined in Section C later in this chapter.

Outward-looking consequences tend to be the primary focus in cases where the central issue is agency formation. The following case, Yost v. Wabash College, involves a very common form of outward-looking consequence — a claim by a tort victim that a principal is liable for the tortious conduct of an agent.

Yost v. Wabash College

3 N.E.3d 509
Supreme Court of Indiana
February 13, 2014

DICKSON, Chief Justice.

The plaintiff, a college freshman and fraternity pledge, filed this personal injury action seeking damages from his college, his campus fraternity, its national organization, and a student fraternity member for personal injuries sustained in an incident at the fraternity house . . . .

The plaintiff, Brian Yost, as an 18-year-old freshman at Wabash College and a pledge at the Phi Kappa Psi fraternity, suffered injuries in an incident at the fraternity house in September 2007. Contending that his injuries resulted from a fraternity hazing incident, the plaintiff initiated this action seeking damages from Wabash College (the owner and landlord of the fraternity house), the campus local fraternity (Phi Kappa Psi Fraternity–Indiana Gamma Chapter at Wabash College, hereafter the "local fraternity"), the national fraternity (Phi Kappa Psi Fraternity, Inc.), and Nathan Cravens, one of the fraternity members . . . . The college and the two fraternity defendants sought summary judgment, which the trial court granted and then ordered entry of final judgments thereon. The plaintiff appealed, and the Court of Appeals affirmed. We granted transfer.

1. Wabash College

Wabash sought summary judgment, asserting . . . it is not subject to vicarious liability for the actions of any co-defendant . . . .

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Yost's complaint . . . asserts that Wabash (and the national fraternity) may be held vicariously liable for the alleged negligence of the local fraternity. In seeking summary judgment, Wabash contends that there is "no evidence that demonstrates the necessary elements of manifestation of an agency relationship-consent and control," and thus that it could not be vicariously liable as a matter of law.

Vicarious liability is "a legal fiction by which a court can hold a party legally responsible for the negligence of another, not because the party did anything wrong but rather because of the party's relationship to the wrongdoer." Sword v. NKC Hospitals, Inc., 714 N.E.2d 142, 147 (Ind. 1999). Under this doctrine of imputed liability, "an employer, who is not liable because of his own acts, can be held liable 'for the wrongful acts of his employee which are committed within the scope of employment.' " Id. at 148 (quoting Stropes v. Heritage House Childrens Ctr. of Shelbyville, Inc., 547 N.E.2d 244, 247 (Ind. 1989)). While frequently discussed within the context of an employer-employee relationship, the terms "employer" and "employee" do not always convey the common understanding of employment but reference the master-servant or principal-agent relationship of agency law. "Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." Restatement (Third) of Agency §1.01 (2006). Two traditional rationales underlying the doctrine are "that the employer is properly held accountable, first, because the servant acts upon an implied command from his master and, second, because the master is presumed to exercise control over the behavior of his servant." ***Stropes***, 547 N.E.2d at 252. The employer-master may thus be held vicariously liable for the wrongful acts of the employee-servant committed within the scope of the agency relationship.

With respect to Wabash, construing the evidence in favor of Yost, the non-moving party, the record establishes the lack of any agency relationship between the local fraternity and Wabash. [Wabash is the owner and landlord of the fraternity house. Wabash prohibits hazing and has responded to previous incidents of hazing with disciplinary measures.] Yost contends that the property lease with right-of-entry and Wabash's practice of disciplining individual participants and sanctioning or withdrawing recognition of fraternities for hazing activities demonstrate that "Wabash had the right to control the activities of [the local fraternity] and its members." But Yost's argument glosses over an essential element of the agency relationship — the agent must "***act on the principal's behalf***." Restatement (Third) of Agency §1.01 (2006) (emphasis added); see also id. cmt. g ("The common-law definition of agency requires as an essential element that the agent consent to act on the principal's behalf, as well as subject to the principal's control. From the standpoint of the principal, this is the purpose for creating the relationship."). Yost contends merely that "Wabash benefits from the presence of fraternities on campus." That Wabash may have benefitted from the presence of the local fraternity does not necessarily mean that the activities, or even the existence, of the local fraternity were as a representative of Wabash. To be sure, the local fraternity operated only with the permission of Wabash, an existence which was predicated on compliance with certain university policies and subject to discipline for noncompliance. But mere consent to governance does not equate to agency. The consent innate to the agency relationship is not merely acquiescence to control, but also the

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undertaking of some action on behalf of the principal. See Restatement (Third) of Agency §1.01 cmt. c (2006) ("The common-law definition [of agency] requires that an agent hold power, a concept that encompasses authority but is broader in scope and connotation."). Moreover, the principal must "manifest[] assent . . . that the agent shall act on the principal's behalf." Id. §1.01. There is neither evidence that Wabash assented to such an arrangement nor evidence that the local fraternity manifested assent to take action on behalf of Wabash. This is not a matter upon which there is any issue of material fact, but rather an issue of law. There is no genuine issue of fact tending to show the existence of an agency relationship, and thus the actions of the local fraternity and its members cannot, as a matter of law, be imputed to Wabash under a theory of vicarious liability.

We conclude that, because Wabash, as landlord, had relinquished control of the house to the local fraternity, because any duties assumed by Wabash did not extend to direct oversight and control of individual students living in the house, and because of the absence of any vicarious liability of Wabash arising from any agency relationship between Wabash and the local fraternity, Wabash is entitled to summary judgment in its favor.

2. The National Fraternity

As to the national fraternity's motion for summary judgment, the question is whether there is an absence of any genuine issue of fact to support . . . vicarious liability for the actions of the local fraternity. To succeed on its motion for summary judgment, the national fraternity must establish that the undisputed designated evidence establishes as a matter of law that it did not have any duty to protect Yost from the injuries he sustained and that it was not vicariously liable for the actions of the local fraternity.

The designated evidence indicates that the national fraternity strongly disapproved of hazing and promoted gentlemanly behavior in its printed charters and bylaws through its aspirational enactments and promotional materials. Additionally, each local chapter is annually provided with a risk guide from the national fraternity's insurance company that prohibits hazing, and each fraternity member completes an online course on fraternity life that contains instruction on the dangers of hazing and hypothetical examples of hazing behavior. As to its authority and practice of direct control, the national fraternity retains the power to "issue and suspend charters and also to revoke the same after due notice and hearing," and to discipline or expel individual members of the fraternity after notice and a hearing. Finally, each local chapter has an advisor that acts as a liaison between the local fraternity and its national namesake. That advisor, however, is a volunteer selected by the local chapter (subject to approval by the national fraternity) and is not under the control of the national fraternity. The national fraternity's manual equates the local chapters to "small corporation[s] " and states that "[e]ach chapter is a complete self-governing body subject to certain rules and regulations set out by the [national fraternity]."

. . .

Yost . . . argues that the national fraternity should be vicariously liable for the conduct of the local fraternity and its members. The national fraternity asserts that it is entitled to summary judgment because the designated evidence shows that it

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did not have the power to control the conduct of the local fraternity or its members toward Yost, nor did the local fraternity members consent to any such control . . . .

The designated facts show that the relationship between the national fraternity and local fraternity involves the national fraternity offering networking opportunities and a brand to the local fraternity, along with providing aspirational goals and encouraging good behavior by individual members. It is not an agency relationship between principal and agent. Subject to retention of the right to suspend or revoke its affiliation with the local fraternity or its members, there is no evidence that the actual management and control over the resident members is a responsibility consensually exercised by the local fraternity as the agent and at the direction of and on behalf of the national fraternity. The conduct of the local fraternity in everyday management and supervision of the activities and conduct of its resident members is not undertaken on behalf of the national fraternity. This is not a matter upon which there is any dispositive issue of material fact, but rather an issue of law. There is no genuine issue of fact tending to show the existence of an agency relationship, and thus the actions of the local fraternity and its members cannot, as a matter of law, be imputed to the national fraternity under a theory of vicarious liability.

Accordingly, summary judgment in favor of the national fraternity is appropriate.

. . . .

Conclusion

We hold that the designated evidence shows that there is no genuine issue as to any material fact and that Wabash College and the national fraternity (Phi Kappa Psi Fraternity, Inc.) are each entitled to summary judgment as a matter of law, but that as to the local fraternity (Phi Kappa Psi Fraternity–Indiana Gamma Chapter at Wabash College), there remain genuine issues of material fact that preclude summary judgment. The judgment of the trial court is thus affirmed in part and reversed in part. This cause is remanded to the trial court for further proceedings.

David, Massa, and Rush, JJ., concur.

Rucker, J., concurs in part and dissents in part with separate opinion [omitted].

PROBLEM 1-1

The franchise relationship is a contractual relationship and both franchisors and franchisees contribute significantly to its success. The Franchise Agreement is the basic governance document for the franchising relationship. Both parties value uniformity within the system and strive to maintain the competitiveness of the system. The terms of a franchising agreement require a balance between predictability (to avoid opportunism) and flexibility (to respond to a changing business environment).

As with most franchises, Cloudberry contributes three things to the franchising relationship: (1) trademarks and trade dress; (2) trade secrets, which are part

of what is often referred to as the “System”; and (3) services, often including site selection, training, promotion, bookkeeping, compliance with laws and system standards, and insurance. In exchange for these things, the franchisees pay a onetime franchise fee ($45,000 in the case of Cloudberry) and ongoing royalties (6% of gross sales). Also, the franchisees are required to pay for the development of the franchise store according to the franchisor’s specifications, which may cost anywhere from $400,000 to $1,500,000, depending on size and location.

To ensure uniformity within the system, franchisors like Cloudberry impose systemwide standards, usually contained in a franchise license agreement or operations manual. These requirements are notoriously detailed and wide ranging. For instance, the Cloudberry License Agreement regulates everything from ingredients and menu items to display signs to advertising formats to hours of operation. Failure to comply with these standards could result in termination of the franchise.

Cloudberry also requires the managers and assistant managers of its outlets to complete a training program prior to opening an outlet. Once the outlet is open, Cloudberry has the right to inspect the outlet, which includes the right to speak to employees of the franchisee. Cloudberry requires franchisees to submit weekly, monthly, quarterly, and annual reports. Often, these reports contain routine financial information regarding Gross Sales. However, Cloudberry may also require franchisees to submit additional operational and statistical information to assist in product purchasing, product development, or System refinements. Finally, Cloudberry explicitly provides for a right to audit each franchisee's books.

Denise Hernandez stopped at a Cloudberry store in Long Beach, California. When Hernandez approached the counter, the store cashier, Rachel Jones, began to insult Hernandez, using profanity and racial epithets. Hernandez, a PhD candidate in biophysics at UCLA, was born and raised in Los Angeles. Before Hernandez had a chance to recover from the shock of being so insulted, Jones also threw a counter display in her direction. After Hernandez retreated from the inside of the store, Jones continued to yell racial epithets and made obscene gestures through the window.

Jones is employed by the Long Beach franchisee for Cloudberry, and the law is clear that Jones is the franchisee's agent. Moreover, the franchisee, as the principal in an agency relationship, would almost certainly be liable to Hernandez for the agent's actions. ***Could***

the franchisor, Cloudberry, also be liable to Hernandez for Jones's actions?

In answering this question, please consider the following provision from Cloudberry's License Agreement:

> Relationship of Licensee to Company. It is expressly agreed that the parties intend by this Agreement to establish between Company and Licensee the relationship of franchisor and franchisee. It is further agreed that Licensee has no authority to create or assume in Company's name or on behalf of Company, any obligation, express or implied, or to act or purport to act as agent or representative on behalf of Company for any purpose whatsoever. Neither Company nor Licensee is the employer, employee, agent, partner or co-venturer of or with the other, each being independent.
>
> . . .
>
> Company and Licensee agree that the relationship created by this Agreement is one of independent contractor and is not a fiduciary relationship.

B. AGENT'S FIDUCIARY DUTIES TO PRINCIPAL

Principals and agents owe duties to each other within an agency relationship. ***See*** Restatement (Third) of Agency, Ch. 8. The principal's duties include performance of contract obligations, indemnification under certain circumstances, and good faith and fair dealing. Restatement (Third) of Agency §8.13-8.15. The agent's duties include performance of contract obligations, care, competence, diligence, obedience, and disclosure. Restatement (Third) of Agency §8.07-8.12. But the most important duty in the law of agency — and the focus of attention here — is the agent's duty of loyalty to the principal. The essence of this duty is that the agent must act "loyally for the principal's benefit in all matters connected with the agency relationship." Restatement (Third) of Agency §8.01. The agent's duty of loyalty is multifaceted and includes, among other obligations, a duty "not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party" (Restatement (Third) of Agency §8.05), a duty not to compete with the principal in any matter within the scope of the agency relationship (Restatement (Third) of Agency §8.04), a duty not to act as an adverse party to the principal in a transaction connected with the agency relationship (Restatement (Third) of Agency §8.03), and a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal (Restatement (Third) of Agency §8.02). If the agent breaches the duty of loyalty, the principal's primary remedies are damages and disgorgement of profits, if any.

The following case introduces the duty of loyalty, which is a fundamental element of entity law, and as such will reappear in numerous permutations throughout this book.

Food Lion, Inc. v. Capital Cities/ABC, Inc.

194 F.3d 505
United States Court of Appeals, Fourth Circuit
October 20, 1999

MICHAEL, Circuit Judge.

Two ABC television reporters, after using false resumes to get jobs at Food Lion, Inc. supermarkets, secretly videotaped what appeared to be unwholesome food handling practices. Some of the video footage was used by ABC in a Prime-Time Live broadcast that was sharply critical of Food Lion. The grocery chain sued Capital Cities/ABC, Inc., American Broadcasting Companies, Inc., Richard Kaplan and Ira Rosen, producers of PrimeTime Live, and Lynne Dale and Susan Barnett, two reporters for the program (collectively, "ABC" or the “ABC defendants”). Food Lion did not sue for defamation, but focused on how ABC gathered its information through claims for fraud, breach of duty of loyalty, trespass, and unfair trade practices. Food Lion won at trial, and judgment for compensatory damages of $1,402 was entered on the various claims. Following a substantial (over $5 million) remittitur, the judgment provided for $315,000 in punitive damages. The ABC defendants appeal the district court’s denial of their motion for judgment as a matter of law, and Food Lion appeals the court’s ruling that prevented it from proving

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publication damages. Having considered the case, we (1) reverse the judgment that the ABC defendants committed fraud and unfair trade practices, (2) affirm the judgment that Dale and Barnett breached their duty of loyalty and committed a trespass, and (3) affirm, on First Amendment grounds, the district court’s refusal to allow Food Lion to prove publication damages.

I

In early 1992 producers of ABC’s PrimeTime Live program received a report alleging that Food Lion stores were engaging in unsanitary meat-handling practices. The allegations were that Food Lion employees ground out-of-date beef together with new beef, bleached rank meat to remove its odor, and re-dated (and offered for sale) products not sold before their printed expiration date. The producers recognized that these allegations presented the potential for a powerful news story, and they decided to conduct an undercover investigation of Food Lion. ABC reporters Lynne Dale (Lynne Litt at the time) and Susan Barnett concluded that they would have a better chance of investigating the allegations if they could become Food Lion employees. With the approval of their superiors, they proceeded to apply for jobs with the grocery chain, submitting applications with false identities and references and fictitious local addresses. Notably, the applications failed to mention the reporters' concurrent employment with ABC and otherwise misrepresented their educational and employment experiences. Based on these applications, a South Carolina Food Lion store hired Barnett as a deli clerk in April 1992, and a North Carolina Food Lion store hired Dale as a meat wrapper trainee in May 1992.

Barnett worked for Food Lion for two weeks, and Dale for only one week. As they went about their assigned tasks for Food Lion, Dale and Barnett used tiny cameras ("lipstick" cameras, for example) and microphones concealed on their bodies to secretly record Food Lion employees treating, wrapping and labeling meat, cleaning machinery, and discussing the practices of the meat department. They gathered footage from the meat cutting room, the deli counter, the employee break room, and a manager's office. All told, in their three collective weeks as Food Lion employees, Dale and Barnett recorded approximately 45 hours of concealed camera footage.

Some of the videotape was eventually used in a November 5, 1992, broadcast of PrimeTime Live. ABC contends the footage confirmed many of the allegations initially leveled against Food Lion. The broadcast included, for example, videotape that appeared to show Food Lion employees repackaging and redating fish that had passed the expiration date, grinding expired beef with fresh beef, and applying barbeque sauce to chicken past its expiration date in order to mask the smell and sell it as fresh in the gourmet food section. The program included statements by former Food Lion employees alleging even more serious mishandling of meat at Food Lion stores across several states. The truth of the PrimeTime Live broadcast was not an issue in the litigation we now describe.

Food Lion sued ABC and the PrimeTime Live producers and reporters. Food Lion's suit focused not on the broadcast, as a defamation suit would, but on the methods ABC used to obtain the video footage. The grocery chain asserted claims of fraud, breach of the duty of loyalty, trespass, and unfair trade practices, seeking millions in compensatory damages. Specifically, Food Lion sought to recover

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(1) administrative costs and wages paid in connection with the employment of Dale and Barnett and (2) broadcast (publication) damages for matters such as loss of good will, lost sales and profits, and diminished stock value. Punitive damages were also requested by Food Lion.

The district court, in a remarkably efficient effort, tried the case with a jury in three phases. At the liability phase, the jury found all of the ABC defendants liable to Food Lion for fraud and two of them, Dale and Barnett, additionally liable for breach of the duty of loyalty and trespass. Based on the jury's fraud verdict and its special interrogatory findings that the ABC defendants had engaged in deceptive acts, the district court determined that the ABC defendants had violated the North Carolina Unfair and Deceptive Trade Practices Act (UTPA). Prior to the compensatory damages phase, the district court ruled that damages allegedly incurred by Food Lion as a result of ABC's broadcast of PrimeTime Live — "lost profits, lost sales, diminished stock value or anything of that nature" — could not be recovered because these damages were not proximately caused by the acts (fraud, trespass, etc.) attributed to the ABC defendants in this case. Operating within this constraint, the jury in the second phase awarded Food Lion $1,400 in compensatory damages on its fraud claim, $1.00 each on its duty of loyalty and trespass claims, and $1,500 on its UTPA claim. (The court required Food Lion to make an election between the fraud and UTPA damages, and the grocery chain elected to take the $1,400 in fraud damages.) At the final stage the jury lowered the boom and awarded $5,545,750 in punitive damages on the fraud claim against ABC and its two producers, Kaplan and Rosen. The jury refused to award punitive damages against the reporters, Dale and Barnett. In post-trial proceedings the district court ruled that the punitive damages award was excessive, and Food Lion accepted a remittitur to a total of $315,000.

After trial the ABC defendants moved for judgment as a matter of law on all claims, the motion was denied, and the defendants now appeal. Food Lion cross-appeals, contesting the district court's ruling that the damages the grocery chain sought as a result of the PrimeTime Live broadcast were not recoverable in this action. We now turn to the legal issues.

II

A.

. . .

ABC argues that Dale and Barnett cannot be held liable for a breach of duty of loyalty to Food Lion under existing tort law in North and South Carolina. It is undisputed that both reporters, on behalf of ABC, wore hidden cameras to make a video and audio record of what they saw and heard while they were employed by Food Lion. Specifically, they sought to document, for ABC's PrimeTime Live program, Food Lion employees engaging in unsanitary practices, treating products to hide spoilage, and repackaging and redating out-of-date products. The jury found that Dale and Barnett breached their duty of loyalty to Food Lion, and nominal damages of $1.00 were awarded.

As a matter of agency law, an employee owes a duty of loyalty to her employer. . . . The courts of North and South Carolina have not set out a specific

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test for determining when the duty of loyalty is breached. Disloyalty has been described in fairly broad terms, however. Employees are disloyal when their acts are "inconsistent with promoting the best interest of their employer at a time when they were on its payroll," Lowndes Prods., Inc. v. Brower, 259 S.C. 322, 191 S.E.2d 761, 767 (S.C. 1972), and an employee who "deliberately acquires an interest adverse to his employer. . .is disloyal," Long v. Vertical Techs., Inc., 113 N.C. App. 598, 439 S.E.2d 797, 802 (N.C. Ct. App. 1994).

ABC is correct to remind us that employee disloyalty issues are usually dealt with in the context of the employment contract: unfaithful employees are simply discharged, disciplined, or reprimanded. Up to now, disloyal conduct by an employee has been considered tortious in North and South Carolina in three circumstances. First, the tort of breach of duty of loyalty applies when an employee competes directly with her employer, either on her own or as an agent of a rival company. Second, the tort applies when the employee misappropriates her employer's profits, property, or business opportunities. Third, the tort applies when the employee breaches her employer's confidences.

Because Dale and Barnett did not compete with Food Lion, misappropriate any of its profits or opportunities, or breach its confidences, ABC argues that the reporters did not engage in any disloyal conduct that is tortious under existing law. Indeed, the district court acknowledged that it was the first court to hold that the conduct in question "would be recognized by the Supreme Courts of North Carolina and South Carolina" as tortiously violating the duty of loyalty. Food Lion, Inc. v. Capital Cities/ABC, Inc., 964 F. Supp. 956, 959 n.2 (M.D.N.C. 1997). We believe the district court was correct to conclude that those courts would decide today that the reporters' conduct was sufficient to breach the duty of loyalty and trigger tort liability.

What Dale and Barnett did verges on the kind of employee activity that has already been determined to be tortious. The interests of the employer (ABC) to whom Dale and Barnett gave complete loyalty were adverse to the interests of Food Lion, the employer to whom they were unfaithful. ABC and Food Lion were not business competitors but they were adverse in a fundamental way. ABC's interest was to expose Food Lion to the public as a food chain that engaged in unsanitary and deceptive practices. Dale and Barnett served ABC's interest, at the expense of Food Lion, by engaging in the taping for ABC while they were on Food Lion's payroll. In doing this, Dale and Barnett did not serve Food Lion faithfully, and their interest (which was the same as ABC's) was diametrically opposed to Food Lion's. In these circumstances, we believe that the highest courts of North and South Carolina would hold that the reporters — in promoting the interests of one master, ABC, to the detriment of a second, Food Lion — committed the tort of disloyalty against Food Lion.

Our holding on this point is not a sweeping one. An employee does not commit a tort simply by holding two jobs or by performing a second job inadequately. For example, a second employer has no tort action for breach of the duty of loyalty when its employee fails to devote adequate attention or effort to her second (night shift) job because she is tired. That is because the inadequate performance is simply an incident of trying to work two jobs. There is no intent to act adversely to the second employer for the benefit of the first. Because Dale and Barnett had the

requisite intent to act against the interests of their second employer, Food Lion, for the benefit of their main employer, ABC, they were liable in tort for their disloyalty.

We hold that, insofar as North and South Carolina law is concerned, the district court did not err in refusing to set aside the jury's verdict that Dale and Barnett breached their duty of loyalty to Food Lion.

PROBLEM 1-2

The Long Beach Cloudberry store has recently been drawing a lot of positive social media attention and long lines for their raw cookie dough topping. Olivia Marten is a graduate student who is pursuing her Master of Science in Nutritional Science at California State University Long Beach, and she also works part-time at Long Beach Cloudberry. Olivia recently learned about the harmful health effects of eating raw batter or dough because of Escherichia coli (E. coli), Salmonella, and other harmful bacteria that can be found in flour and uncooked eggs. She informs her manager of the risks of serving raw cookie dough as a topping but her manager brushes her off. Olivia tells the manager that she will do whatever is necessary to inform Long Beach Cloudberry customers about the harmful effects of eating raw cookie dough.

Is Olivia breaching her fiduciary duty if she publishes a post on social media (under the Long Beach Cloudberry account) warning customers of the potential harmful effects of eating raw cookie dough?

PROBLEM 1-3

An agent's fiduciary duty of loyalty to her principal ends the day the agency relationship ends, and thus the former agent may begin to compete with the former principal. Employers will often protect themselves from competition with their former employees by requiring their employees to sign agreements not to compete with the company after the employment relationship ends. Such agreements will be enforced in most states so long as they are "reasonable," which means so long as they are limited in time (three years or less, typically), and so long as there are sensible geographic boundaries to the noncompetition agreement.

Paul Rockham worked in marketing for Cloudberry for five years and ultimately became responsible for marketing of Cloudberry's franchises. As part of marketing, Cloudberry obtained raw market research data and used it to develop models of consumers' preferences to determine the product areas that were most successful in different geographic areas. Rockham's particular expertise was international marketing — that is, determining which products to sell in which foreign countries, based upon marketing strategies and advertising claims. As a member of worldwide, multifunctional teams at Cloudberry, just prior to leaving the company Rockham developed a confidential ten-year global marketing plan for Cloudberry's franchises.

When Rockham was hired by Cloudberry, he was offered stock options, as were all of the company's top management employees. As a condition for getting the options, Rockham was required to sign an agreement not to compete with Cloudberry for three years after leaving the company.

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Rockham was offered the job of president of Red Mango, Inc., another frozen yogurt franchisor that competed directly with Cloudberry. Soon after Rockham joined Red Mango, Cloudberry brought an injunctive action against Rockham to enforce the covenant not to compete, claiming that Rockham's knowledge of how Cloudberry cross-indexed its market research (in order to be able to determine which products were most successful among which consumers in which countries) and how Cloudberry organized its area developers was confidential information and constituted a trade secret.

While the court hearing Cloudberry's case found that Rockham's agreement to the covenant not to compete was "entirely voluntary," the court also found that failing to agree would have required Rockham to give up the stock options. Rockham was also required to sign a confidentiality agreement when he was hired, as were all other Cloudberry employees, in which he agreed not to disclose any of Cloudberry's trade secrets or confidential information, particularly how it cross-indexed its market research. The trial court ruled in Rockham's favor, finding this was not confidential information and refusing to enforce the covenant not to compete.

How should the court of appeals rule on Cloudberry's appeal? How would you advise someone like Rockham (in advance), who is being asked to sign a broad confidentiality agreement and covenant not to compete?

C. PRINCIPLES OF ATTRIBUTION

As stated above, the existence of an agency relationship has both inward-looking consequences, through, among other things, the imposition of fiduciary duties, and outward-looking consequences. The outward-looking consequences come about because principals can be held liable for the tortious actions of their agents, and can be required to fulfill contracts into which their agents have entered. In this section, we will explore the factors used by courts to justify holding principals responsible for the consequences of their agents' actions.

The official comment c. to Restatement (Third) of Agency §1.01 states:

> The chief justifications for the principal's accountability for the agent's acts are the principal's ability to select and control the agent and to terminate the agency relationship, together with the fact that the agent has agreed expressly or implicitly to act on the principal's behalf.

Reduced to its simplest terms, this passage invokes the concepts of ***control***, ***benefit***, and ***consent***, all of which are commonly found in the cases. The primary rationale for imposing liability based on the existence of control is neatly summarized by the ancient maxim, "***Qui facit per alium facit per se***" ("he who acts through another, acts himself”). The rationale for imposing liability based on the existence of benefits to the principal is simply that those who gain from the actions of another should sometimes be held to answer for costs inflicted by those actions. In addition to control and benefit, courts also seem to rely at times on the notion of ***consent*** to justify

liability. As noted above, consent is central to the determination of when an agency relationship exists, and thus when it is fair to impose liability on the principal for actions of the agent.

As you work through the materials in this section, consider what level of control is necessary to prompt a finding of liability, and think about why control, standing alone, is (usually) insufficient for such a finding. Similarly, the existence of benefits to the principal does not necessarily lead to liability for the agent’s actions. It is useful, therefore, to identify the circumstances in which benefit seems to play an important role in a court’s decision. In thinking about each of these issues, it is also useful to separate the rationales for imposing liability in the tort context from the rationales for holding principals responsible for fulfilling contracts into which their agents have entered.

The following sections examine several bases for holding one person or entity — the principal — responsible for the actions of another person — the agent. The doctrines of authority, both actual authority and apparent authority, are central to agency law. In addition to these doctrines of attribution based on principles of authority, principals may incur liability for the actions of their agents based on the general doctrine of vicarious liability — ***respondeat superior*** — which we do not cover here on the assumption that most students will have encountered this doctrine in Torts.

1. Actual Authority

When an agent acts with authority, her action has legal consequences for the principal. Such action, when taken "in accordance with the principal's manifestations to the agent that the principal wishes the agent so to act" is known as "actual authority." Restatement (Third) of Agency §2.01.

Actual authority is created by a manifestation from the principal to the agent, as reasonably understood by the agent, that the principal consents to the agent taking actions on the principal's behalf. Restatement (Third) of Agency §3.01. Thus, in evaluating the actual authority of an agent, one would evaluate the communications and other manifestations from the principal to the agent, as reasonably understood by the agent. Actual authority may exist even though there is no written contract between a principal and an agent, although certain kinds of authority (such as the authority to sell real estate for another) must be in writing based on individual state law requirements.

An agent's actual authority typically includes both express and implied aspects. The "express actual authority" of an agent to act on a principal's behalf may be conveyed orally or in writing; the "implied actual authority" of an agent is the power to do those things necessary to fulfill the agency. Thus, the express actual authority to: "run my used car business" would imply actual authority to buy used cars, presumably on credit; advertise the cars; hire additional employees as necessary; and enter binding contracts with customers. When potential liability arises from the actions of an agent, principals may seek to narrowly construe their agent's actual authority, both express and implied, as in the following case.

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Castillo v. Case Farms of Ohio, Inc.

United States District Court, Western District of Texas

96 F. Supp. 2d 578
December 1, 1999

JUSTICE, Senior District Judge.

Th[is] civil action was filed on December 19, 1997, by a group of migrant farm workers, claiming violations of the Migrant and Seasonal Agricultural Worker Protection Act ("AWPA"), the Fair Labor Standards Act ("FLSA"), and various state laws. The primary defendant is Case Farms of Ohio, a chicken processing plant located in Winesburg, Ohio.

A bench trial in this civil action commenced on March 29, 1999, and was completed on April 1, 1999. In accordance with Federal Rule of Civil Procedure 52(a), the following memorandum opinion constitutes the court's findings of fact and conclusions of law in this civil action. . . .

INTRODUCTION

I. BACKGROUND

Defendant Case Farms of Ohio, Inc. ("Case Farms"), is a chicken processing plant in Winesburg, Ohio. At this facility, approximately 400,000 live chickens per week, year-round, are live-hung, slaughtered, eviscerated, cleaned, cut and deboned, and ultimately packaged for market. Case Farms employees perform a range of jobs, which include eviscerating, deboning, receiving, grading, wrapping, weighing, and washing chickens.

In consideration of its historically high turnover rate, Case Farms actively recruited workers for its processing plant during 1996 and 1997. Andy Cilona, primarily responsible for recruiting workers for Case Farms, served as Case Farms' Human Resources Director from his date of hire until February 1996, and as Case Farms' Director of Corporate Development, from February 1996 until mid-1997. During one of his recruiting trips in Florida, Cilona initiated contact with a labor agency for temporary employees, America's Tempcorps ("ATC"). In conformity with an unwritten agreement with Case Farms, ATC worked in Texas, recruiting and hiring a number of people to work at Case Farms' chicken processing plant in Ohio. During this recruitment process, ATC gave some of its recruits the telephone number of Alvaro Hernandez, a Case Farms employee, and instructed them to call Hernandez upon their arrival in Ohio. ATC also usually gave its recruits a free bus ticket or other free transportation to Ohio, as well as $20.00 each in traveling expenses. Case Farms ceased doing business with ATC in February 1996. . . .

[The] plaintiffs generally claim that they were recruited in Texas to work at Case Farms' Winesburg facility, and that, upon arriving at Case Farms, they discovered that the actual terms and conditions of their employment, transportation, and housing in Ohio did not coincide with the promises made to them in Texas. At the trial of this case, plaintiffs testified to the inadequate housing conditions and transportation provisions they encountered upon arrival in Ohio.

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Thus, the bases for this civil action are the defendants' alleged misrepresentations and mistreatment of the plaintiffs in the recruitment process in Texas, and, as well, the working and living conditions afforded them in Ohio. Plaintiffs contend that defendants violated a number of the statutory rights of employees created by the Migrant and Seasonal Agricultural Worker Protection Act ("AWPA"), 29 U.S.C. §1801 et seq., and the Fair Labor Standards Act ("FLSA"), 29 U.S.C. §216(b). Plaintiffs further allege that defendants were guilty of breach of contract, fraud, and negligent misrepresentation with regard to the bases of plaintiffs' claims.

Defendant Case Farms responded to these allegations with primarily legal defenses. Generally speaking, rather than refute the veracity of most of the plaintiffs' factual claims, Case Farms' primary defense at trial was that it cannot be held legally responsible for the plaintiffs' alleged mistreatment . . . .

Part I

An Overview of the Law

The Migrant and Seasonal Agricultural Worker Protection Act ("AWPA") is a broad-ranging network of migrant and seasonal worker protections that requires, in part, written and forthright disclosures, in the workers' language, of working conditions at the time of recruitment. It prohibits false and misleading representations concerning employment policies and practices, housing conditions, and transportation arrangements for workers. It also regulates housing and transportation standards for covered workers . . . .

The bulk of the plaintiffs' claims arise out of the AWPA's statutory protections. The specific statutory provisions of the AWPA that are at issue in this civil action are as follows:

(1) utilization of an unregistered farm labor contractor,
(2) failure to provide written disclosures,
(3) the use of false and misleading information,
(4) violations of the terms of the working agreement,
(5) failure to ensure that the housing met applicable health and safety codes,
(6) failure to secure certification that the housing met the applicable health and safety codes,
(7) failure to post or to provide a statement of the terms and conditions of housing,
(8) failure to properly insure and inspect transportation vehicles,
(9) failure to ensure that each plaintiff received a proper pay statement, and

(10) “wages owed when due” violations.

In the event of violation of these provisions, the AWPA provides for statutory or actual damages, or equitable relief, at the discretion of the court.

Plaintiffs also allege violations of the minimum wage, and overtime wage, provisions of the Fair Labor Standards Act. The FLSA establishes a minimum wage, maximum working hours, record keeping and reporting requirements, and child labor prohibitions, as well as a system of civil and criminal penalties for its violation.

The remainder of the plaintiffs’ claims, for breach of contract, fraud, and negligent misrepresentation, are based on state law.

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Part II

General Applicable Liability Principles

The distressing and deplorable conditions allegedly encountered and endured by [the] plaintiffs upon arriving in Ohio stand largely unrefuted. Often with little more than the $20.00 they were given for food during the three-day bus ride from the Rio Grande Valley, the majority of the plaintiffs left behind their homes and families in Texas for the promise of suitable work in Ohio. Once there, many of the plaintiffs found themselves sleeping on floors in bare houses or apartments, often with a dozen or more other workers. One young woman described the frightening experience of sleeping in [an] unfurnished, one-bathroom house with approximately seventeen other people, mostly men. From the stand, she expressed her gratitude to several other male recruits, whom she had met just days before living with them in Ohio, for their willingness to allow her to sleep between them and the wall for protection. Another plaintiff testified that he and his sister were forced to sleep outside their apartment on concrete steps to escape the stench of the raw sewage that was seeping into their apartment. Other plaintiffs described their unremitting encounters with cockroaches and rats. With harrowing detail, plaintiffs related the discomfort and dangerousness of traveling to work in an overcrowded van that not only had only boards laid on cement blocks in lieu of seats, but which also was filled with exhaust fumes. For the most part, these disturbing and unsettling accounts were uncontested by Case Farms.

There can be no doubt that such living and transportation conditions were appalling, and would be, in many contexts, illegal. The plaintiffs' express challenge in this civil action, however, was to establish Case Farms' liability for such conditions. That is, before considering each of the many statutory violations alleged by the plaintiffs, an important threshold issue must be resolved. Does the law allow the plaintiffs to recover for their maltreatment from Case Farms? Can the plaintiffs, recruited and purportedly "employed" by ATC, recover from Case Farms? . . . .

B. An Agricultural Employer's Liability Under Common Law Agency Principles

The fact that Congress has created a statutory framework of protections for migrant workers in no way exempts agricultural employers, recruiters, and overseers from common law agency principles. Rather, the protections afforded by the AWPA are designed to supplement traditional common law principles. Thus, one theory under which the plaintiffs could prove that Case Farms itself committed the alleged violations would be to demonstrate that the ATC defendants' misdeeds were committed by ATC within the scope of its role as an agent of Case Farms.

ATC's Agency

Plaintiffs' supplementary theory of Case Farms liability is, therefore, based on traditional, pre-AWPA common law tenets of agency. Plaintiffs argue that an agency relationship existed between ATC and Case Farms, and that the scope of that relationship included both the express authority to recruit and hire people to work at Case Farms' plant, and the implied authority to do all things proper, usual, and

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necessary to exercise that authority. Case Farms responds that to the extent any agency relationship existed between ATC and Case Farms, the scope of that agency was limited solely to informing recruits about the availability of work in Ohio at Case Farms' processing plant.

The fundamental precepts of the law of agency are well settled. At common law, a principal may be held liable for the acts of its purported agent based on an actual agency relationship created by the principal's express or implied delegation of authority to the agent. Both forms of agency are at issue here. Express actual authority exists "where the principal has made it clear to the agent that he [or she] wants the act under scrutiny to be done." Pasant v. Jackson Nat'l Life Ins. Co., 52 F.3d 94, 97 (5th Cir. 1995). Further, giving an agent express authority to undertake a certain act also includes the implied authority to do all things proper, usual, and necessary to exercise that express authority.

Applying these principles, the plaintiffs assert that the scope of the agency relationship between Case Farms and ATC expressly authorized ATC to recruit and hire people to work at Case Farms' Ohio plant. Such a contention is certainly well-supported by the evidence. Former Case Farms' Director of Corporate Development, Andy Cilona, among others, testified that "the arrangement with ATC was for it to hire workers for Case Farms' production." Based on Case Farms' explicit agreement with ATC, it is found, by a preponderance of the evidence, that such an express agency relationship, the scope of which included recruiting and hiring migrant workers to perform jobs at Case Farms' plant, did exist between Case Farms and ATC.

A principal is liable for the actions of an agent only if those actions are taken in the scope of the agent's employment. While Case Farms acknowledges that ATC was expressly authorized to recruit and hire workers for its plant, the chicken processing company maintains that the scope of that relationship was extremely narrow, and that the vagueness of the plaintiffs' claim that ATC was Case Farms' agent glosses over the exact nature of the relationship between ATC and Case Farms.[16] The plaintiffs, on the other hand, argue that the scope of ATC's express authority to recruit and hire people to work at Case Farms' plant included the implied authority to do all things proper, usual, and necessary to exercise that authority.

A preponderance of the evidence supports the plaintiffs' contention. Credible evidence, adduced at trial, reveals that housing and transportation issues were well within the class of activities proper, usual, and necessary to recruit and hire workers for Case Farms' Ohio processing plant. It is uncontested that the combination of its high turnover rate, and relative isolation from metropolitan areas, complicates Case Farms' recruitment process. For Case Farms, recruitment was, at all relevant times, an on-going, virtually nation-wide undertaking. The very fact that this Ohio chicken processing plant was recruiting workers in Florida and Texas attests to the difficulties it faces finding workers. Furthermore, once the workers arrived in Ohio, it was difficult for workers to find housing on their own because of language

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barriers, lack of personal transportation, and their unfamiliarity with the area. So, it was essential to the success of Case Farms' hiring practices to assist out-of-state workers with housing. Case Farms, before any relationship with ATC, actually did assist incoming workers with housing and transportation in Ohio. Furthermore, it was clear from the evidence adduced at trial that Case Farms meant for ATC to perform these duties. Thus, it is found that Case Farms knew that these duties were proper, usual, and necessary in order to recruit and retain a workforce primarily migrating from out-of-state.

Case Farms points out, and places much weight on the fact, that its representatives Cilona and Kohli both testified that ATC was not authorized to hire workers and make them full fledged "Case Farms" employees. Rather, under the arrangement with ATC, the workers would supposedly remain "ATC employees," despite the fact that they worked in the Case Farms plant, doing the same work, at the same rate of pay, under the supervision of the same supervisors, as Case Farms workers.

Whether or not a plaintiff would become a "full-fledged" Case Farms employee, however, cannot be dispositive of the agency issue at hand. At issue in this civil action is precisely the question of whether superficial differences (such as which company's name appeared on a plaintiff's pay stub) somehow immunize the company that owns and operates the plant from liability. Given the fact that housing and transportation were necessary components of Case Farms' recruitment process, ATC's actions in those arenas were within the scope of its relationship as an agent of Case Farms.

For the foregoing reasons, it is found that the ATC defendants were clearly acting as Case Farms' agent in all of their actions relating to the recruitment and hiring of workers for Case Farms' chicken processing plant in Winesburg, Ohio. And, under the AWPA, recruitment by an agricultural employer includes recruitment through an agent. Hence, ATC's interactions with the plaintiffs may be attributed to Case Farms for the purpose of assessing compliance with AWPA. . . .

C. Case Farms' Liability for the Actions of ATC . . .

It is against the background of these general principles of liability that the many claims brought by the plaintiffs in this civil action will be considered . . . . ATC's actions, under common law precepts of agency, can be attributed directly to Case Farms for the purpose of assessing compliance with the AWPA . . . .

[After a lengthy review of the law, the court concluded that "Case Farms violated the law in its treatment of the plaintiffs, in the manners and ways set forth herein, and that plaintiffs should be awarded judgment therefor."]

PROBLEM 1-4

Utah Cloudberry, Inc. (UCI) is an area developer of Cloudberry franchises in the state of Utah. UCI has opened several Cloudberry outlets, including one in Salt Lake City near the University of Utah. Kevin Macaulay is the general manager of this outlet.

According to his employment contract, Macaulay is responsible for running a "clean, orderly, lawful and respectable place of business in accordance with the

standards established in the Franchise Agreement and Operations Manual." In furtherance of his responsibilities as general manager, Macaulay took the following actions:

- Purchased various cleaning supplies, including an automatic toilet bowl cleaner. The Franchise Agreement and Operations Manual did not specify the supplies to be used in cleaning.
- Purchased the point of sale system (a.k.a., a "cash register") specified by the Franchisor in the Operations Manual.
- Hired an interior decorator to redesign the store. The Franchise Agreement provides, "No furnishings, interior and exterior decor items, fixtures, or equipment shall be used in or upon any Shop unless expressly approved by Franchisor."
- Closed the shop on Sundays to conform to local business norms, even though the Franchise Agreement provides that the

shop "shall be open and operational a minimum of 7 days per week, 12 hours per day, every day of the year."

- Terminated a male employee who showed up at work unshaven, even though being clean shaven was not an employment requirement imposed by the Franchise Agreement or Operations Manual.

How would you analyze whether Macaulay had actual authority to take each of the foregoing actions?

2. Apparent Authority

One person may bind another in a transaction with a third person, even in the absence of actual authority, when the third person reasonably believes — based on "manifestations" by the purported principal — that the actor is authorized to act on behalf of the purported principal. We say "purported principal" because this "apparent authority" does not require the prior existence of an agency relationship. In other words, apparent authority may be the basis for liability in two situations: (1) where persons appear to be agents, even though they do not qualify under the definition discussed above in Section A. (often referred to as "apparent agency"), and (2) where agents act beyond the scope of their actual authority. The apparent authority doctrine seeks to protect third parties who have reasonably relied upon the authority of a person whom a principal or purported principal holds out as possessing the authority to act on their behalf.

The primary difficulties with the doctrine of apparent authority revolve around the notion of "manifestation." "Manifestation" was not defined in Restatement (Second), though the term appeared in many sections. The commentary on Restatement (Second) of Agency §27 provides the following examples:

> [Manifestations from the principal to a] third person may come directly from the principal by letter or by 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 from

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> 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 on a particular agent.

One of the most important innovations in Restatement (Third) of Agency is the inclusion of a new section defining "manifestation":

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

Restatement (Third) of Agency §1.03.

This definition was intended to broaden the concept of manifestation. As noted in the commentary to §1.03, "conduct may constitute a manifestation sufficient to create apparent authority even though it does not use the word 'authority' and even though it does not consist of words targeted specifically to a third party."

Given the commentary on Restatement (Second) of Agency §27 quoted above — notably that manifestations may come "from third persons who have heard of the agent's authority" or merely from appointing a person to a position — one might wonder whether the concept of manifestation needed to be expanded. According to the drafters of the Restatement (Third) of Agency, the most important implication of the new definition of "manifestation" is that communications from the principal need not be directed to third persons before apparent authority is created. The necessity of finding a direct link between the principal and third persons could reasonably be drawn from the Restatement (Second) of Agency's definition of "apparent authority," which required "manifestations to such third persons," yet courts have traditionally not been so restrictive in requiring such manifestations prior to finding apparent authority. Consistent with what these courts have done, the Restatement (Third) of Agency clearly permits the creation of apparent authority when manifestations reach the third party through an intermediary (as long as the manifestations are traceable to the principal), or simply by placing a person in a certain position. The importance of the new definition of "manifestation," therefore, probably lies in the fact that it has now made explicit in the primary sections of the Restatement what previously appeared only in the commentary, and that it endorses what courts were already doing.

In any event, there are two key points to finding apparent authority: (1) the manifestation (however defined) must emanate from the principal (or purported principal) and must be received (either directly or indirectly) by the third person; and (2) the scope of the agent's apparent authority depends on the third person's reasonable interpretation of that manifestation. Whether it was reasonable for a third person to believe that the agent with whom she transacted business had the authority to enter into a particular transaction has both subjective and objective components. Courts consider prior dealings between the parties, customs that apply in the particular setting, and the nature of the proposed transaction (for example, whether the agent proposes a transaction that would benefit the purported principal). For example, appointing someone to a position (such as a manager) that is associated with recognized duties confers upon them the apparent authority to carry out duties that are typically entrusted and expected of someone with that position. In Pasquarella v. 1525 William St., LLC, 120 A.D.3d 982 (N.Y. App. Div. 2014), the court held that the manager of a company has apparent authority to bind the company to contracts regardless of whether the manager had actual authority to do so.

PROBLEM 1-5

Under the terms of the Cloudberry Franchise Agreement, a franchisee may sell only Authorized Cloudberry Products, a term that is defined as follows:

> "Authorized Cloudberry Products" means the foods, yogurts, frozen yogurts, yogurt drinks, frozen desserts, smoothies and beverages, and other food items and other products, which may include specialty foods, packaged foods, books, hats, CDs, DVDs and other media, apparel, retail items, and gift or loyalty cards, as specified by Cloudberry Ventures, Inc. (the "Company") from time to time in the operations manual, or as otherwise directed by Company in writing, for sale at a Shop (or the Licensed Shop), prepared, sold, and/or manufactured in strict accordance with Company's recipes, and Standards, including specifications as to ingredients, brand names, preparation, and presentation.

As noted in Problem 1-4, Utah Cloudberry, Inc. (UCI) is the area developer of Cloudberry franchises in the state of Utah. Kevin Macaulay, the general manager of an outlet in Salt Lake City, is an employee of UCI and is responsible for overseeing the operation of the Salt Lake City store.

Macaulay entered into a long-term contract, purportedly on behalf of UCI, with a supplier of organically grown fruits in Park City, Utah. Macaulay believes that the store's clientele would be interested in locally grown, organic produce, but this produce is not specified in the

Cloudberry operations manual or otherwise directed by the Company in writing. Because organic produce is more expensive than produce grown using pesticides and chemical fertilizers, UCI's profits have declined. Recent rumblings from Cloudberry's attorneys about this state of affairs, using terms like "default on UCI's obligations under the License Agreement," have caused UCI to want to disavow the supply agreement.

What facts would be most important in determining whether UCI would be bound by Macaulay's contract with the produce supplier, and why?

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16. This court again notes with some astonishment that the entire relationship between Case Farms and ATC was oral. No written contract or record of this agreement exists. Such an agreement, of course, would have been invaluable in the resolution of these issues.

CHAPTER 2

PARTNERSHIPS

MOTIVATING HYPOTHETICAL

Lloyd Park was admitted to the California Bar in 1992, and opened his own law office in Newport Beach. He built a successful practice, focusing on family law and estate planning. John Blaylock was admitted to the California Bar in 2011, the year he graduated from law school, and he immediately began working in Lloyd Park's law office.

* * *

General partnerships are plentiful in the United States. Despite the widespread availability of limited liability entities — including corporations, limited liability companies, and limited partnerships — general partnerships are a popular business entity. The primary virtues of general partnerships are simplicity and favorable tax treatment. As will be discussed in more detail below, general partnerships are simple to form and flexible in their organization. In addition, general partnerships are not taxed as separate business entities, unlike most corporations.

Like the law of agency, partnership law first developed through common law. Several states codified partnership law in the second half of the 19th century, but the primary vehicle of standardization of partnership law in the United States was the Uniform Partnership Act (UPA), which was proposed by the Uniform Law Commission (ULC), known until 2007 as the National Conference of Commissioners on Uniform State Laws, in 1914 and subsequently adopted, with minor amendments, by 49 states (Louisiana excepted).

At the time of the drafting of the UPA, there was much debate about the value of codification. After all, the United States was built on the tradition of the common law of England rather than the civil law tradition of the European continent. Nevertheless, the desire for uniformity was strong. Uniformity was not sought for its own sake but for the sake of business efficiency. As noted by William Draper Lewis, one of the principal draftsmen of the UPA, uniformity in partnership law was desirable because "a considerable proportion of existing partnerships do business in more than one state." William Draper Lewis, ***The Desirability of Expressing the Law of Partnership in Statutory Form***, 60 U. Pa. L. Rev. 93, 95 (1911). Lewis contended that conflicts among state partnership laws induced confusion among partners and third parties.

Even more important to Lewis than uniformity, however, was the clarifying effect of a uniform partnership statute. He attributed the existing conflicts among states to "a confusion, and to what we may call a haziness, in respect to fundamental

legal conceptions." ***Id.*** at 96. Lewis hoped the UPA would shed light on those fundamental concepts, thus revealing his view of the value of codification.

The most fundamental concept is the nature of the partnership: Are partnerships treated as entities separate from the individual partners or merely as aggregations of individuals, with the partnership having no separate legal status? The answer to this question has profound implications for almost all legal rules that govern partnerships. Under the common law, partnerships usually were treated as aggregates. Nevertheless, courts often employed the entity theory. This equivocation caused Professor Scott Rowley, in his treatise on partnerships, to remark, "There is no other relation known to law which, in its nature, is so complicated as is partnership." Scott Rowley, ***Rowley on Partnership*** 15 (2d ed. 1960). Frustration over the crazy quilt of rules produced by the common law moved Judge Learned Hand to write in support of universal recognition of the entity theory:

> The whole subject of partnership has undoubtedly always been exceedingly confused, simply because our law has failed to recognize that partners are not merely joint debtors. It could be straightened out into great simplicity, and in accordance with business usages and business understanding, if the entity of the firm, through a fiction, were consistently recognized and enforced. Like the concept of a corporation, it is for many purposes a device of the utmost value in clarifying ideas and in making easy the solution of legal relations.

In re Samuels & Lesser, 207 Fed. 195, 198 (S.D.N.Y. 1913).

Although the drafters of the UPA claimed to embrace the aggregate theory of partnership, the UPA is schizophrenic on the issue of partnership personality. Some provisions suggest that partnerships have a separate legal existence (for example, UPA §9 provides that each partner is considered an agent of the partnership, not of the other partners) while other sections suggest that a partnership is merely an aggregation of partners (for example, UPA §15 imposes liability on partners individually for obligations of the partnership). This confusion within the UPA is partially explained by its drafting history. The initial drafting committee was charged with drafting a statute following the entity approach, and the first drafts of the UPA were prepared by Dean James Barr Ames of Harvard Law School, an enthusiastic advocate of the entity approach. When Ames died in 1910, he was replaced by Dean William Draper Lewis of the

University of Pennsylvania Law School, who believed in an aggregate approach to partnership. Under Lewis's guidance, the drafting committee changed some provisions in the early drafts to reflect an aggregate approach, thus creating the mix of entity and aggregate provisions.

The utility of the entity theory, so obvious today, was not so obvious to the drafters of the UPA, and vigorous debates surrounded the issue. Recounting a meeting of the UPA drafting committee and commentators, Lewis explained that three reasons persuaded the group to unanimously recommend a statute based on the aggregate theory: (1) existing common law was based on the aggregate theory; (2) the aggregate theory better reflected the expectations of third persons dealing with the partnership (creditors expected to hold partners directly liable for partnership obligations); and (3) the draft before the committee had overcome the most serious objections to the aggregate theory (primarily those relating to

ownership of partnership property). William Draper Lewis, ***The Uniform Partnership Act — A Reply to Mr. Crane's Criticism***, 29 Harv. L. Rev. 158, 172-173 (1915). Interestingly, Lewis also noted: "[T] hose with the largest practical experience present were opposed to regarding the partnership as a 'legal person' because of the effect of the theory in lessening the partner's sense of moral responsibility for partnership acts." ***Id.*** at 173.

Although the UPA is still immensely important to partnership law in the United States, discontent with its provisions — largely the result of the incoherence of the aggregate view of the partnership — prompted Georgia and California to adopt substantial amendments to their versions of the UPA in the 1980s. In 1986 the American Bar Association (ABA) recommended changes to the UPA. In 1987 the ULC created a drafting committee to draft a revision of the UPA. After years of work, the committee produced a "final" version of the new act in 1991. Following ABA objections, the committee produced several subsequent revisions to the act. The latest version of the Revised Uniform Partnership Act (RUPA) is dated 1997, but it contains amendments adopted in 2011 and 2013. As of early 2022, 42 states and the District of Columbia have adopted RUPA.

The committee that drafted RUPA did not begin with a mandate to treat the partnership as an entity or an aggregate. Over the course of drafting, however, the committee settled on the entity theory of partnership because it "provides simpler rules and is consistent with RUPA's attempt to give partnerships greater stability." As a result of this recognition, the committee added RUPA §201 to clarify that a "partnership is an entity distinct from its partners." Donald J. Weidner & John W. Larson, ***The Revised Uniform Partnership Act: The Reporters' Overview***, 49 Bus. Law. 1, 3 (1993).

RUPA makes many important changes to the UPA, most of which can be traced to RUPA's commitment to the entity theory throughout. Some of the more important changes RUPA makes, a number of which will be explored in more detail in later sections of the book, include the following: (1) RUPA §203 makes partnership property the property of the entity, not of the individual partners. (2) RUPA does away with the UPA rule that the departure of a partner causes a dissolution of the partnership. The UPA rule reflected the concept that every aggregation of partners is unique and any change causes a new partnership to be formed. The UPA did not account for the fact that some departures trigger the winding up of the partnership business and some simply trigger a buyout of the departing partner. RUPA has different rules for each of these situations, thus tracking business practice more closely. (3) RUPA provides for the merger or conversion of partnerships into limited partnerships. Mergers or conversions of partnership would be unthinkable under UPA because partnerships were not an entity.

In 2006 the ULC launched a project entitled "Harmonization of Business Entity Acts," the purpose of which is to harmonize the language in various business entity statutes to facilitate the development of a uniform law of business organizations. The project contemplates a hub-and-spoke structure for business entity statutes. The hub comprises several general statutes that apply to all business entities, and the spokes are statutes governing specific types of business entities, including general partnerships. Although the harmonized version of the uniform partnership act has not been widely adopted, for ease of reference, our textual citations in

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this chapter quote the current version of the statute, RUPA (1997) as amended in 2011 and 2013, to take account of the harmonization project.

A. FORMATION

The rules contained in the uniform partnership acts apply only to relationships that meet the definition of a "partnership." UPA §6(1) and RUPA §202(a) both define "partnership" as an "association of two or more persons to carry on as co-owners a business for profit." Despite several centuries of judicial consideration — including 90 years of experience with the foregoing statutory definition — partnership formation still poses some of the most challenging issues in partnership law. This is largely attributable to the fact that no formalities are required to form a partnership. Although people may create a partnership through formal agreement, the most difficult formation questions arise in the context of inadvertent partnerships. Courts often find that a partnership has been created in the absence of a written agreement, conscious intent to form a partnership, or knowledge that a partnership has been formed.

The UPA definition of "partnership" comports with prior common law definitions in all essential respects. Nevertheless, no general definition of "partnership" can adequately explain all of the cases. This difficulty is best understood by reflecting on the fact that partnership formation issues are raised almost exclusively in cases where one person is attempting to avoid liability to another — either to a purported partner or to a third party — where such liability is founded on the existence of a partnership. Partnership liability rules will be examined in more detail in Section E. For the present, it is sufficient to understand two general principles: (1) one partner may be bound to third parties by the act of another partner; and (2) partners are personally liable for obligations of the partnership. As a result of these principles, partnership formation issues take on great importance. The finding of a partnership can impose personal liability on an individual who did not act or even know of the action of another partner. Against this backdrop, courts tend to strive for fairness rather than doctrinal purity. The definition of "partnership," therefore, is necessarily flexible.

Courts often state that the existence of a partnership depends on whether the partners had the requisite intent. But what must the parties have intended? Consider Bass v. Bass, 814 S.W.2d 38, 41 (Tenn. 1991):

> [T] he existence of a partnership depends upon the intention of the parties, and the controlling intention in this regard is that ascertainable from the acts of the parties. Although a contract of partnership, either express or implied, is essential to the creation of partnership status, it is not essential that the parties actually intend to become partners. The existence of a partnership is not a question of the parties' undisclosed intention or even the terminology they use to describe their relationship, nor is it necessary that the parties have an understanding of the legal effect of their acts. It is the intent to do the things which constitute a partnership that determines whether individuals are partners, regardless if it is their purpose to create or avoid the relationship. Stated another way, the existence of

> a partnership may be implied from the circumstances where it appears that the individuals involved have entered into a business relationship for profit, combining their property, labor, skill, experience, or money.

Courts are not bound by statements of parties disavowing an intention to enter into a partnership. Nevertheless, expressions of intent by the parties are probably highly persuasive. Courts are most likely to override the expressed intentions of the parties where the rights of third parties are involved.

As in other areas of the law, intent is difficult to discern from a distance. The informality of most partnerships ensures that intent is rarely expressed in written form. As a result, most courts focus on a few indicia of partnership in an attempt to ascertain whether the parties intended to enter into a partnership. The most important of these indicia of partnership is whether a purported partner receives a share of the profits of the business. UPA §7(4) states that "receipt by a person of a share of profits of a business is prima facie evidence that he is a partner in the business." ***Cf.*** RUPA §202(c)(3) (receipt of profits raises a presumption of partnership).

This test originated in the well-known English case, Waugh v. Carver, 2 H. Bl. 235, 126 Eng. Rep. 525 (C.P.D., Nov. 23, 1793), in which Erasmus Carver and William Carver agreed with Archibald Giesler to cooperate in generating business. Under the agreement, each side would "take a moiety" — that is, one half — of the proceeds, but each side would bear its own losses. As to liability, the agreement explicitly stated that neither side would be liable for the acts of the other. The court characterized the moiety as "profit" and held that the parties had formed a partnership because they agreed to share profits. The rationale for this holding was "the principle that by taking a part of the profits, he takes from the creditors a part of that fund which is the proper security to them for the payment of their debts."

Waugh does not admit any possible exceptions to the general rule that sharing of profits results in the formation of a partnership vis-àvis third parties. Nevertheless, courts readily recognized an exception for employees who are paid for their services out of the profits of the firm. Often, distinguishing between employees and partners is easier said than done. Similarly, if creditors receive payments from the profits of the firm, courts will refrain from finding that a partnership has been formed. The analysis in these cases is highly textured. Given that the sharing of profits is present, courts examine other aspects of the relationship closely.

The following case explores some of the difficult questions that surround partnership formation. As you consider the claim in ***Holmes***, contemplate the difference (if any) between forming a partnership and preparing to incorporate a business. Moreover, try to identify why it matters whether a partnership has been formed.

Holmes v. Lerner

74 Cal. App. 4th 442
Court of Appeal, First District, Division 1, California
August 20, 1999 (as modified September 7, 1999)

Marchiano, Judge.

This case involves an oral partnership agreement to start a cosmetics company known as "Urban Decay." Patricia Holmes prevailed on her claim that Sandra

Kruger Lerner breached her partnership agreement and that David Soward interfered with the Holmes-Lerner contract, resulting in Holmes's ouster from the business. Lerner and Soward appeal from the judgment finding them liable to Holmes for compensatory and punitive damages of over $1 million. . . .

We affirm the judgment against Lerner, primarily because we determine that an express agreement to divide profits is not a prerequisite to prove the existence of a partnership. We also determine that the oral partnership agreement between Lerner and Holmes was sufficiently definite to allow enforcement. . . .

Background. . .

Sandra Lerner is a successful entrepreneur and an experienced business person. She and her husband were the original founders of Cisco Systems. When she sold her interest in that company, she received a substantial amount of money, which she invested, in part, in a venture capital limited partnership called “& Capital Partners.” By the time of trial in this matter, Lerner was extremely wealthy. Patricia Holmes met Lerner in late 1993, when Lerner visited Holmes’s horse training facility to arrange for training and boarding of two horses that Lerner was importing from England. Holmes and Lerner became friends, and after an initial six-month training contract expired, Holmes continued to train Lerner’s horses without a contract and without cost.

In 1995, Lerner and Holmes traveled to England to a horse show and to make arrangements to ship the horses that Lerner had purchased. On this trip, Lerner decided that she wanted to celebrate her 40th birthday by going pub crawling in Dublin. Lerner was wearing what Holmes termed “alternative clothes” and black nail polish, and encouraged Holmes to do the same.[1] Holmes, however, did not like black nail polish, and was unable to find a suitable color in the English stores. At Lerner’s mansion outside of London, Lerner gave Holmes a manicuring kit, telling her to see if she could find a color she would wear. Holmes looked through the kit, tried different colors, and eventually developed her own color by layering a raspberry color over black nail polish. This produced a purple color that Holmes liked. Holmes showed the new color to Lerner, who also liked it.

On July 31, 1995, the two women returned from England and stayed at Lerner’s West Hollywood condominium while they waited for the horses to clear quarantine. While sitting at the kitchen table, they discussed nail polish, and colors. Len Bosack, Lerner's husband, was in and out of the room during the conversations. For approximately an hour and a half, Lerner and Holmes worked with the colors in a nail kit to try to recreate the purple color Holmes had made in England so they could have the color in a liquid form, rather than layering two colors. Lerner made a different shade of purple, and Holmes commented that it looked just like a bruise. Holmes then said that she wanted to call the purple color she had made

"Plague." Holmes had been reading about 16th-century England, and how people with the plague developed purple sores, and thought the color looked like the plague sores.[2] Lerner and Holmes discussed the fact that the names they were creating had an urban theme, and tried to think of other names to fit the theme. Starting with "Bruise" and "Plague," they also discussed the names "Mildew," "Smog," "Uzi," and "Oil Slick." Len Bosack walked into the kitchen at that point, heard the conversation about the urban theme, and said "What about decay?" The two women liked the idea, and decided that "Urban Decay" was a good name for their concept.[3]

Lerner said to Holmes: "This seems like a good [thing], it's something that we both like, and isn't out there. Do you think we should start a company?" Holmes responded: "Yes, I think it's a great idea." Lerner told Holmes that they would have to do market research, determine how to have the polishes produced, and that there were many things they would have to do. Lerner said: "We will hire people to work for us. We will do everything we can to get the company going, and then we'll be creative, and other people will do the work, so we'll have time to continue riding the horses." Holmes agreed that they would do those things. They did not separate out which tasks each of them would do, but planned to do it all together.

Lerner went to the telephone and called David Soward, the general partner of & Capital, and her business consultant. Holmes heard her say "Please check Urban, for the name, Urban Decay, to see if it's available and if it is, get it for us." Holmes knew that Lerner did not joke about business, and was certain, from the tone of her voice, that Lerner was serious about the new business. The telephone call to secure the trademark for Urban Decay confirmed in Holmes's mind that they were forming a business based on the concepts they had originated in England and at the kitchen table that day. Holmes knew that she would be taking the risk of sharing in losses as well as potential success, but the two friends did not discuss the details at that time. Lerner's housekeeper heard Lerner tell Holmes: "It's going to be our baby, and we're going to work on it together." After Holmes left, the housekeeper asked what gave Lerner the idea to go into the cosmetics business, since her background was computers. Lerner replied: "It was all Pat's idea over in England, but I've got the money to make it work." Lerner told her housekeeper that she hoped to sell Urban Decay to Estee Lauder for $50 million.

Although neither of the two women had any experience in the cosmetics business, they began work on their idea immediately. Holmes and Lerner did market research by going to stores, talking with people about nail polish, seeing what nail polishes were available, and buying samples to bring back to discuss with each other. They met frequently in August and September at Lerner's home, and experimented with nail colors. They took pictures of various color mixing sessions. In early August, they met with a graphic artist, Andrea Kelly, and discussed putting together a logo and future advertising work for Urban Decay.

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Prior to the first scheduled August meeting, Holmes told Lerner she was concerned about financing the venture. Lerner told her not to worry about it because Lerner thought they could convince Soward that the nail polish business would be a good investment. She told Holmes that Soward took care of Lerner's investment money. Holmes and Lerner discussed their plans for the company, and agreed that they would attempt to build it up and then sell it. Lerner and Holmes discussed the need to visit chemical companies and hire people to handle the daily operations of the company. However, the creative aspect, ideas, inspiration, and impetus for the company came from Holmes and Lerner.

Lerner, Holmes, Soward, and Kelly attended the first scheduled meeting. The participants in these meetings referred to them as "board meetings," even though there was no formal organizational structure, and technically, no board. They discussed financing, and Soward reluctantly agreed to commit $500,000 towards the project. Urban Decay was financed entirely by & Capital, the venture capital partnership composed of Soward as general partner, and Lerner and her husband as the only limited partners. Neither Lerner nor Holmes invested any of their individual funds.

Lerner and Soward went to Kirker Chemical Company later in August of 1995 and learned about mixing and manufacturing nail polish colors. Lerner discouraged Holmes from accompanying them. Although Lerner returned to Kirker, she never took Holmes with her. At the second board meeting, in late August, Soward introduced Wendy Zomnir, a friend of Soward's former fiancé, as an advertising and marketing specialist. After Zomnir and Kelly left the meeting, Holmes, Lerner and Soward discussed her presentation. Holmes was enthusiastic about Zomnir and they decided to hire her. At the conclusion of the September board meeting, after Holmes had left, Lerner and Soward secretly made Zomnir an offer of employment, which included a percentage ownership interest in Urban Decay. It wasn't until a couple of meetings later, when Lerner or Soward referred to Zomnir as the "Chief Operating Officer" of Urban Decay, that Holmes learned of the terms of the offer.

In early October, after Holmes learned of the secret offer to Zomnir, she asked Lerner to define her role at Urban Decay. Lerner responded: “Your role is anything you want it to be.” When Holmes asked to discuss the issue in more detail, Lerner turned and walked away. Holmes believed that Lerner was nervous about an upcoming photo session, and decided to discuss it with Lerner at a later date. At their regular board meetings, Holmes participated with Soward, Lerner, Zomnir, Kelly, and another person in discussing new colors, and deciding which ones they wanted to sell, and which names would be used.

In September of 1995, Soward signed an application for trademark registration as president of Urban Decay. In December of 1995, Urban Decay was incorporated. Holmes asked for a copy of the articles of incorporation, but was given only two pages showing the name and address of the company. On December 31, Holmes sent a fax to Lerner stating that it had been difficult to discuss her position in Urban Decay with Lerner. Holmes asked Lerner: “What are my responsibilities and obligations, and what are my rights or entitlements?” Holmes also asked: “What are my current and potential liabilities and assets?” She requested that Lerner provide the information in writing. At this point, Holmes wanted to memorialize the agreement she and Lerner had made on July 31.

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Soward intercepted the fax and called Holmes, asking: “What’s going on?” Holmes explained that she wanted a written agreement, and Soward apologized, telling her that Lerner had asked him to get “something . . . in writing” to Holmes. Soward told Holmes that no one in the company had a written statement of their percentage interest in the company yet. Soward asked: “What do you want, one percent, two percent?” When Holmes did not respond, he told her that 5 percent was high for an idea. Holmes told him: “I’m not selling an idea. I'm a founder of this company." Soward exclaimed: "Surely you don't think you have fifty percent of this company?" Holmes told him that it was a matter between herself and Lerner, and that Soward should speak to Lerner. Soward agreed to talk to Lerner.

On January 11, 1996, Lerner and Holmes met at a coffee shop to discuss the fax. Holmes explained that she wanted "something in writing" and an explanation of her interest and position in the company. Lerner responded that a start up business is "like a freight train . . . you can either run and catch up, and get on, and take a piece of this company and make it your own, or get out of the way." As a result of this conversation, Holmes decided to double her efforts on behalf of Urban Decay. Because she was most comfortable working at the warehouse, she focused on that aspect of the business.[4] Holmes was reimbursed for mileage, but received no pay for her work.

During January and February, Urban Decay was launching its new nail polish product. Publicity included press releases, brochures, and newspaper interviews with Lerner. An early press release stated: "The idea for Urban Decay was born after Lerner and her horse trainer, Pat Holmes, were sitting around in the English countryside." Lerner approved the press release. In February of 1996, an article was printed in the San Francisco Examiner containing the following quotes from Lerner. "Since we couldn't find good nail polish, in cool colors there must be a business opportunity here. Pat had the original idea. Urban Decay was my spin." The Examiner reporter testified at trial that the quote attributed to Lerner was accurate. Lerner was also interviewed in April by CNN. In that interview she told the story of herself and Holmes looking for unusual colors, mixing their own colors at the kitchen table, and that "we came up with the colors, and it just sort of suggested the urban thing."[5]

Lerner had always notified Holmes whenever there was a board meeting, and she sent Holmes an agenda for the February 20, 1996 meeting. Lerner also sent a memo stating that she thought they should have an “operations meeting” with

the warehouse supervisor first. Lerner’s memo continued: “and then have a regular board meeting, including [Zomnir], me, David, and Pat, and no one else.” Holmes understood that the regular board meeting would be for the purpose of discussing general Urban Decay business. At the operations meeting, Holmes made a presentation regarding the warehouse operations. The financial report showed $205,000 in revenues and $431,000 in expenses. The “directors” thought this early sales figure was “terrific.” Soward handed out an organizational chart, which showed Lerner, with the title “CEO” at the top; Soward, as “President” beneath her; and Zomnir, as “COO” beneath Soward. Holmes asked “Where am I?” Lerner responded by pointing to the top of the chart and telling Holmes that she was a director, and was at the top of the chart, above all the other names.

In March of 1996, Holmes received a document from Soward offering her a one percent ownership interest in Urban Decay. Soward explained that Urban Decay had been formed as a limited liability company, which was owned by its members. For the first time, Holmes realized that Lerner and Soward had produced an organizational document that did not include her, and she was now being asked to become a minor partner. When she studied the document, she discovered that it referred to an exhibit A, which was purported to show the distribution of ownership interests in Urban Decay. Soward had given Zomnir a copy of exhibit A when he offered her an ownership interest in Urban Decay. However, when Holmes asked Soward for a copy of exhibit A, he told her it did not exist.[10] By this time, Holmes was planning to consult an attorney about the document.

Despite the deterioration of her friendship with Lerner, and her strained relationship with Soward, Holmes continued to attend the scheduled board meetings, hoping that her differences with Lerner could be resolved. She also continued to work at the warehouse on various administrative projects and on direct mail order sales. As late as the April board meeting, Holmes was still actively engaged in Urban Decay business. She made a presentation on a direct mail project she had been asked to undertake. As a result of Holmes's attendance at a sales presentation when she referred to herself as a cofounder of Urban Decay, Lerner instructed Zomnir to draft a dress code and an official history of Urban Decay. Lerner told Zomnir that it was a "real error in judgment" to allow Holmes to attend the sales presentation because she did not project the appropriate image. The official history, proposed in the memo, omitted any reference to Holmes. Finally, matters deteriorated to the point that Soward told Holmes not to attend the July board meeting because she was no longer welcome at Urban Decay.

On August 27, 1996, Holmes filed a complaint against Lerner and Soward, alleging 10 causes of action, including breach of an oral contract, intentional interference with contractual relations, fraud, breach of fiduciary duty, and constructive fraud. Holmes eventually dismissed some of her claims and the court dismissed others, sending the case to the jury on the causes of action noted above. At the

trial, cosmetic industry expert Gabriella Zuckerman testified that Urban Decay was not just a fad. In her opinion, Urban Decay had discovered and capitalized on a trend that was just beginning. She reviewed projected sales figures of $19.9 million in 1997, going up to $52 million in 2003, and found them definitely obtainable. Arthur Clark, Holmes's expert at valuing startup businesses, valued Urban Decay under different risk scenarios. In Clark's opinion, the value of Urban Decay to a potential buyer was between $4,672,000 and $6,270,000. Lerner's expert, who had never valued a cosmetics company, testified that Urban Decay had $2.7 million in sales in 1996. He estimated the value of Urban Decay as approximately $2 million, but concluded that it was not marketable.

Lerner and Soward claimed that Holmes was never a director, officer, or even an employee of Urban Decay. According to Lerner, she was just being nice to Holmes by letting her be present during Urban Decay business. Lerner denied Holmes had any role in creating the colors, names, or concepts for Urban Decay. When Holmes asked Lerner about her assets and liabilities in Urban Decay, Lerner thought she was asking for a job. She explained her statements to the press regarding Urban Decay being Holmes's idea as misquotes or the product of her stress.

The jury found in favor of Holmes on every cause of action. The jury assessed $480,000 in damages against Lerner, and $320,000 against Soward. Following presentation of evidence as to net worth, the jury awarded punitive damages of $500,000 against Lerner and $130,000 against Soward. In the judgment, the court declined to add the two amounts together, but stated that the verdict of $320,000 was against Lerner and Soward, jointly and severally, and that the additional $160,000 verdict was against Lerner individually. Lerner and Soward moved for a judgment notwithstanding the verdict, which was denied on December 16, 1997. They appealed from the judgment and the order denying their postverdict motion. . . .

Discussion

Lerner and Soward argue that there was no partnership agreement as a matter of law. . . .

I. There Was No Error in the Determination That a Partnership Was Formed

Holmes testified that she and Lerner did not discuss sharing profits of the business during the July 31, "kitchen table" conversation. Throughout the case, Lerner and Soward have contended that without an agreement to share profits, there can be no partnership. Lerner and Soward begin their argument on appeal by quoting a statement from Westcott v. Gilman (1915) [150 P. 777], that profit sharing is "an essential element of every partnership. . . ." They argue that nothing has changed since the "ancient truth" regarding profit sharing was expressed in ***Westcott***. However, an important element supporting the ***Westcott*** decision has changed, because ***Westcott*** relied on the language of former section 2395 of the Civil Code. That statutory predecessor of the Uniform Partnership Act defined a partnership as: ". . . the association of two or more persons, for the purpose of carrying on business together, and dividing its profits between them." Civil Code former section 2395 was repealed and replaced with the UPA in 1949.

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The applicable version of the UPA omitted the language regarding division of profits and defined a partnership as: "an association of two or more persons to carry on as co-owners a business for profit." When the Legislature enacts a new statute, replacing an existing one, and omits express language, it indicates an intent to change the original act. We can only conclude that the omission of the language regarding dividing profits from the definition of a partnership was an intentional change in the law.[13] The UPA relocated the provision regarding profits to former section 15007, subdivision (4), which provided that in determining whether a partnership exists, "[t] he receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner. . . ." This relocation of the element of sharing the profits indicates that the Legislature intends profit sharing to be evidence of a partnership, rather than a required element of the definition of a partnership. The presence or absence of any of the various elements set forth in former section 15007, including sharing of profits and losses, is not necessarily dispositive. As explained in Cochran v. Board of Supervisors (1978) [149 Cal. Rptr. 304], the rules to establish the existence of a partnership in [former section] 15007 should be viewed in the light of the crucial factor of the intent of the parties revealed in the terms of their agreement, conduct, and the surrounding circumstances when determining whether a partnership exists.

The UPA provides for the situation in which the partners have not expressly stated an agreement regarding sharing of profits. Former section 15018 provided in relevant part: “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 . . . share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied.” This provision states, subject to an agreement between the parties, partners “shall” share equally in the profits. Lerner and Soward argue that using former section 15018 to supply a missing term regarding profit sharing ignores the provision of former section 15007, subdivision (2). That section, headed “rules for determining existence of partnership,” provided that mere joint ownership of common property “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.” Lerner and Soward are mistaken. The definition in former section 15006 provides that the association with the intent to carry on a business for profit is the essential requirement for a partnership. Following that definition does not transform mere joint ownership into the essence of a partnership. . . .

The trial court in this case refused to add additional elements to the statutory definition and properly instructed the jury in the language of former section 15006. We agree with the trial court’s interpretation of the law. The actual sharing of profits (with exceptions which do not apply here) is prima facie evidence,