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BUSINESS ASSOCIATIONS

Glenn G. Morris*

AGENCY

Middleman as Broker or Dealer

When one of the three parties in a supplier-middleman-customer deal becomes insolvent while still owing performance to one of the other parties, the nature of the relationship among the three becomes critical. If the middleman is simply a broker, i.e., an agent for one or both of the other parties, he will not be held responsible either to the supplier or to the customer for the breach of the other's promise. Each must look solely to the other principal, and not to the representative in the middle, for contractual performance. If the middleman is not a broker, however, but instead a principal who undertakes to buy goods and to resell them at a profit, then he is the party that must bear the loss first when either or both sides of his contemplated buy-sell arrangement do not work out as planned. Similarly, because the supplier and customer have no contract with each other, but only related contracts with the dealer, the dealer's failure to perform must be suffered by the aggrieved party without recourse to the supplier or customer on whose performance the dealer was relying.

Three different cases last year considered this "broker or dealer" issue. In two of the cases, middlemen who had normally acted as dealers tried in connection with the particular transactions involved to have themselves treated as mere brokers. One was hoping to avoid the con-
sequences of his supplier's insolvency, while the other was trying to avoid the effects of his customer's inability to pay. Both efforts failed, probably as a result of the courts' skepticism toward the middlemen's claims that the other party really had agreed to modify the normal approach to the type of transaction involved. In the third case, involving the loss by a college student of money he had mailed in for a telescope, the court seemed to lean over backward to find some way to get the student either the telescope or his money. The first two cases seem consistent with commercial expectations. The third does not.

In the first "full service" case, Keahey v. Osborne Ford-Lincoln-Mercury, Inc., the second circuit held that an automobile dealership was responsible to its customer for failing to deliver a special-order replica 1955 Thunderbird. The failure was caused by the bankruptcy of the manufacturer of the car. At the time of the bankruptcy, the dealership had already paid the manufacturer in full for the car, and had already been reimbursed by the customer not only for its out of pocket payments to the manufacturer, but also for $2795 in sales tax, dealer installed options and dealer preparations. There had been conflicting testimony at trial concerning the nature of the dealer's role in the transaction. The appellate court, though, pointed out that the dealership was making some profit on the car and had undertaken to install certain options and to "finish up" the car before delivery to the plaintiff customer. This, combined with the testimony of the customer, convinced the court that the dealership had been acting in its normal dealership role, and not simply as an agent.

The court rejected all the testimony of the dealership's employees to the effect that the customer had been warned about dealing with this manufacturer, and that she had agreed to have the dealership act strictly as her agent. The court said that the testimony of an agent is not admissible to prove the existence of an agency relationship against the principal. This was a misstatement of the law, but it allowed the court to reverse the trial court's factual finding in favor of the dealership without having to justify the reversal on grounds of manifest error.

1. 485 So. 2d 182 (La. App. 2d Cir. 1986).
2. Id. at 187.
3. See infra notes 8-19 and accompanying text.
4. The court itself acknowledged the manifest error rule of Arceneaux v. Domingue, 365 So. 2d 1330 (La. 1978), Keahey, 485 So. 2d at 185, but it seemed determined not to let the trial court's factual finding stand. It not only used an erroneous rule of law to exclude the purported agent's testimony, see infra notes 8-19 and accompanying text, but it also strained to avoid the dealership's very sensible suggestion that the real issue in the case was not whether the contract was one of sale or mandate, or even whether the contract had contained a thing, price and consent, but simply whether the customer had agreed to bear the risk of the manufacturer's nonperformance.
Despite the court's pretended deference to the trial court's findings, it seemed perfectly willing as a practical matter to overturn the trial court's finding of agency. This suggests the difficulty likely to arise in convincing most courts that the parties to a routine type of transaction really have modified the standard way of approaching the transaction, particularly where the alleged change works, as it did in Keahey, to the disadvantage of the less sophisticated, less knowledgeable party.

The difficulty of deviating from normal practice even among businessmen was illustrated in the second "full service dealer" case, Nasco Equipment Co. v. Briggs-Weaver, Inc. In that case, the fourth circuit affirmed a trial court ruling that an equipment dealer was responsible for the payment for a bulldozer supplied through the dealer to one of the dealer's customers, but never paid for by the customer. This ruling was particularly striking, because the supplier had agreed to, and in fact did, bill the customer rather than the dealer for the bulldozer. This was done at the dealer's request, supposedly after he had explained to the supplier that he did not trust the credit of his customer, and so did not himself want to establish a credit account for him. Still, noted the court, several other features of the transaction suggested a standard dealer arrangement. The dealer was to be paid a fee based on the difference between the retail and wholesale prices for the bulldozer and was to perform both predelivery services and postdelivery warranty work. In light of these facts, the court seemed to believe that the billing arrangement was a trick devised by the dealer to transfer the credit risk to the supplier, and to doubt that the supplier understood that that was to be the effect of the dealer's suggested arrangement.

In the "telescope" case, Reeves v. Celestron, Inc., the plaintiff sent $950 to an Arkansas business described by the court as an authorized dealer of Celestron brand telescopes. The dealer notified the plaintiff a couple of months later that it had applied for bankruptcy protection. The telescope was never delivered. This case posed the reverse of the issues in the bulldozer and car cases, for here the customer needed to convince the court that the dealer was really a broker that had acted on behalf of the still solvent supplier of the telescopes.

Little in the opinion supported a finding that the middleman was not a dealer. Nevertheless, the court used a rather novel derivative apparent authority theory to say that the dealer might have appeared to the student's professor to have been a broker, and that the professor's recommendations might have caused the student to deal with this par-

5. 487 So. 2d 625 (La. App. 4th Cir. 1986).
6. 473 So. 2d 397 (La. App. 3d Cir.), writ rejected as not timely filed, 477 So. 2d 698 (La. 1985).
7. See infra notes 32-40 and accompanying text.
ticular middleman. Under these circumstances, the court said, the producer could be held liable as the apparent principal of the dealer, even though this was not the actual nature of the relationship between the two companies.

Restrictions on Testimony of Agents

As mentioned in the preceding section, the second circuit stated in Keahey that "the testimony of the reputed agent is not admissible to prove the fact of agency as against the principal." This was an erroneous statement of a similar sounding rule that is widely accepted throughout the United States. The correct statement of the rule is that the out-of-court declarations of authority by a reputed agent are inadmissible hearsay when introduced to prove the existence of the authority claimed in the statements. Obviously, this is not a rule of agency law at all, but simply an application of the hearsay rule in agency cases. It has nothing to do with the actual testimony of agents.

Although the cases cited by Keahey were not careful enough in their own statements of the rule to make the hearsay rationale clear, all of them in fact had been dealing either with hearsay or with statements not relevant to the issue in the case. Indeed, each of the cases, in stating the rule, had referred strictly to the "declarations" or "representations" of the purported agent.

Keahey actually quoted the "declarations" language accurately at first, but then later changed the words of the rule so that it was

8. 485 So. 2d at 187.
10. Restatement (Second) of Agency § 285 comment a.
12. Lou-Ark Equip. Rentals Co. v. Hong Ah Fong, 355 So. 2d 1019, 1021 (La. App. 4th Cir.), cert. denied, 357 So. 2d 1167 (La. 1978). Although the court in Lou-Ark did not draw this distinction, the testimony of the agent in Lou-Ark was offered to prove the existence of apparent, rather than actual, authority. The testimony, therefore, was not being used as hearsay to prove the truth of the matter asserted (i.e., that authority actually existed), but rather as evidence that the third party had had reasonable grounds to believe that the alleged authority existed. This testimony was still excludable, however, as a principal may be held liable under an apparent authority theory only for the third party perceptions created by the principal's own conduct or statements. Id. at 1021. Thus, the unauthorized, unratified statements of a purported agent would normally not be relevant to the existence of apparent authority. (Statements by the agent showing a lack of authority would, of course, be relevant to the question of the reasonableness of the third party's belief.)
13. Livingston, 393 So. 2d at 397; Patrick, 230 So. 2d at 762; Lou-Ark, 355 So. 2d at 1021. In Patrick, the court did not refer to testimony about the out-of-court declarations, but that was just another way to state the same, familiar hearsay rule.
14. 485 So. 2d at 185.
transformed into a prohibition of the agent's actual, nonhearsay testimony.\(^5\) Apparently missing the hearsay connection, *Keahey* seemed to view the now-modified rule as a prohibition against self-serving testimony.\(^6\) This was an untenable rationale, of course, both because modern rules of evidence clearly permit self-serving testimony,\(^7\) and because the court applied its "no self-serving" rule to only one of the two interested parties.

*Keahey* involved a straightforward contractual interpretation dispute between contracting parties. Each claimed that the other had agreed to bear the risk of the manufacturer's nonperformance.\(^8\) There was no more reason in this case to exclude the testimony of the agent, while admitting the testimony of the principal, than there would have been in a sales contract case to exclude the testimony of the seller, while admitting that of the buyer.\(^9\)

In another recent case, *American Plumbing Co. v. Hadwin*,\(^{20}\) the court followed a rule regarding an agent's testimony which was different from that utilized in *Keahey*, but which was equally erroneous. The court stated the rule as follows: "The special defense of agency cannot be proved by the mere testimony of the reputed agent. He must be corroborated by other evidence."\(^{11}\) Thus, the court in *American Plumbing* did not completely exclude the agent's testimony, as *Keahey* had, but rather imposed a corroboration requirement on such testimony as if it were somehow less credible than the testimony of witnesses who happened not to be agents.

The plaintiff in *American Plumbing* was seeking to hold the owner/agent of a corporation liable on the ground that the owner had failed

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15. Id. at 187.
16. Id.
17. Parties to a controversy are considered satisfactory witnesses even for purposes of La. Civ. Code art. 1846, which requires the testimony of one witness and other corroborating circumstances to prove contracts whose price or value exceeds $500. See Dunham v. Dunham, 467 So. 2d 555, 559 (La. App. 1st Cir.), cert. denied, 469 So.2d 989, 990 (La. 1985); Hurston v. Hurston, 417 So. 2d 407, 408 (La. App. 1st Cir. 1982); O'Rourke v. Tracy, 375 So. 2d 747, 748 (La. App. 4th Cir. 1979).
18. The defendant car dealership argued correctly, but unsuccessfully, that however the contract was classified, as one of mandate or of sale, the parties' actual agreement on the risk of loss issue should have been decisive, and that the trial court had believed the defendant's testimony on this point. The court found, however, that this was just another attempt to have an agent's testimony admitted against the principal, which was impermissible. 485 So. 2d at 186-87.
19. It was ironic, in fact, that while the court held the contract to have been one of sale, it still characterized the testimony of the dealership's employees as the statements of an alleged agent, rather than as the testimony of a seller disputing the buyer's interpretation of the contract. Id.
21. Id. at 173.
to disclose to the plaintiff that he had been acting strictly in an agency capacity when he had contracted with the plaintiff for some remodeling work. Without such a disclosure, or other factors sufficient to apprise the third party that the agent was acting in a representative capacity only, the agent would have been personally liable to the third party for the performance of the contract.22 Despite the recitation of the corroboration requirement, the plaintiff did not win, as the court found that there had been sufficient corroboration of the defendant-owner’s testimony concerning the disclosure of the agency to the third party.23

As in Keahey, the American Plumbing misstatement may be traced to language used in earlier cases for entirely different purposes. Ultimately, the source of the corroboration language was an 1899 murder case, State v. Harris,24 in which the defendant had offered into evidence a letter written to the defendant by a purported agent of the prosecution witnesses. The letter described a proposal allegedly made by the witnesses to change their testimony in exchange for money. The supreme court ruled that the refusal of the trial court to admit the letter had been proper, as the letter was inadmissible hearsay.25 The court noted that, although the purported author of the letter had been present in the courtroom during the trial, he had not been called to testify concerning the letter.

Thus, as in Keahey, the court in American Plumbing was essentially enforcing a rule that had begun as nothing more than an application of the hearsay rule in an agency setting. Nothing in Harris had suggested that the testimony of agents against either principals or third parties ought to be corroborated generally. In fact, the agent in Harris had never testified.

Nevertheless, Harris was cited, gratuitously and erroneously, in support of a general corroboration rule in the 1960 case of De Rouen v. Aiavolasiti.26 In that case, the court simply affirmed a factual finding that the agent had not disclosed his agency, noting that the agent’s own testimony had failed to establish that he had disclosed the agency to the third party. In addition, the court cited Harris, and stated that there was no corroboration of the existence of the agency in the first place.27

De Rouen was cited in Guillory v. Carville,28 and Wilson v. McNabb,29 the cases on which the court in American Plumbing specifically relied.

22. Id. at 172; Fernandez v. Miller Richards Aircraft Sales, Inc., 487 So. 2d 660 (La. App. 5th Cir. 1986).
23. 483 So. 2d at 173.
24. 51 La. Ann. 1105, 26 So. 64 (1899).
25. Id. at 1107, 26 So. at 65.
27. Id. at 853.
28. 158 So. 2d 475 (La. App. 3d Cir. 1963).
29. 157 So. 2d 897 (La. App. 1st Cir. 1963).
In Wilson, the court did use the corroboration requirement to reverse a trial court finding that the agent had disclosed his agency status to the third party. In Guillory, however, the court recited the rule, but found sufficient corroboration. Neither case was well reasoned with respect to this issue, for both relied, as did American Plumbing itself, on a rote recitation of a purported rule that arose originally as a misconstruction of an application of the hearsay rule in a murder case. The rule has arisen by accident, has no discernable basis in policy or legislation, and ought not be followed.

**Apparent Authority—Passive and Derivative**

The court in Reeves, the telescope case discussed earlier, adopted a novel theory of apparent authority in order to treat an insolvent dealer as a broker, so that its apparent “principal,” the supplier, would be responsible to the customer for the dealer’s failure to deliver a telescope.

Apparent authority is strictly a judicial creation; except in connection with the termination of actual authority, the Civil Code provisions on mandate reject the concept. Nevertheless, Louisiana courts have held that even in the absence of actual authority, a principal will be held responsible to a third party for the actions of his purported agent if he has done something to cause the third party reasonably to believe that the agent was authorized to act as he did on behalf of the principal.

Although a statement of the apparent authority doctrine contains more than two distinct concepts, it is commonly said to consist of two “elements”: (i) acts of the principal [causing] (ii) a reasonable belief by the third party in the authority of the purported agent. Reeves affects both of these elements while ignoring the causal connection normally required between them.

30. Id. at 899.
31. 158 So. 2d at 476.
32. See supra notes 6-7 and accompanying text.
34. See La. Civ. Code arts. 3010 (acts of agent beyond authority “null and void with regard to the principal, unless ratified”) and 3021 (principal not bound by acts of agent beyond agent’s authority, “except in so far as he has expressly ratified” them).
36. The most obvious example is the concept of causation, linking the acts of the principal to the perception of the third party. Other distinct concepts would include the objective reasonableness of and the actual, subjective belief by the third party.
Reeves seems to say that the simple failure by the principal to stop the agent's manifestations of authority may satisfy the "acts of the principal" element if it appears that the principal has continued to deal with the purported agent after becoming aware of his claims of authority. The supplier in Reeves had tried to get the dealer to stop using ads that seemed to the supplier to create erroneous impressions of authority. In the court's view, that was not enough, for if the supplier "was serious about correcting this impression, . . . the business relationship should have been terminated." 38

With respect to the "third party belief" element, the court in Reeves first noted that the plaintiff had not even seen the ads that might have misled readers about the dealer's authority to bind the supplier. The court pointed out, however, that the plaintiff's college professor was the type of person that would probably have seen the ads, and that he had recommended that the plaintiff purchase the telescope from the dealer involved. The court then said that in an "esoteric" field such as telescope sales, the supplier must have anticipated that "ordinary people" such as the plaintiff would rely on experts, and so held that "to mislead these experts about an agency relationship is also to mislead the public, or the plaintiff in this instance, on which he [sic] relied." 39

As mentioned earlier, the court made no effort in its opinion to establish any causal connection between the purportedly misleading ads and the plaintiff's purchase. The opinion does not say whether the misinformation in the ads really influenced the professor's recommendation, or even whether the professor himself had ever seen the ads. Under these circumstances the result in Reeves seems to suggest that misinformation in advertising directed, perhaps through "experts," at the public may be used to establish apparent authority without proof of causation.

The court did use language unusual enough to allow this case to be narrowly construed, i.e., to apply only in "esoteric" matters involving unavoidable reliance on "experts." Nevertheless, the case also provides the groundwork for a theory of vicarious contractual liability that is not based on traditional notions of agency law. 40

Agent's Tort Duty to Guarantee or Audit Principal's Contract Compliance

Fryar v. Westside Habilitation Center, 41 purported to deal primarily with a question of long arm jurisdiction. Nevertheless, in reaching its

38. 473 So. 2d at 399.
39. Id. (emphasis added).
40. See text accompanying supra notes 36-39.
41. 479 So. 2d 883 (La. 1985).
result on the jurisdiction issue, the Louisiana Supreme Court said some shocking things about the duties of agents to third parties in connection with agent-administered transactions.

Normally, a disclosed agent is not liable personally for the contractual obligations that he handles in a representative capacity on behalf of his principal. The supreme court in Fryar, however, discovered some tort duties owed by the agent to the third party that could very well make the agent a guarantor or auditor of the principal’s performance.

The agent in Fryar was an officer of an Oklahoma bank who handled an eight million dollar investment by a Louisiana depositor in collateralized certificates of deposit of the bank. The bank failed to deliver the collateral as agreed, and a couple of months later, the bank itself failed.

The court reasoned that jurisdiction could be obtained over the bank officer only if he had personally committed a tort directed toward or affecting Louisiana residents. In finding that such a tort may have been committed (depending on the truth of the allegations in the complaint), the court recited several theories for holding the officer personally liable, despite his status as an agent.

The court said first that the officer had been “the principal for the Bank in this transaction.” Surely, though, the court could not have meant that the officer was a “principal” in the sense that he, and not the bank, had been entitled to the profits from the transaction, or that the bank had been duty-bound to look after his interests in this transaction rather than the other way around. Probably the court meant only that the officer was the bank’s “key” or “principal” representative in this transaction. However, that alone would not have justified the personal, nonrepresentative responsibilities the court imposed on him.

The court’s next statement seemed to be the heart of its analysis. There, the court said that the officer in this transaction owed certain duties to the Louisiana depositor: “[H]e had a duty to see that the Bank’s obligations were carried out, or, alternatively, a duty to warn the other party that these obligations were not being carried out. He had a duty to deliver the collateral and a duty to warn [the Louisiana customer’s representative].” The first of these statements of duty is disjunctive, while the second is conjunctive. It therefore is not clear whether one or both of the duties is owed. Nor is it clear exactly what the duties are. The language the court uses seems deliberately vague, for there was no need to recite a “duty to warn” both specifically in relation the failure to deliver the collateral, and then again generally

\[43.\] 479 So. 2d at 890.
\[44.\] Id.
with respect to no particular danger. Further, it was perfectly obvious to the customer's representative that the collateral had not been delivered as agreed.\textsuperscript{45} The court must have been talking about some other kind of warning, then, perhaps that the delivery of the collateral had become critical because the bank was about to fail.\textsuperscript{46}

In any case, the duties the court described are not consistent with basic principles of agency law.\textsuperscript{47} If an agent really had a duty to ensure that his principal performed his contractual obligations, the agent would essentially be turned into some new kind of guarantor of those obligations. This is at odds with the very idea of representative agency, for it would make it impossible for an agent to engage in a transaction for his principal purely as a representative, without picking up personal responsibility. Of course, compliance with the other duty, i.e., to warn of breaches (or to warn of some unspecified danger), would allow the agent to avoid this personal liability, at least if the duties really were intended to be alternative in nature. However, even a duty to warn would essentially make the agent an auditor of his principal's contractual compliance. That would be an extraordinary notion, for even the principal parties themselves owe no duty to report their own breaches to the other side. Indeed, imposing an auditing or disclosure duty on the agent would cause the agent's duties to third parties to conflict with the confidentiality rights of the principal. This type of conflict would seem to be especially troubling in a banking context, yet the court in this case has essentially identified a state-law tort duty that could be interpreted to require bank officers to tip bank customers concerning the bank's prospective inability to meet its obligations. This obviously could not have been intended by the court, yet one is left wondering what the court really had in mind.

\textsuperscript{45} Id. at 885.
\textsuperscript{46} A causal connection between the failure to warn and the loss of the eight million dollars is difficult to surmise. Conceivably, the depositor might have flown to the bank personally and demanded to take possession immediately of the notes and mortgages involved, but the prospects for success in that sort of effort would seem pretty small, especially in the middle of a financial crisis at the breaching bank. What the depositor needed was performance, not a too-late warning of an obvious instance of nonperformance. The only other way a warning might have helped would have been as a selective tip to this customer, which would have permitted it to obtain a prepayment at the expense of other innocent depositors. That could not have been what the court meant by a duty to warn.

The weakness in the warning rationale forces one back to the conclusion that the court was essentially holding the agent liable for the principal's breach of contract, even if strictly on a tort theory. It is unlikely, of course, that an agent held liable for his principal's nonperformance would care very much whether the court was using a tort or contract theory to impose the liability. Liability under any theory would make service as an agent an unjustifiably risky undertaking.

The court's last statement on the subject may be its most surprising. The court actually said that "[an] employee cannot shield himself behind a corporate wall when he is the officer responsible for the corporation's acts in a particular transaction." This statement is either circular (i.e., the employee can not avoid personal responsibility when he is personally responsible), or it is contrary to all traditional understanding of representative agency principles. A corporation can act only by conferring authority on its agents, i.e., by making them responsible for conducting its affairs. If the exercise of this authority is what the court was referring to when it spoke of an officer's "responsibility" for corporate actions, then it would never be possible for a corporate agent to act in a purely representative capacity. Certainly, agents cannot avoid personal liability for their own torts simply on grounds that they committed the tort as a representative of someone else. For example, a corporate officer is personally liable for any fraud he commits, whether in connection with his own affairs or those of his corporate employer. However, the law has not, until this case, imposed a general tort obligation on agents to see to it that their principals perform their contractual obligations to third parties, or to "warn" the third parties if the principals do not so perform. Imposing these duties would eliminate most of the commercial value of agency law.

It is very unlikely that the court intended its statements concerning the bank officer's personal tort duties to affect agency principles as profoundly as suggested in this discussion. One can only hope that this hard case will not be permitted to make bad law. Perhaps other courts will be willing to limit Fryar to its facts, and to recognize its extraordinary duties only to the extent necessary to exert long arm jurisdiction over an officer of an out-of-state bank that has squandered away eight million dollars invested by a Louisiana nonprofit organization.

**Partnership**

**Inadvertent Creation**

The Louisiana fifth circuit, in *John P. Harris, M.D., Inc. v. Parmley*, recited a new, super abbreviated test for the inadvertent creation of a partnership under Louisiana law. The test consisted of "(1) mutual consent [to something not specified by the court], (2) participation in

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48. 479 So. 2d at 890.
50. 480 So. 2d 500 (La. App. 5th Cir. 1985).
profits and/or losses and (3) [a] proprietary interest in a community of property."

Characteristically, despite the court's recitation of a new test, the test had little to do with the outcome of the case. Rather, the decisive factor seemed to be the powerlessness of the alleged partners in the partnership to exercise any control over the management of its affairs. Only one of the alleged "partners" in the subject group of doctors had any real power over the business; the others considered him the "boss" and testified that he "held the strings."

Shared control is second in importance only to shared profits in finding an inadvertent partnership in the forty-eight states that have adopted the Uniform Partnership Act. However, it is virtually never mentioned as one of the "elements" in the Louisiana test for inadvertent partnerships (except to the extent that it could be considered covered by the "proprietary interest" language in the widely-recited three element tests). This is true even though partners in a Louisiana partnership normally have equal power under the Civil Code both to participate in the management of the partnership and to bind it to third parties. If one were searching for factors that would distinguish a partnership from other forms of business relationships, shared control over management would easily be one of the most important. This case is worth noting, therefore, because it provides at least some implicit recognition in the Louisiana jurisprudence of this commonly-ignored factor.

51. Id. at 502 (emphasis added). For four other tests see Morris, Developments in the Law, 1984-1985—Business Associations, 46 La. L. Rev. 413, 413-14 nn. 1 & 3. This new, "super-abbreviated" three-element test is different from the more traditional three-element tests in two respects: (i) it eliminates from the first element any description of what the parties are supposed to be consenting to, and (ii) it rejects the traditional emphasis on a loss-sharing agreement, requiring instead only a sharing either of profits or of losses. Both changes are improvements. The first eliminates the circularity and redundancy of the requirement in the traditional tests that the parties consent to form a partnership. By stripping the first element of everything but the notion of consent, the Fifth circuit has provided language that might eventually be used to tie consent not to the legal classification of the relationship, but instead to the more useful "profit-sharing" and "proprietary interest" factors in the second and third elements of the partnership tests. The second change, which eliminates the need for a loss-sharing agreement, reflects one of the 1980 changes to the partnership provisions, the very sensible repeal of an article that had made "no loss" agreements unenforceable even between the partners themselves. See Morris, supra, at 419.

52. See Morris, supra note 51, at 413-20.

53. 480 So. 2d at 502.

54. See H. Reuschlein & W. Gregory, Agency and Partnership § 175, at 247-48 (1979). Louisiana and Georgia are the only states that have not adopted the U.P.A. See Table of Adopting Jurisdictions, 6 U.L.A. 1 (Supp. 1986).

55. See Morris, supra note 51, at 413-14 nn. 1 & 3.

Nonbusiness Partnerships

In *Ermert v. Hartford Insurance Co.*, a guest at a hunting camp accidentally shot a fellow guest in the foot. The injured guest sued, in addition to the individual who fired the gun, the owner of the camp, the owner’s business, the owner’s insurer, some hunting friends of the owner who had helped defray some of the expenses of the camp, and the “joint venture and/or partnership” consisting of the owner and the contributing friends. The trial court maintained exceptions of no cause of action or granted summary judgments in favor of all the defendants except the one who had actually shot the plaintiff.

The appellate court treated the existence of the partnership as a question of fact, so that the allegations in the plaintiff’s petition that a joint venture and/or partnership existed had to be treated as true for purposes of ruling on the exceptions. Similarly, the court of appeal held that conflicting evidence on the factual issue precluded summary judgment. Accordingly, the court reversed the trial court’s rulings in favor of the defendants and remanded the case for trial.

This seems erroneous. The trial court’s rulings should have been affirmed on the ground that associations formed other than for business purposes could not, as a matter of law, be treated as partnerships under the Civil Code. Outside Louisiana, this would surely have been the correct result, for under the Uniform Partnership Act, a partnership is defined as “an association of two or more persons to carry on as co-owners a business for profit.” An association formed other than for profit-oriented business purposes is by definition not a partnership.

The Louisiana definition is not quite as clear, but it too seems designed not to reach associations organized for purposes other than the co-ownership of a business (or, as the jurisprudence recognizes, a business venture). The Civil Code defines a partnership as “a juridical person, distinct from its partners, created by a contract between two or more persons to combine their efforts or resources in determined proportions and to collaborate at mutual risk for their common profit or commercial benefit.” Unless the phrase “common profit” is interpreted to include recreational pleasure (or financial savings in connection with pursuing recreational pleasure), this definition would seem to exclude groups of the type involved in *Ermert*. It would be inappropriate to apply to every unincorporated cooperative group (e.g., many social clubs, churches and civic organizations) a set of rules designed to govern...
the vicarious tort liability of the owners of unincorporated business organizations.\(^6\) That would be the logical extension of \textit{Ermert}, however, for it would be very difficult to distinguish the "common profits" of many of these kinds of organizations from the type of "profit" enjoyed by the group of hunters in this case.

\textit{Partner Liability for Delictual Obligations of the Partnership}

Assuming that the plaintiffs in \textit{Ermert}\(^2\) should have been held liable as partners, another feature of the court's analysis is still troubling. The court did not seem to question the plaintiff's position that the defendants, if partners, would have been liable in solido for the damages the plaintiff had suffered.\(^3\) This position might have been defensible had the plaintiff been arguing that the defendants had assisted in the commission of the tort within the meaning of Civil Code article 2324, but he seemed instead to be saying that the defendants would liable solidarily simply as partners of the actual tortfeasor. That was simply incorrect. Partners are liable only on a secondary basis for debts of the partnership entity (as distinguished from the debts of partners), and then only for their per-capita, or "virile" share.\(^4\)

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61. It is easy to understand why the appellate court chose to accept a partnership theory in this case, for there are some easily ascertainable rules concerning the vicarious tort liability of partnerships and partners. See La. Civ. Code arts. 2320 & 2817. In contrast, no legislation or jurisprudence seems to exist in Louisiana that discusses the vicarious tort liability of members of unincorporated associations. The only Civil Code provision dealing with unincorporated associations, La. Civ. Code art. 446, concerns the limited recognition given to these bodies for purposes of owning and transferring property. A court might well reason that such groups should also be recognized for the limited purpose of subjecting the groups' assets to claims by the various creditors of the group, including tort victims. It would be a much greater step, however, and one much harder to justify, for a court to hold the group members themselves personally liable for the obligations of the group. In many cases, these obligations would arise from conduct having only the weakest of connections to non-controlling members of the group.


63. 480 So. 2d at 1001.

64. La. Civ. Code art. 2817. Incidentally, the use of the term "virile" as a synonym of "per-capita" in the new partnership articles (see infra notes 66-70 and accompanying text) has turned out not to have been a very good idea, for later changes in the definition of "virile" in the obligations articles has produced a potential for confusion. After the 1980 revision of the partnership articles, in which the term "virile" was used to describe the per-capita liability imposed under the old provisions on ordinary partners (see La. Civ. Code arts. 2873 (1870), 2103 (1960); Cortiza v. Rosenblat, 291 So. 2d 425 (La. App. 4th Cir. 1974); Cambre v. St. Paul Fire & Marine Ins. Co., 331 So. 2d 585 (La. App. 1st Cir.), cert denied, 334 So. 2d 434 (La. 1976)), the term "virile" was used in article 1804 of the new obligations provisions to refer not only to the per-capita liability imposed as between solidary contractual obligors (see La. Civ. Code art. 2103 (1960)), but also
The official comment to the relevant provision, Civil Code article 2817, does say that the secondary, virile liability rule does not apply where in delictual matters solidary liability is imposed as a matter of law. Nevertheless, this comment must be referring to solidary liability such as that imposed under Civil Code article 2324, because nothing in the Civil Code imposes solidary liability on partners for the tort obligations of the partnership based simply on their status as partners.

Article 2817 is the only provision on point, and it provides that the vicarious liability of partners for the debts of the partnership is virile, not solidary. The comments to this provision say that the article was designed to bring forward into the 1980 partnership articles the old approach to the liability of ordinary partners. That approach was to impose per capita liability with respect to all obligations of the partnership, whether conventional or delictual. This contrasted with the solidary liability imposed on partners in a commercial partnership.

The 1980 provisions abolished the different types of partnerships (except for the distinction between general partnerships and partnerships in commendam) and chose the per-capita, ordinary-partner type of liability for all general partners. That is just as clear under the current to the "percentage of fault" shares of solidary tort obligors. Unfortunately for one trying to interpret the partnership articles, this obligations provision is as close as the Civil Code now comes to defining the term "virile."

It therefore is possible to read articles 2817 and 1804 in conjunction to say that the liability of partners to third parties would depend on fault in a tort case and would be per-capita, subject to contractual modification among the obligor partners, in a contract case. This would be wrong not only from an historical standpoint, but would also be wrong contextually. Article 1804 purports only to describe the inter sese obligations of solidary obligors; as to third parties, the solidary obligors would obviously be liable for the entire debt. It would make no sense, then, to use article 1804 to define the obligations owed by partners not to one another but to third party obligees of the partnership. Also, permitting the partners to agree with one another concerning limitations on their obligations to third parties (as using article 1804 here would allow) would be inconsistent with, and in some cases directly contradictory of, article 2815 of the partnership provisions, which makes "no participation in loss" agreements unenforceable against third parties.

66. Id.
70. See La. Civ. Code art. 2817 comment c. The term, "general partners," was used in the text to exclude partners in commendam from the coverage of the virile portion rule. Partners in commendam must agree to contribute something of value to the partnership, but their membership-based liability is limited to the making of the agreed contribution. La. Civ. Code art. 2840 comment (a).
provisions of the Code as was the solidary rule under the older provisions.

Capital Contribution to Partnership Treated as Donation

In Broussard v. Crochet, Broussard & Co.,71 a variety of contractual interpretation issues were well-handled in the context of a complicated dissolution battle.72 However, the third circuit did seem to err in the approach it took in determining whether certain partnership-related movable property had been contributed to the partnership, or had continued to be owned by one of the partners personally.

This will always be a difficult type of issue factually, for the partnership provisions of the Civil Code contain no rules on the proper mechanism for transferring ownership of movable property from a partner to his partnership. It is recognized, of course, that the partnership is a separate juridical person, distinct from its partners, so that it can own property independently of the ownership interests of the partners in the equity of the partnership.73 Nevertheless, the "contract formation" and "transfer of possession" tests for voluntary transfers of movables74 will normally be difficult to apply with respect to transfers between an individual and the business (or businesses) that he owns. This is so because the law on transfers of movables is based on the assumption that the transferor and transferee are different people. They are, of course, even in partnership cases, under the fiction that the partnership is a juridical person distinct from its owners. Nevertheless, the law's insistence that at least two people are involved in these transfers, even if one is fictional, does not change the simple fact that in many of these transactions just one human being is engaging in observable conduct. Contracts between an owner and his business may very well be negotiated strictly between the owner and himself, and transfers of possession will often take place only in legal contemplation. Thus, a court will often find it difficult to determine whether such contracts have been formed and whether the physical possession of a given item of property has been transferred somehow from the owner in his individual capacity to the owner in his representative capacity.

It therefore would seem appropriate in such cases to shift one's attention from what "really" happened between the fictional person and

71. 477 So. 2d 166 (La. App. 3d Cir. 1985).
72. Two other complicated dissolution cases decided last year were Thompson v. Grantham, 489 So. 2d 414 (La. App. 3d Cir. 1986) and Makar v. Stewart, 486 So. 2d 166 (La. App. 3d Cir. 1986).
73. La. Civ. Code art. 2801 comments (a) & (e).
its owner to what should be deemed to have happened based on the owner's conduct. In the case of a dispute among partners in connection with a dissolution of their partnership, the appropriate approach would seem to be to determine whether the conduct of the partner claiming personal ownership of the property had, from the standpoint of the other partners, created the impression that the property involved had been contributed to the partnership. If so, regardless of that partner's subjective intentions, the property should be treated as partnership property. In effect, the "contract" test of Civil Code article 518 ought to be applied with sensitivity both to the tacit arrangements common in small businesses, and to the difficulties of proving such arrangements except by circumstantial evidence.

In Broussard, this approach would have resulted in treating the property involved, office equipment, as the property of the partnership. The contributing partner had used the assets for years in the partnership business and had permitted them to be counted as partnership property in calculating the partnership's depreciation deductions for tax purposes. It seems unlikely under those circumstances that the noncontributing partners had any idea that the contributor still considered this property to be his personally.

Instead, the court in Broussard took a much different approach. It treated the alleged transfer of equipment as a donation, which meant that the noncontributing partners, lacking an authentic act, had to "show by strong and convincing proof that the donor had the intent to irrevocably divest himself of the thing and that real delivery was made." The court found that proof of the simple use and depreciation of the equipment by the partnership was insufficient evidence to meet this burden.

It is not clear why the court took this donation approach. It appears that the nontechnical meaning of donation, as a rough synonym for a contribution or transfer, led the court to the donation provisions of the Civil Code, where the term is used in a technical sense to refer strictly to transactions motivated at least in part by the liberality or generosity of the donor.

It does not seem plausible that capital contributions by owners to their businesses could be considered to be motivated by unselfish generosity. In fact, if the partnership in Broussard was sol-

75. 477 So. 2d at 174.
76. Id.
77. S. Litvinoff, Louisiana Civil Law Treatise, Obligations, Book 1, § 103, at 180-81 (West 1969).
78. The son of the contributing partner in Broussard did eventually acquire a 15% interest in the partnership, but this occurred after the date of most of the transfers.
vent at the time of the transfers, then the contributing partner would have received in exchange for his contributions claims against the assets of the partnership virtually equal in value to the equipment contributed. Although he no longer owned the equipment directly, he did own a priority equity interest in the partnership that was increased in value as a result of the contribution of the equipment. He thus changed more the form of his assets than their aggregate value. He could not have been making a donation under these circumstances. The Broussard approach to capital contributions is unsound and ought to be rejected.

Withdrawal, Admission of Partners

Bourgeois v. Medical Center of East New Orleans involved an appeal from the dismissal of a declaratory judgment action in which certain partners in a medical partnership had challenged the lawfulness of the managing partner's agreement to sell both his ownership interest and his management powers to a hospital. The fourth circuit reversed the trial court's dismissal, ruling, among other things, that the purported sale of the management powers was "contra bonos mores." Although the result was unquestionably correct, the court might have struck down

Moreover, even with some motive to give, the contributor's receipt of a claim against the partnership virtually equal in value to the contributed assets would have prevented the application of donative formalities under the test in Civil Code article 1526. See infra notes 79-80 and accompanying text.

79. There was no indication that it was not solvent. If, however, the liabilities of the partnership had exceeded its assets, then a contribution of property to the partnership might have served only to increase the pool of assets against which the partnership creditors could have enforced their claims. See La. Civ. Code art. 2833. It is very unlikely even under these circumstances, however, that a contributing partner would be acting with the intention of donating the contributed property to the partnership's creditors.

80. Claims for the repayment of the capital contributions of partners are senior in priority to the partners' claims to the residual. La. Civ. Code art. 2833. This priority treatment would have kept the other partners from sharing in the value of the contributed assets simply as the result of the transfer of title from the owner to the partnership. They would, of course, be entitled (or obligated) to share as owners both in the changes in value (up or down) after the contributions and in the earnings produced by the partnership's utilization of the contributed assets.

Indeed, except for complicating the case factually, the contributing partner in Broussard would probably have been better off not-claiming-the-old, presumably depreciated, office equipment itself, but claiming instead a priority "capital contribution" payment based on the value of the equipment at the time it was contributed. This approach would have allowed him to be compensated for the "using up" of the equipment for the benefit of the partnership.

81. 482 So. 2d 795 (La. App. 4th Cir. 1986).

82. Id. at 800. The court characterized this part of the agreement as an attempt by the manager to sell something he did not "own," a job. This obviously was not a reason to strike down the agreement, but only another way of stating the court's conclusion that the management powers ought not be capable of sale.
this part of the agreement on the narrower, more modest and more
defensible ground that it was simply violative of any reasonable inter-
pretation of the agreement among the partners. It is not at all clear
why the public should be deemed to have some sort of regulatory interest
in this sort of transaction, and the court offers no clues on what it
might have had in mind.\textsuperscript{83}

On a tougher issue, the court ruled that a first refusal provision in
the partnership agreement did \textit{not} have the effect of changing the voting
requirement for the withdrawal or admission of partners from the un-
nanimity established as a suppletory matter by Civil Code article 2807.\textsuperscript{84}
This essentially turned the first-refusal provision on its head, for it now
could be interpreted only as a restriction on the normal power of partners
to “share” their interests and not as a liberalization of the normal
restrictions on the admission of purchasers as actual partners in the
partnership.\textsuperscript{85}

This result could be rationalized technically on the ground that the
court was not free to insert a change in voting standards where the
parties could have specified the term but had not. Nevertheless, the
result was probably not consistent with the intention of the parties. As
the Civil Code indicates, unless the partners agree otherwise, they may
not transfer their interest in the partnership if any other partner objects.\textsuperscript{86}
This makes sense as a suppletory provision because of the management
powers conferred on all members of the partnership.\textsuperscript{87} However, where
the parties have taken the time to negotiate a right of first refusal
provision, the implication is very strong that they intended to replace
the “no transfer if anyone objects” rule with a less rigorous restraint
on alienation.\textsuperscript{88}

\begin{itemize}
\item \textsuperscript{83} It certainly is not self-evident that partners, if they wished to do so, ought not
be permitted to contract for management services, and to make the management contract
assignable.
\item \textsuperscript{84} \textit{482} So. 2d at 800.
\item \textsuperscript{85} It is difficult to imagine why a partner would negotiate a right of first refusal
provision, and then subject a sale of his partnership interest to the almost impossible
second hurdle of a unanimous vote. He would already have had the power simply to
“share” his interest (i.e., to sell or assign it without gaining the actual admission of the
buyer to the partnership) without any need to subject his transaction to a vote or to
offer it first to the partnership. La. Civ. Code art. 2812. If, as the court suggested, the
partners intended to require a unanimous vote for the admission of the partner, even
after satisfying the first refusal provision, then the partners must have intended for the
first refusal provision not to liberalize the admission vote, but to restrict the sharing
decision. This seems unlikely.
\item \textsuperscript{86} La. Civ. Code art. 2807.
\item \textsuperscript{87} La. Civ. Code arts. 2807, 2814.
\item \textsuperscript{88} See supra note 85.
\end{itemize}
These devices are widely used in connection with closely-held corporations, and do not normally require a unanimous vote in that setting.\textsuperscript{89} It is likely that the drafters of the provisions involved in this case simply overlooked the need to consider the peculiarities of partnership law in preparing the pertinent agreement. For the business planner, therefore, the case becomes a warning of a dangerous "trap for the unwary."

Finally, after discussing the voting requirement issue, the court quickly and easily disposed of a desperate-sounding argument by the selling partner that the unanimity requirement of article 2807 applied only to the admission of "new" partners in the sense of "additional" partners, and did not apply where one person was simply being "substituted" for another as partner.\textsuperscript{90} The court took the only sensible approach in holding that article 2807 applied whenever the number or identity of the partners was being changed.\textsuperscript{91}

\textbf{Corporations}

\textit{Stock Transfer Restrictions—Strict Construction}

In \textit{Louisiana Weekly Publishing Co. v. First National Bank of Commerce},\textsuperscript{92} the articles of incorporation of a company granted a right of first refusal to the corporation, and then to shareholders, with respect to any sale by a shareholder of stock in the company. The same provision also stated that upon the death of any shareholder, the stock owned by that shareholder "shall go to his legal heirs."\textsuperscript{93} The transaction being challenged was an inter vivos donation of the stock.

The trial court and the first circuit interpreted the transfer restrictions to prohibit the inter vivos donation, even though that type of transaction was not covered expressly by the articles of incorporation. The courts reasoned that the parties to the transfer restriction had adequately expressed their intention to restrict transfers generally, and could not possibly have intended to provide the "donation" loophole discovered by the transferring shareholder.\textsuperscript{94}

The supreme court reversed, however, on the ground that stock transfer restrictions, as restraints against the free transferability of prop-

\textsuperscript{89} In a corporate setting, it is the restriction of transferability, and not its liberalization, that is subjected to close scrutiny. See \textit{La. Weekly Publ. Co. v. First Nat'l Bank of Commerce}, 483 So. 2d 929, 932-33 (La. 1986).
\textsuperscript{90} 482 So. 2d at 801.
\textsuperscript{91} Id.
\textsuperscript{92} 483 So. 2d 929 (La. 1986).
\textsuperscript{93} Id. at 931.
\textsuperscript{94} Id. at 932.
Property, must be interpreted strictly. The majority quoted one sentence out of Professor André's article, *Restrictions on the Transfer of Shares: A Search for Public Policy*, in support of its holding, while ignoring Professor André's conclusion that there really was no good reason to treat transfer restrictions as a "disfavored" type of legal device. Indeed, the court did exactly what André had criticized in his article: it ignored all of the commonly-recognized, important uses of these types of provisions and then relied on a simple recitation of the law's "favoring" the free alienability of property, in order to reach a result that makes these devices unusually difficult to enforce.

As Justice Lemmon stated in his dissent, citing Professor André accurately, transfer restrictions should not be implied as a matter of law in a corporate setting; free transferability of ownership interests is one of the widely acknowledged "normal" attributes of a corporate form of organization. However, once the parties clearly indicate their intention to abrogate the suppletory rule that favors unrestricted transferability, there is no reason not to interpret the restrictions they do choose to impose in the very same way that most other contracts are interpreted.

Indeed, one has to wonder whether the fight over the interpretational standards in this case did not really mask a more fundamental disagreement over judicial activism in contract interpretation generally. The majority may simply have favored a more literalist approach generally in contract interpretation than did Justice Lemmon. If so, the interpretational device was more a makeweight than the deciding factor in the case, for it would then have been important only as a means of avoiding the broader, more fundamental issue.

**Enforceability of Nonlegended Restrictions**

Without discussing the issue at any length, the court in *Louisiana Weekly* seemed to accept the view that stock transfer restrictions are enforceable against persons with actual knowledge of them, even if they are not noted on the stock certificate. This is at odds with Louisiana Revised Statutes 12:57F, which provides that restrictions not noted are completely unenforceable, but is correct under Louisiana Revised Stat-
ulates 10:8-204, the Louisiana version of U.C.C. Section 8-204, which recognizes an "actual knowledge" exception to the general rule of non-enforceability of nonlegended transfer restrictions. 102 This issue had been discussed explicitly in an earlier appellate decision, Thibodeaux v. Pioneer Land Development & Realty Corp., 103 in which the Louisiana fifth circuit had ruled that the actual knowledge language of the U.C.C. provision controlled. 104 Thibodeaux was cited with approval in a footnote discussion of the issue in Louisiana Weekly. 105

Valuation—Stock of Closely-Held Corporations

In Combs v. Howard, 106 the third circuit affirmed a trial court finding that the defendant had breached a letter agreement to transfer 49% of the stock in his wholly-owned oil field services corporation to a new managing "partner" in exchange for the new participant's agreement to manage the corporation's business for $6500 per month. 107 However, the court reversed the trial court's finding that the plaintiff had failed to prove any damages as a result of the breach. 108

The court implicitly agreed with the trial court's view that the plaintiff was not necessarily entitled to his proportionate share of the $265,000 book value of the company. 109 It disagreed, however, with the trial court's apparent acceptance of the views of the defendant's experts. They had testified that 49% of the stock in a company owned 51% by someone else was, at best, economically worthless. One of the defendant's experts had even testified that the stock actually had a negative value because the company had elected "S corporation" tax treatment. This made the minority owner personally responsible for the payment of taxes on 49% of the company's income, even though the company had never paid any dividends to him.

In rejecting this testimony, the third circuit reasoned that the stock must have had some positive value in order to have been covered in

102. La. R.S. 10:8-204 (1969) ("A restriction on transfer shall be effective, even if the restriction is not noted on the certificate, against persons having actual knowledge of the restriction.").
103. 420 So. 2d 1162 (La. App. 5th Cir. 1982).
104. Id. at 1166.
105. 483 So. 2d at 933 n.10.
106. 481 So. 2d 179 (La. App. 3d Cir. 1985), cert. denied, 484 So. 2d 671 (La. 1986).
107. Id. at 180-86.
108. Id. at 181-82.
109. Id. at 182. The plaintiff apparently did not challenge the use of book value as an appropriate ceiling figure. His expert, a C.P.A., was said to have "admitted" that market value and book value were not always the same. No one presented an "earnings value" or "asset value" calculation, which might have created a starting figure higher than book value.
the letter agreement as part of the compensation for the manager's services. The court also recognized, however, the need for a minority discount in valuing a noncontrolling interest in a closely-held corporation. Accordingly, the trial court's denial of relief was reversed, and the minority discount off book value was set at 80%. Judgment was rendered for $25,000. Judge Knoll felt that the discount should have been only 20%, and so dissented from the valuation part of the opinion.

It was not true, of course, that the simple inclusion of the stock term in the letter agreement had to mean that the stock had had a positive value; the new manager may very well have been mistaken about the economic value of a minority interest in a closely-held corporation. Even if the stock actually had had some economic value, $25,000 seems to have been a pretty generous minimum figure.

On the other hand, it is difficult to say that the court was wrong to reject the accepted wisdom that minority stock in a closely-held corporation is, by itself, virtually worthless. The reason the defendant's experts could testify that the stock was virtually worthless is that corporation law confers virtually no power on a minority participant in a closely-held company to protect his interest in the business. If the law provided better protections, the stock might be more valuable. Thus, in rejecting the experts' widely-accepted "worthlessness" views, the third circuit may simply have been saying that the law in this particular case was going to provide more effective protections. The dissent, of course, did not disagree with this conclusion, it just wanted to go further.

Unfortunately for minority investors, though, Combs does not make this type of protection available generally. Combs dealt only with the valuation of stock for purposes of calculating damages for the breach of a contract to sell the stock. Combs probably could be expanded to

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110. 481 So. 2d at 182.
111. Id. at 182-83.
112. Minority owners of a corporation may (and very often do) receive substantial benefits in the form of salaries and perquisites. Nevertheless, these benefits generally result from informal arrangements that may be terminated on short notice by the controlling persons. The minority stock itself does little more than give the disappointed investor the standing to take a shot at overcoming the business judgment doctrine either in connection with a derivative suit or in an action for involuntary liquidation. The corporation law in this area contrasts sharply with partnership law. In a partnership, in the absence of a contrary agreement, each partner has the right to participate on a per-capita basis in management decisions, and to bind the partnership to good faith third parties in the ordinary course of the partnership's business. See La. Civ. Code arts. 2807, 2814. More importantly, each partner has the power, subject to agreement, to withdraw from the partnership and to require the partnership to pay him the value of his interest. See La. Civ. Code arts. 2822-2825.
113. Of course, the overall value of the company might be depressed by the prospect of effective minority dissension, but a fair-sized piece even of a less valuable company would be worth more to the minority investor than what he gets now.
deal with valuation in the case of other kinds of partial liquidations, but liquidations of any kind are difficult to accomplish without the cooperation of the controlling shareholders. Indeed, the plaintiff in *Combs* was himself lucky both that the defendant breached the agreement, and that the court was willing to award monetary damages, even though a nonsubstitutional remedy, specific performance, would have been both practical and better suited to putting the parties in the positions they would have had the defendant not breached his duties to the plaintiff. Had the plaintiff in this case actually obtained the stock he had been promised, he would have been stuck with a minority interest in a corporation controlled by someone who was already mad at him. He would then have faced the almost impossible task of persuading a court that the corporation involved should be ordered to liquidate, even over the objections of its majority owner, because the two owners could no longer get along.

The inconsistency between this hypothetical result and the one that actually occurred might lead a management-oriented lawyer to conclude that the plaintiff in this case should never have been awarded damages. A lawyer for minority investors, though, might just take what he could get and hope that consistency would be restored by increasing, rather

114. Corporation law calls for involuntary partial liquidations only in connection with the minority shareholders' dissenting from certain types of business combinations. See La. R.S. 12:131 (1969 and Supp. 1986). Otherwise, the minority investor is put in the unenviable position of having to argue that just because he is unhappy and wants out, the entire corporation should be liquidated. See La. R.S. 12:143 (1969 and Supp. 1986). Involuntary liquidation is difficult to obtain. Even in the case of a deadlock among shareholders, it requires a showing not only that "irreparable injury to the shareholders is being suffered," but also that "such irreparable injury warrants dissolution after giving due regard to the interests of the other shareholders, the employees, and the public." La. R.S. 12:143 A (5) (Supp. 1986).

In the absence of provisions openly protecting the minority investors' need to withdraw from incorporated businesses, an owner wishing to withdraw has to negotiate a buy-out with the controlling persons. He will often find it helpful in these situations to threaten costly derivative litigation as a means of improving his negotiating leverage. Still, because of the strength of "business judgment" protections of managerial decisions, and the fact that the dissenter's dispute does not so much concern mismanagement as it does the controlling persons' decisions about allocating some jobs to which the dissenter has no legally-enforceable right, the plaintiff's chance of succeeding on the merits in such litigation is very small. See infra notes 117-31 and accompanying text for a discussion of a liberal demand rule in derivative litigation.

115. The fifth circuit, in *Haggerty v. March*, 480 So. 2d 1064 (La. App. 5th Cir. 1985), avoided the valuation question by declaring null the fraudulently-induced transfer that had given rise to the claim for damages. The analogous remedy in *Combs* would have been an order of specific performance. Had specific performance been granted, the plaintiff would actually have received the stock itself, and the court would have avoided the need to discuss the extraordinarily difficult valuation issue.

116. See supra note 114.
than by consistently denying, effective protections for the interests of minority investors. The overall economic impact of such protections would be extraordinarily difficult to predict or to measure.

**Derivative Suit Demand Futility**

*Smith v. Wembley Industries* is the first Louisiana decision to construe the “demand futility” requirement of article 596 of the Louisiana Code of Civil Procedure. Article 596 requires the plaintiff in a shareholder derivative action to allege “with particularity” either his efforts to obtain corrective actions from the company’s directors, and “if necessary” the shareholders, or the reason for not making such an effort. Most other states, as well as the Federal Rules of Civil Procedure, impose the same requirements.

Enormous uncertainty exists over the interpretation of this procedural rule in the context of enforcing principles of substantive corporation law. While the substantive law imposes fiduciary duties on directors, it also confers management powers, including the power to control corporate litigation, exclusively on the company’s board of directors. Emphasizing the board’s exclusive management powers, Delaware has recently been hostile to the derivative suit, and has interpreted the language involved in *Wembley Industries* in a way that would have rejected the plaintiffs’ allegations of demand futility.

The plaintiffs in *Wembley* alleged that three of the five corporate directors had breached their fiduciary duties to the corporation by causing the corporation to pay the three directors extravagantly, in salaries, bonuses and perks, even though the corporation was having financial difficulties. The other two directors were alleged to have been dependent on the self-dealing directors for their jobs, so that a demand by the plaintiffs for corrective action by the board would have been futile for purposes of article 596.

The trial court granted defendant’s exception of prematurity, but the fourth circuit reversed. Without citing the leading cases, the Louisiana court rejected the heavily-debated Delaware view that a decision

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117. 490 So. 2d 1107 (La. App. 4th Cir. 1986).
120. DeMott, supra note 119.
121. Pogostin v. Rice, 480 A.2d 619 (Del. 1984); Aronson v. Lewis, 473 A.2d 805 (Del. 1984); see infra note 124.
122. 490 So. 2d at 1107-08.
to litigate, like any other management decision, is entitled to "business judgment" deference, and that boards tainted by self-interest are still capable of appointing disinterested litigation committees to make the appropriate decisions for the company. Rather, the court accepted the more traditional view that a director being sued for alleged self-dealing or carelessness cannot be expected to make a disinterested decision about suing himself. Implicitly, the court also seemed to be saying that it was not possible, as the Delaware cases had suggested, for a defendant director to select other, objective, disinterested individuals to make these decisions for the company.

Although the court spoke in its opinion as if the defendants actually were guilty of the wrongs alleged (and that was appropriate to some extent given the procedural posture of the case), it should be emphasized that the impact of the court's ruling is not simply to prevent dishonest directors from blocking derivative actions against them, but is also to allow plaintiffs to skip the demand stage of a derivative action simply by alleging that the directors have been engaged in unlawful behavior. This is what creates the danger of strike suits that the Delaware courts have been so concerned about.

Nevertheless, one major difference between the types of cases that the Delaware courts often see, and those presented to Louisiana courts, is that the Delaware cases are much more likely to involve suits against large, publicly-traded corporations. Roughly half of the Fortune 500 companies are incorporated in Delaware. The likelihood of strike suits is probably greater in connection with these public companies than it

124. Aronson, 473 A.2d at 811-12; Pogostin, 480 A.2d at 624-25. The Delaware court purports to "balance" the business judgment deference against the shareholder's right to bring a derivative action, by requiring only a "reasonable doubt" concerning the "independence, interest and exercise of business judgment" by the defendant directors. Pogostin, 480 A.2d at 624-25. However, in application, it imposes "particularity" requirements on the pleadings so stringent that reasonable doubt is extraordinarily difficult to establish. In Aronson, the court ruled that reasonable doubt had not been created by the plaintiff's allegations that it was futile to demand action from a board composed purely of directors chosen by the dominant stockholder, all of whom were alleged to have breached their fiduciary duties to the corporation (i) by making $225,000 in interest-free loans to the dominant stockholder, and (ii) by an "employment" contract that provided the 75-year-old dominant stockholder a salary of $150,000 annually, plus a 5% bonus, and which was terminable early only by the stockholder, and provided death benefits and six figure salaries for life, even after termination.

125. 430 A.2d at 786.
126. 490 So. 2d at 1108-09.
is with those owned by just a few individuals, for the public-company strike-suit lawyer is not only much more likely to find a stockholder capable of serving as a nominal plaintiff, he also has a better chance at obtaining large attorneys' fees payable, with little cost to himself, out of the treasury of the company.\textsuperscript{128} Similarly, directors of public companies, facing personal liability if no settlement is reached and bearing virtually none of the costs of settlement, are often amenable to settlement arrangements that are highly favorable to the plaintiffs' lawyers.\textsuperscript{129}

In contrast, it is fairly unlikely that the owners of a closely-held company are going to spend their own company's money in connection with a derivative action unless they are engaged in a genuine dispute over the management or earnings distribution policies of the company. In a rough sense, the liberal approach of the fourth circuit in \textit{Wembley}, when applied to closely-held companies, moves the minority investor closer to the position he would be in as a minority partner in a partnership. As a partner, but not as a shareholder, a minority investor would generally have the power to force a liquidation of his interest should he become dissatisfied with his treatment.\textsuperscript{130} While, as a legal matter, \textit{Wembley} still confers no such rights on minority shareholders, it does as a practical matter give the dissatisfied minority investor some leverage in negotiating with the controllers of the company either for a change in company policy, or for a liquidation of his interest. If the controllers refuse to negotiate appropriately,\textsuperscript{131} the minority investor will very often be able to find something in the company's recent past to create factual issues concerning the controlling persons' loyalty, diligence or judgment. This will generally be enough for a derivative action under the \textit{Wembley} rule, and the derivative action will often be settled by liquidating the complaining shareholder's interest. In effect, then, \textit{Wembley} helps the minority investor force a partial liquidation, largely on surreptitious grounds, in the event he becomes so dissatisfied with his treatment at the hands of the controlling persons that he is willing to risk his own money in pursuing a derivative action against controlling directors who will also have something to lose both in the lawsuit and in a settlement. Pure strike suits in this setting are unlikely.\textsuperscript{132} Still, as


\textsuperscript{129} Coffee, supra note 128, at 23-24.

\textsuperscript{130} See La. Civ. Code arts. 2822-2825.

\textsuperscript{131} For a brief discussion of the minority investors' legal position in such negotiations, see supra notes 112-14.

\textsuperscript{132} See supra notes 112-14.
Liberalization of Derivative Suit Indemnification

Much of what Wembley gave to derivative suit plaintiffs, the legislature took away in its 1986 regular session by amending the indemnification provisions of the Louisiana Business Corporation Law. Before they were amended, these provisions followed the widely accepted, traditional approach of prohibiting, without court approval, the reimbursement of company personnel for losses and expenses incurred by them as the result of a derivative action in which they had been adjudged to have violated their fiduciary duties to the corporation. The prohibition made sense because the directors could otherwise avoid all actual liability for their violations of duty simply by causing the company itself, the victim of the wrongdoing, to indemnify the wrongdoers.

Several "loopholes" did exist even under the older provisions: (i) mere judgments for the plaintiffs in the derivative actions were not themselves to be deemed presumptions of wrongdoing by the defendants; (ii) in the absence of true adjudications of misconduct, sympathetic parties could make the determination of compliance with the applicable standards; (iii) certain indemnity-eligible settlements could be made by sympathetic parties that would eliminate the possibility of an adverse adjudication; and (iv) insurance could be purchased by the corporation that would provide coverage for the officers and directors broader than that allowed under the indemnification provisions themselves.

The 1986 amendments liberalized the indemnification statute in three respects. First, the egregiousness of the conduct necessary to cut off the right to indemnification was increased from "negligence or misconduct" to "willful or intentional misconduct." While significant, that was not the most important of the new provisions. Cases imposing liability on

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133. 490 So. 2d 1107.
137. La. R.S. 12:83 C, D (1969)(allowing the board of directors to select the "independent legal counsel" that is to make the misconduct determination).
138. La. R.S. 12:83 A (Supp. 1986)(Indemnity payment in derivative action may include settlement amounts not exceeding "in the judgment of the board of directors the estimated expense of litigating the action to conclusion." As a practical matter, of course, the court could review such a settlement under La. Code Civ. P. art. 594 if the action was being pursued as a secondary class action.).
the right to indemnification was increased from "negligence or miscon-
duct" to "willful or intentional misconduct."\textsuperscript{140} While significant, that was not the most important of the new provisions. Cases imposing liability on directors for simple negligence, without some self-dealing thrown in, are rare anyway.\textsuperscript{141}

The second change consisted of a series of clarifications and liberalizations of the existing loopholes concerning the determination of the indemnitees' compliance with the applicable standard of conduct. The rule concerning adjudications of misconduct was changed to allow the exhaustion of all appeals before the right to indemnification was cut off.\textsuperscript{142} Also, it was made clear that in the absence of such an adjudication of misconduct, "independent legal counsel" could upon the request of the board make the appropriate determination, even if the directors on the requesting board were themselves parties to the litigation.\textsuperscript{143} A couple of other similar "conflict of interest" problems were resolved in a similar fashion, by permitting the conflict to exist without affecting the validity of the decision involved.\textsuperscript{144} As was true for the modification of the standard of conduct itself, these incremental procedural changes were important, but not earth-shaking. For the most part, they simply cleared up ambiguities in favor of defendant directors.

The last change, however, was fundamental. It expanded the existing "insurance" exception so much that it is now capable of swallowing the rule. A company still may not indemnify its personnel for breaches of their duties to the corporation, but they may provide them benefits under "self-insurance" arrangements containing on any terms the board of directors may deem appropriate.\textsuperscript{145} The provisions of the Insurance Code are not to apply to wholly-owned subsidiaries that issue only this kind of insurance to their parent companies, and "[i]n the absence of


\textsuperscript{141} In the well-known words of Professor Joseph Bishop, "[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L. J. 1078, 1099 (1968). Professor Bishop found only four such cases. Later research has uncovered three more. Cohn, Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 Tex. L. Rev. 591, 591 nn. 1 & 2 (1983).


\textsuperscript{144} Subsections D and E were amended to make it clear that expenses could be advanced, and other benefits paid, despite the fact that the decision-makers were parties to the litigation involved or beneficiaries of the action taken. La. R.S. 12:83 D, E (as amended by 1986 La. Acts No. 561).

actual fraud, the judgment of the board of directors as to the terms and conditions of such insurance . . . shall be conclusive." The insurance arrangements may not be voided, nor do they not expose approving directors to liability on any ground other than "actual fraud," even if the approving directors are themselves beneficiaries of the very insurance they establish.

This provision seems to be designed to allow indemnification on any terms the board desires, as long as it is called self-insurance. Although the new provisions do appear to contemplate separate funds for the self-insurance arrangements, that should pose no serious problem to any reasonably imaginative lawyer, for wholly-owned subsidiaries can provide such insurance without becoming subject to any of the usual regulatory restrictions on how the "insurance" funds are to be "invested." Some careful intercompany bookkeeping should do the trick, permitting "self-insurance" without affecting in any significant way the real costs of running the corporation.

The new provisions are likely to strengthen the position of the controlling persons of corporations, for they will be capable of causing the company to "insure" them against liability with the company's own money (even if held in a different corporate pocket), on terms they could never obtain in arms-length negotiations with a true, independent insurance company. This weakening of the legal protections afforded to noncontrolling corporate investors should strike particularly hard at minority investors in closely-held companies, for it is much more important for them than for investors in publicly-traded corporations to have some means of forcing the issuing company (or its controlling persons) either to provide them some reasonable share of corporate revenue, or to liquidate their investments. Minimizing the prospect of true personal liability for the controlling persons of an issuing company is likely to minimize the minority investors' leverage in any buy-out negotiations with these persons. Although the arrangements in the statute do not appear absolutely foolproof for protecting a company's controlling persons (a court hostile to the provisions could interpret the term "insurance" strictly or the term "actual fraud" liberally), they should still strengthen the controller's hand considerably by creating a whole new

146. Id.
147. Id.
148. The provision says that the corporation may "create a trust fund or other form of self-insurance arrangement," and that the provisions of Insurance Code do not apply to "a wholly-owned subsidiary" that issues the type of self-insurance permitted by the new act. Id.
149. The subsidiary might loan back to the parent the funds used to capitalize it, and might arrange a line of credit with the parent so that it could borrow the funds necessary to pay its insurance-related obligations.
set of issues to litigate, and by giving him a good chance of prevailing on these new issues.

It is noteworthy that Act 561 added a retroactivity provision, subsection G, to Louisiana Revised Statutes 12:83. The effect of this provision is to validate “insurance” arrangements made before the enactment of Act 561, as long as they are “not inconsistent” with Section 83 as amended. This suggests that the act was custom-designed, and that it was not simply a thoughtful solution to a widely-perceived social problem. One has to wonder whether the legislature really understood that, in a roundabout way it was eliminating derivative suit exposure for those controlling persons of Louisiana corporations willing to cause the companies they run to spend the money necessary to set up the right kind of “self-insurance” fund. It is difficult to see what social purpose is advanced by effecting this elimination of liability, conditioned only on the empty formalism of creating a separate, but controlled and unregulated “insurance” fund. Had the legislature really intended to eliminate derivative suit liability, a more direct mechanism could surely have been devised.

150. *Wembley*, 490 So. 2d 1107, does not seem to have been the impetus for the new act, for the act’s changes in the standard of conduct would not have helped the *Wembley* defendants, who were charged with intentional misconduct, and not with mere negligence.