Employment Law and Business Entities

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EMPLOYMENT AT WILL

A basic understanding of employment law is important for any insurance professional. An insured's compliance with employment laws and regulations may be a consideration for underwriters, claim adjusters, producers, risk control representatives, and premium auditors.

Laws involving employer-employee relations are complex and vary by state. The employer-employee relationship in every state is rooted in a legal doctrine known as employment at will. However, statutory changes, at both the state and federal levels, and court decisions have created a web of exceptions to the doctrine. There are four types of exceptions to the employment-at-will doctrine:

- Public policy exception
- Implied-contract exception
- Covenant-of-good-faith exception
- Statutory exception

Employment-at-Will Doctrine

Under the traditional common law doctrine of employment at will, in the absence of an express contract or union collective bargaining agreement stating otherwise, an employer is free to terminate any employee at any time, for any reason or for no reason at all.

The employment-at-will doctrine stems from the philosophy that employees and employers are on equal footing and should be free to enter into and terminate employment relationships as they choose. Beginning with the industrial revolution, however, this philosophy began to change, and a number of exceptions to the employment-at-will doctrine arose through court decisions or statutory change. The employment-at-will doctrine continues to form the basis of employment law in every state and the District of Columbia except Montana, where it was substantially modified by statute. Today every state recognizes statutory exceptions to the employment-at-will doctrine, and nearly every state recognizes one or more of the other exceptions.

Public Policy Exception

Wrongful discharge
A cause of action an employee may have against an employer for illegal termination of employment.

Under the public policy exception, an employee may not be fired for reasons that violate established public policy of the state. For example, an employee may claim **wrongful discharge** if the employee is fired because of refusal to participate in an illegal act at the request of the employer. Violation of a law is clearly contrary to public policy. When an employee is fired contrary to established public policy, the employee may bring suit based on wrongful discharge, a cause of action for illegal termination of employment.

However, whether an action violates public policy may not always be clear and is a matter for the court to decide. The employee also bears the burden of proving that the termination was in retaliation for refusal to perform an action deemed contrary to public policy. The public policy exception to the employment-at-will doctrine is the most widely accepted exception, recognized by nearly every state. See the exhibit "Examples of Public Policy Exceptions."

Examples of Public Policy Exceptions

In a state that recognizes public policy exceptions to the employment-at-will doctrine, an employee may have a cause of action for wrongful discharge if the employee can prove that he or she was fired for a reason contrary to public policy. These are examples of grounds for firing that fall under the public policy exception:

- Refusing to commit perjury at the request of the employer
- Filing a workers compensation claim after being injured on the job
- Applying for medical leave specifically provided under state or federal law
- Refusing to participate in illegal price-fixing
- Refusing to violate another employee's or a customer's privacy without permission

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Implied-Contract Exception

Breach of contract claims may arise when a party to a contract alleges that another party has failed to fulfill a contractual promise. Under an express contract, the terms and intentions of the employment relationship are explicitly stated, resulting in a relatively clear determination as to whether a breach of contract has occurred. Breach of contract claims may also involve implied contracts.

An implied contract may exist if the terms and intentions of employment are indicated by the actions of the parties to the contract and the surrounding circumstances, rather than expressly written. For example, an employee handbook or supervisor's statement that an employee could be fired only for "just cause" might be interpreted as an implied contract that prohibits termination without cause. The majority of states recognize the implied-contract exception.

Covenant-of-Good-Faith Exception

Some courts have recognized the covenant-of-good-faith exception, also called the implied-in-law contract exception, to mean that an obligation exists due to the conduct of the parties or some special relationship between them. Even in the absence of an actual contract, an employer could be found to have acted in bad faith for firing an employee without just cause. For example, an employer might be found to have acted in bad faith for firing a long-term employee, without just cause, just before that employee becomes eligible for retirement benefits.

The covenant-of-good-faith exception creates a very broad exception to the employment-at-will doctrine, essentially interpreting a requirement of good faith as part of the employee-employer relationship. This type of exception is not as widely recognized by the states as the other types of exceptions.

Statutory Exception

Beginning in the mid-twentieth century, Congress and the states began to enact laws and adopt regulations specifically intended to protect employees and to define and prohibit certain discriminatory practices. Such statutes and regulations, which prohibit firing employees due to stated reasons, provide specific and generally clear exceptions to the employment-at-will doctrine.

An employee who believes he or she has been fired contrary to the applicable state's law or recognized exceptions to the employment-at-will doctrine may have a cause of action against an employer.

Various court cases in the **common-law system** expand or add exceptions to employment at will. Unless specific administrative procedures are established by a statutory exception, the remedy for employees who believe they have been wrongfully discharged is by legal action through the courts. Employees may also claim damages for other issues stemming from termination of employment, such as defamation.

Common-law system
A legal system in which the body of law is derived more from court decisions as opposed to statutes or constitutions.

ANTIDISCRIMINATION LAWS

Laws prohibiting discrimination in employment affect all aspects of the employee-employer relationship, from the application process through termination. By expressly prohibiting termination of employees on specific grounds, these laws define major exceptions to the employment-at-will doctrine.

Employment at will
A legal doctrine under which an employer may terminate any employee at any time for any reason or for no reason.

Antidiscrimination laws represent exceptions to the doctrine of **employment at will**. Congress has enacted laws that prohibit an employer from intentionally treating individuals differently solely because of several characteristics:

- Age
- Sex, race, color, religion, or national origin
- Disability
- Other factors (military service, jury duty, wage garnishment)

Every individual legally employed in the United States today falls under the protection of one or more federal antidiscrimination laws.

Discrimination Based on Age

Two federal laws protect workers from age discrimination: The Age Discrimination in Employment Act (ADEA) of 1967[1] and the Older Workers Benefit Protection Act (OWBPA) of 1990.[2]

Age Discrimination in Employment Act (ADEA)

The ADEA prohibits discrimination, on the basis of age, against persons age forty or older. This prohibition extends to all aspects of employment, including hiring; pay; terms, conditions, and privileges of employment; and termination. The Act applies to employers with twenty or more employees in an industry affecting interstate commerce, as well as to labor organizations, employment agencies, and governmental agencies.

ADEA addresses three legal employment practices regarding age:

Bona fide occupational qualification (BFOQ)
The minimum qualification, under federal antidiscrimination laws, that an employee needs in order to be able to perform the duties of a particular job.

- An employer may establish an age limit on employment if age is a **bona fide occupational qualification (BFOQ)**. An example of a BFOQ is a mandatory retirement age for commercial airline pilots established for safety reasons.
- An employer may use preference in hiring, promoting, and paying employees if it is based on "reasonable factors other than age." For example, an employer might determine that a particularly strenuous job requires a high degree of fitness; however, the employer may not assume that everyone over a certain age is physically unfit to handle the job.
- An employer may hire, promote, pay, or dismiss employees according to a bona fide seniority system as long as the employer does not require retirement based on age.

The ADEA prohibits mandatory retirement based on age with the exception of two types of employees:

- Executives in high policy-making positions who are over age sixty-five and entitled to a pension exceeding a minimum amount per year
- Employees over age seventy who are serving under contracts of unlimited tenure at institutions of higher learning

The ADEA is administered by the Equal Employment Opportunity Commission (EEOC). A person alleging age discrimination must file a complaint with the EEOC, or the appropriate state agency, and exhaust an administrative process that usually takes at least six months (unless a compromise is reached) before filing suit. The complainant may be eligible for remedies including back pay, reinstatement of employment, and legal damages.

Older Workers Benefit Protection Act (OWBPA)

The OWBPA, enacted in 1990, amended the ADEA. Congress specifically intended this act to prohibit age discrimination in the offering of benefits, but to allow employers to reduce benefits to older workers when such "age-based reductions in employee benefit plans are justified by significant cost considerations." For the most part, benefits offered must be the same for employees of all ages. However, where the cost of the benefit is much higher for older employees (for example, for life insurance), the employer may meet the requirements of the OWBPA by spending the same amount for the benefit among all groups, even though the older employees may receive lesser benefits than younger employees. In some cases, employers may also offer lesser benefits to older workers if additional benefits, including those offered by the government, make up the shortfall.

The OWBPA also allows waivers of rights under the ADEA if done knowingly and voluntarily. Employers may choose to provide severance payments to discharged employees only if the employee agrees to a general release of all claims against the employer. The employee must be given at least twenty-one days to consider such an agreement (or forty-five days in the case of an exit incentive program), advised to consult with an attorney prior to signing, and given at least seven days after signing in which to revoke the agreement.

Discrimination Based on Sex, Race, Color, Religion, or National Origin

Congress has passed several laws prohibiting discrimination based on sex, race, color, religion, or national origin. Because the laws differ in protection provided and remedies available, an individual alleging discrimination may choose to bring suit under the law that is most favorable to his or her case.

Civil Rights Acts of 1866 and 1871

The first law prohibiting discriminatory practices in employment was the Civil Rights Act of 1866,[3] more commonly called Section 1981. Congress passed this act shortly after the Civil War for the purpose of giving "all people within United States jurisdiction the same rights as white citizens" (in the wording of the act). While the law originally addressed only the right to make contracts, the courts interpreted the law to apply to all aspects of employment. The Supreme Court later interpreted Section 1981 to protect not only African-Americans, but all identifiable classes of persons who might be subject to intentional discrimination solely due to ancestry or ethnic characteristics. Section 1981 does not apply to discrimination based on sex or religion. The Civil Rights Act of 1866 allows for recovery of compensatory and punitive damages in a potentially unlimited amount.

The Civil Rights Act of 1871[4] did not create any new classes of protected individuals; instead it established the right to bring suit for monetary damages for a violation of civil rights by individuals acting under state or federal authority. The law is very rarely applied to private employers.

Civil Rights Act of 1964

The next major antidiscrimination act was the Civil Rights Act of 1964,[5] amended in 1991, that extended the basis for protection against discrimination to include religion and sex. Title VII of the Act, titled "Equal Employment Opportunity," governs most employment discrimination actions, including these:

- Prohibited employment practices
- Permissible employment practices
- Pregnancy discrimination
- Sexual discrimination
- Sex-based insurance rates

Title VII applies to any employer that regularly employs fifteen or more persons in an industry that affects interstate commerce—most employers in the U.S. Even a small store with sixteen employees can affect interstate commerce when, for example, an out-of-state customer purchases an item. The law also applies to labor organizations and employment agencies. Title VII does not apply to the U.S. government or to any corporation wholly owned by the U.S. It does not apply to any religious group regarding employment of individuals of a particular religion to perform work connected with the group's activities, including educational institutions associated with it. It also does not apply to bona fide not-for-profit private-membership organizations, other than labor organizations.

Although the Act permits exceptions based on BFOQ, such exceptions are very narrowly construed and difficult to prove. To defend a BFOQ exception, an employer must prove that an employment practice is directly based on a business necessity and that no less-restrictive alternative is available. Race or color is almost never considered a BFOQ.

The EEOC oversees compliance with Title VII. If a settlement is not reached within 180 days after a complaint has been filed with the EEOC (within the specified time limit for filing), the EEOC must issue a right-to-sue letter to the complainant, who may then bring suit within 90 days of receiving the letter.

Because Title VII does not preempt state law, many states have expanded the list of protected classes. Common additions prohibit discrimination on the basis of political affiliation, sexual preference, and physical characteristics such as weight.

A case of employment discrimination under Title VII may be based on either the **disparate treatment theory** or the **disparate impact theory**. See the exhibit "Employment Discrimination Legal Theories."

Employment Discrimination Legal Theories

Disparate Treatnent Theory

The disparate treatment theory requires the plaintiff to establish that the employer intended to unlawfully discriminate. An employment decision motivated in part by discrimination is also unlawful, even if other factors also motivated the decision (a "mixed motive" case). However, if the employer can show that the same decision would have been made without the discriminatory motivating factor, the court's judgment is limited to declaring the parties' rights, attorney fees, and costs to the plaintiff, and damages cannot be awarded.

Disparate Impact Theory

Under the disparate impact theory, the employer's intent is not an issue. The 1991 Civil Rights Act altered the litigants' respective burdens of proof in disparate impact cases. The act permits a plaintiff to challenge the disparate impact of the employer's entire decision-making process as one employment practice and places the burden to persuade a judge or jury on the employer to show that the challenged practice is job related and consistent with business necessity. Before the 1991 act, the plaintiff had to show specifically what practice of the employer led to the disparate impact and also had to prove that the employer did not have a legitimate business reason for the practice.

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The EEOC recognizes sexual harassment as a form of sex discrimination and, in 1980, developed rules to address claims of sexual harassment under Title VII. The EEOC defines sexual harassment as any unwelcome sexual advances, requests for sexual favors, or other verbal or physical conduct of a sexual nature when submission or rejection of such conduct would affect employment or the work environment. The two basic types of sexual harassment claims that have emerged under title VII are **quid pro quo sexual harassment** and **hostile work environment**. Along with civil rights remedies, a plaintiff claiming sexual harassment may also have a tort claim for such harassment under common law.

Disparate impact theory
A legal basis for an employment discrimination complaint requiring the plaintiff to establish that an apparently neutral employment practice or criterion, applied equally to all individuals, operated to exclude a disproportionate number of the protected class.

Disparate treatment theory
A legal basis for an employment discrimination complaint requiring the plaintiff to establish the employer's practice of intentionally treating individuals differently solely because of their sex, race, color, religion, or national origin.

Quid pro quo sexual harassment
A practice whereby an employer demands or expects sexual favors in exchange for continued employment, workplace advancement, or other job-related benefits.

Hostile work environment
An environment that exists when an employee is subjected to harassment that is so severe or pervasive that it alters the conditions of his or her employment and creates an abusive working environment.

Civil Rights Act of 1991

The Civil Rights Act of 1991[6] enacted technical revisions to the following previously enacted antidiscrimination laws:

- The Civil Rights Act of 1866
- Title VII of the Civil Rights Act of 1964
- The Age Discrimination in Employment Act of 1967
- The Rehabilitation Act of 1973[7]

The 1991 Civil Rights Act included these changes:

- Broadened the scope of Section 1981 of the Civil Rights Act of 1866 to expressly apply to all aspects of the employment relationship, including hiring and termination. As a result, persons alleging unlawful intentional discrimination on the basis of race, color, ancestry, or ethnicity (but not sex or religion) can recover potentially unlimited compensatory and punitive damages.
- Amended Title VII and the Americans with Disabilities Act (ADA) to allow plaintiffs to recover compensatory and punitive damages in suits alleging intentional discrimination.
- Changed the law regarding the burden of proof placed on each litigant in disparate impact cases brought under Title VII and the ADA, making it easier for plaintiffs to prove their cases.
- Allowed for jury trials in cases in which the plaintiff seeks compensatory damages under Title VII or the ADA.

Executive Order 11246

Employers with federal government contracts are subject to the civil rights laws as well as to Executive Order 11246[8] of 1965, which also bans job discrimination on the basis of sex, race, color, religion, or national origin. The order applies to federal contractors and subcontractors who do more than $10,000 in business with the federal government in a one-year period.

Affirmative action plan
A written plan that the federal government requires of employers with federal contracts, detailing how the employer will meet hiring goals for groups the law protects from discrimination.

The Order originated both the terms "Equal Opportunity Employment" and **affirmative action plans**. It requires those with federal contracts of $50,000 or more to establish programs to affirmatively ensure nondiscrimination and to offer employment opportunities to minorities, women, and veterans. The Office of Federal Contract Compliance (OFCC) of the Labor Department oversees compliance with the Order. Penalties for noncompliance include cancellation of the federal contract and a ban on any future contracts.

Equal Pay Act

The Equal Pay Act (EPA)[9] of 1963 prohibits employers from paying lower wages to employees of one sex than it pays to those of the other sex for work requiring equal skill, effort, and responsibility and performed under similar working conditions. There are several affirmative defenses to the EPA. Wage differentials are acceptable if based on a seniority system; a merit system; a system that measures pay by quality or quantity; ability tests; or employees working in different locations, if such differences are not the result of an intention to discriminate because of sex, race, color, religion, or national origin. For example, an employer could legally base wage differentials on substantial differences in working conditions. To avoid conflict with the provisions of the Civil Rights Act of 1964, an amendment to the 1964 Act incorporated the defenses under Title VII.

Immigration Reform and Control Act of 1986

The Immigration Reform and Control Act (IRCA) of 1986[10] prohibits employers and employee-referral services from hiring, employing, or referring aliens not authorized to work in the U.S. The act also bars employment discrimination based on national origin and citizenship status. Although an employer cannot legally hire a person not authorized to work in the U.S., the employer also cannot legally discriminate against aliens who have obtained appropriate authorization to work. The IRCA is enforced by the Special Counsel's Office of the Justice Department.

The IRCA requires employers to attest that they have verified the identities of their employees and of their employees' right to work in the U.S. Employers can face civil penalties for record-keeping violations, even if persons hired are U.S. citizens.

Discrimination Based on Disability

Two significant federal laws prohibit discrimination based on disability; the Rehabilitation Act of 1973 and the American with Disabilities Act (ADA).

Rehabilitation Act of 1973

The Rehabilitation Act of 1973[11] prohibits employers with federal government contracts exceeding $2,500 from discriminating against disabled persons who are otherwise qualified to fulfill the contract. An "otherwise qualified person" is one who can perform the essential functions of the job either unaided or with reasonable accommodations from the employer. Accommodations are considered unreasonable if they impose undue financial hardship on the employer or require a fundamental change to the nature of the job.

Employers with federal contracts that employ fifty or more individuals must also implement an affirmative action program. Compliance with the act falls under the jurisdiction of the OFCC of the Department of Labor.

Americans With Disabilities Act

The Americans with Disabilities Act[12] prohibits discrimination against qualified individuals with disabilities. The act applies to all aspects of the employment process, including job application procedures; hiring; advancement; termination; training; compensation; and other terms, conditions, and privileges of employment. The ADA applies to all employers with fifteen or more employees and engaged in a business affecting interstate commerce, governments and government agencies, employment agencies, and labor organizations. The act, passed in 1990, became effective for most businesses in 1992.

The ADA defines "disability" as "a physical or mental impairment that substantially limits one or more of the major life activities of such individual" and defines "qualified individual with a disability" as an individual who, with or without reasonable accommodation, can perform the essential functions of the job. Infectious and communicable diseases, mental illness, and drug addiction are all considered disabilities under the ADA. Some states, including California and Washington, have much broader definitions of "disability" that might require employers to accommodate a wider group of individuals.

The ADA requires employers to accommodate a disability unless doing so would impose undue hardship on the employer. Reasonable accommodations include job restructuring, modified work schedules, and equipment modification.

As provided by the 1991 Civil Rights Act amendments, plaintiffs seeking relief for intentional discrimination under the ADA may demand a jury trial and seek to recover compensatory and punitive damages. Reinstatement, back pay, and attorney fees are also remedies available to the plaintiff. An employer can avoid damages by showing that it made a good-faith effort, in consultation with the employee, to identify and make reasonable accommodations.

The Act was amended in 2008 to broaden the scope of protection in response to U.S. Supreme Court decisions that narrowed the scope and eliminated protection for many individuals whom Congress intended to protect. The amendment includes the requirement that the determination of whether an impairment substantially limits a major life activity shall be made without regard to the effects of mitigating measures, such as medication, prosthetics, or hearing aids.

Discrimination Based on Other Factors

Antidiscrimination laws protect employees in many situations. Federal law protects employees from discrimination based on factors such as military service, jury duty, and wage garnishment.

The Vietnam Era Veterans' Readjustment Assistance Act of 1974[13] prohibits employers from terminating employees because they leave employment to serve in the military and requires employers with federal contracts of $25,000 or more to implement an affirmative action plan for Vietnam-era veterans.

The Uniformed Services Employment and Reemployment Rights Act of 1994[14] (USERRA) is intended to ensure that persons who serve or have served in the Armed Forces, Reserves, National Guard, or other "uniformed services" do not experience a disadvantage in their civilian careers because of their service, are promptly reemployed in their civilian jobs upon return from active duty, and are not discriminated against in employment based on their military service.

Under the Jury Systems Improvement Act,[15] an employer may not discharge, threaten to discharge, intimidate, or coerce any employee who misses work due to jury duty.

The Consumer Credit Protection Act[16] prohibits termination due to an order of garnishment of any employee's wages.

LABOR-MANAGEMENT RELATIONS

There was a period in United States history when employees who united to demand better wages or working conditions could be tried for criminal conspiracy. Federal labor laws now protect workers by guaranteeing them the right to form associations or unions for negotiating with employers.

Labor unions are associations formed to negotiate with employers on behalf of employees, usually for wages, benefits, and better working conditions. The rise of labor unions in the U.S. can be traced back to the industrial revolution in the eighteenth and nineteenth centuries. In the 1930s, U.S. labor laws began establishing the conditions and terms for negotiations between labor unions, union members, and employers. There are three key areas of law regarding labor-management relations:

- Collective-bargaining relationships
- Collective-bargaining process
- Economic pressures

Collective-Bargaining Relationships

Collective bargaining stemmed from the belief that employees negotiating with an employer as a group were likely to have more influence than individual employees negotiating alone.

Collective bargaining
A process by which employees, represented collectively by a union, negotiate (bargain) with the employer on a labor contract dealing with wages, hours, and working conditions.

Norris-LaGuardia Act of 1932 and National Labor Relations Act (NLRA) of 1935

The first modern labor law was the Norris-LaGuardia Act of 1932.[17] Although this law did not require recognition of labor unions, it prohibited any federal district court from issuing an injunction in a labor dispute until all efforts to resolve the issue through negotiation were exhausted. The Norris-LaGuardia Act permits an injunction on a finding that unlawful acts may occur and may result in irreparable harm; however, the injunction is limited to the illegal activity. The act also prohibits employers from requiring an employee, as a condition of employment, to promise not to join a union.

The National Labor Relations Act (NLRA) of 1935[18] (also called the Wagner Act) was the first law to require recognition of labor unions and protected employees from economic retaliation based on union membership. The NLRA remains the primary law governing relations between unions, their members, and employers in the private sector. Federal government employees, agricultural workers, and employees of the airline and railroad industries are not covered under the scope of the act.

The NLRA grants employees the right to be represented by a union and to participate in collective bargaining. The NLRA is administered by the National Labor Relations Board (NLRB), created by Congress as part of the NLRA. The NLRB's purpose is twofold:

- To prevent and remedy unfair labor practices, whether conducted by labor organizations or employers
- To determine whether or not certain groups of employees desire labor organization representation, and their selection of a union, for collective-bargaining purpose

Exclusive Bargaining Agent

The NLRA rules provide that the union becomes the exclusive bargaining agent between employees and employer when a majority of employees in a "unit appropriate for such purposes" agrees to union representation. This selection process begins when the union, usually without the employer's knowledge, provides authorization cards to employees of the unit for their signature. The signed cards become, in essence, the employees' votes for representation.

In measuring the appropriateness of the unit, the NLRB considers the similarity or dissimilarity of the employees' skills, duties, working conditions, and interests. Determination of an appropriate "unit" is important to the success or failure of a unionization drive. For example, it is not sufficient to receive a majority of signatures from one department of a company if the entire company should appropriately be considered as the unit. On the other hand, one particular group of employees within a large manufacturing company (for example, electricians) may be a more appropriate unit than all employees. After employees return the authorization cards, the union has two alternatives:

- The union can make a direct request to the employer to initiate collective bargaining. If more than 50 percent of the employees have returned authorization cards agreeing to union representation, the employer frequently proceeds to collective bargaining. If the employer refuses to recognize the union, the union can file an unfair labor practice charge with the NLRB. As a defense to the charge, an employer may challenge whether the union actually represents a majority of the employees.

- The union can file a representation petition with the NLRB. The NLRB will then hold an election among the employees to certify the union as the authorized labor representative. The union must have cards signed by at least 30 percent of the employees before it can request an election.

Before an election, the employer can be expected to conduct a campaign to influence workers to reject union representation. The NLRA states that it is an unfair trade practice for employers to interfere with, restrain, or coerce employees while they exercise their rights of self-organization. It is unlawful for an employer to threaten reprisal, such as threatening to move a plant or discharge workers, or to confer benefits immediately before an election (for example, granting a pay raise or extra holidays). An employer is permitted to set forth any views, arguments, or opinions that are not threats of reprisal, intimidation, or promises of benefits.

If the employees elect union representation, the union is certified and will then proceed to collective bargaining with the employer, following mandated procedures. Once a majority of the workers vote for union representation, all workers become bound to the collective bargaining agreements negotiated by the union, including, in states where permitted, those workers who do not join the union.

Collective-Bargaining Process

The NLRA makes it an unfair labor practice for either an employer or a union to refuse to bargain collectively and imposes a duty to bargain in good faith. The law does not specify what constitutes a refusal to bargain; however, the NLRB and the courts have inferred a requirement that the representatives of both sides meet at reasonable times and confer in good faith regarding issues under negotiation. In determining whether a party has engaged in good-faith bargaining, the NLRB will first consider whether collective bargaining is mandatory by law for the issue or issues under dispute. The NLRB will then consider the totality of the actions taken, including the employer's past labor relations.

Collective bargaining is mandatory for "wages, hours and other terms of employment." Over the years, court decisions have sought to set standards to define the broad reference to mandatory issues. Any issue relating to an aspect of the relationship between the employer and employee is considered an issue requiring mandatory bargaining.[19] Issues such as vacation pay, bonuses, workload, seniority, insurance benefits, and grievance procedures are examples of mandatory issues. Refusal to engage in collective bargaining on mandatory issues is considered bad faith. See the exhibit "Examples of Bad Faith in Collective Bargaining."

Examples of Bad Faith in Collective Bargaining

- Refusal by either side to enter into negotiations on mandatory issues
- A take-it-or-leave it approach by the employer from the time of the first bargaining conference
- Participation in a lengthy series of bargaining conferences with no intention to enter into an agreement

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For those issues that are not mandatory for collective bargaining, either side may agree to collective bargaining; a refusal to do so will not constitute bad faith, and one party's request for bargaining does not require the other party to participate. Examples of subject matter for which collective bargaining is not mandatory include the right to subcontract work (unless it constitutes a departure from existing practices) and balloting procedures during labor negotiations.

The NLRA specifically prohibits bargaining over activities that are considered illegal under the act. For example, a union and an employer cannot negotiate terms of discrimination against nonunion members. Collective bargaining also may not result in any agreement that would violate other federal or state laws or regulations or that would waive obligations imposed by law. For example, a collective bargaining agreement may not eliminate rights granted to employees under antidiscrimination statutes or reduce safety protections required under law.

When the collective bargaining process results in a settlement of terms, members of the union must still accept or reject the settlement by majority vote. If a majority of employees accepts the agreement, the contract is ratified and becomes legally binding. If the majority of employees reject the settlement, the negotiation process begins again.

If the parties fail to reach an agreement, they may voluntarily agree to mediation. If an agreement still cannot be reached, the next step may be **arbitration**. Arbitration is usually agreed to voluntarily by the union and the employer; however, in rare occasions, arbitration may be mandated by the federal government.

Arbitration
An alternative dispute resolution (ADR) method by which disputing parties use a neutral outside party to examine the issues and develop a settlement, which can be final and binding.

Economic Pressure

If the union and the employer cannot agree on a contract after good-faith bargaining, each side can strengthen its position with tactics intended to exert economic pressure on the other party. The economic tactics of the union include a strike, boycott, or picketing. Employer tactics include employment of replacement workers or, under certain conditions, a lockout of employees.

Union Economic Tactics

Employees may vote to strike or cease work. The employees' right to strike, however, is not absolute. For example, sit-down strikes, in which employees seize and occupy a part of the plant, are illegal. Employees cannot be simultaneously at work and on strike; they must be either subject to the employer's authority or off the job on a total strike. Therefore, a refusal to work overtime or a work slowdown to protest a work condition are considered illegal.

Another tactic unions might use is boycott, or refusal to deal with an employer. A boycott can be either primary or secondary. A primary boycott occurs when customers or vendors are encouraged to stop doing business with the employer in support of the union's position. A boycott is often enforced by picketing as union members stand or protest outside the employer's premises.

A secondary boycott occurs when unionized employees apply a boycott against one employer to pressure that employer to stop doing business with another. Under a secondary boycott, the employees refuse to work on or with materials coming from or going to the second employer. The second employer either may be engaged in a labor dispute or may employ a nonunion workforce.

Similarly, a sympathy strike is a strike by union members, who have no grievance against their own employer, to support another union in a labor dispute. The Taft-Hartley Act of 1947[20] (also called the Labor-Management Relations Act) amended the NLRA and made both secondary boycotts and sympathy strikes illegal. The Landrum-Griffin Act of 1959[21] (also called the Labor Management Reporting and Disclosure Act) strengthened the Taft-Hartley Act by making it illegal for a union and an employer to evade the statutory prohibition against secondary boycotts by entering into an agreement under which the employer must refrain from using or transporting another employer's goods.

Employer Economic Tactics

An employer may not fire an employee for striking. However, the employer may apply economic pressure by using replacement employees. When a strike occurs because the parties have not been able to agree on labor contract terms, the employer can hire replacement employees and refuse to reinstate the striking employees. However, if the strike is wholly or partially due to unfair labor practices, the employer must reinstate all striking employees, even if doing so requires dismissing the replacements. A refusal to do so makes the employer liable for full back pay.

A lockout occurs when the employer withholds work from the employees. Generally, during bargaining negotiations, an employer cannot either lock out or threaten to lock out employees in order to gain a more favorable bargaining position. However, a lockout is permissible under certain circumstances. For example, an employer may lock out employees if the employer has reasonable grounds to believe that a strike is threatened or imminent, or if employees intend to stage a sit-down strike or to commit acts of sabotage.

EMPLOYEE WELFARE LAWS

Congress has enacted a number of laws intended to address employee welfare. Insurance professionals should be familiar with the various laws that, while protecting employees, create numerous liability exposures for employers.

The vast majority of workers today benefit from myriad laws intended to protect their safety and well-being. Employee welfare laws address several areas:

- Safety and health
- Wages and hours
- Family medical leave
- Privacy

Regulation of Employee Safety and Health

Occupational Safety and Health Act of 1970 (OSH Act)
An act passed by Congress in 1970 to ensure every employee a safe place to work by setting safety standards for employers and imposing penalties for violation of the standards.

The **Occupational Safety and Health Act of 1970 (OSH Act)**[22] is a comprehensive federal law that provides for safety and health standards in the workplace. Standards adopted under the law include specific requirements designed to protect employees against workplace hazards and cover subjects such as mandatory safety devices and equipment; training, protecting and medically examining employees; and warning of hazards. The standards also mandate how employees must do their jobs safely.

The OSH Act applies to all employers engaged in a business affecting interstate commerce, with some exceptions. The act essentially governs health and safety standards applicable to general industry, such as retail operations, offices, and factories. It does not directly apply to the United States or any state or political subdivision as an employer, but it requires federal agency heads to establish and maintain safety and health programs consistent with the standards applicable to the private sector. The act also does not cover self-employed workers, family farms, and workers in occupations covered by other federal laws (such as railroad workers). See the exhibit "Occupational Safety and Health Act General Duty Clause."

Congress created the Occupational Safety and Health Administration (OSHA) to enforce the OSH Act. Under the jurisdiction of the Department of Labor, OSHA is responsible for issuing and modifying the occupational safety and health standards applicable to businesses. OSHA is also given the responsibility to conduct workplace inspections, to investigate complaints regarding working conditions, and to issue regulations requiring employers to record and report certain work-related injuries, illness, or deaths.

Under the OSH Act, a state may assume exclusive jurisdiction over the health and safety aspects of employees' working conditions by developing and enforcing programs that meet or exceed federal requirements. Before assuming jurisdiction over workplace health and safety, the state must obtain OSHA approval of its program; therefore, another responsibility of OSHA is to certify and monitor state programs.

Occupational Safety and Health Act General Duty Clause

The OSH Act requires employers to comply with safety and health standards promulgated under the authority of the act covering workplace conditions and operations. Section 5 of the act, known as the general duty clause, imposes a general requirement on employers. This requirement applies to serious hazards not otherwise covered by a specific standard.

Section 5. Duties

(a) Each employer -

1. shall furnish to each of his employees employment and a place of employment which are free from recognized hazards that are causing or are likely to cause death or serious physical harm to his employees;
2. shall comply with occupational safety and health standards promulgated under this Act.

[DA06209]

The OSH Act is enforced through workplace inspections and investigations, typically conducted during regular working hours and without advance notice, by OSHA compliance officers. Violations of the act may result in civil and criminal penalties.

Regulation of Employee Wages and Hours

The Fair Labor Standards Act (FLSA)[23] establishes requirements relating to minimum wage, overtime compensation, child labor, and equal pay for men and women. States may also establish laws regarding wages and work hours, provided the requirements meet or exceed federal laws.

The FLSA applies to employers engaged in interstate commerce or in the production of goods for interstate commerce, broadly defined to include most employers with exceptions for very small businesses. The act also covers employees of local, state, and federal government.

The act's overtime pay and minimum wage requirements generally apply to all **nonexempt employees**. Simply because an employee is salaried and not hourly, however, does not necessarily mean that he or she is an **exempt employee** and will not fall under the overtime or wage requirements of the FLSA. Regulations issued by the Secretary of Labor[24] establish several characteristics that must apply to a particular employee's duties and specify a minimum weekly salary requirement to determine whether an employee is exempt in terms of the act's overtime requirements. Generally, the act's overtime provisions do not apply to certain job categories, including executives, administrative workers, learned or creative professionals, outside salespersons, and certain other workers as defined by the regulations.

Nonexempt employee
An employee who is paid by the hour and who receives hourly overtime pay.

Exempt employee
An employee who is paid a salary and who does not receive overtime pay.

Under the FLSA's overtime provisions, an employer must pay nonexempt employees one and one-half times (often called "time-and-a-half") the employee's basic rate for time worked in excess of forty hours per week. If the employee is at least sixteen years old, the act does not limit the number of hours or the number of days per week that an employee may be required to work or the number of overtime hours that may be required. For example, if a nonexempt employee works sixty hours one week and ten hours the next, the employer must pay time-and-a-half for twenty hours of overtime worked during the first week.

Despite regulations implementing the act, it is not always clear whether a worker falls under the act or whether a worker is subject to the law's overtime requirements. For example, whether an insurance claim representative is entitled to overtime pay has been an area of some dispute and controversy. In addition, independent contractors are not considered employees for the purpose of the act and therefore are not covered by overtime pay and minimum wage requirements; however, whether a worker is correctly classified as an independent contractor is sometimes a matter for the courts to decide.

In addition to the FLSA requirements, three other federal laws specifically address minimum wages for employees working on federally funded projects. The Davis-Bacon Act,[25] applicable to employers with federal contracts greater than $2,000, establishes the minimum rate of wages for laborers and mechanics. The Walsh-Healey Public Contracts Act[26]applies to government contracts of more than $10,000 to manufacture or supply materials and requires covered employers to pay the prevailing minimum wage, plus overtime for hours worked in excess of forty per week. The Service Contract Act of 1965[27] applicable to employers with government contracts in excess of $2,500 to furnish services, requires employers to notify employees of statutory wage rights and to pay not less than the federal minimum wage.

Family Medical Leave Act

The Family Medical Leave Act (FMLA)[28] requires employers to provide employees with unpaid leave time for circumstances covered under the act. Employers must offer eligible employees up to twelve weeks of unpaid leave in a twelve-month period, with no loss of any employment benefits accrued prior to leave. Covered absences include parental leave following a birth or an adoption; an employee's serious health condition; or a serious health condition of the employee's spouse, child, or parent. In some circumstances, the act permits employees to take intermittent leave or to work a reduced schedule. An employee is not required to invoke the term "FMLA" to receive protection under the act; employers bear the responsibility to decide whether an absence qualifies for FMLA.

The FMLA applies to employers and employees meeting very specific criteria:

- The employer has fifty or more employees (including full-time, part-time, and temporary workers) during at least twenty weeks in the current or preceding year, located within a seventy-five mile radius of the work location where the employee requests leave.

- The employee must have worked for an employer subject to FMLA requirements for at least twelve months (not necessarily consecutive) and for at least 1,250 hours during the twelve-month period preceding the leave.

Regulation of Employee Benefits

Congress has addressed protection of employee benefits through three key laws. The Employee Retirement Income Security Act (ERISA) is intended to safeguard employee pensions, while the Consolidated Omnibus Budget Reconciliation Act (COBRA) ensures that terminated employees may still have access to health insurance benefits. More recently, the Health Care and Education Reconciliation Act of 2010 places requirements on employers for the purpose of expanding the availability and affordability of healthcare coverage.

Employee Retirement Income Security Act (ERISA)

The Employee Retirement Income Security Act (ERISA)[29] of 1974 created fiduciary duties for pension and health benefit plan administrators, trustees, upper management, insurance brokers, and other parties with respect to how they invest and distribute plan funds. The act also requires plan administrators to notify participants of important information about benefit plans and their funding; and requires an appeals process for denied claims. Employers are not required to provide an employee benefit plan under ERISA. An employer's obligations under ERISA arise only when a benefit plan is in place.

The federal act replaced a maze of state laws that previously governed employee benefit plans and trusts. The act preempts all state laws relating to employee benefit plans, except state laws that regulate insurance, banking, and securities.

Consolidated Omnibus Budget Reconciliation Act (COBRA)

The Consolidated Omnibus Budget Reconciliation Act (COBRA)[30] of 1986 amends ERISA to require certain employers who sponsor group healthcare plans to offer employees and their dependents continuation of group health insurance for a period of time after a qualifying event, defined as a termination of employment for any reason other than gross misconduct, or a reduction in hours resulting in loss of coverage.

The act applies to group health insurance plans sponsored by employers that have twenty or more employees (including part-time workers) on at least fifty percent of working days during the preceding year. Plans sponsored by the federal government and religious organizations are exempt from COBRA.

Benefits under COBRA must be offered to qualified beneficiaries, meaning the employee, spouse, and dependent children, for a period of eighteen months. Benefits offered must be identical to those provided before the qualifying event; however, the employer is not required to continue any premium subsidies offered during employment. In the event of a second qualifying event during the eighteen months, such as death of the employee, the spouse or dependent children are entitled to an additional eighteen months of coverage under the group healthcare plan.

Health Care and Education Reconciliation Act of 2010

The Health Care and Education Reconciliation Act[31] of 2010 does not require employers to offer group healthcare plans, but includes financial penalties for those who do not. Effective in 2014, employers with fifty or more employees that do not offer group healthcare benefits, or do not offer "affordable" coverage, as defined by law, will be taxed "free-rider" penalties, up to $3,000 per employee annually. Also beginning in 2014, employers must provide "free choice vouchers" to certain qualified employees, allowing the employee to take the amount of the employer's contribution to healthcare coverage and apply that amount toward coverage in a state-sponsored healthcare exchange.

Employee Privacy

A number of federal laws protect specific aspects of employee privacy. Common law often provides broader protections with respect to privacy, and employees may also bring common law suits for invasion of privacy.

Privacy Statutes

Federal laws protect employee privacy regarding drug, alcohol, and polygraph testing, as well as searches and surveillance.

The Drug-Free Workplace Act[32] of 1988 requires federal contractors with contracts of $100,000 or more and all federal grantees to establish drug-prevention programs and to maintain a drug-free workplace in compliance with the act. Such employers are also required to track and report drug-related employee convictions resulting from workplace activity. Drug testing (testing employees for the presence of illegal substances) is not required under the act but is required by federal regulation for certain jobs.

Private employers are generally permitted to require drug testing in all but a few states; however, the courts have not upheld the right to do so in all cases. The Substance Abuse and Mental Health Services Administration (SAMHSA) within the U.S. Department of Health and Human Services (DHHS) established guidelines for federal workplace drug testing. Drug testing programs that follow the guidelines have been supported by the courts, and private employers are free to follow these guidelines as well.

The Employee Polygraph Protection Act[33] of 1988 prohibits most private-sector employers from requiring or even requesting employees or applicants to submit to lie detector tests, or from inquiring about or considering the results of any such test. The act provides limited exceptions to administer tests as part of an investigation into employee theft, embezzlement, or industrial espionage. The act does not cover government employees and does not prohibit the federal government from administering tests to contractors or for purposes of national defense and security.

Title III of the Omnibus Crime Control and Safe Streets Act[34] of 1968 and the Electronics Communications Privacy Act of 1986 prohibit interception of any wire or oral communication in a place of business engaged in interstate commerce. Interception of communication is permissible, however, if one of the parties to a conversation has consented to monitoring. An example is recording or monitoring a customer service representative's phone conversation in order to monitor appropriate communications with customers.

Employee background investigations present another area where privacy may be a concern. The federal Fair Credit Reporting Act (FCRA),[35] as well as numerous state federal credit reporting acts, govern permissible disclosure of background information collected by consumer reporting agencies and commonly used for employment prescreening. See the exhibit "Employee Actions."

Health Insurance Portability and Accountability Act (HIPAA)

The Health Insurance Portability and Accountability Act[36] of 1996 (HIPAA) was enacted to improve the portability of health insurance coverage for workers in the event of job changes and unemployment. The law has had significant impact on medical record privacy and confidentiality by replacing inconsistent state laws and establishing national standards for handling and accessing medical records. Under HIPAA, healthcare providers, health plans, and other healthcare services must adhere to guidelines established by the statute. The Department of Health and Human Services (DHHS) administers the act.

The act grants all patients the right to see, copy, and request to amend their own medical records. Notice of privacy practices about how a patient's medical information is used and disclosed must be given to the patient by each medical professional or medical facility (typically by a notice given the first time the patient sees a medical professional for treatment). The notice must provide information on how to file a complaint with the healthcare provider or with the DHHS Office of Civil Rights.

Under HIPAA, healthcare providers must also account for disclosures of patients' health information, and a patient may learn the identity of those who have accessed their records for the prior six years, with exceptions.

Employee Actions

Usually Do Not Create Privacy Exposures	May Create Privacy Exposures
• Monitoring of employee e-mails	• Intrusion into employee's private affairs ("emotional sanctum")
• Monitoring of employee Internet usage	• Disclosure of private facts regarding employees
	• Potential defamation suits because of information given in employee references

[DA06210]

Employers are not covered entities under HIPAA; they are defined as plan sponsors. Employers that require medical information about employees or others must protect that information, may not disclose information except as permitted by law, and must account for all disclosures. These HIPAA requirements create liability exposures for employers, as well as insurers, that have reason to obtain and possess confidential medical information.

CORPORATIONS: FORMATION

Business entities can be organized in a number of different ways. The structure of a business entity may affect every aspect of the insurance transaction, including underwriting, coverage considerations, and contractual issues.

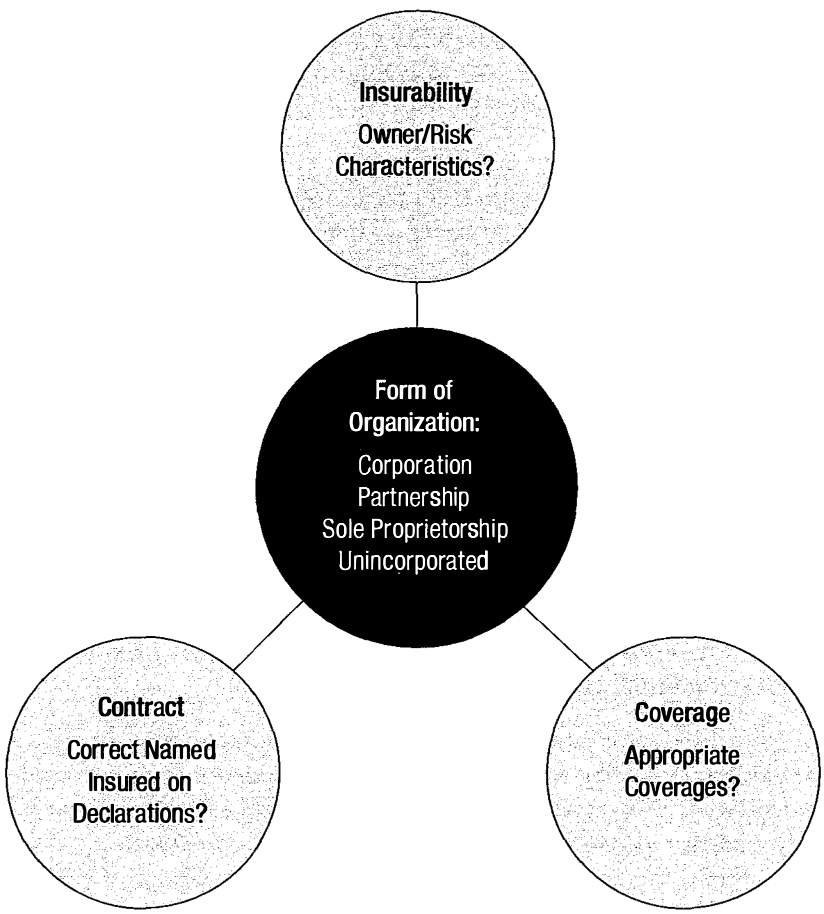
Business entities can be organized as corporations, partnerships, sole proprietorships, or unincorporated associations. Corporations have a legal existence separate from their owners. Partnerships enable individuals to join together for a specific business purpose. Sole proprietorships allow individuals to conduct a business. Unincorporated associations allow volunteers to join together to work toward a common purpose.

Business owners may incorporate for a variety of reasons. These topics are key to understanding corporate structure:

- Advantages of incorporation
- Federal and state regulation of corporations
- Foreign corporations
- Incorporation process
- Corporate ownership

A corporation is a separate, legally recognized business entity organized under state law and entitled to the same rights as a person, distinct from its owners. A corporation can sue, be sued, own property, hire employees, and enter into contracts in its own name. As a separate legal entity, the corporation provides protection against liability to its owners. See the exhibit "Form of Organization and Insurer Considerations."

Form of Organization and Insurer Considerations



[DA06212]

There are three main types of corporations:

1. Government corporations, such as cities, counties, and states
2. Charitable or not-for-profit corporations, such as colleges, universities, hospitals, and religious institutions
3. Business for-profit corporations

The corporation charter, also known as its articles of incorporation, defines the corporation's reason for existence and its powers. Corporate bylaws include more detail about the corporation's overall operations and determine how the organization will be managed.

Advantages of Incorporation

The primary advantage of incorporation is that it limits the owners' liability for the corporation's contracts and torts. For example, if the corporation goes bankrupt, or if a tort claim exhausts both the corporation's available insurance and assets, the owners (stockholders in a for-profit corporation) are generally not liable for any remaining debt. However, in closely held (privately owned) or family-owned corporations, loan contracts may be written to bypass the stockholders' immunity from liability for corporate debts. Banks lending money to such corporations can demand from stockholders, as collateral, signed notes to secure the obligation with their credit, as well as with the corporation's credit.

Bypassing stockholders' immunity from tort liability is much more difficult than bypassing immunity from contractual liability. Therefore, a corporation, or even a private individual, may choose to incorporate a particularly hazardous business, or part of a business, separately to isolate loss exposures that might otherwise affect the main business.

Certain state laws may make exceptions to corporate owners' limited liability. For example, several states hold stockholders liable for employee wages and unemployment benefits earned but unpaid before a corporation's insolvency.

Pierce the corporate veil
A court act of imposing personal liability on corporate officers, directors, and stockholders for the corporation's wrongful acts.

Courts may also make exceptions, or "**pierce the corporate veil**," for the corporation's wrongful acts. This typically occurs when a plaintiff alleges that a corporation is actually a sham—formed to advance the private interests of owners or to commit a fraud. Courts may also hold owners liable when the stockholders themselves ignore the separate identity of the corporation (for example, by commingling personal and business funds).

Finally, "thin financing" and inadequate capitalization can also defeat the limited liability of a corporation. "Thin financing" occurs when a corporation has inadequate equity capital and excessive loans. For example, investors may loan the corporation money for a start-up venture. In the event of insolvency, the loans of investors may be treated as investments rather than loans, meaning that outside creditors will have priority for repayment over the investors. Inadequate capitalization occurs when a corporation creates a subsidiary without sufficient capital to ensure success. In the event the subsidiary fails, the courts may overlook the separate identities of the parent corporation and the subsidiary, requiring the parent to respond to the subsidiary's debts.

In addition to the advantage of limited liability, other advantages are associated with incorporating, including these:

- Possible tax advantages
- Easier to sell or transfer ownership
- Easier to raise capital
- Perpetuity beyond the death of owners

Federal and State Laws and Regulations

Federal law plays a large role in many corporate operations. The Commerce Clause in the United States Constitution provides Congress with the authority to regulate commerce among the states, and most corporations are involved in interstate commerce.

State law governs the formation of corporations. All states have general laws that authorize corporate formation for any lawful purpose, with the exception of certain businesses and the practice of a profession. The American Bar Association Revised Model Business Corporation Act (RMBCA) has been widely adopted by the states and is used as the reference point of this discussion. See the exhibit "Corporate Law Provisions."

General business corporation laws prohibit professionals such as doctors, lawyers, and accountants from incorporating because of the personal and confidential relationships required with their clients. However, many states have adopted specific laws to allow members of the same or associated professions to form professional corporations (PCs). In a professional corporation, the members are liable for their own malpractice, but they are not liable for the malpractice of other employees of the corporation. See the exhibit "Special Incorporation Laws."

A corporation is a citizen of the state where it is chartered (incorporated), and that state is the corporation's domicile, or legal home. A corporation that confines its business to one state will usually find it advantageous to incorporate there. Choosing a different state might increase organizational and operational costs and taxes. For a corporation that operates in several states, the incorporators choose the state in which to incorporate. A business may choose a particular state of domicile for business reasons, often because of attractive laws regarding incorporation and taxation.

A corporation formed in one state is a foreign corporation in any other state, and a corporation chartered in another country is an alien corporation outside that country. A corporation may elect to maintain a principal place of business outside the state of domicile and may wish to do business in other states. However, a corporation is a legal entity only in the state of incorporation; no state can grant a corporation the right to operate in another state. If a corporation wants to do business in another state, it must comply with the other state's laws.

Foreign Corporations

Foreign corporations (those incorporated and domiciled in another state) must be admitted and recognized by a given state to do business in that state. For example, the RMBCA requires a foreign corporation to obtain a certificate of authority from the secretary of state before transacting business.[37]

Corporate Law Provisions

General state corporation law contains provisions about the following features and functions of a corporation:

- Formation
- Powers
- Principal office and agent
- Books
- Certificates
- Reports
- Officers
- Stock
- Dividends
- Meetings
- Elections
- Directors
- Amendments
- Mergers and consolidations
- Dissolution

[DA06213]

Special Incorporation Laws

Special incorporation laws apply to these businesses:

- Insurance
- Banking
- Railroads
- Telephone Companies
- Savings and Loans
- Not-for-Profit Corporations

[DA06214]

A state can forbid or control the activities of a foreign corporation with respect to intrastate (within the state) commerce but has no jurisdiction over interstate (between the states) commerce of any corporation. Federal laws apply to activities defined as interstate commerce. Congress and federal courts have consistently broadened the definition of interstate commerce. Activities that may occur outside the state of incorporation but are not considered interstate commerce include holding stockholders' or directors' meetings; maintaining financial accounts; conducting isolated, short-term transactions; suing or being sued; and other transactions not completed for profit.

State laws governing insurance company admissions are stricter than those governing general business corporations. State laws may include requirements regarding deposits, reports, examinations, background checks on officers, and other requirements specific to insurance regulation. Out-of-state insurers generally apply to the state department of insurance rather than to the secretary of state for authority to conduct business.

States have enacted "long-arm" statutes that allow residents to sue, in their own state's courts, people or entities (including corporations) who are not physically present in the state but who have minimum contacts there. These laws provide jurisdiction to local courts over foreign (out-of-state) defendants. Long-arm statutes may apply to torts, contracts, or both.

To sue a person or business, a plaintiff must accomplish service of process—that is, physical delivery of a complaint and summons to a defendant. With respect to insurance, the majority of states have enacted the National Association of Insurance Commissioners' (NAIC's) model Unauthorized Insurers Process Act, which provides that service on a foreign insurer must be delivered to the state department of insurance.

Incorporation Process

A promoter is a person who creates a corporation. The promoter can be one or more persons, corporations, or paid organizations. For example, the promoter might be a shareholder in the organization being promoted. The promoter works to recruit interest, cooperation, and financing in forming the corporation and completes the legal and practical steps required to create the corporation.

State statute requires a minimum number of incorporators, or those who sign the formal articles of incorporation filed with the state. Most states require three incorporators, and the promoter can be, but is not required to be, one of the incorporators. Along with the articles of incorporation, states require appropriate filing fees, and some require proof of public notice via proof of publication in a newspaper or legal publication.

Under the RMBCA, a corporation's existence begins when the articles of incorporation are filed with the state.[38] In some states, however, the state issuance of the certificate of incorporation signifies corporate existence.

A corporation formed in compliance with the law is called a de jure (in law) corporation. If, however, despite a good-faith attempt to comply with the law, there was failure to meet some minor requirement, the corporation is a de facto (in fact) corporation. Only the state can legally challenge the existence of a *de facto* corporation.

If a corporation is neither *de jure* nor *de facto,* then it technically does not exist, and individuals engaged in the business and aware that the corporation does not exist can be held personally liable for the debts and contracts of the business. However, a third party that has dealt with those individuals as a valid corporation may not be able to legally deny its corporate existence.

After the certificate of incorporation is issued, the corporate organizational meeting is held. The corporate bylaws are the formal provisions for the corporation's structure, regulation, and operation. See the exhibit "Typical Corporate Bylaw Provisions."

Typical Corporate Bylaw Provisions

- Stockholders' meetings—date, place, conduct of elections, order of business
- Directors—term of office, compensation, meetings, loans, authority to elect officers
- Officers—names and functions, appointment, removal, authority to sign checks and enter contracts
- Indemnification of directors, officers, and agents of the corporation—provides for corporate reimbursement for individuals' liability
- Shares of stock—issuance, transfer, record date
- Corporate seal and officers' signatures
- Procedures for transfer or dissolution
- Future amendment of bylaws

[DA06215]

Corporate Ownership

Bond

A long-term debt instrument that requires the issuer to pay a set annual rate of interest and to repay the borrowed sum on a specified date.

Corporations raise funds by issuing two principal types of securities: debt securities and equity securities. A debt security, or **bond**, is a debt obligation. Equity securities are the corporation's capital stock and represent the stockholders' ownership of and equity, or financial interest, in the corporation. Bondholders are creditors of the corporation, while stockholders are owners of the corporation.

Stock

Common stock

An ownership interest in a corporation that gives stockowners certain rights and privileges, such as the right to vote on important corporate matters and to receive dividends.

Preferred stock

Stock that is generally nonvoting but that has priority over common stock, usually regarding dividends and capital distribution if the corporation ends its existence.

Par value

An arbitrary dollar value that an organization assigns to its shares.

Common stock may be issued as different classes of stock, where voting rights differ according to the class. **Preferred stock** is an ownership interest that generally does not provide voting rights to the stockholder. If the corporation dissolves, preferred stockholders will receive preference in corporate assets and are entitled to the stock's **par value** (face value), plus any accrued dividends, after the corporation's debts have been paid. Stock certificates are evidence of the stockholder's interest in the corporation and are considered negotiable instruments under the Uniform Commercial Code (UCC). Thus, stockholders are subject to the rights and obligations provided under the UCC, and other federal and state laws, with respect to such instruments. See the exhibit "Stock Purchase Rights."

Stated capital is the total amount of capital contributed by stockholders. If a stock sells for less than its par value amount stated in the articles of incorporation, the stock is said to be "watered" or "diluted," and the directors and stockholders are liable to unsatisfied creditors for the difference.

Capital surplus is the difference between the stock's purchase price and par value when stocks sell for more than par value. The difference is considered surplus for use against future liabilities. Capital surplus can be converted

Stock Purchase Rights

- Stock Rights: Short-term options to purchase corporate shares. Often given to current stockholders to encourage purchase of a proportional quantity of new stock, often at less than market prices.
- Stock Warrants: Similar to stock rights, but evidenced by a negotiable instrument, typically issued with preferred stocks or bonds.
- Stock Options: Typically used to provide deferred compensation for corporate executives, they permit executives to purchase a certain number of shares at a stated price, relative to status or salary.
- Preemptive Rights: Rights, when given, of existing stockholders to purchase the portions of a new issue of stock relative to an individual stockholder's total outstanding shares of the same class of stock.

[DA06216]

to stated capital by obtaining stockholder consent to amend the articles to increase the common share's par value to match the selling price.

A corporation may reacquire issued securities by repurchasing them. This reacquisition is known as redemption. The original agreements between the corporation and the purchasers of debt securities and preferred stock can include provisions to make the securities redeemable at the corporation's option, or to provide for a mandatory retirement of the security. This type of agreement allows the corporation to reshape its financial structure at will when needed. A corporation may also provide for redemption of nonvoting stock but cannot provide for the redemption of all common voting stock. A corporation can redeem stock only if its assets exceed its liabilities, including any obligations to preferred stockholders in the event of dissolution.

When a corporation with sufficient surplus buys its own shares in the market, it can either hold the stock without reissuing it or retire the shares. Stock issued as fully paid to a stockholder and subsequently reacquired, but not retired, by the corporation is called **treasury stock**. Treasury shares are considered authorized and issued, but not outstanding, and have no dividend or voting rights.

Treasury stock
A corporate stock issued as fully paid to a stockholder and subsequently reacquired by the corporation to use for business purposes.

Corporations may choose to repurchase stock for a number of reasons, including these:

- Reducing the number of issued shares may result in a stronger return on investment. If earnings are static, the earnings per share will increase with fewer outstanding shares.
- Repurchasing shares can make a corporation less attractive for a takeover. Stock repurchases can reduce accumulation of excessive cash in the corporation and increase the market value of remaining outstanding stock. Both are deterrents to a takeover.

In closely held (privately owned) or family-owned corporations, there is generally no market for trading shares. Ownership may be retained by a few persons or even one. Without the ability to trade stock, such corporations may have a more difficult time raising capital. However, closely held or family-owned corporations also have advantages. For example, they do not have to comply with securities laws and may be able to make business decisions more quickly.

Board of Directors

The corporation's board of directors makes two types of decisions: it decides the corporation's structure and form, and it determines business policy. The first requires stockholder approval, while the second does not. See the exhibit "Sarbanes-Oxley Act."

Sarbanes-Oxley Act

The 2002 Sarbanes-Oxley Act was enacted in response to a succession of corporate scandals that arose as a result of gimmickry or fraud in some companies' financial statements. The act's requirements are intended to ensure the credibility of financial requirements and include these provisions:

- Creation of the Public Company Accounting Oversight Board to establish and oversee standards for auditors of public companies
- Independence of the audit committee of a public company's board of directors
- Certification of corporate financial reports by the company's chief executive and chief financial officers
- Rapid, current, and transparent reporting

15 U.S.C. § 7241 [DA06217]

Board decisions that would change the terms of the contract between the corporation and its stockholders require stockholder approval. These are examples of such decisions:

- Amendments to the articles of incorporation, including capital structure, purpose, name, or preemptive right limitations
- Mergers or consolidation
- Dissolution of the corporation

Board decisions that do not require stockholder approval (providing they are not otherwise limited by the articles of incorporation) include these:

- Issuing stock or borrowing money
- Electing and assigning officer duties
- Declaring dividends

- Purchasing or selling property in the normal course of business
- Decisions concerning insurance coverage
- General policy decisions regarding company operations

State statutes may establish the minimum number of directors required, if a board is required at all. In some states, the articles specify the number of directors, while other states allow the articles of incorporation to state how the number will be set (for example, in the bylaws). Statutes may also specify whether directors must be stockholders or meet residency requirements.

Inside director
A corporate officer that serves on the corporation's board of directors.

Outside director
A member of a corporation's board of directors who is a corporate officer and who may not necessarily be connected with the corporation.

Directors can be **inside directors** or **outside directors**. For example, an outside director might be a respected businessperson who can provide perspectives on the organization that are distinct from those of persons involved in the day-to-day operations of the business. Directors, whether inside or outside, have no legal right to act individually on behalf of the corporation and can make decisions only when acting together in a meeting. An exception may occur if all directors have consented in writing to a decision. Unanimous written consent has the same legal effect as a unanimous vote at a meeting.

While directors are concerned with corporate form and decisions relating to business policy, corporate officers, in turn, implement the policies determined by the board of directors. Officers of the company manage the corporation's internal affairs and deal with persons outside the organization. See the exhibit "Corporate Officers."

CORPORATIONS: DUTIES AND OBLIGATIONS

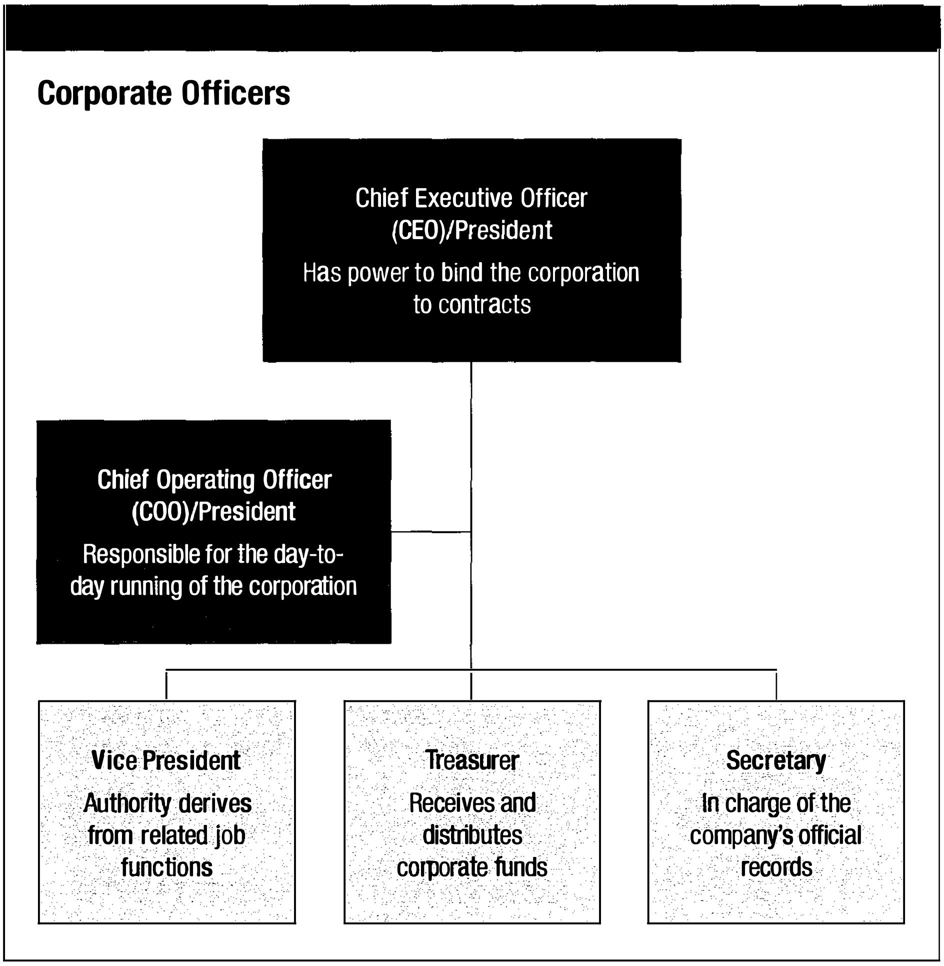
An understanding of the various responsibilities of corporations, directors, officers, and stockholders is important to insurance professionals in assessing corporate risks.

Ownership and management of a corporation include numerous responsibilities that extend beyond business operations. Both common law and statutory or civil law address, directly or indirectly, numerous areas, including these:

- Corporate powers
- Liability for torts and crimes
- Duties of directors and officers
- Stockholders' powers and duties
- Dividends

Corporate Powers

State corporation statutes define and limit the powers of corporations. Laws require corporations to file corporate charters, also called articles of incorporation, which specify the type of business for which a corporation is being formed and the goals and objectives of the corporation. Traditionally, the



[DA06218]

charter stated the corporation's precise purpose; however, most states now permit the stated purpose to be written as "for any lawful purpose."

In addition to the powers given by law and those stated in the charter, corporations have implied powers to do all things necessary or convenient (and not in violation of law or regulation) to achieve the corporation's purpose. For example, a corporation has implied power to sue, purchase property, or invest funds. A corporation can exercise its powers, express or implied, only to further its primary purpose.

Ultra vires
An act of a corporation that exceeds its chartered powers.

A corporation that exceeds its chartered powers acts **ultra vires.** Under corporate law, a contract entered into *ultra vires* is illegal. If a corporation has a restricted purpose per its articles of incorporation, stockholders can sue to enjoin (stop) the corporation's directors from engaging in *ultra vires* activities. For example, stockholders might sue if the corporation's charter states that business will be limited to book publication and the corporation subsequently begins to manufacture tires. Additionally, if the corporation loses money in an *ultra vires* activity, the directors who authorized the activity are personally liable for the loss. Today, the doctrine of *ultra vires* is rarely an issue for private corporations. This is because states now permit corporations to be chartered with broad, rather than specific, stated purposes. Corporations may also amend their charters, or articles of incorporation, as needed to recognize changes to their business. See the exhibit "Articles of Incorporation."

Articles of Incorporation

Typical Items Included in Articles of Incorporation

- Corporate name
- Duration (usually perpetual)
- Purpose (usually broadly stated)
- Number, classes, and par (face) value of shares
- Provisions, if any, for the stockholders' right to purchase a proportionate share of newly issued stock
- Provisions, if any, restricting the transferability of shares
- Registered office or place of business and registered agent
- Number, names, and addresses of the initial board of directors
- Names and addresses of incorporators

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Liability for Torts and Crimes

A corporation, its directors, and its officers can be liable for their actions under both tort and criminal law. Under tort law, a corporation is liable as a principal or an employer under the doctrine of *respondeat superior* ("let the master answer") for all torts committed by its agents or employees within the scope of their agency or employment. Corporate officers and directors, however, are not liable for any employee's or agent's tort. In addition to the corporation itself, the actual tortfeasor (employee or agent) is always liable.

Under criminal law, corporations can sometimes be found guilty of a crime even with no specific criminal intent. For such crimes, often called absolute liability crimes, lack of intent is immaterial. Crimes under this category include food and drug violations and participation in restraint of trade. The test of corporate criminal responsibility for absolute liability crimes is whether the responsible employee or agent acted within the scope of employment to benefit the corporation.

Other crimes, such as larceny, price-fixing, and obtaining money under false pretenses, require a specific criminal intent. The test for corporate liability is the same as that for absolute liability: whether the employee was acting within the scope of employment to benefit the corporation. A corporation can be held responsible for an employee's criminal activity if the corporation could have uncovered the activity through reasonably diligent supervision.

Officers and employees are personally responsible for their criminal acts. In addition, under statutes that impose criminal liability for unintentional acts, an officer can be criminally responsible for failure to ensure that subordinates comply with the statute.

Corporations may also have the right or the duty of indemnification to directors, officers, and other employees. Under corporate law, indemnification means reimbursement of expenses incurred in defending a lawsuit instituted or threatened against a person in his or her official capacity with a corporation. Defense expenses include attorneys' fees, judgments, fines, and settlement amounts. Some state statutes require indemnification only to directors and officers, while others extend the duty of indemnification to employees and agents. Some statutes permit reduction of the statutory right of indemnification if such is included in the articles of incorporation; others do not permit rights to be reduced.

All states require indemnification, unless denied by the article of incorporation, when a person is found not liable in a civil case or not guilty in a criminal case. If a court imposes civil liability, a corporation may choose to indemnify the person anyway, especially when the person acted in good faith and believed the action was in the best interest of the corporation.

Duties of Directors and Officers

Directors are not the corporation's agents, but the law imposes similar duties upon them. Officers are agents of the corporation and, as such, have the fiduciary duties of agent to the corporation (their principal).

Duties of Care and Loyalty

Directors and officers have a duty of care to the corporation. They must act honestly and in good faith and exercise a degree of care that a reasonable officer or director would exercise. They do not guarantee profitability of the business and are not required to have business skills. The law provides that a decision is proper if made within the range of reasonable "business judgment."

Directors and officers also owe a duty of loyalty to the corporation. The duty of loyalty exceeds the general duty not to defraud others. A fiduciary has not only a duty to avoid misrepresentation, but also an affirmative duty to disclose all material facts.

The Employee Retirement Income Security Act (ERISA) of 1974[39] also imposes duties on officers and directors. The act created fiduciary duties for pension and health benefit plan administrators, trustees, upper management, insurance brokers, and others with respect to how they invest and distribute plan funds and how they treat participants and beneficiaries. A director or an officer who exercises discretionary control in such a plan's management or over its assets, or who gives investment advice, is a fiduciary under ERISA with specific statutory duties and liabilities. Directors and officers have these duties under ERISA:

- To act solely in the plan participants' interest
- To exercise the care and skill of a reasonable person conducting a similar enterprise
- To diversify investments unless it is clearly unreasonable to do so
- To act in accordance with the plan documents

Transactions With the Corporation

In the course of business, directors and officers often enter into business transactions on behalf of the corporation. Sometimes, when beneficial, the corporation may enter into business with one of its own directors or with another corporation that shares some or all of the same directors (referred to as interlocking directors). State statutes generally provide that such contracts are valid, even if the director involved voted in favor of the contract, provided the material facts of the relationship were known and voted on by the board or the stockholders, and the contract is fair to the corporation.

Appropriation of a Corporate Business Opportunity

Directors and officers may not appropriate a business opportunity that belongs to the corporation for their own gain. For example, a director may not purchase a business that he or she knows the corporation is seeking to purchase. Similarly, a director or officer may not compete with the corporation.

Directors and officers are privy to confidential information about the corporation. Material information about a corporation's affairs that could, if made public, change the value of the corporation's stock, is called insider information. It is illegal for directors or officers of a corporation to use insider information to their own advantage, such as to buy or sell stock to profit or to avoid loss. If they do, stockholders from whom they purchased shares or to whom they sold shares can sue for damages.

In addition to the private right of action afforded to wronged stockholders, directors or officers who improperly use insider information for personal gain are also subject to stiff civil penalties. The Insider Trading Sanctions Act of 1984,[40] amended by the Insider Trading and Securities Fraud Enforcement Act of 1988,[41] imposes a civil penalty on anyone who deals in securities based on "material, nonpublic" information. This penalty is based not on a duty to the corporation's stockholders, but on a duty to the investing public. Information gained by legitimate research can be used freely in investment decisions. Information cannot be used that comes from such sources as a corporate insider, an investment firm entrusted with the information for business purposes, or a law firm representing the corporation.

Stockholders' Powers and Duties

Stockholders normally delegate management powers of the corporation to the board of directors. The board and the officers appointed by the board have the power to create and implement business policy. Stockholders have the power to make decisions on issues likely to fundamentally affect them. Stockholder decisions include these:

- Electing board members and, in many states, removing them without cause.
- Approving changes to the articles of incorporation.
- Making or amending bylaws.
- Approving loans to the corporation's directors, officers, or agents.
- Ratifying (approving) board actions. If a board explains specific actions and then obtains stockholder ratification, an approving stockholder cannot later sue the board regarding that action. If the stockholders have no knowledge of the board's actions, a blanket shareholder resolution approving a board's actions for the past year is ineffective.
- Suing directors for mismanagement. To exercise that right, stockholders may initiate a suit on behalf of the corporation, called a shareholder derivative suit.

Stockholders have a right to the corporation's financial statements, which they receive by mail or electronically, at least annually. Stockholders also have the right to inspect certain books or records, such as some types of financial records, minutes of stockholder meetings, and lists of stockholders' names and addresses.

Stockholders have no fiduciary relationship to the corporation and therefore can vote in their own best interests. However, majority stockholders may not manipulate corporate affairs to the disadvantage of minority stockholders.

Stockholders' Meetings

Stockholder meetings are held annually for the purpose of giving stockholders, as the corporation's owners, an opportunity to vote on corporate matters over which they have power. To determine which stockholders are eligible to vote, state laws permit the establishment of a cutoff date before the meeting. Only those stockholders owning stock with voting rights as of the cutoff date will be eligible.

Most state laws require an annual meeting but leave it to the bylaws to specify meeting details. If no annual meeting occurs within a statutory time limit, a stockholder can apply to the court to hold a meeting. In addition to annual meetings called by the corporation, holders of a certain percentage of the outstanding shares may also call special meetings, when permitted by statute, articles of incorporation, or the bylaws. The articles or bylaws may also permit other persons, such as the president, to call meetings.

Meeting notice is provided to stockholders in writing, along with information on specific board-proposed actions, such as amendments to the articles that require stockholder approval. A quorum, established by statute, articles, or bylaws, is needed to transact business lawfully at the meeting. In other words, the specified proportion of outstanding shares of voting stock must be represented, either in person or by proxy.

Stockholders' Actions

Stockholders may file one of three types of civil lawsuits to pursue complaints: class action suits, derivative suits, and direct action suits. Stockholder suits are usually either class actions or **derivative suits**.

Derivative suit
A lawsuit brought by one or more shareholders in the name of the corporation.

- Class actions—When a transaction damages many people, one or more damaged persons can file a representative suit, or class action, on behalf of all, thus avoiding multiple suits on the same factual and legal questions. A common example is a stockholder class action suit against directors and officers for damages for fraud, such as failure to make a full disclosure in connections with a public stock offering.
- Derivative actions—One or more stockholders may initiate a suit on behalf of the corporation for damages incurred by the corporation. For example, one or more stockholders might file a derivative suit if an outside auditing firm negligently audited the books of a corporation. Any recovery from the suit belongs to the corporation, because the corporation was directly injured, although successful plaintiffs may also be awarded reimbursement for litigation expenses.
- Direct actions—A stockholder might also file suit to seek remedy for direct harm. For example, a stockholder might file a direct action for harm sustained while engaged in company business.

Dividends

Dividends are shares of corporate profits paid to stockholders. To the stockholder, dividends are considered capital gains, or profits on owned stock. Therefore, some stockholders may prefer to invest profits back into the corporation, while others may prefer to receive dividends. Corporate management decides whether to declare dividends in good faith and for a corporate purpose. Directors can also defer (postpone) dividends or exercise bond call (redemption) provisions to provide expansion capital, build surplus, or accomplish other business goals. To force payment of dividends, stockholders must prove bad faith, which has rarely been found by the courts.

Dividends are usually paid in cash, but there are other types of dividends. Property dividends are shares of another corporation that the declaring corporation has acquired. Stock dividends are corporate profits issued in the form of additional shares of the issuing corporation and can be paid in treasury stock or from authorized but unissued shares. The board may also decide to issue an extra dividend, a dividend in addition to the usual and expected regular dividend. Distribution of assets during a corporate reorganization is often called a liquidating dividend; however, such a distribution is not a true dividend because a dividend comes from corporate profits.

Once the board formally declares a dividend, the stockholders become creditors of the corporation. If the corporation becomes insolvent before paying the dividend, the stockholders participate equally with other creditors to the extent of the dividend. Because declaration of the dividend creates a debtor-creditor relationship, the board cannot revoke a declared dividend.

CORPORATIONS: MERGERS, DISSOLUTION, AND REORGANIZATION

Corporations exist forever unless they merge, dissolve, or reorganize.

Corporations may cease to exist through merger, dissolution, or reorganization:

- Merger is the joining together of two or more corporations to become a new organization.
- Dissolution is a voluntary or involuntary termination of a corporation.
- Reorganization occurs when a corporation becomes bankrupt.

Merger

In a corporate merger, two or more corporations join to become a new, single corporation. The newly merged corporation owns all the assets and is subject to all the liabilities of the merging corporations. A true merger is considered a friendly transaction to which the boards of both (or all) merging organizations agree.

Before a merger, the board of directors of each corporate party to the merger must adopt a plan of merger. The stockholders of the "disappearing" corporations (those corporations that will be dissolved as a result of the merger) must approve the merger plan, but the stockholders of the new (or acquiring) corporation are required to approve the plan only if the number of voting or participating (sharing in corporate profits) shares increases substantially.[42]

Stockholders are entitled to dissent to a merger, a share exchange, or to the sale of all or substantially all of a corporation's assets that does not occur in the usual course of businesses. They are also entitled to an appraisal and to receive fair value for their shares in any merger that requires shareholder approval. If a stockholder files a written dissent to a merger before or during the stockholders' meeting, he or she must receive a written notice after the action giving rise to dissenters' rights that provides a time period and procedure to file a buyout demand.[43]

A corporation that owns at least 90 percent of another corporation's stock may merge that subsidiary corporation into itself without stockholder approval.[44] The corporation need only send the merger plan to the subsidiary's stockholders. Many insurance corporation statutes require 95 percent rather than 90 percent ownership of a subsidiary before such a merger can occur, along with approval from the state department of insurance.

Share Exchange and De Facto Mergers

In a share exchange merger, a corporation acquires all of another corporation's outstanding shares in return for shares of the acquiring corporation. A share exchange plan must be adopted by the board of directors of the "disappearing" corporation and approved by the stockholders of the corporation whose shares are being acquired, but it does not have to be approved by the stockholders of the acquiring corporation.

Another form of merger is one in which a corporation sells all or most of its assets to another corporation, in return for the purchasing corporation's shares for distribution to its stockholders. In this way, two organizations are merged, but not necessarily in accordance with the statutory requirements for a merger. This transaction is known as a *de facto* merger—a merger in fact, if not in law.

Under the American Bar Association Revised Model Business Corporation Act (RMBCA), widely adopted by the individual states, a sale of all or substantially all of a corporation's assets not in the usual course of business requires stockholders' approval in the manner of a statutory merger or consolidation.[45]

When a *de facto* merger meets the structural changes of a statutory merger, the new corporation assumes the liabilities of the predecessor organizations. The courts will not necessarily find the new organization responsible for the liabilities of the acquired corporation if the successor organization is not a continuation of the prior business. See the exhibit "Corporate Mergers."

Takeovers and Tender Offers

One corporation may wish to gain control of another corporation for various business purposes, such as increase in market share or acquisition of assets. There are various methods a corporation may use to achieve a **takeover** of another corporation.

Takeover
The assumption of control by one corporation over another through merger, acquisition, or some other type of transaction.

When one corporation wants to control or acquire a corporation against the will of that corporation's board, the acquiring company can attempt a hostile takeover. Often, a hostile takeover attempt subsequently becomes a friendly takeover when the terms offered by the acquiring corporation improve or the acquiring corporation gains the endorsement of the target corporation's board.

One corporation can gain control over another by bypassing the target corporation's board and acquiring sufficient proxies from the target's stockholders

Corporate Mergers

There are a number of reasons that one or more organizations may initiate a merger, including the desire to increase market share, achieve operational efficiencies, and expand marketing and distribution channels. These are the most common types of mergers:

Horizontal Merger—A merger between businesses that directly compete with each other.

Vertical Merger—A merger between an organization and a customer or supplier. An example is a merger between an ink company and a printer manufacturer.

Conglomerate Merger—A merger of two organizations that are not competitors or linked as customer and supplier. An example is a merger between a paint retailer and a carpeting retailer.

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to elect its own board of directors or to vote for a merger. United States Securities and Exchange Commission (SEC) rules and regulations govern proxy solicitation in these situations.

Tender offer
A purchase offer made directly to the shareholders of the target, typically at an offer price greater than the current market price.

Another method a corporation may use to acquire a corporation that is unwilling to merge is to purchase sufficient shares of the target corporation to become eligible to vote on its board of directors. To purchase shares, the prospective acquirer will make a **tender offer**. Federal law requires mandatory disclosure of certain information in a tender offer. Any person or group that acquires, or intends to acquire, more than 5 percent ownership of a class of securities registered with the SEC must file a statement with the SEC and send a copy of the statement to each offeree and to the issuing company. This information enables stockholders to make an informed decision about whether to sell their shares in the target company. See the exhibit "Insurance Company Mergers."

Dissolution

Dissolution, or termination, of a corporation can either be voluntary or involuntary. Each method follows a different procedure and has different repercussions for the parties involved.

Voluntary corporate dissolution begins with a board resolution to dissolve the corporation, approved by a majority of the stockholders. The corporation must also file a formal "statement of intent to dissolve" with the state. The corporation then proceeds with liquidation. The corporation can request court supervision for liquidation, if necessary.

Involuntary dissolution occurs when the state of incorporation, the stockholders, or corporate creditors file for involuntary dissolution proceedings. State proceedings are unusual and occur only in cases of gross abuse of the corporate privilege or fraudulent acquisition of the articles of incorporation. A state

Insurance Company Mergers

Most states' insurance company merger laws mimic general corporation laws. However, there are also significant differences between insurance company mergers and general corporation mergers:

- Regulated corporations, such as insurance companies, can engage in only one type of business; insurers can merge only with companies in the same business.
- State departments of insurance must approve insurance company mergers.

Sometimes corporations with diverse interests wish to purchase controlling interests in insurance companies for investment purposes. Corporations that purchase controlling interests in other corporations are called holding companies. Merger laws do not apply in these situations because the insurance companies continue as separate corporations. Instead, every state and the District of Columbia have adopted the National Association of Insurance Commissioners (NAIC) Model Insurance Holding System Regulatory Act. The model act includes requirements that insurer subsidiaries file information with the state department of insurance relating to capital structure, ownership, financial condition, and general business operation. The act also limits dividend payments by insurance subsidiaries to holding companies.

Under the act, persons wishing to acquire control of, or merge with, an insurer are required to file a specific form (Form A, Statement Regarding the Acquisition or Control or Merger with a Domestic Insurer), which is analyzed by the state to determine whether to approve or disapprove the transaction. The filed form is also shared with other states.

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might hold such a proceeding when a corporation has allegedly defrauded the public repeatedly.

Stockholders can ask a court for involuntary dissolution on the basis of the right to protect stockholders. The court can then order liquidation of corporation assets and distribution of the proceeds, after payment of debts, to the stockholders. The RMBCA provides that stockholders can file suits to dissolve the corporation on these grounds:[46]

- The directors are deadlocked, the stockholders cannot break the deadlock, and irreparable injury to the corporation either has occurred or might occur.
- The directors' or officers' acts are illegal, oppressive, or fraudulent.
- The stockholders are deadlocked in voting power and have failed to elect directors for two successive meetings.
- The corporate assets are being wasted or misapplied.

If a judgment for a creditor's claim is unsatisfied, or the corporation admits insolvency in writing, the creditor can sue for dissolution of the corporation. The corporation need not be bankrupt, with its liabilities exceeding its assets. Insolvency means only that the current liabilities (as opposed to total liabilities) exceed current assets. Thus, a corporation that cannot meet its current obligations is insolvent, even though its total liabilities are less than its total assets.

Because of the public interest in an insurance company's ability to pay its claims, the courts designate the state department of insurance as the receiver in an insurance company dissolution process.

Reorganization

Under Chapter 11 of the Bankruptcy Reform Act of 1978,[47] a corporation may be placed under federal bankruptcy court supervision for reorganization purposes. Chapter 11 proceedings may be voluntary or involuntary and may end in either a restructured organization or termination through bankruptcy liquidation.

Chapter 11 filings are the most common way for corporations to restructure debt. Corporations will typically restructure, that is, make changes to the ownership or operational structure of the organization in order to be more profitable. Under Chapter 11, the bankruptcy court must appoint a committee of creditors and also might appoint a committee of stockholders to work under its supervision. The court can permit the current managers to continue control of the business and may appoint an examiner to investigate and monitor the reorganization. The court can appoint a case trustee, separate from the U.S. Trustee, to take control of the business if it finds management guilty of fraud, dishonesty, incompetence, or gross mismanagement or if it finds that the appointment of a trustee is in the best interests of the creditors, stockholders, or other persons.

In the absence of a satisfactory reorganization or other plan, the bankruptcy court may convert the case to a regular bankruptcy liquidation proceeding under Chapter 7 of the federal bankruptcy laws.

PARTNERSHIPS

Formation of partnerships allows individuals to pool their resources and capital to pursue a business for profit. However, partnerships involve complex responsibilities and liability exposures for owners that vary depending on the type of partnership structure.

Partnerships, limited partnerships, limited liability partnerships, and limited liability companies are forms of business ownership that share some characteristics but differ with respect to the liability exposures of the owners. The insurance professional should have a basic understanding of these partnership characteristics:

- Partnership formation
- Partnership liability
- Partners' relationships to one another

- Relationship of partners to third parties
- Dissolution, winding up, and termination
- Limited partnerships and limited liability partnerships
- Limited liability companies

Partnership Formation

A **partnership**, also called a general partnership, is a form of legal ownership of a business. The Uniform Partnership Act (UPA), a model law adopted by a majority of states, defines a partnership as "an association of two or more persons (legally defined as individuals, groups, companies, or corporations) to carry on as co-owners of a business for profit."[48] An advantage of forming a partnership is that income is taxable at each individual partner's tax rate rather than at a rate that would apply to a corporation.

Partnership
A for-profit business entity jointly owned by two or more persons who share ownership and profits (or losses), although not necessarily on an equal basis.

Partnerships can arise by people's actions as partners, by oral agreement, or by written agreement. Two or more persons are presumed to be partners if they agree to work together in any line of activity and share the profits and losses, although not necessarily on an equal basis. To be considered a partnership, the enterprise need not have physical assets but must have profit as its goal.

Unlike corporations, formation of partnerships does not need government approval. However, if the partnership uses a fictitious name or any name other than all the partners' surnames, state laws require registration of the name in a public records office. See the exhibit "Joint Ventures."

Joint Ventures

A joint venture is an unincorporated association of two or more persons (legally defined as individuals, groups, companies, or corporation) established to conduct a single transaction or a series of related transactions, as compared with an ongoing business involving many diverse transactions. Examples include a business established to buy a single tract of land in order to subdivide it for sale to others or to drill for oil offshore.

The concepts of joint venture and partnership have virtually merged. Because a joint venture can range from an association for a single transaction to a complex, long-range association, joint ventures can differ more among themselves than they do from a partnership.

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Partnership Liability

Only a legal entity can be a party to a lawsuit, but under common law partnerships were not considered legal entities. Therefore, for a partnership to sue or be sued, all the partners had to be joined individually in legal actions by or against the partnership. A plaintiff suing a partnership would have to serve papers on each of the partners. Due to the burden of determining all

Common name statute
A law that permits service of process on a partnership by serving any one of the partners.

the partners to a business, as well as the difficulties of serving papers on every party, some states passed **common name statutes**, permitting suits against the partnership in its name. Some state laws permit satisfaction of judgment only from the firm's assets and not from those of the individual partner who was served personally. Typically, when the partnership is the plaintiff, all partners must join in the suit.

In cases in which more than one person was at fault, the common law distinguished between contract and tort liability. If two or more persons, such as partners, were liable on a contract, the liability was joint, and a plaintiff had to sue all of those at fault. For tort cases, however, the liability was joint and several. The plaintiff could choose to sue all the partners or any number of them. Many states have adopted laws amending the common law rule so that liability on all obligations, both contract and tort, are joint and several.

The laws of agency govern liability of a partnership and of the individual partners for torts committed by one of the partners. If a partner's act or omission in the ordinary course of the partnership's business causes loss or injury to a third person, the partnership, that partner, and each of the other partners are liable, and the partners' private property can be used to satisfy the judgment. The acting partner is ultimately liable. If the partnership or any other partner is forced to respond in damages to the third party, theoretically the acting partner must reimburse the other partner or the partnership. In reality, however, insurance usually covers the liability.

A partnership is not usually responsible as a business entity for a crime; only a partner who has participated in a crime is held criminally responsible. Vicarious liability, or holding the partnership legally responsible for the actions of a partner, does not usually exist in criminal law.

Partners' Relationships to One Another

The partnership agreement, the UPA, and general principles of contract and agency law govern the relationship among partners. Unless contrary to public policy, the partnership agreement can deviate from UPA provisions.

Financial Relationship

Unless otherwise provided by the partnership agreement, each partner shares equally in profits, losses, and any surplus that remains on dissolution of the partnership (after satisfaction of all liabilities), even when the partners' capital or service contributions are unequal. See the exhibit "Example of a Partnership Financial Relationship."

The partnership indemnifies each partner for payments made or personal liabilities incurred in the business when a partner has acted within the scope of his or her authority. However, a partner who is guilty of gross negligence, fraud, or wanton misconduct that gives rise to damages is solely liable and is not entitled to indemnification.

Example of a Partnership Financial Relationship

Assume that Anne and Bob form a partnership with start-up capital of $100,000, Anne contributes $90,000 in cash and Bob contributes $10,000 in cash. Bob also has a special skill the partnership will use.

If the partnership makes a $10,000 profit in a given year, Anne and Bob are each, unless otherwise provided, entitled to $5,000.

If the firm dissolves and $70,000 remains after all liabilities are paid, Anne and Bob must share the $30,000 loss unless the partnership agreement provides otherwise. How much would Anne and Bob receive?

Anne is entitled to $75,000 ($90,000 – $15,000, her original contribution minus half of the $30,000 loss). Therefore, Bob must provide Anne with $5,000 ($10,000 – $15,000, his original contribution, minus his half of the $30,000 loss) to augment the partnership's remaining $70,000. Anne then receives the full $75,000, and Bob loses $5,000.

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Fiduciary Relationship

Every partner has a fiduciary relationship with the other partners and the firm, meaning each partner owes a duty of trust, loyalty, and good faith to the partnership, similar to the duty of an agent trustee. The fiduciary duties are implied in law, and cannot be waived by contract.

A partner who derives any personal benefit from any transaction connected with the partnership without the other partners' consent must account to the partnership for the benefit and hold any profits for the partnership as a trustee.[49] For example, Nadia and Paul are partners in a dog grooming business. Paul's neighbor brings her West Highland terrier to receive grooming services from Paul, who keeps the payment for himself instead of putting it in with the business receipts. Nadia can demand that he turn the payment over to the partnership.

Partners are liable to the partnership for failing to render the services they originally agreed to perform. A partner is not liable to the partnership for ordinary negligence or for loss caused by errors in judgment. The partnership assumes the risk of ordinary poor judgment. However, a partner is liable for gross negligence, fraud, or wanton misconduct.

Partnerships' Books and Property

Unless otherwise provided, the partnership's books must be kept at its principal place of business. All partners have the right of access to the partnership's books for purposes related to the partnership.

Assignment of Partner's Interest in Partnership

A partner's transferable interest in the partnership is his or her share of the profits and losses and the right to receive distributions.[50] A partner can assign a financial interest in the partnership if agreed to by the other partners (either in the original partnership agreement or when the assignment occurs) but cannot assign the partnership status. Assignment of financial interest does not give the assignee any right to participate in management, to require information or an accounting, or to inspect the partnership's books. On dissolution, however, the assignee is entitled to the assignor's interest and can require an accounting from the date of the last accounting agreed to by all the partners.

Relationships of Partners to Third Parties

A partner has neither the right nor the power to bind the partnership by any contract with a third party that requires unanimous or majority consent of the partners. Third parties are at risk in dealing with partnerships if they are unaware of which partnership decisions require unanimous consent. However, any partner can make ordinary day-to-day contracts involving third parties.

Every partner is the partnership's agent for its business purposes,[51] so agency rules apply. A partner may have actual authority to bind the partnership (with express or implied authority or by ratification), but even without actual authority, a partner can bind a partnership under principles of estoppel.

Apparent Authority (Estoppel) of Partners

Apparent authority is also called authority by estoppel. See the exhibit "Partnership by Estoppel."

The existence of partnership itself creates the appearance that a partner has authority to act on behalf of the partnership. A third party might assume that all partners can act in the partnership's day-to-day business. If a partner lacks authority or has been denied authority to act, and a third party changes legal position because of the partner's actions, the partnership is estopped from denying that partner's authority.

For example, assume that Anne, Bob, and Carla are partners in the business of selling hunting and fishing equipment. Anne and Bob vote not to sell equipment for bow-and-arrow hunting, although Carla favors doing so. Other hunting and fishing equipment retailers in the area sell archery equipment. Carla, despite the partnership's policy, contracts to purchase a quantity of bows and arrows from a supplier who is unaware of the restriction. The partnership is bound because the third party could have reasonably assumed that this partnership also sells such equipment.

Partnership by Estoppel

The doctrine of partnership by estoppel protects innocent third parties who have relied on the appearance of a partnership. A partnership by estoppel results if three elements are present:

- A person who is not a partner purports to be a partner or permits others to think he or she is a partner.
- The third party deals with the entity in justifiable reliance on a belief that it is a partnership or that the person who purports to be a partner is actually a partner.
- The third party changes his or her legal position because of reliance on that belief, for example, entering into a contract.

Under these circumstances, the person who has permitted the appearance is liable to the third party to the same extent that an actual partner would be. In addition, the purported partner has the power to bind the partnership, just as an actual partner would. If all the partners consent to the representation, the apparent partner's transaction is a partnership act or obligation. If fewer than all the parties consent, the act is the joint obligation only of the consenting partners and not of the partnership itself.

Risk of partnership by estoppel may occur when a retired partner has not provided appropriate notice of the retirement to people who previously knew of the partnership.

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Acts Outside the Usual Scope of Business

The term "usual scope of business of the partnership" refers not only to what the partnership usually does, but also to what similar partnerships in the geographical area ordinarily do. These practices create appearances on which the third party might rely, thus estopping the partnership from denying liability. A partner's act outside the partnership's usual scope of business does not expose the partnership to liability because the partnership created no appearances. Instead, the third party merely relied on its own perceptions.

Referring to the example of Anne, Bob, and Carla, who sell hunting and fishing equipment, if Carla enters into a contract to purchase a line of guitars, the partnership would not be bound to the contract. Unless Anne and Bob had given Carla this actual authority, Carla, not the partnership, created the appearance of her authority, and the partnership therefore can deny Carla's binding authority. The third party could, however, sue Carla for breach of the implied warranty of authority (for giving the impression of authority where it did not exist) under the law of agency.

Ability to Convey Real Property

The real property belonging to a partnership is held in the name of the partners and the partnership, such as in the name of "Adams, Burns, and Cunningham, partners doing business as The Excelsior Company." In such a case, all the partners must sign a deed to transfer legal ownership to a purchaser.

Partnership property might also be titled in the name of one or more partners without naming the partnership. Those partners are the property's "apparent owners." If a purchaser of the property gives full value and does not know of the partnership's interest in the property, good title passes on principles of estoppel. The same principles apply to other types of property for which a written document indicates ownership, such as a bill of sale or an automobile title.

Dissolution, Winding Up, and Termination

A partnership dissolves whenever any partner ceases to be associated in carrying out the business, if it becomes unlawful to carry on the partnership, or if the partnership becomes bankrupt. Unless otherwise provided or agreed to, partnership affairs are then "wound up," or liquidated, and the partnership is terminated.

A partnership agreement can provide that the partnership will not dissolve on any partner's death but will continue with the surviving partners. In legal terms, the partnership dissolves but is reformed immediately with the surviving partners as the partners.

Rightful and Wrongful Dissolution

Partnerships may dissolve voluntarily, or the courts can declare dissolution. A partner can apply to the court for a decree of dissolution for certain situations, such as one partner becoming incapable of performing his or her part of the contract (for example, due to illness), or if a partner is guilty of conduct that harms the business.

A dissolution (also called dissociation) can be considered rightful or wrongful. A rightful dissolution is one that is in accordance with the partnership agreement and is not any partner's fault. On rightful dissolution, the partnership is liquidated. If the partnership is solvent at the time of dissolution, the parties share in any surplus remaining after payment of debts and partners' equity. If the partnership is insolvent, the partners share the losses.

These are examples of rightful dissolutions:

- The term of a partnership ends.
- A partnership without a term (a partnership at will) is dissolved by one or more partners.
- All the partners agree to dissolve even if the partnership has a term.
- A partner has been declared incompetent in any judicial proceeding or is shown to be of unsound mind.
- A partner has become incapable of performing his or her part of the partnership contract, for example, because of extended illness.
- The partnership business can continue only at a loss.

If dissolution is wrongful, the innocent partners can choose to either wind up the business and hold the at-fault partner liable for breach of contract damages or continue the business for the remainder of the partnership term. If they choose to continue, the remaining partners must pay the wrongful partner his or her share of the assets, less any damages the wrongful dissolution caused. Remaining innocent partners must then release the wrongful partner from all liability for existing debts.

Examples of wrongful dissolutions include the following:

- A partner becomes bankrupt.
- A partner is guilty of conduct that harms the operation of the business, such as competing with the partnership, embezzlement, or breach of the fiduciary relationship.
- A partner willfully or persistently breaches the partnership agreement.

Winding Up the Partnership Business

If the partnership dissolves, the business is liquidated. Remaining partners, or the last surviving partner's legal representative, must wind up the partnership affairs. If dissolution is by court decree, the court may either appoint an outside person, called a receiver, or designate one of the partners to wind up the business.

Unless the partnership agreement provides otherwise, upon dissolution the partnership's assets are distributed in this order:

1. Partnership creditors
2. Partners' advances
3. Each partner's capital (If partnership assets are insufficient, the loss of capital is deducted from each partner's capital contribution according to each partner's share of the profits.)
4. Surplus to the partners, divided in the same proportion as profits

If the partnership has sufficient assets to pay creditors, partners' advances, and partners' capital contributions, there are few problems. If the partnership is insolvent, the partners have unlimited liability for partnership debts.

If the partnership and all of the partners are insolvent, the case goes into a bankruptcy court in liquidation proceedings. Federal bankruptcy law permits partnership creditors to enter the full amount of their claims against both the partnership assets and each individual insolvent partner's assets. If one or more of the partners is solvent and their assets are sufficient to pay both their creditors and the partnership's outside creditors, they must do so.

Effect of Dissolution on Third Parties

Dissolution does not affect the rights of the partnership's existing creditors against the partnership, the partners, or the estates of deceased partners. If new contracts arise, such as those needed for orderly liquidation, the partnership, the partners, and the deceased partner's estate are all liable for these contracts.

A problem can arise if, after dissolution and without any authority, a partner enters into a completely new contract on the partnership's behalf. Even if the partner lacked actual authority to enter into the new contract, he or she might have had apparent authority. If, however, a third party has or should have had knowledge of dissolution, the contract cannot be enforced. For example, if a partnership dissolves because one partner has filed bankruptcy, third parties are held to have notice of such matters of public record.

If a partner knowing of dissolution enters into a new contract, the partnership and the other partners might be bound, but they have rights against the partner who entered the contract. If a contracting partner has no actual knowledge of dissolution, for example resulting from a partner's illness, but has received notice of dissolution (as in a letter left unopened) the partner is solely responsible for a contract he or she entered into after dissolution.

A partner who has retired remains liable to third parties for obligations incurred while a member of the firm. Even the continuing partners' agreement to relieve the retiring partner of prior obligations does not change a third-party creditor's rights. To be relieved of these obligations, the retiring partner must obtain the third-party creditor's agreement to obtain payment only from the remaining partners. The term "retiring partner" includes a deceased partner's personal representative.

Limited Partnerships and Limited Liability Partnerships

Limited partnership
A form of partnership made up of one or more general partners, who have unlimited liability, and one or more limited partners, whose liability is limited to the amount of capital they have contributed to the partnership.

To form a **limited partnership**, the partners must comply with state statute and file a certificate of limited partnership with the appropriate public official. Limited partners receive a return on their investment as agreed upon in the partnership agreement.

If a limited partner exercises any control over the management, the limited partner might face an unlimited liability exposure. The firm can employ a limited partner, but this practice can raise difficult questions concerning when the limited partner's advice or review of management decisions becomes actual participation in management.

A limited partnership can provide tax advantages to investing partners. Federal income tax laws treat a limited partnership as a partnership. The partnership itself is not taxed, and the income attributable to each partner is taxed at the partner's personal tax rate. However, in businesses with high up-front costs (such as theatrical productions) or with high depreciation allowances (such as some real estate developments), "paper losses" are attributable to each partner each taxable year. A paper loss is an unrealized loss. These paper losses are particularly valuable to high-bracket taxpayers who, under some circumstances, can use these losses to reduce their taxable income while the limited partnership develops its business.

A **limited liability partnership (LLP)** differs from a limited partnership in that it limits liability for each partner. This limitation, however, does not apply in situations such as these:

Limited liability partnership
A partnership limiting each partner's personal liability for acts or omissions of other partners.

- Individual acts of negligence or wrongful acts by a withdrawing partner
- Debts or obligations of the partnership for which a withdrawing partner has agreed to be liable
- Debts and obligations expressly undertaken in the partnership agreement

States differ with respect to the extent of liability protection recognized. Some states, referred to as "limited shield" states, significantly reduce liability protection for limited liability partnerships. In such states, partners have limited liability only with respect to actions of their partners, but still have unlimited personal liability in all other situations.

Limited Liability Companies

In a **limited liability company (LLC)**, owners are called members. The members appoint managers to conduct the LLC's business operations. Members may also serve as managers.

Limited liability company (LLC)
A form of business entity that provides its owners the limited liability of a corporation and the tax advantages of a partnership.

The limited liability structure is appealing to real estate firms, high-technology start-up companies, and other entrepreneurial businesses with small numbers of active investors. Not all businesses can operate as LLCs. State laws generally prohibit banking, trust, and insurance industry businesses from forming LLCs, and some states also prohibit professionals (such as doctors and accountants) from forming LLCs.

UNINCORPORATED ASSOCIATIONS

The First Amendment of the United States Constitution has been interpreted to protect freedom of association; thus, it protects the right of individuals to form unincorporated associations to accomplish a common legal purpose.

Unincorporated associations share characteristics with both corporations and partnerships. Examples include trade associations, labor unions, religious organizations, and clubs.

Unincorporated association
A voluntary association of individuals acting together under a common name to accomplish a lawful purpose.

These four areas provide a basic understanding of these organizations:

- Characteristics of unincorporated associations
- Formation and financing
- Liability of members to third parties
- Dissolution and winding up

Characteristics of Unincorporated Associations

An unincorporated association is sometimes called a voluntary association, a voluntary organization, or an association. Although defined as "voluntary," some associations may actually be involuntary. In such cases, membership is required by state law.

Associations are the most common organizational form of not-for-profit organizations, but associations can be organized as for-profit entities as well. Some corporations, particularly not-for-profit corporations, can be described as associations, and some state statutes provide for the incorporation of associations. For purposes of this discussion, the term "association" is used only in the sense of an unincorporated association.

Associations, although unincorporated, resemble corporations in their form and organization. The biggest difference between a corporation and an association is that, in common law, an association is not a legal entity separate from its members and managers. Corporations can sue and be sued in the corporate name, but in many jurisdictions, an association cannot. Because they are not legal entities, unincorporated associations also cannot hold or transfer property in the name of the association. Associations are formed under the common law right of contract, have no separate legal existence, and do not legally possess perpetual life.

Associations are not subject to franchise, transfer, and other taxes commonly levied on corporations. However, not-for-profit associations enjoy tax-exempt status similar to not-for-profit corporations. Unlike corporations, associations do not need to register in the states in which they do business or file various reports required of corporations; however, they may have to comply with fictitious name statutes.

An association resembles a partnership in that, because an association is not a separate legal entity like a corporation, its members may be individually liable for the association's activities.

Associations differ from partnerships in several ways:

- An association cannot usually hold title to real property or execute a lease in the association's name.
- A member's withdrawal does not cause dissolution.
- Any expense-sharing or profit-sharing in an association is frequently other than per capita.
- An association's individual members do not have authority to participate directly in its day-to-day management.

State Regulation

States have statutes concerning many aspects of associations. Some states have laws that address specific matters, such as suits by or against associations in the association's name. Associations such as labor unions, insurance organizations, and credit unions are also subject to any specific laws governing such operations.

State laws do not restrict the formation of associations for any legal purpose. The constitutional guarantee of freedom of assembly implies the right to form or join associations, and no legislation can eliminate that right. Any law affecting associations cannot unreasonably inhibit free speech or assembly; however, it may forbid activities that pose a clear and present danger to society.

The National Conference of Commissioners on Uniform State Laws (NCCUSL) adopted a model law in 1996, The Uniform Unincorporated Nonprofit Association Act (UUNAA), to address unincorporated not-for-profit associations. This act was revised in 2008 as the Revised Uniform Unincorporated Nonprofit Association Act (RUUNAA). The model act addresses tort and contractual liability of members, owning and conveying of property, and suits by and against an unincorporated nonprofit association. Additionally, the model law recognizes an unincorporated not-for-profit association as a separate legal entity, distinct from its members—meaning that it may own and transfer property and sue and be sued in its own name. The model also provides that liability stemming from contract or tort is solely the liability of the association and not of its members. Although the model law has been enacted in only a few states, it contains provisions similar to those found in most states' statutes.

Types of Associations

These are the six major types of unincorporated associations:

- Trade associations—The largest group of unincorporated associations is composed of more than 10,000 American trade associations. These organizations foster their members' interests by exchanging and compiling information, lobbying, setting standards, and issuing publicity. They include boards of trade, chambers of commerce, and other business organizations.
- Labor unions—The next largest group of associations is labor unions. Local unions, as well as national organizations representing multiple smaller unions, may be formed as associations. Any benefits, such as health insurance, provided by the union are regulated according to relevant state and federal law. Labor unions are also subject to applicable state and federal employment laws. The group liability of unions organized as associations is limited in most states.
- Benevolent and fraternal associations—Fraternal and benevolent societies have long taken the form of associations. If these organizations provide insurance or credit for their members, they must comply with state laws governing such issues. Some benevolent and fraternal associations are referred to as "secret societies," a term describing organizations that

conceal their activities from nonmembers. Special statutes in many states regulate secret societies.

- Religious organizations—Religious associations may be unincorporated associations or may choose to incorporate.
- Clubs—A club is an association of persons for some common objective, such as social purposes or the pursuit of literature, science, or politics. For example, a local sports league or a club of antique auto owners may be structured as an unincorporated association. Clubs follow agency rather than partnership rules. A club member, therefore, is liable to pay money beyond the required subscription if that person expressly or impliedly authorizes a contract. The club's limitations on its agents bind third parties.
- Condominium owners' associations—Most states have statutes regulating condominium association activities. Some condominium associations are incorporated, although statutes do not require incorporation. State statutes usually specify limitations on the formation, powers, finance, and operation of condominium associations. All unit owners within the condominium are association members, and the association is responsible for the condominium's operation and the care and preservation of the common areas (the shared areas of the property).

Formation and Financing

Associations are generally defined as voluntary, formed by a group of individuals for some common lawful purpose and financed as they desire. However, involuntary associations may be established by statute or regulation. For example, assigned risk automobile insurance plans, Fair Access to Insurance Requirements (FAIR) plans, and insurance guaranty funds are involuntary associations because, by law, all insurers that write applicable lines of insurance in a given state must belong to that state's association. The statutes creating such involuntary associations frequently specify the means of formation, financing, and management, or they may specify that state regulation governs those aspects of the association.

Articles of Association and Bylaws

The contract of association is embodied in an instrument usually termed the "articles of association," "constitution," or "charter." Like a corporate charter, this instrument is the fundamental body of rules governing the association.

A voluntary association can adopt bylaws to serve as the rules of the association and provide regulations concerning discipline, doctrine, or internal policy. Association members are bound by the provisions of the bylaws.

The bylaws of an unincorporated association typically include provisions addressing these issues:

- Qualifications, selection, and terms of directors and trustees
- Meetings
- Qualifications for membership
- Acquisitions and transfer of property
- Rights and duties of members
- Dissolution

The association has the right to interpret and administer the bylaws and regulations. However, courts will not enforce them if they compel a person to lose rights in accumulated assets or to forgo basic constitutional rights, or if they are illegal, immoral, or against public policy.

Rights of Members in Association Property

Every voluntary association member has a property right in its assets. Because associations are not legal entities, any property that an association ostensibly holds belongs jointly to its members as tenants in common. Therefore, unless state statute provides otherwise, common law gives members the right to dispose of the property at their joint pleasure. The articles of association, however, can give the right to control and dispose of property solely to the board of directors. Unless the articles or bylaws state otherwise, members lose whatever interest they have when their membership ends.

Dues and assessments paid by members become the association's property, free from any individual right or claim. An individual member cannot prevent use of his or her dues for objectives to which a majority of the members agree.

Directors or Trustees

Individual members of the association normally do not participate in the day-to-day management of the association; that authority is usually given to the association's elected board of directors or trustees. Association directors and trustees have legal rights and duties almost identical to those of corporate directors. Association directors have no legal right to act individually on behalf of the association and can make decisions only as a group. One difference is that directors of not-for-profit associations do not have as high a standard of care as directors of corporations or associations engaged in business for profit. This is because their positions in not-for-profit associations are often part-time and uncompensated.[52] If they receive compensation, their standard of care is higher.

Liability of Members to Third Parties

Individual members can be liable for both torts and contracts arising from the association's activities. Association members are jointly and severally liable for torts committed by the association's agents and employees acting within the scope of their employment. However, under the Volunteer Protection Act,[53] those who provide voluntary services are immune from liability in many instances.

In common law, an unincorporated association is not liable for the actions of its members because it is not a separate legal entity and cannot be sued. Many state statutes now allow unincorporated associations to sue and be sued; however, the fact that an association might be sued in its own name does not eliminate the members' individual liability.

A member who has suffered damage to his or her person, property, or reputation through the tortious conduct of another member or an agent of the association cannot sue the association but can sue the other member or agent individually.

Absent statutes to the contrary, members of an association organized for trade or profit are individually liable for contracts made by an authorized officer or agent in the association's name or incurred in the course of business for which the association was organized. This liability exists even if the other party does not know the individual members' names.

Members of not-for-profit associations organized for social, moral, patriotic, political, or similar purposes and not for trade or profit do not have individual liability to third parties unless they join in authorizing a contract. In this situation, agency rules apply, and agency cannot be implied by the mere fact of association or paying dues.

Dissolution and Winding Up

Because no specific statutory provisions apply to the dissolution of associations, they can be dissolved in a variety of ways:

- By members' vote
- By the death or withdrawal of a majority of the members
- By court action on application of creditors or members, or for illegal conduct
- By the expiration of a period stated in the articles

The person authorized to wind up association affairs liquidates the assets and pays all debts and obligations. That person distributes the remaining assets pro rata (proportionately) among the members unless the articles provide otherwise. Sometimes, the articles state that the remainder of the liquidated assets will go to a charitable or benevolent purpose. See the exhibit "Unincorporated Associations Characteristics Summary."

Unincorporated Associations Characteristics Summary

- Formation—Voluntary: Group of individuals with common purpose. Involuntary: Established by statute or regulation.
- Ownership—Individual members have rights in the association assets.
- Liabilities—Individual members can be liable for both torts and contracts arising from the association's activities. Association members are jointly and severally liable for torts committed by the association's agents and employees acting within the scope of their employment.
- Termination—Unincorporated associations can terminate by membership vote, by the death or withdrawal of substantially all the members, by court action on application of creditors or members or for illegal conduct, or by the expiration of a period stated in the articles.

[DA04686]

SUMMARY

Under the doctrine of employment at will, an employer is free to terminate any employee at any time, for any reason or for no reason. Exceptions to the doctrine, intended to protect employees, have arisen through common law or statutory changes. The four major types of exceptions to the doctrine of employment at will are public policy, implied contract, covenant of good faith, and statutory.

While nearly every state recognizes the employment-at-will doctrine with respect to the employer-employee relationship, there are exceptions to the doctrine resulting from federal laws intended to protect workers against discrimination because of age; sex, race, color, religion, or national origin; disability; or other factors, including military service, jury duty, or wage garnishment.

The collective bargaining process allows unions to represent employees in labor contract negotiations with employers. Federal laws and oversight ensure that both parties to a labor dispute bargain in good faith. Labor-management relations include collective-bargaining relationships, the collective-bargaining process, and economic pressure.

Numerous laws protect employee welfare in the areas of safety and health, wages and hours, family medical leave, benefits, and privacy. These laws create numerous obligations and compliance issues for employers, as well as significant liability exposures.

The primary advantage of incorporation is that it limits the owners' liability for the corporation's contracts and torts. State law governs the formation of most corporations, and corporations may have to comply with the laws of the state of incorporation and every other state where it does business, as well as applicable federal laws. A corporation is a foreign corporation in states other than the one where it is domiciled. Stockholders share in the ownership of corporations and may have voting rights, including approval of some decisions made by the corporation's board of directors.

The powers of a corporation stem from statute and are delineated by the corporation's charter, or articles of incorporation, filed in accordance with the law. Corporations, directors, and officers can be liable for their actions under both tort and criminal law. Directors and officers have the power to manage the operations of the corporation, and they owe a care of duty to the corporation and must make decisions for the benefit of the organization. Directors and officers can be liable to the corporation's stockholders (owners) for their misdeeds or mismanagement. Stockholders have the power to elect board members and to approve board decisions that would fundamentally change the organization or otherwise affect stockholders. Stockholders may file suit on behalf of the corporation or themselves. Stockholders, as owners of the corporation, have the right to share in the profits of the organization, usually in the form of cash dividends.

In a corporate merger, two or more corporations join to become a new, single corporation. Companies may merge for a variety of reasons, but they typically merge to form a more competitive or efficient organization. Dissolution occurs when a corporation is terminated, either voluntarily or involuntarily, and ceases to do business. Reorganization occurs when a corporation becomes bankrupt. Reorganization may result in a restructured corporation, or in the complete dissolution of the corporation due to bankruptcy.

Partnerships, limited partnerships, limited liability partnerships, and limited liability companies are types of business ownership. These structures, although similar in many respects, differ in the liability of the partners. The Uniform Partnership Act sets forth rules governing the formation, relationships, rights, responsibilities, and dissolution of partnerships.

Unincorporated associations are a form of business ownership defined as a voluntary association of individuals acting together under a common name to accomplish a lawful purpose. Associations may also be involuntary; in such cases, the association is formed by statute or regulation, and membership is mandatory for a particular group (for example, automobile assigned risk plans). Associations are the most common organizational form of not-for-profit institutions, but associations can be organized as for-profit entities as well.

Individual members are bound by the terms of the bylaws of the association. Members do not have a say in the day-to-day management of the association, but elect directors or trustees to oversee management decisions. Association members are jointly and severally liable for torts committed by the association's agents and employees acting within the scope of their employment.

Unincorporated associations may terminate in a number of different ways. Upon dissolution, after liquidation of assets and payment of all debts and obligations, the remaining assets are distributed among members on a pro-rata basis.

ASSIGNMENT NOTES

1. 29 U.S.C., § 621.
2. 29 U.S.C., § 626.
3. 42 U.S.C., § 1981.
4. 42 U.S.C., § 1983.
5. 42 U.S.C., § 2000e.
6. 42 U.S.C., § 12101.
7. 29 U.S.C. § 794.
8. 30 F.R. 12319, September 16, 1965.
9. 29 U.S.C., § 2.6d.
10. 8 U.S.C., § 1324a-b.
11. 29 U.S.C. § 793-794.
12. 42 U.S.C. § 12101 et seq.
13. 38 U.S.C., § 2021.
14. 38. U.S.C., § 4301.
15. 28 U.S.C., §1875.
16. 15. U.S.C., §1601.
17. 29 U.S.C., § 101.
18. 29 U.S.C., § 151 et seq.
19. 29 U.S.C., § 158(d).
20. 29 U.S.C. § 141-197.
21. 29 U.S.C. § 401.
22. 29 U.S.C., § 651.
23. 29 U.S.C. § 201.
24. 29 C.F.R., § 541.0.
25. 40 U.S.C., § 276a.
26. 41 U.S.C., § 35.
27. 41 U.S.C., § 351.
28. 29 U.S.C., § 2601.
29. 29 U.S.C., § 1001.
30. Pub. L. Nos. 99-272–102-26 (codified as amended in sections of U.S.C.; see 42 U.S.C.§ 1395).
31. Pub. L. No. 111–152.
32. 41 U.S.C., § 701.
33. 29 U.S.C., § 2001.
34. Pub. L. Nos. 90-51–102-332 (codified as amended in various sections of U.S.C.).
35. 15 U.S.C., § 1681.
36. Pub. L. Nos. 104–191.
37. American Bar Association, Revised Model Business Corporation Act (RMBCA), 1984, Chapter 15.

38. American Bar Association, Revised Model Business Corporation Act (RMBCA), 1984, §2.03(a).
39. 29 U.S.C., § 1001.
40. 15 U.S.C., § 78a et seq.
41. 15 U.S.C., § 78u et seq.
42. Revised Model Business Corporation Act (RMBCA), Chapter 11.
43. RMBCA, § 13.02, 13.21, 13.22.
44. RMBCA, § 11.04.
45. RMBCA, § 12.02.
46. RMBCA, § 14.30.
47. 11 U.S.C., § 101 et. seq.
48. Uniform Partnership Act, revised (1997), § 101(6).
49. UPA, § 404.
50. UPA, § 502, 503.
51. UPA, § 301(1).
52. 42 U.S.C. §14503(a).
53. 42 U.S.C. §14503(a).