FEBRUARY 2001 CALIFORNIA BAR EXAMINATION
ESSAY QUESTIONS AND SELECTED ANSWERS

Corporations

QUESTION

Adam owns 100% of the stock of Sellco, a corporation that sells houses. Sellco's board of directors consists of Adam and his wife Betty.

Sellco owns 90% of the stock of Buildco, another corporation. Pat owns the remaining 10% of Buildco's stock. Buildco's business is home construction. Buildco's board of directors consists of Adam, Betty, and Evan. Betty is the president of Buildco and, as such, is a salaried employee. Neither Adam nor Evan is an officer or employee of Buildco.

Adam urged Buildco's other directors (Betty and Evan) to approve an arrangement whereby Buildco would build houses and sell them to Sellco at cost. Sellco, in turn, would sell the homes for a profit. Based solely upon Adam's representation that the arrangement "made sense," Buildco's board unanimously approved this arrangement. Buildco thereafter commenced constructing homes exclusively for the purpose of selling them to Sellco. Buildco sold the houses at cost to Sellco, and Sellco sold the houses for a considerable profit.

Pat objects to this arrangement because it deprives Buildco of the only source of money with which to pay dividends.

What personal and/or derivative claims can Pat reasonably assert against Sellco, Adam, Betty and/or Evan, and is he likely to succeed on each claim? Discuss.

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<u>ANSWER A</u>

<u>Shareholder Derivative Suits</u>

To bring a shareholder's derivative suit, the plaintiff must be a shareholder at the time the claim arose and throughout the course of the litigation. The shareholder must be asserting a claim for which the corporation could sue. He must make a demand on the Board of Directors to rectify the situation unless he can show that it would be futile, and may be required to make a demand on the shareholders to rectify unless the majority of the shareholders are also wrongdoers. He must then file a verified complaint with the corporation as a nominal defendant and post a bond.

Here, Pat, is seeking to rescind this agreement as it deprives Buildco any ability to pay shareholders' dividends. The company is not making a profit so not only is Pat as a shareholder injured but so is Buildco. Since Buildco's Board of Directors already approved the Buildco-Sellco arrangement it would be futile to demand of them to rescind it. Also, Sellco is the majority shareholder, which in turn is owned by Adam, who is on the Board of Directors of Buildco; thus, to ask Sellco to rescind this profitable agreement would also be futile.

<u>Pat v. Sellco</u>

Pat can sue Sellco in his individual capacity as a shareholder or under a shareholder's derivative suit if Sellco's actions as a majority shareholder injure the corporation. Traditionally a majority shareholder had no duty to minority shareholder; however, there is a trend to impose such a duty, particularly in close corporations. Close corporations are those that have a few number of shareholders and are not traded on national exchange. Here, Sellco and Pat are the only shareholders of Buildco. Nothing in the facts indicate whether Buildco is traded on national exchange.

<u>Duty of Sellco</u>

The trend is to impose a duty on the majority shareholder, not to act to the detriment of a minority shareholder. The court will look to the Entire Fairness Test, i.e., 1) fair price and 2) fair dealing.

<u>Sellco as the majority shareholder of Buildco</u>

Sellco as a company is reaping great profits at the expense of Buildco making no profits. Buildco cannot issue dividends to its shareholders, who are Sellco and Pat. Since Sellco is already making money, it is only Pat who suffers. Thus, Sellco by making this agreement has breached its duty of fairness to Pat and its duty of fairness to the corporation.

Pat should be able to disgorge the profit made by Sellco, but he will want the recovery personally rather than to Buildco; otherwise, Sellco would benefit as the majority shareholder.

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<u>Pat v. Adam</u>

Adam, as a member of the Board of Directors of Buildco, owes the fiduciary duties of care and loyalty to the corporation.

<u>Duty of Care</u>

The duty of care is the standard a reasonably prudent person would use in the course of his own business affairs. The plaintiff bears the burden of proof to show this fiduciary duty has been breached. Adam urged the other directors to vote for the agreement with Sellco saying that it "made sense." He made no further statements.

Adam may argue the Business Judgment Rule as a defense. The Business Judgment Rule excludes a director from liability where 1) he acted in good faith, 2) the decision was reasonable, and 3) it was supported by a rational basis. To be reasonable, a decision must be made after the directors investigate, analyze and deliberate over a corporate action.

Other than the statement that the agreement "made sense," there is no indication that Adam, Betty, or Evan further discussed or questioned the agreement. Thus, none of them abided by their duties of care. Thus, Adam may be liable for lost profits to Buildco as a result of the Buildco-Sellco Agreement.

<u>Duty of Loyalty</u>

The duty of loyalty is such that a director must act in good faith belief that his actions or decisions are in the best interest of the company. The duty of loyalty prohibits directors from self-dealing, i.e., profiting at the expense of the company.

<u>Company</u>

The Interested Director's Rule forbids a director from any transactions with his company unless he fully discloses the arrangement in which he has an interest and the deal is approved by a majority of the disinterested directors or shareholders. Some jurisdictions count the involved directors for purposes of a quorum; others do not. The problem here is that Buildco's board consists of Adam and his wife Betty, both of whom are interested in the transactions. Evan, the only disinterested director, was not made aware of Betty and Pat's involvement with Sellco. Thus there was no disclosure of the appropriate involvement of Adam and Betty with Sellco, and 2 of 3 board members were interested persons. Adam, as owner of Sellco, and therefore 90% owner of Buildco, could've submitted the agreement to Pat, but Pat's dissent would not have mattered.

Since Adam violated his duty of loyalty to Buildco, any loss suffered by Buildco he will be held liable for. However, if the corporation receives the profits, Adam will benefit as a company shareholder, so Pat may want to sue personally to recover.

<u>Pat v. Betty</u>

Betty, as a director and officer of Buildco, owes the fiduciary duties of care and loyalty to Buildco discussed above. She is in violation of both duties for the same reason as her husband, Adam, and will be held liable to Buildco and Pat for damages.

<u>Pat v. Evan</u>

Evan also owes the fiduciary duties of care and loyalty to Buildco as discussed above. However, as he had no personal interest in the Sellco-Buildco arrangement he will not be liable for breach of the duty of loyalty. However, Pat will be able to show that Evan breached the duty of care.

A reasonably prudent person would have further inquired of Adam and Betty about the proposed transaction, particularly where he knows Sellco is the majority shareholder in Buildco. Evan also knew Buildco would not be making any profit. Evan failed to act with the care a reasonably prudent person would in his own business affairs and, thus, is liable for any damages to Buildco.

<u>ANSWER B</u>

<u>Pat v. Sellco</u>

Pat will bring both a derivative shareholder action and a personal action against Sellco on behalf of Buildco.

In a personal action against Sellco, Pat will claim that Sellco, as a majority and controlling shareholder of Buildco, breached its fiduciary duty to him, a minority shareholder. A controlling shareholder has a general duty to deal fairly with the other shareholders and to not take any action that will affect their interest. Here, Sellco entered into a deal with Buildco that was unfair to Buildco and deprived Buildco of the only source of money with which to pay dividends. Thus, this will not only cause Pat as a minority shareholder to receive no dividends, but it will greatly decrease the value of his stock.

<u>Action to Declare a Dividend</u>

Pat may also attempt to bring an action against the company demanding that it pay a dividend. The facts tell us that the company has not been able to pay dividends because of the arrangement between Sellco and Buildco.

Corporations

A shareholder is generally not entitled to a dividend until it is declared. Furthermore, a dividend can only properly be paid out of net earnings or, in some states, excess capital. Here, there were no net earnings because the company was not making any money. Thus, payment of a dividend was not warranted.

Nonetheless, some courts may entertain an action demanding a dividend where a shareholder can show Board misconduct. For the reasons discussed below, Pat can show that the Board acted improperly. Thus, the Court may require the corporation to declare a dividend. More likely, however, the court will order a buyout of Pat's shares at a reasonable price.

Pat (on behalf of Buildco) v. Sellco - Shareholder Derivative Suit

Pat will also bring a shareholder's derivative action against Sellco on behalf of Buildco. A shareholder can bring a derivative action on behalf of the corporation if he was an owner of stock both at the time of the action complained of (here, the entering in the contract with Buildco) and throughout the course of the lawsuit. Before bringing such a suit, a shareholder must generally either make a demand on the Board of Directors to bring the suit themselves or, in some states, make a demand to the shareholders to bring a suit. A shareholder is excused from this requirement where the making of such a demand would be futile. Here, the making of the demand would be futile since a majority of the Board (both Adam and Betty) have an interest in the deal. Adam is the 100% owner of Sellco and thus would not likely approve an action to sue the company. Betty is Adam's wife and is thus indirectly interested in Sellco. Pat will have to file a complaint alleging that the demand was futile with specificity and then he will have to likely post a bond. If Pat is successful in his suit, he will be entitled to an award of attorney's fees and the company will receive any damages.

Pat's suit will allege that Sellco, as a majority shareholder, breached its duty of loyalty and care to Buildco. A majority shareholder such as Sellco stands in a fiduciary relationship with Buildco, since it in essence has control of the Board. Here, Sellco breached its duty of loyalty to Buildco by entering into a deal that was entirely unfair to Buildco and which will cause Buildco to lose a lot of money.

Unjust Enrichment

Pat will also sue Sellco derivatively alleging that the contract between Sellco and Buildco is unenforceable because it was unconscionable when made. He will bring an action against Sellco in equity to rescind the contract and for restitution in the amount that Sellco was unjustly enriched at Buildco's expenses. This would include any and all profit, which Sellco made on the sale of Buildco homes, which, according to the facts, was a considerable profit. Pat may also seek a constructive trust on the profits made off of Sellco's sale of Buildco-built homes. Because the deal was unfair to Buildco, Pat is likely to succeed on these claims.

Pat (on behalf of Buildco) v. Adam

Corporations

Pat will bring a shareholder derivative action against Adam on behalf of Buildco. Again, he will be able to show that a demand on the Board is futile because Adam is a Board Member.

Adam is a member of the Board of Directors of Buildco, and as such owes certain fiduciary duties to the corporation. A board member owes the corporation a duty of care, which requires that he act with respect to the corporation as a reasonable person would with respect to their own business affairs. He also owes a duty of loyalty, which requires that he act in good faith, and with the reasonable belief that he is acting in the best interest of the company.

Breach of the Duty of Loyalty

Adam engaged in self-dealing when he urged the other Buildco directors to approve an arrangement whereby Buildco would build houses and sell them to Sellco at cost. The facts indicate that Adam made a representation that the arrangement "made sense" and thus the Board unanimously approved the arrangement. Adam clearly had much to gain from the transaction, as he was the 100% shareholder of Sellco. A transaction benefiting a Board member is a breach of the duty of loyalty unless: (1) it is fair to the corporation; or (2) the interested Board member makes a full disclosure of his interest to the Board and a majority of uninterested Board members or shareholders approve the deal. Here, it is not clear that Adam disclosed his interest in Sellco to Evan (presumably Betty knew of his interest since she was his wife). Furthermore, this deal was not fair to Sellco as it took away all of its profits.

Breach of the Duty of Care

Adam also breached his duty of care to Buildco because, as discussed above, the deal was not fair to the corporation. As a result of his breaches of care and loyalty, Pat is likely to succeed on his claims and Adam will be liable to Buildco for the losses it sustained as a result of the bad deal with Sellco.

Pat v. Adam (directly) - Piercing the Corporate Veil

Adam is also a 100% owner of Sellco. Pat will sue Adam directly, arguing that the corporate veil should be pierced and that Adam should be directly liable for the same causes of action Buildco has against Sellco discussed above. A court will hold a shareholder directly liable where there is evidence that the corporation was a mere shell for the shareholder. The court will consider factors such as the amount of control of the shareholder and the amount of capital the company maintains. Here, Sellco's Board of Directors consists of Adam and his wife, Betty. Thus, it is clear that Adam controls Sellco. It also appears that Sellco is merely a holding company, as the facts do not indicate that Sellco has any purpose other than holding

Buildco stock and reselling Buildco homes. Thus, the interests of justice would allow Pat to pierce the corporation veil and bring a direct cause of action against Adam.

Pat (on Behalf of Buildco) v. Betty

Pat will also bring a shareholder derivative suit on behalf of Buildco against Betty: Again, because Betty and her husband are on the Board, Pat will be able to show that a demand on the Board would be futile.

Betty is both a President and Board Member of Buildco. In both roles, she also owes duties of care and loyalty to the corporation. Betty, as Adam's wife, also engaged in self-dealing, because she stands to benefit from any profit made by Adam. Thus, for the reasons discussed above with respect to Adam's breach of the duty of loyalty, Betty also breached this duty.

Betty breached a duty of good faith (to) the company also. The facts indicate that the Board approved the action "based solely on Adam's representation that the agreement made sense."

Business Judgment Rule

Under the Business Judgment Rule, a Board member will not be held to breach the duty of good faith if the facts show that the judgment was made in good faith, reasonably informed, and rationally based. Here, the decision was not reasonably informed or rationally based. Furthermore, Betty cannot claim that she relied in good faith upon the representations of another Board member, because this was not reasonable under the circumstances, particularly since Betty knew that Adam (and she) had an interest in the deal.

Pat may also be able to bring an action against Betty based upon the theory of piercing the corporate veil if she has an ownership interest in the stock (e.g., based on her community property interest).

Pat (on behalf of Buildco) v. Evan

Finally, Pat will bring a shareholder derivative suit against Evan. Pat will again argue that a demand on the board would be futile since Evan is on the Board and the deal he complains of involves both Adam and Betty.

Evan was a Board member and thus owed Buildco duties of care and loyalty. For the same reasons discussed above with respect to Betty, Evan acted in an uninformed and unreasonable manner in approving the deal with Sellco. Thus, he is liable to Buildco for any losses it incurred.

Conclusion

As a result of the above actions, Pat will successfully bring shareholder derivative suits on behalf of the company and will be able to seek damages against all of the defendants jointly. A court will rescind the Sellco-Buildco contract. In addition, the company will be entitled to unjust enrichment against Sellco and damages from the Board Members, which represents the damage caused to the company as a result of the contract.