

## Question 6

Stage, Inc. (“SI”) is a properly formed close corporation. SI’s Articles of Incorporation include the following provision: “SI is formed for the sole purpose of operating comedy clubs.” SI has a three-member Board of Directors, consisting of Al, Betty, and Charlie, none of whom is a shareholder.

Some time ago, Charlie persuaded Al and Betty that SI should expand into a new business direction, real estate development. After heated discussions, the board approved and entered into a contract with Great Properties (“GP”), a construction company, committing substantial SI capital to the construction of a new shopping mall, which was set to break ground shortly.

Although Charlie remained enthusiastic, Al and Betty changed their minds about the decision to expand beyond SI’s usual business. SI was struggling financially to keep its comedy clubs open. Al and Betty decided to avoid SI’s contract with GP in order to devote all of SI’s capital to its comedy clubs.

Last month, GP approached Charlie about another real estate project under development. GP was building a smaller mall on the other side of town and was seeking investors. Aware that Al and Betty were unhappy about the earlier contract with GP, Charlie believed that SI’s board would not approve any further investments in real estate. As a result, Charlie decided to invest his own money in the endeavor without mentioning the project to anyone at SI.

Meanwhile, Al and Betty have come to suspect that Charlie has been skimming corporate funds for his personal activities, and, although they have little proof, they want to oust Charlie as a director.

1. Under what theory or theories might SI attempt to avoid its contractual obligation to GP and what is the likelihood of success? Discuss.
2. Has Charlie violated any duties owed to SI as to the smaller mall? Discuss.
3. Under what theory or theories might Al and Betty attempt to oust Charlie from the Board of Directors and what is the likelihood of success? Discuss.

## **Answer A to Question 6**

### **Stage, Inc. (S) vs. Charlie**

1. The issue is whether Al and Betty can avoid its contractual obligations to GP under the theory that the contract is ultra vires (outside scope of corporations purpose). Ultra vires statement is the corporation's statement of purpose and can either be broad and indicate that the corporation is incorporated for the purpose of "conducting lawful business" or can be as specific as Stage, Inc.'s and indicate that "SI is formed for the sole purpose of operating comedy clubs." At common law, if a corporation acts outside the scope of its statement of purpose, the contract is voided. At modern law, when a corporation conducts ultra vires activities, the transaction is valid; however, individual directors and officers who enter into the transaction can be held personally liable. Here, SI's Articles of Incorporation include the provision that SI is formed for the sole purpose of operating comedy clubs and decided at a later point to expand into the real estate development area.

In entering into the contract with Great Properties (GP), a construction company, and committing substantial SI capital to the construction of a new shopping mall, SI has acted outside its statement of purpose because the business of real estate is wholly different and apart from the business of running comedy clubs. Thus, SI has committed an ultra vires act and, modernly, it cannot avoid its contractual obligations with SI. The corporation's assets, however, will not be liable for the act of its Board of Directors, but the directors can be held personally liable for entering into an ultra vires act. Thus, although SI may not be able to void the contract, its assets are protected and Al, Betty, and Charlie will be held personally and be responsible for damages to GP.

2. The issue is whether Charlie has violated his duty of loyalty to SI by investing money into GP's project of building a smaller mall. A director owes the

corporation a duty of loyalty to act in good faith and in the best interest of the corporation. One of the several ways a director can violate his duty of loyalty to the corporation is by usurping a corporate opportunity. Before taking a business opportunity upon himself that he reasonably believes the corporation would be interested in, the director must inform the corporation of such opportunity and wait for the corporation to reject it. It is important to note that it is not a valid defense to state that at the point the corporation was not adequately financed to take on the opportunity.

The courts use the interest/expectancy test in order to determine whether an opportunity is one that the director should believe the corporation is interested in. Here, the corporation's statement of purpose is to operate comedy clubs and not deal in real estate; thus, the business opportunity is not within the corporation's line of business. Further, given that Charlie, Betty, and Al engaged in heated discussions before approving and entering into the contract with GP and given that Al and Betty later changed their minds about the decision and sought to void its contractual obligation to GP, it was reasonable for Charlie to believe that the opportunity was one that SI was not interested in. Also, the facts also state that Al and Betty decided to devote all of SI's capital to its comedy clubs since it was short on capital and struggling financially to keep its comedy clubs open. Finally, the facts state that Charlie was aware that Al and Betty were unhappy about the earlier contract with GP and believed that SI's board (which consisted of Al, Charlie, and Betty) would not approve any further investments in real estate. Thus, given the fact that the business of real estate development was out of SI's line of business and one that they would not likely be interested in taking advantage of, Charlie did not usurp a corporate opportunity and did not violate his duty of loyalty to the corporation in investing in the smaller mall with GP.

3. The issue is whether Al and Betty could oust Charlie from the Board of Directors for fraud and gross abuse of authority and for violating his duty of due care to the corporation.

## **Duty of Due Care**

A director owes the corporation a duty of due care and must act as a reasonable prudent person and run the business as if it were his own. A director who takes action that harms the corporation (misfeasance) will be liable to the corporation unless he can defend himself under the business judgment rule. Here, if Charlie did in fact skim corporate funds for his personal activities as Al and Betty suspected, and if they could prove such activities, Charlie has violated his duty of due care to the corporation because a reasonably prudent person would not embezzle funds from a corporation. Under these facts, he will not be able to defend under the business judgment rule because that requires a showing that he acted in good faith and made a reasonably and well informed decision. It would be difficult and near impossible to show he was acting in good faith for the corporation's interest in embezzling money for personal use. Thus, he has violated his duty of due care to SI.

## **Removal of a board member for fraud and gross abuse of authority**

The issue is whether Al and Betty would be able to remove Charlie from the Board of Directors for his acts of skimming corporate funds for his personal activities. A Director may be removed from the board by court order for fraud or gross abuse of authority or by a vote of the majority of shares of the corporation for any reason. Here, given that the corporation is a closed corporation with no shareholders, Al and Betty can petition the court to remove Charlie if they can show that he engaged in fraud or gross abuse of authority as a director of SI.

Here, the facts state that Al and Betty only suspected Charlie of skimming corporate funds for his personal use and had little proof of his unlawful activities. Further, Charlie would likely argue that SI has been struggling financially and thus it is unlikely that he was able to skim funds from SI. Additionally, the fact that Charlie was able to invest his own funds into the mall project with GP may

show that he is financially stable enough to not have to skim funds from a struggling corporation. Finally, Charlie could also defend himself on the grounds that perhaps Al and Betty are acting in retaliation because they resent him for convincing them to enter into the contract with GP which they wish to rescind at this point.

Unless Al and Betty can show clear proof that Charlie has engaged in such fraud, it is unlikely that the court will oust Charlie from his position as Board Member of SI.

## Answer B to Question 6

### I. SI's Ability to Avoid the Contract with GP

SI may attempt to avoid its contractual obligations on the basis that it was an ultra vires act. A corporation may only engage in activities which fall within the stated business purpose in its Articles of Incorporation. SI's Articles explicitly stated that it was formed for the sole purpose of operating comedy clubs. The contract with GP had nothing to do with comedy clubs, but rather was for an investment of capital into construction of a new shopping mall. Traditionally, corporations could always void contracts that were ultra vires and, in a jurisdiction that retains that approach, SI would prevail on this theory. SI could make a strong argument that the use of the term sole purpose left no ambiguity as to whether SI was able to take action in the form of real estate development. Modernly, however, most corporations are allowed to engage in any legitimate business purpose and are not able to void contracts on the mere claim that they were ultra vires. This protects the other contracting party from being abandoned if the corporation determines that the contract would not be profitable and then cites their Articles of Incorporation, which the other contracting party probably had no notice of, as a reason to evade contractual obligations. Insofar as that is exactly what is happening here (Al and Betty knew what the stated purpose of their corporation was and discussed and approved entering into the area of real estate development, then had second thoughts because of SI's struggling financial position), this theory may not work. Furthermore, the shareholders would have to bring the suit and SI is a close corporation, so it may be unlikely that a court would believe that the directors acted in complete defiance of the shareholder's wishes. Finally, it could be argued that investing in real estate is a way to earn capital that would ultimately be used to operate their comedy clubs, and thus the contract was actually within the corporate purpose.

The shareholders of SI may argue that the directors had no authority to enter into the contract and that the corporation should not be bound by the unauthorized acts of its agents. This would require showing that the directors had no actual, implied, or apparent authority to contract with GP and would likely fail. The entire Board of Directors approved the decision to expand in the direction of real estate development after heated discussion and subsequently entered the contract with GP. The directors of a close corporation most likely have implied, if not actual, authority to conduct the business of the corporation by approving and entering contracts. The role of the Board is to manage the corporation's affairs and make decisions about actions to be taken by the corporation. Often the actual authority to pursue those approved actions would be vested in a corporate officer like a president, but the small size and nature of a closely-held corporation typically implies a more fluid power structure. If there are, in fact, officers who are expressly vested with exclusive authority to enter [into] contracts on behalf of SI and none of the directors hold those officer positions, then SI may be able to avoid the contract on the basis that it was an unauthorized act. However, at the very least, it is likely that the directors held themselves out to GP as having authority to bind the corporation such that GP could argue they had apparent authority and prevail in enforcing the contract. Finally, the Directors did approve the decision, so it is likely that they ratified the contract in some way even if it was entered into by someone without authority.

The easiest way for a corporation to avoid a contract is not present here. If SI had not yet been formed and someone like Charlie had entered into the contract as a pre-incorporation contract, SI could claim they were not bound if the corporation never ratified the contract or received the benefit of it. SI has been properly formed and the directors approved the contract so this defense is not available.

## **II. Charlie's Potential Breach of Duties to SI**

As a director of SI, Charlie owes the corporation the fiduciary duty of loyalty which involves a duty to avoid usurping corporate opportunities. When a director learns of an opportunity based on his position as director (Charlie was approached by GP about "another" real estate project of theirs), he may not personally benefit from the knowledge by acting on the opportunity until he presents it to the corporation and allows the corporation to reject it. Here, Charlie will claim that he knew Al and Betty were unhappy with the earlier contract and that they wouldn't approve any further contracts with GP. However, Charlie's mere "belief" that the board would not approve further contracts does not absolve him of the duty to report the opportunity to them and wait for them to reject it. Considering the circumstances of SI's financial difficulties, they probably would have rejected it immediately and Charlie could proceed on the investment with his own money after fully and properly disclosing it to SI. Instead, Charlie never mentioned the project to anyone at SI, but went forward with investing his own money into the opportunity. Traditionally, the financial inability of the corporation to take advantage of the opportunity may have been an adequate defense to a director accused of usurping a corporate opportunity, but even if that was the case here, this defense is no longer a good one. Charlie breached his duty of loyalty.

The other fiduciary duty which Charlie owes SI, the duty of care, could also be potentially implicated in this situation if Charlie denied the GP smaller mall contract on behalf of SI and it would have been a good investment. The duty of care requires a director to act as a reasonably prudent person would in similar circumstances. As discussed above, Charlie should have presented the opportunity to SI's board and let them vote to refuse it. Given SI's financial struggles, it would have been a proper exercise of business judgment to decline the opportunity and a court would not question Al, Betty, or Charlie's decision to not enter the contract under the business judgment rule.



### **III. Removing Charlie from the Board of Directors**

Betty and Al will attempt to oust Charlie from the Board of Directors on the theories that he breached his fiduciary duties. If they know about his usurpation of the opportunity to enter a contract with GP related to the smaller mall, they would be able to show that he breached his duty of loyalty. If he is, in fact, skimming corporate funds, then he is self-dealing, another violation of the duty of loyalty which exists when a director reaps personal advantage at the expense of the corporation. They would also argue that he breached his duty of care by acting unreasonably in his pursuit and advocacy of the new business direction of real estate development. A director has the responsibility of acting in the corporation's best interests as a reasonably prudent person would in the investments they make. Betty and Al would argue that the investment of a "substantial" amount of SI's capital into real estate development (especially given that their sole purpose is operating comedy clubs) would not escape scrutiny and condemnation, even under the business judgment rule. However, Al and Betty agreed to taking SI in that new direction and no matter how "heated" the discussions were, they eventually approved the decision.

Importantly, Betty and Al cannot oust Charlie from the Board of Directors by their own act because only shareholders can remove a director. Thus, Al and Betty would need to bring all of the information they have about Charlie's breaches of fiduciary duties and any other reasons they have to desire his removal to the shareholders and let the shareholders address the question. A majority vote of all shareholders would be required for Charlie's removal. Considering what appears to be bad financial judgment on Charlie's part, the obvious breaches of the duty of loyalty, and the fact that shareholders can remove a director with or without cause, the shareholders would probably vote to remove him and Al and Betty would succeed in their ousting, although indirectly.