

Question 5

Bob owns 51 percent of the shares of Corp., a California corporation. Cate owns 30 percent. Others own the remaining shares.

Bob and Cate have entered into a shareholder agreement stating they would vote their shares together on all matters, and that, if they fail to agree, Dave will arbitrate their dispute and Dave's decision will be binding. Bob and Cate also executed perpetual irrevocable proxies granting Dave the power to vote their shares in accordance with the terms of the shareholder agreement. Attorney Al handled Corp.'s incorporation and drafted the shareholder agreement and the proxies.

Bob and Cate have been able to elect the entire board of directors every year. The board currently consists of Bob, Cate, and Bob's wife, Wanda. Bob and Wanda decided, as directors, to sell substantially all of Corp.'s assets to Bob's sister, Sally. Cate thinks the price is too low. Bob claims he no longer regards their shareholder agreement as binding. He has gone to Al for advice in the matter, and Al has agreed to provide it.

At the shareholders' meeting at which the matter is to be put to a vote, Bob announces he is voting his shares in favor of the sale. Dave says that since Bob and Cate disagree, he is voting the shares against the sale.

1. Is the shareholder agreement between Bob and Cate enforceable? Discuss.
2. Are the perpetual proxies executed by Bob and Cate enforceable? Discuss.
3. Would any sale of Corp.'s assets to Sally be voidable? Discuss.
4. What ethical violations, if any, has Al committed? Discuss. Answer according to California and ABA authorities.

Answer A to Question 5

1. Shareholder agreement between Bob (B) and Cate (C)

A shareholder's agreement is an agreement whereby shareholders agree to combine their votes for voting matters related to their rights as shareholders. The agreement is less formal than a voting trust and requires simply that the shareholders agree to the course of action. Where a voting trust is required to notify the Secretary of the Corp. the shareholder agreement need not be recorded by the Secretary. In addition, where a voting trust is only good for 10 years, a shareholder agreement has no durational requirement.

In this case, B and C have entered into a shareholder agreement stating they would vote their shares in agreement or else submit to Dave to arbitrate any disputes. Dave's decision would be binding. While B and C have entered into a valid shareholder agreement, as they can agree to arbitration to settle disputes, it is necessary to look at Dave in this instance.

It is not clear what, if any, relation Dave has to the corporation. If Dave is familiar with the corporation, then there would be no issues with him arbitrating disputes. If he is a true "outsider" he may not have the knowledge and ability to make the informed decisions in the corp's best interest. In this case, B and C would violate their fiduciary duties to the corp. and the agreement would be ineffective.

2. Perpetual Proxies

A proxy is an agreement between shareholders to have one vote on their behalf. The corp. must be notified and a proxy is valid for 11 months, unless otherwise agreed. An irrevocable proxy requires that the proxy be labeled irrevocable and must be coupled with an interest.

In this case, the proxies are perpetual and irrevocable. As stated above, an irrevocable proxy must be labeled such and be coupled with an interest. It is not clear here what, if any, interest Dave received as part of the proxy agreement, or if the proxies were

labeled irrevocable. If neither requirement was met, the irrevocable proxies would be unenforceable.

If both conditions were satisfied, it would be necessary to determine if the corp. was notified. In addition, proxies typically last for only 11 months. Because the facts state this is perpetual, it is likely that the courts would find this unenforceable.

3. Sale of Corp. Assets

Directors have a duty to manage a corporation. Directors also have fiduciary duties of Care and Loyalty in managing the corporation. Directors may be insulated from violating the duty of care by the Business Judgment Rule.

Duty of Care

Directors have a duty to manage a corporation as a reasonably prudent person would in handling his/her own affairs. Directors must act in the best interest of the corporation.

Here, it is not clear from the facts if Bob and Wanda, as directors, are acting in good faith as reasonably prudent persons would in their own affairs.

Business Judgment Rule

Directors are protected from liability under the Business Judgment Rule when they act in the corp.'s best interest and make a reasonable, innocent mistake.

Here, because it is not clear if Bob and Wanda acted in good faith, it is not possible to determine if this is a simple mistake.

Duty of Loyalty

A director has a duty of loyalty to his corporation, which means that without full disclosure and independent ratification, a director cannot engage in a self-dealing transaction or usurp a corporate opportunity.

In this case, Bob and Wanda, as directors, have voted to sell substantially all assets to Sally, who is Bob's sister. A self-dealing transaction is one that benefits the director or his family members. In order for the transaction to be valid, there must be independent ratification, as defined above. It would be impossible to obtain independent ratification as 2 out of the 3 Directors will not be independent. Both Bob and Wanda, Bob's wife, stand to benefit from the self-dealing transaction, and it does not appear that there was full disclosure, so independent ratification is impossible.

Controlling Shareholders

Controlling shareholders have fiduciary duties to other shareholders in a corporation. As defined above, the controlling shareholder has a duty of loyalty and care as fiduciary duties.

As described above, Bob will have violated his fiduciary duty of loyalty to the corp. by engaging in a self-dealing transaction. In addition, courts have held controlling shareholders liable for looting a corporation in the event the corp. is substantially sold to a 3rd party and that party loots the company. It is not clear here what Sally will do.

Fundamental Change

A corporation must hold a special meeting when a fundamental change is proposed for that corporation. A fundamental change would include selling substantially all assets to another corporation. Therefore, the corporation would be required to have a special meeting.

A special meeting requires that a special notice be mailed to shareholders. This notice must include the reason for the special meeting, date and time, and place. It is important because no other business can be discussed at a special meeting that was not included in the notice. In addition, holding the meeting is important because it gives rise to appraisal and dissenter rights whereby the corporation would be required to repurchase a dissenter's shares.

Because Bob violated his fiduciary duties as a director and controlling shareholder, and because the corp. was undergoing a fundamental change without a properly scheduled special meeting, any sale to Sally would be voidable.

4. Ethical Violations

A. Duty of Loyalty

Al owes a duty of loyalty to the corporation. Al has drafted the incorporation of the corp. and has drafted agreements on behalf of the corporation. Therefore, Al's client is the corporation.

Al has a potential conflict in that he represented the corporation and then drafted the shareholder agreement and proxy on behalf of 2 shareholders. This is permissible under ABA rules and CA rules whereby an attorney can represent multiple parties if he reasonably believes that he can provide necessary legal services without impact. The attorney must also get this consent in writing.

Al has another potential conflict by representing Bob at a later time. As stated above, an attorney can represent multiple parties if he reasonably believes that representation of both will not impact either party. He must get consent in writing. Al would have violated his duty of loyalty if he did not get consent in writing.

This potential conflict would become an actual conflict when Bob has gone to Al for advice and Al agreed to provide it. Al previously represented Bob and Cate in drafting a shareholder agreement and proxies. CA Rules of Ethics strictly prohibits an attorney from representing a client when that client is being represented by the same attorney. Only when the matter ends can the attorney represent another client whose interest is adverse to a current client.

Al will have violated his duty of loyalty.

Duty of Confidentiality

An attorney has a duty to keep all communications with a client confidential. When an attorney represents 2 parties, and one party then approaches the attorney for representation on a similar matter, the attorney will not be able to represent the client because he has confidential information from both clients.

Here, Al arguably represents both parties, as he has drafted a shareholder agreement and proxy for both Bob and Cate. Al should advise both parties to obtain separate Legal Counsel instead of continuing to represent them, as by doing so, he may disclose confidential information received by Cate in representing Bob.

Duty of Competence

An attorney should have the skill and training to be able to competently represent a client. If not the attorney should be able to receive such training in a reasonable time.

In this case, as described above, it is not clear if the proxies were drafted correctly; therefore Al may have breached his duty of competence.

Answer B to Question 5

SHAREHOLDER AGREEMENT

Shareholder agreements in which shareholders agree to vote their shares together are valid, although historically they were not permitted and voting trusts were required. They must be in writing and signed by both parties. Shareholder agreements are governed by regular contract principles, and are not revocable unless as a contract they would be revocable. A valid contract requires mutual assent and consideration. Bilateral contracts are contracts in which the parties exchange promises, and the promises can constitute consideration for the contract.

In this case, the shareholder agreement appears to be in writing, and signed by the parties. It was prepared by an attorney, Al, and so presumably has been validly drafted. In this case, the shareholder agreement is a mutual agreement for Bob and Cate to vote stocks together. It appears that there has been valid mutual assent to the contract, including offer and acceptance. Because the parties have exchanged promises to vote together, it is a bilateral contract. As a result, the contract is supported by consideration based on the exchange of mutual promises to vote together or have disputes decided by arbitration. Thus, Bob would be unable to revoke the shareholder agreement at will, and Cate could sue for damages or for specific enforcement of the agreement.

PERPETUAL PROXIES

PROXY GENERALLY - A proxy agreement must be in (1) writing, (2) signed by the party whose shares are affected, (3) addressed and delivered to the corporation's secretary, (4) clearly state they are delegating the authority to vote.

In this case, it appears that the requirements for a valid proxy agreement have been met. The agreement appears to be in writing, the problem notes it was executed so presumably is signed, it clearly states the procedures for the proxy, indicating that the

shares will be voted in line with the shareholder agreement. Although the facts do not indicate whether the proxy was filed with the corporation, because Al the attorney assisted, presumably the requirement was met.

IRREVOCABLE PROXY - A proxy is normally for a duration of 11 months, and will be revocable at will. To be irrevocable, a proxy must be (1) supported by an interest and (2) clearly state it is irrevocable.

In this case, it appears that the proxy agreement did state that it was irrevocable, and thus the agreement has met the second requirement. However, there is no indication that the agreement was supported by any interest. Normally, the interest must be some exchange for value or, for example, a situation where the record date holder sells his shares to the owner and executes a proxy, and thus the new owner's purchase creates an interest. In this case, there is no interest to support the agreement. Cate may argue that the exchange of promises provides consideration for the proxy in the form of the mutual promises, as was the case for the shareholder agreement, and therefore that the mutual promise is a sufficient interest to meet the element and make the proxy irrevocable. However, the exchange of promises is not a sufficient interest to support a proxy as being irrevocable because the promisor has no interest in the shares to which she is making a promise, and therefore this element has not been met. As a result, Bob is free to revoke the proxy agreement at will.

While the proxy agreement would be revocable because it is not supported by an interest, the shareholder voting agreement would not be. As a result, Cate could sue Bob to enforce the agreement and then Dave would have the power as the arbitrator to vote the shares under the agreement as he saw fit.

WOULD SALE OF CORP BE VOIDABLE

FUNDAMENTAL CORPORATE CHANGE - A fundamental corporate change includes a (1) merger, (2) consolidation, (3) amendment of the articles of incorporation, or (4) a

sale of all or substantially all of the business assets. A fundamental corporate change must be approved by a majority of all shareholders at a special noticed meeting in which notice of the change was given before the meeting. Additionally, the corporation must give dissenters rights of appraisal if the transaction is approved.

In this case, the sale of substantially all of Corp.'s assets is a fundamental change and thus must be approved by a majority of all shareholders in Corp.

DECISION OF DIRECTORS - All decisions of directors must either (1) be approved at a board meeting or (2) be approved by unanimous written agreement of the board. At a board meeting the majority of all directors must be present to have a quorum. A resolution will be adopted if a majority of the directors present approve. Before a fundamental corporate change is brought before a special meeting of shareholders, it must be approved by the board of directors.

In this case, the facts indicate that Bob and Wendy agreed to the sale, but that Cate disagreed. It is unclear if they met at a board meeting and the majority of directors, Bob and Wendy, approved. This would be a requirement that if not met, could lead to a rescinding of the transaction or allow Cate and other shareholders to sue Bob and Wendy for losses suffered as a result of the transaction.

DUTY OF LOYALTY OF DIRECTORS - A Director has a fiduciary duty of loyalty to a corporation to not engage in self-dealing or usurp business opportunities. Self-dealing includes transactions in which the director has a conflict of interest.

In this case, Bob is a member of the board of Corp, and thus has a duty to not engage in self-dealing.

CONFLICT OF INTEREST TRANSACTION - A conflict of interest transaction is one in which the director or his close relative is (1) a party to the transaction, (2) has a financial interest so closely linked to the transaction that would reasonably be expected to affect

her judgment, or (3) is a director, officer, employee or agent of the other party to the transaction and the transaction is of such importance that it would normally be brought before the board. If a Director enters into a transaction in which he has a conflict of interest without approval, that transaction can be rescinded and the director can be held liable for any losses to the shareholders.

In this case, Bob is engaging in a sale of Corp's assets to Sally, Bob's sister. Thus Bob, a director, is engaged in a transaction in which a close relative, his sister Sally, is a party to the transaction, and therefore Bob would have a conflict of interest in the transaction. Thus, unless Bob has the transaction approved, it could be rescinded. Furthermore, because Wanda is also a director, and Sally is also a close relative of hers, her husband Bob's sister, she would also have a conflict of interest.

CONFLICT APPROVAL - A conflict of interest transaction will be considered approved if (1) after full disclosure a majority of the disinterested directors, if more than one, approve; (2) after full disclosure a majority of disinterested shareholders approve; and (3) if it is fair under the circumstances.

DISINTERESTED SHAREHOLDERS - In this case, it is unclear if Bob fully disclosed. Even if he did, the transaction would not be considered to be approved by shareholders if Bob used his 51% of shares to approve the sale because he is not disinterested due to his conflict of interest created by his sister, Sally, being the purchaser. Thus, a majority of the outstanding, the remaining 49% would need to approve. Because Cate owns 30% of the shares, she could essentially block the transaction because she owns more than 50% of the disinterested shares. Thus approval by disinterested shareholders would not be possible.

DISINTERESTED DIRECTORS - Similarly, both Wanda and Bob are considered to have a conflict of interest. Therefore the only disinterested director is Cate. Cate would not approve the transaction and furthermore, for a transaction to be approved by the majority of disinterested directors there must be more than one disinterested director.

Thus, the directors could not approve the transaction because 2 of the 3, Bob and Wanda, are not disinterested.

FAIR - As a result, the only way the transaction could be upheld is if under the circumstances at the time it was entered into it was fair. In this case, Cate claims that the price is too low, but there is no indication if this is really the case. If Bob could show that the price was fair, and thus the transaction was fair then the conflict of interest transaction would be upheld despite the lack of approval from disinterested shareholders and directors.

ACTING AS SHAREHOLDER NOT DIRECTOR - Bob may argue that in voting to approve the sale he is acting as a shareholder, and not as a director and thus does not owe the same duties to the corporation. However, this argument will fail because (1) a director has a duty of loyalty to the corporation even when selling his own shares, and (2) Bob may also have a duty as controlling shareholder.

DUTY OF CONTROLLING SHAREHOLDER - While a shareholder is normally not liable beyond the value of their shares, a controlling shareholder may be liable towards other shareholders if she uses her power in a way to disadvantage the minority shareholders. This is because a controlling shareholder has a fiduciary duty to minority shareholders to not use their controlling share to the minorities' disadvantage.

In this case, because Bob owns 51% of the shares, he is a controlling shareholder. He has a fiduciary duty to not use his controlling share to gain unfair advantage over the minority shareholders. This would likely include selling substantially all of Corp.'s resources to his own sister, Sally, if the price was not fair. Thus, even if Bob is successful in arguing that he is not under a duty as a director when trading on his shares, as a controlling shareholder he would still be liable for breaching his fiduciary duty.

AL'S VIOLATIONS

DRAFTING ARTICLES AND SHAREHOLDER AGREEMENTS - When an attorney represents a corporation, he represents the organization itself and not the directors or officers. While an attorney may also represent the directors and officers separately, these representations are governed by normal rules of conflict of interest. A lawyer may represent two clients so long as he reasonably believes he can do so and that there is no conflict of interest between them. If there is a conflict of interest he must (1) reasonably believe he can adequately represent each of them, (2) disclose the conflict, under the Cal RPC such disclosure must be in writing, and (3) must get the clients' consent in writing. While potential conflicts of interest can be waived, actual conflicts normally may not be waived by the parties because a reasonable attorney would not believe they could represent clients with an actual conflict.

In this case, there is no conflict of interest, potential or otherwise, between Corp and its shareholders. Therefore, Al did not violate any rules by drafting the agreement.

ADVISING BOB -

CONFLICT BETWEEN BOB AND CATE-

CURRENT CLIENTS- As noted previously a lawyer may not represent one client who has a conflict of interest with another client unless (1) the lawyer reasonably believes he can adequately represent each of them, (2) the lawyer discloses the conflict, under the Cal RPC such disclosure must be in writing, and (3) the client consents in writing. While potential conflicts of interest can be waived, actual conflicts normally may not be waived by the parties because a reasonable attorney would not believe they could represent clients with an actual conflict.

In this case, it is unclear who Al represented in the drafting of the shareholder agreement and whether or not he continues to represent Cate. If Al does represent Cate

then agreeing to represent Bob in this matter constitutes a current conflict between clients, and Al would have to provide written disclosure and receive written consent. However, even if he did he would not be able to maintain representation because a reasonable lawyer would not believe he could adequately represent both Cate and Bob because their conflict is not just potential, it is an actual conflict.

FORMER CLIENTS- A lawyer may not represent a current client (1) in a matter that is the same or substantially the same as a matter he represented a former client, and (2) the current client's interests are adverse to the former client unless he gets written consent from the former client.

In this case, if Al represented Cate in drafting the shareholder agreement and proxy agreement then he would likely be in violation of this rule. Cate is a former client, and the matter now in dispute is whether the very agreements Al drafted for Cate are valid, and thus it is the same matter. Furthermore, Bob's position, that the agreements are not binding, is directly in conflict with Cate's interest. As a result Al could not represent Bob without Cate's approval because doing so would be in violation of his duty of loyalty to a former client.

Al could also be disqualified if he had gained confidential information in representing Cate, though that is unlikely here, considering he was drafting a shareholder agreement.