

Question 4

Testco, Inc. conducts market surveys, and is solely owned by Amy, Ben, and Carl. Each paid \$50 for one-third of Testco's no-par shares. Amy and Ben, respectively, are Testco's president and secretary and its only two directors. Carl holds no office and is not involved in any aspect of Testco's business. Amy and Ben are scrupulous about holding directors' meetings to conduct corporate business and to make monthly distributions to the shareholders of almost all cash on hand. As a result of the latter practice, Testco has little cash on hand and frequently finds itself in the position of negotiating extensions for payment of its debt.

While Ben was on vacation, Examco called Amy, asking to enter into a one-year contract with Testco. Amy said that if Examco would agree to a ten-year contract, Testco would grant its standard fifty-percent discount. Examco agreed, and Amy signed the contract in the following manner: "Testco, by Amy, President." When Ben returned, he said that he had thought for some time that Testco's standard fifty-percent discount was unwise, and convinced Amy to revoke the contract with Examco.

Examco wants to sue Testco, Amy, Ben, and Carl for damages. If found liable, Testco will not be able to pay.

On what theory or theories may Examco bring an action for recovery of damages against:

1. Testco? Discuss.
2. Amy, Ben, and Carl as individuals? Discuss.

QUESTION 4

Answer A

Examco v. Testco

Breach of Contract

If Testco is to be found liable to Examco, it will be on a breach of contract theory. Breach of contract occurs where there is a valid contract, a breach, and then damages as a result of the breach. A valid contract exists when there is an offer, acceptance, consideration, and no defenses to contract formation.

Here, Examco asked Amy to enter into a ten-year contract, which Amy then signed on behalf of Testco. Amy agreed that in consideration for the length of time of the contract, that she would give Examco a fifty percent discount. Thus there was a valid contract between both Examco and Amy on behalf of Testco.

A breach of the contract occurred when Amy anticipatorily repudiated the contract between the two companies. It is likely that Examco will receive damages as a result of not getting the benefit of their bargain with Testco; thus there is a valid action for breach of contract. However, Testco will only be bound to this contract if Amy had authority to enter into the agreement with Examco (see below).

Agency

Agency is where a principal with capacity manifests assent that an agent act on behalf of the principal for its benefit and subject to its control followed by the agent manifesting assent to do the same. Here, Amy as president of Testco was an agent of the company since she was appointed to the position of president (assent), working for the benefit of the company, and subject to the control of the board of directors. Thus

Amy was an agent of Testco and Testco will be liable on the contract with Examco if she had some form of authority to enter into the contract.

Amy's Authority

A principal is liable on the contracts entered into by their agent on their behalf so long as the agent has authority. Authority can come in three forms: actual authority, apparent authority, and ratification.

Actual Authority

Actual authority is the authority that the agent reasonably believes that they have based upon the manifestations of the principal. Actual authority can be express or implied.

Express Actual Authority

Express actual authority is the authority given from the four corners of the agency agreement.

Here, there is no agency agreement between Amy and Testco; however, there is probably some sort of express manifestation of assent in the bylaws or articles of incorporation of Testco. Usually in the corporate setting, when a contract such as this is entered into, the board of directors will usually vote to pass a resolution to give the president of the company the authority to enter into the contract. However, there was no such board resolution here since Amy did not consult with Ben prior to signing the contract. Since there are no facts going to express authority, a different form of authority must be found to bind Testco to the contract with Examco.

Implied Actual Authority

Implied actual authority is the authority that the agent reasonably believes that they have based upon necessity in order to carry out their express authority, customs of the position held by the agent, and by prior dealings with the principal.

Here, Amy, as president of Testco, would likely have implied actual authority to enter into the Examco contract by virtue of her position as president of the company. Presidents of corporation[s] customarily have the authority to enter into binding contracts with other companies. Additionally, it is necessary for a president to enter into contracts with other companies in order to make the corporation profitable. Making the corporation profitable is a duty of the president of the company and thus it is necessary that Amy entered into this contract in order to fulfill that duty.

Testco will argue that, although Amy was president and had authority to enter into smaller contracts, this contract was different in the fact that it went ten years into the future and that Amy was giving such a huge discount. Testco will argue that this sort of contract required express board resolution and thus Amy could not have reasonably believed to have authority to enter into it. However, the facts state that Amy gave the "standard fifty-percent discount;" thus it seems like this was a regular occurrence of the corporation to enter into contracts of this nature. As such there was implied actual authority.

Apparent Authority

In the event that the court finds that there was no actual authority, they could find apparent authority to bind Testco to the contract. Apparent authority is the authority that a third party reasonably believes that the agent possesses based upon the manifestations of the principal. One form of manifestation by the principal would be the position that the principal has placed the agent in is a position that is usually associate[d] with the grant of authority.

Here, Examco can successfully argue that Amy had apparent authority do [sic] to her title of president of Testco. When they were entering into the contract they dealt

directly with the president of the company. Additionally when the contract was signed, it was signed "Testco, by Amy, President". As such, it would have been reasonable for Examco to believe that Amy had apparent authority to enter into the contract.

Ratification

Another form of authority is ratification. Ratification occurs where after the agent has entered into a contract, the principal has knowledge of it and accepts its benefits. Here, when Amy told Ben about the contract, he told her to immediately revoke it. Thus there was no board resolution ratifying the contract with Examco and there will be no finding of authority based upon ratification.

Conclusion

Since there is at least the finding of apparent authority on behalf of Amy for Testco, Testco is bound to the contract with Examco and will be liable to them on a theory of breach of contract.

Examco v. Amy, Ben, and Carl as Individuals

Liability of Shareholders

Shareholders of a corporation are only personally liable for the cost of their shares of stock in the corporation. They are not personally liable for the corporation's debts, liabilities, or obligations. Thus, Amy, Ben, and Carl will not be liable to Examco personally unless the corporate veil can be pierced (see below).

Piercing the Corporate Veil

In order to recover from the personal assets of the shareholders of Testco, Examco will have to make a sufficient showing to pierce the corporate veil. The corporate veil is pierced based upon a variety of factors. These factors include whether

there was fraudulent conduct by the shareholders, whether the corporation is undercapitalized, whether the corporation is simply an alter ego of the shareholders, and whether the creditor of the corporation is an involuntary creditor.

Fraud

Fraud is the misrepresentation of a material fact known to be false with the intent to induce some action upon another where the other suffers damages. Here, the facts do not suggest that Amy made any misrepresentations when entering into the contract with Testco; thus a pierce of the corporate veil will not be achieved on the ground of fraud.

Alter-Ego

A corporation acting as the alter ego of the shareholders will be found where the shareholders forgo the usual formalities of corporate status. Here, Testco has officers and a board of directors; however, the facts state that Amy and Ben are "scrupulous" about holding director's meetings to conduct business. Thus it could be seen that they have foregone the formalities of a usual corporation. Thus this factor weighs in favor of a pierce of the veil.

Undercapitalization

Undercapitalization of a corporation occurs where the corporation does not keep enough surplus cash on hand in order to pay the foreseeable liabilities of the corporation. Here this factor weighs heavily on favor of piercing the veil since all of the extra cash on hand was distributed to the shareholders. It was foreseeable that eventually a contract would be breached or some mistake would be made causing liability on behalf of Testco. Thus since there was not enough cash on hand to pay the liability to Examco, the veil may be pierced.

Involuntary Creditor

An involuntary creditor is usually a tort victim or tort judgment holder. Here, Examco had every opportunity to inspect records and the financial security of Testco prior to entering into the contract. Thus they were not an involuntary creditor.

Carl's Liability

Usually a shareholder that is uninvolved with the daily operations of the company will not be held liable as a result of veil piercing. Here, Carl did not participate in any of the activities of Testco except to receive distributions from the company. Thus he may or may not be held liable to Examco.

Conclusion

The factors presented above weigh in favor of piercing the corporate veil; thus Examco may go after the shareholders of Testco, with the possible exception of Carl.

QUESTION 4

Answer B

The remedies that are available to Examco for Testco revocating their agreement depend on the legal status of the agreement and whether Amy had the authority under agency principles to bind Testco to the agreement if it can be legally enforced. The agreement concerns money which is proper consideration from Examco to Testco for providing its market survey services. There were negotiations between both parties regarding the price and discount that would be offered as well as the length of the contract. Both parties agreed on the 10 year terms and the 50% discount. Amy signed the contract. This is enough to create a legally enforceable contract if Amy had the authority to enter into contracts on behalf of the corporation — this is determined by principles of agency which I now analyze.

Amy as Agent of Testco

An agent is a person or entity that acts on behalf of another, the principal. For an agency relationship to exist there must be assent by the agent to the existence of the relationship and its duties, the agent must act for the benefit of the principal, and the principal must control the agent's actions on its behalf.

Here Amy is the President of the corporation. She has assented to the relationship by accepting this employment and the duties and privileges (e.g., salary, benefits) that come along with it. She acts for the benefit of the corporation in this capacity. This is because by virtue of her position in the management of the corporation as an officer she has a Duty of Care to the corporation and must act in good faith and as a reasonably prudent person would with his or her own business. Further, in addition to this Duty of Care she also has a Duty of Loyalty whereby she must act in the best interest of the corporation before all others including herself. These duties insure that Amy's actions should be for the benefit of the corporation in all actions she does on its behalf. Third, the corporation itself has control over Amy. This is because Amy is an employee of the corporation and serves at the will of the board of directors and at its direction. Her

employment can be terminated at any time by the board or shareholders (by majority vote at a meeting or special meeting).

Because the three prongs of agency have been satisfied, Amy is an agent of the corporation. As such, she may be able to bind the corporation to agreements depending on whether she has the appropriate authority to do so.

Actual Express Authority

Actual express authority is the authority that is expressly given to an agent by a principal for some particular task. This authority can be orally conveyed or it can be in writing. According to the equal dignity rule, if a writing would be required for the transaction or action at issue if the principal were to act directly for himself instead of through his agent, the principal is required to expressly give the agent express written authorization to undertake the action on the principal's behalf.

There is no factual information to suggest that Amy had either oral or written actual express authority to enter into contracts on behalf of the corporation. Further, even if the board or shareholders expressly passed a resolution stating that Amy had such authority, or that the President of the corporation has such authority, the resolution and authorization it granted must be in writing. This is due to the equal dignity rule. Because the contract that was actually signed by Amy called for her firm's services to be rendered over the course of 10 years, the Statute of Frauds requires a signed writing (because performance necessarily will take longer than one year by the terms of the contract). Amy herself signed such a writing. However, there is no evidence to suggest that the board gave her such written authorization.

Thus, Amy did not have actual express authority to enter into the contract on behalf of Testco on the basis of the factual information given. However, she may have had implied authority to do so.

Actual Implied Authority

Actual implied authority is that authority which is necessary for it to carry out its expressly authorized actions and in fact was implied from that authorization, or authority that comes with virtue of the position the agent has with respect to the principal and the duties associated with this position.

Here if Amy had received express authority from the board to manage all sales regarding Testco's service contracts, she would have the implied authority to enter into a contract with Examco at terms that she determined because such authority is necessary to manage all sales of service contracts. However, since there is no evidence of an express authorization this prong of implied authority will not suffice.

The second possibility that will give rise to implied authority is if the agent by virtue of his or [her] position and the duties associated with such a position has authority to enter into a contract. Here Amy has been appointed by the board of directors of Testco as its president. As such, she is the chief executive officer of the corporation and is responsible for overseeing all day-to-day operations of the corporation. By virtue of this position and the duty that comes with it — to manage the corporation — Amy has the implied authority to act on the corporation's behalf in her management of the corporation.

Thus, when she signed the contract with Examco she was acting with the implied authority granted to her by virtue of her position as president charged with management of the company. On this basis, Testco can be held liable for a breach of contract.

Apparent Authority

Apparent authority is the authority that arises when a third party reasonably believes that the agent has such authority because the principal "cloaked" the agent with the appearance of such authority.

Here Amy is the president of the corporation. She holds herself out as such when she entered into the contract with Examco. By virtue of permitting Amy to negotiate such service agreements, which appears to be the case given Ben's objection to the usual 50% reduction, Testco was holding her out to third parties as having the authority to enter into such agreements. Further, Amy signed the contract with Examco as "Testco, by Amy, President." Acting in the cloak of authority given to her by Examco by virtue of her ability to negotiate sales service agreements with customers and by virtue of the apparent authority she has as Testco's president, she had the apparent authority to bind the corporation when contracting with a third party, here Examco, who reasonably believed she had such authority.

Thus, because Amy had the implied authority and apparent authority to enter into this contract on Testco's behalf and she did so, Testco is liable for breach of the contract by its revocation. Examco can seek damages directly against Testco.

2) The determination of whether there is liability for Amy, Ben, and Carl will depend on whether there is director liability for Amy and Ben in their capacities as directors and officers of the corporation. And for all three, Amy, Ben, and Carl based on whether the veil can be pierced for purposes of their limited liability.

Piercing the Veil

Directors, managers, and shareholders are generally not liable for their actions to a third party that is suing the corporation. That is true, unless the corporate veil that insulates them from liability can be pierced. Piercing of the corporate veil is an extraordinary remedy that is only awarded when the directors, officers, and shareholders do not provide for sufficient capital or insurance for the corporation's debts and where the corporation is but an alter ego of the shareholders. The latter can be established in part by the officers and managers not observing sufficient corporate formalities.

Undercapitalization

Directors are not permitted to make a dividend distribution that puts the corporation at risk for insolvency. In fact, the prohibition against this is so strong that the directors will be personally liable for such a distribution unless they believed the corporation was not at risk of insolvency based on the financial officer's report which they are allowed to reasonably rely upon.

Amy and Ben

Here Amy and Ben voted in favor of making monthly distributions that put little cash on hand and leading to the corporation needing to negotiate extensions for payment of its debt. This put the corporation at risk for insolvency because if a large judgment came through or one of its creditors was unwilling to renegotiate its payment terms. Amy and Ben as shareholders and directors did this to benefit themselves at the expense of the corporation. This violated their duty of loyalty to act in the best interests of the corporation above even their own. They did not do this because they held 2/3 of the shares and put the corporation at risk of insolvency merely to line their own pockets with distributions. This would also violate their duty of care to the corporation because they would not put themselves at such risk of insolvency in the management of their personal business. This undercapitalization will lead to Examco likely not being able to recover its damages for breach of its contract. It should be permitted to recover its expectation damage measure, the amount it reasonably expected to profit from the agreement at the time it was entered into.

Courts are more likely to pierce the veil for a tort action than they are for a contract dispute.

Here we have a contract dispute between a corporation and another corporation. It is due to the fact that Amy and Ben determined that the contract would not be profitable. While normally this would not be such an egregious breach, because it may lead to an overall benefit if the breach was efficient, here it is especially so because Amy and Ben

have undercapitalized the corporation and there are likely no assets which Examco can reach when it successfully sues. As such, the court should pierce the corporate veil to allow Examco to recover the impermissible cash distributions that Amy and Ben had been awarding themselves and would otherwise be available.

Carl

While Carl is also a shareholder and normally his 1/3 interest in the corporation would be sufficient to raise him to the status of a controlling shareholder, here he does not have such control. Amy and Ben are the only two officers, the only two directors, and when combined they hold a 2/3 interest in the corporation as shareholders. Carl is merely a passive investor that is not involved in any aspect of Testco's business. He merely invested \$50 in no-par stock in a venture run by Amy and Ben. As such, while the veil should be pierced for Amy and Ben as to their shareholders' limited liability but should not be for Carl because he committed no improper acts and was merely a passive investor.

Limited Liability