QUESTION 4

Years ago, Art incorporated Retail, Inc. He paid $100 for its stock and lent it $50,000. He elected himself and two family members to the Board of Directors, which in turn elected him as President and approved a ten-year lease for a store. He managed the store and was paid 10% of Retail's gross revenues as compensation.

Subsequently, Barbara bought 20% of Retail's stock from Art.

Retail's board approved a contract to buy 30% of the inventory of XYZ Co., a company owned by Art.

Subsequently, Art began taking home some of Retail's inventory without paying for it.

Retail had net profits in some years and net losses in others. It paid dividends in some years, but not in others. In some years, Retail's board met three times a year; in others, it never met.

Recently, Retail ceased business. Its assets were limited to $5,000 in cash. Among the claims against Retail was one by Supplier, who was owed $10,000 for computer equipment. Another claim was Art's, for the $50,000 that he had lent and had just become due. Supplier and Barbara, individually, filed lawsuits against Retail and Art.

1. On what legal theory, if any, can Supplier reasonably seek to recover against Art on its claim against Retail? Discuss.

2. Does Barbara have a cause of action against Art, either derivatively or personally? Discuss.

3. If Retail is forced into bankruptcy court, will Art be able to collect from Retail any portion of his $50,000 loan? Discuss.

QUESTION 4: SELECTED ANSWER A

1. Recovery Against Art on Supplier's Claim Against Retail

Corporation

Retail, Inc. is a corporation, as indicated by the word "Inc." (for Incorporated) in its name and by the fact it was "incorporated". Perhaps the most important feature of a corporation is the limited liability of its shareholders. The shareholders of a corporation are generally not liable to the corporation's creditors, beyond the amount of their capital contributions (i.e. their stock ownership). There is an important public policy interest in preserving the limited liability of shareholders, so that corporations can feel free to take risks, which is good for the economy and society in general.

Limited liability can be ignored by the courts only in very particular circumstances. This is called "piercing the corporate veil", and requires that: (i) the corporation be a closely-held corporation, (ii) it be necessary to prevent fraud or abuse, and (iii) it would be unfair not to do so. Courts will rarely order a piercing of the corporate veil, but may do so in circumstances such as these ones, which require piercing to avoid unfairness to Retail. Where piercing is ordered, the shareholders involved in the wrongdoing can be held personally liable for the corporation's liabilities.

Here, Art incorporated Retail, Inc. and owned 100% of the stock. He later sold 20% of Retail's stock to Barbara. Accordingly, Retail is a closely held corporation (held by Art an Barbara only). Supplier has a claim against Retail, not guaranteed by Art personally, for $10,000 for computer equipment. Absent a finding by the court that the situation warrants piercing the corporate veil, i.e. that there is sufficient fraud or abuse, and sufficient unfairness, Supplier cannot seek recovery against Art.

Piercing the Corporate Veil

Piercing of the corporate veil can occur under either a finding of "alter ego", fraud or insufficient capitalization.

Alter Ego. Under the alter ego doctrine, the corporate veil can be pierced where the shareholders have sought to benefit from the benefits of incorporation but ignored all of its burdens. Factors which will be taken into consideration by the courts include: failure to observe corporate formalities, failure to keep the corporation's assets separate from that of its shareholders, failure to keep proper accounting, self-dealing, etc.

Here, there is some evidence that Art used the corporation as his alter ego. He elected himself and two family members to the Board of Directors and elected himself as President, all things which ensure that he keeps full control over the corporation, but which are not wrongful in any way. He then used that control to approve a compensation for himself of 10% of Retail's gross revenues, which is also not wrongful. Retail's board then approved a contract to buy 30% of the inventory of XYZ Co., a company owned by Art. Although XYZ Co. was owned by Art, the transaction is not necessary self-dealing, if it was fair to the corporation. The terms of the transaction are not known, but there is no indication of abuse or that the transaction was so much more detrimental than beneficial to Retail as to be "fraudulent" vis-a-vis Retail's creditors.

Art then began taking home some of Retail's inventory without paying for it. The facts do not state whether Art intended to return this inventory, or to keep it, or to use it for his own purposes, but it seems that he failed to keep the corporation's assets separate from his own. A court would frown upon this and see it as a relevant element in the action for piercing the corporate veil.

Retail had net profits in some years and net losses in others. It paid dividends in some years but not others. This in itself is perfectly normal.

In some years, Retail's board met three times a year; in others, it never met. This shows a disregard for corporate formalities, since a corporation's directors must meet on a regular basis. A board that does not meet at least twice a year is not complying with corporate formalities. A court would frown upon this and see it as a relevant element in the action for piercing the corporate veil.

Fraud. Under the fraud theory, the corporate veil can be pierced where the shareholders have been using the corporation merely as a shield against their existing liability and for the sole purpose of defrauding existing creditors.

Here, there is no indication that Art has used the corporation only to defraud existing creditors. The fact that the corporation is now insolvent and has unpaid debts is not in itself indicative of fraud.

Insufficient Initial Capital. Under the insufficient capitalization theory, the corporate veil can be pierced where the initial capital contributions of shareholders at the inception of the corporation were clearly insufficient to meet the corporation's foreseeable future liabilities, taking into account the corporation's foreseeable future revenues.

Here, Art incorporated Retail Inc. years ago. He paid $100 for his stock and lent it $50,000. Retail then entered into a ten-year lease for a store, approved compensation for himself, etc. The liabilities of a retail store are likely to quickly exceed $100. In particular, if Art had to lend the corporation $50,000 at its inception, it is an indication that Retail needed this amount of funding either to fund its initial operations or to induce potential co-contractants, such as the landlord, to enter into transactions. By choosing to do almost all of Retail's initial funding by loan rather than by capitalization, Art was likely trying to ensure his $50,000 would not be last in the waterfall in the event of a distribution in bankruptcy.

It is for situations like this one that the insufficient capitalization theory exists. It was foreseeable at incorporation that Retail would have liabilities greater than $100, yet its initial capital was no more than $100. When Barbara became a shareholder, she bought 20% of the stock from Art, not in the context of a corporate issuance. The corporation's capital was not increased.

Art will argue that Retail is a retail store and that it has expected revenues, which should be sufficient to satisfy liabilities. He was not operating a highly risky business. The facts show that he has had net profits in some years and that at some point Retail probably had become capable of meeting its liabilities "on its own". However, the facts also show that the initial capitalization was extremely low and that large liabilities, such as the ten-year lease, were incurred immediately at Retail's inception.

It appears that Retail was inadequately capitalized at incorporation.

Unfairness. In all cases, the proponent of piercing the corporate veil must show it would be unfair if the veil was not pierced.

Here, Retail has ceased business and its assets ($5,000) are insufficient to satisfy all of its liabilities. If Supplier cannot seek recovery against Art personally, it will receive next to nothing on the dollar for its $10,000 debt. Among the reasons that Retail is insolvent, Art's wrongful conduct is likely responsible: Art took home some of Retail's inventory; Art had Retail enter into a transaction with XYZ Co., a company owned by Art - which transaction was potentially unfair to Retail (this will be up to Supplier to prove); one of the biggest claims on Retail's assets is a loan by Art himself (which he had to make to Retail to make up for the insufficient initial capital contribution), etc.

Supplier can make a strong argument that it would be unfair to allow Art to hide behind the corporate veil and not hold him directly liable for Retail's debt to Supplier.

Conclusion

Accordingly, Retail is a closely held corporation and there is evidence that Art, a shareholder, has insufficiently capitalized it at incorporation (and perhaps even used Retail as its alter ego, although this will be much harder to prove), and that it would be unfair not to allow Supplier to seek recovery against Art directly. The court will likely pierce the corporate veil and allow recovery against Art.

2. Barbara's Cause of Action Against Art

Art's Duties to Barbara and Direct Action

Shareholders generally do not owe fiduciary duties to each other. Only in closely-held corporations, majority shareholders can be found to owe fiduciary duties of care and loyalty to the minority shareholders. In accordance with those duties, majority shareholders may not abuse their position of power to abuse the minority shareholders and deny them their rights as shareholders.

If they do, a minority shareholder can ask the court to order remedies in oppression, including a mandatory repurchase by the corporation of the minority shareholder's stock. Other remedies in oppression are available to the court, going all the way to mandatory dissolution of the corporation in particularly egregious situations of oppression. Where a minority shareholder is oppressed, the proper recourse is a direct recourse by the minority shareholder against the majority shareholder(s), seeking oppression remedies.

Here, while Art and two of his family members composed the Board of Directors, Retail's board approved a contract to buy 30% of the inventory of XYZ Co., a company owned by Art. If there is evidence that the corporation was not made on arm's length terms, Barbara could argue that the transaction was an abuse of power of a majority shareholder. Art began taking home some of Retail's inventory without paying for it, which Barbara can argue is an abuse of his power as a majority shareholder, director and President of Retail.

Because Retail is closely held, Barbara cannot simply sell her shares on a stock exchange and exit the corporation. Barbara could likely seek oppression remedies. If the corporation is ordered to buy out her shares for their fair value, this will likely be worthless to Barbara: her stock is worth nothing or next to nothing, since the corporation is insolvent, and even if it had a worth the corporation would not have sufficient assets to buy her back.

A dissolution of the corporation will not be helpful either, given that the corporation is insolvent and creditors will be paid first.

Accordingly, Barbara can likely take oppression remedies against Art, but unless she can convince the court to order damages in her favor (which would be extremely difficult), this recourse will not be useful.

Art's Duties to Retail

Shareholders generally do not owe fiduciary duties to the corporation, unless they participate in the management of the corporation to a great extent, either as directors or if a unanimous shareholders' agreement gives them the power to do so.

Here, Art is a director of Retail.

Directors owe fiduciary duties of care and of loyalty to the corporation.

Duty of Care. The duty of care requires a director to act as a reasonable, prudent person would do in the management of his own affairs. The directors are not "guarantors" of their bad decisions and will generally be protected by the business judgment rule (the "BJR"), and found not to have breached their duty of care even where they made a decision which later turns out to have been ill-advised. The BJR protects directors only where the decision has been (i) informed, (ii) made in good faith, (iii) made in the absence of a conflict of interest and (iv) had a reasonable basis.

Directors will also generally be found to have acted in compliance with their duty of care if they have relied on reports, opinions, information, etc. reported to them by directors, officers and employees of the corporation, by outside advisors or by a committee of the board of which they are not a member, in each case provided that the information reported was within the competence of the person(s) reporting it and that the reliance was reasonable, taking into account the directors' duty of care to the corporation.

Here, Art voted on his own compensation (10% of Retail's gross revenues) - this is not necessarily a breach of the duty of care or duty of loyalty, if the compensation is what a reasonable, prudent person would grant to a manager. 10% of gross revenues is not unreasonable for a store manager, although it could be unreasonable depending on the store's revenues. There is no clear breach of the duty of care here.

Here, Retail entered into a transaction with XYZ Co. There is no indication that Art breached his duty of care by entering into this transaction, because the terms of the transaction are not known. Art is not protected by the BJR here because he is in a conflict of interest, but again, there is no indication that the transaction was not one which a reasonable, prudent person would approve.

The distribution of dividends is at the directors' discretion - failure to pay a dividend in some years is not a breach of the duty of care or duty of loyalty and will not be reviewed by the court absent extreme circumstances.

Finally, Art began taking home some of Retail's inventory without paying for it. This is a breach of the duty of care and a breach of the duty of loyalty.

Duty of Loyalty. The duty of loyalty requires a director to act in good faith, in what he reasonably believes to be the best interests of the corporation. A director is in a conflict of interest if he (or a close relative or another of his corporations) has a personal interest in a transaction with the corporation.

In the event of such a conflict, the director will be found to have breached his duty of loyalty unless the transaction is shown either (i) to have been fair to the corporation, or (ii) to have been approved by a majority of disinterested directors or disinterested shares, after having been fully informed.

Here, the Retail/XYZ transaction involved a conflict of interest for Art. He should not have voted on it. Neither should the other board members have voted on it, since they are family members of Art, and therefore not "disinterested" directors. A vote of a majority of disinterested shares (i.e. Barbara's shares) should have been held to approve the transaction, and she should have been fully informed.

However, the facts do not describe the terms of the transaction. If Art can show the transaction was fair to the corporation, he will not be held to have breached his duty of loyalty.

Art breached his duty of loyalty by taking home some of Retail's inventory without paying for it, unless he reasonably believed this to be in the best interests of the corporation. There are no facts indicating that this might be the case, and the conduct appears improper. This is likely a breach of Art's duty of loyalty.

Derivative Action

Where a director breaches his duty of loyalty or his duty of care to the corporation, only the corporation has a recourse, not the shareholders individually. A shareholder may, however, take a derivative action provided that (i) the shareholder held stock at the time of the alleged breach and continues to do so throughout the derivative action, (ii) the shareholder can adequately represent the corporation's interests, (iii) the shareholder has made a written demand on the board to enforce the claim, but his demand was denied, and (iv) the shareholder joins the corporation as a defendant to the lawsuit.

In some cases, the court may accept a derivative action without a written demand having been made on the board, if the shareholder can show such demand would have been futile (for instance, if he is asking the corporation to sue all of the directors, it is extremely unlikely that the directors will agree).

If the shareholder is successful in his derivative action, the corporation will receive the benefit of the judgment. The shareholder can be indemnified for his legal costs and fees. If the shareholder is unsuccessful, he will be personally liable for all legal costs and fees, including the other party's if their reimbursement is ordered.

The corporation itself can have the suit dismissed only if it can show to the court that the transaction was fair as determined by an independent committee of the board or outside independent advisors.

Here, Barbara was a shareholder at all relevant times. She can likely represent Retail's interests adequately - there is no indication she can't do so. As noted above, she would have to first make a written demand on the board to take action. If they refuse, she can then take a derivative action to enforce Retail's rights against Art.

Conclusion

Retail has a recourse against Art for any loss caused by a breach of his duty of care or duty of loyalty. The recourse can be taken by Barbara in a derivative action. However, except for a recourse for the value of items which Art took home without paying for it, it will be difficult to show that Art is otherwise liable to Retail.

3. Collection by Art of The $50,000 Loan to Retail

In bankruptcy, secured creditors have a priority. All unsecured creditors are treated the same, unless there has been subordination. Under the Deep Rock doctrine, when the corporate veil is pierced, the court can order that any loans made by the shareholders to the corporation be subordinated to the debts of the corporation to other ordinary creditors.

Here, Art lent $50,000 to Retail. Given the piercing of the corporate veil described above, Art's claim can be subordinated to the claim of Supplier. Accordingly, Supplier will be able to recover the $5,000 if Retail is forced into bankruptcy.

Art will be unable to collect from Retail any portion of his $50,000 loan.

QUESTION 4: SELECTED ANSWER B

1. Supplier's legal theories of recovery against Art on its claim against Retail.

Supplier's ability to recover from Art depends on what type of business entity was created and if Art has breached any duty to Supplier.

<u>Corporation</u>

A corporation is a business entity separate from its shareholders. Therefore, shareholders of a corporation are not personally liable for the corporation's obligations unless the corporation was not properly formed, or the shareholders abused its corporate form. A corporation requires proper formalities for creation, which include filing with the secretary of state. A closely held corporation is one in which there are few shareholders, and liability of the shareholders is more readily found because of its more intimate nature.

Here, it appears that Art incorporated Retail, Inc. years ago; therefore without any further facts it appears that Retail Inc. was properly formed with regards to formalities. Retail Inc. can also be seen to be a closely held corporation by the court.

<u>Shareholder Liability: Corporate Veil</u>

Assuming the corporation was properly formed at its onset, Art can only be liable if the corporation abused its corporate form and thus will not be afforded the protections of the corporate veil.

A shareholder is generally not personally liable unless the corporate form is abused. A court will disregard the separateness of a corporation and its shareholders and pierce the veil if it appears that 1) the corporation was undercapitalized at its inception, 2) the corporate formalities were not adhered to, or 3) the corporation was created to perpetrate a fraud. It will also consider whether a parent corporation was operating by mixing its directors and officers with another corporation owned by it.

Alter Ego

Art is a shareholder, director, and as president, he is an officer of Retail Inc., and at the same time he is XYZ Co.'s owner. Retail Inc.'s board approved a contract to buy 30% of XYZ's inventory, which alone may appear to only have an impact on Art's duty of loyalty as a director of Retail Co. who approved the transaction. However, it does not appear that Retail Co. owns or otherwise deals with XYZ other than the contract. Nonetheless, because Art is an owner of both, a court will consider it.

Undercapitalized

The shareholders of a corporation must put at risk enough unencumbered capital to take care of the corporation's potential liabilities.

When Art incorporated Retail, he paid $100, for its stock, and thus he became a 10% shareholder. He also lent the corporation $50,000 at its onset, which appears to have satisfied Retail Inc.'s potential debts because after years it had only owed $10,000 under a contract to outside creditors and ceased business with $5K left. Therefore, since it was able to operate for years with the $50K capitalization, this appears to be sufficient.

Formalities

Supplier would argue that Retail's board did not hold meetings every year, which shows that it was not a proper corporation. However, Art will likely argue that since Retail's board had no significant matters to discuss, it only met when necessary, which is apparent by the fact that it met three times a year in some years. Because a corporation should hold regular meetings, this appears to be against the proper corporate formalities.

Therefore, a court can use this to decide whether to hold Art liable.

Perpetrate a fraud

There appears to be no bad faith in creating the corporation so this will not be considered.

Overall, a court is reluctant to pierce a veil absent clear evidence of lack of separateness; therefore Art may be personally liable to Supplier, but it is unlikely.

Personal Liability

If the veil is pierced, Supplier will be able to obtain $10,000 personally from Art.

2. Barbara's cause of action against Art.

Barbara's Derivative Suit

Barbara may bring an action on her own or as a shareholder of Retail Inc. against the corporation.

Derivative Actions

A shareholder may bring a derivative action on behalf of the other shareholders of the corporation for a breach by the directors. Any recovery will go to the corporation rather than to the shareholder personally. To bring such an action, the shareholder must 1) have made a demand on the board for the complained-of action, to which the board either refused, or 90 days have passed without an answer, or demand would be futile; 2) the shareholder must adequately represent the other shareholders; and 3) the shareholder must hold shares throughout the entire suit.

Futile

Here, there are no facts to suggest that Barbara made any demand on the board, however, because Retail's board consists of Art and two of his family members, Barbara will argue that demand would be futile, because his family members would be biased in favor of Art. Art will argue that had she made a demand it would have been answered, and the derivative suit would be improper. Nonetheless, the fact that only three members are on the board and all three are related, would likely render the demand futile.

Adequately represents

The shareholder must have enough shares to adequately represent the shareholders.

Here, the only shareholders appear to be Barbara and Art; therefore, since Art took action with regard to the complained-of event, Barbara is essentially asserting it on her own behalf; therefore this is met.

Shareholder throughout suit

Barbara owns 20% stock and has retained that stock until suit, therefore this is met.

Therefore, Barbara can bring a derivative action.

Breach of Duty of Loyalty

A director has the duty to put the corporation's best interest before his own. The duty of loyalty can be breached in three ways: 1) usurping a corporate opportunity, 2) engaging in an interested director transaction, and 3) engaging in a competing venture.

Interested Director Transaction

A director is not permitted to engage as an interested party in a transaction, which essentially means that he may not sit on both sides of the transaction, or that the director may not engage in a transaction with one of his family members, unless he gets the approval of the majority of the disinterested board or its shareholders, or the transaction is substantively fair.

Here, Barbara can bring an action for a breach of duty of loyalty by Art for approving a contract to buy 30% of the inventory of XYZ Co., a company owned by him. Since Art is a director of Retail Inc. and also an owner of XYZ Co., he sat on both ends of the transaction when he approved a contract to buy inventory from a company he owned.

Approval by Board

However, Art will argue that the board approved the contract, and in the alternative that the transaction was substantively fair. However, since the board consisted of three people, who were each related to one another, and the board also consisted of Art, who was the primary interested party, then the approval was not obtained by a majority of the disinterested shareholders, because family members are always interested parties in their family's affairs. This can be further shown by the fact that the family has close ties, since Art elected the two family members to the board, which in turn elected him as president.

Substantively Fair

If the transaction is substantively fair, an interested party transaction will be permitted after full and fair disclosure.

Even though the board could not have properly approved, the transaction involved buying 30% of XYZ's inventory, which is close to half of its inventory. While there is no price indicated, it is likely that Art gave a discounted price for the contract because he was a party to both sides. Art will argue that it was beneficial to the corporation to buy from XYZ since he could provide them with better quality inventory at a better price, whereas an outsider would have no such incentive. Nonetheless, he would have had to disclose the information to the board, and the board would have to agree. Since the board approved, he may be able to defend against the derivative suit for breach of loyalty under this theory.

However, if the court finds that the bias of his family members on the board is superior to the transaction being substantively fair, Barbara will prevail in showing a breach of the duty of loyalty.

Competing Venture

Art has taken Retail’s property for himself, and since XYZ appears to have a similar business as Retail, perhaps the inventory was that which originally came from the contract between them. Therefore, if so, he would be replenishing his inventory at XYZ at the expense of Retail Co., and thus would be engaging in a competing venture.

Therefore, Barbara can also prevail by showing this.

Duty of Care

A director owed the corporation a duty of care to act in good faith as a reasonable prudent director would under the circumstances.

Good Faith

Art's taking of the inventory from Retail without paying for it can be used to show bad faith by a director. He may also be seen as an officer because he managed the lease for a store and was paid 10% of Retail's gross revenues as compensation. Therefore, as an officer, he must have also acted in good faith for the best interest of the corporation.

Ordinary Prudent Director

Barbara can argue that an ordinary prudent director would not steal inventory from the corporation without paying for it; therefore he acted against his duty of care.

Business Judgment Rule

The business judgment rule protects the good-faith decisions made by directors in compliance with the duty of care that in hindsight end up being erroneous.

Here, Art did not act in accordance with the duty of care because he acted in bad faith with regards to taking the inventory. Therefore the BJR will not protect him.

Dividends

Barbara can also bring an action derivatively for the fact that the corporation did not distribute dividends in some years. However, a corporation has discretion whether to distribute dividends, because dividends are not a right of the shareholders.

Since Retail had net profits in some years and net losses in others, it was prudent for them to withhold dividends for the years they had no profits, assuming that the times corresponded. Even if they did not correspond, distributing dividends is in the discretion of the board.

Barbara's Personal Action

A personal action may also be brought by Barbara against Art (if the veil is pierced - as a director) and if it is not pierced, then as a shareholder.

<u>Duty To Shareholders</u>
Generally, shareholders do not owe a duty to other shareholders, however, a majority shareholder owes the duty to a minority shareholder not to use its majority share to discriminate against the minority shareholder, and not to sell his shares to a prospective looter.

There are no facts to suggest how much the stock of Retail Inc. cost; however Art paid $100 for its stock and Barbara owned 20% of the stock from Art. Assuming Art holds the remaining stock himself, Art would be a majority shareholder, and would thus be required to act fairly with regards to the use of his shares.

Here, Art's transaction with XYZ does not appear to prejudice Barbara as a shareholder in any way; therefore Barbara will not be able to prevail in a personal suit against Art.

3. Liability of Retail Inc. for Art's loan.

<u>Liability of Corporation at Dissolution</u>
A corporation that ceases business is still held liable for debts to creditors. A shareholder who contributes capital will receive reimbursement.

<u>Equitable Subordination</u>
Under equitable subordination, all creditors, whether shareholder creditors or outsiders, may seek to collect their debt to the corporation equally. However, if a shareholder acted wrongfully, the Deep Rock doctrine prevents him from recovering equally.

If Retail Co. is forced into bankruptcy, Art will be able to recover his loan in proportion to the debt owed to Supplier. Since there is only $5,000 cash left, he will be able to obtain a proportional amount, taking into consideration Supplier's $10K debt. If Art is found to have acted wrongfully, however, then he will not be able to recover since there is only $5,000 left and Supplier would have priority over Art's debt.