JULY 1997 CALIFORNIA BAR EXAMINATION
ESSAY QUESTIONS AND SELECTED ANSWERS

Corporations

QUESTION

Artis, a respected computer engineer, invented a unique computer device, but she lacked sufficient financial resources to manufacture and market it. Artis presented to Ben, a wealthy acquaintance, a business plan for producing and selling the device. Ben and Artis agreed that: 1) Artis would form a corporation named "Compco" to manufacture and market the device; 2) Ben would provide the financing by contracting with the corporation to loan it $1 million; and 3) Ben would receive periodic loan payments, a number of shares of the corporation equal to the number that would be issued to Artis and 20% of the net profits of the corporation for ten years.

Artis caused the articles of incorporation to be prepared for the corporation as a close corporation. She also caused to be prepared a loan agreement in which Ben and Compco were the parties. The agreement contained the provisions to which Artis and Ben had agreed. Artis signed the agreement as president of Compco, and Ben promptly funded the $1 million loan. Under state law, legal existence of the corporation would begin only when the articles were filed with the secretary of state. However, through inadvertence the articles were not filed with the secretary of state until ten days after the loan agreement was executed and the loan funded. Artis was duly elected as sole officer and director of Compco. Thereafter, the computer device was manufactured, Compco enjoyed some initial business success, made payments on the loan and paid 20% of its net profits to Ben.

Compco authorized only 1,000 no par common shares for an issue price of $1,000 per share. Compco issued 200 shares to Artis in return for her assignment of all rights in her invention to Compco and 200 shares to Ben pursuant to the loan agreement. Compco issued 500 shares to others in return for their payment of $1,000 per share. Artis caused the remaining 100 shares to be issued as a gift to her friend, Carla, a busy and successful computer marketing expert, in an attempt to induce Carla to provide free marketing advice to Compco, which was facing increasing competition. However, after receiving the stock, Carla refused to provide any advice.

Recently, Compco has operated at a loss, and Ben has not received any further payments under the loan agreement.

1. Are Compco and/or Artis liable to Ben for the payments due under the loan agreement? Discuss.

2. Is Artis liable to Compco for having issued stock to herself and to Carla, and if so, what is the basis of any such liability? Discuss.

3. Is Ben liable to Compco because he was issued stock in Compco and, if so, what is the basis of any such liability? Discuss.

4. Is Carla liable to Compco because she was issued stock in Compco and, if so, what is the basis of any such liability? Discuss.

Corporations

ANSWER A

1) LIABILITY OF COMPCO AND/OR ARTIS TO BEN FOR LOAN

COMPCO'S LIABILITY: Generally, a corporation is liable for breach of the contractual obligations it enters into, so under normal contract principles Compco would be liable to Ben for the periodic loan payments it promised, and for 20% of any net profits that have not been paid to Ben. However, Compco will assert two theories as a defense to its contractual duties to Ben in this situation. Unfortunately for Compco, it will probably not prevail on either theory.

A. CORPORATE LIABILITY FOR PRE-INCORPORATION CONTRACTS: Compco will try to argue that because Artis signed this contract with Ben before Compco was incorporated, the contract is a preincorporation contract for which Compco has no liability because it was not a party to the contract. However, there are at least two ways that a corporation can become liable for pre-incorporating contracts: adoption or novation. Here, Compco has adopted the pre-incorporation contract because it has 1) benefited under the contract through the receipt and use of the $1 million capital received from Ben, 2) it has acknowledged the contract by making periodic payments to Ben, and 3) it has acknowledged the contract by paying Ben 20% of its net profits. A corporation is estopped from denying its duties under a contract that it has relied on, benefited from, or acknowledged under the theory of adoption. Compco has clearly adopted this contract, and will be liable under its terms to Ben.

B. DEFECTIVE INCORPORATION: Compco will also try to argue that because Artis never filed the articles of incorporation with the Secretary of State, Compco does not legally exist as a corporation, and thus lacks the capacity to enter into a valid contract and cannot be legally bound. However, a corporation is estopped from asserting defects in its own incorporation to avoid liability to third parties, so Compco will also fail here.

Thus, Compco is liable to Ben for the payments under the loan agreement.

ARTIS' LIABILITY: In entering into the preincorporation contract with Ben, Artis was acting as a corporate promoter. Generally, corporate promoters remain liable to third parties on preincorporation contracts, unless 1) there has been a post-incorporation novation of the contract, or 2) it was the intent of the third party at the time the contract was entered into to have only the corporation and not the promoter remain liable on the contract after incorporation.

Novation: As discussed above, Compco has probably adopted the loan agreement, thus becoming liable on the contract. However, a corporation's adoption of a pre-incorporation does not release the promoter from also being liable on the contract. The promoter will only be released if there is a novation of the contract after the incorporation. Under general contract theories, a novation is a renewal of the contract whereby the original parties to the contract and

the third party all agree that one of the original parties to the contract is released from all duties under the contract, and that the third party replaced the original party in the contract. Here, Artis would try to argue that there was a novation in which Ben agreed to release Artis from the obligation and replace her with Compco, and that Compco agreed to replace Artis as the party primarily liable to Ben on the contract. The facts do not indicate that such a novation occurred, so under this theory Artis remains liable to Ben.

Intent of the parties: Artis may also try to argue that because she signed the contract as president of Compco and not as an individual, and because of the understanding and intent of both her and Ben at the time the contract was entered into, that she was not intended to be held personally liable on the contract and thus should not be liable to Ben. However, given the fact that Artis has breached her duties of care and good faith as a corporate officer and director, and unless there is clear evidence on the face of the contract that Ben did not intend for Artis to remain personally liable on the contract after incorporation, Artis' argument will probably fail, and she will remain personally liable to Ben on the pre-incorporation contract.

2) LIABILITY OF ARTIS FOR ISSUING-STOCK TO HERSELF AND CARLA

ISSUING STOCK TO HERSELF: Artis should not be liable to Compco or anyone else for issuing the stock in Compco to herself. The shares have no par value under the articles, so the issuance does not raise the problem of "watered stock," which is stock issued for less than par value. Stock may be issued in exchange of any property, including intangible property such as Artis' rights in her own invention. Provided that Artis did in fact have rights in her invention, and provided that the exchange of 200 shares for those rights was a reasonably fair transaction in terms of value, Artis is not liable to the corporation for the issuance.

ISSUING STOCK TO CARLA: Artis may be liable to Compco for the issuance of the 100 shares to Carla. Stock may be issued in exchange for any valid property, or for past services, but it can not be issued when the consideration is a mere promise of future service. The facts indicate that Artis issued the shares to Carla "in an attempt to induce" her to provide free marketing advice to Compco. Even if the issuance had been made in exchange for an enforceable contract for such future services, it would probably subject Artis to liability. Since the stock was apparently issued for less than a full promise, Artis will definitely be liable.

Apart from the traditional prohibition on issuing stock for invalid consideration (such as future services), Artis owes the corporation both a duty of care and a duty of loyalty as an officer and director of Compco. Under the duty of care, Artis must treat the corporation as a reasonably prudent person would treat her own personal business or assets. Under the duty of loyalty, Artis must take all actions relating to the corporation in good faith and in the best interests of the corporation. Issuing 100 shares to Carla either as a gift or as consideration for vague future services would violate these duties, and would make Artis liable to Compco for her actions.

3) BEN'S LIABILITY TO COMPCO FOR HIS STOCK:

Traditionally, the issuance of stock in exchange to debt was prohibited because debt was considered invalid consideration for the issuance of equity securities. However, on these facts, there are several factors that probably make the issuance of stock to Ben in exchange for his "loan" acceptable, so Ben will not be liable to Compco.

Ben gave $1 million to Compco as startup capital in exchange for 200 shares, an agreement to repay the principal, and 20% of net profits. Because this was a startup company with no other capital (other than Artis' idea), Ben's loan was very risky. The issuance of stock is partially justified by the amount of risk Ben subjected himself to in supplying the capital. Under the facts, Compco did not contract to pay Ben any "interest" on his loan, but instead agreed to pay back only the principal, plus 20% of net profits. Because this venture was new, the likelihood of substantial profits in the early years was low, and Ben subjected himself to considerable risk that he would receive little or no profits from Compco. Thus, his acceptance of the stock may have been justified in lieu of a guarantee of interest. .

In conclusion, under modern and more liberal corporate codes, Ben's contribution of capital to Compco was probably sufficient consideration for his stock, even though the money he provided can be partly characterized as a "loan."

4. <u>IS CARLA LIABLE TO COMPCO FOR HER STOCK</u>?

As a recipient of 100 shares of stock, Carla is only a ten per cent shareholder in Compco. The facts do not indicate that she is either an officer or director of Compco. Under these facts, Carla owes no special duty to Compco or to the other shareholders, and so she is probably not liable to Compco for the issuance of her stock.

However, Carla might be liable on one of two theories. First, under contract law, if Carla made an enforceable contract to provide marketing advice to Compco in exchange for her stock and then refused to perform, she might be liable. Under these facts, it does not appear that she entered a contract, as it states only that Artis "attempted to induce her" to provide such services.

Second, under tort theories, if Carla misrepresented to Compco that she would provide advice, and intentionally induced Compco reliance on the promise without intent to perform, she may be liable for fraud or misrepresentation. Again, under these facts, it does not appear that Carla will be liable under this theory.

<u>ANSWER B</u>

<u>Liability for Loan Payment</u>

<u>Artis' Liability</u>

Artis (A) acted as a promoter of Compco, since she acted on its behalf before the corporation was formed. In such capacity, A signed a contract with Ben (B) by which B made a

loan and A promised to repay it, partly with Compco's profits. As promoter, A is liable on all pre-incorporation contracts she signed on behalf of Compco, until there is a novation, or agreement by which A is replaced by Compco as a party to the contract. Since there was no novation here, A remains personally liable to B under the loan agreement.

Compco's Liability

A corporation is not liable on any pre-incorporation contract signed by its promoter until it adopts such a contract either expressly or impliedly (by accepting benefits of the contract). Since Compco was not formed (i.e., its articles weren't filed) until 10 days after the loan agreement was made, its liability under the agreement depends on whether it adopted the contract by accepting the benefits of the contract. Arguably, it did because the loan proceeds were used by Compco to finance production. If the court finds that this is the case, Compco is liable to B for the loan payments (but note - A remains liable as well, until there is a novation replacing her with Compco as party to the contract).

A's Liability for Stock Issuance

Issuance to A

Stock can be issued for money, property, or past services. Where stock has a par value, that is the minimum issue price; with no par stock, generally the board of directors determines the appropriate price and the amount to be contributed to the "stated capital" fund.

Where stock is used to pay for property by the company, generally a good faith determination of the value of such property (and hence the amount of stock to be paid for it) by the board controls. In a close corporation (generally less than 35 share holders, stock not publicly traded), a good faith determination by the controlling shareholders, who owe fiduciary duties to minority shareholders, will control.

Here, A has caused Compco to issue 200 shares to her in return for an assignment of her rights to the invention. Thus, the requirement that money, property (which such assignment is), or past services be paid as consideration is met. In addition, A must have made a good faith determination that such an assignment is adequate consideration for the 200 shares. If so, she is not liable for such issuance. But if her determination was not in good faith, she is liable to Compco for the issuance; she has violated her fiduciary obligation to act in good faith and in a manner she reasonably believes to be in Compco's best interest. She may be required to pay Compco the additional value of the stock.

Issuance to Carla

Since 100 shares were issued to Carla as a gift, adequate consideration has not been received for the shares and A is liable to Compco for their value, as is Carla. A will argue that she gave the shares to Carla in return for her marketing advice. However, many states prohibit

issuance of stock in exchange for future services; in such a state, A remains liable for the value of the stock. In addition, even if Compco's state of incorporation permitted future services as consideration for stock, A did not obtain a sufficiently certain agreement from Carla to provide such services; in fact, it does not appear that any promise at all was obtained from Carla before the shares were issued to her. Thus, A's argument fails and she is liable to Compco.

As sole officer and director of Compco, A owes Compco a duty of loyalty; she must avoid self-dealing transactions. Her issuance of 200 shares to herself for less than their fair value (if that is the case) would be a self-dealing transaction, which must either be fair to the company or disclosed to and approved by the shareholders. No such disclosure was made nor approval sought, and it is unlikely that obtaining company stock without paying fair value can be construed as fair to the company.

A also owes Compco a duty of care; she must act in a good faith, informed, and rational manner and as a prudent person in management of her own affairs. This duty was breached when A issued Compco shares to Carla for no consideration, and also if the court determines that A herself paid insufficient consideration.

Ben's Liability to Compco

Ben apparently received his shares in return for his agreement to loan Compco $1 million. This would seem to satisfy the requirement that stock be issued in return for consideration, since a loan is valuable property, particularly where other sources are unwilling to lend or are charging higher interest.

Note, however, that in return for his agreement to loan, Ben also received a promise of periodic repayment and 20% of Compco's net profits for 10 years. This tends to negate the argument that Ben's shares were issued for adequate consideration (i.e., it looks like the stock was a gift, on top of the loan repayment and 20% of profits).

If in fact Ben did receive stock without paying any value for it, Ben is liable to Compco for the value of the stock. This would be analogous to having received "watered stock," or stock issued for less than par value, for which a person is liable to the corporation. Since this is no-par stock, Ben's liability depends on a determination of whether A made a good faith determination that Ben provided adequate consideration for the stock under the loan agreement; if not, A and Ben are both liable to Compco.

Carla's Liability to Compco

As discussed above, Carla received her stock as a gift; the facts suggest that, despite A's hopes, Carla made no promise to give marketing advice, which might have served as consideration for the stock in those states which permit payment for stock with future services.

Corporations

Like Ben, Carla is liable to Compco as if she had received watered stock. However, here there is no good faith argument that consideration was paid for the stock. Thus, Carla is liable to Compco for the value of the stock.