

JULY 1998 CALIFORNIA BAR EXAMINATION ESSAY QUESTIONS AND SELECTED ANSWERS

Corporations

QUESTION

Carl owned 30% of the common stock of Motco, a corporation engaged in manufacturing high priced motorcycles. Motco has 200 shareholders. No shareholder other than Carl owned more than 2% of Motco's stock. Motco's most valuable asset has been a large plant where its internationally famous motorcycles are made.

Bigco is a corporation, all of the stock of which is owned by Albert Rich ("Rich"). Three other corporations that were recently acquired by Bigco have since become insolvent and failed. Bigco made an offer to Carl to buy all of Carl's Motco, stock for \$25 per share.

Before he accepted the offer, Carl received a letter from the former president of one of the three failed companies asserting that the failure had been caused by Rich "looting" the company after Bigco acquired it. The letter also stated that Bigco and Rich had been sued in an action in which it was alleged that they had dissipated the assets of all three failed companies after Bigco acquired control to raise funds for other business acquisitions. When Carl questioned Rich about this letter, he was told that the writer was a disgruntled former employee who had been fired for incompetence. Based on that response, Carl conducted no further inquiries. If he had, he would have found that final judgments had been entered in litigation concerning Bigco's control of the three failed companies, holding Bigco and Rich liable for wrongful diversion of assets.

Carl accepted Bigco's offer. At the time of purchase, Motco's common stock was selling for \$11 per share. As part of the stock sale agreement with Bigco, Carl undertook to ensure that all nine members of Motco's board of directors would resign and that Bigco's nine nominees would be elected as the replacement Motco directors, before ownership of Carl's 30% block of Motco stock passed to Bigco. The replacement of the Motco directors took place as planned.

Thereafter, Motco's new board of directors voted unanimously to convert the Motco motorcycle plant exclusively to the manufacture of motor-driven bicycles (mopeds), despite recent adverse publicity over an increasing number of moped accidents. This decision was motivated by a desire to provide an outlet for moped parts manufactured by another corporation controlled by Rich. At present, Motco's earnings from the sale of mopeds are substantially less than its former earnings from the sale of motorcycles.

Pat is a 1% shareholder of Motco. By proper procedures, she has instituted a shareholders' derivative action against Carl, Motco's new directors, and Bigco based on the events described above.

To what relief is Pat entitled in the derivative action, and on what bases and against which defendants?

Discuss.

Do not discuss federal or state securities law issues.

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ANSWER A

Pat v. Carl, Motco's New Directors, Bigco

1. Derivative Shareholders' Action

A derivative action by Pat is a tool to enforce the corporation's cause of action for harm to the corporation. All of the below theories harm Motco and are proper actions for a derivative suit. If Pat recovers on the theories below, she will be entitled to cost and attorneys' fees. The corporation will receive the remainder of the recovery from the action.

2. Pat v. Carl

A. Sale to a Looter

Under the common law, a majority shareholder could sell his majority for a premium. Under modern law, in most jurisdictions, there are limits on a controlling shareholder selling at a premium. A majority shareholder is a shareholder with either an actual majority of shares or a working majority of shares such that the shareholder can effectively control the corporation with his shares.

A controlling shareholder cannot sell his majority to a looter who will buy the shares to loot the corporation and cause damage to the corporation. Carl, if liable, will owe the corporation (Motco) for all resulting losses.

1. Carl is a controlling shareholder

Carl is a controlling shareholder. He owns 30% of Motco's stock. No other shareholder other than Carl owns more than 2% of Motco stock.

As a controlling shareholder, Carl cannot sell his control to a looter.

2. Sale to a Looter

Rich is the sole owner of stock of Bigco. Bigco has bought other corporations recently and all have become insolvent and failed. In fact, a court has held that Rich and Bigco were liable to those 3 corps for wrongful diversion of assets.

Carl knew of the three failed corporations which were bought by Rich and Bigco because a former president of one of the failed companies told Carl.

Carl also knew that his stock was being bought for \$14 over trading value - a fact which should have made Carl inquire further. With further inquiry (other than asking Rich, the wrong doer) would have revealed Rich and Bigco's history of looting.

Despite Carl's actual knowledge and inquiry notice which would have produced more knowledge - Carl sold all of his stock to Rich and Bigco. Rich sold to a known or knowable looter.

3. Liability for Sale to a Looter

Carl is liable for all losses which Motco suffers as a result of his knowingly selling to Rich and Bigco for a premium.

B. Sale of a Corporate office

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A controlling shareholder cannot sell a corporate office/directorship as a part of his sale of his controlling shares.

Carl sold to Bigco 30% of Motco's shares with a promise that all 9 members of Motco's board of directors would resign. As a part of the deal, all nine members did resign. The members were replaced by Rich and Bigco through their controlling share of the corporation.

Through his agreement to have the 9 directors resign which allowed Rich and Bigco to fill the positions. Carl sold a corporate office with his shares and is liable to Motco.

Carl is liable for either the premium he received (\$14 x Carl's shares) or the loss to Motco as a result of his actions.

The loss to Motco as a result of Carl's actions included changing production of internationally known motorcycles to publicly decreed mopeds and loss of revenue.

Carl is liable for sale of corporate office to Motco.

3. Pat v. Motco's new Board of directors

The new board of directors have a duty of care and duty of loyalty to Motco.

A. Duty of care

The Board must act with the care, skill and prudence a reasonable person would use in handling her own financial affairs.

The board, upon election, immediately voted to convert Motco's highest asset - the Motco motorcycle plant to a moped plant. This does not seem prudent because there has been recent adverse publicity about the increasing number of moped accidents. Also, the motorcycles of Motco are internationally known, high priced, and have not suffered adverse publicity recently.

1. Business Judgment rule

The directors will not be liable for misfeasance if their decision merits the Business Judgment Rule. Under this rule, the directors must make an informed decision based on sufficient facts and make the decision they feel is in the best interest of Motco.

The only reason the directors changed the plant to mopeds is to provide an outlet for moped parts for another corp owned by Rich. This is not informed reasonable decision making - it is self-serving.

The directors decision to switch to mopeds does not meet the Business Judgment Rule. They are liable to Motco for violation of the duty of care.

B. Duty of Loyalty

The Motco board breaches the duty of loyalty if it allows any interest of theirs or another's to interfere with the boards ability to act in the best interest of Motco.

The directors changed the motorcycle plant into a moped plant to give Rich a place to sell his manufactured moped parts from another corporation.

The directors let their interest (because they need Rich for their directorship) to get in the way of their management of Motco.

The directors breached their duty of loyalty to Motco which caused Motco harm (decreased earnings). The directors are liable.

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4. Pat v. Bigco - Cannot recover derivatively because harm to Pat not Motco
As controlling shareholder, Bigco cannot use its majority to oppress the minority shareholders. At common law, the controlling shareholder had no duty to minority shareholders. Bigco bought Carl's stock and became controlling shareholder. Thereafter, Bigco elected new directors who act on Rich's desires and not out of their own judgment. The new Board is implementing losing strategies; (i.e.: mopeds). All of this is to the detriment of the minority shareholders.
Pat can recover for Bigco's abuse of minority shareholders but not derivatively.

ANSWER B

I. Shareholder Derivative Suit

A shareholder may bring a cause of action on behalf of corporation. That is, assert a corporation's claim for relief. Any award goes to the corporation and the shareholder gets her costs.

The shareholder must have been a shareholder at the time the cause of action arose and during the course of the litigation. P seems to meet these requirements.

The shareholder must also make a demand on the directors to institute the suit themselves, unless such a demand would be futile. Here such a demand would be futile if the directors, as discussed below, are found to have violated their duties.

II. Claims Against Carl

Here, P may be able to assert that C was a controlling shareholder who violated his duties not to sell to looters, not to sell corporate office and to not oppress minority shareholders.

(A) Controlling Shareholder

Carl owns 30% of M's common stock and no other shareholder owned more than 2%. This degree of voting power is enough to make him a controlling shareholder, especially; vis-a-vis other much smaller shareholders. His control is also shown by the \$14 premium over market paid by B for his shares, and by the fact he controlled all 9 director positions enough to force them to resign.

As a controlling shareholder, C owed duties to the other minority shareholders.

(B) Duty to Avoid Sale to Corporate Looters

A controlling shareholder owes a duty to other shareholders not to sell his shares to a corporate looter - someone who will run the corporation into the ground for his own personal profit. As such, controlling shareholders have a duty to investigate whether a prospective buyer is a looter, especially where they have cause to suspect so.

Here, Carl was informed by a victim of R & B's past looting escapades. Although C properly asked R about this incident, he unreasonably accepted R's explanation, however plausible, on blind faith.

As a controlling shareholder, C had a duty to reasonably investigate the matter in order to find the truth. If he had, he would have discovered R & B's past looting of 3 companies and

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reasonably concluded that this was probably also their present intent. Although receiving a premium for control shares is not improper per se, the fact C was getting more than twice the FMV of his shares should also have raised suspicion by C of R & B's motives. Therefore, C breached his duty.

(C) Duty to Not Sell Corporate Office

A controlling shareholder cannot agree to ensure the buyer will control certain directors in a sale of his stock. Where a sale is conditioned on the resignation of directors of the election of the buyer's new preferred directors, there has been an improper sale of corporate office. A very large premium may also be evidence of such a sale.

Here, as part of the sale, C "undertook" to ensure the replacement of all directors with the buyer's new chosen directors, and C received an extra large premium. This is a clear case of selling office and Carl breached his duty.

(D) Duty Not to Oppress Minority Shareholders

In general, a controlling shareholder cannot act in a way that oppresses and harms the interest of minority shareholders. In addition to the above described sale to looters and sale of corporate office, C may have breached his duty by getting an unjustifiably high price for his shares at the expense of the other shareholders.

(E) Duty to Not Sell Corporate Assets

If by selling his shares at an abnormally high price C was in fact selling the right to control M's plant, its major corporate asset, he may have breached his duty to not sell corporate assets.

(F) Relief

(1) Pat

Pat will successfully show the above breaches and will therefore recover her costs. P may be able to rescind the sale as an improper one to a corporate looter.

(2) Motco

Motco will recover damages from C for his breach. M will also recover C's profits from the improper sale of corporate office and asset, if so found.

III. Claims Against Motco's New Directors

P will be able to successfully assert breaches of the directors' duties of care and loyalty.

(A) Duty of Care

Directors owe the corporation a duty of care: they must act as a prudent person would with respect to their own business affairs.

Directors will not be held liable for their decisions if they meet the Business Judgment Rule: They made a (1) good faith decision (2) that was reasonably informed (3) on a rational basis.

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Here, if the director's decision to convert M's plant to mopeds was swayed by Rich's ulterior interests in creating a customer, they did not make a good faith decision and this was not a rational decision. Also, given the adverse publicity about moped safety, they should have investigated the propriety and profit prospects of a switch to moped production. If they did not so inform themselves, they voted imprudently and did not comply with the BJR and thus violated their duty of care.

If so, P may recover her costs against directors, and M can recover all foreseeable damages, such as lost profits and losses due to the change.

(B) Duty of Loyalty

Directors owe a corporation a duty of loyalty: they must act in good faith and in a manner they reasonably believe is in the corporation's best interests.

It is not clear whether the directors were motivated by R's conflicting interests, but if so, they have breached their duty of loyalty. If any of the directors knew of this interest of P's they had a duty to disclose it to the board, and are liable for any breach. Finally, if any of the directors were shareholders in R's other companies, or had some other interest, they were self dealing and violated their duty of loyalty.

If the directors breached this duty they are liable for any foreseeable damages - like lost profits and losses due to the change.

(C) No Indemnity if Directors Held Liable

If the directors are held liable, they cannot receive indemnity from M. If not liable, M may have to indemnify them as acting on behalf of M.

IV. Claims Against Bigco

(A) Controlling Shareholder

For the same reasons discussed above regarding Carl, B is a controlling shareholder and owes duties to not loot the corporation and not oppress the minority shareholders. As the sole shareholder of B, Rich essentially owes these duties and Rich's conflicts of interest are B's too.

(B) Duty Not to Loot

If B procured the change over to moped production, it is essentially looting the company by forcing it to buy products from Rich's other companies. B would be liable for M's losses and P's costs of suit.

(C) Duty Not to Oppress Minority Shareholders

Again, if B procured the change over to benefit B's sole shareholder, Rich, it is harming the interests of M's minority shareholder.

This is essentially self-dealing and hence improper and B has breached its duties to the minority shareholders. B is liable to P for costs and M for lost profits/losses.

(D) Piercing Corporate Veil of B

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If Rich is using Bigco to commit fraud as his alter ego, P and M may recover directly from him, since if B were unable to pay damages for harm it caused on R's behalf, that would be unfair. In such a case, a court would pierce B to hold R liable.