Question 4

Beth, Charles, and David are the directors of Web, Inc. (Web), a corporation that is in the business of creating websites.

Adco, Inc. (Adco), a corporation that markets computer advertising, had an urgent need for a complex website that would cost thousands of dollars to create. Adco approached Web about creating the website. Adco explained that it did not have the cash to pay for the work but claimed that it was a well-established corporation and asked Web to extend credit for the work.

Beth, Charles, and David unanimously agreed to take on the work, conditioned upon a prior review of Adco's financial statements and a determination of Adco's credit- worthiness. After learning this, Adco contacted David and told him that the sooner Web could start on the website, the sooner Adco would be able to pay Web.

David was anxious to obtain Adco's business. He falsely told Beth and Charles that he had obtained and reviewed Adco's financial statements and that, based on his review, "we should proceed with the work." Beth and Charles, without further inquiry, agreed, and Web created the costly website. Adco is unable to pay Web.

Beth, Charles, and David have now learned that Adco's shareholders have regularly taken its funds for their personal use.

In an unrelated transaction, Charles received a call from his friend Sam who wanted Web to create a new game website. Charles told Sam that the new game website was such a small job that he could do it at home for less money than Web.

Charles told Sam to send the payment for the game website to Charles at his home. Sam was pleased with the work and sent the check to Charles as requested. Shortly afterwards, Beth and David learned of this transaction.

1. What duties to Web, if any, have been breached by Beth, Charles, and David regarding the money lost on the Adco job? Discuss.

2. What rights, if any, does Web have against Adco's shareholders for Adco's failure to pay for the website? Discuss.

3. What rights, if any, does Web have against Charles regarding the contract with Sam? Discuss.

Answer A to Question 4

4)

1. Directors' Breach Regarding the Adco Job

Duty of Care:

Since corporate directors have a fiduciary duty to the corporation, directors of a corporation owe the corporation a duty of care. The duty of care requires that the directors act with good faith and the degree of care which a prudent person would proceed with in regard to his own business,

Here Adco asked that Web perform complex work that would cost thousands of dollars to create on credit. Adco claimed to be a well-established corporation, but the directors had a duty to investigate Adco's financial situation to determine whether it was safe and in the Web's best interest to extend credit for the work. Beth, Charles and David all agreed to take the work conditioned upon a prior review of Adco's financial statements. Their decision to review was correct, but they did not adequately follow through with it.

David, anxious to obtain Adco's business, decided to proceed with the work. This decision violated David's duty of care. David should have conducted a reasonable inspection of the financial records and then reasonably determined whether it was in the corporation's best interests to extend the credit. Instead, David made an uninformed decision. Further, David acted in bad faith by misrepresenting to the other directors that he reviewed the financial statements and made his determination to proceed based on information he obtained from them. Therefore, David clearly breached his duty of care to Web.

Charles and Beth relied on David's decision without inquiring further as to what was found in the financial reports. They will likely claim that the[y] reasonably relied on David's statements in making their decision and should, therefore, not be liable. However, Charles and Beth cannot completely delegate their responsibility to the corporation and should have at least inquired further about what David based his decision on. Because Beth and Charles blindly followed David's conclusory statement, they too violated their duty of care to the corporation.

Business Judgment Rule:

Directors may be protected under the business judgement rule. Courts will not second guess a business judgment if, at the time it was made, it was informed, reasonable (based on sound business judgment), and made in good faith. Directors will still be liable for decisions which are grossly negligent or reckless.

This will certainly not serve as a defense for David, who was not informed when making his decision and acted in bad faith by lying to the other directors about having obtained and reviewed Adco's financial statements. Beth and Charles have a better chance to succeed with this defense since they did not act in bad faith and will claim that their reliance on Charles' decision was reasonable. However, it is likely that their decision to proceed in such a risky, costly and extensive project without any independent investigation or at least further inquiry was probably not sufficiently reasonable or informed under the circumstances. Therefore, they should not be able to be protected from liability from their breach by the business judgment rule.

2. Web's Rights Against Adco's Shareholders

General Rule Regarding Shareholder Liability

Generally, shareholders are not liable for the debts and liabilities of the corporation. One of the main benefits of the corporate form is that it provides limited liability; protecting shareholders from personal liability caused by corporate loss. This benefits the economy, because more risks are likely to be taken.

Piercing the Corporate Veil

Despite the general rule, courts may decide to pierce the corporate (PCV) veil and hold shareholders personally liable if there appears to be fraud or bad faith. Courts will often PCV if (1) the corporation is actually just an alter ago of the shareholders, or (2) the corporation was inadequately capitalized at its inception.

A corporation will be found to be the alter ego of its shareholders when there is serious lack of corporate formalities. If, for example, shareholder commingle corporate funds with personal funds, use corporate funds for any personal benefit, that would be grounds to PCV. Also, if meetings are not held or decisions are consistently made without meeting or voting, that may constitute grounds to PCV. Courts are generally more willing to PCV for the benefit of tort creditors than contract creditors, since contract creditors presumably had the opportunity to investigate and make an informed decision about whether to enter into the contract.

Here, it was determined that Adco's shareholders have regularly taken its funds for their personal use. This would constitute violating the corporate form and creates grounds to PCV. Web can successfully argue that Adco's shareholders are using the corporate form in bad faith to commit fraud use[,] then use the corporation as a shield from personally [sic] liability. It can argue that since Adco is operating as an alter ego and [sic] therefore, its shareholders should be held personally liable for Adco's liabilities. However, since Web voluntarily decided to enter into the contract and could have investigated before making their decision to assume the risk of doing business with Adco, they will have a higher burden. If Web can convince the court to PCV, it will be able to sue the shareholders of Adco personally to the debt owed.

3. Charles' Contract with Sam

Duty of Loyalty

Director has a fiduciary relationship with the corporation and has a duty of loyalty towards the corporation. The director must act in the corporation's best interests and not engage in any self dealing or receive personal gain at the corporation's expense. If a director comes across a situation which would breach his duty of loyalty, the director may cure the problem by disclosing it and getting approval by a majority of disinterested directors or disinterested shares.

Here, Charles did work that the corporation was entitled to and received personal profit from it. He therefore violated his duty of loyalty by acting in his own interest rather that [sic] the corporation's. If he really wanted to proceed with the work, he could tell the other disinterested directors about Sam's interest and see if a majority of disinterested directors or shares would decide that he could proceed to do the work on his own. In this case, he convinced Sam to allow him to do the work, received profit that the corporation could have had, and did so without proper disclosure and approval. Therefore, Charles breached his duty of loyalty to Web.

Usurping a Corporate Opportunity

A director should not usurp a corporate opportunity. A corporate opportunity is one which the corporation has a business interest or reasonable expectancy in. Something that is in the corporation's line of work/field will usually be deemed a corporate opportunity. If a director learns of a corporate opportunity in his capacity as director and wants benefit from it personally, he may be able to do so if he takes certain steps: (1) he must inform the corporation of the opportunity [and] (2) wait for the corporation to decline to take the opportunity.

Here, Web clearly had an interest in the job Sam was asking about. Sam wanted Web to create a new game website, which is exactly the kind of work Web does. As a business that creates websites, Web clearly has an expectancy interest in the work and would benefit (profit) from it. Charles usurped Web's legitimate right to the opportunity by convincing Sam that the job was small and that he could do it at home for less money than Web. Charles should have first disclosed the opportunity and waited to see if Web would have taken it. In this case, since the job is exactly in the line of work Web ordinarily conduct[s], Web would have likely taken the job. As a remedy, Web can recover any profit that Charles earns from performing the work for Sam.

<u>Charles's Defenses:</u>

Charles may argue that he learned of the corporate opportunity in his personal capacity, from his friend, and not because of his position as director of Web. However, Sam called Charles asking for Web to create a new game website, not asking for Charles to do it personally. Therefore, Charles was being contacted in his professional capacity as director of the corporation, and will not succeed with this argument.

Answer B to Question 4

4)

(1) Beth, Charles and David breach with regard to Web

As directors of Web, Inc., Beth[,] Charles[,] and David owe a Duty of Care to the corporation. In their dealings for Web they must behave as a reasonably prudent person would with regard to his personal finances. All three directors have breached this duty.

David

David has breached the duty of care by failing to properly investigate Adco's finances and by falsely reporting to the other directors that he had investigated Adco's finances and falsely indicating that Adco's creditworthiness was sufficient to allow Web to extend Adco credit for Web's work.

All three directors initially made a responsible decision to investigate the financial condition and creditworthiness of Adco before extending credit for the work Adco wanted Web to do. However, David did not act as a reasonably prudent person would when he subsequently failed to make this investigation and instead misrepresented to the other directors that he had made an investigation and that Web should proceed with the work. A reasonably prudent person would not have extended credit without making any investigation into the finances and creditworthiness of the person or company to whom they were extending credit. Furthermore, David's failure to make any investigation cause[d] damage to Web because Web created a costly website for Adco and will not be paid for this work. Therefore, David has breached his duty of care and will be liable to the corporation for the damage that he caused.

Finally, David's conduct cannot be saved by the business judgment rule because he did not act in good faith after a reasonable investigation of the facts. He made no investigation and had none of the relevant facts. Furthermore, he did not act in good faith when he lied about having made an investigation.

David also probably [sic]

Beth and Charles

Beth and Charles have also breached their duty of care owed to Web because they too agreed to extend credit to Adco without making any investigation of Adco's creditworthiness. Again, after initially making a reasonable and prudent decision to investigate they did not car[r]y through and instead agreed to extend credit without making any investigation. A reasonably prudent person would not behave in this manner. Furthermore, it was not reasonable them to rely on David's assertion that he had investigated and come to the conclusion that Web should proceed. Although directors are allowed to rely on the reports of officers of committees of directors assigned to perform a certain role (as well as the reports of officers of the corporation, accountants[,] etc[.]) directors may not delegate all their duties to a committee and serve simply as a "rubber stamp" for the committee's decisions. A director may not delegate his duty to make independent decisions. Therefore, Beth and Charles should have insisted on seeing at least some further information about the financial health of Adco so that they could evaluate for themselves whether the decision to extend credit was a good decision. This is, at minimum, what a reasonably prudent person would do with regard to their own finances. Web suffered damage as a result of Beth and Charles['] breach, and therefore these directors are personally liable to Web for the loss they caused.

Finally, Beth and Charles cannot take shelter in the business judgment rule because they did not act in good faith after a reasonabl[e] investigation. They made no investigation and knew none of the relevant facts. Therefore, their decision was not within the business discretion protected by the business judgment rule.

<u>(2) Web's rights against Adco's shareholders</u>

A company must maintain corporate form and structure if the shareholder's personal assets are going to be protected by the corporate form. The shareholders may not use the corporate form fra[u]dulently - as simply a cloak for their personal business activities. Therefore, the shareholders may not intermingle corporate and personal assets or take the corporation[']s assets for their personal use. When shareholders behave in this way, a court may disregard or pierce the corporate veil to hold the shareholders personally liable if justice requires it.

Here, Adco's shareholders have been regularly taking its funds for their personal use. Usually, a court will not pierce the corporate veil simply because a corporation is unable to pay its debts. Undercapitalization when a company is formed is usually required for veil piercing. However, if the shareholders have made an extensive practice of draining the corporate assets for their personal benefit, then it will appear that they have been abusing the corporate form to shield their personal business transactions from creditors. This pattern of behavior will introduce the required element of fraud.

The shar[e]holders who took the corporate assets probably cannot claim that they were just receiving dividends. A company cannot pay out dividends if paying the dividends will cause it to become insolvent (unable to pay its bills when they come due). Therefore, the shareholders (who seem to control Adco) will not be allowed to make themselves dividend payments and then not pay Web.

Web can make a strong case that a court should pierce Adco's veil to reach the shareholder's assets to satisfy Adco's debt to Web. The court will be able to reach the assets of those shareholders who engaged in the improper behavior (although the shareholders who did not take part in the misbehavior will not be liable).

Even if a corporation's shareholders have abused the corporate form, a court will not pierce the corporate veil unless justice requires it. Furthermore, a court is generally more willing to pierce the corporate veil in tort situations than in contract situations since tort victims usually do not cho[o]se to interact with the corporation. Because Web has been harmed by Adco's failure to pay its debts, Web can argue that the interest of justice require[s] holding the shareholders personally liable. However, because Web did not make an adequate investigation of Adco before doing work for them, it may be more difficult for Web to prevail. On the other hand, Web can try to argue that Adco intentionally and fraudulently misrepresented its financial health to Web (both by saying it was a "well-established corporation" and that "the sooner Web could start on the website, the sooner Adco would be able to pay"), and that this weighs in favor of piercing the veil even though Web did not take all possible precautions to protect itself.

Finally, if Adco is a close corporation and the shareholders who were siphoning money from Adco were the same people who participated in negotiations with Web and David, then Web may be able to make a claim against them personally for fraud. To do this Web would have to show intentional misrepresentation (of fact) with the intent to induce reliance by Web, which did induce reliance and reasonable reliance by Web. It is unlikely they can show reasonable reliance on misrepresentations of fact.

<u>(3) Web's rights against Charles</u>

Corporate directors owe a duty of loyalty to the corporation. They must reasonably believe that their actions are in the best interest of the corporation. A director violates the duty of loyalty when he usurps a corporate opportunity and takes it for himself. A corporate opportunity is one in which the corporation has a reasonable expectation or one that is in the business of the corporation. A director cannot excuse taking a corporate opportunity by showing that the corporation would not have been able to take the opportunity. Before a director may take advantage of any corporate opportunity he must disclose it to the corporation and wait for the corporation to turn it down.

Here Charles took for himself a corporate opportunity (work) that should reasonably have gone to the corporation. He did not fully disclose the existence of opportunity to the other directors nor did he wait for the other (disinterested directors) to refuse the opportunity. Instead he did the work himself and was paid for it. Here it seems likely that Web would have been fully capable of doing the work (taking the corporate opportunity) but even if it wasn't this would not excuse Charles's behavior.

Charles is therefore liable to the corporation for the money he made by doing the work and must disgorge it to Web.