QUESTION 5

Online, Inc. was duly incorporated as an Internet service provider. Its articles of incorporation authorized issuance of 1,000 shares of stock at $1,000 par value.

Online initially issued only 550 shares to its shareholders as follows: Dick and Sam each received 200 shares and Jane received 150 shares. Online's Board of Directors (composed of Jane, Sam, and Harry) named Jane as the Chief Executive Officer and named Harry as General Counsel.

Online's business grew substantially in the following months. Still, Online was short on cash; as a result, instead of paying Jane $10,000 of her salary in cash, it issued her 50 additional shares with the approval of its Board of Directors.

Looking to expand its operations, Online sought to enter a strategic partnership with LargeCo, Inc. Jane had learned about LargeCo through Harry's wife, who she knew was the majority shareholder of LargeCo. Jane directed Harry to negotiate the terms of the transaction with LargeCo. In the course of Harry's negotiations with LargeCo, LargeCo offered to acquire the assets of Online in exchange for a cash buy-out of $1,000,000. Harry telephoned Jane and Sam; Jane and Sam agreed with Harry that the offer was a good idea; and Harry accepted LargeCo's offer.

Two days after completion of the transaction, LargeCo announced a joint venture with TechCo, which was solely owned by Harry. The joint venture was valued at $10,000,000. In its press release, TechCo described the joint venture as a "remarkable synergy of LargeCo's new technology with TechCo's large consumer base."

The following week, Dick learned of LargeCo's acquisition of Online's assets. An expert in technology matters, he was furious about the price and terms of the acquisition, believing that the value of Online had been seriously underestimated.

1. What are Dick's rights and remedies, if any, against Jane, Sam and/or Harry? Discuss.

2. What ethical violations, if any, has Harry committed? Discuss. Answer according to California and ABA authorities.

QUESTION 5: SELECTED ANSWER A

1)

Directors of corporations owe fiduciary duties to the corporation. Among these duties are the duties of care and the duties of loyalty. If a director breaches either of these duties, affected shareholders may bring either a direct action or a derivative action against the director, based upon the nature of the injury the shareholder suffered.

Duty of Loyalty.

Directors owe a fiduciary of duty of loyalty to the corporation, which requires the director to act in the best interest of the corporation, to refrain from self-dealing with the corporation, and to refrain from usurping business opportunities from the corporation.

Harry's Breach of the Duty of Loyalty as a Director:

One aspect of the duty of loyalty is that it requires the director to refrain from self-dealing with the corporation. Here, the facts indicate that Harry negotiated the terms of a transaction with LargeCo., of which Harry's wife is the majority shareholder. Self-dealing extends not only to the director or businesses in which the director has a financial interest, but also those of the director's family. Here, because LargeCo is mostly owned by Harry's wife, the acquisition of Online's assets by Online was a self-dealing transaction.

In order not to be liable for a breach of duty regarding a self-dealing transaction, the terms of the deal must be objectively fair to the company, or the decision must be ratified at a meeting by a majority of disinterested directors who are fully informed about the conflicting interest and the terms of the agreement. (Or, by unanimous written consent of disinterested directors, if no meeting). Here, Harry provided no notice for a special meeting of the board of directors. There was no vote by the disinterested investors (Jane and Sam). Harry's telephone call to Jane and Sam, and Jane and Sam's subsequent agreement was insufficient to ratify the transaction.

Furthermore, the facts indicate that the acquisition was not fair to the company. LargeCo. offered $1,000,000 for all of the assets of Online. However, two days after completion of the transaction, LargeCo announced a joint venture with TechCo, valued at $10,000,000. This suggests, but is not conclusive, that the $1,000,000 acquisition offer may have been lower than fair market value for the acquisition.

Harry also arguably breached the duty of loyalty by usurping a corporate opportunity. TechCo, owned solely by Harry, entered into a joint venture with LargeCo two days after the completion of the acquisition of Online by LargeCo. A director may not obtain business opportunities for his own benefit at the expense of the corporation. Whether a business opportunity is one that should first be offered to the corporation is usually determined by the corporation's business, and whether the corporation is in the same general business as the opportunity. It is unclear from the facts whether the joint venture with LargeCo was a business opportunity that TechCo usurped from Online, but, if TechCo and Online conduct similar business, Harry likely violated the duty of loyalty in this aspect as well.

Harry, Jane, and Sam's breaches of the duty of care.

Corporate directors also owe the fiduciary duty of care to the corporation, which requires directors to act as reasonably prudent directors and in good faith when making corporate decisions. Under the business judgment rule, a court will not disturb a director's business decisions, and will find compliance with the duty of care, if a director takes reasonable steps in becoming informed, bases decisions on a reasonably rational basis, acts in good faith, and refrains from self-dealing with a corporation.

Under this standard, Harry, Jane, and Sam have breached the duty of care, and will not be afforded the protection of the business judgment rule. The facts indicate that Jane knew that LargeCo was largely owned by Harry's wife, yet Jane directed Harry, a director she knew to be interested, to negotiate the terms of a transaction with LargeCo. This was likely unreasonable; a reasonable director would have had a disinterested party negotiate the terms of a possible acquisition. Furthermore, Jane and Sam failed to take reasonable steps in becoming informed about the deal. The facts indicate that Harry, again an interested party, telephoned Jane and Sam, and that Jane and Sam agreed that the offer was a good idea. This is not sufficient; Jane and Sam undertook no independent investigation to determine if the terms of the proposed acquisition were fair to the corporation. Sufficient steps would have included, for example, obtaining an independent audit of Online's value as a business. Here, there are no facts Jane and Sam took **any** steps in becoming informed about the deal. Therefore, they have both breached the duty of care in this respect.

Finally, Harry's negotiations with LargeCo. were not in good faith. Harry's wife was the majority shareholder of LargeCo. Furthermore, mere days after the completion of the transaction, LargeCo entered into a $10,000,000 joint venture with Harry's solely owned company. Both of these facts indicate that Harry was acting not in the best interest of the corporation, but in his own best interests.

Issuance of the Stock For Less Than Par Value.

Dick may also bring a derivative suit on behalf of the corporation to recover for the issuance of the stock to Jane. Par value sets the minimum price for which stock may be issued. Here, Online Inc's stock has a par value of $1,000. This means shares cannot be issued for less than $1,000. The facts indicate that Online, short on cash, issued Jane 50 shares of Online stock, in lieu of $10,000 salary she was owed. This was improper. The board, Jane, Sam, and Harry, are liable to the corporation for the difference between the par value of the 50 shares ($50000) and the price paid ($10000). This is known as the "water." Jane is also personally liable as the party who received the stock, because, as a director with knowledge of the par value, she was aware that the stock was being issued to her below par value.

Failure to provide Notice and Obtain Shareholder Vote for Acquisition of Substantially All of Online's Assets.

Certain major events in a corporation must be put to a shareholder vote. These include a merger or an acquisition of substantially all of the corporation's assets. Before disposing of substantially all of a corporation's assets, there are procedures that must take place. First the board must pass a resolution, either during a meeting or by written consent, agreeing to the acquisition. Appropriate notice must then be given to shareholders, informing them of the terms of the transaction and the date of the shareholder's meeting for purpose of the vote. At the meeting, a quorum must be present, and a majority of shares voted must be in favor of the acquisition.

Here, none of these procedures took place. Dick, as a shareholder, was uninformed of the acquisition, which was agreed to solely by the directors, Harry, Jane and Sam, and accepted solely by Harry.

Derivative Action.

Here, Harry would be able to bring a derivative action on behalf of Online Co against Harry, Jane, and Sam, for the above violations. Normally, a shareholder must make a demand upon the board of directors, before bringing the action on its behalf. Here, however, demand will be excused, because the action would be against all members of the board of directors, who would be defendants in the action. Harry will likely be able to recover, for the corporation, the "water" from the stock issued to Jane, and damages for breaches of the duties of loyalty by Harry, Jane and Sam. Furthermore, Harry, again, on behalf of the corporation, may be able to rescind the acquisition, because the proper procedures for the acquisition of Online's assets were not followed. If he is successful in his derivative action, Harry will be entitled to attorney’s fees and costs of suit.

2) Harry's Ethical Violations

Duty of Loyalty:

Harry has also violated his ethical duty of loyalty. Under both the ABA and CA rules, an attorney must always act in good faith and in the best interest of the client.

An attorney may not represent a client where the attorney's representation creates either a possible or actual conflict of interest. Under the ABA, an attorney may represent a client if the attorney reasonably believes he will be able to represent the client without a conflict, and the client provides informed written consent. In California, there is no reasonableness standard, but the attorney must receive informed written consent in the case of a possible conflict and again if the conflict ripens into an actual conflict.

Here, Harry has a conflict of interest in representing Online Co. with respect to its transaction with LargeCo. LargeCo's majority shareholder is Harry's wife, so Harry has a financial interest that is directly in conflict with Online Co's interest. Harry failed to disclose the conflict to Jane and Sam (it is immaterial that Jane knew this on her own; Harry still has a duty to inform), and Harry failed to obtain written consent from the company. Having violated this duty, Harry is subject to discipline.

Business Deal with the Client:

When entering into a business deal with the client, the deal must meet four specified criteria. First, the deal must be on objectively fair terms to the client. Second, all terms of the deal must be clearly and thoroughly disclosed in writing to the client. Third, the client must be advised that outside counsel is recommended. Fourth, the client must provide written consent.

Here, Harry has failed to meet these requirements. By entering Online into a deal with LargeCo, of which his wife is majority shareholder, Harry is essentially entering into a business deal with Online. The facts suggest the deal is not fair, because 2 days later Harry enters into a joint venture with LargeCo for 10x the price paid to Online. The terms of the deal were not fully disclosed in writing, because the deal was discussed over telephone. Harry did not advise Online that it should have independent counsel. Finally, Harry did not receive written consent by Online for the deal.

Accordingly, Harry has violated his duties regarding this deal, and is subject to discipline.

Duty of Competence

An attorney has a duty of competence in his representation of a client. An attorney must exercise reasonable skill while representing the client. Reasonable skill is determined by a number of factors, including how long the attorney has practiced, the attorney's expertise, the amount of time the attorney put into becoming informed, and the ability to associate with more knowledgeable counsel. Here, the facts indicate that Harry, as general counsel of Online, breached numerous fiduciary duties. Harry approved the issuance of stock for significantly below par value, resulting in liability to himself, the other directors, and Jane, in her role as purchaser. Furthermore, Harry represented Online in a transaction in which he knew he had a personal financial interest. Finally, Harry accepted LargeCo's offer, without proper board approval and approval by shareholders. These actions suggest that Harry did not exercise reasonable skill in his representation of Online Inc.

While each of these may subject Harry to discipline under the ABA, California requires a repeated, reckless, or intentional failure to exercise reasonable skill, in order to be subject to discipline. Even under the California standard, it is likely that Harry could be disciplined, due to both his intentional conduct in violating the duty of loyalty, and in his repeated failure to exercise reasonable skill in the issuance of stock and acceptance of LargeCo's acquisition offer.

QUESTION 5: SELECTED ANSWER B

1. What are Dick's remedies?

Direct Remedies

Dick will likely be unsuccessful in bringing direct action in his own right as a shareholder, as he likely cannot succeed in suing for oppression. In a closely-held corporation, with a small number of shareholders, when one shareholder owns a majority of the shares, that shareholder may not take actions to oppress the minority shareholders and deprive them of their ability to exercise their rights as shareholders, such as voting, or unreasonably deprive them of dividends.

Here, Online Inc. is probably a close corporation, as it has only three shareholders: Dick, Sam, and Jane. However, Dick will probably be unable to argue for oppression because he owns 200 shares, which is equal to Sam's holdings, and after Jane received an additional 50 shares, she is also a holder of 200 shares. Therefore, because the shareholders own equal portions of Online, there is no majority shareholder oppression here, and Dick will need to take action in a shareholder's derivative suit on behalf of the corporation to obtain relief for the acts of Sam, Jane, and Harry.

Derivative Suit

Dick will be able to sue on behalf of Online Inc, in a shareholder's derivative suit. To bring a derivative suit, the shareholder must first petition the board of directors, and be rejected by the board. However, many states now do not require this step if the petition would be futile (i.e. where a majority of the board would be defendants in the derivative suit). Here, because the entire board would be defendants, it would be futile, and Dick would be able to bring his shareholders' derivative suit.

a. Jane

i. Watered Stock

When a corporation is incorporated, it can include a par value for its shares in the articles of incorporation. A par value is the minimum value that the share can be issued for. A share issued for below par is called "watered." A shareholder who takes knowing of the water may be liable for it, and the board of directors will be liable to the corporation for the "water": the difference between the par and the issued value.

The issue here is whether the board issued watered stock to Jane when it gave her 50 shares in the place of a $10,000 salary payment. A corporation may exchange shares for anything of value, including real property and wages, but that exchange must still meet the par value. Here, Online's par value for its shares was $1,000 per share. Thus, 50 shares would be worth $50,000 par. The board of directors voted to issue Jane $50,000 worth of stock for $10,000 worth of labor, creating $40,000 of water. Therefore Dick could sue on behalf of the corporation to recover the value of the water from either Jane, who took the shares with knowledge of the water, and also voted to issue them as a board member, or the other two directors for the water as well.

ii. Breach of Duty of Loyalty

All directors of a corporation owe fiduciary duties of loyalty and care to the corporation. A director must not deal with the corporation as an outsider, and must not engage in transactions where the director is interested in the transaction. Here, Jane breached the duty of loyalty by issuing herself the watered stock. Thus, she took advantage of her position as a board member, and obtained stock at below par in exchange for her services.

iii. Breach of Duty of Care

All directors owe a corporation a duty of care. A director must conduct business as a reasonably prudent director in the same or similar circumstances. A director may rely upon experts when voting on decisions, and may also rely upon other members of the board, but only if they are reasonably qualified to give that advice. A director will not be held liable for good faith business judgment decisions. Here, in voting on the decision to sell Online, Jane "agreed with Harry" that the offer was a good idea, and Harry accepted the offer. This deal was for the sale of the entire company, and Jane did absolutely no due diligence whatsoever to ensure that the deal was in fact a good one. Importantly, she relied only upon Harry, an attorney, and not upon Dick, who was an expert in technology matters, and who would have been a better resource on the value of the company. Jane could argue for the business judgment rule, but because she did so little in the way of due diligence, she will not be able to argue good faith successfully. This is especially true because she knew of Harry's marital relationship with the majority shareholder of LargeCo.

Therefore, Jane will be liable for a breach of the duty of care.

b. Sam

i. Watered Stock

Sam will be liable as a board member for the "water" on the stock issued to Jane, for the same reasons Jane was liable as a board member.

ii. Breach of the duty of Care

Sam will be liable for a breach of the same duty of care as Jane, because he too relied solely upon Harry when agreeing to sell Online to LargeCo.

c. Harry

i. Interested Director/Breach of Loyalty

The same duty of loyalty applies to Harry as a director as applied to Jane. A director is part of an "interested director transaction" where the director is personally part of the opposite side of a deal with the corporation, or is in a close relationship with a majority owner or board member of the other corporation. In this situation, any transaction may be voidable and the director may be held liable for the damages.

Here, Harry was an interested director. He was engaged in negotiations with LargeCo, in which his wife was the majority shareholder. He had a duty to disclose that to the board. He did not, and thus breached his duty. Harry could argue that Jane knew of the relationship, and thus the board was aware of the interest he had. That argument will fail because he had a duty to inform the entire board, not just rely on one member.

Thus, Harry will be liable for the deal between LargeCo and Online.

ii. Duty of Care

Harry also breached his duty of care, by not doing any due diligence on the deal, and by accepting an offer that undervalued the company. The same reasonably prudent director standard applies here. Because Harry alone negotiated the deal, did not do any research into the value of the company, and took a low offer, Harry breached his duty of care.

d. Fundamental Corporate Change

Dick will also have a successful action against all three board members together for a failure to put a fundamental corporate change to a vote of the shareholders. A fundamental corporate change includes the sale of all, or substantially all of the corporation's assets. A fundamental corporate change must be approved by a resolution of the board, at a board meeting, and then submitted to the shareholders, who must approve it by a majority vote.

Here, the board agreed to a fundamental corporate change when it allowed the cash buy-out of all Online assets for $1 million. Thus, they were required to hold a board meeting to approve the change and submit it to the shareholders. They did not. A board meeting must be an in person meeting, and a special meeting requires written notice to all board members. Neither occurred here, only a phone call, without an actual vote. More importantly, the change was not submitted to the shareholders for a vote. In fact, the non-board shareholder Dick was not informed at all.

Therefore, the board will be liable to the shareholders for damages on the fundamental change.

2. Harry's Ethical Violations

<u>Potential Conflicts</u>

Under the California rules, an attorney may not represent a client where the representation would be directly adverse to another client in the same matter, or where there is a significant risk that the representation will be materially limited by the lawyer's representation of another client, or the lawyer's own personal interests. A lawyer may still take on a representation under the California rules if the lawyer believes that he can still competently represent both clients, all affected clients give informed, written consent, and the representation is not prohibited by law or ethical rule. California extends the written notice requirement to potential conflicts, while the ABA does not. The ABA rules also include a "reasonable lawyer standard" where a lawyer must reasonably believe he can competently represent both parties.

Here, a potential conflict existed when Harry sat on the Board and was also General Counsel. He put himself into the position where he may have been interested in taking an action on the board for his own personal financial gain, that may not have been in the corporation's best interest. Thus, in California, he would have had to give Online written disclosure of this potential conflict, and under the ABA and CA rules, would have had to get informed, written consent if the conflict became actual. Harry did not do this, and therefore violated the rules.

Actual Conflicts

Harry also engaged in actual conflicts of interest when he negotiated the deal with LargeCo. Here, under the California rules, Harry's personal interest with his wife, the majority shareholder, was likely enough on its own to trigger a conflict. Because Harry's relationship with his wife would lead him to be more willing to make a deal unfavorable to his client, Online, an actual conflict existed when he began negotiating. Under the ABA, the conflict is a bit more remote, as Harry is not *personally* interested in the transaction, but it would probably still be enough that his wife is the majority shareholder. Therefore, Harry was in a representation where he had an interest that was probably directly adverse to his client, or at the least posed a significant risk that it would materially limit his ability [to] represent Online. Thus, Harry would have had to obtain informed written consent, and did not. Further, it is possible that this conflict could be non-consentable under the CA and ABA rules, as it seems unlikely that *any* lawyer would advise a client to allow an attorney to negotiate a deal with a company majority-owned by that attorney's wife. Therefore he violated both the ABA and CA rules.

Duty of Loyalty

An attorney owes the highest duty of loyalty to a client, and may not take any actions directly adverse to the client's interests. An attorney can enter into regular business transactions with client, so long as those transactions are fair and are in the client's usual course of business. Any other business transactions between a lawyer and client where the lawyer is adverse, the lawyer must give the client an opportunity to obtain independent counsel, and get informed consent to the deal in writing.

Here, Harry did not disclose his own company TechCo, which put his interests in the sale directly adverse to Online, as he could then negotiate a deal with LargeCo for a greater sum. TechCo, which was owned by Harry, eventually negotiated with Harry's wife's company for a deal 10x more valuable than the one he negotiated for his client, Online. Because Harry did not inform Online of the opportunity to seek independent counsel, or obtain informed consent, Harry violated both the CA and ABA rules.