San Luis Obispo College of Law

Business Organizations II

Spring 2024

Professors: E. Wagner & P. Stirling

General Instructions:

Answer Three (3) Essay Questions.

Recommended Allocation of Time: Equal Time per Question

SLO
Business Organizations II
Spring 2024
Final Exam
Prof. E. Wagner & P. Stirling

Question 1

Mike, Suzanne and Bruce decide to organize a corporation for their holistic health center in Cambria, CA, named Namaste. The center will offer yoga, spa services, saunas, a full gym, a pool and personal trainers. They each contribute $1 million. They use an online template for their articles and bylaws, but don't make any changes to them, or even read them. Mike signs and sends the articles to the secretary of state, but doesn't notice that the name is incorrect (it is listed as "GOLD's GYMyoga"). and there is no information about shares. They have a shareholders' meeting and elect themselves as directors and adopt the unread bylaws which someone told them they had to do. Suzanne says she will open their bank account, but becomes so busy the first week that she forgets, keeping all of the contributions in her account.

One month after the business has begun, the center is extremely busy and popular. There is a big sign saying NAMASTE, Inc. on the door. Suzanne finally remembers the bank account and sets it up under the name Namaste, Inc., and transfers the investments. The very next day everything goes pear shaped. One member hits her head in the pool and almost drowns, but is rescued just in time. Another member is burned in the sauna. And a third member has a stroke during a somatic breathwork session. All three incur large medical fees and sue both Namaste, Inc., and Mike, Suzanne and Bruce.

The three come to you to ask what they can do and if they are liable.

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Question 2

Albert is a director of IronMan Corporation, a private California corporation with 1,000 shareholders and a board of 9 directors. The corporation manufactures and sells vitamins and natural health supplements. It is averaging a yearly net profit of $65 million. Albert and the other directors all have travel credit cards which can be used only for travel costs to the board meetings as per the bylaws.

Albert gets married to Taylor Swift and they leave for their honeymoon in Bali. At the airport, Albert realizes he forgot his personal credit card so he uses the company travel card and charges the entire trip (total $1 million for the jet and the villa on the beach). He is so happy that he forgets to tell the company about this, and it is charged to company travel expenses.

While in Bali, Albert meets a farmer who grows Cambria berries on his 50-acre farm. These berries grow nowhere else in the world and, according to the farmer and the locals, extend longevity, cure cancer, and make regular vitamins unnecessary. It appears that no one outside that part of the island knows about the berries. Albert persuades the farmer to sell the farm to him and all the berries produced every year in exchange for the farmer living on the land, growing the berries for albert, and being paid $1 million per year. Albert pays the farmer from his personal funds. Albert calls three of the directors who are his friends and lets them in on the deal. They happily agree, but are inclined to think they should keep the opportunity for themselves.

When Albert returns, the entire board schedules a meeting to confront Albert and the other three directors about the travel costs and the Bali farm.

Albert has asked you to help him prepare. He wants to remain a director and does not want to resign. What must he do? What must the board do?

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Question 3

Burrito Shell, Inc. ("Burrito") is a large food service and supply corporation that owns 55% of Lettuce, Inc. ("Lettuce"), 70% of Tomato Corp. (Tomato), and 90% of Pico de Gallo, Inc. ("Pico"). Burrito has the power to select a majority of directors of Lettuce, a supermajority of directors of Tomato and all directors of Pico.

Burrito causes Lettuce to declare dividends distributing all profit from 2023 to shareholders. This dividend complies with all applicable statutory laws generally applicable to dividends, including approval by disinterested directors. Lettuce continues being able to operate at a modest profit based on its traditional business model. The dividend, however, leaves Lettuce unable to pursue a new growth opportunity wherein Lettuce would grow its own vegetables rather than merely source and repackage vegetables.

Burrito causes Tomato to declare dividends distributing all profit from 2023 to shareholders. This dividend complies with all applicable statutory laws generally applicable to dividends, including approval by disinterested directors. However, at the time dividends were declared, it was widely known that Tomato was expected to face competition from new startups in 2024 and would need additional cash flow. Due to the dividend, Tomato is unable to compete in 2024, and enters bankruptcy in 2024.

Burrito enters into a contract with Pico wherein Pico supplies all salsa to Burrito's other businesses on an as-needed basis with no fixed price maximum. Unexpectedly, during the term of the contract, Pico's costs increase due to supply chain issues and Burrito's needs also increase to a point where the contract is no longer profitable for Burrito. Burrito pays only half the negotiated price, but Pico continues to supply Burrito with all needed salsa, and never seeks to enforce the contract price.

Minority shareholders of Lettuce, Tomato, and Pico seek to recover against Burrito. What must they show to qualify and prove their case, and what might the result be?

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Business Organizations - Corporations II – Spring 2024

Final Exam

Question 1

ANSWER 1 (OUTLINE)

20% Organization (Similar headings – boldfaced below)

20% Issue (Spot all issues)

20% Rules (Name all rules – <u>underlined</u> below)

20% Analysis (Apply law to facts – all non-underlined, non-italicized font below)

20% Conclusions (Provide correct conclusions – as italicized below)

Introduction

Nature of the transaction: corporate existence (filings, naming, content of bylaws) and status, personal versus corporate liability

When did the corporation exist?

- *<u>California law requires an incorporator to file the articles of incorporation with the secretary of state. The articles must contain the name, the address, the number of shares authorized, the names of the directors (if they have been designated), and the permitted activities, though California forms have a standard clause allowing any activity legal in the state of California.</u>*
- *<u>The name must include a corporate designation such as Inc., or Corporation.</u>*
- *<u>A de facto corporation is one in which there has been a colorable intent to incorporate, but there are some errors in the filings. Such a corporation cannot be invalidated by a third party, but can be invalidated by the state.</u>*
- *In this case, the name was not correct, and may have been too close to an existing corporate name, thus causing confusion. The did use their intended name when they opened for business and it contained "inc.".*
- *The shares were not listed, but all other information appears to be present based on the facts provided.*
- *Accordingly, the three appear to have formed a corporation at the time of filing, though the name needs to be update which can be done by filing an amendment to the articles, which could also include the authorized shares.*
- *If this is a defacto incorporation, a third party may not claim it was not a corporate form providing liability protection to the shareholders.*

Are the three shareholders/directors personally liable for the injuries of the customers?

- *<u>Shareholders are liable only for the amount of their investment in the event the corporation is dissolved.</u>*
- *<u>Directors are not liable so long as they carry out their duties with reasonable care.</u>*
- *<u>Directors' decisions are protected under the business judgment rule and are considered correct so long as there is no indication of gross mismanagement or negligence.</u>*
- *<u>In addition, the bylaws of the corporation may detail the roles and responsibilities of the directors, as well any indemnification provided by the corporation.</u>*

- *The three would not be held liable as shareholders except to the amount they invested in the corporation. It appears their investments were designated as part of the corporation when they were deposited into the corporate account, prior to the accidents. The facts do not indicate that the shares were actually issued, however, so the amount of each shareholder's investment may not be clear, and indeed may appear to be Suzanne's only, depending on how she opened the account.*
- *Directors may be held liable in the event of a failure to fulfill their duties using reasonable business judgement. The facts do not indicate that the accidents were due to an error in their decisions. If sued, they will likely need to show that they built and equipped the facility using reasonable and informed business judgment.*
- *In addition, the facts do not indicate the content of the bylaws (unread by the directors), so it is not clear whether the corporation will indemnify them for any personal liability should the injured parties prove liability.*
- *Accordingly, the facts indicate that the shareholders will not be liable beyond their investments as a de facto corporation was formed prior to the injuries.*
- *The directors may be liable depending on the level of care and judgment when planning, and whether the bylaws provide further protection.*
- *However, as the state has the ability to invalidate a de facto corporation, the risk exists that the directors and shareholders may be liable should the state remove the corporate form. A partnership would result in such a case, and the directors' liability would be determined under partnership law.*

ANSWER 2 (OUTLINE)

20% Organization (Similar headings – boldfaced below)

20% Issue (Spot all issues)

20% Rules (Name all rules – <u>underlined</u> below)

20% Analysis (Apply law to facts – all non-underlined, non-italicized font below)

20% Conclusions (Provide correct conclusions – as italicized below)

Introduction

Nature of the transaction: corporate opportunity doctrine, misuse of corporate assets

Did Albert misuse corporate funds by charging his honeymoon to the corporation?

- *<u>Under California law sec 309, directors are required to act only in the best interests of the corporation and with a duty of care.</u>*
- *<u>Misuse of corporate assets would be a violation of the fiduciary duty of care, particularly when the director is aware that the use of those assets was prohibited.</u>*
- *In this case, Albert was aware that the corporate card was to be used for directors' travel in relation to the corporation only as it was stated in the bylaws.*
- *Despite this knowledge, he used the card for a substantial sum charged to the corporation for his personal travel.*
- *Accordingly, Albert violated his fiduciary duty to the corporation by using corporate funds for personal purposes.*
- *Albert will be required to reimburse the corporation and may be removed from the board should the requisite number of directors agree.*

Did Albert usurp a corporate opportunity by purchasing the farm in Bali

- *California law requires directors to act in the best interests of the corporation and adhere to their fiduciary duties of care and loyalty and avoid self-dealing.*
- *Corporations have a prior claim to opportunities that are sufficiently connected to the corporation's business, or the acquisition of the opportunity is accomplished through disloyalty and unfairness to the corporation.*
- *Usurping a corporate opportunity is not permitted without following specific procedures such as disclosure to the board and allowing the board to determine whether to adopt the opportunity. The board may vote, but only disinterested directors' votes will be counted.*
- *Under California section 310, directors must not engage in an opportunity personally if that opportunity may have a material interest to the corporation.*
- *In this case, the farm produced berries that have medicinal qualities very similar to the products produced by the corporation. Hence, the corporation would have a material interest in acquiring the opportunity.*
- *Albert usurped the opportunity by purchasing the farm without allowing the corporation the chance to investigate and possibly pursue it.*
- *In addition, the berries may have a negative impact on the market for the corporation in that they would be in direct competition.*
- *Accordingly, Albert did violate his duties under Section 310 by not disclosing the opportunity and by not acting in the best interests of the corporation.*
- *While Albert may argue that he found the opportunity while in a personal situation (his honeymoon), this argument would fail in light of the close relation to the products of the corporation.*
- *In order to avoid liability, Albert must fully disclose all relevant information to the board and the board must vote whether to adopt the opportunity, or to forfeit it to Albert. In the vote, Albert's vote would not be counted as he is an interested party and only disinterested directors' votes will be counted.*

Did the other three directors usurp a corporate opportunity?

- *The other three directors will be held to the same standard as Albert under Section 310.*
- *If they agreed to partner with Albert, they will have acted outside of their fiduciary duties and usurped a corporate opportunity.*
- *If the directors fail to disclose, as the facts appear, they will be subject to the same treatment.*
- *In this case, the other three directors appear to want to keep the opportunity and not share it with the company. This is a clear violation of their fiduciary duties as explained above.*
- *The disinterested directors may pursue an action to disgorge any profits should they determine the opportunity should belong to the corporation.*
- *Accordingly, the three directors also usurped the corporate opportunity when they agreed to join Albert. The remaining board members may either bring an action against them or vote to determine whether to adopt the opportunity.*

What procedure must the board follow under California rules?

- *Under California law, the board may vote to adopt the corporate opportunity, or forfeit it to the interested directors.*
- *Under section 310, only those disinterested directors' votes will be counted, so long as the number of the disinterested directors constitutes a quorum and required by the by laws.*
- *In this case, the board must determine whether the opportunity should be adopted by the corporation. In taking the vote, only the five disinterested directors' votes will be counted. As there are nine directors, five would constitute a quorum if the corporation's bylaws define the necessary quorum for such votes as a simple majority.*
- *Accordingly the board must vote whether to adopt the opportunity, forfeit it, or possibly take action against the interested directors for a violation of their fiduciary duties to the corporation.*

ANSWER 3 (OUTLINE)

20% Organization (Similar headings – boldfaced below)

20% Issue (Spot all issues)

20% Rules (Name all rules – underlined below)

20% Analysis (Apply law to facts – all non-underlined, non-italicized font below)

20% Conclusions (Provide correct conclusions – as italicized below)

.Type of suit

A. A derivative suit is one on behalf of the corporation, where a shareholder suffered a loss due solely to their status as a shareholder, and recovery from such a suit is to the corporation.

A. Here, the minority shareholders would be bringing a derivative suit because no facts suggest that they suffered special or unique damage beyond their status as shareholders.

B. A plaintiff in a derivative suit must have held at least one share at the time of the wrongdoing, have clean hands (not have consented, acquiesced, or partaken in the wrong), and not delay. Here, there are no facts to suggest that the minority shareholders lack standing or have personal defenses.

C. Typically, a plaintiff in a derivative suit must also make a demand on the board, unless they can show that making such a demand would be futile. Here, as Burrito controls the board, there is a reasonable argument that demand would be futile as the board has acquiesced in the actions in each suit.

D. Recovery: Typically, recovery goes to the corporation, then is divided pro rata among shareholders. However, where a shareholder engaged in the wrong, the court may use equitable principles to redistribute the recovery. Here, where Burrito is found to have engaged in wrongdoing, a court may therefore consider redistributing the recovery.

II. Duty generally

A. Generally, shareholders owe no duty to the corporation or to each other.

A. However, a controlling shareholder (CS) may have some duties. A CS is one who owns an outright majority of shares or who has sufficient power, despite not owning a majority, to control managerial decisions. Here, we are told Burrito has a majority share and controls a majority of the board of all three affected companies so Burrito is a CS.

B. A CS has the following duties:

1. *Refrain from harming the minority (act in the best interest of the corporation as a whole)*
2. *Refrain from self-dealing (benefitting at the expense of the corp)*

III. Procedure: Burden will be on the minority to prove unfairness of a transaction. Examine procedure (uninterested directors, adequate information) and substance of transaction. Here very few facts re: procedure except the fact that Burrito controls the BODs, but each fact pattern says a disinterested majority approved the transaction, so the transactions appear to be procedurally fair. Focus should be on substance.

.Lettuce: We are told that a dividend is properly declared that leaves Lettuce solvent. There does not appear to be a reason to set aside the BJR. The speculative opportunity of loss of a possible expansion is likely not sufficiently unfair to equate to a breach of duty by Burrito. The minority shareholders have no claim.

.Tomato: We are told that Burrito was on notice of competition that could necessitate additional cash flow for Tomato to remain competitive. Despite this info, Burrito declared a dividend, leaving insufficient cash for Tomato to continue to function. Close call (given dividend was fairly declared and competition can be speculative) but it seems likely that Burrito's dividend unfairly prejudiced Tomato and would not be declared by a disinterested holder. The minority shareholders likely have a claim.

.Pico: We are told that Pico never enforces its contract with Burrito despite suffering cost increases and only being paid half of what Pico is owed. This failure has no rational explanation; the only explanation is Burrito's conflicted self-dealing. The minority shareholders have a strong claim.

1)

Formation

When a corporation is formed, the pre-formation process is to determine the initial capitalization, and establish articles of incorporation. Next, the corporation needs to determine its bylaws, and elect its initial slate of directors. Until the corporation is formed, the pre-formation agent is liable for any debts or errors incurred.

Articles of Incorporation

Articles of incorporation define the name of the corporation, its registered agent, primary address, and initial issuance of stock. Stock--or shares--are portions of ownership in the corporation. A corporation can have as few as one share or as many as millions. Here, the articles of incorporation were taken from an online template with no changes and no indication of how much stock is being issued. There is also no indication if the registered agent was established when the articles were filed.

At this stage, Mike, as the one to sign and send the articles to the secretary of state, is acting as the incorporator. Prior to the corporate formation, the incorporator may be liable for any debts incurred or harms done.

The articles are rife with errors, including the incorrect name and lack of information about shares.

Bylaws

Bylaws are a document that is adopted by the shareholders--usually at the initial meeting and amended by vote in future meetings. The bylaws include defining the size of the board of directors, when regular meetings will be held, various rules for voting and changing bylaws, etc., and similar aspects of corporate governance.

Commented [ps1]: Or the directors

Directors

Directors of a corporation have fiduciary duties to the corporation in the governance and in managing the best interests of the corporation. Directors also enjoy a limitation on their personal liability. This means that in general they cannot be sued or held liable for the debts of the corporation. This protection can be overcome by piercing the corporate veil, with a showing that there has been a breach of key fiduciary responsibilities.

Duty of Care

Directors have a duty of care that requires them to exercise responsibility and act with good faith and fair dealing. Suzanne failed to open the corporate bank account, and as a result corporate funds and her personal funds ended up commingled. This commingling could be seen as a violation of her duty of care, however she also mitigated the failure as soon as she became aware of it.

Duty of Loyalty

Directors also have a duty of loyalty in their role governing a corporation that requires them to properly disclose any competitive opportunities or other conflicts of interest. Here, all three have acted in relative good faith--mostly their mistakes have been unintentional oversights--so there does not appear to be any violation of the duty of loyalty.

Commented [ps2]: The duty arises when the corporation has been formed

Is Namaste, Inc. a Corporation?

The key question that Mike, Suzanne, and Bruce all have is are they liable--and the answer to this question depends entirely on whether or not they have effectively formed a corporation that will provide them with the liability shield. It is clear that there were errors in the articles of incorporation--the name was incorrect, no shares were issued. At the same time, there was a significant $1 million investment from each of the three, and a very clear understanding between them as to the purpose of that investment. Even if their corporation name is technically "GOLD's GYMyoga" they could still do business as Namaste, Inc.

None of the three read the bylaws, which suggests a violation of their Duty of Care. As directors, it is their responsibility to understand what their role is and what types of limitations and requirements they have in those roles. They also have failed to appoint officers, leaving some question as to who is responsible for the day-to-day operations.

If, in spite of all of these flaws in their process, they can show that they still formed a corporation, they can be shielded from the liability. In advising them, the emphasis on how they should consider their situation would be as follows.

Clarify

First, they should hold a special board meeting and formalize and establish any roles, issues, etc. that have occurred so far. Even if this does not guarantee they are indemnified for past actions, it will be important to clarify that they had the good faith intent to form a corporation and did what they believed were the correct steps.

Commented [ps3]: Good point!

Second, they should formally agree that Suzanne was holding those investments in trust and that they were known and intended to be corporate investments from the beginning.

Commented [ps4]: Good idea!

Third, they should vote to amend the articles of incorporation to change their name to Namaste, Inc., and also vote to agree that they have been intentionally doing business as Namaste, Inc. from the beginning.

Commented [ps5]: And add the shares?

De Jure Corporation

A de jure corporation is one that is formed by law and by the rules of the state of incorporation. Here, there have been some oversights that may make it difficult to prove that they were a de jure corporation when the incidents occurred. This--and for future liability protection--is why it is essential that they meet and properly amend all of their documents, and ratify the investments as having been held in trust but always intended as investments in the corporation. Nevertheless, their liability protection is threatened by the mistakes in their paperwork. Therefore, it is also important to establish that they had every intention, and by their outward behavior, and their relationship to customers and other entities, acted as a corporation. By this they can show that they were a de facto corporation.

De Facto Corporation

A de facto corporation is one that, although not perfect in its legal formation, and perhaps not a legal corporation at all, has held itself to be a corporation, acted in every respect as a corporation, and been treated as a corporation in the larger marketplace. Sometimes this claim may be made by a vendor or customer seeking to enforce a contract or hold a corporation liable. Other times it may be used to assert the availability of limited liability even in the face of imperfect legal documentation. Here, if Mike, Suzanne, and Bruce want to avoid personal liability for the injuries, and have the debts and any court judgments apply only to Namaste, Inc., they will need to show that Namaste is a de facto corporation.

In support of this argument they can point out that they made a good faith effort to file the articles of incorporation, that they adopted bylaws, and that they each contributed $1 million in investment. Even if shares were not issued, because they each invested an equal amount of money it would be reasonable to assume that there were three shares created when they formed the agreement.

Commented [ps6]: Good point!

Next, they will argue that they advertised their business as Namaste, Inc., that they operated their holistic health center under this assumption, and most importantly that they entered into member contracts with customers and with personal trainers and other service providers, all under the moniker of Namaste, Inc. Their bank account is in the name Namaste, Inc., and the money for the investments was transferred there before any of the incidents occurred.

Corporation by Estoppel

There is one other way that a corporation may be implied to exist in spite of errors in the formal organization, and that is by estoppel. Typically this applies when a party has a contract with the corporation, and has relied to their detriment on the assumption that the corporation was properly formed. This could benefit the members, if Namaste, Inc. was to deny any contractual obligation, or the yoga instructor who was conducting the breathwork session, however it is unlikely to be of much help to Mike, Suzanne, and Bruce. That said, it is further evidence that they should be treated as a corporation.

Here, the three should review the language of the membership contract and see if it provides some support to their limited liability as the contracts are likely exclusively in Namaste, Inc.'s name. Nike, Suzanne, and Bruce should hold these contracts up as further evidence that Namaste, Inc. was a proper corporation even though there were errors in its legal formation.

Conclusion

Mike, Suzanne, and Bruce should continue to conduct their affairs as a corporation. They should first ensure that the articles of incorporation and bylaws are correctly updated, with the appropriate name, issuance of shares, and registered agent. To begin this process, it would help if they would read them--and probably to hire someone to help explain them as well. And then to follow the appropriate state and bylaw procedures to make the amendments as needed.

Next, they should establish that Suzanne was merely holding the investments in trust until she would be able to establish the new bank account for Namaste, Inc. Otherwise, the commingling of personal funds will be an easy target for the lawsuits seeking to pierce the corporate veil. They should review their member contracts, advertisements, signage, and everything else to fully conform to their corporate identity.

Finally, they should assert that they have been a de facto corporation based on how they have presented themselves and acted.

O 15
I 15
R 15
A 15
C 15
Total 75

Excellent! Well -crafted answer. The one item to clarify is that the fiduciary duties arise when the corporation has been formed.

2)

Issue:
Is Albert liable for using a corporate business opportunity for himself? Can he remain a Board member and what action must the Board take against him?

Corporation:
A corporation is a legal entity that has standing in court. A corporation, a legal entity is organized and usually funded through the buying and selling of shares, and generally exist to earn a profit. Members of corporations look to limited their liability by forming such an organization and seeking to remove business liability away from them personally.

Here we are told that this is a private corporation so it is not publicly traded on a stock exchange. The company is also not close held because in CA for a CC you cannot have more than 35 shareholders (SH) nor is it an S-Corp that has no more than 100 because Iron Man Corp. has 1,000 SH and 9 Directors.

Nonetheless, it appears to be a valid corporation.

Commented [ps7]: good

Corporate Business Liability/Opportunity:
A member of the Board of Director has a fiduciary duty to look out for the best interest of the corporation which means not putting their own business desires and interest above that of the corporation, particularly if those desires are in the same line of business as the corporation they are a Board Member for.

Here, we are told via the fact pattern that Albert is a Director of Iron Man Corporation, a private CA corporation in the sale of vitamins and natural health supplements.

I am first going to address his business deal with the local farmer in Bali and then proceed to his charging his personal trip on the corporation card.

Purchase of Bali Farm:

While in Bali, Albert learns of a farmer who grows what sounds like a miracle vitamin for health, longevity, and cures and we are told it makes "regular vitamins unnecessary." This latter point is important because remember Albert is a Board of Director for a vitamins and natural health supplement company; therefore, buying this farm where the miracle berries are grown can arguably be "in the line" of the same business as Iron Man Corporation. The facts further tell us, that Albert persuades the farmer to sell him the land in exchange for the farmer to work and live on the land for $ 1million per year. Though Albert pays the farmer from his personal funds, IronMan Corp. may still argue there is a conflict of interest of here via Albert.

Commented [ps8]: Good point!

Regarding corporate business opportunity, if a Director engages or is presented with a personal business opportunity and it is in line with the corporation they are a Board Member for, the corporation gets first bite at the apple in terms of taking up the opportunity. This is because as a Director you have a fiduciary duty and are suppose to put the interest of the corporation first and you have a duty of loyalty and this type of conflict can see has not being loyal to the corporation, Board, or shareholders.

Under the court case *Guth*, which California follows, an individual Director may engage in a business opportunity outside of the corporate board it serves on if: this is purely an individual opportunity and pursuit, he fully disclosed the opportunity, it is not inline with the business you sit on the Board for, you are not exploiting company resources in ascertaining the business opportunity, and you are not acting opposed to your fiduciary duties.

Commented [ps9]: Excellent!

Here, Albert can say this is an individual business opportunity, but it is in line with vitamins or very well may put IronMan out of business since the word on the street is that these berries on the farm he purchased make vitamins unnecessary. He also has not disclosed this to the board, he also only sneakily told three other Board members. It can be argued that Albert is exploiting IronMan's resources in pursuit of this business opportunity because he used his IronMan corporate credit card to charge the entire trip.

But for having this credit card on hand (since he forgot his own) he would not have gotten to Bali and been able to pursue this opportunity that is only in Bali. Finally, for the reasons specified, it can be argued that this move is at odds with Albert's fiduciary duties because it is a conflict of interest with Iron, it can put them out of business and that is not in the best interest of IronMan, which is Albert's job to look out for.

Commented [ps10]: Good analysis

Albert then calls three of the directors and loops him into the deal and they agree, so they are in breach of their fiduciary duties as well. None of this has been fully disclosed to the Board, which would be required due to the nature of the business arrangement/deal. The facts tell us that the other three Directors want to not tell the Board and keep the opportunity to themselves which violates the principal that the corporation should get the first crack at the bat here, not individual Board of Directors.

Personal Travel Expenses:

The fact pattern also tell us that Albert uses his corporate credit to charge the entire trip, a total of $1 million. Albert has not been given authority to do this. Again, this action is a breach of his fiduciary duties because he is putting his own needs to expense his honeymoon over the proper financial policies of the corporation. This also co-mingles personal and corporate business assets.

Though Albert may say he did not intend to do anything against the company he was just so happy on his honeymoon he forgot, that is a big purchase and some of money to forget about. And the Board will argue that Albert has essentially usurped corporate assets for himself. As a remedy the corporation will seek for him to pay this amount back. They may also without cause (though they arguably have it) vote to dismiss him as a Director by the outstanding shareholders.

Board Meeting:

The Board has called a meeting to confront Albert. The Board of Directors (BOD) has a fiduciary duty to inspect and investigate and this is part of that process. Albert failed in his duty to fully disclose the purchase of the farm with the magical berries that render no need to take a regular vitamin, and again, IronMan is a vitamin and health supplement company. The Board may need to call this meeting quickly, and under California law they can call such a "special" meeting with two days notice.

The Board will need to ensure they have a proper quorum to meet that is inline with their Bylaws. They will also need to make sure they have enough disinterested voters (meaning those that do not have a stake in this business opportunity) to vote on whether Albert can legitimately pursue this opportunity individually or if he will have to forgo it because it is in line with the business of IronMan or as also said before, in some ways opposed to it since it may make the need for a regular vitamin no more. Albert and his his three friends on the Board that he told the business opportunity too are interested and therefore cannot and should not vote on this matter. Albert will need to make a argument that the purchase of the farm is not inline with IronMan, he might argue it is not line because he is purchasing a farm outside of CA and the product is berries not vitamins. Again, the Board will argue that the berries provide the same function as vitamins and their supplements and therefore there is a conflict of interest. Albert will not be able to use the Business Judge Rule which takes a decision from a Board member or Board as legitimate even if unreasonable as long as it is done in good faith, because Albert's actions involve self dealing and also interested Board members. The Board may decide to ratify Albert's business decision if they feel it was fair, but if not they will void it. However, Albert has already bought the farm so this is challenging for the Board, Albert probably is not going to sell it back to the farmer so the Board may force him to step down and they could argue and avoid a litigation for doing so my arguing that Albert is liable for corporate business opportunity and engaged in a business transaction that was against his fiduciary duty for all the reasons specified above.

In many ways, it can be argue that Albert is too late to fully disclose and make an argument per Guth on his own behalf because the fact pattern leads us to believe that the Board called the meeting before Albert contacted them, as a matter of fact, there is nothing in the facts that say Albert tried to to reach out to Board about him leaving his personal credit card and needing to use the corporate one or about the farm purchase, so the Board may argue that Albert did not make an effort to disclose these transactions to the board, revealing more of his self dealing and conflict of interest.

Conclusion:

Given the facts and the analysis, I would tell Albert that he needs to fully disclose and it would have been better to do so immediately, even calling the Board while away or holding off on the purchase and presenting it to the Board first before pursing it. However, Albert did not do this, so I would tell him to go to meeting and disclose openly he forgot his personal card and here is a check to pay you back today. Second, I would tell him to disclose to the Board the purchase and if true, perhaps tell the Board that you had to move on the sale immediately before someone could and that you had every intention having this be a business opportunity for the company or to share with the company and that it was the three other directors that were "inclined" to keep the opportunity for themselves, no him.

Commented [ps11]: Good idea

I would caution my client, Albert that the Board may be incline to remove him because this was all done before disclosing to the Board but that these are his options at this point.

Commented [ps12]: Might the board find that taking the opportunity from albert through a constructive trust or forfeit be more profitable than removing him?

O 14
I 14
R 15
A 14
C 14
Total: 71

Very well done. Note that not taking advantage of the opportunity to obain it from albert may be seen as bad judgement by the directors as it could be very profitable. Even if they end up with a constructive trust instead of owning the farm, they still get the benefits and albert has the relationship with the farmer.

3)

First, in order to recover against Burrito, the minority shareholders would have to show that they have standing, that they made a demand, and that Burrito breached its duty of care to shareholders of Lettuce, Tomato, and Pico.

Valid Corp.

There are no facts to show that Burrito, Lettuce, Tomato, and Pico are not valid corporations, so we will presume that they are valid corporations.

Derivative and Direct Actions:

A direct action is where the shareholder has been personally harmed by the actions of the corporation.

A derivative action is where the shareholders bring an action on behalf of the corporation for harms that have incurred by the corporation. Here, Lettuce, Tomato and Pico are bringing actions against Burrito as to harms to their corporations. Therefore they would each bring derivative actions.

Standing:

In order to have standing to sue, the shareholders would have to show that they were record owners of shares at the time of the transaction and through out the case. Here, there are no facts to indicate when the minority shareholders bought their shares, but we will assume that they have standing.

Commented [ps11]: good

Demand:

Shareholders first need to make a demand to the corporation before filing their lawsuit. The demand is for the corporation to take action on their behalf. In California, the shareholders must make a demand or explain why they didn't make a demand. They also have to send the corporation a list of their demands or a copy of the proposed complaint. They must wait 90 days until they can file the suit. In some jurisdictions, in order to get out of the demand requirement, they have to show that it would be futile, that there are not enough disinterested board members to the transaction and asking for a demand would be futile because they would just say no. Assuming that the demand requirement is met, 90 days pass, they can file their suits.

Controlling Shareholder:

A controlling shareholder is an entity or person who owns enough of a corporation to control who is on the board of directors. A controlling shareholder owes the same fidicuiary duties as a director because they have the power to control who sits on the board.

Here, Burrito owns 55% of Lettuce, 70% of Tomato and 90% of Pico. Burrito would be considered a controlling shareholder.

Lettuce v. Burrito:

Duty of Care: A director owes a duty to act in good faith, in the interest of the corporation, and as a reasonably prudent person would in the same situation. There is a presumption that a business decision made by the board is sound. In order for the BJR to apply, a decision needs to be made, the decision was reasonbly decided, it was made in good faith, and the board members did not receive financial benefit from the decision.

The BJR can be rebutted by the shareholder proving that the decision wasn't made in good faith, wasn't made with sufficient information, or there was a personal financial benefit to the board. If the BJR is not presumed, then the board can argue that the transaction was entirely fair (fair process and fair price)

Here the facts state that the decision to declare a dividend complies with the statutory requirements, which would include that after the divident is made, the assets are equal to or more than the liabilities, and that the corporation would still be able to pay its liabilities including any uncured preferred dividends after the dividends were made. Declaring a dividend is in the sole discretion of the board. The minority would argue that because of the dividend it is not able to pursue a new growth opportunity, and therefore the board did not act with due care. They would argue that the board made the decision because of Burrito and not because they used good information to make the decision.

However, the courts usually defer to the board in regards to the decision to issue a dividend. Therefore, in this case, there would likely be no breach of duty of care.

Duty of Loyalty:

Here, Lettuce could argue a breach of duty of loyalty. A breach of the duty of loyalty occurs when there is a self interested transaction or an usurption of a corporate opportunity. Burrito breached this duty because it caused the board to declare dividends which resulted in Lettuce missing business opportunities.

However, just because a controlling shareholder receives more from the issuance of a dividend, the minority shareholders still received their proportional amounts from the dividends. Therefore, if all applicable statutory provisions were complied with, and the BJR presumption applies, Lettuce would fail in its suit against Burrito.

Tomato v. Burrito:

Duty of care, supra.

Here, Tomato would argue that even though the issuance of dividends is usually left to the discretion of the board, there was information available at the time dividends were declared (which is before issuance), that Tomato was expected to face competition form new startups and would need additional cash flow. This would have been information that the board should have considered when making the decision to issue dividends. However, Burrito would argue that just because a decision did not turn out to be the best decision, it still doesn't mean that the BJR does not apply. Tomato would have to show that at the time of the dividend it would have been likely that the dividends would have caused the bankruptcy.

Commented [ps12]: Good point

If the BJR did not apply, then Tomato would still have to show a breach of care. Review of decisions in hindsight are not allowed. However, if the decision was not an informed one, the burden would shift to Burrito to show that it was a fair price and process. If the BJR does not apply, Tomato may have a case for breach of care.

Breach of Loyalty, supra

This would be the same analysis as Lettuce.

<u>Pico v. Burrito</u>:

Duty of Care, supra:

Here, Burrito failed to pay the contract and Pico continued to suppy it with products. The minority shareholders would sue both Burrito and probably the board for failing to act with due care. They allowed Pico to enter into a contract with Burrito for all of its products. When Buritto failed to pay, they continued to deliver and did not act to enforce the contract. Pico would argue that Burrito and the board did not act in good faith and it wasn't a sound decision and therefore the BJR does not apply. Pico would also argue that the transaction wasn't fair because it had to supply all salsa to Buritto's businesses with no fixed price.

Duty of Loyalty:

Here, Pico could argue a breach of duty of loyalty. A breach of the duty of loyalty occurs when there is a self interested transaction or an usurption of a corporate opportunity. Here, Pico entered into a contract with Burrito, the majority shareholder of its company. Buritto failed to pay on its contract therefore causing damage to Pico. Burrito profitted from Pico at Pico's expense. Also, Pico still supplied Burrito while not getting paid. Burrito took advante of the situation at the minority shareholders' expense.

Commented [ps13]: Good point

This is a conflict of interest and a breach of loyalty and Pico would have a case against Burrito and Pico for breach of duty of care and breach of duty of loyalty.

Close Corporation:

There are no facts to indicate that the corporations are close corps, but in that situation, the minority shareholders can prevail by showing that they suffered oppression by the majority shareholder. Their reasonable expectations as a shareholder in the company were thwarted by the majority. The Majority shareholder can then claim that the decision qualified under the BJR which shifts the burden to the minority to show that there was a better alternative than the decision that was made.

Commented [ps14]: Very good

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A 15
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Total 71
Well done. Great comment about oppression.

END OF EXAM