QUESTION 2

Ann and Joe each contributed $500 to open a children's clothing store. They decided to do business as a corporation, A - J, Inc. Joe typed the articles of incorporation and submitted them to the Secretary of State's office in September of 1997. By mistake, Joe typed "December 1, 1997" rather than "October 1, 1997" as the date when he intended A - J, Inc. to begin doing business. All the formalities of forming a corporation were correctly completed, including issuing shares of stock in Joe's and Ann's names.

During October, A - J, Inc. entered into a lease, obtained insurance, and ordered $100,000 worth of children's clothing on credit from various suppliers, with Ann signing as President. The grand opening of the store was held on November 1, 1997. On November 15th, 1997, the contents of the store were destroyed by fire.

The insurer refused to pay for the destroyed goods, claiming its policy only covered corporate property. Because A - J, Inc.'s certificate of incorporation was not issued until December 1, 1997, the insurer claimed that there was no corporation at the time of the loss and thus no coverage.

QUESTION:

The suppliers seek to hold Joe and Ann personally liable for the amount owed for the children's clothing. Ann has come to you for advice concerning her personal liability to the suppliers and the insurer's obligation to pay for the destroyed goods. Please limit your discussion to principles of corporate law.

DISCUSSION FOR QUESTION 2

The determination of Ann's liability to the suppliers, as well as of the insurer's obligation to pay for the destroyed goods, depends on whether A-J Inc. will be recognized as a corporation prior to December 1, 1997.

A de jure corporation is one created as a result of compliance with all legal requirements of the state of incorporation. At the time of the fire, A-J Inc. was not a de jure corporation. The articles stated that the corporate existence would not begin until December 1st, and the certificate of incorporation was not issued by the Secretary of State until that date. It is the general rule that organization in accordance with its charter and the statutory provisions is necessary before a corporation can enter into a binding contract or transact any business. Under modern statutes, incorporation is complete upon the issuance of the certificate of incorporation. Fletcher Cyc. Corp. (Perm. Ed.) § 3737.

Ann ordered the goods on behalf of A-J Inc. prior to the formation of the corporation. She may be deemed to have acted as a promoter by entering into pre-incorporation contracts and be held personally liable to the suppliers on that basis. Id. § 190.

However, A-J Inc. may be a de facto corporation. The three elements necessary to form a de facto corporation appear to have been met in this case. There apparently was a law under which a corporation could be formed, Joe made a bona fide attempt to form the corporation pursuant to that law, and through the use of "Inc." and the observance of corporate formalities, there was an attempt to use or exercise corporate power. People v. Zimbelman, 194 Colo. 384, 572 P.2d 830 (Colo. 1977); Fletcher Cyc. Corp. (Perm. Ed.) § 3777.

With respect to the suppliers and the insurer, A-J Inc. may be a corporation by estoppel. As of October 1st, Ann and Joe held the business out as a corporation. If in their dealings, the suppliers and insurer relied solely on the corporate entity as the other contracting party, then they may be estopped from claiming the corporation did not exist. Id. § 3910.

Shareholders are not generally liable for the debts of the corporation. Id. § 6647. Even if there is a corporation, however, whether de facto or by estoppel, the suppliers may be able to pierce the corporate veil and reach the shareholders' assets, especially here, where the original capitalization of the corporation was small. Id. § 44.

If there is no corporation or if the corporate veil is pierced, then Ann will probably be held personally liable to the suppliers and the insurer will probably not be obligated to honor its contract. If there is a corporation and if the corporate veil cannot be pierced, Ann will probably not be personally liable to the suppliers and the insurer will probably be obligated to cover the loss.

Examinee # ______

Final Score ______

SCORESHEET FOR QUESTION 2
ASSIGN ONE POINT FOR EACH STATEMENT BELOW

1. A de jure corporation is one created as a result of compliance with all legal requirements of the state of incorporation. 1. ______

2. A-J Inc. was not a de jure corporation until December 1, 1997, when the certificate of incorporation was issued. 2. ______

3. Prior to that time, A-J Inc. may have been a de facto corporation. 3. ______

4. Elements of a de facto corporation:

   4a. The existence of a law under which A-J Inc. could have been validly incorporated on October 1, 1997. 4a. ______

   4b. Bona fide attempt to comply with such law. 4b. ______

   4c. The business was carried on as a corporation. 4c. ______

5. The insurer and the suppliers may be estopped from claiming there is no corporation. 5. ______

6. Shareholders are not generally liable for the debts of the corporation. 6. ______

7. The suppliers may be able to pierce the corporate veil to reach shareholder assets on the basis that the corporation when established was undercapitalized. 7. ______

8. By entering into agreements to purchase inventory before the corporation was formed, Ann may be personally liable to the suppliers as a promoter. 8. ______

QUESTION 5

ABC Corporation ("ABC"), a midsized corporation incorporated under the laws of the State of Imagination, is a software company. The State of Imagination follows the Model Business Corporations Act.

ABC has been in the news for the past year and a half because it is a star in launching new software products. Recently, after about two months of steady publicity, ABC released its newest product, Web Alert. Web Alert is designed to alert parents when their children have contacted inappropriate Internet sites.

Peter Piper is an investor looking to "make it big" in the stock market. Peter saw the publicity about Web Alert and invested a substantial sum of money in purchasing stock in ABC prior to release of Web Alert, hoping to make a hefty return on his investment.

Unfortunately, on the day that Web Alert was released, ABC's largest competitor, XYZ Corporation, released a similar product called Mommy Watch. All of the trade papers and news media called Mommy Watch the most innovative product of the decade. The positive press for Mommy Watch and XYZ Corporation sent its stock soaring and the stock of ABC, its competitor, plunging.

Peter is disgusted. He thinks that the Board of Directors and the officers of ABC should have seen this coming, and that they improperly failed to take action to prevent the stock from plummeting. He wants to sue ABC because he has lost a substantial amount of money due to the drop in value of the stock. He is certain that other investors in ABC lost money also.

QUESTION:

Discuss possible actions Peter may have against ABC, and what he must do in order to file suit against the corporation.

DISCUSSION FOR QUESTION 5

In this case, the initial determination to make is whether or not there is an actual basis for a lawsuit, or whether Peter's losses are simply the result of the vagaries of the marketplace. If it is established that the drop in stock value here is actionable, then the most likely cause of action would be a possible shareholder derivative action. Shareholder derivative actions are those lawsuits brought by a shareholder of a corporation to obtain relief for alleged wrongs committed against the corporation. Brooks v. Land Drilling Co., 564 F. Supp. 1518 (D.C. Colo. 1983). Such actions can be used only where it is evident that the facts and circumstances make it clear that a corporation will not take action to remedy a particular situation that is injurious to itself. Id. The theory of shareholder derivative proceedings is that any harm done in a situation such one which harms the value of the stock of the corporation, is done not to the individual but to the corporation. Nicholson v. Ash, 800 P.2d 1352 (Colo. App. 1990). In other words, a stockholder may only maintain a personal action against a corporation if the type of injury complained of is unique to that shareholder, see id. This does not appear to be the situation here. Rather, the drop in the value of the stock in this case appears to be harm done to the corporation and not to the individual, and thus, may be proper for a shareholder derivative action.

As a threshold requirement, the plaintiff in a shareholder derivative action must be a holder of record of the shares at the time of a transaction of which he complains. Model Business Corp. Act, section 7.41(1). From the facts set forth in the question, it appears that this threshold requirement of the law is met. At the time of the stock drop, Peter owned the shares.

Beyond this threshold inquiry, certain preliminary steps be taken prior to filing suit. First, a shareholder must make a written demand upon the corporation. Id. at section 7.42(1), and either the claim must have been rejected by the corporation, or 90 days must have expired, or "irreparable injury" to the corporation must be inevitable by waiting the 90 days. Id. So, Peter must make a demand upon the Board of Directors of the corporation to right the alleged wrong. This would provide an opportunity for the corporation to correct its actions in the interest of the corporation. Once the demand is made, Peter would need to allow the corporation 90 days to solve the problem, or meet one of the other elements of section 7.42.

Additionally, it is imperative that the shareholder bringing suit "fairly and adequately represent[s] the interests of the corporation in enforcing the right of the corporation." Id. at section. 7.41(2). This means that a shareholder should represent not just his own interests, but those of all other shareholders. Peter, then, must be representing the interest of the corporation in this special type of civil suit designed to be brought in the right of a corporation.

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Essay 5 GradeSheet **Seat** ____ **Score** ____

Please use blue or black pen and write numbers clearly

1. Peter may bring a shareholder derivative suit. 1. ________

2. A shareholder derivative suit is a lawsuit brought by a shareholder of a corporation to obtain relief for wrongs committed against the corporation. 2. ________

3. A shareholder cannot bring an individual suit against a corporation for harm done to the corporation unless it is a harm unique to that shareholder. 3. ________

4. In this case, the wrong done to the corporation — a drop in the value of the stock — is not unique to Peter Piper and therefore, he must bring suit through a shareholder derivative action. 4. ________

5. A shareholder must have standing to bring a derivative suit. 5. ________

6. Standing in a derivative suit means that the plaintiff must have legal or equitable title to stock in the corporation at the time of the alleged wrong. 6. ________

7. A shareholder must make a written demand upon the Board of Directors of the corporation that the wrong be corrected prior to filing of the lawsuit. 7. ________

8. A shareholder need not make a written demand if such demand would be futile. 8. ________

9. A shareholder must wait 90 days after the demand or show irreparable injury to the corporation by waiving such 90 days before filing suit. 9. ________

10. A shareholder must fairly and adequately represent the interests of the corporation in bringing the derivative action. 10. ________

11. Peter Piper may allege that the board of directors and officers breached its Duty of Care to the corporation. 11. ________

12. The board of directors and officers may defend against Peter's suit on the basis of the "Business Judgment Rule." 12. ________

13. The Business Judgment Rule holds that directors and officers of corporations will not be held liable for errors or mistakes in judgment, pertaining to law or fact when they have acted on a matter called for the exercise of their judgment or discretion, when they have used such judgment and have so acted in good faith. 13. ________

QUESTION 4

Alice formed ABC Corporation by properly filing articles of incorporation with the appropriate state agency on January 1, 1995. The articles authorized the corporation to issue 100 shares of common stock at a par value of $100 per share, and provided that the corporation would have three directors on its board, Alice, Bob, and Carol, who would each serve a term of one year. At the first meeting of the board of directors on January 1, 1996, the board approved the issuance of 75 shares to Alice and 25 shares to Bob. Alice and Bob paid the corporation $7,500 and $2,500 cash, respectively, for their stock.

Over the next four years, ABC became very successful in the party supply business. Alice and Bob made huge salaries and borrowed money freely from the corporation at below-market interest rates without shareholder or director approval. Carol felt left out of their success and asked Alice and Bob for shares of ABC stock. Alice called a board meeting on January 1, 1999, and at that meeting the board approved the issuance of 25 shares to Carol for $2,500 cash. This meeting was the only meeting of the board since the initial January 1, 1996 meeting. Carol paid $2,500 cash to the corporation and received a share certificate for 25 shares.

On March 1, 1999, Alice sold all of the assets of ABC to Big Corp for $1 million, which was $500,000 more than the true market value of ABC's assets. Alice did not receive shareholder or director approval for the sale. Alice had the corporation's accountant pay dividends of $750,000 to Alice and $250,000 to Bob. As a result of the sale, the corporation has no cash or assets of any kind remaining.

QUESTION:

Discuss all possible claims which Carol may have against ABC, Alice, or Bob, and which Bob may have against Alice. Do not discuss any possible shareholder derivative suits. Assume that ABC is not a close corporation.

DISCUSSION FOR QUESTION 4

Carol versus ABC, Alice, and Bob

Carol may claim that she is a shareholder of ABC and should consequently share in the sale of assets to Big Corp. Although Carol paid for 25 shares of stock, there is a question as to whether the share issuance is valid. If the issuance of stock is not authorized by the articles of incorporation, then the transfer of shares is void, regardless of shareholder or director ratification. Model Business Corporation Act, 3rd Ed., §6.03. ABC's articles authorized the issuance of only 100 shares, which ABC had already issued (75 to Alice and 25 to Bob). Therefore, Carol's 25 shares likely are void and ineffective to confer shareholder status on Carol.

Even though Carol is not a shareholder, she may be able to recover her $2,500 investment from ABC as a creditor. Fletcher Cyc. Corp., Vol. 12B, §5755. This poses a problem for Carol, however, as the corporation is insolvent because it sold all its assets and the shareholders, Alice and Bob, took $1 million as dividends.

Carol may have to try to recover her $2,500 from Alice and Bob personally by "piercing the corporate veil." A creditor of the corporation may persuade a court to disregard the corporate entity (pierce the corporate veil) and hold the shareholders personally liable if 1) the shareholders have not respected the separateness of the corporate entity, and 2) injustice would otherwise result. Henn, Law of Corporations, 2nd Ed., §146 and Fletcher Cyc. Corp., §41.30 (p.619). A corporation's separateness is not respected where the shareholders fail to observe formalities such as holding annual shareholder and director meetings and the shareholders commingle corporate funds with their own. Fletcher Cyc. Corp., §41.30 (p. 626). ABC failed to observe numerous formalities: 1) the shareholders and directors did not hold the annual shareholder and director meetings required by law; 2) the corporation acted for over three years without duly elected directors because the terms of the original three directors expired one year after formation of the corporation under the articles; and 3) the shareholders freely borrowed money from the corporation without the approval of the disinterested directors and shareholders as required by law.

Additionally, in order to pierce the corporate veil, it must be shown that without such "piercing," an injustice would be done. *Id.* at §41.30 (p.619). Most courts define "injustice" as undercapitalization of the corporation. *Id.* at §41.30 (p.625). A corporation is undercapitalized where it was organized without sufficient capital to meet reasonably anticipated business risks, as measured at the time the corporation began conducting business. *Id.* at§ 41.30 (p. 625). Alice and Bob capitalized the corporation with a total of $10,000. This may, or may not, be seen as enough capital, depending on the inherent risk of liability from the sale or use of party supplies. The fact that the corporation is now insolvent is irrelevant.

Bob versus Alice

Bob may claim that Alice's sale of ABC's assets to Big Corp violated Alice's fiduciary duties to the other shareholders. A majority shareholder breaches his or her fiduciary duty if he or she engages in an act that is unfair to the minority shareholders. *Id.* at § 5810. In order to pursue such a claim, Bob would have to show 1) that the sale of assets was not properly approved by the shareholders, and 2) that the sale was unfair to him as a minority shareholder. *Id.* at §§ 5811, 5837.

The sale of all of a corporation's assets must be approved by a majority of the corporation's voting shares. *Id.* at § 2949.20.10 and Henn, Law of Corporations, §195. Shareholders must act in meetings, and the shareholders must either receive proper notice of the meeting or all shareholders must waive notice. Fletcher Cyc. Corp., §§392, 405. Because there was no notice of any shareholder's meeting, and the shareholders did not waive notice, there was no shareholder approval of the sale. This is so even though Alice owns 75% of the shares; she must still adhere to the notice or waiver formalities required by law because this is not a close corporation. *Id.* at § 410. Therefore, the sale of ABC's assets to Big Corp was unlawful.

While the sale was clearly unlawful, there is no apparent unfairness to Bob, because Alice obtained an excellent price by selling the assets for 200% of their market value. However, if Bob were to unfairly lose something of value as a result of the transaction, such as a share of the future profits of ABC, or a long term salary from ABC, then Alice would be liable to Bob for those damages. *Id.* at § 5837.

Bob may also claim that Alice breached her fiduciary duty by taking loans at below-market interest. Self-dealing transactions between the corporation and a shareholder or director must be approved by a majority of the disinterested shareholders or directors. *Id.* at § 955. Because Alice did not obtain shareholder or director approval for the loans, she will be liable to Bob for the unfair profit she received on the transaction, e.g., 25% of the difference between the interest she actually paid and the fair market rate of interest. The fact that Bob also took the same unapproved loans from the corporation is not relevant to Alice's liability, but it may provide Alice with an argument that the court should set off her liability against Bob's liability for improper shareholder borrowing. *Id.* at § 955.

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Essay 4 GradeSheet **Seat** [ ] **Score** [ ]

Please use blue or black pen and write numbers clearly

Carol's Claims

1. She may claim that as a shareholder, she is entitled to share in the assets of the sale. 1.________

2. However, there is an issue of whether Carol is a bona fide shareholder. Her shares were not authorized by articles and are likely void. 2.________

3. Carol may be able to recover her $2,500 investment, as she and ABC have creditor-debtor relationship. 3.________

4. Alice and Bob may be personally liable to Carol (under the theory of piercing the corporate veil). 4.________

5. In order to pierce the corporate veil, Carol must show that:

   5a. There was no respect for the separateness of the corporate entity. 5a.________

   5b. She was treated unjustly. 5b.________

6. Alice and Bob failed to abide by the articles of incorporation. e.g., they failed to hold annual meetings; they acted for over three years without authority; and they borrowed freely from ABC. 6.________

Bob's/Carol's Claims

7. Majority shareholder owes fiduciary duty to minority shareholder(s). 7.________

   7a. By selling ABC without Bob's approval, Alice violated that duty. 7a.________

Bob's Claims

8. Bob must show that the sale of assets was not approved by shareholders and that the sale was unfair to him. 8.________

9. Difficult for Bob to claim unfairness; he made good return on the sale. 9.________

QUESTION 4

Gator Amusements, Inc., ("Gator") is a for profit corporation formed under the laws of the State of Blue. Gator's articles of incorporation provide that Gator may engage in "any lawful business activity." Gator operates outdoor amusement parks and other "family friendly" amusement facilities in several states. Last year, legislation was introduced in the State of Blue which would legalize casino gambling. At that time, Chuck Chairman, Chairman of the Board of Gator, decided to study the possibility of Gator becoming the operator of a casino in Blue. Chairman asked Doug Director, who was on the Gator Board of Directors, to head up a feasibility study. Soon thereafter, Director submitted a report to Chairman recommending that Gator begin laying the ground work for building a casino. After reading the report, Chairman instructed Director to look for a casino site. Within weeks Director found what he thought was a suitable site and informed Chairman; Chairman instructed Director to buy the land. Director then began a long period of negotiation with the land owner.

During his visits to the potential casino site, Director noticed that the soil on the site was rich in potassium nitrate phosphate crystals. Director, a chemical engineer by training, knew that the presence of such crystals could mean only one thing - oil. Director did not tell anyone about what he found.

While Director was negotiating the purchase of the land on behalf of Gator, the state legislature voted down the gambling legislation. Chairman called Director and told him "the land deal is off, Gator isn't in the casino business." Director, practically smelling money, bought the land himself. Soon thereafter, Director had wells on the land pumping oil.

QUESTION:

Discuss what cause(s) of action, if any, Gator may have against Director.

DISCUSSION FOR QUESTION 4

Gator has a cause of action against Director for diversion of (or usurping) a corporate opportunity. A director has a fiduciary relationship to the corporation that he or she serves. U.S. v. Byrum, 408 U.S. 125 (1972); see also, generally, 18B *Am. Jur. 2d* § 1689. A director has both a duty of care and a duty of loyalty to the corporation that he or she serves. Id. at § 1695, 1711. The duty of care requires that a director exercise ordinary care and diligence. Id. at § 1695. The duty of loyalty requires that a director hold the interests of the corporation over his or her own interests. Id. at § 1711.

Arising out of the duty of loyalty is a director's obligation not to divert a corporate business opportunity for his or her own gain. Id. at § 1770. If a director diverts a corporate opportunity for his or her own gain, the director will be liable to the corporation for any profits that the director may have realized from the diverted opportunity. Id. at § 1774.

A threshold determination in deciding whether a director has usurped a corporate business opportunity is the determination of whether the "corporate opportunity" belonged to the corporation in the first place. This is a question of fact to be decided under the "interest or expectancy test," the "fairness test," and the "line of business test." Miller v. Miller, 222 N.W.2d 71 (1974). The interest or expectancy test and the fairness test are closely related. Both are equitable tests. The interest or expectancy test provides that a corporate officer or director may not acquire property or a business opportunity where the corporation has an equitable interest in such property or opportunity. 18B *Am. Jur. 2d* § 1779. The fairness test requires the fact finder to look at all of the underlying facts surrounding the business opportunity, including whether the director disclosed all material facts to the corporation and whether the director acted in good faith, in order to determine whether the business opportunity belongs to the corporation. Id. at § 1784. The line of business test provides that a business opportunity belongs to a corporation if the opportunity is logically and naturally adaptable to its business. Id. at § 1780. In deciding whether a corporate opportunity has been diverted, a court will generally look at all three of these tests in making its decision.

In the instant case, Director breached his duty of loyalty to Gator and diverted a corporate opportunity under the "interest or expectancy test," the "fairness test," and the "line of business" test. When Director began negotiating for the purchase of the land, he was clearly doing so on behalf of Gator. Gator was planning on opening a casino and therefore the purchase of the land was clearly within Gator's normal line of business. The fact that Chairman called off the land deal is irrelevant. Even though the gambling legislation failed, and Gator no longer needed the land, Director was aware of the value of the land and thus the purchase of the land remained a "corporate opportunity" belonging to Gator. Director's knowledge regarding the value of the land was obtained while acting on behalf of Gator. If Gator hadn't decided to look into opening a casino, and Chairman had not asked Director to look for a site for the casino, Director would probably never have located the land.

As noted above, the duty of loyalty requires Director to hold the interests of Gator over his own interests. Accordingly, Director had a duty to disclose the value of the land to Chairman. Director's failure to disclose this information was in bad faith and as such, under the fairness test and the interest or expectancy test, the opportunity to buy the land, even after the gambling legislation failed, remained with Gator. Director is liable to Gator for any profits derived from the land.

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Essay 4 GradeSheet **Seat** [ ][ ][ ] **Score** [ ][ ]

Please use blue or black pen and write numbers clearly

1. A director has a fiduciary relationship to the corporations. 1. ________
2. A director has a duty of loyalty to the corporation. 2. ________
3. A director has a duty of care to the corporation. 3. ________
4. A director has an obligation not to divert a corporate opportunity. 4. ________
5. A director must disclose all material facts to corporation. 5. ________
6. A director must act in good faith. 6. ________
7. Was the opportunity within Gator's current line of business? 7. ________
8. Was the opportunity to corporation logically and naturally adaptable to its business. 8. ________
9. Director breached his duty of loyalty to Gator and therefore, he is liable to Gator for profits from the land. 9. ________

QUESTION 2

XYZ Corporation manufactures laptops and palm organizers. XYZ is incorporated in the State of Blue Ox, which follows the Model Business Corporations Act.

Paul Bunyan bought 1500 shares of XYZ stock for $60 a share in March 2000. XYZ stock peaked at $200 a share in November 2000. This jump in stock value was largely fueled by record projected earnings announced during 2000 by the officers and president of XYZ. In March 2001, the actual earnings figures for XYZ for 2000 were released; they were significantly less than the projections. As a result, the stock fell to $8 a share.

When it released the actual earnings figures, XYZ said that a new computer system installed in late 1999 made it difficult to track actual costs of the company, and so the company was forced to rely on estimates until the end of the fourth quarter of calendar year 2000. At that time, an audit was conducted which revealed a much less rosy picture for XYZ.

Paul is upset about the loss in value of his XYZ shares. In investigating this matter, he learned that the compensation of the officers of XYZ was determined on December 1, 2000, and based upon the stock's performance for the previous eleven months. He believes that the corporate officers may have manipulated financial data in order to increase their compensation, and that the Board of Directors, who hired the officers, knew of this.

QUESTION:

Discuss the potential liability of XYZ, its officers, and its directors. Also discuss any defenses which XYZ, its officers or directors might have.

DISCUSSION FOR QUESTION 2

There are two possible bases for liability. The first would be based in the Model Business Corporations Act ("MBCA") provisions regarding standards of conduct for officers, set forth in MBCA at section 8.42, and the standards of conduct for directors, *id.*, sect. 8.30 -- in other words, a lawsuit alleging breach of fiduciary duty. The second would be based in the shareholder derivative sections of the MBCA at section 7.40, *et seq.*

The MBCA requires that officers and directors discharge their duties in good faith, with the care an ordinarily prudent person in a like position would exercise in similar circumstances, and in the best interests of the corporation. *Id. at* sect. 8.30(a)(1)-(3) (directors); sect. 8.42(a)(1)-(3) (officers). This means that the officers and directors must act in good faith, exercise what is known as the duty of care, and act in accordance with his or her fiduciary responsibility to the corporation. *See Briggs v. Spaulding*, 141 U.S. 132 (1891) (enumerating the standard of care for a corporate director). In the current situation, it does not appear that the officers, whose own compensation was tied to stock performance, acted in accordance with these provisions of the MBCA. It would appear that the officers acted in their own best interests instead. There is also the possibility that upon further fact investigation, similar claims can be made regarding the directors. Thus, Paul appears to have a valid claim against the officers and possibly the directors of XYZ which would support a civil suit by Paul against them.

One caveat here, however, is the additional standard set forth in the MBCA regarding reliance on information, opinions, reports and statements, including financial statements and other financial data. The MBCA states that officers are "entitled to rely on" such information, if prepared or presented by a class of persons including officers or employees of the corporation "whom the officer believes to be reliable" in such matters; legal counsel; public accountants; or other professionals within whose expertise the information falls. Model Business Corp. Act sect. 8.42(b)(1)-(2).[1] Thus, if the officers released the corporate earnings reports based upon information obtained from persons of the above-referenced class, the officers would most likely not be liable for problems with the reports,[2] because their actions would be in accordance with the provisions of the MBCA. *See id. at* sect. 8.42(d).

Another possible avenue for Paul to consider would be a shareholder derivative suit. A derivative suit is a suit brought in the name of the corporation. *See id. at* sect. 7.40(1). In other words, it is a suit which is brought by a shareholder of the corporation in the name of the corporation, alleging that harm was done to the corporation. This type of lawsuit, which has been acknowledged in our judicial system at least since the 1800s, *see Dodge v. Woolsey*, 59 U.S. 331 (1855), provides a mechanism for protecting corporate interests against the misdeeds of

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[1] A similar provision exists for directors and is set forth at sect. 8.30(b)(1)-(3) of the Model Business Corporations Act.

[2] Note, however, that the good faith exception is void if the officer has knowledge about the matter in question that makes the reliance discussed herein unwarranted. So if the officers had knowledge of the actual financial affairs of the corporation, and yet released reports to the contrary, the "good faith" exception of the MBCA would not apply to shield the officers from possible liability.

corporate management by enabling a shareholder to sue persons such as officers and directors on behalf of the corporation when the Board of Directors fails to take action on its own. A derivative wrong "injures the shareholders directly and independently through direct injury to the corporation."*Avacus Partners, L.P. v. Brian*, 1990 Del. Ch. LEXIS 178, at *21-*22 (Del. Ch. 1990). The theory in this situation would be that Paul, and other similarly situated shareholders, could sue on behalf of the corporation to right the wrong done in this instance against the corporation, and derivatively, the shareholders.

This type of lawsuit would be a possibility in this situation if Paul first meets certain criteria. In accordance with section 7.42 of the MBCA, he must first make a written demand upon the corporation, through its Board of Directors, to take suitable action, and wait either until the shorter of the end of a 90 day period from the date of the demand or until the demand has been rejected by the corporation, unless irreparable injury to the corporation would result by waiting for the expiration of the 90 day period. Model Business Corp. Act sect. 7.42(1)-(2). Provided that Paul meets these threshold requirements of the MBCA, he could possibly file a derivative action alleging that either the officers or directors (or both) knowingly or recklessly overstated the financial earnings figures of XYZ and manipulated the financial results.

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Essay 2 GradeSheet **Seat** **Score**

Please use blue or black pen and write numbers clearly

1. Officers and Directors owe a fiduciary duty to the Corporation comprised of the duty of loyalty and duty of care. 1. ________

2. Paul could bring a direct action against XYZ and its Officers and Directors for breach of fiduciary duty. 2. ________

3. XYZ, the Officers and Directors could defend on the grounds that they relied upon reliable information from the company employees. (Business Judgment Rule) 3. ________

4. Paul could also bring a derivative suit against the Officers and Directors in behalf of all Shareholders. 4. ________

5. A derivative suit seeks to recover damages for the corporation when the Officers/-Directors fail to take such action for the corporation. 5. ________

6. Before initiating a derivative action, Paul must give notice to the Directors to take such action unless such notice would be futile. 6. ________

7. To bring a derivative action, the Shareholder must be a Shareholder at the time of malfeasance and through the entire litigation. 7. ________

8. The Officers and Directors could be liable to the Shareholder for the decrease in the value of their stock. 8. ________

9. Officers and Directors may be liable in a derivative suit for the excess compensation paid to the Officers/Directors. 9. ________

QUESTION 3

Sally and Carol own, operate, and teach in a martial arts school in Alpha. Students frequently have suffered minor injuries while at the school. This concerned Sally and Carol about their personal liability in the event a student is seriously injured. They sought advice from Joe Attorney with regard to limiting their liability. Attorney suggested that Sally and Carol incorporate; Sally and Carol agreed.

Attorney prepared Articles of Incorporation in accordance with the laws of Alpha, signed the Articles as the incorporator, and agreed to serve as the Registered Agent for the corporation, Martial Arts Academy Incorporated. Attorney then properly filed the Articles with the Secretary of State.

In the Articles, Sally and Carol were named as the initial members of the Board of Directors and the officers of Martial Arts. Sally and Carol were each issued one share of common stock with a stated value of $10,000 in return for continuing to teach in the School. No meetings of the board of directors were ever held and no corporate minutes were maintained.

Sally and Carol use tuition collected from students to pay all current operating expenses such as rent and utility bills. Whatever is left each month after payment of such expenses is divided equally between them.

Sally and Carol hired Alex Instructor to assist in giving lessons. A few months later, Sam Student was seriously injured while participating in a class taught by Sally due to her negligence.

QUESTION:

Discuss theories of liability under which Student may recover damages for his injuries against Sally, Carol, Instructor, Attorney, and/or Martial Arts. Do not discuss any aspects of partnership that may be raised by the facts.

DISCUSSION FOR QUESTION 3

Sam Student has a variety of potential causes of action to recover for his injury. First, Student can sue Sally for her negligence. As a tortfeasor, Sally is liable directly for injuring Student as a consequence of her negligence. See Model Corp. Bus. Act. §6.22.

Second, an action against the corporation may also be available. Sally is a teacher for the corporation and is considered to be an employee of the corporation when she is teaching. Her negligence occurs while she is teaching, and therefore she injured Student while she was acting within the scope of her employment. Consequently, the Corporation may be vicariously liable in an action by Student against the Corporation for the negligence of Sally. See Prosser and Keeton on Torts 499-505 (West 1984).

Third, Student may also have a claim to compel Sally and Carol to pay into the Corporation proper consideration for their shares. A shareholder may be personally liable to corporate creditors if the shareholder has unpaid (watered) shares. Watered shares are shares which have been issued for inadequate consideration. In such a case, the person to whom such shares have been issued is personally liable for the amount that should have been paid for the shares. See Model Bus. Corp. Act §6.22. One share each, with a stated value of $10,000, was issued to Sally and Carol in return for their continuing to teach at the School. This amounts to future services as consideration for the issuance of shares. This is not permissible consideration. See Model Bus. Corp. Act section 21. Therefore, the shares are watered, and Sally and Carol are obligated to pay to the Corporation the stated consideration for the shares. Sally and Carol are obligated to pay $10,000 each to the Corporation.

Fourth, Student does not have a cause of action against Joe Attorney. The Articles were properly filed with the Secretary of State, the initial directors were named in the Articles. Joe has no personal liability to the Company or to any of the creditors of the Company by serving as the incorporator or as the registered agent. See Model Bus. Corp. Act §§ 2.05 and 5.01.

Fifth, Student does not have a cause of action against Alex Instructor. There is no indication that he was involved in the injury to Student or that he was personally negligent.

Sixth, Student may be able to bring an action against Carol and Sally as members of the Board of Directors for making distributions to shareholders which makes the corporation unable to pay its debts as they become due in the usual course of business. Members of the board may be liable to the extent of excessive distributions made to shareholders if the company is rendered insolvent as a result of such distributions. The amount of their liability is limited to the amount of the excessive distributions. See Model Bus. Act §6.40.

Seventh, Student may be able to bring an action against Carol and Sally personally based on the equitable theory that the corporation should be disregarded (piercing the corporate veil) to reach the personal assets of Carol and Sally who are shareholders. Under this theory Carol and Sally, as shareholders, would be personally liable for the obligations of the Corporation. See Laws of Corporations 344-52 (West 1983). This theory may be available because of the way the Corporation is being operated.

A) The Company has no capital because all available capital is used to pay operating expenses with the remainder being paid out to Sally and Carol. The Corporation is kept in an undercapitalized state by the actions of Sally and Carol. After they pay all the monthly operating expenses they divide whatever capital is left between them.

B) The Corporation also lacks paid-in capital because shares were issued to Sally and Carol without adequate consideration. The failure to pay proper consideration for the shares amounts to a failure of Sally and Carol to comply with the statutory corporate requirement that shares only be issued for proper consideration.

C) Sally and Carol have not treated the Corporation as a proper separate legal entity by not holding board meetings and not maintaining minutes.

These factors, undercapitalization, failure to pay the stated value of the shares, and failure to comply with the basic operational requirements for maintaining a corporation, support a disregarding of the corporate entity to reach shareholders. See DeWitt Truck Brokers, Inc. v. Ray Flemming Fruit Co., 540 F.2d 681 (4th Cir. 1976) (corporate veil pierced where all corporation funds paid out to shareholder); Minton v. Cavaney, 364 P.2d 73 (Cal.1961) (court noted it would pierce corporate veil where no capital paid into corporation by shareholders and corporate formalities where not complied with). Also See Model Bus. Corp. Act § 6.40.

Eighth, Student does not have a claim against Sally or Carol as members of the board or as officers, except to the extent of excessive distributions to shareholders. No director or officer is personally liable for any injury to person or property arising out of a tort committed by an employee. See Model Corp. Bus. Act §2.02.

21382

Essay 3 GradeSheet **Seat** | | | | **Score** | | |

Please use blue or black pen and write numbers clearly

1. Action against Sally for her own negligence. 1. ________

2. Action against Corporation based on Corporation being vicariously liable for negligence of Sally. 2. ________

   2a. Sally's negligence occurred within scope of her employment. 2a. ________

3. Action against both Sally & Carol for unpaid (watered) shares. 3. ________

   3a. Sally & Carol liable for the stated value ($10,000) of each share issued to them. 3a. ________

4. No cause of action against Joe Attorney. 4. ________

5. No cause of action against Alex Instructor, no indication he was negligent, and as employee he has no liability for negligence of others. 5. ________

6. Action against Carol and Sally as members of the Board to the extent of excessive distributions to shareholders. 6. ________

7. Action against Carol (and Sally) based on piercing the corporate veil. 7. ________

   7a. Undercapitalization of Corporation due to shareholders paying out all capital to themselves after payment of expenses. 7a. ________

   7b. Failure to comply with statutory requirement that shares be issued only for full and adequate consideration. 7b. ________

   7c. Failure to treat the corporation as a separate legal entity (keep minutes, hold meetings). 7c. ________

8. Generally no action against Sally and Carol as directors, officers or shareholders for tort injuries. 8. ________

QUESTION 8

Daniels is one of three directors of Corporation, a duly-licensed and registered for-profit corporation. Daniels is also president of Charity, a non-profit, charitable association.

At a regularly scheduled board meeting of Corporation, all three directors voted to donate $10,000 of Corporation's profits to Charity. Daniels had not informed the other two directors of his connection to Charity. The other directors had no affiliation with Charity.

Corporation's articles of incorporation and bylaws say nothing about making donations to charitable organizations.

<u>QUESTIONS</u>:

Discuss whether: (1) Corporation's gift to Charity is voidable; and (2) whether Daniels is liable to Corporation for the amount of the gift to Charity.

DISCUSSION FOR QUESTION 8

Corporation's donation to Charity is within its corporate powers. Unless its articles of incorporation provide otherwise, a corporation has the power "to make donations for the public welfare or for charitable, scientific, or educational purposes." *Model Business Corporation Act* Sec. 3.02(13). No direct or immediate benefit to the corporation need be shown. *See Theodora Holding Corp. v. Henderson*, 257 A.2d 398 (Del. Ch. 1969); H. Henn & J. Alexander, *Laws of Corporations* 474-475 (3d ed. 1983).

The contribution also received the requisite vote from the board of directors. Ordinarily, unless the articles of incorporation or bylaws require a greater number, approval by a majority of the directors is sufficient for valid corporate action. *Model Business Corporation Act* Sec. 8.24(a).

The primary problem with the contribution to Charity is Daniel's management positions with both Corporation and Charity. Directors of corporations owe their corporations a general fiduciary duty of undivided loyalty. *See Generally,* R. Clark, *Corporate Law* 141-150 (1986); H. Henn & J. Alexander, *supra* at 628. Under the Model Business Corporation Act, a transaction presents a conflict of interest if another entity of which the corporation's director is a director or officer is a party to the transaction or has a beneficial interest in the transaction. *Model Business Corporation Act* Sec. 8.60(i)(ii)(A). Thus, the charitable contribution to Charity is a conflict of interest transaction.

Under the common law, conflict of interest transactions are not entitled to the usual presumptions of the business judgment rule, but are voidable. H. Henri & J. Alexander, *supra* at 65840. However, under the Model Act, no contract or transaction is voidable <u>solely</u> because it involves self-dealing if one of three conditions is satisfied: (1) the transaction is approved by a disinterested majority of the board after full disclosure of all material facts; (2) the transaction is approved by a majority of the corporation's shareholders after full disclosure of all material facts; or (3) the transaction was fair to the corporation. *Model Business Corporation Act*, Sec. 8.61(b). A disinterested majority of Corporation's board approved the transaction; see *Model Business Corporation Act,* Sec. 8.62; but they were unaware of Daniels' conflict of interest at the time of their approval. Therefore, Sec. 8.61(b)(1) is unavailable. *Model Business Corporation Act*, Sec. 8.60(4), 8.62(a), (b). The transaction is valid only if it was fair to the corporation. *Model Business Corporation Act,* Sec. 8.61(b)(3).

The measure of fairness is whether an independent corporate fiduciary in an arm's length bargain would bind the corporation to such a transaction. H. Henn & J. Alexander,*supra* at 659 and cases cited in note 7. The burden is on the interested directors to demonstrate that a challenged conflict of interest transaction is fair. *See e.g.*, *Lewis v. S.L. & E., Inc.,* 629 F.2d 764, 768 (2d Cir. 1980). Courts generally have been reluctant to upset charitable donations of reasonable amounts even when the interested director is closely connected to the charity. *See Theodora Holding corp. v. Henderson*, supra. Therefore corporation's contribution to Charity probably will be upheld.

21686

Essay 8 GradeSheet **Seat** ☐☐☐ **Score** ☐☐

Please use blue or black pen
and write numbers clearly

1.	A Director has a fiduciary duty and a duty of care to the corporation.	1. ________
2.	A Director has a duty of loyalty to the corporation.	2. ________
3.	Unless its articles of incorporation provide otherwise, a corporation has the power to make charitable contributions.	3. ________
4	Daniels has a conflict of interest because he is an officer in both Charity and Corporation.	4. ________
5.	Such conflict of interest transactions may be voidable.	5. ________
6.	A conflict of interest transaction may be upheld if:	
	6a. it is approved by the vote of a disinterested majority of the board of directors after full disclosure of all material facts;	6a. ________
	6b. approved by the vote of a majority of the shareholders after full disclosure of all material facts; or,	6b. ________
	6c. the transaction is fair to the corporation.	6c. ________
7.	The burden of proving fairness is on the corporation or the interested directors.	7. ________
8.	Courts have been reluctant to upset charitable contributions of reasonable amounts even when the interested director is closely connected to the charity.	8. ________
9.	If the transaction is voidable, then Daniels may be required to repay the amount of the contribution to the charity.	9. ________

QUESTION 2

Corporation has one hundred shares of issued and outstanding common stock. Fifty shares are owned by Joan, twenty-five shares are owned by Tom, and twenty-five shares are owned by George. Corporation also has fifty shares of treasury stock.

Corporation's annual meeting was held on January 12, 2004. Corporation's staff prepared a list of the shareholders entitled to vote (Joan, Tom, and George), and mailed proper notice to them prior to the meeting. The notice explained that a proposal requiring shareholder approval was to be voted on at the meeting and gave instructions for proxy voting.

At the shareholder meeting, Corporation's president voted, on behalf of Corporation, all of the treasury shares in favor of the proposal. In a timely manner, Joan mailed in her proxy, indicating that her shares were to be voted in favor of the proposal. Before the shareholder meeting, however, Twelfth National Bank advised Corporation that Joan's stock was held by Twelfth National as collateral for a loan the bank made to Joan, and the bank was voting against the proposal. Tom duly executed a proxy in favor of Mary, who timely mailed the proxy, voting against the proposal. Tom, however, attended the shareholder meeting and announced he was revoking his proxy and voting for the proposal. George personally appeared at the shareholder meeting and voted against the proposal.

Corporation's Articles of Incorporation require a two-thirds majority vote to approve any shareholder action. The bylaws require a unanimous vote of the shareholders to approve any shareholder action.

QUESTION:

Discuss the validity of the votes cast at the shareholder meeting, and whether the proposal will receive shareholder authorization.

DISCUSSION FOR QUESTION 2

Treasury stock is stock that at one time was outstanding but which has been reacquired by the corporation. Since these shares are no longer outstanding, they cannot be voted. (Clark, Corporate Law 361 (1986). See 106-103 & 106-302 of the Model Act.

The name of the owner of shares as it appears on the shareholder list dictates who is entitled to vote those shares of stock at the shareholder meeting. If the shares have been pledged and if evidence is given to the corporation that the pledgee has actual power to vote the shares, then the pledgee is the proper party for voting purposes. If no such evidence is presented to the corporation, then the pledgee does not have the power to vote the shares. When a pledgor and a pledgee of stock dispute the authority to vote, the pledgor has the voting power, while the stock is pledged. (Clark, Corporate Law 360 (1986). Thus, Joan's votes for the transaction will be counted.

A shareholder may vote shares in person or by proxy. A proxy is revocable by the shareholder unless the proxy appointment form conspicuously states that it is irrevocable and is coupled with an interest. A proxy can be revoked by taking any action that is inconsistent with the continued existence of the authority granted in the proxy. As Tom's attendance at the shareholder meeting to vote is inconsistent with granting Mary the authority to vote on his behalf, Tom has revoked his proxy. (Hamilton, Corporations 207 (2d ed. 1986). Thus, Tom's 25 shares will be voted for the transaction.

George personally appeared at the meeting, thus he is a shareholder of record and is entitled to vote his shares opposing the transaction.

In determining the question of how many votes are required to approve the transaction, there is a conflict between the Bylaws and the Articles of Incorporation. In such a conflict, the Articles pre-empt the bylaws. *See Paulek v. Isgar,* 551 P.3d 213 (Colo.App. 1976). Accordingly, the provision requiring a 2/3 vote in the Articles controls.

As the proposal needed a two-thirds majority vote, and three-fourths of the outstanding shares were voted for the proposal, it has been validly approved.

COLORADO SUPREME COURT
Board of Law Examiners

FEBRUARY 2004 BAR EXAM
Regrade

ESSAY Q2

SEAT | | | |

ISSUE			YES	NO
1.	The name of the owner on the Shareholder List or shareholder of record dictates who is entitled to vote those shares.	1.	○	○
2.	The pledgor (Joan), not the pledgee (bank), has the voting rights, therefore Joan's vote will count.	2.	○	○
3.	A proxy is a written authorization from the owner of the shares giving power to another to vote the shares.	3.	○	○
4.	Most proxy appointments are revocable.	4.	○	○
5.	An irrevocable proxy must be coupled with an interest.	5.	○	○
6.	Shares may be voted in person or by proxy.	6.	○	○
7.	Tom's attendance at the shareholder meeting is inconsistent with the proxy issued to Mary therefore, Tom has successfully revoked his proxy and his 25 votes for the transaction will be counted.	7.	○	○
8.	George's vote will be counted.	8.	○	○
9.	If there is a conflict between the articles and the bylaws, the articles prevail; therefore, a 2/3 vote is required to approve the transaction.	9.	○	○
10.	Treasury stock is stock that at one time was outstanding and which the corporation has repurchased.	10.	○	○
11.	Treasury stock cannot be voted.	11.	○	○
12.	The transaction will have 75 out of 100 outstanding shares voted for it; therefore, the transaction will have been validly approved.	12.	○	○

QUESTION 6

Peter Perry owns ten percent (10%) of the common stock of SKI Corporation (SKI) which specializes in the manufacture and distribution of ski bindings. One day, Perry was reading the latest edition of Downhill Magazine and happened upon a story about SKI which detailed the lifestyle of one of SKI's directors, Tom Turner. In the article, Turner was quoted as saying that he had recently been appointed President of SKI. In the accompanying picture, Turner was shown outside his beautiful new house in Aspen.

Perry was disturbed by the article. Not only did he not know that Turner had been appointed President, but he also was upset that Turner appeared to be living a lavish lifestyle at a time when SKI's stock was floundering. Perry decided to investigate SKI's financial dealings. As a result of his investigation, Perry discovered that SKI's Board of Directors had properly followed all procedures in approving Turner's appointment as President. However, Perry also found out that the Board of Directors had voted to lend money to Turner to help him buy his Aspen house. Perry believes that this action was a flagrant example of corporate mismanagement of funds which may have impaired the value of his stock.

QUESTION:

Discuss any action that may be available to Peter Perry against SKI's Board of Directors for lending money to Tom Turner.

DISCUSSION FOR QUESTION 6

This question deals with the issue of shareholder derivative actions. Shareholder derivative actions are those lawsuits brought by a shareholder of a corporation to obtain relief for alleged wrongs committed against the corporation. Brooks v. Land Drilling Co., 564 F. Supp. 1518 (D.C. Colo. 1983). They are often described as representative actions, since the shareholders are enforcing the rights of another, *i.e.*, the corporation. Such actions are to be used only where it is clear that a corporation will not act to redress an injury to itself -- in other words, in those situations where it is evident that the facts and circumstances are such that a corporation will not take action to remedy a particular situation that is injurious to the corporation. Id.

The basic premise for the action here is that the corporation, by the authority of its Board of Directors has lent money to an individual who is both an officer and a director of the corporation, and this resulted in corporate mismanagement of funds, affecting the value of the stock of the corporation. This type of issue would be proper for a shareholder derivative action, since, generally, a shareholder cannot maintain an individual action against the directors (or other third parties) whose actions caused some type of harm to the corporation, because the harm done in actuality has been done to the corporation and not to the individual. Nicholson v. Ash, 800 P.2d 1352 (Colo. App. 1990). A shareholder may maintain a personal action against a corporation only if the type of injury complained of is unique to that individual shareholder. See id. In this instance, since that does not appear to be the case from the facts presented, the claim is beneficially owned by the corporation itself, and the purpose of any action would be to redress the wrong done to the corporation and not to the individual. See Greenfield v. Hamilton Oil Corp., 760 P.2d 664 (Colo. App. 1988).

Section 7.42 of the Revised Model Business Corporation Act ("RMBCA") requires that to commence or maintain a derivative proceeding, a shareholder must have been a shareholder of the corporation at the time of the act or omission complained of, or have become a shareholder through transfer by operation of law from one who was a shareholder at that time. Since the fact statement here discusses a relatively recent action by the Board of Directors, and since it also reveals that Peter owned the shares during the past year, we can assume that this threshold requirement of the law is met.

Beyond this threshold inquiry, the RMBCA, and general principles of corporation law as well, require that certain preliminary steps be taken by any potential plaintiff prior to filing suit in a shareholder derivative action. First, the shareholder must make a written demand on the corporation to take suitable action. A derivative proceeding may not be commenced until 90 days after the date of the demand, unless: the shareholder has been earlier notified that the corporation has rejected the demand; or irreparable injury to the corporation would occur by waiting 90 days. RMBCA § 7.42. While previous law excused a demand if it would be futile, such as where the board would be unlikely to approve an action accusing the board of self-dealing, it has been argued this exception does not apply under the RMBCA. There are two arguments advanced: the RMBCA does not provide for the exception, and, even though it may seem futile, the demand gives the corporation the opportunity to resolve the issue without litigation.

In a derivative action, the corporation must be named as a party defendant, because the failure of the corporation to assert its own claim justifies making it a defendant. If a majority of the directors, at least two, who have no personal interest in the suit find in good faith after reasonable inquiry that the suit is not in the corporation's best interests, the suit may be dismissed on the corporation's motion. RMBCA § 7.44. The shareholder has the burden of proof to prove the decision was not made in good faith. If a majority of directors had a personal interest, however, the burden would shift to the corporation. A derivative suit may be discontinued or settled only with court approval.

ESSAY Q6

SEAT

ISSUE | POINTS AWARDED

1. A shareholder seeking redress for a wrong done to the corporation, may sue only by means of a shareholder derivative suit. 1. ○

2. Generally, a shareholder cannot bring an individual suit against a corporation for harm done to the corporation. 2. ○

   2a. A shareholder can bring a direct action for a harm unique to that shareholder. 2a. ○

3. A shareholder must have been a shareholder (through legal or beneficial title to stock) of the corporation at the time of the act or omission complained of, or have become a shareholder through operation of law from one who was a shareholder at that time. 3. ○

4. A shareholder must make a demand upon the Board of Directors of the Corporation to take suitable action prior to filing suit. 4. ○

5. A derivative proceeding may not be commenced until 90 days after the demand unless: 5. ○

   5a. the shareholder has been notified that the corporation rejected the demand, or 5a. ○

   5b. it would cause irreparable harm to the corporation to wait. 5b. ○

6. Arguably a demand may be excused if it would be futile, but: 6. ○

   6a. the RMBCA does not explicitly provide this exception; 6a. ○

   6b. though futile, a demand gives the corporation the opportunity to resolve the issues without litigation. 6b. ○

7. The corporation must be named as a party defendant. 7. ○

   7a. The failure of the corporation to assert its own claim justifies making it a defendant. 7a. ○

8. The suit may be dismissed if at least two directors determine in good faith after reasonable inquiry that the suit is not in the corporation's best interests. 8. ○

9. A derivative suit may be settled or dismissed only with court approval. 9. ○

QUESTION 4

Paula agreed to act as a promoter for a company to be known as Colorado Casting Corporation (CCC). Prior to the formation of CCC, Paula actively conducted negotiations with Larry, a local land owner, for the purchase of a parcel of land upon which to build CCC's headquarters. Paula explained to Larry that although CCC was still being organized, it was important to consummate the land purchase as soon as possible. The negotiations between Paula and Larry resulted in a signed agreement in which Larry agreed to sell the land for $1,000,000. There was no reference of any kind to CCC in the body of the agreement. Paula signed the agreement as follows:

> Paula, principal organizer acting on behalf of Colorado
> Casting Corporation, a corporation in the process of
> being incorporated.

After CCC had been properly formed and incorporated, CCC's board of directors decided to purchase land on which to build its headquarters from another landowner at a price of $800,000. When Larry demanded that CCC perform under the agreement that had been entered into with Paula, CCC refused.

<u>QUESTION</u>:

Discuss the rights and obligations of Paula, Larry, and Colorado Casting Corporation with respect to the agreement signed by Paula and Larry.

DISCUSSION FOR QUESTION 4

Paula was acting as a promoter of CCC. Promoters are involved in the first steps of forming corporations in procuring commitments for capital and other instrumentalities that will be used by the corporation after formation. Upon incorporation, promoters owe a fiduciary duty to corporations and to those persons investing in them.

The general rule states that if a person acts on behalf of a corporation, knowing that there has been no incorporation, the person is jointly and severally liable for any obligations incurred. *Revised Model Business Corporation Act* (*RMBCA*) 2.04. Thus, Paula, as a promoter entering into agreements with third parties on behalf of the as of yet unformed Colorado Casting Corporation, is likely personally liable on pre-incorporation agreements.

A promoter can avoid liability if she can establish that the other party to a pre-incorporation the agreement (1) knew that the corporation did not exist; and, (2) expressly agreed to look solely to the corporation when it was ultimately formed for performance under the agreement. Any number of authorities can be cited as standing for this general rule. <u>Stanley J. How & Associates. Inc. v. Boss,</u> 222 F. Supp. 936 (S.D. Iowa 1963); <u>John A. Goodman v. Darden. Doman & Stafford Associates,</u> 100 NW 2d 476 (1983); ROHRLICH ' 5.06(1).

A promoter's liability on pre-incorporation agreements continues after the corporation is formed, even if the corporation adopts the contract and benefits from it. The promoter's liability can be extinguished only if there is a novation an agreement among the parties releasing the promoter and substituting the corporation. To clearly establish a novation, the third party should expressly release the promoter after the corporation has adopted the contract. When a promoter is liable on a pre-incorporation contract and the corporation adopts the contract but no novation is agreed upon, the promoter may have the right to indemnification from the corporation if she is subsequently held liable on the contract. In this case, Larry did not sign a novation.

Paula can’t claim an agency relationship since Colorado Casting did not yet exist at the time of the agreement with Larry. A promoter can’t act as an agent of the corporation prior to incorporation; an agent can’t bind a nonexistent principal. Restatement (Second) of Agency '1 (1957).

The corporation can become bound by a promoter’s contracts through adoption. The effect of adoption is to make the corporation a party to the contract, although this in and of itself doesn’t relieve the promoter of her liability. ROHRLICH 5.06(1). In this case, when Colorado Casting finally was formed and came into existence, it chose not to adopt the Paula/Larry agreement but chose instead to purchase land from another party. Therefore, Colorado Casting is not liable to Larry for performance under the agreement

While it is clear that Larry knew that Colorado Casting was still being organized, there was nothing in the body of the agreement that indicated that Larry would look solely to Colorado Casting for performance under the agreement. In fact, the agreement contained no reference of any kind to Colorado Casting. Furthermore, as we have already seen, Paula' signatory statement of purported representation of a nonexistent principal is without effect. Thus, Paula is liable to Larry for performance of the agreement.

ESSAY Q4

SEAT

ISSUE		POINTS AWARDED
1.	A promoter acts in the first steps of the formation of a corporation in procuring commitments for capital and other instrumentatlities that will be used by the corporation after formation.	1. ○
2.	Paula was a promoter for Colorado Casting.	2. ○
3.	The general rule is that a person acting on behalf of a corporation before it is incorporated is liable for any obligations incurred.	3. ○
4.	A promoter can avoid liability if: the other party (Larry) to the pre-incorporation agreement knew the corporation didn't exist yet and expressly agreed to look solely to the corporation for performance.	4. ○
5.	Larry knew that Colorado Casting did not yet exist.	5. ○
6.	There is no evidence that Larry had agreed to look solely to Colorado Casting for performance.	6. ○
7.	A promoter's liability on pre-incorporation agreements continues after the corporation is formed, even if the corporation adopts the contract.	7. ○
8.	A corporation can become bound by adoption.	8. ○
9.	In this case, Colorado Casting didn't adopt the agreement.	9. ○
10.	Promoter's liability extinguishes only with novation.	10. ○
11.	Novation is an agreement among the parties to release the promoter.	11. ○
12.	In this case, no novation.	12. ○
13.	Paula can't assert that she was acting as an agent, since Colorado Casting corporation had not yet been formed and it isn't possible to act on behalf of a nonexistent principal.	13. ○
14.	Paula is likely liable for the agreement.	14. ○
15.	Colorado Casting is not likely liable.	15. ○

QUESTION 9

Motion Picture Corporation (MPC) is a large public corporation with a thirty person board of directors. MPC's Articles of Incorporation state:

> The board of directors shall have authority to establish an Executive Committee. This committee shall have authority to act on behalf of MPC to enter into routine contracts and engage in routine activities.

The board met, with all directors present, and unanimously voted to establish an Executive Committee. They then elected three directors to the Executive Committee. The board also unanimously passed a new bylaw which states:

> The Executive Committee shall have authority to act on behalf of the board in all business transactions entered into by MPC except for dissolution of the corporation itself.

The Executive Committee entered into a contract, on behalf of MPC, with Sam Producer to produce a movie. The budget for the movie was six times larger than the budget for any movie ever produced by MPC. After the movie was completed, the full board met and approved two contracts for worldwide distribution of the movie. A dispute subsequently arose over ownership of the movies and MPC breached its contract to pay Sam Producer.

***QUESTION*:**

Discuss any arguments that MPC may raise claiming it is not liable on the contract. Also, discuss counter-arguments that Sam Producer can make that MPC is liable on the contract.

DISCUSSION FOR QUESTION 9

MPC is only liable on the contract with Sam Producer if they are legitimately a party to the contract. MPC is a corporation and therefore can not enter a contract on its own since a corporation is an artificial being created by law. Instead, MPC can only become a party to a contract if the contract is entered on behalf of the corporation by a party or entity that has authority to enter a contract on behalf of the corporation. See Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co., 156 A. 350, 351 (Del. Super. Ct. 1931). Therefore, the question of authority is central to the analysis. Generally, authority can be granted to someone to act on behalf of the corporation by the Articles of Incorporation, the corporate bylaws or by a resolution passed by the board of directors. Id. at 351-52; Revised Model Business Corporation Act (RMBCA), section 50.

Additionally, a corporation can become bound on a contract that was entered on its behalf if the corporation adopts or ratifies the contract after the fact. This applies to a contract that the corporation is not initially a party to because it was entered into on behalf of the corporation by a party that lacked authority to enter the contract on behalf of the corporation. Such adoption can be a formal adoption by express action by the board of directors or it can be an informal adoption implied from the actions of the board or corporation. See McArthur v. Times Printing Co. 51 N.W. 216 (Minn. Sup. Ct. 1898; Restatement of Agency 2d Section 104.

In determining the authority of the board or of an executive committee, conflicts may arise between what is permitted by the bylaws and by the Articles of Incorporation. Although bylaws may contain any provision for managing the corporation, such provisions cannot be inconsistent with the Articles of Incorporation. RMBCA, section 2.06. In a conflict situation, the Articles of Incorporation preempt the bylaws. See Paulek v. Isqar, 551 P.2d 213, 215 (Colo. App. Ct. 1976).

MPC's arguments that they are not liable on the contract

The contract entered into by the Executive Committee, on behalf of MPC, and Sam Producer involves a budget six times larger than the budget for any other movie ever produced by MPC. Therefore, this is not a routine contract. It is an extraordinary contract.

Under the Articles of Incorporation, the Executive Committee only has the authority to enter routine contracts. The action of entering this contract therefore exceeds the authority of the Executive Committee that is granted by the Articles of Incorporation. Actions by the Executive Committee that exceed the committee's authority can not bind MPC.

In contrast to the Articles of Incorporation, the new bylaw passed by the board grants the Executive Committee unlimited authority to enter transactions on behalf of MPC. The Executive Committee has authority to enter the transaction in question under the bylaw.

The Articles of Incorporation and the bylaws are in conflict with regard to the authority of the Executive Committee to enter contracts on behalf of MPC. The contract with Sam Producer would be binding on MPC under the bylaw, but it would not be binding under Articles of Incorporation. When conflicts arise between the Articles of Incorporation and the bylaws, the Articles control. Therefore, in this case, under the authority granted to the Executive Committee by the Articles, the committee exceeded its authority in entering the contract with Sam Producer. MPC should argue that it is consequently not liable on the contract because the Executive Committee lacked authority to enter the contract on behalf of MPC.

Sam Producer's arguments that MPC is liable on the contract

Despite the authority limitation in the Articles of Incorporation, MPC may have informally adopted the contract by the actions of the full board of directors subsequent to the Executive Committee's entering the contract on behalf of MPC.

The MPC board of directors, on their own, would have authority to enter the contract with Sam Producer, because the board is charged with managing the business and affairs of the corporation. *See* RMBCA, section 35. Therefore, the full board has the authority to adopt the contract in question even though at the time the contract was consummated it did not bind MPC because the Executive Committee lacked authority to bind MPC.

Although the full board has not expressly adopted the contract in question, it has approved two worldwide distribution contracts for the movie created as a result of the contract with Sam Producer. This may be an implied adoption of the contract with Sam Producer because the board is attempting to take advantage of the benefits of that contract which indicates intent to bind the corporation to the contract. It would be anomalous for MPC to take advantage of the contract with Sam Producer and then claim they were not bound by the contract when it breaches it.

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ESSAY Q9

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ISSUE | POINTS AWARDED

1. Executive Committee must have authority to enter contract with Sam Producer for MPC to be bound on contract. 1. ○

2. Executive Committee doesn't have authority under Articles of Incorporation to enter contract with Sam Producer because it is not a routine contract as the contract involves movie budget six times larger than any previous movie budget. 2. ○

3. Bylaws may contain any provision for managing the corporation. 3. ○

4. Executive committee has authority to enter the contract under bylaw because bylaw grants committee authority to enter all transactions on behalf of MPC. 4. ○

5. Where authority granted by bylaws and Articles of Incorporation are in conflict, Articles of Incorporation control. 5. ○

6. MPC may argue that here the Articles and bylaws conflict, therefore the Executive Committee did not have the authority to enter into the contract. 6. ○

7. Corporation can adopt or ratify the contract made on behalf of corporation where there was no authority. 7. ○

8. Sam Producer may argue that actions of full board of MPC amount to ratification or adoption:
   - 8a. Full board approval of worldwide distribution contracts for movie resulting from Sam Producer contract indicates that MPC intends to be bound by the contract. 8a. ○
   - 8b. Anomalous for MPC to get benefits of Sam Producer contract and then deny liability for breach of the contract. 8b. ○