Professor M. Jonathan Hayes
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6:30-8:30 pm

University of West Los Angeles
Final Examination
Business Organizations

QUESTION 1. (50%)

Yoga, Inc. owns and operates 51 yoga studios throughout the western part of the United States. The corporation is very profitable. Alvin, Brenda and Chucky together own 39% of the total outstanding common stock. The remainder of the outstanding stock is owned by 71 different individuals. Alvin, Brenda and Chucky are members of the seven person Board of Directors. Yoga, Inc. has never declared dividends because the company has been growing. As a result, the company has a lot of money in the bank.

At a recent board meeting, the board members discussed expanding the business into Canada. After some discussion, the board voted unanimously not to expand into Canada. They also discussed declaring dividends since Maggie, a minority shareholder who owns 8% of the outstanding stock, has been demanding dividends and threating to sue the board if it did not declare dividends. After a lot of discussion, the board voted 5-2 not to declare dividends.

Recently, while in Canada watching a hockey tournament, Chucky discovered that a small chain of Yoga studios in Canada was for sale. He decided to buy the chain and operate it himself. It is very profitable. He did not tell anyone at Yoga, Inc about it. Maggie however has discovered the purchase.

Maggie has filed a derivative suit against the Board of Directors for failing to declare dividends, and for not expanding into Canada and against Chucky separately because of the Yoga Canada purchase. What is the likelihood of her success? Discuss. (Do not discuss any procedural requirements for bringing a derivative action against the directors.)

Analysis

Dividends:

As to the alleged failure to declare dividends, that is a consequential decision that is made by the board of directors ("BOD"). Each director must use good faith business judgment and the care of a reasonably prudent person under the circumstances when making the decision. If the individual director uses care in the process, and there is no conflict, fraud, illegality, waste or bad faith, the director will win. That is the business judgment rule. The facts say that there was a lot of discussion about the dividends and a vote - 5 to 2. That is evidence that they used care in the process. Three of the directors (at least) are also shareholders and would therefore receive dividends if they were declared. That suggests a conflict but since 5 of the directors voted for no dividends, it is pretty obvious that the "conflict" did not affect their decision. They voted not to get dividends. The two directors that voted no, in other words, voted *for* the dividends did not breach their duty of care in any event. They did exactly what Maggie is saying they should have done.

Shareholders can file a direct suit against the BOD for failure to declare dividends since there is injury only to the shareholder, not to the corp. But they must establish that the BOD is refusing to declare dividends in bad faith, meaning for some improper reason directed at the shareholders. The improper purpose is often that the BOD is trying to force some shareholder to sell their shares or do something else. There are no facts that suggest that is why the refusal came about.

Maggie has little chance of success on these facts.

Expansion into Canada:

Again the BOD must use care when making this decision. If each director used care in the process and there was no conflict etc, the BJR will protect the directors. The facts say that the BOD "discussed" the issue and voted unanimously not to expand into Canada. There is no way to know if that is enough care in the process but courts are generally reluctant to second guess decisions especially when there is no conflict etc. Maggie has no chance of success unless she can show that the "discussion" was so abbreviated that there was really no care in the process.

Chucky's purchase of the chain in Canada

Chucky's purchase of the chain in Canada may have violated his duty of loyalty to the corporation. The purchase may have been a usurpation of corporate opportunity. If it was, Chucky will have to turn the chain over to the corp. The corp would presumably also have to return Chucky's purchase price to him less whatever damages he might have caused the corp. The order for turnover is equitable relief and therefore the court must balance the equities.

Is this a breach of the fiduciary duty of loyalty? It is if Chucky received something unreasonable at the expense of the corporation. If Chucky received something himself that was not fair to the corp. Is it a usurpation of corporate opportunity? Chucky did not learn of the opportunity in his official capacity but it is so close to the line of business that the corp is in, it is something that the corp presumably would have wanted to consider. Chucky's defense would be presumably that the BOD specifically voted not to expand into Canada. That means, Chucky would say, that it is not - in fact - in the same line of business. The facts do not say why they voted not to expand but the vote after discussion may be enough. We would have to look at the minutes of the meeting where expansion was voted down to see what was said. If the reason was something general, such as simply deciding not to expand *now* - for some reason, Chucky has a big problem. He is going to lose since the business purchased by him is in the exact same line of business. But if the decision was designed to be a long term and/or permanent decision, it might be a defense. Chucky certainly should have advised the BOD of the opportunity before taking it himself. But he didn't so there is no safe harbor.

MY COMMENTS RE QUESTION 1

Most students set out a reasonably good analysis of the two decisions made by the BOD. Many students, probably half the class, misstated the rule of the fiduciary duty of care. It is not that the director must use good faith *care in the process*. That conflates care and the business judgment rule. The director must use the care of a reasonably prudent person - if he or she doesn't, he or she is liable for the damages to the corp. How do we figure out if she used care? We look at the *process* the directors used. Did they study it, read the reports etc? If so AND there is no conflict, fraud etc, then it is presumed they used care of a reasonably prudent person. Many students said that if the director had no conflict, bad faith, fraud etc, then it is presumed he used care in the process. That is wrong. The court cannot presume a person read the reports, showed up to the meeting, discussed the issues etc. There must be facts that support that. If there such facts AND there is no conflict etc, then care is presumed.

As to Chucky, the answers were not generally as good. The issue was - is the Canada chain a corporate opportunity as to Yoga, Inc.? The BOD had just rejected expanding into Canada. I was looking for a discussion of how that factors into the analysis. Most students went on and on about the safe harbor rule and what Chucky should have done. The question was "Will Maggie be successful in her suit?" Not what should Chucky have done. Maggie will be successful if Chucky usurped a corp opportunity by taking advantage of an opportunity that

Yoga, Inc. should have or would have (might have?) taken advantage of. Since this is a derivitive suit, the BOD could just say - in response to the suit - they would not have been interested. It is Maggie saying they should have been interested. If they were not, Chucky is safe.

By the way, some students said that Chucky could not compete with Yoga, Inc by operating a similar business and being on the Yoga, Inc BOD at the same time. Good point. But that just restates the real issue - is a business in Canada competing with Yoga Inc when the BOD expressly decided not to do business in Canada. I had no problem with students saying that Chucky could not compete while on the BOD. That is completely true.

QUESTION 2. (50%)

Jerry, George and Kramer have decided to start a bakery. At the first meeting, they agree to form a corporation and that Jerry will be the President, George the Vice President and Kramer the Chief Financial Officer. Kramer volunteers to contact Legal Zoom and get the corporation formed. The three of them agree that they will each work full time at the business. They find a location to open the bakery and negotiate a five year lease for the space. The lease provides that the tenant is Bakery, Inc. Jerry signs the lease as President of Bakery, Inc.

Shortly after signing the lease, Jerry finds a large oven on Amazon. He agrees to buy it on behalf of Bakery, Inc. for $10,000, again signing as President of Bakery, Inc. George and Kramer are upset with him because he did not ask them about it first and they do not think the oven is any good.

After several months of business, they have run out of money. They owe the landlord $20,000 and Amazon $10,000. They discover that Kramer never did get the Article of Incorporation filed.

1. Who can Landlord sue, what would the cause(s) of action be, and what is the likelihood of success?
2. Who can Amazon sue, what would the cause(s) of action be, and what is the likelihood of success?

Assume that the corporation was properly formed immediately after the first meeting of the three of them.

3. Who can Landlord sue, what would the cause(s) of action be, and what is the likelihood of success?
4. Who can Amazon sue, what would the cause(s) of action be, and what is the likelihood of success?

Analysis

1. Landlord and no corp.

Since the articles were never filed, there is no corp. Some states will recognize a corporation even though none exists if there was a good faith belief by the promoters that the corp was actually formed. This is called a de facto corp. Here Kramer could not have a good faith belief since he knew he did not file the articles. As to Jerry and George, I don't think Kramer's offer to file the Articles is sufficient to give them a good faith belief that a corp was actually formed. If there is a de facto corp, it is liable for the debt and not them.

Assuming no corp, Landlord can sue Jerry as the promoter since promoters are generally liable for debts created by contracts entered into by them on behalf of a corp that doesn't exist. He might be successful against George and Kramer as promoters since the facts say that "they" found the location and agreed to the terms of the lease. But certainly Jerry is a promoter and liable for the debt of the non-existent corp to the landlord.

Since the three of them agreed to operate the business together and the corp was never formed, they have created a partnership. There is no agreement as to the division of profit in the facts but that is not mandatory. Clearly they are operating the business together. As partners the three of them are personally liable for the debts of the partnership. The lease is clearly a partnership debt. Landlord will sue the partnership for breach of the lease. Landlord will win and will be able to collect from the three of them.

2. Amazon and no corp.

Again it is unlikely that there is a de facto corp. Also again, Jerry is clearly the promoter since he bought the oven on behalf of a corp that doesn't exist. Also again, there is a partnership. But as to Amazon, it is a partnership debt? It is if it as a debt incurred within the scope of the partnership. Well clearly a bakery would need an oven. But was Jerry authorize to enter into the contract on behalf of the partnership? In other words, did he have authority to bind the partnership?

He did not have express authority since the other two didn't know about it and didn't agree. There is no partnership agreement so we can't look to that to find his express authority. His authority might be implied from his agreed upon title as President of the corp. It doesn't seem that a $10,000 oven would be a consequential decision so it certainly would be within the ordinary scope of a President to purchase.

But here there is a partnership, and general partners of a partnership are presumed to have full authority to bind the partnership. So the partnership is certainly bound by the decision made by Jerry. And it looks like the partnership used the oven "for several months" which would constitute ratification of the purchase.

3. Landlord and corp.

If there is a corp, landlord is limited to suing the corp unless landlord can pierce the corporate veil. The corp entered into the contract, not the individuals. Piercing the corp veil happens when there is a unity of interest between the individual and the corp and allowing the individual to be protected by the corp veil would result in injustice. We figure that out by looking to a bunch of factors such as co-mingling, lack of formalities, lack of capitalization. The only facts suggesting unity of interest or injustice here are that the business is out of money. That suggests that there was a lack of capitalization. But given that corps are formed specifically to protect individuals, I think more than a suggestion is required. On these facts there is no chance the corp veil would be pierced.

The is also no issue as to whether Jerry had authority since it says that the three of them agreed up on the lease. Jerry obviously had express authority.

4. Amazon and corp.

If there is a corp, Amazon is also limited to suing the corp and trying to pierce the corp veil as to the individuals. See above discussion. There is the same authority issue as to Jerry. The corp is bound by his decision only if he had authority to act on behalf of the corp. As to express authority again there is apparently none since Kramer and George didn't even know about it. There isn't much doubt that the President has implied authority to buy assets for the corp UNLESS the purchase is a consequential decision. Then it MUST be made by the BOD. The President cannot make consequential decisions on his own. There cannot be implied authority if it is a consequential decision because of the basic rule that those decisions are left to the BOD. But is it consequential? There aren't any facts to help us decide that. If there is an issue over whether it is consequential, there might be apparent authority if the corp had made other similar purchases on Jerry's authority alone, that is the corp signaled to Amazon that the purchase was not a consequential decision and therefore Jerry had authority. Even if there is no authority, the corp would be bound if it accepted the oven and used it. The acceptance however may be a consequential decision by itself. If it is, Jerry cannot unilaterally decide to accept the oven.

MY COMMENTS RE QUESTION 2

The answers to question 2 were much worse than question 1. Again, some students run out of gas or out of time. That is a mistake. Use half the time you have to answer the first question if it counts for 50%. Most answers were also completely disorganized. On part 1, students threw in de facto corp, piercing the corp veil, authority, partnerships, promoters seemingly at random. Some students started out by saying they assumed there was a corp, i.e., parts 3 and 4 or assuming there was no corp but then responding as if there were a crop. Many students then copy and pasted their answers to part 1 into part 2 - sometimes even the whole answer! (or almost the whole answer). Some students copied long paragraphs 3-4 times into other parts of the answer. That is a mistake and is just lazy if nothing else. There were different issues in each part. Repeating a long paragraph verbatim makes your analysis hard to read, especially if the part you copied had errors. Many students - very surprising to me - made little effort to identify which part they were answering and just jumbled everything together.

As to parts 1 and 2, the big issue to me was whether there is a partnership which there clearly was. Most students saw that. Partners are liable for the debts of the partnership, not for the debts of the other partners, a mistake made by many (although not a big deal to me). I thought that whether Kramer and George were promoters as to the landlord and Amazon was a big issue which few people focused on - most just saying they were all promoters. Whether Jerry had authority was relevant only to Amazon since the three of them agreed on the lease.

As to parts 3 and 4, the answer is easy. The corp is *solely* liable a) if it is liable at all, i.e., did Jerry have authority, and b) if they can pierce the corp veil (then the individuals would be liable). There cannot be a partnership is the corp owns the business. Who is a promoter is irrelevant if there is a corp.

OVERALL COMMENTS

As I have said many times, I am trying to figure out whether you have a reasonable grasp of the rules and can provide a reasonable analysis using the very few facts given. It is incomprehendable to me that students do not reread their answers before turning them in. Easy errors can be corrected. Repetition can be cleaned up. A jumbled mess does not help you. The rules are not that hard, and there are not that many rules. The typical student has a reasonable grasp of the rules although many have nothing more than a faint knowledge of a few key words and no appreciation of what those words means. The hard part is communicating to the client and the court how the rules relate to the particular facts given. Communicating in our world is largely done in writing.