Business Organizations II

Final Examination

Spring 2023

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Professor H. Mendola
Prof. E. Wagner

Instructions:

There are Three (3) questions in the examination.

You will be given 3 hours to complete the examination.

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Question 1

After years of perfecting their homemade craft beer recipes, a group of friends: Frank, Franny, and Fred, from California have decided to take their passion for brewing to the next level and start a business. Frank, Franny, and Fred have chosen to form a corporation to take advantage of the limited liability protection and potential for growth through the sale of shares. The friends hired Adam Attorney to incorporate their business under the name "Brewski Bros". Adam Attorney properly prepared all necessary documents to incorporate the business but carelessly failed to file them with the Secretary of State.

Frank, Franny, and Fred believed they had formed their corporation and continued operating as if their enterprise had been properly incorporated, including entering into a 3-year lease with Lenny Landlord in the name of Brewski Bros.

Due to mismanagement, Brewski Bros went out of business 6 months into operation and had to break the lease. Lenny Landlord wants to go after Frank, Franny, and Fred personally.

Please discuss the following:

1. What are the legal requirements for forming a corporation in California?
2. What type of enterprise is Brewski Bros?
3. Will Lenny Landlord be able to successfully sue Frank, Franny, and Fred personally for breaking the lease?

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1)

A corporation is a legal entity that is perpetual in existence, provides limited liability, has centralized management, and free transferability of ownership (through shares).

1. Requirements for Formation of a Corporation

In order to properly form a corporation in the state of California, the Articles of Incorporation must be filed with the Secretary of State. The steps to forming a corporation are as follows: (1) selection of the state of incorporation; (2) selection of the name of the corporation; (3) appointment of an agent for service of process; (4) proper filing of the articles of incorporation; (5) holding the initial board meeting; (6) appointment of the board of directors; (7) formation of company bylaws; and (8) issuance of the shares of stock.

2. Was Brewski Bros. properly formed and how will the court classify them?

Given that the company wishes to grow through the sale of shares, it is assumed that it was intended for Brewski Bros. to become a public corporation. In order to determine the liabilities of Frank, Franny, and Fred, we must first determine whether the corporation was properly formed in accordance with the steps and requirements noted above.

this means registered on an exchan - share can be sold privately so not necessary to be public.

<u>State of Incorporation</u>

Here, the parties are all from California, and it is assumed from the facts that the state selected for incorporation is California. As such, it will be considered a domestic corporation and its internal affairs will be governed by the California Corporations Code per the Internal Affairs Doctrine.

<u>Name</u>

Here, the parties have selected "Brewski Bros." as their corporation name. In California, it is required that the name of the company contain "corporation" or "incorporated" or an abbreviation thereof. The name selected, "Brewski Bros." does not contain the name requirement in California. There is no indication that the Articles of Incorporation specified a name otherwise.

Proper Filing of the Articles of Incorporation

In order to properly form a corporation in California, it is required that the Articles of Incorporation be filed with the secretary of state. The Articles of Incorporation require the following: (1) corporation name; (2) business address; (3) purpose; (4) authorized stock; (5) par value of stock; and (6) agent for service of process.

While it is unknown if the documents prepared by Adam Attorney contained the appropriate requirements, he failed to file the Articles of Incorporation with the state altogether. As such, the court is not likely to find Brewski Bros. a de jure, or properly formed corporation.

However, if there is substantial compliance with the requirements but for error or deficiency, the court may find the company to be a de facto corporation, which for all intents and purposes would be considered a corporation in the suit.

Here, from the known facts, it appears that the only errors are with the selection of the corporation name and the actual filing of the Articles of Incorporation. However, Frank, Franny, and Fred believed that the corporation was properly formed. **As such, it is likely that the court will find Brewski Bros. to be a de facto corporation for purposes of this suit.**

3. Can Frank, Franny, and Fred be held personally liable for the breach of contract (lease) with Lenny?

If the court does find Brewski Bros. to be a de facto corporation, in order to hold Frank, Franny, and Fred personally liable for the breach of contract, the corporate veil must be pierced.

Piercing the Veil

One of the characteristics of a corporation is that there is a "veil" protecting the members from personal liability. However, this veil of liability, referred to as piercing the corporate veil, may only be pierced if (1) there is no unity of interest and ownership with the corporation; and (2) not piercing the veil would result in fraud or promote injustice.

In evaluating whether there is unity of interest and ownership with the corporation, the court will look at the following factors: (1) commingling of assets; (2) not following corporate policies or lack thereof; (3) undercapitalization to operate; and (4) fraud or illegality.

Commingling of Assets

If assets are commingled between Frank, Franny, Fred, and the corporation, this may weigh in favor of piercing the corporate veil of liability. Here, there is no indication that any personal and corporate funds were commingled. As such, this factor weighs in favor of Frank, Franny, and Fred.

Corporate Policies

There is no indication from the facts that Frank, Franny, or Fred did not follow corporate policies, or what policies they had in place.

Undercapitalization

Here, it is unknown the amount of capital the corporation possessed. However, the corporation did go out of business six (6) months into operation. As such, if the company did not possess enough capital to operate, this factor may weigh in Lenny's favor in piercing the corporate veil.

Promotion of Injustice

If not piercing the corporate veil would promote fraud or injustice, the court may decide to hold Frank, Franny and Fred personally liable. Lenny may argue that not doing so would promote injustice as he would be left without remedy.

Promoter Liability

Prior to incorporation, a "promoter" may enter into contracts on behalf of the corporation, in their own name, for which they will be held personally liable. As the corporation is not in existence yet, to be deemed a legal entity, the promoter may be held liable. Even after the corporation is formed, the promoter will still be liable under the contract.

promoter is liable as the contract is in his/her name

Here, the contract was entered into by "Brewski Bros." There is no evidence that the contract was entered into by Frank, Franny, or Fred in their own names. As such, they will not be held liable as "promoters" under the lease. good

Estoppel

If court finds no corporation, or that the corporation is not "de facto", Frank, Franny, and Fred may be personally liable for the breach of contract. However, the doctrine of estoppel may apply herein.

Under the doctrine of estoppel, if a third-party conducts business with corporation and enters into a contract in the belief that they are a corporation, the third-party is estopped from claiming that they are not a corporation. As such, it is unlikely that the court will hold Frank, Franny, and Fred personally liable under the doctrine of estoppel. ✓

Conclusion

Given the above, it is unlikely that the court will pierce the veil of corporate liability and hold Frank, Franny, and Fred personally liable for the contract entered into between Brewski Bros. and Lenny, unless the court finds that not piercing the corporate veil would promote injustice.

If the corporate veil is not pierced by the court, Lenny's only recourse for the breach of contract would be to pursue the corporation itself, as a de facto corporation.

very good!

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R 34
A 37
C 36
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2)

Corporation

A corporation is a distinct legal entity separate from its owners, Shareholders (SH). A key advantage to the corporate form is that the SH are shielded from personal liability (liable ✓ to the extent of their investment. The following analysis will be conducted in accordance with the California Corporate Code.

Here, the facts state that Hercules is a corporation that owns a number of outdoor fitness obstacle courses.

Thus, a corporation has been formed.

Type of Corporation

A close corporation has less than 35 shareholders, not public market for its stock and a majority of the SH are also involved in the operations and management of the corporation.

This is a close corporation because there are 10 SH, no public market for the stock and with Zeus being a majority stockholder there is a majority of SH involved in the direction and management of the corporation.

Thus, this is a close corporation. — facts do not indicate. corp must choose this option

Will the Board, Zeus and/or Hades be protected from liability by the Business Judgment Rule (BJR)?

Fiduciary Duties

Director and officers owe fiduciary the duties of good faith, care and loyalty to the corporation.

Directors of the Board

Will the directors of the board be protected by the BJR?

The Duty of Care | Business Judgment Rule (BJR)

The duty of care requires that directors and officer act in good faith, act as a reasonably prudent person under the circumstance, and act in a manner that is in the best interest of the corporation

Directors' decision are protected by the BJR. The BJR is a presumption that director and officers acted in good faith, advisedly and in a manner reasonably believed to be in the best interest of the corporation.

Directors may rely on reports, opinions statements from outside professionals (lawyers, accountants) and even inside officers and employees provided the board believes the sources are credible.

A challenger may rebut the BJR by showing that the officers/directors acted in bad faith (fraud, illegality, reckless disregard), made an irrational / unintelligent decision, engaged in a conflict of interest or acted unadvisedly.

The director/officer can then rebut the challenger by showing that the transaction was entirely fair (fair as to price and process).

Here, the directors of the board were approached by Zeus to purchase his apartment complex in order to expand the company. Zeus told them that the property would make a profit of approximately $2M. The board approved the purchase based on Zeus' comments. The board did not conduct any investigation into the property on their own.

Had they done so, they would likely have uncovered that the property had problems that would cost them and extra $250k. Moreover, they likely would have learned that how profitable the property could be ($2M v. the resulting $1M).

Even though directors may rely on an officers opinion that the transaction would be a good one, in this case, Zeus was also an interested party because he owned the property which would not make his opinions reliable. Thus, it is clear the board did not act advisedly and therefore the BJR would not provide protection. Moreover, the board would not be able to defend on the basis of fair price and fair process because they had not investigated the price and they had relied on and Zeus (an insider) for the advise provided.

Note: it is assumed when the board approved the transaction, proper notice (at least 2 days) quorum (majority of board members present) and voting requirements have been met (as provided in the bylaws but at a minimum a majority of disinterested directors). Had that not been the case, the board would have breached its duty of care for for not acting in the best interest of the company or in a manner that a reasonably prudent person would under the circumstances.

Thus, the board would not be protected by the BJR.

Zeus

Is Zeus protected by the business judgment rule?

See rules above.

Here, Zeus was an interested party because he owned the apartment complex and he was both the president and a director in the corporation. Moreover, Zeus did not conduct any investigation as to the value of the property or whether there were any potential problems when he told the board members that they would make a profit of approximately $2M.

When he learned that the price of the property had increased, he should directly disclosed that to the board - instead he simply stated "shouldn't be a big deal". Had he conducted an investigation, he likely would have uncovered that there may have been issues in developing the property costing an extra $250 and that when completed the project would only have brought a profit of $2M. Thus, Zeus was not only an interested party (conflict of interest which is a breach of a duty of loyalty), he also failed to act advisedly (failure to investigate) when he brought the proposal to the board. Moreover, Zeus would be unable to establish that the transaction was the result of a fair price or fair process because he failed to investigate the price and a fair process would have involved outside opinions.

Thus, Zeus would not be protected under the BJR because he was an interested party and failed to act advisedly.

Controlling SH

Controlling SH also owe the corporation the same fiduciary duties as officers and directors. A controlling SH either owns a majority of the share or a smaller number but maintains control of the board. Controlling shareholders must not use their power to benefit at the disadvantage of minority SH's.

Here, Zeus owns 20% of the corporations stock while the other 9 own between 5-10% each. As such it is likely Zeus is a controlling SH and owes a duty not to benefit at the disadvantage of the other SH. By selling the property to the corporation for $1.5M without any investigation as to whether that price point represented fair market value or whether the potential profit would be $2M was an act of bad faith.

Accordingly, Zeus would not be protected by the BJR.

note that BJR usually applies to the board. Z was acting as an individual and an interested party/director.

Hades

Will Hades be protected by the BJR?

See rule above.

Here, Hades was appointed to close on the property. The agent told Hades that the value of the property had increased from $1.25M to $1.5M, a $250k difference. Instead of bringing this new information to the board, Hades made the decision on his own accord to move forward with the transaction at the increased price. As a result, Hades acted in bad faith showing a reckless disregard for corporate formalities. A director cannot act alone, in order to making corporate decisions (all decision/resolution need to be approved by the board acting as a group and following proper procedures as detailed in the bylaws (ie. notice, quorum, and adhering to proper voting requirements). Hades did not seek proper board approval and thus acted with reckless disregard. Moreover, there was no investigation on Hades part to find out why there was an increase of $250k and whether such increase made sense which shows that Hades decision was irrational/unintelligent decision. Finally, Hades would not be able to show that the price or process was fair because he did not consult anyone as to whether the additional $250k was a fair price. and he acted outside the scope of his authority

true b. he was appointed the bd to act as agn

Thus, Hades would not be protected by the BJR.

Conclusion

Accordingly, neither the board, Hades or Zeus would be protected by the BJR.

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3)

ERIC V. VIKING

In this case, the plaintiff, Eric, has filed a personal injury suit against Viking (parent corporation) after suffering injury from a tractor from its subsidiary corporation, Freya. Is Viking liable for the personal injury sustained by Eric?

Piercing the Corporate Veil

In order for parent company, Viking, to be liable, the corporate veil of the subsidiary company, Freya, must be pierced under the the alter ego doctrine.

Under this doctrine, this veil of liability, referred to as piercing the corporate veil, may only be pierced if (1) there is no unity of interest and ownership with the corporation; and (2) not piercing the veil would result in fraud or promote injustice. This is a fact specific analysis and will be determined by the trier-of-fact.

In evaluating whether there is unity of interest and ownership with the corporation, the court will look at the following factors: (1) commingling of assets; (2) not following corporate policies or lack thereof; (3) undercapitalization to operate; and (4) fraud or illegality.

Commingling of Assets

If assets are commingled between Viking and Freya, this may weigh in favor of piercing the veil of liability.

Here, there is no indication of commingling of assets between Viking and Freya, aside from the purchase of capital stock to the directors. The directors are the same for both Viking and Freya. This may be seen by the court as commingling of assets.

Corporate Policies and Procedures

If the subsidiary corporation does not follow its own policies and procedures, this may also weigh in favor of piercing the veil of liability to the parent corporation. Additionally, failure to maintain adequate records may be looked at by the court.

Here, it is indicated that the meeting notes from the initial board meeting were printed on Viking letterhead, not Freya. There is no reference to Freya on the notes of the meeting. Additionally, the bylaws of Freya are identical to that of Viking with the only difference being the company name change at the top.

Given the above, this factor is likely to weigh in favor of piercing the veil as well.

Undercapitalization

If a subsidiary corporation, Freya, does not possess enough capital to run its own operations, the court may weigh this factor in support of piercing the veil.

Here, it is noted that Freya had the minimum amount of capital required to incorporate. Viking may argue this in its defense.

However, it is noted that at the first board meeting, Freya opted not to obtain an insurance policy for any liability due to the premiums being too high. As such, it may be argued by Eric herein that Freya was undercapitalized to conduct operations on its own and was dependent on the parent corporation, weighing in favor of piercing the corporate veil. This is especially due to the fact that the directors knew that they were entering into a high-risk business and opted not to purchase insurance due to lack of funds and were waiting to see if the business grew first.

This factor weighs in Eric's favor of piercing the veil.

Fraud/Promotion of Injustice

If not piercing the corporate veil would promote fraud or injustice, the court may decide to hold the parent corporation, Viking, liable.

It may be argued here that advertisements for Freya stated that the company was "fully-bonded and insured". This was not the case as Freya decided not to purchase an insurance policy. As such, this may be seen by the court as fraudulent due to their misrepresentation and weigh in favor of piercing the veil.

Conclusion

Taking into account the above factors, it is likely that the court will pierce the veil of liability to the parent corporation, Viking. Thus, Viking will fail in its argument that it is a separate company and may be liable to Eric for the injuries sustained.

ERIC V. BJORN

Bjorn was hired by Freya to "run the business" of Freya. It may be demonstrated that Bjorn was acting as an officer of Freya. If Bjorn is considered an officer, in order to file suit against him, the corporate veil must be pierced of the subsidiary, Freya, AND its parent company, Viking.

no indication he was appointed as officer so presumption is that he is an employee

If Bjorn was not acting as an officer, he was merely an employee and would not be liable under the principles of agency and the doctrine of respondeat superior.

Here, there is no indication from the facts that Bjorn was appointed as an officer of the corporation, Freya. As such, he will be shielded from any personal liability from suit against Eric.

Bjorn - fraud/misrepresentation? told them he had "a lot of experience".
↳ this would be an action between bjorn + the corp, not eric

END OF EXAM

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I 34
R 33
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Business Organizations
Spring 2023
SLO/HYB
Prof. Mendola, Stirling, E. Wagner,

Answer Outline:

1. What are the legal requirements for forming a corporation in California?
    a. **<u>Organizing a Corporation</u>**
        i. First step is filing a certificate of incorporation in a designated office in the stat in which the organizers have chosen to corporate
            1. Must state the classes of stock and number of shares of each class
            2. Only stock that has been authorized in the certificate can be issued
            3. Stock that has been authorized but unissued is called: unissued stock
            4. Authorized stock that has been issued is known as issued stock or outstanding stock
            5. If a corporation repurchases stock that it has previously issued, that is treasury stock or authorized and issued but not outstanding stock
            6. The power to issue stock
        ii. The corporation must then issue stock to get its business up and running
        iii. The power to issue stock is normally vested in the board
        iv. The board is normally elected by the shareholders and until stock is issued there are no shareholders
            1. Under the laws of some states the corporation's incorporator's have the powers of directors until the directors are elected and the powers of shareholders until stock is issued
                a. Under this approach the incorporators will adopt by-laws and elect initial directors to serve until the first annual meeting of shareholders
            2. Under DE law: the initial directors can be named in the corporation's certificate of incorporation
        v. Once directors are named, there is an organization meeting and there's an operative corporation.
2. What type of enterprise is Brewski Bros?
    a. **Consequences of Defective Incorporation**
        i. **De Jure Corporation**
            1. A corporation that is organized in compliance with the requirements of the relevant statute
            2. A de jure corporation's status cannot be attacked either by private parties or by the state in a quo warranto proceeding
            3. Most courts hold that perfect compliance with the statutory requirements for incorporation is not required to attain de jure status
            4. SUBSTANTIAL COMPLIANCE will suffice
                a. If the noncompliance is deemed "insubstantial" then an enterprise that fails to meet all requirements for incorporation may still be a de jure corporation
            5. Some Courts:
                a. Find that for a corporation to reach de jure status they must have exact compliance with all mandatory statutory requirements but the failure to

comply with requirements that are only "directory" will not preclude de jure status

b. Whether a requirement is mandatory or directory is a matter of statutory interpretation

ii. **De Facto Corporation**

1. Happens when the steps taken to incorporate the enterprise were insufficient to result in a de jure corporation with respect to a challenge by the state in a quo warranto proceeding but were sufficient to treat the enterprise as a corporation with respect to third parties
2. There must have been a colorable attempt to incorporate and some exercise of corporate privileges
3. THREE REQUIREMENTS:
    a. A statute in existence by which incorporation was legally possible
    b. A colorable attempt to comply with the statute
    c. Some actual use or exercise of corporate privileges

3. **<u>Will Lenny Landlord be able to successfully sue Frank, Franny, and Fred personally for breaking the lease?</u>**

    a. **Estoppel**

        i. In cases where neither a de jure nor a de factor corporation have been formed, the courts have held that a third party who has dealt with an enterprise on the basis that it is a corporation is estopped from denying the enterprise's corporation status

        ii. This one is murky and has a cluster of several different rules

        1. May only be applied to a specific transaction which is different from de facto

        2. Because a decision on estoppel relies heavily on the plaintiff's conduct – it may have very limited precedential effects based on the same theory and other different plaintiffs and plaintiff's conduct

<u>Q2 Answer Outline</u>

I. Director's Liability

    a. Business Judgment Rule:

        i. Director's decision not challenged if director:
            1. Acted in good faith;
            2. Acted with care of a reasonably prudent person in the same circumstances; and
            3. acted in the best interests of the corporation

        ii. Here, the directors did not take any other steps to analyze the transaction.

        iii. The directors should have taken better precautions when entering into a transaction that directly benefitted a director on the board.

        iv. The business judgment rule will not likely protect the directors here.

II. Zeus

    a. Business Judgment Rule:

        i. Zeus might be protected by the BJR if he reasonably acted under the circumstances.
            1. Arguably acted reasonably by going to the Board and disclosing the circumstances.

ii. Acted with care?
    1. Zeus arguably did not take the steps necessary when making his business proposal.
    2. He should have had more than an approximate figure.

iii. Best Interests of the Corporation?
    1. Zeus was arguably acting within his best interests when proposing this transaction to the corporation.
    2. It appears that Zeus was likely going to sell the property anyway, so this could arguably be in the best interests of the corporation, because he went to them first before selling the property.

b. Is Zeus protected because the Board approved the transaction?
    i. Unlikely.
    ii. A director must disclose all material facts to disinterest members of the board, and the transaction must be fair.
    iii. Once Zeus found out about the value of the property increasing, he should have gone to the Board instead of assuming that the Board would be okay with it.
    iv. In hindsight, if this were presented, then the board would have sustained less damages, and this was just a bad investment.

III. Hades
  a. BJR
    i. Unlikely that Hades will be protected, since he should have used reasonable care in entering into the transaction. He could have performed research on the market, gone to the board before entering.

ANSWER 3(OUTLINE)

20% Organization (Similar headings – boldfaced below)

20% Issue (Spot all issues)

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

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

20% Conclusions (Get correct conclusions – as *italicized* below)

Introduction

1. Nature of Organizations
2. Viking and Freya are both corporations. Bjorn is an agent of Freya.

3. A corporation is a legal entity and can be held liable on its own.

What might the court decide?

1. Is Bjorn liable?
    a. Bjorn is an employee of Freya and is therefore an agent of Freya which is the principal.
    b. Under respondeat superior, the principal/employer is responsible for the actions of its employees acting in the ordinary course and scope of their employment.
    c. The facts do not indicate that Bjorn was acting outside the scope of his employment.
    d. While he may not have been qualified, the principal did not inquire further about his training or experience.
    e. ***Accordingly, Freya is liable for the actions of Bjorn, and Bjorn should be dismissed as a party to the action.***
2. Can Viking, as sole shareholder, be held liable for the actions of its subsidiary, Freya?
    a. Normally, the shareholders of a corporation are not personally liable for the actions of the corporation.
    b. If corporate separateness is maintained and all proper corporate formalities are observed, a parent corporation/shareholder, will not be liable for the actions of its subsidiary.
    c. In this case, Viking's directors were also the directors of Freya. While this arrangement does not in and of itself illustrate a lack of separateness, the actions of Freya's directors appear to have disregarded the separateness of the two entities. In holding the board of directors' meeting, the directors used Viking letterhead and signed without indicating their correct titles (directors of Freya). As such it is questionable whether the directors were acting in their roles for Freya or for Viking.
    d. California law allows a court to look beyond the liability limits of the shareholders and "pierce the corporate veil" if the subsidiary is a mere instrumentality or alter ego of its shareholder.
    e. In California, two conditions must be met before the alter ego doctrine will be invoked. First, there must be such a unity of interest and ownership between the corporation and its equitable owner that the separate personalities of the corporation and the shareholder do not in reality exist. Second, there must be an inequitable result if the acts in question are treated as those of the corporation alone.
    f. In this case, the directors are the same in both the parent and subsidiary and the directors do not appear to observe corporate separateness as evidenced by the form of their meeting notes and resolutions, such that it is not clear who is making decisions for Freya. In addition, the address is the same for both companies.
    g. Whether the company is adequately capitalized for its corporate undertaking is also a factor in determining a unity of interest. In this case, Freya was clearly undercapitalized and under-insured for the type of business planned.
    h. As there is a unity of interest and ownership, the two companies do not have separate personalities.

i. As to the second prong of the test, if Freya is held solely liable as a separate company, there will be very little cash and no insurance to award Eric for his damages and thus an inequitable conclusion.

j. ***Accordingly, there will be an inequitable result if Freya's actions are treated as those of Freya's alone. As such, Freya is the alter ego of Viking and Viking should be liable.***

3. In addition to the test noted above, did Viking and its directors use Freya to perpetuate the violation of a statutory or other positive legal duty, or dishonest and unjust act in contravention of the plaintiff's rights?
   a. While normally not necessary to pierce the corporate veil, a plaintiff can demonstrate a fraud or wrongdoing on the part of the parent/shareholder as an overall element of injustice or unfairness.
   b. In this case, the directors decided to forego insurance for the company, but then proceeded to advertise it as fully bonded and insured. By not insuring Freya, they also enabled Viking to benefit from reduced cash outflow in financing its subsidiary.
   c. As a result, Freya would have no funds to pay Eric's damages.
   d. <u>Courts will disregard the corporate form and pierce the corporate veil in order to hold the shareholders liable whenever necessary to prevent fraud or achieve equity.</u>
   e. ***Accordingly, the court may pierce Freya's corporate veil to hold its shareholder liable.***

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QUESTION 2

The Hercules Corporation is a corporation that owns a number of outdoor fitness obstacle courses. The appeal of Hercules Co. gyms and courses was the unique experience where you feel like you are exercising in another world. With 10 shareholders total, Zeus owns 20% of the shares, while the other shareholders own between 5% - 10% of the rest of the shares.

Hercules Co. has a very popular outdoor course that is surrounded by apartment complexes. Zeus, who is also the president and director of the Hercules Co., has owned the apartment complexes since before he became a shareholder, president, and director of the corporation. He also disclosed to the Board when he purchased shares that he was the owner, and the Board did not see a problem with it.

The apartment complexes are out of date and are being overshadowed by the Hercules Corporation's outdoor facility. Zeus would rather sell the property and give the corporation a chance to claim the property and expand the outdoor facilities. Zeus schedules a meeting with the Board to discuss his idea to expand the corporation's business.

Zeus discloses that he believes the fair market value of his property is approximately $1.25 million, and wants to sell the property to the corporation so they can expand upon their very popular outdoor course. Zeus also estimated that the after purchasing the property, developing the property, and opening the course, the corporation would make a profit of approximately $2 million within the next year. Trusting Zeus and liking the idea of making a profit, the Board approved the transaction and appointed Hades, another shareholder and director, to close on the property.

Zeus sold the property through an agent, who worked directly with Hades on closing the property. The agent appraised the property and discovered the value of the property increased to $1.5 million. The agent brought this to the attention of Zeus who said, "Shouldn't be a big deal. I told them the price was approximate and they will still make a profit." The agent subsequently told Hades that the value of the property increased to $1.5 million, and they could not sell for any less. Hades, thinking that the extra $250 they'd be spending wasn't a big issue, agreed to purchase the property.

Hercules Corporation proceeded with the expansion project, but ran into some unexpected issues developing the property, which cost them an extra $250,000. After the development of the property was complete, the Hercules Corporation only profited $1 million from the transaction, resulting in a $750,000 loss.

A derivative suit was filed against Hercules Corporation's Board of directors for breach of their fiduciary duties.

Will the directors of the Board, Zeus, and/or Hades be protected from liability by the Business Judgment Rule? Discuss.

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Question Three

The Viking Company of California (Viking) operates a landscape and construction business. The company is owned by three brothers, Ragnar, Floki and Ivar, who are equal shareholders. The are also the directors of the company. Business is very good and the company has a lot of cash on its balance sheet. It also carries a large and expensive insurance policy to cover the risks in its business.

The brothers realize that there is a brisk market in the sales of used construction equipment. They form the Freya Company (Freya) as a wholly-owned subsidiary of Viking with only the minimum amount of capital required to incorporate and issue $3,000 in capital stock to themselves (1,000 shares each). They are also the directors of Freya. Freya uses the same address as Viking. They hire Bjorn to run the business. Bjorn told them he had "a lot of experience" with rebuilding equipment, but did not provide any references, nor did they ask for any. The advertisements for Freya state that the company is fully-bonded and insured.

During their first board meeting, the directors of Freya decide, even though it is a high-risk business, to delay obtaining an insurance policy for any liability as the premiums are so high. They decide to wait to see if the business grows. The notes/resolutions of the meeting are printed on Viking letterhead, and signed by the three, all using the title "director" with no other designation. The bylaws are a copy of Viking's with just the Company name changed.

The first week Freya is open, Bjorn fixes up a tractor and sells it to Eric, a sole proprietor/farmer. Two days later, the tractor breaks and Eric is injured and unable to work for an extended period. Eric files a personal injury suit against Viking. Viking counters that it is not liable as it is a completely separate company and that the proper party is Freya. Eric also sues Bjorn.

What might the court decide?

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