# CALIFORNIA BAR PAST EXAMS

カリフォルニア州司法試験過去問

## ⑨ BUSINESS ASSOCIATIONS

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# Business Organization

# California Bar Examination

## Essay Questions and Selected Answers

February 2002

# Question 3

Acme Corporation was a publicly traded corporation that operated shopping malls. Because of an economic slowdown, many of Acme's malls contained unrented commercial space. Additionally, the existence of surplus retail space located near many of Acme's malls prevented Acme from raising rents despite increasing costs incurred by Acme.

In June 2001, Sally, president and sole owner of Bigco, approached Paul, Acme's president. She proposed a cash-out merger, in which Bigco would purchase for cash all shares of Acme, and Acme would merge into Bigco. Sally offered $100 for each outstanding share of Acme's stock even though Acme's stock was then currently trading at $50 per share and historically had never traded higher than $60 per share.

Paul, concerned about Acme's future, decided in good faith to pursue the merger. In July 2001, before discussing the deal with anyone, Paul telephoned his broker and purchased 5000 shares of Acme at $50 per share. Paul then presented the proposed merger to Acme's board of directors and urged them to approve it. The board met, discussed the difference between the current market share price and the offered price, and, without commissioning a corporate valuation study, voted to submit the proposed deal to a shareholder vote. The shareholders overwhelmingly approved the deal because of the immediate profit they would realize on their shares. Based solely on shareholder approval, the board unanimously approved the merger, and all shareholders received cash for their shares.

In December 2001, shortly after completing the merger, Bigco closed most of the Acme malls and sold the properties at a substantial profit to a developer who intended to develop it for light industrial use.

1. Did Paul violate any federal securities laws? Discuss.
2. Did Paul breach any duties to Acme and/or its shareholders? Discuss.
3. Did the board breach any duties to Acme and/or its shareholders? Discuss.

## ANSWER A TO QUESTION 3

PAUL'S VIOLATION OF FEDERAL SECURITIES LAW

The issue here is whether Paul violated any federal securities laws by purchasing 5000 shares of Acme stock prior to the merger with Bigco. The two main federal securities laws that Paul could be liable under are Rule 10b-5, which prohibits insider trading, and Section 16(b), which imposes strict liability on officers, directors, and 10% shareholders for trading the stock of their company within 6 months of each other. Each will be discussed below:

Rule 10b-5

The issue is whether Paul violated rule 10b-5 of the SEC. Rule 10b-5 prevents insider trading by making it illegal for one who owes a fiduciary duty to a corporation and possesses "inside information" to use an instrumentality of interstate commerce to buy or sell the corporation's stock. Additionally, the rule contains a scienter requirement. The "insider" must either disclose the information or abstain from trading.

A person who owes a fiduciary duty is one who is an officer, director, attorney, employee, etc. who owes some duty (duty of care, loyalty, confidentiality, etc.) to the corporation. As the president of Acme, Paul is an officer and is clearly within the class of persons owing Acme a fiduciary duty.

Inside information is that information that a reasonable trader would want to know before buying or selling the corporation's stock. Here, the information was that Bigco had proposed a merger and buyout of Acme's stock at twice its current selling price and $40 higher than it had ever traded before. This information would be crucial to any person who was trading Acme's stock.

Using an instrumentality of interstate commerce is easily satisfied. Here, Paul used the telephone to place the order to his broker. The telephone lines cross state lines and are used to conduct business across state lines. Therefore, this requirement is satisfied as well.

Paul did purchase 5000 shares of Acme's stock. And, he did so with improper intentions. This is what is required in "scienter" -- it is knowledge that what one is doing is wrong. In short, Rule 10b-5 requires that the insider to something "slimy" and repugnant to an ordinary person. Purchasing 5000 shares of his company's stock on the basis of inside information is just what Rule 10b-5 was enacted to prevent.

The "abstain or disclose" rule is also part of 10b-5. Here Paul did eventually disclose the Bigco offer to the Board of Directors, and then to the shareholders, he traded on the information prior to disclosing. The announcement could have increased the current trading price of Acme, and Paul took advantage of the low price of Acme stock by purchasing before the disclosure.

In short, Paul has violated Rule 10b-5 and will be forced to disgorge his profits to the corporation.

Section 16(b)

The issue here is whether Paul violated Section 16(b). Section 16(b) imposes strict liability on any officer, director, or shareholder owning 10% or more of the outstanding stock from buying and selling or selling and buying stock of the company within 6 months of each transaction. There is no "guilty mind" requirement as in 10b-5 because the idea is that it is simply bad policy and bad for the market to have these persons trading. In order for Section 16(b) to apply, the corporation has to either be publicly traded or be of sufficient size to meet the guidelines. Here, Acme is a publicly traded corporation, and Paul, as president is an officer; therefore, the rule applies.

Here, Paul bought 5000 shares in July of 2001. If he sold those shares within 6 months, he is strictly liable to the corporation. The facts do not indicate when Bigco purchased the shares, but it had to be prior to December of 2001, when Bigco closed the malls. This is 6 months or less from the purchase. Paul therefore is strictly liable for profits.

Profits under 16(b) are tricky -- the calculation is the difference between the lowest price in the six month period and the highest price in the six month period. Paul's profits were at least the same as they would be under 10b-5. However, if the price fluctuated under $50 or sold for more than $100, P would be liable for that additional amount as well.

Conclusion

Paul has violated both Rule 10b-5 and Section 16(b).

PAUL'S BREACHES OF DUTY TO ACME/SHAREHOLDERS

The issue is whether Paul breached any duty to Acme or the shareholders. Paul owes two overarching duties to the corporation and hence the shareholders: the duty of care and the duty of loyalty. Each are discussed below.

Duty of Care

As an officer, Paul owes a duty of care to Acme. Paul must act as a reasonably prudent person would in this situation. He must act in good faith and in what he honestly believes is the corporation's best interest.

Paul, in good faith, decided to pursue the Bigco merger. A reasonably prudent person would most likely do the same thing. A merger would be good for the shareholders because the company was suffering from financial hard times. However, Paul apparently did not do any checking on Bigco's intentions after the merger. Had Paul done some investigating, he might have been able to discover that the reason Bigco was offering so much for the Acme stock was because it had a developer waiting to purchase the property and make a substantial profit.

Business Judgment Rule

Paul will assert that his actions did not violate the duty of care he owes the corporation because he acted under the protection of the business judgment rule. The

business judgment rule provides that when an officer or director acts in a way motivated by a good faith belief that he is acting on behalf of the corporation's best interests and that judgment turns out in hindsight to be wrong, the court will not step in [and] hold the officer or director liable.

However, the corporation or the shareholders will be able to argue that a reasonable person would have made the further inquiries, that the high asking price should have tipped Paul off that something else was happening here. This was a substantially high price for stock here -- Acme had never traded higher than $60/share, and Sally offered $100/share while the market was depressed and Acme was suffering financial hardship. This would have tipped off any reasonable person that something was motivating her.

Therefore, the business judgment rule will probably not protect Paul's decision in the end. While pursuing the merger might have been a wise choice, the failure to inquire into the basis of the merger was a violation of the duty of care.

<u>Duty of Loyalty</u>

As an officer, Paul owes a duty of loyalty to the corporation as well. This means that Paul must put the corporate interest ahead of his own, or those close to him, at all times. There are many ways to violate the duty of loyalty; of particular relevance here is the duty not to engage in interested transactions.

Normally, an interested transaction is one where the officer has an interest such as an ownership in another corporation that this corporation is considering doing business with. Here, however, the interest came in the $250,000 Paul spent on Acme's stock before he went to the Board with the merger proposal. A quarter of a million dollars -- there was no way that Paul would be able to act in an impartial manner in this transaction. By purchasing the stock before he even went to the meeting and informed the board of the merger proposal, he had indicated that he had decided it was going to happen. Otherwise, he risked losing that money.

As such, Paul violated his duty of loyalty to the corporation.

Conclusion

Paul has violated both the duty of loyalty and the duty of care he owed to the corporation.

THE BOARD'S BREACHES OF DUTY TO ACME/SHAREHOLDERS

The issue is whether the Board breached any duty to Acme or the Shareholders. Directors owe two overarching duties to the corporation and hence the shareholders: the duty of care and the duty of loyalty. Each are discussed below.

Duty of Care

The board of directors owes the same duty of care that Paul, as an officer, owes. The Board will, like Paul, argue that the Business Judgment Rule protects their decision to take the merger to the shareholders. However, like Paul, the argument will fail.

One of the fundamentals of the duty of care is that the directors need to investigate. Here, all the directors saw was dollar signs. They did not take the time to get a corporate valuation study, which in all likelihood would have revealed the developer that Bigco was dealing with, or some other similar venture. Directors are allowed to base decisions on the recommendations of employees or other people who have relevant information. However, there has to be some basis for this reliance. Here, the directors only relied on Paul's recommendation. Paul had done nothing to indicate that he had substantially investigated the deal. All the board based its decision on was the price. While price is important, it is not the only concern of the board. The board should have investigated further.

Therefore, the board breached its duty of care to the corporation and is not protected by the business judgment rule.

Duty of Loyalty

The board owes the same duty of loyalty that Paul, as an officer, owes. There is no evidence here of any interest on the part of the directors. If the directors were also large shareholders in Acme, that might provide the basis for the breach of the duty of loyalty, but absent such or similar evidence, there is no indication that the board breached any duty of loyalty to the corporation.

## Conclusion

The board has violated its duty of care owed to Acme, but no facts indicate that a suit for violation of the duty of loyalty could be maintained.

## POSSIBLE DEFENSES BY PAUL AND THE BOARD

### Shareholder Approval

Paul and the board both could attempt to defend any liability based on the fact that the shareholders approved the merger. The merger constituted a fundamental corporate change, and as such, required shareholder approval. Therefore, the board acted properly in submitting it to them. However, the shareholders are permitted to rely on the board's recommendation, as they did here.

Therefore, the shareholder approval will not protect either Paul or the Board.

## ANSWER B TO QUESTION 3

1. Did Paul violate any federal securities laws?

Rule 10b-5

Rule 10b-5 is a federal law that makes it illegal for any person to use any means or instrumentality of interstate commerce to engage in a scheme to defraud, make an untrue statement of material fact (or omit a material fact) or engage in any practice that operates a fraud, in connection with the purchase or sale of a security. The elements of a violation of Rule 10b-5 therefore include an instrumentality of interstate commerce, scienter, an act or misstatement and the purchase or sale of a security.

Here, Paul telephoned his broker, which satisfies the element of interstate commerce. The "means or instrumentality" requirement is broadly defined to include anything that affects interstate commerce, and the use of the telephone is included. (Also, the facts state that Acme Corporation is publicly traded. If it is traded on a national exchange, Paul would satisfy this element even without using the telephone.)

Paul purchased 5000 shares of Acme while in possession of insider information, which is insider trading. Paul is an insider of Acme Corporation because, as its president, he is in a position of trust and confidence to the corporation. He knew about the merger proposal when he purchased the shares, even though not even the Board, much less

the public, knew about it. Inside information is material nonpublic information, which includes any information about which there is a substantial likelihood a person would be interested (or that a person would find persuasive) in deciding whether to buy or sell the security. A potential $50 per share profit in a month or two is certainly material.
Because Paul is an insider and he possessed inside information, he had an obligation to either disclose the information or abstain from trading on it. He violated this duty when he purchased the shares without disclosing the offer.

Paul's knowing disregard of his duty to disclose or abstain fulfills the scienter element of a Rule 10b-5 violation. His purchase of the shares is the requisite act and also satisfies the purchase or sale requirement.

Paul has violated Rule 10b-5.

Section 16b

Section 16b makes it illegal for any director, officer or 10% shareholder of a company to profit from the purchase and sale, or sale and purchase of shares of that company's equity securities within a time frame of 6 months; if the company has 500 shareholders and $10,000,000 in assets or is traded on a national exchange.

Here, Paul purchased 5000 shares of Acme stock at $50 per share in June of 2001. Because he was a shareholder of Acme when the merger was approved, he received $100 per share. The merger was completed prior to 2001, so Paul's profit was

sustained within 6 months. Acme Corporation is publicly traded. If it has 500 shareholders and $10M in assets or is traded on a national exchange, Paul has violated Section 16b. His profit of $50 per share times 5000 shares must be disgorged to the company. Therefore, Paul owes Acme (now Bigco) $250,000, assuming someone pursues this claim against him. He will have to defend a claim by any shareholder who held shares of Acme in June 2001 when Paul purchased the 5000 shares, and remained a shareholder through the merger and the suit.

2. <u>Has Paul breached any duties to Acme and/or its shareholders</u>?

As Acme Corporation's President, Paul owes Acme and its shareholders the duties of care and loyalty. He is therefore required to act in good faith as a reasonably prudent person would and in the best interests of Acme and its shareholders.

Paul's decision to pursue the merger was in good faith and supported by his concern about Acme's future. Therefore, this decision did not breach his duties.

However, Paul's purchase of 5000 shares of Acme stock based upon material inside information breached his duty of loyalty. An officer or director may not profit at the expense of the company or its shareholders. Paul purchased his shares from either Acme or another shareholder, so he profited at their expense when he reaped the $50 profit per share associated with the merger.

Paul may also have breached his duty of care when he submitted the merger proposal to the Board and urged them to approve it. Other than Paul's good faith concern about Acme's future, there is nothing in the facts to suggest that Paul did any research regarding the offer or the other possible ways Acme could make a profit. Since the facts indicate that Bigco sold Acme's properties at a substantial profit shortly after the merger, it appears that there were options Paul failed to look into or convey to the Board.

3. Did the Board breach any duties to Acme and/or its shareholders?

As with Paul, the Board as directors have duties of care and loyalty they owe to the corporation. This means that they must act as reasonably prudent persons would, and in good faith, in the best interests of the corporation and its shareholders.

The business judgment rule prevents the directors from being liable for any action taken in good faith that they reasonably believed to be prudent in their business judgment. The directors are also allowed to rely on the recommendations of officers in good faith.

Here, the Board was unaware of Paul's breach of duty when it relied on his recommendation, so the reliance was probably justified. However, a closer question arises regarding the Board's decision to submit the merger proposal to shareholders without commissioning a corporate valuation study or, as with Paul (above), considering alternative sources of profit. If a reasonably prudent person in conducting his or her

own business affairs would have taken such actions then the Board's failure to do so breached their duty of care owed to both the corporation and its shareholders.

As with Paul, the Board likely should have considered other possibilities or commissioning a valuation study. A reasonably prudent person, when offered double what that person previously believed to be the fair value of his or her property, would probably look into whether there was value to the property of which he or she was unaware.

On the other hand, the fact that the shareholders overwhelmingly approved the deal undermines this argument and could be used as evidence that the Board acted prudently.

The Board also breached its duties by failing to vote on the merger proposal until after the shareholders had already approved it. The Board may not shirk its responsibility to make decisions for the corporation and leave the decisions to the shareholders. The shareholders must see the Board's decision in the proposal.

**ESSAY QUESTIONS AND SELECTED ANSWERS**

**JULY 2003 CALIFORNIA BAR EXAMINATION**

This publication contains the six essay questions from the July 2003 California Bar Examination and two selected answers to each question.

The answers received good grades and were written by applicants who passed the examination. The answers were prepared by their authors, and were transcribed as submitted, except that minor corrections in spelling and punctuation were made for ease in reading. The answers are reproduced here with the consent of their authors and may not be reprinted.


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## Question 1

Corp is a publicly held corporation whose stock is registered under Section 12 of the Securities Exchange Act of 1934. The following sequence of events occurred in 2003:

**January 2**: Corp publicly announced that it expected a 25% revenue increase this year.

**March 1**: A Corp director ("Director") sold 1,000 Corp shares for $25 each.

**June 15**: Corp learned that, because of unforeseen expenses, its revenues would decrease by 50% this year, contrary to its January 2 announcement.

**June 16**: A Corp officer ("Officer") consulted his lawyer ("Lawyer") for personal tax advice. Officer mentioned, among other things, the probable devaluation of his Corp stock.

**June 17**: Lawyer telephoned his stockbroker and bought a put option for $1,000 from OptionCo. The put option entitled Lawyer to require OptionCo to buy 1,000 Corp shares from Lawyer for $20 per share.

**June 18**: Corp publicly announced that its revenues would decrease by 50% this year. Its stock price fell from $30 to $5 per share.

**June 19**: Lawyer bought 1,000 Corp shares at $5 per share and required OptionCo to buy the shares for $20,000 pursuant to the put option.

**July 1**: Director bought 1,000 Corp shares for $5 per share.

1. In each of the foregoing events, which of the actions by Director, Officer, and Lawyer constituted a violation of federal securities laws and which did not? Discuss.

2. Did Lawyer violate any rules of professional responsibility? Discuss.

## Answer A to Question 1

### Publicly Held Corporation

Corp is a publicly held corporation and is thus subject to federal securities laws. The two laws at issue in this question are Rule 10(b)5 and Rule 16(b).

### Director Liability for violating Rule 16(b)

Rule 16(b) prohibits a director, officer or 10% shareholder of a publicly traded corporation on a national stock exchange or with assets of over $10,000,000 and 500 shareholders from purchasing and selling or selling and purchasing stock of the corporation in less than 6 months. This is deemed short swing trading. The policy behind prohibiting short swing trading is that short swing trading is against the interests of the corporation.

Corp is entitled to recover the maximum difference between an[y] sale and purchase during this 6 month period.

On these facts, Director sold 1,000 corp shares for $25 each on March 1. Less than 6 months later on July 1, director purchased corp shares for $5 per share.

The corp is entitled to recover $25-$5=$20 multiplied by 1,000 shares or $20,000 dollars from this violation of Rule 16(b).

### Officer Not Likely Liable for violating Rule 10(b)(5)

Rule 10(b)(5) prohibits the use of an instrumentality of inter-state commerce in any scheme to defraud, make material misrepresentations or omissions or in any other way use fraud in the purchase or sale of securities. An insider must either disclose inside information or not trade in the securities. An insider may also be liable for tipping information regarding the company for an improper purpose.

On these facts, officer had a fiduciary duty to Corp. That duty included not disclosing private information regarding Corp. Officer violated his fiduciary duty to Corp when he improperly mentioned the probable devaluation of Corp stock on June 16th prior to public disclosure of this information on June 18th.

However, Officer is only liable for a 10(b)(5) violation if he tipped this information to his lawyer for an improper purpose. An improper purpose would be personal gain of Officer either by pecuniary gain or by gifting to Lawyer. It is unclear whether Officer used a telephone to speak with Lawyer or whether he met him in person. Thus, the instrumentality of inter-state commerce requirement may be lacking as well. The facts tell us that Officer was seeking tax advice, then he mentioned the devaluation. There is no other indication of personal gain by Officer resulting from telling Lawyer about the devaluation.

Officer is not likely liable for tipping for an improper purpose and thus did not violation[sic] Rule 10(b)(5).

**Lawyer Not Liable under Rule 10(b)(2) but is Liable for Misappropriation**

A tippee is only liable if the tippee knew that the tipper was giving them non-public information for an improper purpose. As detailed above, it is unlikely that Officer will be liable for tipping for an improper purpose. Thus, Lawyer is not liable under this section.

Note that if Officer had an improper purpose, it would be easier to find Lawyer satisfied the other tippee requirements because Lawyer should have known that the information from Officer was private information regarding Corp. Lawyer knew that Officer had a duty not to disclose such information. Nonetheless, Lawyer traded on such information.

**Misappropriation Liability**

Some courts would find that Lawyer is liable for misappropriation of non-public (insider) information in the purchase or sale of securities.

Lawyer used the insider information to purchase a put option from Option Co[.] prior to the public announcement on June 18th. This bound Option Co. to purchase 1,000 Corp shares from Lawyer at $20 per share. Lawyer then purchased Corp shares at the discounted rate of $5 per share after the public announcement (June 19th). Lawyer profited at $15 per share multiplied by 1,000 shares=$15,000. This $15,000 was ill gotten gain from misappropriating non-public information about Corp's revenue decline.

**2. Lawyer's Violations of Rules of Professional Responsibility**

Lawyer violated the duty of loyalty to Officer, the duty of confidentiality, the duty of care, and engaged in deceitful, dishonest/fraudulent conduct that both negatively reflects on Lawyer's ability to practice law and that harms the dignity of the profession.

**Duty of Care**

A lawyer has a duty to act as a reasonable lawyer of ordinary skill, judgment and preparation. Here, Lawyer's actions were patently unreasonable. Use of a client's corporation information fell below the standard of care of a reasonable attorney.

**Duty of Loyalty**

A lawyer has a duty to act in the best interests of the client and not to personally benefit at the client's expense. This includes a duty not to self-deal. Lawyer took advantage of a breach of Officer's fiduciary duty to keep Corp's information private for personal gain. Lawyer benefitted from the insider trading. Lawyer may also have created professional and legal liability for his client by using this information. Lawyer breached the duty of loyalty to

Officer.

**Duty of Confidentiality/Confidential Communications**

A lawyer has a duty to keep all communications from his client related to his representation of the client confidential. Courts interpret "related to the representation" quite broadly. Officer consulted Lawyer about personal tax advice. The equity value of Corp may have been related to this representation. This includes using any of such confidential communication. As discussed above, Lawyer used such confidential communication to do insider trading. Lawyer violated his duty to keep Officer's information confidential.

**Attorney-Client Privilege**

The attorney-client privilege is a more narrow evidentiary exception that prevents a court from obtaining information told to a lawyer by his client related to the litigation at issue. Here, there is no pending litigation discussed. Under the ABA rules, an attorney may disclose confidential communication to prevent a future crime involving death or serious bodily injury. California does not have a clear exception for death. On these facts, Officer's statement regarding Corp's shares would not likely fall under the attorney-client privilege.

**Duty Not to Engage in Deceit, Fraud in Personal Dealings**

A lawyer has a duty not to use deceit or fraud in private dealings. Here, the facts show that Lawyer deceitfully misappropriated insider information and used fraud to obtain a lucrative option from Option Co. Lawyer should be subject to discipline for these private acts as well.

**Duty to Maintain Dignity of Profession**

A lawyer also has a duty to maintain the dignity of the profession. For all of the reasons mentioned above, Lawyer violated this duty. A lawyer who acts with deceit and fraud in his private dealings stemming from improperly used information from a client lowers the reputation of the entire profession.

## Answer B to Question 1

### Director's Actions

The Director ("D") may be liable for violations of federal securities law based on his sale and purchase of 1,000 Corp stocks during 2003. The Corp stock is an equity security, and therefore, is subject to federal securities laws. There are two bases for D's liability under federal securities law: violation of Rule 10B-5 and violation of Section 16B. Please note that D may also be liable for common law violations of his duty of loyalty as a corporate director, but that issue is not to be addressed here.

### Rule 10B-5 Liability

Rule 10B-5 makes it illegal to use deceit or any fra[u]dulent scheme in connection with the purchase or sale of a security. Here, the issue is whether D used deceit and/or fraud when he sold Corp stock on March 1, and when he bought it at a lower price on July 1.

### Rule 10B-5 Elements

The elements of Rule 10B-5 are as follows: (1) use of the instrumentalities of interstate commerce (which gives the federal government jurisdiction over the transaction); (2) a fraudulent scheme or device, which includes (a) misrepresentation of a material fact and (b) insider trading; that is, trading on the basis of material inside information; (3) in connection with the purchase or sale of a security; (4) with scienter, which must be at least recklessness; and (5) reliance by the person on the other side of the transaction, which is presumed in cases of misrepresentation and insider trading. Any person may be liable for insider trading, and plaintiffs include both private persons on the other side of the transaction and the SEC. In addition, "materiality" means that which a reasonable investor would want to know in making his investment decision.

With these elements in mind, I shall assess D's liability under Rule 10B-5.

### March 1 Sale

D sold 1,000 Corp shares for $25 on March 1. This transaction will fall under the jurisdiction if D used the instrumentalities of interstate commerce, which includes the telephone, US mails or internet. Here, I will assume that he did so. Note that if D had not used interstate commerce, he could still be liable under state securities laws. In addition, since D actually sold his shares, the transaction is "in connection with a purchase or sale" and, thus, D will be liable if he used fraud or deceit in this sale with necessary scienter.

**Misrepresentation of a Material Fact.** The main issue is whether the Corp's public announcement that it expected a 25% increase in 2003 constituted a misrepresentation of a material fact for which D may be liable. Surely, an investor would consider it material that the revenue increase would not happen, and would instead decline.

If the corporation recklessly made that announcement in order to pump up its stock price, then D, as a corporate director, would be liable. However, the facts indicate that D sold his stock on March 1, many months before the Corp learned that its revenues would actually decrease by 50% during 2003. In addition, the facts also indicate that the revenue decrease was due to "unforseen expenses". If anything, Corp was negligent in making a bold revenue prediction that was reversed six months later. Therefore, Corp, and hence, D, did not have the necessary scienter to be liable under Rule 10B-5.

**Insider Trading.** For D to be liable for insider trading, he would have to had traded on material inside information. Since D is a corporate director, he is considered an "insider". Therefore, he may not trade on material inside information. The critical issue is whether D possessed any material inside information when he sold his shares on March 1. If D, in fact, knew on March 1 that Corp would not have a 25% revenue increase, and that revenues would drastically decline, then he may not trade based on that information.

Again, the facts indicate that D sold his shares 3 ½ months before the Corp learned that it would suffer a serious revenue decline, and, thus, probably did not trade on the basis of inside information. However, if he did suspect that the Corp would not reach its revenue target of 25% in his capacity as a corporate insider, then he would be liable under Rule 10B-5.

July 1 Purchase

On July 1, D purchased 1,000 Corp shares for $5. Since the revenue decrease of 50% had been publicly and accurately disclosed a few weeks earlier, D is not liable under Rule 10B-5.

Rule 10B-5 Conclusion

Because the revenue decline was due [to] "unforseen expenses", D probably did not have material inside information, nor possess the necessary scienter to be found liable under Rule 10B-5. However, if the court did find him liable, he would have to disgorge his profits made or losses averted.

**Section 16B**

D may be liable under Section 16B of the '34 Act, which holds "insiders": directors, officers and 10% shareholders, strictly liable, if they make a "profit" on the purchase and sale of their corporation's stock within a 6 month period. Section 16B applies to public companies, that is, ones that are traded on a public exchange and/or meet the number of stockholders/asset test. Here, Corp is a public company, registered under Section 12 of the '34 Act, and thus, Section 16B applies to D's actions.

March 1 Sale D was an "insider" when he sold his 1,000 shares of Corp stock for $25/share on March 1, and, thus, must comply with Section 16B. The facts do not indicate that D

bought or sold any Corp shares before this date, so I will focus on the subsequent transaction. If D bought shares within 6 months following this sale for a lower price, then he is strictly liable under Rule 16B.

July 1 Purchase On July 1, 4 months following his sale of Corp stock, D purchased 1,000 shares for $5 per share. Since this occurred within 6 months of his sale, D is strictly liable and must disgorge his "profit." Here, D's profit is calculated by the difference between the sale price and purchase price multiplied by the number of shares, which totals $20,000 (1,000*(25-5)).

**Officer Liability**

The Officer's ("O") only action was consulting his Lawyer ("L") for personal tax advice on June 16, and mentioning that the value of Corp stock would probably go down, since the Corp had just learned that its revenues would decrease the day before.

Rule 10B-5 - Tipping

The elements of Rule 10B-5 are discussed above. As indicated, O did not purchase or sell any securities. Instead, the only basis for his liability would be "tipping". A corporate insider is liable for "tipping" if he has a fiduciary relationship with the corporation and discloses material insider information, at least recklessly, to a "tippee", who trades on the basis of that information. Here, O would be the "tipper" and Lawyer would be the "tippee." A tipper can be liable even if he discloses only to make a gift to the tippee or to enhance his reputation. A tippee will not be liable unless the tipper is first found liable.

O did disclose material insider information to Lawyer, but it does not appear that he did so recklessly, that he intended to make a gift to Lawyer, or wanted to enhance his reputation. Instead, O consulted L for personal tax reasons. As a client, O had every reason to expect that L would keep this information confidential. If, however, O disclosed this information to L to make a gift, use it to pay for legal services, or to enhance his reputation; or if he was reckless in disclosing this info (by shouting it in a public place), he would be liable. However, the facts indicate that O was careful and confidential in disclosing this info.

Therefore, since O was not reckless in disclosing the inside information to L, and [sic] therefore, is not liable under Rule 10B-5.

Section 16B

Although O is an "insider" of a "public company" for Section 16B purchases, since O did not purchase or sell any securities, he has no liability here.

**Lawyer Liability**

Unbeknownst to O, L traded on the basis of the material inside information about Corp's

unexpected revenue decline that had not been made public as of June 17. On June 17, L bought a "put" option that entitled him to sell Corp shares for $20 per share. He presumably did so fraudulently in order to personally benefit from the inside information. The issue, is however, whether he is liable under Rule 10B-5 or Section 16B.

Rule 10B-5 L's liability would be based on his status as "tippee", since the facts do not indicate that he is an insider of Corp. As discussed above, a tippee is not liable if the tipper is not liable. Since O was not liable as a tipper, L is not prevented from trading on the basis of inside information.

Misappropriation theory. The Supreme Court had found non-insiders liable under a misappropriation theory, where the person uses and trades on inside information that he knows or should know is inside info. Here, L clearly knew that it was inside information since Corp did not publicly disclose its revised revenue forecast until June 18. Therefore, he could be found liable for the misappropriation theory, and be subject to sanctions by the SEC. He would have to disgorge his profits of $15,000 from the put option, which he made on June 19, when he purchased shares for $5,000 in toto and sold them for $20,000.

The misappropriation theory does not apply to individual actions under rule 10B-5.

**2. L's Professional Responsibility**

L violated several rules of professional responsibility when he traded on the inside information, including the duty of confidentiality, duty of loyalty, duty of fairness and duty to uphold the law.

Duty of confidentiality

A lawyer may not use or reveal anything learned in the course of representing his client without the client's consent. Here, O was L's client, who revealed confidential information to L about the possible devaluation of Corp stock. O did not consent for L to use this information or reveal it to anyone. Although it does not appear that L revealed this information, he certainly used it and therefore, violated the duty of confidentiality. He should not have traded on this information.

Duty of loyalty

A lawyer also owes a duty of loyalty to his client, and may not let personal interests, or the 3rd party or other client interfere with his representation of his client. Here, there is a conflict of interest between O and L. L may not use O's confidential information for his own benefit, which L did so when he purchased the put option.

Duty of Fairness/Candor

A lawyer also owes a duty of fairness and candor to the public and 3rd parties. Here, L

violated that duty by “misappropriating” the inside information and trading on it to his own advantage. By using this info, he acted unfairly to OptionCo, forcing it into a bad deal.

Duty to Uphold the Law

A lawyer also has a duty to uphold the law. Here, L violated the laws of securities trading and committed several breaches of his ethical duties when he used inside information. If he were in California, he would be required to “self-report” this fraudulent activity.

**ESSAY QUESTIONS AND SELECTED ANSWERS**

**FEBRUARY 2005 CALIFORNIA BAR EXAMINATION**

This publication contains the six essay questions from the February 2005 California Bar Examination and two selected answers to each question.

The answers received good grades and were written by applicants who passed the examination. The answers were prepared by their authors, and were transcribed as submitted, except that minor corrections in spelling and punctuation were made for ease in reading. The answers are reproduced here with the consent of their authors and may not be reprinted.


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## Question 3

Molly and Ruth were partners in the operation of a dry cleaning store. Recent government environmental regulations relating to dangers posed by dry cleaning fluids increased their exposure to liability and caused a decline in their business. Molly and Ruth decided to convert their partnership into Dryco, Inc. ("Dryco"), a corporation, to limit their potential personal liability.

Molly and Ruth each contributed $20,000 in cash to Dryco. In return, each received a $15,000 promissory note from Dryco and 5,000 shares of stock with a value of $1 per share.

Prior to incorporation, Molly entered into a contract on behalf of Dryco with Equipment Company ("EC") for the unsecured credit purchase of an environmentally safe dryer for $100,000. EC was aware that Dryco had not yet been formed. EC delivered the dryer one week after the incorporation, and Dryco used it thereafter and made monthly installment payments.

Dryco had been incorporated in compliance with all statutory requirements, and Molly and Ruth observed all corporate formalities during the period of Dryco's existence. One year after incorporation, however, Dryco became insolvent and dissolved. At the time of the dissolution, Dryco's assets were valued at $50,000. Its debts totaled $120,000, consisting of the two $15,000 notes held by Molly and Ruth and a $90,000 balance due EC for the dryer.

1. As among EC, Molly, and Ruth, how should Dryco's $50,000 in assets be distributed? Discuss.

2. On what theory or theories, if any, can Molly and/or Ruth be held liable for the balance owed to EC? Discuss.

## Answer A to Question 3

1. Distribution of Dryco's $50,000 in Assets

Valid De Jure Corporation

A corporation is conclusively formed when the articles of incorporation are filed with the state. Here, the facts indicate that Dryco had been incorporated in compliance with all statutory compliances. Therefore, Dryco will be treated as a de jure corporation.

The Equipment Company Contract (EC)

Whether EC will have a claim to Dryco's assets on dissolution depends on whether EC's pre[-]incorporation contract with Molly as a promoter was adopted by Dryco.

A corporation is not liable for pre-incorporation contracts unless the corporation adopts the contract. Since Dryco did not exist at the time the contract was made, it can have liability unless: i) the corporation expressly adopts the contract (i[.]e[.,] through board resolutions or ii) the corporation accepts or retains benefits from the contract and therefore impliedly adopts the contract.

On these facts, Dryco accepted the dryer, used it, and made monthly payments on it. Even though EC was aware that Dryco had not yet been formed, Molly entered the contract on Dryco's behalf. Further the dryer was delivered after incorporation. EC will argue that Dryco's acceptance and use of the dryer constitutes implied adoption, and will likely prevail.

Therefore, EC has a valued unsecured claim against Dryco's assets.

Promissory Note

Promissory Notes are debt securities of a corporation. The holders of these notes have a creditor/debtor relationship with the corporation, and are on equal grounds with other unsecured creditors of the corporation.

Shareholders' Claims

Shareholders own an equity interest in a corporation. Shareholders are not entitled to distribution of a dissolved corporation's assets until all debts of the corporation have been satisfied.

Distribution

EC and Molly and Ruth stand on equal footing as unsecured creditors. As

shareholders, Molly and Ruth will receive no part of the $50K, as explained above.

As between unsecured creditors, however, there is a possibility that Molly/Ruth's claim will be subordinated by a court to EC's claim, based on corporate veil piercing principals [sic] due to inadequate capitalization at the outset of the corporation.

Piercing the Corporate Veil

A corporation is a separate legal entity designed to insulate its officers, directors, and shareholders from personal liability. However, the corporate form will be ignored in some circumstances, including when i) the corporation is acting as the alter ego of the shareholders or ii) when there was inadequate capitalization of the corporation at the outset.

Inadequate capitalization is determined by looking at if the corporation had adequate funds to meet its prospective liabilities. The time between incorporation and dissolution is also considered.

Here, Dryco was funded with $40,000, and dissolved within one year. The short time in existence may be an indication that the corporation was not adequately funded. However, it is unclear from these facts what caused Dryco's dissolution. If Molly/Ruth were aware of increasing environmental costs and liability, $40,000 may not have been sufficient. If this is so the corporate veil will be pierced. (Desire to shield from personal liability from environmental regulation is not enough to pierce the veil in and of itself.)

When shareholders use the corporation[']s assets as their own or otherwise ignore corporate formalities, the corporate form may be ignored to hold the SHs personally liable for the corp's debts[.] Here, there is no indication that Ruth/Mary used Dryco's assets as their own, and they did observe all corporate formalities. Therefore, the veil will not be pierced on this theory.

Since the veil can be pierced due to inadequate capitalization, however, Ruth/Mary's claim on the unsecured notes will be subordinated to EC's claim. EC will receive the entire $50,000.

In the event the claims are not subordinated, EC, Mary and Ruth will equally divide the $50,000.

2. Molly and[/] or Ruth's liability

A corporation is a separate legal entity that insulates its SHs from personal liability. As discussed above, Dryco was a de jure corporation. Unless circumstances exist to pierce the corporate veil, Ruth/Mary will not be liable to EC for the excess debt.

Piercing the Veil

As explained above, the corporate veil may be pierced for inadequate capitalization at the outset. Also as explained above, if the veil is pierced, Ruth/Mary will be liable to EC for the $40,000 of unpaid debt.

Promoter Liability

When a promoter raises capital or enters contracts on behalf of a [sic] unformed corporation, the promoter is personally liable on those contracts. Absent novation, this liability remains even if the corporation has adopted the contract.

Here, Molly entered the contract with EC on behalf of Dryco. Therefore, absent novation, she is personally liable. There is no indication of a novation here, so Molly will be liable for the 40K even though Dryco adopted the K.

Ruth may be liable based on vicarious liability. Ruth and Molly were joint venturers, co-promoters, so EC may try to reach Ruth on this theory, or at minimum, Molly may seek contribution from Ruth. Since Ruth did not sign the contract[,] however, this theory will likely fail.

## Answer B to Question 3

3)

1. Distribution of $50,000 of Dryco's assets

Dryco has [sic] $120,000 in debt at the time the corporation became insolvent. This includes the $30,000 in promis[s]ory notes to Molly and Ruth, and the $90,000 still owed to EC, for the environmentally safe dryer. Dr [sic]

Pre-incorporation contract

The issue is whether the debt to Equipment is owed by the corporation. Corporations are only liable for pre-incorporation contracts that they adopt. Here before the corporation was formed, Molly entered into a contract for the the [sic] purchase of the dryer. The facts do not indicate that there was an express adoption of this contract. However the fact that after the corporation was formed, the dryer was delivered to Dryco, used by Dryco, and the monthly installment payments totaling $10,000 were made by Dryco, is sufficient to establish that Dryco impliedly adopted this contract. Furthermore without the Dryer the business might not be able to comply with the governmental regulations imposed on the drycleaning industry. Therefore the dryer is an essential piece of equipment to Dryco and its adoption of the purchase contract entered into by Molly[.]

Inside/Outside Debt

Dryco only has $50,000 in assets, and has $120,000 in debt. Therefore it must be determined which creditors have prio[r]ity for satisfaction. In determining which creditors will be satisfied first the court will generally, in the interest of fairness, subvert inside debt, and allow outside debt to be satisfied first. The reason for this is that the insiders, Molly and Ruth, could have given the $15,000 for stock interests, which would only receive distributions after creditors are satisfied.

Here Molly and Ruth elected to make $15,000 of their $20,000 contribution as a loan. They were trying to insulate themselves further from any potential losses, by only putting at risk the $5,000 for their stock. The court will not allow inside shareholders to try to put their equity investment on an equal level with outside creditors who have no equity interest in the corporation.

Therefore EC should be given priority as an outside creditor and should receive the $50,000 that Dryco has. Molly and Ruth's interest will be subverted to EC's interest and their loan will not be satisfied.

2. Molly and Ruth Personal Liability

After the $50,00 in assets are given to EC, EC is still left with $40,000 that has not been satisfied. EC will thus try to hold Molly and Ruth, as sole shareholders in Dryco[,] personally liable for the remaining debts.

Incorporator liability

Prior to incorporation Molly entered into a contract with EC for the dryer. As a general rule, an incorporator is not relieved of liability of the pre-incorporation contract, until there has been a novation, that is[,] an agreement by all parties to relieve the incorporator of personal liability. Here Molly would have to show that both Dryco and EC to relieved[sic] Molly of personal liability. As discussed above, Dryco impliedly adopted the contract, and thus becomes primarily liable for the contract. However there is no indication that EC relieved Molly of her personal liability, and can be held secondarily liable, because there was no novation.

However, Molly can argue that the contract was entered into "on behalf of Dryco[.]" The corporation by estoppel doctrine holds that a party who knew the contrace[sic] was being entered into on behalf of a corporation is estopped from later claiming that the other party is personally liable. Molly can argue that because EC knew that Dryco had not been incorporated yet, but knew that Molly was entering "on behalf of Dryco" they should be estopped from claiming that Molly is personally liable.

Molly will likely be successful in this claim, and EC will be estopped from claiming that Molly was personally liable, because EC knew that Dryco was not yet incorporated, but still signed a contract "on behalf of Dryco". It would therefore not be equitable for EC to be able to hold Molly personally liable under this theory[.]

Shareholder liability

As a general rule shareholders are not personally liable for the debts of the corporation. The shareholders only put at risk what they invest in the corporation. As discussed above Molly and Ruth each invested $20,000, which will all be treated as equity in Dryco. Therefore under the general rule Molly and Ruth will not be liable for the $40,000 remainder owed to EC.

However where it is necessary to prevent a fundamental unfairness courts may elect to pierce the corporate veil, and hold the shareholders personally liable. Courts generally elect to pierce the corporate where the corporation has attempted to defraud the corporation[']s creditors. Courts are much less likely to pierce the corporate veil for tort creditors than for contract creditors. Here EC was a contract creditor, so EC will have to have a very strong claim to succeed.

Courts will pierce the corporate veil where the shareholders of the corporation fail to follow corporate formalities, or where there [sic] corporation was inadequately capitalized

at the time of formation.

Here the facts state that Molly and Ruth observed all corporate formalities. There are no facts to indicate that there was any com[m]ingling of personal and corporate funds, or that Molly or Ruth treated any of the corporate assets as their own.

EC will try to argue that Dryco was inadequately capitalized at the time of formation, that is[,] that Dryco would be unable to pay debts at the time they came due. Because the EC is a contract creditor they have to make a strong showing. Here Molly and Ruth put in a total of $40,000 cash. Because the inside claim will be subverted to EC claim the full $40,000 should be considered[.] EC wil[l] fail on this claim because the facts indicate that Dryco was able to make the monthly installment payments.

The court will likely find that there was no fundamental unfairness in this transaction, especially because EC was a contract creditor. EC could have protected itself by entering into a separate agreement with Ruth and Molly to agree to personally assume the debt. Because EC did not do this they cannot later claim Molly and Ruth['s] personal assets. Therefore Molly and Ruth will not be personally liable on this claim.

<u>Director liability</u>

As the sole shareholder[s] of Dryco, Molly and Ruth are probably the directors, and as such owe Dryco fiduciary duties of Loyalty and Due Care. Directors can be held personally liable for injuries caused from breaching this duty. However there are no facts suggesting a violation of these duties, such as self[-]dealing or uninformed decision making and [they] should not be held liable for breaching their fiduciary duties.

**ESSAY QUESTIONS AND SELECTED ANSWERS**

**JULY 2005 CALIFORNIA BAR EXAMINATION**

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## Question 3

Alice is a director and Bob is a director and the President of Sportco, Inc. (SI), a sporting goods company. SI owns several retail stores. Larry, an attorney, has performed legal work for SI for ten years. Recently, Larry and Carole were made directors of SI. SI has a seven-person board of directors.

Prior to becoming a SI director, Carole had entered into a valid written contract with SI to sell a parcel of land to SI for $500,000. SI planned to build a retail store on the parcel. After becoming a director, Carole learned confidentially that her parcel of land would appreciate in value if she held it for a few years because it was located next to a planned mall development. At dinner at Larry's home, Carole told Larry about the planned mall development. Carole asked for, and obtained, Larry's legal opinion about getting out of her contract with SI. Later, based on Larry's suggestions, Carole asked Bob to have SI release her from the contract. She did not explain, nor did Bob inquire about, the reason for her request. Bob then orally released Carole from her contract with SI.

The next regular SI board meeting was attended only by Bob, Alice, and Larry. They passed a resolution to ratify Bob's oral release of Carole from her contract with SI. Larry never disclosed what Carole had told him about the proposed mall development.

Three years later, Carole sold her parcel of land for $850,000 to DevelopCo, which then resold it for $1 million to SI.

1. Was Bob's oral release of Carole from her contract with SI effective? Discuss.

2. Was the resolution passed by Bob, Alice, and Larry to ratify Bob's oral release valid? Discuss.

3. Did Carole breach any fiduciary duty to SI? Discuss.

4. Did Larry commit any ethical violation? Discuss.

## Answer A to Question 3

1. Bob's oral release

Bob, a director of SI, entered into an oral agreement to release Carole, another director, from a contract into which she had entered with SI for the sale of land. The question is whether this release was valid.

Statute of Frauds

Contracts for the sale of land must comply with the statute of frauds, and modifications of such contracts must also comply with the statute. Here, the original contract was in writing, but Bob's release was oral. This statute requires a writing signed by the party to be charged. That requirement was not met.

However, courts have held that parties may rescind a contract without complying with the statute. This appears to have been such a rescission. Further, Carole's reliance on the release – by selling the land to another party – was probably sufficient to make the release effective.

Bob's authority to release SI

The release was valid only if executed by someone with authority to bind SI. On these facts, there is no indication that Bob had such authority.

The Board of Directors has the authority to oversee the management of a corporation and approve major business decisions. However, individual directors do not have such authority.

An officer or director may be given actual authority by the articles of incorporation or bylaws to engage in particular duties. Further, a board of directors can delegate certain responsibilities to a committee of directors (which can be a single director). There is no indication here, however, that Bob was delegated authority to enter into land sale transactions. Because these are significant business decisions, it would be inappropriate in any case to delegate them to a single director.

Finally, because making or rescinding land sale contracts is not one of the ordinary duties of a director, Bob had no implied authority as director to release Carole.

In his position as president, however, Bob may have had authority to execute the release. A president of a company may be given specific powers in the articles and bylaws. Again, there is no indication that Bob had such explicit powers. However, a president may also exercise implied or inherent powers necessary to do his job. A president would certainly have the authority to bind the corporation, for example, to ordinary services or employment contracts. Such authority is implied because it is necessary to exercise the

management powers of his job.

In this case, however, the land sale was a major capital investment. Such a major decision was probably not within the province of the president's authority and required Board approval. Therefore, Bob's release was probably not valid.

Board Resolution

The issue here is whether the subsequent ratification of the release was valid.

Quorum

Board actions are valid only if a vote occurs when a quorum of the Board is present. A quorum is normally defined as more than half the directors – in this case, 4 out of 7. Only three directors were present, however.

In its bylaws, a corporation can establish a smaller number for a quorum if it is more than 1/3 of directors. There is not indication, however, that Sportco had varied the normal rule in this case. Therefore, a quorum was not present and the Board's action was invalid.

Interested Director Transaction

As discussed below, this was an interested director transaction because Carole, a director, stood to profit from the sale of the land. Such transactions may be ratified only by a majority of non-interested directors. In this case, then four directors – a majority of the six non-interested directors – would have had to approve this transaction.

Further, to ratify an interested director transaction, the Board would need to know the facts of Carole's transaction in acco[r]dance with their duty of care. Here, Bob, Alice, and Larry did not know Carole's motives.

Because there was no proper ratification of an interested director transaction, the Board's action was invalid.

3. Carole's fiduciary duties

As a director, Carole had a duty of loyalty to the corporation. She had a duty to act in what she reasonably believed to be the corporation's best interest, and not to profit at the corporation's expense.

Here, Carole violated that duty in several ways. First, she used confidential information for her personal gain. This was a violation because she had a duty to keep confidences acquired in the course of her duties and not use them for personal profit.

Second, Carole usurped a corporate opportunity by selling the parcel to DevelopCo. Having learned that the parcel would appreciate in value, Carole had an obligation to let Sportco profit from that opportunity because it was part of Sportco's line of business – that is, finding suitable locations for its sporting good stores. Carole could only have taken advantage of the opportunity herself had she first offered it to Sportco & Sportco had turned it down. Here, however, Sportco was clearly interested in acquiring the land – since, after the land's value became apparent, Sportco brought it.

Finally, Carole's conduct in withholding her true motives from Bob was arguably fraudulent. Because of her fiduciary duty, Carole was obliged to disclose material facts. Carole's knowledge of the proposed mall development would certainly have been material in the Board's decision.

Carole also violated her duty of care as a Board member. She did not act in conducting the corporation's business affairs as a reasonably prudent person would in her own activities. Certainly passing up a valuable business opportunity that Sportco could have profited from was not prudent.

4. Larry's ethical violations

Conflict of Interest

Larry represented SI, not any individual director. By seeking Larry's legal advice on a personal transaction, Carole attempted to use Larry as her personal lawyer. This created at least a potential conflict of interest if Carole's interests should differ from SI's. In this situation, Larry could not represent Carole unless he informed both Carole & SI & both gave consent that an independent lawyer would find reasonable. By advising Carole without seeking such consent, Larry violated his duty of loyalty to each client.

Further, once it became apparent that Carole was seeking to profit at Carole's expense[sic], the conflict was direct. At that point, Larry should have sought Carole's permission to withdraw. Further, as discussed below he probably should have sought to withdraw from the Board as well. In failing to do so, he further violated his duty of loyalty.

Larry's Board Service

No per se rule exists barring a lawyer from serving on his client's board. However, such service may create problems with the duties of confidentiality and loyalty. Here, as a board member, Larry owed fiduciary duties to SI. He was therefore obliged to tell them material information he received relating to Carole's proposed rescission. He violated these by concealing the information. Further, he acted in Carole's best interest, not SI's, by voting to ratify the transaction. Larry should instead have disclosed the existence of a conflict (giving as little information as possible to avoid breaching his duty of confidentiality to Carole for all information arising out of the course of representation). He should then have sought to resign from the Board, and probably from representation of SI as well.

Duty of Loyalty

A lawyer has a duty to represent each client zealously & and put that client's best interests first. Larry did not do so in regard to SI because he did not advise SI how to enforce the contract with Carole – which would have been in SI's best interests.

Duty of Competence

A lawyer has a duty to thoroughly investigate his client's legal issues. Here, Larry failed to learn the facts of SI's transaction with Carole[.]

Duty of Communication

A lawyer must give a client the information necessary to make major decisions relating to the representation. Here, Larry withheld material information re: his consultation with Carole. SI needed this information in order to fully exercise its legal rights.

Because Larry could not fulfill duties to SI w/out breaching his duties of loyalty & confidentiality to Carole, he should have withdrawn from representation of both clients. In addition, he violated his board member fiduciary duties.

## Answer B to Question 3

**3)**

**I. Bob's Oral Release of Carole**

**Bob's Powers as President**
A corporate officer, such as president, can only act under proper authority. In his capacity as president, Bob's release of Carole must have arisen under his express, implied, or apparent authority to bind SI.

Express Authority
A corporate officer acts with express authority to bind (unbind) the corporation when the board has formally conferred that authority to him. Here, the board did not not know abou[t] Carole's intention to be released from the contract. It neither held a vote nor a meeting to grant Bob the express authority to "bind" the corporation in this way. Thus Bob lacked express authority to release Carole from her contract with SI.

Implied Authority
A corporate officer has implied authority from the board to bind the corporation to relatively minor obligations that arise in the everyday course of business. Here, however, a sporting goods corporation had bought and was planning to develop a retail store on a parcel of land worth $500,000. SI only owned "several" sporting goods stores, so the addition of another one is a fairly important development. The facts suggest that this was a relatively major business initiative, and so would not fall within the scope of a corporate officer's implied powers. Thus, Bob as acting as president could not have released Carole from her contract under implied authority.

Apparent Authority
A corporate officer has apparent authority to bind (or unbind) the corporation when he is held out to a third party as having such authority, and the third party relies on that authority. Here, apparent authority is not likely, because Carole, as a board member would not precisely [sic] the metes and bounds of Bob's authority as president. She would thus not be able to claim detrimental reliance on Bob's release based on apparent authority.

**Bob's Powers as a Director**
Carol[e] might also claim that Bob released Carole from her contract based on Bob's position as a director. In order to bind a corporation, board action must consist of a unanimous vote of all members, or a majority of a meeting with quorum. Here, Bob acted unilaterally as a director; there was no meeting and no vote so he, acting as a single director, could not bind the corporation.

## II. Validity of the Resolution Passed by Bob, Alice, and Larry

### Quorum Rules for Binding Board Action

As mentioned, binding board action can only arise when there is a unanimous vote, or upon a majority of votes at a meeting with quorum. Here, SI's board has seven members, so quorum would constitute four members. Therefore, since quorum was not achieved, no business of the board meeting with only Bob, Alice and Larry could be binding.

### Interested Directors

Even if there were additional board members at the meeting, only directors who do not have a personal interest in a transaction can be counted for quorum. Thus, any vote on whether to release Carole from the contract would have to exclude Carole, because she stood to gain considerably if the contract were released based on the appreciation of the land price. It is not clear if Larry should also be excluded. While he was privy to confidential information not shared with the other members of the board, he did not aim to materially gain from cancelling Carole's contract, unless Carole agreed to pay him. If so, then Larry should be excluded from any vote of whether to release Carole from her contract.

## III. Carole's Breach of Fiduciary Duties to SI

Carole breached several fiduciary duties to SI.

### Breach of Loyalty

Seeking Release from the Land Contract

A director owes a fiduciary duty of loyalty to the corporation, and must always act in the best interests of the corporation without regard for self-interest. Here, Carole sought release from a valid contract with SI for the land for $500,000. Her motivation in doing so was personal gain; after making the contract, she sought release from it because land prices were appreciating and she stood to gain a profit by retaining ownership of the land and selling to another buyer at a higher price. This behavior clearly contravened her duty of loyalty to SI, which was to obtain the land at the lowest possible price[.]

Since she breached her duty, Carole is liable both for any personal gain as well as material loss to the corporate [sic] as a result of her breach. Instead of selling to SI for $500,000, Carole sold the land to DevelopCo for $850,000; the resulting profit of $350,000 must be disgorged and returned to SI.

In addition, SI originally contracted to buy the land for $500,000 but ultimately paid $1 million. SI can thus recover the damages of $500,000 due to Carole's breach.

Not Disclosing Confidential Information of Land Appreciation

As part of her duty of loyalty to SI, Carole has a duty to communicate all information in her possession that could be used for the corporation's advantage. The fact that the land that SI had obtained via contract was appreciating in value was relevant to SI's business objectives, since it could have decided to keep the land and then sell it later for a substantial profit. Carole's withholding of this confidential information thus marked another breach in her duty of loyalty to SI.

Corporate Opportunity

Related to her duty to communicate information, under the duty of loyalty Carole must present any corporate opportunities to SI first, and can only pursue them upon the board's decision not to pursue them on behalf of the corporation. Here, Carole became aware of a corporate opportunity through obtaining information that the land she had sold to SI was going to appreciate because of the mall development. She thus had a duty to present this opportunity first to the board, and only pursue it if they refrained.

Carole might argue that this does not apply since SI is in the business of sporting goods, not real estate speculation, and that therefore the corporate opportunity did not lie within SI's line of business. Modern authorities, however, state that a corporation may take opportunities broadly defined, even those outside their traditional line of business. Here, then, Carole had a duty to inform SI of the mall development and likely appreciation in land values, and she breached that duty.

**Breach of Duty of Due Care**

A director owes a duty of due care to the corporation, and must make decisions in the best interest of the corporation as if it were her own business. Here, it was clearly a breach of the duty of due care for Carole to engineer a rejection of a land sale contract at a very favorable price to SI.

Business Judgment Rule

The business judgment rule will normally protect directors whose decisions, made in good faith and with good business basis[sic], nevertheless result in adverse consequences. Here, however, Carole's efforts to seek release from her contract were not made in good faith. She was self-interested and desired to retain the profit from land speculation to herself at SI's expense, and Carole thus cannot be protected by the business judgment rule.

## IV. Ethical Violations by Larry

**Representation and Service on a Board**

Although it is discouraged, a lawyer is allowed to serve as a board member on an organization he represents if he can do so effectively and without jeopardizing his ethical duties to the client organization. Here, Larry performed legal services for several years for SI, which was his client. At the time he accepted his board position, because there was no apparent conflict with his duties as lawyer, this acceptance was permissible.

**Duty of Loyalty – Conflicts between Clients**

A lawyer owes a duty of loyalty to his client, and must act in his client's best interest. Here, Carole came over for dinner and sought advice regarding her plans to annul the contract. At the time, Carole informed Larry that she was seeking his legal advice, and a putative lawyer-client relationship between Carole and Larry formed.

A lawyer can take on a potential client conflict where 1) the lawyer believes he can reasonably and effectively serve all parties, 2) he informs each party, 3) each party presents written consent, and 4) that consent is reasonable. When Carole disclosed her plans, her interests became materially adverse to those of Larry's client, SI. At that point, Larry should have informed Carole that he could not represent her and urged her to seek independent counsel. His not doing so consti[t]uted a breach of his duty of loyalty to SI.

**Duty of Communication**

A lawyer has a duty to relay all helpful information to his client. Here, Larry learned that the land that SI had purchased was going to appreciate rapidly, and this information should have been related to his client. This duty, however, conflicted with his duty of confidentiality to Carole, which had attached because she sought legal advice from him. Though a close question, Larry's decision to honor Carole's confidence and not tell SI of the land value was probably correct.

**Duty of Competence**

A lawyer owes his client a duty of competence. Here, Larry did not disclose and breached.

**Assistance in a Crime or Fraud**

Under ethical rules, a lawyer must not assist a client in a criminal enterprise or fraud. Here, Carole approached Larry about cancelling the land sale contract because of Carole's desire to profit at the expense of SI. Larry's legal opinions led Carole to seek release from Bob, which involved breaches of fiduciary duties on behalf of Carole owed to SI. Larry might counter by noting that no actual fraud was perpetrated, since Carole never disclosed to Bob the reasons for seeking release. Nevertheless, Larry assisted in breaching a fiduciary duty, and thus breached ethical duties of his own.

California
Bar
Examination

# Essay Questions
# and
# Selected Answers

July 2006

# Question 4

Beth, Charles, and David are the directors of Web, Inc. (Web), a corporation that is in the business of creating websites.

Adco, Inc. (Adco), a corporation that markets computer advertising, had an urgent need for a complex website that would cost thousands of dollars to create. Adco approached Web about creating the website. Adco explained that it did not have the cash to pay for the work but claimed that it was a well-established corporation and asked Web to extend credit for the work.

Beth, Charles, and David unanimously agreed to take on the work, conditioned upon a prior review of Adco's financial statements and a determination of Adco's credit- worthiness. After learning this, Adco contacted David and told him that the sooner Web could start on the website, the sooner Adco would be able to pay Web.

David was anxious to obtain Adco's business. He falsely told Beth and Charles that he had obtained and reviewed Adco's financial statements and that, based on his review, "we should proceed with the work." Beth and Charles, without further inquiry, agreed, and Web created the costly website. Adco is unable to pay Web.

Beth, Charles, and David have now learned that Adco's shareholders have regularly taken its funds for their personal use.

In an unrelated transaction, Charles received a call from his friend Sam who wanted Web to create a new game website. Charles told Sam that the new game website was such a small job that he could do it at home for less money than Web.

Charles told Sam to send the payment for the game website to Charles at his home. Sam was pleased with the work and sent the check to Charles as requested. Shortly afterwards, Beth and David learned of this transaction.

1. What duties to Web, if any, have been breached by Beth, Charles, and David regarding the money lost on the Adco job? Discuss.

2. What rights, if any, does Web have against Adco's shareholders for Adco's failure to pay for the website? Discuss.

3. What rights, if any, does Web have against Charles regarding the contract with Sam? Discuss.

Answer A to Question 4

4)

1. Directors' Breach Regarding the Adco Job

Duty of Care:

Since corporate directors have a fiduciary duty to the corporation, directors of a corporation owe the corporation a duty of care. The duty of care requires that the directors act with good faith and the degree of care which a prudent person would proceed with in regard to his own business,

Here Adco asked that Web perform complex work that would cost thousands of dollars to create on credit. Adco claimed to be a well-established corporation, but the directors had a duty to investigate Adco's financial situation to determine whether it was safe and in the Web's best interest to extend credit for the work. Beth, Charles and David all agreed to take the work conditioned upon a prior review of Adco's financial statements. Their decision to review was correct, but they did not adequately follow through with it.

David, anxious to obtain Adco's business, decided to proceed with the work. This decision violated David's duty of care. David should have conducted a reasonable inspection of the financial records and then reasonably determined whether it was in the corporation's best interests to extend the credit. Instead, David made an uninformed decision. Further, David acted in bad faith by misrepresenting to the other directors that he reviewed the financial statements and made his determination to proceed based on information he obtained from them. Therefore, David clearly breached his duty of care to Web.

Charles and Beth relied on David's decision without inquiring further as to what was found in the financial reports. They will likely claim that the[y] reasonably relied on David's statements in making their decision and should, therefore, not be liable. However, Charles and Beth cannot completely delegate their responsibility to the corporation and should have at least inquired further about what David based his decision on. Because Beth and Charles blindly followed David's conclusory statement, they too violated their duty of care to the corporation.

Business Judgment Rule:

Directors may be protected under the business judgement rule. Courts will not second guess a business judgment if, at the time it was made, it was informed, reasonable (based on sound business judgment), and made in good faith. Directors will still be liable for decisions which are grossly negligent or reckless.

This will certainly not serve as a defense for David, who was not informed when making

his decision and acted in bad faith by lying to the other directors about having obtained and reviewed Adco's financial statements. Beth and Charles have a better chance to succeed with this defense since they did not act in bad faith and will claim that their reliance on Charles' decision was reasonable. However, it is likely that their decision to proceed in such a risky, costly and extensive project without any independent investigation or at least further inquiry was probably not sufficiently reasonable or informed under the circumstances. Therefore, they should not be able to be protected from liability from their breach by the business judgment rule.

2. Web's Rights Against Adco's Shareholders

General Rule Regarding Shareholder Liability

Generally, shareholders are not liable for the debts and liabilities of the corporation. One of the main benefits of the corporate form is that it provides limited liability; protecting shareholders from personal liability caused by corporate loss. This benefits the economy, because more risks are likely to be taken.

Piercing the Corporate Veil

Despite the general rule, courts may decide to pierce the corporate (PCV) veil and hold shareholders personally liable if there appears to be fraud or bad faith. Courts will often PCV if (1) the corporation is actually just an alter ago of the shareholders, or (2) the corporation was inadequately capitalized at its inception.

A corporation will be found to be the alter ego of its shareholders when there is serious lack of corporate formalities. If, for example, shareholder commingle corporate funds with personal funds, use corporate funds for any personal benefit, that would be grounds to PCV. Also, if meetings are not held or decisions are consistently made without meeting or voting, that may constitute grounds to PCV. Courts are generally more willing to PCV for the benefit of tort creditors than contract creditors, since contract creditors presumably had the opportunity to investigate and make an informed decision about whether to enter into the contract.

Here, it was determined that Adco's shareholders have regularly taken its funds for their personal use. This would constitute violating the corporate form and creates grounds to PCV. Web can successfully argue that Adco's shareholders are using the corporate form in bad faith to commit fraud use[,] then use the corporation as a shield from personally [sic] liability. It can argue that since Adco is operating as an alter ego and [sic] therefore, its shareholders should be held personally liable for Adco's liabilities. However, since Web voluntarily decided to enter into the contract and could have investigated before making their decision to assume the risk of doing business with Adco, they will have a higher burden. If Web can convince the court to PCV, it will be able to sue the shareholders of Adco personally to the debt owed.

3. Charles' Contract with Sam

Duty of Loyalty

Director has a fiduciary relationship with the corporation and has a duty of loyalty towards the corporation. The director must act in the corporation's best interests and not engage in any self dealing or receive personal gain at the corporation's expense. If a director comes across a situation which would breach his duty of loyalty, the director may cure the problem by disclosing it and getting approval by a majority of disinterested directors or disinterested shares.

Here, Charles did work that the corporation was entitled to and received personal profit from it. He therefore violated his duty of loyalty by acting in his own interest rather that [sic] the corporation's. If he really wanted to proceed with the work, he could tell the other disinterested directors about Sam's interest and see if a majority of disinterested directors or shares would decide that he could proceed to do the work on his own. In this case, he convinced Sam to allow him to do the work, received profit that the corporation could have had, and did so without proper disclosure and approval. Therefore, Charles breached his duty of loyalty to Web.

Usurping a Corporate Opportunity

A director should not usurp a corporate opportunity. A corporate opportunity is one which the corporation has a business interest or reasonable expectancy in. Something that is in the corporation's line of work/field will usually be deemed a corporate opportunity. If a director learns of a corporate opportunity in his capacity as director and wants benefit from it personally, he may be able to do so if he takes certain steps: (1) he must inform the corporation of the opportunity [and] (2) wait for the corporation to decline to take the opportunity.

Here, Web clearly had an interest in the job Sam was asking about. Sam wanted Web to create a new game website, which is exactly the kind of work Web does. As a business that creates websites, Web clearly has an expectancy interest in the work and would benefit (profit) from it. Charles usurped Web's legitimate right to the opportunity by convincing Sam that the job was small and that he could do it at home for less money than Web. Charles should have first disclosed the opportunity and waited to see if Web would have taken it. In this case, since the job is exactly in the line of work Web ordinarily conduct[s], Web would have likely taken the job. As a remedy, Web can recover any profit that Charles earns from performing the work for Sam.

<u>Charles's Defenses:</u>

Charles may argue that he learned of the corporate opportunity in his personal capacity,

from his friend, and not because of his position as director of Web. However, Sam called Charles asking for Web to create a new game website, not asking for Charles to do it personally. Therefore, Charles was being contacted in his professional capacity as director of the corporation, and will not succeed with this argument.

Answer B to Question 4

4)

(1) Beth, Charles and David breach with regard to Web

As directors of Web, Inc., Beth[,] Charles[,] and David owe a Duty of Care to the corporation. In their dealings for Web they must behave as a reasonably prudent person would with regard to his personal finances. All three directors have breached this duty.

David

David has breached the duty of care by failing to properly investigate Adco's finances and by falsely reporting to the other directors that he had investigated Adco's finances and falsely indicating that Adco's creditworthiness was sufficient to allow Web to extend Adco credit for Web's work.

All three directors initially made a responsible decision to investigate the financial condition and creditworthiness of Adco before extending credit for the work Adco wanted Web to do. However, David did not act as a reasonably prudent person would when he subsequently failed to make this investigation and instead misrepresented to the other directors that he had made an investigation and that Web should proceed with the work. A reasonably prudent person would not have extended credit without making any investigation into the finances and creditworthiness of the person or company to whom they were extending credit. Furthermore, David's failure to make any investigation cause[d] damage to Web because Web created a costly website for Adco and will not be paid for this work. Therefore, David has breached his duty of care and will be liable to the corporation for the damage that he caused.

Finally, David's conduct cannot be saved by the business judgment rule because he did not act in good faith after a reasonable investigation of the facts. He made no investigation and had none of the relevant facts. Furthermore, he did not act in good faith when he lied about having made an investigation.

David also probably [sic]

Beth and Charles

Beth and Charles have also breached their duty of care owed to Web because they too agreed to extend credit to Adco without making any investigation of Adco's creditworthiness. Again, after initially making a reasonable and prudent decision to investigate they did not car[r]y through and instead agreed to extend credit without making any investigation. A reasonably prudent person would not behave in this manner. Furthermore, it was not reasonable them to rely on David's assertion that he had

investigated and come to the conclusion that Web should proceed. Although directors are allowed to rely on the reports of officers of committees of directors assigned to perform a certain role (as well as the reports of officers of the corporation, accountants[,] etc[.]) directors may not delegate all their duties to a committee and serve simply as a "rubber stamp" for the committee's decisions. A director may not delegate his duty to make independent decisions. Therefore, Beth and Charles should have insisted on seeing at least some further information about the financial health of Adco so that they could evaluate for themselves whether the decision to extend credit was a good decision. This is, at minimum, what a reasonably prudent person would do with regard to their own finances. Web suffered damage as a result of Beth and Charles['] breach, and therefore these directors are personally liable to Web for the loss they caused.

Finally, Beth and Charles cannot take shelter in the business judgment rule because they did not act in good faith after a reasonabl[e] investigation. They made no investigation and knew none of the relevant facts. Therefore, their decision was not within the business discretion protected by the business judgment rule.

<u>(2) Web's rights against Adco's shareholders</u>

A company must maintain corporate form and structure if the shareholder's personal assets are going to be protected by the corporate form. The shareholders may not use the corporate form fra[u]dulently - as simply a cloak for their personal business activities. Therefore, the shareholders may not intermingle corporate and personal assets or take the corporation[']s assets for their personal use. When shareholders behave in this way, a court may disregard or pierce the corporate veil to hold the shareholders personally liable if justice requires it.

Here, Adco's shareholders have been regularly taking its funds for their personal use. Usually, a court will not pierce the corporate veil simply because a corporation is unable to pay its debts. Undercapitalization when a company is formed is usually required for veil piercing. However, if the shareholders have made an extensive practice of draining the corporate assets for their personal benefit, then it will appear that they have been abusing the corporate form to shield their personal business transactions from creditors. This pattern of behavior will introduce the required element of fraud.

The shar[e]holders who took the corporate assets probably cannot claim that they were just receiving dividends. A company cannot pay out dividends if paying the dividends will cause it to become insolvent (unable to pay its bills when they come due). Therefore, the shareholders (who seem to control Adco) will not be allowed to make themselves dividend payments and then not pay Web.

Web can make a strong case that a court should pierce Adco's veil to reach the shareholder's assets to satisfy Adco's debt to Web. The court will be able to reach the assets of those shareholders who engaged in the improper behavior (although the

shareholders who did not take part in the misbehavior will not be liable).

Even if a corporation's shareholders have abused the corporate form, a court will not pierce the corporate veil unless justice requires it. Furthermore, a court is generally more willing to pierce the corporate veil in tort situations than in contract situations since tort victims usually do not cho[o]se to interact with the corporation. Because Web has been harmed by Adco's failure to pay its debts, Web can argue that the interest of justice require[s] holding the shareholders personally liable. However, because Web did not make an adequate investigation of Adco before doing work for them, it may be more difficult for Web to prevail. On the other hand, Web can try to argue that Adco intentionally and fraudulently misrepresented its financial health to Web (both by saying it was a "well-established corporation" and that "the sooner Web could start on the website, the sooner Adco would be able to pay"), and that this weighs in favor of piercing the veil even though Web did not take all possible precautions to protect itself.

Finally, if Adco is a close corporation and the shareholders who were siphoning money from Adco were the same people who participated in negotiations with Web and David, then Web may be able to make a claim against them personally for fraud. To do this Web would have to show intentional misrepresentation (of fact) with the intent to induce reliance by Web, which did induce reliance and reasonable reliance by Web. It is unlikely they can show reasonable reliance on misrepresentations of fact.

<u>(3) Web's rights against Charles</u>

Corporate directors owe a duty of loyalty to the corporation. They must reasonably believe that their actions are in the best interest of the corporation. A director violates the duty of loyalty when he usurps a corporate opportunity and takes it for himself. A corporate opportunity is one in which the corporation has a reasonable expectation or one that is in the business of the corporation. A director cannot excuse taking a corporate opportunity by showing that the corporation would not have been able to take the opportunity. Before a director may take advantage of any corporate opportunity he must disclose it to the corporation and wait for the corporation to turn it down.

Here Charles took for himself a corporate opportunity (work) that should reasonably have gone to the corporation. He did not fully disclose the existence of opportunity to the other directors nor did he wait for the other (disinterested directors) to refuse the opportunity. Instead he did the work himself and was paid for it. Here it seems likely that Web would have been fully capable of doing the work (taking the corporate opportunity) but even if it wasn't this would not excuse Charles's behavior.

Charles is therefore liable to the corporation for the money he made by doing the work and must disgorge it to Web.

**ESSAY QUESTIONS AND SELECTED ANSWERS**

**FEBRUARY 2007 CALIFORNIA BAR EXAMINATION**

This publication contains the six essay questions from the February 2007 California Bar Examination and two selected answers to each question.

The answers selected for publication received good grades and were written by applicants who passed the examination. These answers were produced as submitted, except that minor corrections in spelling and punctuation were made during transcription for ease in reading. The answers are reproduced here with the consent of their authors.


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However, even where the offender's conduct is found to interfere with the property right of the injured, the court must determine if the interference is unreasonable. Unreasonableness is determined by balancing the hardships - balancing the interests and needs of the homeowners against the interests in having the business continue operating. During this process, the court will look at many factors including: whether the homeowners purchased their land at a discount because of its near location to the shopping center (coming to the nuisance), the offender's right to use his property as he wishes, the value of the business to the community including the number of employees, whether the nuisance can be abated by modifications of the offender's business, the length of time the offender has been in business, the possibility of using the property for some other purpose, the offender's investment in the business, etc.

In this case, certain factors indicate that the use by FF will be considered unreasonable. The offender has only been in business for a short period of time. It is unclear from the facts whether HO purchased at a discount based on nearness to the shopping center, but because the business is new the court is unlikely to find that HO came to the nuisance.

However, other factors indicate that the use by FF will not be considered unreasonable: FF has a right to use his property as he sees fit; FF has a right to use the shopping center property for a restaurant. Further, FF has put considerable investment into the operation as a FF establishment by purchasing top of the line equipment. This is not an unusual use for such a property. Further, it does not appear that the business could be abated. We know that FF is complying with all health ordinances and that the business is operated using the best equipment.

While the facts of this case will present a close call, the court is unlikely to find that there is a nuisance that should be abated. This is particularly true if there are a few number of warm days. The interest in allow [sic] FF to operate its business outweighs the interest of the homeowners for the reasons discussed above. As such, the court will not grant an injunction. However, if the court finds that there is some level of nuisance, the court may require FF to pay some measure of damages to HO to compensate them for their injuries arising from their nuisance.

# Question 2

Rita and Fred wanted to form a corporation to be named "Rita's Kitchen, Inc." (RKI) for the purpose of opening a restaurant. They contacted 75 friends who agreed individually to become investors in RKI. Five of these investors also agreed to serve on the RKI Board of Directors with Rita and Fred.

Rita and Fred entered into a five-year lease with Landlord for restaurant space, naming "Rita's Kitchen, Inc., a corporation in formation" as the tenant. They signed the lease as "President" and "Secretary," respectively.

Rita and Fred retained Art as their attorney to form the corporation. They told Art that 75 of their friends had committed to invest and become shareholders of RKI. Irv was a duly appointed representative of the 75 investors. Rita, Fred and Irv met with Art, and they agreed that Art would represent Rita, Fred, and all the investors. After extensive discussions with Rita, Fred, and Irv about the operation of the proposed business, Art agreed to prepare the necessary documentation to incorporate RKI.

Later, outside of Irv's presence, Rita and Fred asked Art to draft a shareholder agreement that would specifically designate Rita and Fred as permanent directors and officers of RKI and set Rita and Fred's annual salaries at 12.5% of the corporate earnings. Without further discussion, Art properly formed the corporation. He then prepared the shareholder agreement, including the terms that Rita and Fred had requested.

The 75 investors each purchased their shares of stock and signed the shareholder agreement. RKI operated for one year but failed to make a profit. RKI ceased operations and currently owes three months of back rent under the lease.

1. Can Landlord recover the unpaid rent from Rita and Fred individually? Discuss.

2. Is the shareholder agreement valid? Discuss.

3. What ethical violations, if any, has Art committed? Discuss, including distinctions, if any, between the ABA Model Rules and California authorities.

Do not discuss federal and state securities laws.

## Answer A to Question 2

**2)**

1. Can the Landlord recover unpaid rent from Rita and Fred individually?

Liability of Promoters on Pre-Incorporation Contracts

Until such time as a corporation complies with all formalities of incorporation and files its articles of incorporation, it does not have a separate legal existence, and cannot enter into contractual obligations such as a lease. Prior to incorporation, it is typical for the corporation's promoters and/or founders to enter into contracts on its behalf. Here, Rita and Fred entered into the lease with the Landlord on behalf of Rita's Kitchen, Inc. ("RKI"), which had not yet been formed. Under the law, a promoter remains personally liable on a pre-incorporation contract unless there has been a subsequent novation (ie., all parties agree to substitute the corporation for the promoters as the party liable on the contract whereby the promoters are thereafter relieved of further personal liability) or unless the contract is explicit in providing that the promoter has no personal liability on the contract.

Here, there has not been a novation to relief [sic] Fred and Rita of liability. However, they would argue that they entered into the contract on behalf of RKI, a corporation in formation, and signed as officers, and therefore made it clear that it was only the corporation and not them personally who would be liable on the lease. Their arguments would not likely succeed because the lease was not explicit in stating that they would not be personally liable thereunder. In the absence of such explicit language, the most likely result is that the court would hold that Rita and Fred as promoters are and remain personally liable on the lease. Therefore, the landlord should be able to recover the unpaid rent from either or both of them.

Indemnification from Corporation

Note also that it is not clear where RKI has ever ratified the lease. If no corporate action was taken to ratify the lease, then the corporation would not be liable thereunder, unless it silently took the benefits of the lease. Here, if RKI did not ratify the lease, it could still be held liable because it took the benefit of the lease without objection.

Note that although Fred and Rita would be held liable for the unpaid rent on the lease, they would have a claim for indemnification against RKI for any amounts that they had to pay personally to the landlord. They will not be able to recover, however, if the corporation does not have sufficient funds to pay.

2. Is the shareholders agreement valid?

As a general matter, shareholders of a privately held corporation such as RKI can and often do enter into shareholders agreements dealing with their rights and obligations as shareholders. These types of agreements commonly provide for matters such as transfer restrictions, rights of first refusal, put and call rights, "tags and drags", preemption rights and registration rights in the event that the corporation becomes public in the future.

Shareholders agreements can also provide shareholders with certain veto rights regarding the overall management of the company. In the context of a closely held private corporation, shareholders can also enter into a shareholders agreement whereby they become the directors of the corporation by agreement, thus doing away with the need to have a separate board of directors. In such situations, the shareholders step into the shoes of the directors and owe each other and the corporation duties as fiduciaries.

It appears that the shareholders agreement in question is problematic for two main reasons. First, it prohibits shareholders from exercising their rights as shareholders to be able to elect and fire directors. Secondly, it prohibits the directors from being able to exercise their responsibility for setting their compensation and the compensation of officers in accordance with principles of prudence and good faith.

Rights of Shareholders to Elect and Remove Directors

Shareholders have the right to elect and fire directors, both with and without cause. An agreement that prohibits shareholders from being able to exercise these powers would be contrary to public policy and likely unenforceable. At the very best, shareholders must have the authority to fire directors for cause (ie, breach of duty of care, duty of loyalty, etc.). To the extent that the shareholders agreement prohibits shareholders for exercising their powers as shareholders by giving Fred and Rita permanent directorships, it is invalid. While shareholders can agree as to the election of directors, directors cannot make themselves permanent and unremovable by way of a shareholders agreement.

Rights and Duties of Directors

A director is a fiduciary, and obligated at all times to act in the best interests of the corporation. A director has certain powers and obligations granted under the corporation's code and at law.

Right to Appoint and Fire Officers

The Board of Directors has the power to appoint and fire officers. The shareholders agreement is problematic because it usurps the authority of the Board to make this determination by making Rita and Fred permanent officers. Officers owe a corporation duties of care and loyalty, and cannot by agreement be made unremovable. At the very least, they must be removable for cause. Therefore, the provision in the shareholders agreement which makes Rita and Fred unremovable as officers is invalid.

Duty of Care and Business Judgment Rule

A director owes the corporation the duty to act as a reasonably prudent person in the management of his of her own affairs, in good faith and in the best interests of the corporation. In exercising his or her duty of care, a director can rely on the business judgment rule if he or she acted in a reasonable, informed manner, with due care and diligence, in exercising his or her judgment.

Duty of Loyalty

A director owes the corporation a duty of loyalty as a fiduciary to act in the best interests of the corporation and to avoid self-dealing to his or her own benefit and/or to the detriment of the corporation.

Breach of Duty of Care and Loyalty

Under the law, directors cannot, as a general matter, agree in advance as to how they will exercise their powers as directors. Here, the shareholders agreement in essence does just that – it provides that the directors (recall that the Board of Directors is made up of five of the investors, plus Rita and Fred) agree in advance not to fire Rita and Fred as officers. This the directors cannot do and, for this reason also, this provision is invalid.

This provision is also likely in violation of the directors' duty of care, because it is improper to agree to never remove officers, as there may be good reason and justification to remove Rita and Fred at some point in the future. Likewise, directors have the duty and obligation to set their own compensation and officers' compensation in accordance with reasonable, good faith parameters, taking into account the needs of the corporation and ensuring that they do not commit a waste of corporate assets in setting compensation. Agreeing in advance to what Fred and Rita's compensation is going to be - at 12.5% of corporate earnings - may constitute a violation of this duty, because it is unclear whether this figure will or won't be a reasonable and proper amount as the corporation moves forward.

Likewise, making themselves unremovable and giving themselves a fixed salary as a percentage of earnings, regardless of whether it is appropriate in light of the corporation's then financial circumstances, constitutes a breach of Fred and Rita's duty of loyalty to the corporation, as they are clearly putting their personal interests ahead of those of the corporation.

For all of the foregoing reasons, the provisions in the shareholders agreement are invalid.

3. What Ethical Violations has Art Committed?

An attorney owes his clients various duties under the applicable rules of professional responsibility. Chief among these is the duty of care, the duty of loyalty and the duty of confidentiality. One of the chief difficulties Art faces is that he has not separately addressed or differentiated between the different clients he represents. He has acted to incorporate RKI, and is arguably counsel to the corporation, whereby he would owe the corporation itself duties of care and loyalty. He is also apparently counsel for Fred and Rita in their personal capacities as incorporators and as officers of the corporation. Finally, he has acted as counsel for the investors in drafting the shareholders agreement. Art's main ethical violation stems from failing to differentiate between the potential and actual conflicting interests of his various clients and failing to advise them to obtain separate counsel as appropriate.

Duty of Care/Competent Representation

Art clearly acted as counsel for the investors by meeting with Irv and representing the investors' interest in drafting the shareholders agreement. In so doing, he breached his duty of competence to exercise the skill, knowledge and diligence that would be expected of an attorney practicing in his community. As discussed above, the shareholders agreements contain provisions that are not in compliance with applicable corporate law and corporate governance principles. Art should not have drafted an agreement containing provisions that are invalid and, in so doing, likely committed malpractice. Likewise, in his role as counsel for Rita and Fred, he should have advised them that the provisions that they sought would not be enforceable, and breached his duty to them in this regard also.

Duty of Loyalty

An attorney is obligated to act in the best interests of his client and cannot take on representation that will result in him not being able to properly represent a client on account of conflicting duties and obligations owed to other clients (for example, where one client's interests are adverse to another's). If an attorney is of the view that he can competently represent all of his clients, he is required to disclose to all that he is representing everyone's interests and to seek the written consent of each client to such joint representation.

Here, Art failed to obtain the written, informed consent all parties to his joint representation of each of them and, in so doing, breached his ethical obligations. Moreover, he failed to seek further consent when it became apparent that Fred and Rita's personal interests as officers (ie, to be permanently appointed and to obtain a guaranteed percentage of corporate earnings) came into conflict with the investors' interests as shareholders in maximizing the return on their investment and fully exercising their rights as shareholders. When it became apparent to Art that Fred and Rita's interests were different than those of the investors (ie, when Rita and Fred spoke to him outside of Irv's presence), he should have alerted them to the fact that he was representing the investors and the corporation and that he could not separately seek to represent their interests. He should have advised Fred and Rita to seek separate, independent counsel to negotiate their compensation and tenure packages with the corporation. Art also failed to alert Irv, as he was arguably required to do, of the validity and desirability (or lack thereof) that Rita and Art had requested. Art therefore failed to fulfill his ethical responsibilities to all clients involved.

## Answer B to Question 2

1. Can Landlord recover unpaid rent form Rita (R) and Fred (F)?

Promoter Liability

A promoter is a person who works prior to the incorporation of an entity to secure contracts and services for the to-be-formed entity. A promoter has a fiduciary duty to the other promoters and to the entity to be formed. A promoter can enter agreements on behalf of the to-be-formed entity but can be subject to liability on those agreements.

Adoption and Novation

A corporation does not become liable on a contract entered by a promoter until it adopts the contract. A contract can be adopted expressly by the corporation agreeing to be bound or impliedly by the corp. choosing to accept the benefit of the promoter's contract. Here, there is nothing to indicate that RKI expressly adopted the terms of the lease entered into by their promoters - R and F. However, RKI did accept the benefit of the lease by using the space for its restaurant. Thus, RKI will be bound on the lease.

R & F are also bound

The corporation's act of adapting a contract does not absolve the promoters from liability unless there is an express provision in the contract or a novation in which the corp. and the other party agree that the promoter will not be liable. Here, there is nothing on the lease to indicate R and F would not be liable. It only says they signed as Pres. and Sec. of RKI, "a corporation in formation". Further, there is no evidence of an agreement or novation after RKI was formed absolving them of their liability. Thus, there is no novation and R and F will still be individually liable on the lease with Landlord for the unpaid rent because they were promoters who were not relieved of liability.

2. Is the Shareholder Agreement Valid?

To have a valid shareholder agreement, there needs to be approval from the shareholders. Here, we are told that each of the 75 investors signed the shareholder agreement. Thus, the shareholder agreement is presumptively valid but the terms of the agreement must be examined.

Election of Directors

Directors of a corporation are elected by shareholders at the corporation's annual meeting. Here, the shareholder agreement specifically designated R and F as permanent directors and officers of RKI. By having this provision in the shareholder agreement, the agreement purports to strip the shareholders of their ability to elect directors annually. In this regard, it is invalid.

Removal of Directors

Along with the ability to elect directors, shareholders also have the ability to remove directors with or without cause. The provision of this shareholder agreement indicates that

R and F would be permanent directors. Because shareholders have the ability to remove a director, no director can be permanent. Thus, to the extent the shareholder agreement purports to make R & F permanent directors, it violates the right of shareholders to remove a director and is invalid.

Shareholders Can't Have a Predetermined Agreement of How They Will Vote if Elected Officers [sic]

Shareholders may have agreements for how they will vote on shareholder elections but can't agree to how they will vote as directors. To the extent this shareholder agreement commits R and F along with the 5 other investors who agreed to serve on the RKI board to elect R and F as officers and to set R and F's annual salaries at 12.5% of corporate earnings, it takes away their ability to act in their fiduciary capacity as duly elected directors and is invalid.

Board Decides Its Own Salaries

A board of directors is charged with the management of the company and makes decisions for the company on things such as their salaries. Here, the SH agreements purports to set R and F's salaries. Because the board, and not the shareholders, have the power to manage the company, the shareholders cannot set director and officer compensation. To the extent the SH agreement tries to do this, it is beyond the shareholder's powers and invalid.

Board Elects Officers

Another power inherent in the board of directors is the power to elect officers. Shareholders may have the power to elect directors but they can't elect officers. Thus, to the extent that shareholder agreement elects R and F as permanent officers of RKI, it is invalid because the directors, not the shareholders, are responsible for electing officers.

Thus, while the shareholder agreement as signed by all shareholders is presumptively valid, it is invalid to the extent it improperly elects directors and officers, it does not provide for removal of directors, it binds shareholders to how they will vote as directors, and it improperly sets director and officer compensation.

3. Art's Ethical Violations

Who Does Art Represent?

The first issue in deciding whether Art (A) committed any ethical violations is to determine who Art represents. Here, Art was originally approached by R and F to form the corporation. Also, A met with R and F as well as Irv (I) who was the duly appointed representative of the 75 investors. After meeting with R, F, and I, A agreed to prepare the necessary documentation to incorporate RKI. As a result, A potentially represents R & F, Irv and two other investors, and RKI, the corporation he helped form.

Duty of Loyalty

An attorney owes his client the duty to exercise his professional judgment solely for

the client's interests. If the interest of the attorney, another client or a third person may materially limit the attorney's representation or becomes adverse to the client's interests there is an actual or potential conflict of interest. When an attorney is presented with a conflict, he can only accept or continue the representation if he reasonably believes he can effectively represent all parties, he informs each party about the potential conflict, and the client consents to the representation in writing.

Without consent, an attorney should refuse to take the representation or withdraw from the representation.

A representing R & F and Irv and the Investors

Here, A has a potential conflict by representing both R & F as well as Irv and the investors. While A can say that R, F, and I all had the same interests and wanted to incorporate RKI, because he was representing multiple interests, he needed to be aware of potential or emerging conflicts.

When R & F approached A to draft the shareholder agreement without Irv being involved, A should have been suspicious. When he learned that they wanted the agreement to designate them as officers and directors and set their salaries, their interests were potentially conflicting with I and the investors. At that point, A should have disclosed the proposal to Irv and obtained written consent from I to draft the agreement as requested by R and F. It is also unlikely that a reasonable attorney would believe he could adequately represent both R and F and the investors.

In any event, A should have sought written consent from Irv. Because he did not, he violated his duty of loyalty.

Duty of Confidentiality

A lawyer also has a duty not to reveal anything related to a client's representation without consent. Thus, A can argue that he couldn't tell Irv about his conversation with R & F outside of his presence without violating his duty of confidentiality to R & F. If this is the case, A should have withdrawn from his representation of Irv and the investors and advised them to seek independent counsel re: the shareholder agreement.

Duty of Competence

A lawyer owes his client the duty to use the legal skill, thoroughness, preparation, and knowledge necessary and reasonable for the representation. Here, A had a duty to competently draft the shareholder agreement. For all the problems pointed out above about the shareholder agreement, A violated this duty.

Duty to Communicate

An attorney owes his client a duty to communicate about the matters of the case. Here, A had a duty to tell Irv about the provisions he was drafting in the agreement. Again, A would claim he could not communicate this to I without breaking his duty of confidentiality to R & F. As mentioned above, this again meant A should have withdrawn from the

representation of at least Irv and possibly R & F and urged the parties to seek independent counsel.

Art's Defense

Art will argue that any potential problems were avoided because the investors signed the agreement with the term R & F requested. However, the ends do not justify the means. A had ethical obligations to his client during the representation that he breached. Their later approval of the agreement does not equal informed consent to his breaches throughout.

**ESSAY QUESTIONS AND SELECTED ANSWERS**
**FEBRUARY 2008**
**CALIFORNIA BAR EXAMINATION**

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# Question 6

Albert, an attorney, and Barry, a librarian, decided to incorporate a business to provide legal services for lawyers. Barry planned to perform legal research and draft legal memoranda. Albert intended to utilize Barry's work after reviewing it to make court appearances and argue motions on behalf of other attorneys. Albert and Barry employed Carla, an attorney, to prepare and file all of the documentation necessary to incorporate the business, Lawco, Inc. ("Lawco").

Carla properly drafted all required documentation to incorporate Lawco under the state's general corporation law. The documentation provided that: Lawco shares are divided equally between Albert and Barry; Lawco profits will be distributed equally to Albert and Barry as annual corporate dividends; Barry is president and Albert is secretary.

Albert and Barry opened their business in January, believing that Lawco was properly incorporated. In February, they purchased computer equipment in Lawco's name from ComputerWorks. The computer equipment was delivered to Lawco's office and used by Barry.

Carla, however, neglected to file the articles of incorporation until late April.

In May, Albert, without consulting anyone, contracted in Lawco's name to purchase office furniture for Lawco from Furniture Mart. On the same day, also without consulting anyone, Barry contracted in Lawco's name to purchase telephones for Lawco from Telco.

1. Is Lawco bound by the contracts with:
    a. ComputerWorks? Discuss.
    b. Furniture Mart? Discuss.
    c. Telco? Discuss.

2. Has Albert committed any ethical violation? Discuss.

Answer question number 2 according to California and ABA authorities.

## Answer A to Question 6

1A) Lawco's Contract with Computer Works

Status of the Corporation

The first defense Lawco might raise against enforcement of this contract is that while it was entered into by Lawco, Inc., no such entity existed at the time the contract was formed. They might argue that because no corporation existed, the corporation is not liable on the contract. There are three scenarios under which a corporation might be bound.

If the corporation is a de jure corporation, it has been validly created by observing the formalities of incorporation and receiving its articles of incorporation from the state. While the second and third contracts discussed below were entered into by a de jure corporation, this first one was not, as attorney Carla had neglected to file the articles of incorporation with the state until April, two months later.

A corporation is a de facto corporation where the formalities have been entered into, and the corporation had a good faith belief that it is a corporation, but the paperwork has not been processed and the state has not actually issued corporate status. A corporation can rely on its de facto status in such a situation to enforce a contract that it might not otherwise be able to enforce. Here, A and B both believed that Lawco had been properly formed, though it had not yet been so. If they wanted to enforce the contract, they would depend on their de facto status. If they are trying to avoid being bound by it the de facto characterization might be considered, but the doctrine of corporation by estoppel is probably more appropriate.

Corporation by estoppel results when a corporation holds itself out to the public as a corporation, acts as such, and enters into contracts under that banner, but is not actually a corporation at the time. Such an entity is estopped from claiming that it was not in fact a corporation when it entered into those contracts, as it benefited from claiming that it was.

Adoption of Pre-Incorp Contract

Even if none of the doctrines above are successful, ComputerWorks (CW) will argue that the contract was a pre-incorporation contract and that Lawco adopted it by accepting and using the computers that it delivered. It will argue that such actions demonstrate its intent to profit from the contract.

Quasi-Contract

If no contract is found, CW will argue that Lawco benefited from the use of its computers after holding itself out as ready to contract and that under the doctrine of quasi-contract, should not be unjustly enriched. Under such a theory, CW will receive the value conferred upon Lawco.

Sue A and B personally

If none of the above work, CW can sue whomever signed the contract (A, B, or both) and claim that it was a pre-incorporation contract which was not adopted by the corporation and hold them personally liable.

1B) Lawco's contract with Furniture Mart (FM)

As described above, Lawco was a validly formed corporation when it entered into a contract with FM for furniture. The issue is whether or not Albert, by himself, had authority to enter into such a contract, or whether B's consent was required. This issue is best analyzed under the law of agency.

Agency

If FM can establish that A was acting as an agent of Lawco when he entered into the contract, then Lawco will be bound. An agent can have actual or apparent authority.

Actual Authority

Actual authority can be either express or implied. Actual authority is express when the agent and principal have agreed that the agent will act on behalf of the principal in a certain capacity. Authority can be implied to the extent that an agent's express authority requires it to do certain other acts as a matter of course in order to perform its functions as an agent.

In this case, A entered into the contract with FM. Under the articles of incorporation, A is the secretary of Lawco. While there is no evidence of express authority for A to purchase for Lawco, a corporation is not an individual and so must act through agents by necessity. Lawco will argue that as a 50% shareholder, A needed to have approval of B in order to enter into a contract to purchase assets for the corporation and that he was not an agent. It is much more likely that B will possess actual authority than A will, and this argument will probably fail.

Apparent Authority

If the argument for actual authority fails, FM will argue that, instead, A had apparent authority to act for Lawco. Apparent authority is authority that results from 1) an agent's position or title with respect to the principal, 2) where the principal has held the agent out in the past as its agent and has not published the revocation of authority, or 3) the principal ratifies the agent's actions after the fact.

In this case, FM will argue that because of his position as secretary of the corporation, even if A did not have actual authority to contract, they relied on his apparent authority to do so as the secretary of the corporation. This will be a weak argument, as the secretary is not usually expected to enter into contracts for a corporation. Although the facts are silent as to what happened after the contracts were entered into, if Lawco accepted the benefits of the contract with

FM, they will also argue that Lawco ratified the contract entered into by A when they accepted the furniture and used it.

Lawco will argue that A's role in the corporation was a 50% shareholder and secretary. It will argue that there was no express agency agreement, nor did it ever act in a manner that might hold A out as its agent. Futhermore, A's shareholder status grants him no right to enter into contracts on behalf of the corporation as that is a job for the officers and directors. Finally, A's role as a secretary is to take notes at meetings, and perhaps oversee documents. It is not to make unilateral decisions for the corporation or spend money.

Unlike the situation of B below, FM will not have access to some of the more persuasive arguments of apparent authority. Unless there is some manifestation of express authority in the corporate records, absent a decision by the officers or vote of all shareholders, they will probably not be able to bind Lawco under A's contract, unless Lawco takes some action after the fact to ratify A's actions. They may, however, be able to go after A personally for any damages due to breach on a contract he signed as a purported agent.

<u>1C) Lawco's Contract with Telco (TC)</u>

As described above, Lawco was a de jure corporation when B entered into the contract with TC on its behalf. As above with A, the issue will be whether B qualifies as an agent who might bind Lawco as the principal. Unlike A, however, who was the secretary of Lawco, B was the president. The president arguably has actual or apparent authority to enter into contracts for the corporation where the secretary is less likely to have such.

The same principles will be applied as above, but in this case, the facts probably dictate a different outcome. The president of a corporation is arguably an agent thereof by [the] very nature of his position. FM will argue that for a necessary business expense of the corporation, like securing furniture, the president had actual or at least implied authority to secure them. They will argue that the corporation cannot act on its own and that its president is the obvious choice to enter into contracts on behalf of it. They will also argue that Lawco accepted the benefit of B's actions and that in doing so it ratified B's actions.

TC will have access to more persuasive arguments than FM had above due to B's apparent authority as president, and will have a much stronger case to enforce its contract against Lawco than FM did.

<u>2) Albert's Ethical Violations</u>

<u>Albert's Duty Not to Aid in the Unauthorized Practice of Law</u>

A has a duty not to help a nonlawyer practice law. The practice of law includes advising or counseling clients, as well as arguing before the court. In this case, the facts state that B's duties are to perform legal research and to draft legal memoranda. A intends to review this work and use it to make court appearances

and argue motions. While B's legal research is probably not prohibited, his drafting of legal memoranda may be. The fact that A intends to review this work and basically attach his name to it after verifying its contents makes it a close call. Law clerks are able to engage in such activity before graduating from law school and passing the bar as long as they are appropriately supervised. A will argue that B's work is almost identical to that of a law clerk and that with proper supervision there is no breach of his duty.

Albert's Duty Not to Go Into Business With a Nonlawyer

A has a duty not to incorporate with a nonlawyer when he plans to practice law. Lawyers are allowed to form partnerships with each other, but they cannot form partnerships or corporations with another type of professional or nonlawyer such as a CPA. Here, A will argue that the actuality of the relationship is exactly like a lawyer – experienced paralegal. He is mistaken, however, in that the liability of Lawco, the ownership interests, and the division of power between A and B are almost exactly equal. A should not allow himself to enter into a business transaction with a nonlawyer like B who may try to exert influence on his decisions in legal matters as a result of his partial ownership in the venture. The fact that B is the president and A is the secretary makes this arrangement particularly suspect. B arguably has a persuasive role in determining the direction of the venture due to his office. Furthermore, he is the face of the venture that is in its very name offering legal services, yet he is not himself a lawyer. A has violated this duty.

A's Duty Not to Share Profits with A Nonlawyer

A has a duty not to share profits with a nonlawyer in his practice of law. Lawyers may hire paralegals or research assistants for salary, but arrangements under which a nonlawyer is entitled to a preset ratio of the profits is forbidden. In this case, Lawco's articles provide that Lawco's profits are to be distributed equally to Albert and Barry as annual corporate dividends. The form the profit sharing takes is not nearly as important as the fact that it exists. A will not be able to hide behind the fact that the distribution scheme is couched in dividends rather than an outright sharing. A has violated this duty.

## Answer B to Question 6

1A) Contract with ComputerWorks

In [order] for Lawco to be bound, (i) the corporation must be validly incorporated, (ii) the doctrines of de facto corporations or corporations by estoppel must apply or (iii) the contract must have been adopted by the corporation after incorporation.

Valid Incorporation

A corporation is formed when the incorporator validly complied with the requirements of the state's general incorporation law. This typically requires the filing of the articles of incorporation. Since the articles were not filed until April and the contract was entered into in February, Lawco was not validly incorporated at the time of the contract.

Generally, a corporation is not liable for contracts entered into before it was incorporated until it adopts the contract. It can adopt the contract through (i) express adoption, such as a writing, or (ii) implied adoption, which may be accomplished by accepting the benefits of the contract without protest.

De facto Corporation

ComputerWorks could argue that Lawco is still liable on the contract since it was a de facto corporation. A de facto corporation may be found where (i) there is a valid general corporation law, (ii) the incorporation made a colorable good faith attempt to comply with the statute, (iii) the incorporator was not aware that the attempt to comply with the statute was invalid and (iv) the corporation took some action indicating that it considered itself a corporation.

In this situation, Carla properly drafted all the required documentation to incorporate Lawco. The state does have a general corporation law. Albert and Barry entered into the contract with ComputerWorks believing that the corporation was valid. The corporation took an action typical of a corporation by purchasing computer equipment in the corporation's name and having the equipment delivered to the corporation's office and used by a corporate employee.

This question of de facto corporation will revolve around whether Carla's neglect in delaying the filing of the articles negates her "good faith, colorable" attempt to comply with the corporation statute. Since Carla is a lawyer and knew her job was to prepare and file all the documentation necessary to incorporate Lawco, it is likely that this is not a good faith, colorable attempt to comply with the statute, and there is no de facto corporation.

Corporation by Estoppel

ComputerWorks can argue that Lawco should be estopped from denying the corporation existed since it received a benefit under the contract and would be unjustly enriched if the contract were not enforced. ComputerWorks can argue that there was (presumably) a promise to pay. ComputerWorks can argue that Lawco received a benefit by accepting and using the computers. It would be unjustly enriched by retaining the computers without paying for them. ComputerWorks can argue that it was foreseeable that it would expect to be paid for the computers and it was reasonable that it should be paid for the computers.

Adoption of the Contract

Finally, ComputerWorks could argue that Lawco should be bound on the contract since it adopted the contract after formation. A corporation adopts a contract after formation when it impliedly accepts the benefits of the pre-incorporation contract after incorporation. Here, Lawco retained the computers and probably continued to use them after formation in April.

The result is that the court would likely find that Lawco adopted the contract, or if not, that it should be estopped from denying the contract.

1B) Contract with Furniture Mart

In order for Lawco to be bound, (i) the corporation must have been validly incorporated at the time of the contract and (ii) the action taken must validly bind the corporation.

First, since the articles were filed in April, and it is presumed that all other requirements of the statute have been complied with, Lawco was validly in existence at the time of its contract with Furniture Mart in May.

Express Authorization by Articles

Second, there is the issue whether Albert validly bound Lawco when he contracted in Lawco's name with Furniture Mart. Albert is the secretary of the corporation and is thus a senior officer. The articles of the corporation would likely delineate the powers of the officer, and so Albert may be authorized under the articles.

Implied Authorization under Agency Law

If not, Albert may also be authorized under general principles of agency law to bind the corporation. Generally, an agent may bind a principal if he has express authorization, implied authorization or apparent authorization to do so. There is no evidence that Albert received express authorization to enter into the contract.

Albert would have implied authorization if (i) it was customary for someone in his position to bind the corporation, (ii) he reasonably believed, based on past behavior and actions, that he had the power to do so, or (iii) it was necessary for the performance of his duties that he be able to bind the corporation. It is also necessary that Albert acted within the scope of the authorization.

Since it is probably necessary for Albert's position as secretary that he be able to bind the corporation on such routine contracts as buying office furniture, he probably had implied authority.

He may also have had apparent authority if (i) the corporation "cloaked" him with the apparent position of being able to enter into the contract and (ii) Furniture Mart relied on this position.

In conclusion, even though he did not consult anyone, it is likely that the contract is valid since Albert had implied and apparent authority to enter into the contract. Since the contract is valid, Lawco is bound on the contract.

1C) Contract with Telco

In order for Lawco to be bound, (i) the corporation must have been validly incorporated at the time of the contract and (ii) the action taken must validly bind the corporation.

First, since the articles were filed in April, and it is presumed that all other requirements of the statute have been complied with, Lawco was validly in existence at the time of its contract with Telco in May.

Please see part (1)(B) for detailed discussion of agency law. Below is the application of the discussed legal principles to this situation:

Express Authorization by Articles

As President, it is likely that Barry was expressly authorized by the articles to enter into routine contracts, such as the purchase of telephones, for the corporation.

Implied Authorization under Agency Law

If not, Albert may have validly entered into the contract by express, implied or apparent authority. The facts give no indication of express authority. However, it is probably necessary for the president of a corporation to enter into contracts for routine items, so he probably had implied authority. It is also perfectly reasonable for another corporation to believe that the president has the power to bind the company, so Barry definitely had apparent authority.

In conclusion, even though he did not consult anyone, Barry had apparent and implied authority to enter into the contract, and Lawco is thus bound by the contract.

2. Possible Ethical Violations by Albert

Unauthorized Practice of Law

An attorney may be disciplined for aiding a nonlawyer to practice law. The practice of law consists of making decisions which require the exercise of legal judgment by the lawyer. However, activities related to law, which do not involve the "practice of law," may be performed by any nonlawyer. Also, under the ABA Rules and California law, a nonlawyer may practice law under certain very specific circumstances. For example, under ABA Rule, a nonlawyer may practice law under the direct supervision of a practicing lawyer who is licensed in that jurisdiction.

Albert is an attorney, and he knowingly decided to incorporate a business in which Barry, who is not an attorney, would perform legal research and draft legal memoranda. Not only did Albert know that Barry would be doing these things, he intended to use Barry's work to make court appearances and argue motions. There is no mention of Albert supervising Barry or reviewing his work before using it. Therefore, Albert can be disciplined for assisting Barry in the unauthorized practice of law.

Partnering with Nonlawyers

A lawyer is permitted to partner with a nonlawyer in a business providing legal services. A lawyer may hire a nonlawyer to work in such a business as long as they are not practicing law in an unsupervised way.

Here, Albert, a lawyer, and Barry, a nonlawyer, incorporated to form a business together. The business was specifically to provide legal services. The shares of business would be divided equally between Albert and Barry. Therefore, Albert may be disciplined for partnering with Barry to perform legal services, in a corporation in which they have equal shares.

Splitting Fees with Nonlawyers

A lawyer is not permitted to split fees with nonlawyers, except in certain very specific circumstances, such as employee benefit plans. Albert could argue that he was not splitting fees with Barry, and that fees for his services would be paid to the corporation. However, profits are distributed equally to Albert and Barry as corporate dividends. Therefore, Albert would be disciplined for splitting fees with Barry since his argument that fees are not split is illusory.

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**ESSAY QUESTIONS AND SELECTED ANSWERS**
**FEBRUARY 2009**
**CALIFORNIA BAR EXAMINATION**

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# Question 6

Stage, Inc. ("SI") is a properly formed close corporation. SI's Articles of Incorporation include the following provision: "SI is formed for the sole purpose of operating comedy clubs." SI has a three-member Board of Directors, consisting of Al, Betty, and Charlie, none of whom is a shareholder.

Some time ago, Charlie persuaded Al and Betty that SI should expand into a new business direction, real estate development. After heated discussions, the board approved and entered into a contract with Great Properties ("GP"), a construction company, committing substantial SI capital to the construction of a new shopping mall, which was set to break ground shortly.

Although Charlie remained enthusiastic, Al and Betty changed their minds about the decision to expand beyond SI's usual business. SI was struggling financially to keep its comedy clubs open. Al and Betty decided to avoid SI's contract with GP in order to devote all of SI's capital to its comedy clubs.

Last month, GP approached Charlie about another real estate project under development. GP was building a smaller mall on the other side of town and was seeking investors. Aware that Al and Betty were unhappy about the earlier contract with GP, Charlie believed that SI's board would not approve any further investments in real estate. As a result, Charlie decided to invest his own money in the endeavor without mentioning the project to anyone at SI.

Meanwhile, Al and Betty have come to suspect that Charlie has been skimming corporate funds for his personal activities, and, although they have little proof, they want to oust Charlie as a director.

1. Under what theory or theories might SI attempt to avoid its contractual obligation to GP and what is the likelihood of success? Discuss.

2. Has Charlie violated any duties owed to SI as to the smaller mall? Discuss.

3. Under what theory or theories might Al and Betty attempt to oust Charlie from the Board of Directors and what is the likelihood of success? Discuss.

## Answer A to Question 6

### <u>Stage, Inc. (S) vs. Charlie</u>

1. The issue is whether Al and Betty can avoid its contractual obligations to GP under the theory that the contract is ultra vires (outside scope of corporations purpose). Ultra vires statement is the corporation's statement of purpose and can either be broad and indicate that the corporation is incorporated for the purpose of "conducting lawful business" or can be as specific as Stage, Inc.'s and indicate that "SI is formed for the sole purpose of operating comedy clubs." At common law, if a corporation acts outside the scope of its statement of purpose, the contract is voided. At modern law, when a corporation conducts ultra vires activities, the transaction is valid; however, individual directors and officers who enter into the transaction can be held personally liable. Here, SI's Articles of Incorporation include the provision that SI is formed for the sole purpose of operating comedy clubs and decided at a later point to expand into the real estate development area.

In entering into the contract with Great Properties (GP), a construction company, and committing substantial SI capital to the construction of a new shopping mall, SI has acted outside its statement of purpose because the business of real estate is wholly different and apart from the business of running comedy clubs. Thus, SI has committed an ultra vires act and, modernly, it cannot avoid its contractual obligations with SI. The corporation's assets, however, will not be liable for the act of its Board of Directors, but the directors can be held personally liable for entering into an ultra vires act. Thus, although SI may not be able to void the contract, its assets are protected and Al, Betty, and Charlie will be held personally and be responsible for damages to GP.

2. The issue is whether Charlie has violated his duty of loyalty to SI by investing money into GP's project of building a smaller mall. A director owes the

corporation a duty of loyalty to act in good faith and in the best interest of the corporation. One of the several ways a director can violate his duty of loyalty to the corporation is by usurping a corporate opportunity. Before taking a business opportunity upon himself that he reasonably believes the corporation would be interested in, the director must inform the corporation of such opportunity and wait for the corporation to reject it. It is important to note that it is not a valid defense to state that at the point the corporation was not adequately financed to take on the opportunity.

The courts use the interest/expectancy test in order to determine whether an opportunity is one that the director should believe the corporation is interested in. Here, the corporation's statement of purpose is to operate comedy clubs and not deal in real estate; thus, the business opportunity is not within the corporation's line of business. Further, given that Charlie, Betty, and Al engaged in heated discussions before approving and entering into the contract with GP and given that Al and Betty later changed their minds about the decision and sought to void its contractual obligation to GP, it was reasonable for Charlie to believe that the opportunity was one that SI was not interested in. Also, the facts also state that Al and Betty decided to devote all of SI's capital to its comedy clubs since it was short on capital and struggling financially to keep its comedy clubs open. Finally, the facts state that Charlie was aware that Al and Betty were unhappy about the earlier contract with GP and believed that SI's board (which consisted of Al, Charlie, and Betty) would not approve any further investments in real estate. Thus, given the fact that the business of real estate development was out of SI's line of business and one that they would not likely be interested in taking advantage of, Charlie did not usurp a corporate opportunity and did not violate his duty of loyalty to the corporation in investing in the smaller mall with GP.

3. The issue is whether Al and Betty could oust Charlie from the Board of Directors for fraud and gross abuse of authority and for violating his duty of due care to the corporation.

**Duty of Due Care**

A director owes the corporation a duty of due care and must act as a reasonable prudent person and run the business as if it were his own. A director who takes action that harms the corporation (misfeasance) will be liable to the corporation unless he can defend himself under the business judgment rule. Here, if Charlie did in fact skim corporate funds for his personal activities as Al and Betty suspected, and if they could prove such activities, Charlie has violated his duty of due care to the corporation because a reasonably prudent person would not embezzle funds from a corporation. Under these facts, he will not be able to defend under the business judgment rule because that requires a showing that he acted in good faith and made a reasonably and well informed decision. It would be difficult and near impossible to show he was acting in good faith for the corporation's interest in embezzling money for personal use. Thus, he has violated his duty of due care to SI.

**Removal of a board member for fraud and gross abuse of authority**

The issue is whether Al and Betty would be able to remove Charlie from the Board of Directors for his acts of skimming corporate funds for his personal activities. A Director may be removed from the board by court order for fraud or gross abuse of authority or by a vote of the majority of shares of the corporation for any reason. Here, given that the corporation is a closed corporation with no shareholders, Al and Betty can petition the court to remove Charlie if they can show that he engaged in fraud or gross abuse of authority as a director of SI.

Here, the facts state that Al and Betty only suspected Charlie of skimming corporate funds for his personal use and had little proof of his unlawful activities. Further, Charlie would likely argue that SI has been struggling financially and thus it is unlikely that he was able to skim funds from SI. Additionally, the fact that Charlie was able to invest his own funds into the mall project with GP may

show that he is financially stable enough  to not have to skim funds from a struggling corporation.  Finally, Charlie could also defend himself on the grounds that perhaps Al and Betty are acting in retaliation because they resent him for convincing them to enter into the contract with GP which they wish to rescind at this point.

Unless Al and Betty can show clear proof that Charlie has engaged in such fraud, it is unlikely that the court will oust Charlie from his position as Board Member of SI.

## Answer B to Question 6

### I. **SI's Ability to Avoid the Contract with GP**

SI may attempt to avoid its contractual obligations on the basis that it was an ultra vires act. A corporation may only engage in activities which fall within the stated business purpose in its Articles of Incorporation. SI's Articles explicitly stated that it was formed for the sole purpose of operating comedy clubs. The contract with GP had nothing to do with comedy clubs, but rather was for an investment of capital into construction of a new shopping mall. Traditionally, corporations could always void contracts that were ultra vires and, in a jurisdiction that retains that approach, SI would prevail on this theory. SI could make a strong argument that the use of the term sole purpose left no ambiguity as to whether SI was able to take action in the form of real estate development. Modernly, however, most corporations are allowed to engage in any legitimate business purpose and are not able to void contracts on the mere claim that they were ultra vires. This protects the other contracting party from being abandoned if the corporation determines that the contract would not be profitable and then cites their Articles of Incorporation, which the other contracting party probably had no notice of, as a reason to evade contractual obligations. Insofar as that is exactly what is happening here (Al and Betty knew what the stated purpose of their corporation was and discussed and approved entering into the area of real estate development, then had second thoughts because of SI's struggling financial position), this theory may not work. Furthermore, the shareholders would have to bring the suit and SI is a close corporation, so it may be unlikely that a court would believe that the directors acted in complete defiance of the shareholder's wishes. Finally, it could be argued that investing in real estate is a way to earn capital that would ultimately be used to operate their comedy clubs, and thus the contract was actually within the corporate purpose.

The shareholders of SI may argue that the directors had no authority to enter into the contract and that the corporation should not be bound by the unauthorized acts of its agents. This would require showing that the directors had no actual, implied, or apparent authority to contract with GP and would likely fail. The entire Board of Directors approved the decision to expand in the direction of real estate development after heated discussion and subsequently entered the contract with GP. The directors of a close corporation most likely have implied, if not actual, authority to conduct the business of the corporation by approving and entering contracts. The role of the Board is to manage the corporation's affairs and make decisions about actions to be taken by the corporation. Often the actual authority to pursue those approved actions would be vested in a corporate officer like a president, but the small size and nature of a closely-held corporation typically implies a more fluid power structure. If there are, in fact, officers who are expressly vested with exclusive authority to enter [into] contracts on behalf of SI and none of the directors hold those officer positions, then SI may be able to avoid the contract on the basis that it was an unauthorized act. However, at the very least, it is likely that the directors held themselves out to GP as having authority to bind the corporation such that GP could argue they had apparent authority and prevail in enforcing the contract. Finally, the Directors did approve the decision, so it is likely that they ratified the contract in some way even if it was entered into by someone without authority.

The easiest way for a corporation to avoid a contract is not present here. If SI had not yet been formed and someone like Charlie had entered into the contract as a pre-incorporation contract, SI could claim they were not bound if the corporation never ratified the contract or received the benefit of it. SI has been properly formed and the directors approved the contract so this defense is not available.

## II. Charlie's Potential Breach of Duties to SI

As a director of SI, Charlie owes the corporation the fiduciary duty of loyalty which involves a duty to avoid usurping corporate opportunities. When a director learns of an opportunity based on his position as director (Charlie was approached by GP about "another" real estate project of theirs), he may not personally benefit from the knowledge by acting on the opportunity until he presents it to the corporation and allows the corporation to reject it. Here, Charlie will claim that he knew Al and Betty were unhappy with the earlier contract and that they wouldn't approve any further contracts with GP. However, Charlie's mere "belief" that the board would not approve further contracts does not absolve him of the duty to report the opportunity to them and wait for them to reject it. Considering the circumstances of SI's financial difficulties, they probably would have rejected it immediately and Charlie could proceed on the investment with his own money after fully and properly disclosing it to SI. Instead, Charlie never mentioned the project to anyone at SI, but went forward with investing his own money into the opportunity. Traditionally, the financial inability of the corporation to take advantage of the opportunity may have been an adequate defense to a director accused of usurping a corporate opportunity, but even if that was the case here, this defense is no longer a good one. Charlie breached his duty of loyalty.

The other fiduciary duty which Charlie owes SI, the duty of care, could also be potentially implicated in this situation if Charlie denied the GP smaller mall contract on behalf of SI and it would have been a good investment. The duty of care requires a director to act as a reasonably prudent person would in similar circumstances. As discussed above, Charlie should have presented the opportunity to SI's board and let them vote to refuse it. Given SI's financial struggles, it would have been a proper exercise of business judgment to decline the opportunity and a court would not question Al, Betty, or Charlie's decision to not enter the contract under the business judgment rule.

## III. Removing Charlie from the Board of Directors

Betty and Al will attempt to oust Charlie from the Board of Directors on the theories that he breached his fiduciary duties. If they know about his usurpation of the opportunity to enter a contract with GP related to the smaller mall, they would be able to show that he breached his duty of loyalty. If he is, in fact, skimming corporate funds, then he is self-dealing, another violation of the duty of loyalty which exists when a director reaps personal advantage at the expense of the corporation. They would also argue that he breached his duty of care by acting unreasonably in his pursuit and advocacy of the new business direction of real estate development. A director has the responsibility of acting in the corporation's best interests as a reasonably prudent person would in the investments they make. Betty and Al would argue that the investment of a "substantial" amount of SI's capital into real estate development (especially given that their sole purpose is operating comedy clubs) would not escape scrutiny and condemnation, even under the business judgment rule. However, Al and Betty agreed to taking SI in that new direction and no matter how "heated" the discussions were, they eventually approved the decision.

Importantly, Betty and Al cannot oust Charlie from the Board of Directors by their own act because only shareholders can remove a director. Thus, Al and Betty would need to bring all of the information they have about Charlie's breaches of fiduciary duties and any other reasons they have to desire his removal to the shareholders and let the shareholders address the question. A majority vote of all shareholders would be required for Charlie's removal. Considering what appears to be bad financial judgment on Charlie's part, the obvious breaches of the duty of loyalty, and the fact that shareholders can remove a director with or without cause, the shareholders would probably vote to remove him and Al and Betty would succeed in their ousting, although indirectly.

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# ESSAY QUESTIONS AND SELECTED ANSWERS
# FEBRUARY 2010
# CALIFORNIA BAR EXAMINATION

This publication contains the six essay questions from the February 2010 California Bar Examination and two selected answers to each question.

The answers received good grades and were written by applicants who passed the examination. The answers were prepared by their authors, and were transcribed as submitted, except that minor corrections in spelling and punctuation were made for ease in reading. The answers are reproduced here with the consent of their authors.


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# Question 2

Able, Baker, and Charlie are successful attorneys who set up a law firm under the name "ABC Legal Services LLP" ("ABC LLP"). They agreed to share profits and losses equally. Able prepared the documents required to register the firm as a limited liability partnership and instructed his assistant to file them with the Secretary of State. Inadvertently and unbeknownst to Able, Baker, and Charlie, Able's assistant never filed the appropriate documents.

Able, Baker, and Charlie leased office space for four attorneys in the name of ABC LLP. They rented the extra office to David, an attorney who had a small solo law practice, for a monthly rent of the greater of $1100 or 10% of his billings. David committed malpractice arising from a case that he undertook soon after he moved into the ABC LLP office space.

Able, Baker, and Charlie hired Jack as head of computer services. Jack had just graduated from college with a degree in computer science. Jack, in an effort to save ABC LLP the cost of Internet access budgeted at $500 a month, accessed and used the wireless network of an adjacent law firm for free. Able, Baker, and Charlie were surprised at the savings, but did not inquire how it came about. Their use of the network resulted in the disclosure to a third party of confidential client information for one of Able's clients, which caused the client economic loss.

1. May Able, Baker, and Charlie each be held personally liable for the economic loss to Able's client caused by the disclosure of confidential client information? Discuss.

2. May Able, Baker, and Charlie each be held personally liable for David's malpractice? Discuss.

3. Have Able, Baker, and Charlie breached any rules of professional conduct? Discuss. Answer this question according to California and ABA authorities.

# Answer A to Question 2

**Limited Liability Partnerships:**

The main benefit of an LLP is that the partners have limited liability – meaning that they are not personally liable for the debts and obligations of the partnership. To be properly formed, the LLP papers must be filed with the Secretary of State. Here, the ABC paperwork was not filed and the LLP was never registered. Without the proper paperwork, this venture is likely to be treated as a general partnership.

**General Partnerships:**

General Partnerships ("GP") are formed by two or more persons carrying on a business for profit. There are no filing requirements for forming a GP. GPs can be made up of general partners and limited partners. General partners have a duty to manage the business and can be held personally liable for partnership debts and/or obligations. Limited partners, however, are not liable for partnership debts and may lose their limited status if they engage in management. Absent any agreement each partner has an equal vote, profits are shared equally, and losses are shared as profits are.

A, B, and C are likely to be seen as general partners in a GP; thus they are entitled to an equal say in the management of the business and may be held personally liable for partnership debts.

**Ethical Duties of Attorneys:**

Attorneys owe a wide array of duties – to clients, the court, opposing counsel, and the public generally. The duties are established by ABA rules as well as state-specific rules. California's rules on ethical conduct of attorneys largely follows the ABA rules, but there are variances which will be noted if applicable below.

**Duties to clients:**

Attorneys owe clients the duties of confidentiality, loyalty, financial responsibility, and competence. Duties owed to the court and opposing counsel include the duties of

candor, fairness, and decorum. Attorneys must also ensure that all members of their firm, including staff, act in accordance with the ethical standards imposed. To the extent that one attorney has a conflict, such conflicts are imputed to the firm and are shared by all other attorneys unless the conflict arises from prior governmental work or a personal relationship with the opposing party's counsel, for example.

1. The disclosure of client information:

One of the most important duties owed to clients is the duty of confidentiality. This duty requires the attorney to act so as to not reveal any confidential information of the client – without consent, either express or implied. The facts do not indicate that any consent was given to the disclosure of this information in this case.

Here, the client information was revealed due to the use of an un secured wireless network which the firm used. Although the facts indicate that the attorneys were not aware of the use of the adjacent building's wireless network, we do know that they were surprised by the cost savings. If the attorneys were aware of unexpected savings, they should have spoken with Jack to determine why internet access was so much cheaper than expected. Because they did not so inquire, and consequently were unaware of the issue, Jack acted unethically by using another network for free. A, B, and C all had a duty to ensure that Jack's actions were proper and ethical.

Because ABC is likely to be deemed a GP, all general partners may be held liable for the debts of the firm. These debts can include the economic losses incurred from the disclosure of information and/or debts incurred if the client sues the firm for malpractice.

2. David's liability for malpractice:

Here the issue will be whether David is a partner of the firm or merely a lessee of an office. A, B, and C will argue that D was merely renting space from the firm, making him not a partner, and therefore not subjecting the firm to any liability for his actions. We do not have facts to indicate whether David ran his business under a separate name, kept his files in a separate room, used the same office staff, or contributed any money to the partnership. The first three factors would indicate a separate firm, while the final factor – buying into the partnership – would indicate that D had become a partner of ABC.

What we know is that David paid monthly rent. Absent other facts, paying rent indicates the D was likely a separate practitioner. If D was acting as a separate practitioner, the ABC firm partners would not be liable for this malpractice.

However, if there were facts to indicate the D was a partner of the firm, or that the malpractice occurred with regard to a firm client, the firm general partners may be liable for D's malpractice. In a LLP, as intended, partners are all liable only for their own malpractice, but in a GP, the general partners can be held liable for all partnership obligations. In a GP incoming partners are not liable for existing partnership debts, through the money they contribute can be used to pay off such debts. Outgoing partners of a partnership are liable for debts of the partnership until creditors have been given notice of their departure or 90 days have passed since their departure.

D's malpractice occurred shortly after he took up office space with ABC. If he were deemed to be a partner, and the malpractice occurred after joining the partnership, ABC general partners would be liable for partnership debts arising out of his malpractice.

3. Professional conduct:

The attorneys of ABC have violated a number of rules of professional conduct.

a. Management of Staff:

The attorneys have a duty to properly manage staff and ensure that all members of the firm are in compliance with the rules of conduct. Here, A gave partnership documents to an assistant for filing. While staff members of a firm frequently are in charge of filing court documents or making deliveries, it was likely imprudent to allow such an important document to be handled by an assistant. Because of the assistant's negligence the firm likely lost its privileges as an LLP. Attorneys cannot allow the unauthorized practice of law by non-attorneys. Here the documents likely did not need to be filed by an attorney, but the task was nonetheless important enough that it should have been done by a partner so as to ensure accuracy.

The attorneys were prudent in hiring Jack as a computer services manager as he was properly qualified with a degree in computer science. The use of non-attorneys does

not violate any ethical rules so long as fee sharing does not occur (payment of non-attorney salaries is not considered fee sharing.) The attorneys likely violated their ethical duties in their management of Jack, however. By not managing Jack properly and being unaware of Jack's use of an unsecured wireless network, A, B, and C breached not only their duties as managers, but also their duty of confidentiality to their client.

b. Duties to clients:

Attorneys owe their clients the duty of confidentiality – the duty to not reveal any confidential information without consent. Information may be revealed where necessary to defend oneself against a claim of malpractice or potentially if the attorney knows of conduct which will result in death or serious bodily harm which can be prevented through disclosure. The CA rules indicate that the conduct must be criminal; however the ABA makes no such distinction. Here, the requisite facts for proper revelation of client information do not appear. ABC breached its duty of confidentiality to its client by allowing the transmission of client information to a third party.

Attorneys also owe clients the duty of loyalty, which prevents attorneys from taking on representation or taking actions which are in conflict with current clients. Attorneys must always act in the best interests of their clients and with their interests at heart. It is unclear to whom the confidential information was revealed, but the ABC firm may have breached their duties of loyalty as well if the use of the network resulted in revelation of information to an adverse party.

Financial responsibility imposes on an attorney the duty to properly manage client funds and avoid commingling personal money. There are no facts indicting a breach of this duty by ABC.

The duty of competence requires that attorneys provide clients with professional, skilled, competent services. Here, by use of an unknown wireless server which allowed for the disclosure of confidential information, the attorneys of ABC have acted competently. A competent attorney would have ensured that information was not revealed, and would have properly managed all staff members.

# Answer B to Question 2

**<u>Liability for Loss Due to disclosure of confidential information</u>:**

A partnership is an association of persons to carry on a business as coowners for profit. The partners are jointly and severally liable for the debts of the partnership, both in contract and in tort. A limited liability partnership is a partnership that registers as an LLP with the Secretary of State. As an LLP, the partners are liable for their own torts incurred in furtherance of the partnership but not for the torts of the other partners or the partnership.

Filing the documents to register the partnership as an LLP is a prerequisite to attaining limited liability status. By not doing so the partnership retains the status of a general partnership and, therefore the partners would be personally liable for all liabilities of the partnership to the extent the debt was not satisfied by the partnership.

They could argue they intended to be an LLP and treated themselves as such, so they should be deemed to be a "de facto LLP." However, this argument is likely to fail because filing is such a simple act and the "de facto" argument has been applied in the corporation, not the partnership contract. Also, an LLP by estoppel argument would fail because there are no facts to indicate Abel's client thought he was dealing with an LLP, and, even if he did believe that, this defense would not apply to a loss caused by a tort – i.e., negligence.

As partners A, B, and C are liable for failing to properly supervise Jack. Jack was their employee. His tapping into a wireless network directly caused the disclosure of client information. As his employee A, B, and C Legal Services is vicariously liable for the torts of their employee. Here Jack committed the intentional tort of conversion, the intentional taking of the personal property of another. He did this while working for the ABC LLP and with the intent of furthering their business. Therefore, even though the tort was intentional, ABC LLP is liable. Further they could be found liable for negligently hiring an inexperienced computer person and then failing to adequately supervise him. See the discussion of their failure to supervise and prevent breach of confidentiality

rules infra. Violating the rules does not show a personal liability but is evidence they breached their standard of care. Since ABC LLP is liable, the partners are jointly and severally liable for reasons discussed above.

David's Malpractice

A partnership is defined above. In order to prove the existence of a partnership, the primary element is whether the parties intend to share profits. Other indications are whether they share in losses and share in the management of the enterprise.

In this case David leased an office for a monthly rent that included 10% of his billings. While that relates to David's profits, it does not represent a sharing of profits because the amount is received as rent under a landlord-tenant relationship. Moreover, there is no indication of any sharing of losses or management responsibilities. There is no partnership between David and A, B, or C. Likewise, there is no indication that David otherwise held himself out as a partner of A, B, and C. One can be deemed to be a partner if he is deemed to have apparent authority by being held out as a partner. Since that is not the case here, ABC LLP is not liable for David's malpractice, and therefore ABC or its partners are not liable.

Breach of Rules of Professional Conduct

Lawyers have a duty to preserve the confidentiality of confidential client information. It may only be disclosed if expressly or impliedly authorized by client or permitted by the rules of professional conduct. None of the exceptions are relevant here, such as to present a crime involving death or serious bodily harm, serious economic loss (ABA rules only) or in response to a court order or order of the ethics committee.

Partners in a law firm have an obligation to put in place procedures to assure compliance with the rules of professional conduct.

They also have a responsibility to take any action to prevent or mitigate violation of the rules if they are able to do so.

Here ABC did not adequately supervise Jack or have any procedures in place to prevent violations of the confidentiality rule, resulting in a breach of the confidentiality rules. They breached the rules and may be disciplined accordingly.

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**ESSAY QUESTIONS AND SELECTED ANSWERS**
**JULY 2010**
**CALIFORNIA BAR EXAMINATION**

This publication contains the six essay questions from the July 2010 California Bar Examination and two selected answers to each question.

The answers received good grades and were written by applicants who passed the examination. The answers were prepared by their authors, and were transcribed as submitted, except that minor corrections in spelling and punctuation were made for ease in reading. The answers are reproduced here with the consent of their authors.

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# Question 4

Alfred, Beth, and Charles orally agreed to start ABC Computers ("ABC"), a business to manufacture and sell computers. Alfred contributed $100,000 to ABC, stating to Beth and Charles that he wanted to limit his liability to that amount. Beth, who had technical expertise, contributed $50,000 to ABC. Charles contributed no money to ABC but agreed to act as salesperson. Alfred, Beth, and Charles agreed that Beth would be responsible for designing the computers, and that Charles alone would handle all computer sales.

ABC opened and quickly became successful, primarily due to Charles' effective sales techniques.

Subsequently, without the knowledge or consent of Alfred or Charles, Beth entered into a written sales contract in ABC's name with Deco, Inc. ("Deco") to sell computers manufactured by ABC at a price that was extremely favorable to Deco. Beth's sister owned Deco. When Alfred and Charles became aware of the contract, they contacted Deco and informed it that Beth had no authority to enter into sales contracts, and that ABC could not profitably sell computers at the price agreed to by Beth. ABC refused to deliver the computers, and Deco sued ABC for breach of contract.

Thereafter, Alfred became concerned about how Beth and Charles were managing ABC. He contacted Zeta, Inc. ("Zeta"), ABC's components supplier. He told Zeta's president, "Don't allow Charles to order components; he's not our technical person. That's Beth's job."

Charles later placed an order for several expensive components with Zeta. ABC refused to pay for the components, and Zeta sued ABC for breach of contract.

Not long afterwards, ABC went out of business, owing its creditors over $500,000.

1. How should ABC's debt be allocated? Discuss.

2. Is Deco likely to succeed in its lawsuit against ABC? Discuss.

3. Is Zeta likely to succeed in its lawsuit against ABC? Discuss.

# Answer A to Question 4

**1. How should ABC's Debt be Allocated?**

To begin, one must determine the nature of the organization that was created. In this instance, there were no formalities or written arrangements to begin a business with Alfred (A), Beth (B), and Charles (C). Corporations require formal articles of organization to be filed with the state. In this instance, it is much more likely that a partnership existed. No formalities are required to form a partnership. Partnerships exist when two or more people agree to carry on a business for profit. In this case, ABC was formed to sell computer items for profit. Generally, partnerships are also presumed if there is an agreement to share profits equally. In this instance, there is no indication as to what profit sharing arrangement existed, if any at all. As such, the default rule is that this would be a partnership with equal sharing of profits. Furthermore, without an express agreement as to how losses will be shared, the default is that they will be shared just as the profits are shared. Therefore, losses will also be shared equally. The amount of capital contribution by each partner is irrelevant to this equation.

A will argue that he expressed a desire to limit this liability. However, absent a formal agreement and filing of the proper limited liability forms with the state (articles of organization and an operating agreement) for a Limited Liability Company, A is going to be considered a general partner. This is further indicated by his general managerial position, apparent equal voting rights, and active management in the company. A was the one to call Zeta (Z) and tell them not to accept orders from C. This indicates his active management. Limited partners, those with limited liability, generally have no managerial functions. Given there is no formal limited liability structure or arrangement, and given the various management positions by each person, they are all general partners who will share equally in the profits and losses of the business.

On top of profit and loss sharing, each general partner is liable for the debts of the entire partnership. Each partner is considered an agent of the partnership. Under agency law, any contract or tort entered into in the scope of the partnership is deemed to be partnership debt, and all partners are jointly and severally liable. As such, any of the following contracts that were properly entered into and authorized by a partner having

authority are partnership debts that A, B and C will be jointly and severally liable for as individuals.

In the event that the copy is forced to liquidate and pay, the order of payment is as follows. First, the company must pay all debt creditors first. Second, the company must pay back all capital contributions from each partner, which would be $100,000 to A and $50,000 to B. While C may argue that his contribution was in sales, partners generally have no right to salary or compensation for services unless they are winding up. As such, C is not entitled to this amount as a capital contribution absent any other agreement. Finally, any remaining loss or profit would be distributed as applicable, which is equally in this case.

**2. Is Deco likely to Succeed in its Lawsuit against ABC?**

Validity of the Agreement

In order to prevail Deco (D) must show that B was authorized to enter the contract. In general, all partners are authorized as agents. However, the nature of their authority may vary. Express authority exists when the arrangement expressly states what an agent may do. Here, there is no indication that B was told to enter into a sales contract. In fact, sales were expressly reserved to C. Implied authority exists when the function is 1) necessary to carry out other responsibilities, 2) one that has been done in the past dealings without object[ion], or 3) normal custom for someone with the position of the agent. Here, sales are not necessary to B's technical design responsibilities, and she has never sold before. However, D could argue that a general partner in a business customarily has authority to enter contracts. Still, the express reservation of the right to likely kills this argument. Finally, D may argue apparent authority. This exists when the company cloaks the agent with authority to do certain things and later withdraws or limits that authority without notifying a customer who is still relying on that authority. In this case, there is no indication that ABC held B out to be a sales representative in the first instance. There was likely no good basis that D had to rely on any authority from ABC. However, given that B herself is a managing partner, D likely could argue that B's actions were sufficient to show that the corporation had given her authority to act. As such, they will argue that it was reasonable to rely on this without any other notice. This would bind ABC. Failing to perform on the contract is a breach of duty and the

partnership, as well as the individual partners, will be obligated to pay as described above.

Breach of Duty of Good Faith and Loyalty

Partners have fiduciary duties to each other that are described as the utmost duty of good faith and loyalty. Under the duty of loyalty, a partner must not engage in self-dealing, usurping business opportunities, or competing against the company. In this instance, B engaged in a transaction with her sister who owned D. The terms were apparently very favorable to D. This could be viewed as self-dealing because it promoted B's familial interest with her sister and was not in the best interest of the company. The duty of good faith requires that partners act in a way that solely benefits and is advantageous to the partnership. Again, B's deal with D didn't garner the profits that it should have. Furthermore, this duty requires disclosure of conflicts of interest to the other non-interested partners so that they can either cleanse the transaction through ratification or disapprove it. There is no indication that B informed her partners. The other partners have a very strong argument to bring a claim against B for these breaches in duty. This would place the entire liability for the breached contract on B, which would deviate from the normal liability scheme described above.

**3. Is Zeta likely to Succeed in its Lawsuit against ABC?**

Validity of the Agreement

Zeta's (Z) claim on this contract again hinges on the authority of C to enter into it. In this instance, C has the express authority to enter into sales contracts. However, this contract was for components being purchased by C, which is outside his express authority. Z may argue that components are necessary to production and later sales, which gives C implied authority to enter into contracts. Plus, it is reasonable to assume that a partner who can sell can also buy. This also lends credence to a claim of apparent authority. Z will argue that ABC has held C out as a person whose sole responsibility is to contract, and it reasonably relied on that representation. Z's main issue is that A called and gave actual notice that C could not enter into this contract. This would destroy any reasonable reliance that Z had. A told Z that B was the technical person, not C. As such, Z should have seen that his was outside the scope of C's authority.

Notwithstanding the arguments above, C is still a general partner in the company. If Z is at all knowledgeable about agency law and partnerships, Z could rightly assume that one partner doesn't have the sole authority to terminate the management authority of another partner. Management functions are only transferable and alterable upon a unanimous vote of the partnership. In this case, A alone tried to limit what C could do. Z may argue that it knew this wasn't a proper action by A and more reasonably relied on C. In the end, I think it is likely that the court would find that Z at least should have investigated further once given notice that C may not have authority, and failure to follow through made there [sic] reliance on his apparent authority unreasonable. As such, this contract is invalid and will not bind ABC. Should the court disagree, any resulting contract liability would be distributed among the partnership and A, B and C as described above.

Effect of A's Notice on C's Duties

A might also claim that C's activities outside his scope of duty were not in good faith. There is no indication that loyalty of fair dealings are implicated. So far as we know, the contract with Z could have been completely advantageous and proper. However, the argument is that acting in an area in which C knows nothing about shows a lack of obedience to his agency limits and lack of good faith in honoring partnership agreements on authority. However, nothing in C's behavior indicates an improper motive. This is a young startup with new partners. It is unlikely that C thought he was doing anything wrong. Rather, it is reasonable to assume he thought he was helping out in another area. Also, A didn't act with the consent of B. As such, there is no indication that the majority of management is at odds with C's decision to enter the contract. This appears to be solely the reservation of A with B and C. In the end, there was likely no breach of duty and any potential liability from this contract would flow to all, not just C.

## Answer B to Question 4

**1.) How should ABC's Debt be Allocated?**

The preliminary issue to determine is what type of business was formed when Alfred (A), Beth (B), and Charles (C) agreed to start ABC computers.

Formation of a General Partnership

A general partnership is formed when two or more people agree to run a business for profit, contribute funds or services in exchange for a share of the profits. Unlike a limited liability corporation or limited partnership, a general partnership requires no formal paperwork to be filed with the secretary of state. If the above definition of a general paratnership is met, then the business will be presumed to operate like a general partnership. Here, A,B, and C agreed orally to start ABC computers and did not file any corporate or partnership paperwork with the state. A contributed $100,000, B contributed $50,000 and her technical expertise and C contributed his services as a salesperson. They distributed the work amongst themselves. Although the facts do not state that they shared in the profits, it can be assumed that they shared in the profits because ABC becomes successful. Thus, because no formal paperwork was filed, all three members contributed money or services and share in the profits, there is a presumption that ABC operated as a general partnership.

Characteristics of a General Partnership

General Liability

In a general partnership, all partnerships share equally in liability and are personally liable for the debts of of the other partners and the partnership. Although A stated that he wanted to limit his liability, there are no facts to support that this was actually accomplished through an agreement, contract or that the partnership filed for a limited liability partnership. The only way that A could limit his liability would be to become a limited partnership, but that can only be done if the proper paperwork is filed with the state; there is at least one limited partner and at least one general partner. Because there is an absence of the necessary components of a limited liability partnership, A's liability will not be limited.

Each Partner is a Fiduciary and Agent to the General Partners and Partnership

Each partner is a fiduciary and agent to the general partnership and general partners. Thus, the laws of agency apply to the partners when acting in furtherance of and conducting business for the partnership.

Default Rules for General Partnership

In absence of an agreement governing the partnership, the default rules of partnership will be applied by the court. Here, A, B, C only had an oral agreement about how to run the business and not formal structure or governing documents for the partnership. Thus, the default rules will be applied.

Several of the key default rules that are applicable in the present situation include: Each partner has equal power to manage the partnership; when there are profits they are shared equally and losses are shared like profits.

Dissolution of General Partnership

Upon dissolution of a general partnership, there is a specific order in which assets must be distributed. First, creditors must be paid and general partners who loaned money to the partnership. Second in line to [be] paid are general partners who made capital contributions. Lastly, any surplus or profits will go to the general partners or the general partners may be personally liable for existing debt of a dissolved corporation. Partners who contributed capital contributions and made loans to the company should receive their money back if it is possible upon dissolution.

Here, ABC went [out] of business and owed its creditors over $500,000. It is unclear how much profit was made or the assets of the partnership at the time it went out of business. Assuming the partnership went out of business due to lack of profits or funds, then the creditors are to [be] paid all that was left of the partnership's assets and each general partner will be personally liable for the remaining that is owed to the creditors. As discussed above, although A wanted to limit his liability, that is not done properly, so each partner will be equally liable for the debt after all partnership assets have been used to pay the creditors and there remains a debt stilled owed to the creditors.

**2.) Is Deco likely to Succeed in Lawsuit against ABC?**

Here, B as a general partner of ABC entered into a written sales contract with Deco, Inc. The contract was extremely favorable to Deco and not ABC. Deco was owned by B's sister. When A and C learned of the agreement with Deco they informed Deco that B had no authority to enter into sales contracts and that ABC could not profit if it sold computers at that price. ABC refused to deliver the computers and Deco sued. The issues are whether B can bind the partnership and whether A and C can cancel the contract that B made.

B's Authority to Enter Into Agreements that Bind the General Partnership

Absent an agreement, the default rules of partnership state that each general partner has an equal right to manage the partnership and act as agents for the partnership in the usual course of business. This means that the general partners have authority to enter into contracts that bind the corporation as long as the contracts are in the regular course of business of the partnership. The other partners do not need to assent to know about the agreement, but will become liable on any agreement that is validly entered into by one of the other partners in the course of business. Here, A, B, and C agreed that B would be responsible for designing computers and C alone would handle computer sales. Although they delegated responsibility for tasks, there is no agreement that limited authority of any of the partners; thus the default rules apply (although one could argue that their delegations of tasks was akin to agreement to limit authority, but the mere oral agreement is not sufficient to rise to a degree of limited partnership rights). Therefore, B can enter into contracts in the regular course of business the bind the general partnership without the knowledge or consent of either A or C. Thus, it was proper for B to use her authority as a general partner to enter into an agreement with Deco to sell computers to Deco.

B's Fiduciary Duties of General Partners and Partnership

However, every general partner owes a duty to the partnership and general partners. Each partner must act as a fiduciary, owing a duty of care and loyalty to the general partnership. Each partner has a duty of lolyalty to the corporation to do [sic] not compete with the partnership, usurp the partnership's opportunities or engage in any

self-dealing where the paratner receives a benefit to the detriment of the corporation. Here, B entered into a contract with Deco, which was owned by her sister. Inherently, there is nothing outrightly wrong with entering into an agreement with a family member. However, the contract that B entered into with her sister was extremely favorable to her sister and would actually cause ABC not to profit. Thus, the agreement was extremely beneficial to Deco, and B's sister, to the detriment of the partnership. Therefore, B's actions can be characterized as self-dealing because her sister received a benefit to the detriment of the partnership. Thus, B breached her duty of loyalty to the partnership.

When a partner breaches a duty of loyalty, the profits can be disgorged and the contract can be revoked or rescinded. Here, because B breached her duty of loyalty to the partnership in forming the contract with her sister, the contract can be revoked. Further, a court would likely allow the contract to be revoked. Because B's sister was a wrongdoer because [she] was well aware of B's positon and responsibility/duty to the general partnership, B's sister cannot claim that she was innocent and did not know that her sister owed a fiduciary duty to the corporation.

Thus, although B had authority to enter into the contract with Deco, because B breached her duty of loyalty to ABC, ABC can refuse to deliver the computers under the contract and hold B personally liable for damages.

**3.) Is Zeta likely to Succeed in Lawsuit against ABC?**

Here, A contacted Zeta, Inc., a supplier of components for ABC, and told the President to not allow C to order components because that was B's job. Then C placed an order with Zeta and ABC refused to pay for components. Zeta, Inc. then sued ABC. The issues are whether A can limit C's power and whether after informing Zeta that C should not be allowed to place orders, whether ABC can refuse to pay for the components ordered by C.

<u>A's Authority to Revoke C's Authority</u>

As discussed above, in absence of an agreement the default partnership rules apply. In the present case, ABC has no formal agreement and thus each partner will share equally in the management duties. Additionally, each manager has the authority to bind

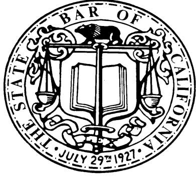
the partnership. Here, A and C have equal management power and power to bind the coporation. The issue is whether A has the authority to revoke C's power and authority absent any agreeement.

A does not have authority to revoke C's power and authority to enter into contracts simply because he is concerned about how B and C were managing the corporation. There was no agreement as to what A was responsible for. In light of the fact that no partner was given a power similar to that of a CEO or oversight or management of the entire partnership and other partners' action, A had no authority to revoke C's authority.

Further if A was under the impression that he was [a] limited partner, he would not be allowed to engage in managing the partnership under the traditional limited liability partnership model. Under the traditional limited liability partnership model, limited partners have limited liability and cannot engage in management of the partnership. If limited partners engage in management of the partnership, then they forfeit their limited liability status. However, under the newly revised Uniform Partnership Code, if it applies in this jx, limited partners may retain their liability and manage the partnership.

Although A had no power to revoke C's authority, the president of Zeta was put on notice that A did not want C to have the ability to bind the partnership due to how management powers/oversight was delegated. Thus, the president of Zeta should have thought twice before entering into an agreement with C, because at the very minimum with such informtion Zeta's president should have known that there was some conflict over management powers or personal issues between C and A. It was irresponsible of Zeta's president to enter into the contract with C after receiving such information from A.

C had authority to enter into the agreement with Zeta because C's authority was not limited in any way. Thus, although Zeta was aware that he could potentially have problems with the contract, the contract was validly entered into by C (assuming all contract formalties were met). Thus, the partnership and all the partners will be personally liable for breach of contract to Zeta.

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# ESSAY QUESTIONS AND SELECTED ANSWERS
# FEBRUARY 2011
# CALIFORNIA BAR EXAMINATION

This publication contains the six essay questions from the February 2011 California Bar Examination and two selected answers to each question.

The answers received good grades and were written by applicants who passed the examination. The answers were prepared by their authors, and were transcribed as submitted, except that minor corrections in spelling and punctuation were made for ease in reading. The answers are reproduced here with the consent of their authors.


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# Question 5

Bob owns 51 percent of the shares of Corp., a California corporation. Cate owns 30 percent. Others own the remaining shares.

Bob and Cate have entered into a shareholder agreement stating they would vote their shares together on all matters, and that, if they fail to agree, Dave will arbitrate their dispute and Dave's decision will be binding. Bob and Cate also executed perpetual irrevocable proxies granting Dave the power to vote their shares in accordance with the terms of the shareholder agreement. Attorney Al handled Corp.'s incorporation and drafted the shareholder agreement and the proxies.

Bob and Cate have been able to elect the entire board of directors every year. The board currently consists of Bob, Cate, and Bob's wife, Wanda. Bob and Wanda decided, as directors, to sell substantially all of Corp.'s assets to Bob's sister, Sally. Cate thinks the price is too low. Bob claims he no longer regards their shareholder agreement as binding. He has gone to Al for advice in the matter, and Al has agreed to provide it.

At the shareholders' meeting at which the matter is to be put to a vote, Bob announces he is voting his shares in favor of the sale. Dave says that since Bob and Cate disagree, he is voting the shares against the sale.

1. Is the shareholder agreement between Bob and Cate enforceable? Discuss.

2. Are the perpetual proxies executed by Bob and Cate enforceable? Discuss.

3. Would any sale of Corp.'s assets to Sally be voidable? Discuss.

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

## Answer A to Question 5

1. Shareholder agreement between Bob (B) and Cate (C)

A shareholder's agreement is an agreement whereby shareholders agree to combine their votes for voting matters related to their rights as shareholders. The agreement is less formal than a voting trust and requires simply that the shareholders agree to the course of action. Where a voting trust is required to notify the Secretary of the Corp. the shareholder agreement need not be recorded by the Secretary. In addition, where a voting trust is only good for 10 years, a shareholder agreement has no durational requirement.

In this case, B and C have entered into a shareholder agreement stating they would vote their shares in agreement or else submit to Dave to arbitrate any disputes. Dave's decision would be binding. While B and C have entered into a valid shareholder agreement, as they can agree to arbitration to settle disputes, it is necessary to look at Dave in this instance.

It is not clear what, if any, relation Dave has to the corporation. If Dave is familiar with the corporation, then there would be no issues with him arbitrating disputes. If he is a true "outsider" he may not have the knowledge and ability to make the informed decisions in the corp's best interest. In this case, B and C would violate their fiduciary duties to the corp. and the agreement would be ineffective.

2. Perpetual Proxies

A proxy is an agreement between shareholders to have one vote on their behalf. The corp. must be notified and a proxy is valid for 11 months, unless otherwise agreed. An irrevocable proxy requires that the proxy be labeled irrevocable and must be coupled with an interest.

In this case, the proxies are perpetual and irrevocable. As stated above, an irrevocable proxy must be labeled such and be coupled with an interest. It is not clear here what, if any, interest Dave received as part of the proxy agreement, or if the proxies were

labeled irrevocable. If neither requirement was met, the irrevocable proxies would be unenforceable.

If both conditions were satisfied, it would be necessary to determine if the corp. was notified. In addition, proxies typically last for only 11 months. Because the facts state this is perpetual, it is likely that the courts would find this unenforceable.

3. Sale of Corp. Assets

Directors have a duty to manage a corporation. Directors also have fiduciary duties of Care and Loyalty in managing the corporation. Directors may be insulated from violating the duty of care by the Business Judgment Rule.

Duty of Care

Directors have a duty to manage a corporation as a reasonably prudent person would in handling his/her own affairs. Directors must act in the best interest of the corporation.

Here, it is not clear from the facts if Bob and Wanda, as directors, are acting in good faith as reasonably prudent persons would in their own affairs.

Business Judgment Rule

Directors are protected from liability under the Business Judgment Rule when they act in the corp.'s best interest and make a reasonable, innocent mistake.

Here, because it is not clear if Bob and Wanda acted in good faith, it is not possible to determine if this is a simple mistake.

Duty of Loyalty

A director has a duty of loyalty to his corporation, which means that without full disclosure and independent ratification, a director cannot engage in a self-dealing transaction or usurp a corporate opportunity.

In this case, Bob and Wanda, as directors, have voted to sell substantially all assets to Sally, who is Bob's sister. A self-dealing transaction is one that benefits the director or his family members. In order for the transaction to be valid, there must be independent ratification, as defined above. It would be impossible to obtain independent ratification as 2 out of the 3 Directors will not be independent. Both Bob and Wanda, Bob's wife, stand to benefit from the self-dealing transaction, and it does not appear that there was full disclosure, so independent ratification is impossible.

Controlling Shareholders

Controlling shareholders have fiduciary duties to other shareholders in a corporation. As defined above, the controlling shareholder has a duty of loyalty and care as fiduciary duties.

As described above, Bob will have violated his fiduciary duty of loyalty to the corp. by engaging in a self-dealing transaction. In addition, courts have held controlling shareholders liable for looting a corporation in the event the corp. is substantially sold to a 3rd party and that party loots the company. It is not clear here what Sally will do.

Fundamental Change

A corporation must hold a special meeting when a fundamental change is proposed for that corporation. A fundamental change would include selling substantially all assets to another corporation. Therefore, the corporation would be required to have a special meeting.

A special meeting requires that a special notice be mailed to shareholders. This notice must include the reason for the special meeting, date and time, and place. It is important because no other business can be discussed at a special meeting that was not included in the notice. In addition, holding the meeting is important because it gives rise to appraisal and dissenter rights whereby the corporation would be required to repurchase a dissenter's shares.

Because Bob violated his fiduciary duties as a director and controlling shareholder, and because the corp. was undergoing a fundamental change without a properly scheduled special meeting, any sale to Sally would be voidable.

4. Ethical Violations

A. Duty of Loyalty

Al owes a duty of loyalty to the corporation. Al has drafted the incorporation of the corp. and has drafted agreements on behalf of the corporation. Therefore, Al's client is the corporation.

Al has a potential conflict in that he represented the corporation and then drafted the shareholder agreement and proxy on behalf of 2 shareholders. This is permissible under ABA rules and CA rules whereby an attorney can represent multiple parties if he reasonably believes that he can provide necessary legal services without impact. The attorney must also get this consent in writing.

Al has another potential conflict by representing Bob at a later time. As stated above, an attorney can represent multiple parties if he reasonably believes that representation of both will not impact either party. He must get consent in writing. Al would have violated his duty of loyalty if he did not get consent in writing.

This potential conflict would become an actual conflict when Bob has gone to Al for advice and Al agreed to provide it. Al previously represented Bob and Cate in drafting a shareholder agreement and proxies. CA Rules of Ethics strictly prohibits an attorney from representing a client when that client is being represented by the same attorney. Only when the matter ends can the attorney represent another client whose interest is adverse to a current client.

Al will have violated his duty of loyalty.

Duty of Confidentiality

An attorney has a duty to keep all communications with a client confidential. When an attorney represents 2 parties, and one party then approaches the attorney for representation on a similar matter, the attorney will not be able to represent the client because he has confidential information from both clients.

Here, Al arguably represents both parties, as he has drafted a shareholder agreement and proxy for both Bob and Cate. Al should advise both parties to obtain separate Legal Counsel instead of continuing to represent them, as by doing so, he may disclose confidential information received by Cate in representing Bob.

Duty of Competence

An attorney should have the skill and training to be able to competently represent a client. If not the attorney should be able to receive such training in a reasonable time.

In this case, as described above, it is not clear if the proxies were drafted correctly; therefore Al may have breached his duty of competence.

## Answer B to Question 5

**SHAREHOLDER AGREEMENT**

Shareholder agreements in which shareholders agree to vote their shares together are valid, although historically they were not permitted and voting trusts were required. They must be in writing and signed by both parties. Shareholder agreements are governed by regular contract principles, and are not revocable unless as a contract they would be revocable. A valid contract requires mutual assent and consideration. Bilateral contracts are contracts in which the parties exchange promises, and the promises can constitute consideration for the contract.

In this case, the shareholder agreement appears to be in writing, and signed by the parties. It was prepared by an attorney, Al, and so presumably has been validly drafted. In this case, the shareholder agreement is a mutual agreement for Bob and Cate to vote stocks together. It appears that there has been valid mutual assent to the contract, including offer and acceptance. Because the parties have exchanged promises to vote together, it is a bilateral contract. As a result, the contract is supported by consideration based on the exchange of mutual promises to vote together or have disputes decided by arbitration. Thus, Bob would be unable to revoke the shareholder agreement at will, and Cate could sue for damages or for specific enforcement of the agreement.

**PERPETUAL PROXIES**

PROXY GENERALLY - A proxy agreement must be in (1) writing, (2) signed by the party whose shares are affected, (3) addressed and delivered to the corporation's secretary, (4) clearly state they are delegating the authority to vote.

In this case, it appears that the requirements for a valid proxy agreement have been met. The agreement appears to be in writing, the problem notes it was executed so presumably is signed, it clearly states the procedures for the proxy, indicating that the

shares will be voted in line with the shareholder agreement. Although the facts do not indicate whether the proxy was filed with the corporation, because Al the attorney assisted, presumably the requirement was met.

IRREVOCABLE PROXY - A proxy is normally for a duration of 11 months, and will be revocable at will. To be irrevocable, a proxy must be (1) supported by an interest and (2) clearly state it is irrevocable.

In this case, it appears that the proxy agreement did state that it was irrevocable, and thus the agreement has met the second requirement. However, there is no indication that the agreement was supported by any interest. Normally, the interest must be some exchange for value or, for example, a situation where the record date holder sells his shares to the owner and executes a proxy, and thus the new owner's purchase creates an interest. In this case, there is no interest to support the agreement. Cate may argue that the exchange of promises provides consideration for the proxy in the form of the mutual promises, as was the case for the shareholder agreement, and therefore that the mutual promise is a sufficient interest to meet the element and make the proxy irrevocable. However, the exchange of promises is not a sufficient interest to support a proxy as being irrevocable because the promisor has no interest in the shares to which she is making a promise, and therefore this element has not been met. As a result, Bob is free to revoke the proxy agreement at will.

While the proxy agreement would be revocable because it is not supported by an interest, the shareholder voting agreement would not be. As a result, Cate could sue Bob to enforce the agreement and then Dave would have the power as the arbitrator to vote the shares under the agreement as he saw fit.

**WOULD SALE OF CORP BE VOIDABLE**

FUNDAMENTAL CORPORATE CHANGE - A fundamental corporate change includes a (1) merger, (2) consolidation, (3) amendment of the articles of incorporation, or (4) a

sale of all or substantially all of the business assets. A fundamental corporate change must be approved by a majority of all shareholders at a special noticed meeting in which notice of the change was given before the meeting. Additionally, the corporation must give dissenters rights of appraisal if the transaction is approved.

In this case, the sale of substantially all of Corp.'s assets is a fundamental change and thus must be approved by a majority of all shareholders in Corp.

DECISION OF DIRECTORS - All decisions of directors must either (1) be approved at a board meeting or (2) be approved by unanimous written agreement of the board. At a board meeting the majority of all directors must be present to have a quorum. A resolution will be adopted if a majority of the directors present approve. Before a fundamental corporate change is brought before a special meeting of shareholders, it must be approved by the board of directors.

In this case, the facts indicate that Bob and Wendy agreed to the sale, but that Cate disagreed. It is unclear if they met at a board meeting and the majority of directors, Bob and Wendy, approved. This would be a requirement that if not met, could lead to a rescinding of the transaction or allow Cate and other shareholders to sue Bob and Wendy for losses suffered as a result of the transaction.

DUTY OF LOYALTY OF DIRECTORS - A Director has a fiduciary duty of loyalty to a corporation to not engage in self-dealing or usurp business opportunities. Self-dealing includes transactions in which the director has a conflict of interest.

In this case, Bob is a member of the board of Corp, and thus has a duty to not engage in self-dealing.

CONFLICT OF INTEREST TRANSACTION - A conflict of interest transaction is one in which the director or his close relative is (1) a party to the transaction, (2) has a financial interest so closely linked to the transaction that would reasonably be expected to affect

her judgment, or (3) is a director, officer, employee or agent of the other party to the transaction and the transaction is of such importance that it would normally be brought before the board. If a Director enters into a transaction in which he has a conflict of interest without approval, that transaction can be rescinded and the director can be held liable for any losses to the shareholders.

In this case, Bob is engaging in a sale of Corp's assets to Sally, Bob's sister. Thus Bob, a director, is engaged in a transaction in which a close relative, his sister Sally, is a party to the transaction, and therefore Bob would have a conflict of interest in the transaction. Thus, unless Bob has the transaction approved, it could be rescinded. Furthermore, because Wanda is also a director, and Sally is also a close relative of hers, her husband Bob's sister, she would also have a conflict of interest.

CONFLICT APPROVAL - A conflict of interest transaction will be considered approved if (1) after full disclosure a majority of the disinterested directors, if more than one, approve; (2) after full disclosure a majority of disinterested shareholders approve; and (3) if it is fair under the circumstances.

DISINTERESTED SHAREHOLDERS - In this case, it is unclear if Bob fully disclosed. Even if he did, the transaction would not be considered to be approved by shareholders if Bob used his 51% of shares to approve the sale because he is not disinterested due to his conflict of interest created by his sister, Sally, being the purchaser. Thus, a majority of the outstanding, the remaining 49% would need to approve. Because Cate owns 30% of the shares, she could essentially block the transaction because she owns more than 50% of the disinterested shares. Thus approval by disinterested shareholders would not be possible.

DISINTERESTED DIRECTORS - Similarly, both Wanda and Bob are considered to have a conflict of interest. Therefore the only disinterested director is Cate. Cate would not approve the transaction and furthermore, for a transaction to be approved by the majority of disinterested directors there must be more than one disinterested director.

Thus, the directors could not approve the transaction because 2 of the 3, Bob and Wanda, are not disinterested.

FAIR - As a result, the only way the transaction could be upheld is if under the circumstances at the time it was entered into it was fair. In this case, Cate claims that the price is too low, but there is no indication if this is really the case. If Bob could show that the price was fair, and thus the transaction was fair then the conflict of interest transaction would be upheld despite the lack of approval from disinterested shareholders and directors.

ACTING AS SHAREHOLDER NOT DIRECTOR - Bob may argue that in voting to approve the sale he is acting as a shareholder, and not as a director and thus does not owe the same duties to the corporation. However, this argument will fail because (1) a director has a duty of loyalty to the corporation even when selling his own shares, and (2) Bob may also have a duty as controlling shareholder.

DUTY OF CONTROLLING SHAREHOLDER - While a shareholder is normally not liable beyond the value of their shares, a controlling shareholder may be liable towards other shareholders if she uses her power in a way to disadvantage the minority shareholders. This is because a controlling shareholder has a fiduciary duty to minority shareholders to not use their controlling share to the minorities' disadvantage.

In this case, because Bob owns 51% of the shares, he is a controlling shareholder. He has a fiduciary duty to not use his controlling share to gain unfair advantage over the minority shareholders. This would likely include selling substantially all of Corp.'s resources to his own sister, Sally, if the price was not fair. Thus, even if Bob is successful in arguing that he is not under a duty as a director when trading on his shares, as a controlling shareholder he would still be liable for breaching his fiduciary duty.

**AL'S VIOLATIONS**

DRAFTING ARTICLES AND SHAREHOLDER AGREEMENTS - When an attorney represents a corporation, he represents the organization itself and not the directors or officers. While an attorney may also represent the directors and officers separately, these representations are governed by normal rules of conflict of interest. A lawyer may represent two clients so long as he reasonably believes he can do so and that there is no conflict of interest between them. If there is a conflict of interest he must (1) reasonably believe he can adequately represent each of them, (2) disclose the conflict, under the Cal RPC such disclosure must be in writing, and (3) must get the clients' consent in writing. While potential conflicts of interest can be waived, actual conflicts normally may not be waived by the parties because a reasonable attorney would not believe they could represent clients with an actual conflict.

In this case, there is no conflict of interest, potential or otherwise, between Corp and its shareholders. Therefore, Al did not violate any rules by drafting the agreement.

**ADVISING BOB** -

CONFLICT BETWEEN BOB AND CATE-

CURRENT CLIENTS- As noted previously a lawyer may not represent one client who has a conflict of interest with another client unless (1) the lawyer reasonably believes he can adequately represent each of them, (2) the lawyer discloses the conflict, under the Cal RPC such disclosure must be in writing, and (3) the client consents in writing. While potential conflicts of interest can be waived, actual conflicts normally may not be waived by the parties because a reasonable attorney would not believe they could represent clients with an actual conflict.

In this case, it is unclear who Al represented in the drafting of the shareholder agreement and whether or not he continues to represent Cate. If Al does represent Cate

then agreeing to represent Bob in this matter constitutes a current conflict between clients, and Al would have to provide written disclosure and receive written consent. However, even if he did he would not be able to maintain representation because a reasonable lawyer would not believe he could adequately represent both Cate and Bob because their conflict is not just potential, it is an actual conflict.

FORMER CLIENTS- A lawyer may not represent a current client (1) in a matter that is the same or substantially the same as a matter he represented a former client, and (2) the current client's interests are adverse to the former client unless he gets written consent from the former client.

In this case, if Al represented Cate in drafting the shareholder agreement and proxy agreement then he would likely be in violation of this rule. Cate is a former client, and the matter now in dispute is whether the very agreements Al drafted for Cate are valid, and thus it is the same matter. Furthermore, Bob's position, that the agreements are not binding, is directly in conflict with Cate's interest. As a result Al could not represent Bob without Cate's approval because doing so would be in violation of his duty of loyalty to a former client.

Al could also be disqualified if he had gained confidential information in representing Cate, though that is unlikely here, considering he was drafting a shareholder agreement.

**ESSAY QUESTIONS AND SELECTED ANSWERS**
**FEBRUARY 2012**
**CALIFORNIA BAR EXAMINATION**

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# Question 4

Testco, Inc. conducts market surveys, and is solely owned by Amy, Ben, and Carl. Each paid $50 for one-third of Testco's no-par shares. Amy and Ben, respectively, are Testco's president and secretary and its only two directors. Carl holds no office and is not involved in any aspect of Testco's business. Amy and Ben are scrupulous about holding directors' meetings to conduct corporate business and to make monthly distributions to the shareholders of almost all cash on hand. As a result of the latter practice, Testco has little cash on hand and frequently finds itself in the position of negotiating extensions for payment of its debt.

While Ben was on vacation, Examco called Amy, asking to enter into a one-year contract with Testco. Amy said that if Examco would agree to a ten-year contract, Testco would grant its standard fifty-percent discount. Examco agreed, and Amy signed the contract in the following manner: "Testco, by Amy, President." When Ben returned, he said that he had thought for some time that Testco's standard fifty-percent discount was unwise, and convinced Amy to revoke the contract with Examco.

Examco wants to sue Testco, Amy, Ben, and Carl for damages. If found liable, Testco will not be able to pay.

On what theory or theories may Examco bring an action for recovery of damages against:

1. Testco? Discuss.

2. Amy, Ben, and Carl as individuals? Discuss.

# QUESTION 4
## Answer A

**Examco v. Testco**

Breach of Contract

If Testco is to be found liable to Examco, it will be on a breach of contract theory. Breach of contract occurs where there is a valid contract, a breach, and then damages as a result of the breach. A valid contract exists when there is an offer, acceptance, consideration, and no defenses to contract formation.

Here, Examco asked Amy to enter into a ten-year contract, which Amy then signed on behalf of Testco. Amy agreed that in consideration for the length of time of the contract, that she would give Examco a fifty percent discount. Thus there was a valid contract between both Examco and Amy on behalf of Testco.

A breach of the contract occurred when Amy anticipatorily repudiated the contract between the two companies. It is likely that Examco will receive damages as a result of not getting the benefit of their bargain with Testco; thus there is a valid action for breach of contract. However, Testco will only be bound to this contract if Amy had authority to enter into the agreement with Examco (see below).

Agency

Agency is where a principal with capacity manifests assent that an agent act on behalf of the principal for its benefit and subject to its control followed by the agent manifesting assent to do the same. Here, Amy as president of Testco was an agent of the company since she was appointed to the position of president (assent), working for the benefit of the company, and subject to the control of the board of directors. Thus

Amy was an agent of Testco and Testco will be liable on the contract with Examco if she had some form of authority to enter into the contract.

Amy's Authority

A principal is liable on the contracts entered into by their agent on their behalf so long as the agent has authority. Authority can come in three forms: actual authority, apparent authority, and ratification.

Actual Authority

Actual authority is the authority that the agent reasonably believes that they have based upon the manifestations of the principal. Actual authority can be express or implied.

Express Actual Authority

Express actual authority is the authority given from the four corners of the agency agreement.

Here, there is no agency agreement between Amy and Testco; however, there is probably some sort of express manifestation of assent in the bylaws or articles of incorporation of Testco. Usually in the corporate setting, when a contract such as this is entered into, the board of directors will usually vote to pass a resolution to give the president of the company the authority to enter into the contract. However, there was no such board resolution here since Amy did not consult with Ben prior to signing the contract. Since there are no facts going to express authority, a different form of authority must be found to bind Testco to the contract with Examco.

Implied Actual Authority

Implied actual authority is the authority that the agent reasonably believes that they have based upon necessity in order to carry out their express authority, customs of the position held by the agent, and by prior dealings with the principal.

Here, Amy, as president of Testco, would likely have implied actual authority to enter into the Examco contract by virtue of her position as president of the company. Presidents of corporation[s] customarily have the authority to enter into binding contracts with other companies. Additionally, it is necessary for a president to enter into contracts with other companies in order to make the corporation profitable. Making the corporation profitable is a duty of the president of the company and thus it is necessary that Amy entered into this contract in order to fulfill that duty.

Testco will argue that, although Amy was president and had authority to enter into smaller contracts, this contract was different in the fact that it went ten years into the future and that Amy was giving such a huge discount. Testco will argue that this sort of contract required express board resolution and thus Amy could not have reasonably believed to have authority to enter into it. However, the facts state that Amy gave the "standard fifty-percent discount;" thus it seems like this was a regular occurrence of the corporation to enter into contracts of this nature. As such there was implied actual authority.

Apparent Authority

In the event that the court finds that there was no actual authority, they could find apparent authority to bind Testco to the contract. Apparent authority is the authority that a third party reasonably believes that the agent possesses based upon the manifestations of the principal. One form of manifestation by the principal would be the position that the principal has placed the agent in is a position that is usually associate[d] with the grant of authority.

Here, Examco can successfully argue that Amy had apparent authority do [sic] to her title of president of Testco. When they were entering into the contract they dealt

directly with the president of the company. Additionally when the contract was signed, it was signed "Testco, by Amy, President". As such, it would have been reasonable for Examco to believe that Amy had apparent authority to enter into the contract.

Ratification

Another form of authority is ratification. Ratification occurs where after the agent has entered into a contract, the principal has knowledge of it and accepts its benefits. Here, when Amy told Ben about the contract, he told her to immediately revoke it. Thus there was no board resolution ratifying the contract with Examco and there will be no finding of authority based upon ratification.

Conclusion

Since there is at least the finding of apparent authority on behalf of Amy for Testco, Testco is bound to the contract with Examco and will be liable to them on a theory of breach of contract.

**Examco v. Amy, Ben, and Carl as Individuals**

Liability of Shareholders

Shareholders of a corporation are only personally liable for the cost of their shares of stock in the corporation. They are not personally liable for the corporation's debts, liabilities, or obligations. Thus, Amy, Ben, and Carl will not be liable to Examco personally unless the corporate veil can be pierced (see below).

Piercing the Corporate Veil

In order to recover from the personal assets of the shareholders of Testco, Examco will have to make a sufficient showing to pierce the corporate veil. The corporate veil is pierced based upon a variety of factors. These factors include whether

there was fraudulent conduct by the shareholders, whether the corporation is undercapitalized, whether the corporation is simply an alter ego of the shareholders, and whether the creditor of the corporation is an involuntary creditor.

Fraud

Fraud is the misrepresentation of a material fact known to be false with the intent to induce some action upon another where the other suffers damages. Here, the facts do not suggest that Amy made any misrepresentations when entering into the contract with Testco; thus a pierce of the corporate veil will not be achieved on the ground of fraud.

Alter-Ego

A corporation acting as the alter ego of the shareholders will be found where the shareholders forgo the usual formalities of corporate status. Here, Testco has officers and a board of directors; however, the facts state that Amy and Ben are "scrupulous" about holding director's meetings to conduct business. Thus it could be seen that they have foregone the formalities of a usual corporation. Thus this factor weighs in favor of a pierce of the veil.

Undercapitalization

Undercapitalization of a corporation occurs where the corporation does not keep enough surplus cash on hand in order to pay the foreseeable liabilities of the corporation. Here this factor weighs heavily on favor of piercing the veil since all of the extra cash on hand was distributed to the shareholders. It was foreseeable that eventually a contract would be breached or some mistake would be made causing liability on behalf of Testco. Thus since there was not enough cash on hand to pay the liability to Examco, the veil may be pierced.

Involuntary Creditor

An involuntary creditor is usually a tort victim or tort judgment holder. Here, Examco had every opportunity to inspect records and the financial security of Testco prior to entering into the contract. Thus they were not an involuntary creditor.

Carl's Liability

Usually a shareholder that is uninvolved with the daily operations of the company will not be held liable as a result of veil piercing. Here, Carl did not participate in any of the activities of Testco except to receive distributions from the company. Thus he may or may not be held liable to Examco.

Conclusion

The factors presented above weigh in favor of piercing the corporate veil; thus Examco may go after the shareholders of Testco, with the possible exception of Carl.

# QUESTION 4
## Answer B

The remedies that are available to Examco for Testco revocating their agreement depend on the legal status of the agreement and whether Amy had the authority under agency principles to bind Testco to the agreement if it can be legally enforced. The agreement concerns money which is proper consideration from Examco to Testco for providing its market survey services. There were negotiations between both parties regarding the price and discount that would be offered as well as the length of the contract. Both parties agreed on the 10 year terms and the 50% discount. Amy signed the contract. This is enough to create a legally enforceable contract if Amy had the authority to enter into contracts on behalf of the corporation — this is determined by principles of agency which I now analyze.

Amy as Agent of Testco

An agent is a person or entity that acts on behalf of another, the principal. For an agency relationship to exist there must be assent by the agent to the existence of the relationship and its duties, the agent must act for the benefit of the principal, and the principal must control the agent's actions on its behalf.

Here Amy is the President of the corporation. She has assented to the relationship by accepting this employment and the duties and privileges (e.g., salary, benefits) that come along with it. She acts for the benefit of the corporation in this capacity. This is because by virtue of her position in the management of the corporation as an officer she has a Duty of Care to the corporation and must act in good faith and as a reasonably prudent person would with his or her own business. Further, in addition to this Duty of Care she also has a Duty of Loyalty whereby she must act in the best interest of the corporation before all others including herself. These duties insure that Amy's actions should be for the benefit of the corporation in all actions she does on its behalf. Third, the corporation itself has control over Amy. This is because Amy is an employee of the corporation and serves at the will of the board of directors and at its direction. Her

employment can be terminated at any time by the board or shareholders (by majority vote at a meeting or special meeting).

Because the three prongs of agency have been satisfied, Amy is an agent of the corporation. As such, she may be able to bind the corporation to agreements depending on whether she has the appropriate authority to do so.

Actual Express Authority

Actual express authority is the authority that is expressly given to an agent by a principal for some particular task. This authority can be orally conveyed or it can be in writing. According to the equal dignity rule, if a writing would be required for the transaction or action at issue if the principal were to act directly for himself instead of through his agent, the principal is required to expressly give the agent express written authorization to undertake the action on the principal's behalf.

There is no factual information to suggest that Amy had either oral or written actual express authority to enter into contracts on behalf of the corporation. Further, even if the board or shareholders expressly passed a resolution stating that Amy had such authority, or that the President of the corporation has such authority, the resolution and authorization it granted must be in writing. This is due to the equal dignity rule. Because the contract that was actually signed by Amy called for her firm's services to be rendered over the course of 10 years, the Statute of Frauds requires a signed writing (because performance necessarily will take longer than one year by the terms of the contract). Amy herself signed such a writing. However, there is no evidence to suggest that the board gave her such written authorization.

Thus, Amy did not have actual express authority to enter into the contract on behalf of Testco on the basis of the factual information given. However, she may have had implied authority to do so.

Actual Implied Authority

Actual implied authority is that authority which is necessary for it to carry out its expressly authorized actions and in fact was implied from that authorization, or authority that comes with virtue of the position the agent has with respect to the principal and the duties associated with this position.

Here if Amy had received express authority from the board to manage all sales regarding Testco's service contracts, she would have the implied authority to enter into a contract with Examco at terms that she determined because such authority is necessary to manage all sales of service contracts. However, since there is no evidence of an express authorization this prong of implied authority will not suffice.

The second possibility that will give rise to implied authority is if the agent by virtue of his or [her] position and the duties associated with such a position has authority to enter into a contract. Here Amy has been appointed by the board of directors of Testco as its president. As such, she is the chief executive officer of the corporation and is responsible for overseeing all day-to-day operations of the corporation. By virtue of this position and the duty that comes with it — to manage the corporation — Amy has the implied authority to act on the corporation's behalf in her management of the corporation.

Thus, when she signed the contract with Examco she was acting with the implied authority granted to her by virtue of her position as president charged with management of the company. On this basis, Testco can be held liable for a breach of contract.

Apparent Authority

Apparent authority is the authority that arises when a third party reasonably believes that the agent has such authority because the principal "cloaked" the agent with the appearance of such authority.

Here Amy is the president of the corporation. She holds herself out as such when she entered into the contract with Examco. By virtue of permitting Amy to negotiate such service agreements, which appears to be the case given Ben's objection to the usual 50% reduction, Testco was holding her out to third parties as having the authority to enter into such agreements. Further, Amy signed the contract with Examco as "Testco, by Amy, President." Acting in the cloak of authority given to her by Examco by virtue of her ability to negotiate sales service agreements with customers and by virtue of the apparent authority she has as Testco's president, she had the apparent authority to bind the corporation when contracting with a third party, here Examco, who reasonably believed she had such authority.

Thus, because Amy had the implied authority and apparent authority to enter into this contract on Testco's behalf and she did so, Testco is liable for breach of the contract by its revocation. Examco can seek damages directly against Testco.

2) The determination of whether there is liability for Amy, Ben, and Carl will depend on whether there is director liability for Amy and Ben in their capacities as directors and officers of the corporation. And for all three, Amy, Ben, and Carl based on whether the veil can be pierced for purposes of their limited liability.

Piercing the Veil

Directors, managers, and shareholders are generally not liable for their actions to a third party that is suing the corporation. That is true, unless the corporate veil that insulates them from liability can be pierced. Piercing of the corporate veil is an extraordinary remedy that is only awarded when the directors, officers, and shareholders do not provide for sufficient capital or insurance for the corporation's debts and where the corporation is but an alter ego of the shareholders. The latter can be established in part by the officers and managers not observing sufficient corporate formalities.

Undercapitalization

Directors are not permitted to make a dividend distribution that puts the corporation at risk for insolvency. In fact, the prohibition against this is so strong that the directors will be personally liable for such a distribution unless they believed the corporation was not at risk of insolvency based on the financial officer's report which they are allowed to reasonably rely upon.

Amy and Ben

Here Amy and Ben voted in favor of making monthly distributions that put little cash on hand and leading to the corporation needing to negotiate extensions for payment of its debt. This put the corporation at risk for insolvency because if a large judgment came through or one of its creditors was unwilling to renegotiate its payment terms. Amy and Ben as shareholders and directors did this to benefit themselves at the expense of the corporation. This violated their duty of loyalty to act in the best interests of the corporation above even their own. They did not do this because they held 2/3 of the shares and put the corporation at risk of insolvency merely to line their own pockets with distributions. This would also violate their duty of care to the corporation because they would not put themselves at such risk of insolvency in the management of their personal business. This undercapitalization will lead to Examco likely not being able to recover its damages for breach of its contract. It should be permitted to recover its expectation damage measure, the amount it reasonably expected to profit from the agreement at the time it was entered into.

Courts are more likely to pierce the veil for a tort action than they are for a contract dispute.

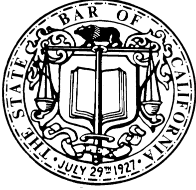
Here we have a contract dispute between a corporation and another corporation. It is due to the fact that Amy and Ben determined that the contract would not be profitable. While normally this would not be such an egregious breach, because it may lead to an overall benefit if the breach was efficient, here it is especially so because Amy and Ben

have undercapitalized the corporation and there are likely no assets which Examco can reach when it successfully sues. As such, the court should pierce the corporate veil to allow Examco to recover the impermissible cash distributions that Amy and Ben had been awarding themselves and would otherwise be available.

<u>Carl</u>

While Carl is also a shareholder and normally his 1/3 interest in the corporation would be sufficient to raise him to the status of a controlling shareholder, here he does not have such control. Amy and Ben are the only two officers, the only two directors, and when combined they hold a 2/3 interest in the corporation as shareholders. Carl is merely a passive investor that is not involved in any aspect of Testco's business. He merely invested $50 in no-par stock in a venture run by Amy and Ben. As such, while the veil should be pierced for Amy and Ben as to their shareholders' limited liability but should not be for Carl because he committed no improper acts and was merely a passive investor.

<u>Limited Liability</u>



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# ESSAY QUESTIONS AND SELECTED ANSWERS

## FEBRUARY 2013

## CALIFORNIA BAR EXAMINATION

This publication contains the six essay questions from the February 2013 California Bar Examination and two selected answers to each question.

The answers received good grades and were written by applicants who passed the examination. The answers were prepared by their authors, and were transcribed as submitted, except that minor corrections in spelling and punctuation were made for ease in reading. The answers are reproduced here with the consent of their authors.

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## Question 6

In 2011, Molly and Lenny started a computer software business. Molly prepared marketing materials and Lenny made sales calls. During the first year, Lenny sold 10 copies of certain software programs for $50,000 each. The business had a net profit of $480,000 and Molly and Lenny each received $240,000.

In January 2012, Molly and Lenny hired an attorney to incorporate their business under the name "Software Inc." The attorney properly prepared all necessary documents to incorporate the business but carelessly failed to file them with the Secretary of State.

Lenny continued to make sales calls to sell the software. He also sold a five-year service contract developed by Molly. Due to brisk sales, Software Inc. projected income of about $300,000 per year for the next five years from the service contracts alone. Software Inc. obtained a $100,000 business loan from National Bank secured by the accounts receivable for the service contracts.

In May 2012, Lenny had an automobile accident, caused solely by his own negligence, on the way to visit a prospective buyer. The accident injured a pedestrian. As a result of the accident, Lenny stopped working and sales collapsed.

In July 2012, Software Inc. went out of business, leaving negligible assets and the unpaid loan to National Bank.

1. Is Software Inc., Molly, and/or Lenny liable to the pedestrian for the injury? Discuss.

2. Is Software Inc., Molly, and/or Lenny liable to National Bank for the loan? Discuss.

# ANSWER A TO QUESTION 6

## I. Liability to the Pedestrian

### A. Lenny's Liability

This issue is whether Lenny is liable to the pedestrian for the automobile accident.

Generally, persons are liable for their own negligent conduct. While employers can be vicariously liable (discussed below) for an employee's tortuous conduct, this liability is in addition to the employee's liability. However, if an employee was acting within the scope of their employment, to further the goals of the business, they could seek indemnification from the business.

Here, Lenny had an automobile accident, caused solely by his own negligence, on his way to visit a prospective buyer. The accident injured a pedestrian. Lenny will most likely be liable for the damages he caused. However, because he was on his way to visit a prospective buyer, Lenny could seek indemnification from Software Inc., because he was driving solely for the purpose of furthering Software's business by attracting a new buyer. In addition, his conduct was negligent, rather than intentional, which would prohibit indemnification. If, because of a failure to incorporate (as discussed below), Software Inc. is not actually a valid corporation, Lenny could still seek indemnification from the partnership between him and Molly, since he was still acting in furtherance of Software, the partnership (also discussed below). However, given Software's negligible assets, and its debt to National Bank, there may not be much to seek indemnification from.

Therefore, Lenny is liable to the pedestrian, but may be able to seek indemnification from Software, Inc.

**B. Software Inc.'s, Vicarious Liability**

This issue is whether Software Inc. is vicariously liable for Lenny's tortuous conduct.
A corporation/partnership/principal can be vicariously liable for the tortuous conduct of its agents if those agents act in furtherance of the principal, under the principal's control, and with the principal's express, implied, or apparent authority.

Here, Lenny had an automobile accident, caused solely by his own negligence, on the way to visit a prospective buyer. By driving to visit a buyer, it appears clear that Lenny was acting in furtherance of Software Inc. While Software Inc.'s corporation or partnership status will be discussed below, it is clear that Lenny was functioning as both a principal and as an agent. He was a principal in the sense that he was expressly authorized to make sales calls and presumable visit prospective buyers given that he started the computer software business and that he and Molly agreed to divide the work as such. He was an agent acting for the benefit of Software Inc. in driving to meet the buyer and further Software Inc.'s goals of collecting buyers.

Therefore, regardless of Software Inc.'s status, Software Inc. is probably vicariously liable for Lenny's tortuous conduct.

**C. Molly's Liability**

**1. De Facto Corporation**

This issue is whether Software Inc. had a de facto corporation status, such as to shield Molly from personal liability for Lenny's tortuous conduct.

A corporation is a unique organizational framework for a business, in which management is centralized, and shareholders enjoy limited liability. A corporation must file its articles of incorporation with the Secretary of Interior in order to be a valid corporation, and thus to enjoy this limited liability. However, a corporation that does not

file its articles of incorporation may nevertheless enjoy limited liability via de facto corporation. A de facto corporation 1) attempted to incorporate in good faith, 2) is otherwise eligible to incorporate, and 3) subsequently acted like a corporation in good faith.

In January 2012, Molly and Lenny hired an attorney to incorporate their business under the name "Software Inc." However, while the attorney properly prepared all necessary documents to incorporate the business, he carelessly failed to file them with the Secretary of State. It does not appear that Molly or Lenny knew that the attorney had failed to file the documents. Instead, Molly and Lenny continued to make sales and sell the software. In fact, they obtained a business loan from National Bank secured by its accounts receivable, thereby acting like a corporation in which corporation debts are secured by corporation profits. By hiring an attorney, and subsequently acting like a corporation, it appears that Molly and Lenny attempted to incorporate in good faith, and later acted as if they were a corporation in good faith, with no knowledge (or should have had the knowledge) that they were not actually a corporation. In addition, Software Inc. appears otherwise eligible to incorporate, but-for the failure to file the documents with the Secretary of State.

Therefore, it is possible that Molly will be shielded from liability if Software Inc. has de facto corporation status.

**2. Piercing the Corporate Veil**

This issue is whether Molly can be personally liable if the pedestrian pierces Software Inc.'s corporate veil.

Shareholders of a valid corporation may nevertheless be personally liable for corporation debts if the corporate veil is pierced. Courts allow a corporation's veil to be pierced when it is clear that there is such a commonality between the corporation and the shareholders, that the shareholders are actually the "alter ego" of the corporation,

and to not permit piercing would sanction a grave injustice. Failing to comply with corporate formalities and insufficient capitalization are common reasons courts have pierced a corporation's veil.

Here, if Software Inc. has de facto corporation status, Molly can be shielded from liability, unless Software Inc.'s corporate veil is pierced. There is no evidence that Molly and Lenny intentionally aimed for Software Inc. to act as their corporate alter ego. However, there is evidence that Software Inc. was severely under-capitalized. In 2011, Molly and Lenny made a net profit of $480,000. However, instead of investing any of that profit back into the business, they instead each received $240,000. In 2012, Software Inc. sold a five-year contract, and projected an income of $300,000/year based just on service contracts. In addition it took out a $100,000 loan. However, in July 2012, after Lenny stopped working for just two months, Software Inc. had only negligible assets AND its unpaid loan. It appears that either Molly and Lenny were taking dividends when the corporation could not pay its debts, or that Software Inc. was otherwise severely under-capitalized. Further, there are no facts to suggest that Molly and Lenny abided by any corporate formalities, such as holding a general meeting, issuing bylaws, or keeping accounting books. However, there is no information that they did not do these things either.

Therefore, it is possible that the pedestrian can pierce Software Inc.'s corporate veil and hold Molly personally liable.

## 3. General Partnership

This issue is whether if Software Inc. does not have a corporation status, they are instead a general partnership, and Molly can be held personally liable thereby.

A general partnership is a partnership between two or more people to go into business together. The formation of a general partnership only requires the intent to form a partnership. No documents need to be filed with the Secretary of State, unlike a limited partnership, a limited liability corporation, and a corporation. A general partnership only includes general partners who are personally liable for the debts and obligations of the partnership. The equal sharing of profits is presumptive evidence that parties intended to form a general partnership.

In 2011, Molly and Lenny started a computer software business. Molly prepared marketing materials and Lenny made sales calls. At the end of the year, the business had a net profit of $480,000, and Molly and Lenny each received $240,000. In 2012, Lenny and Molly continued to operate their software business in apparently the same way, with the same division of labor, as they had in 2011. They attempted to form a corporation, but their attorney negligently failed to properly file the forms. By sharing the profits equally in 2011, Molly and Lenny appeared to have presumptively formed a general partnership. In 2011, it appears that they operated as a general partnership, with an equal, but distinct division of labor. By sharing the profits, they implicitly agreed to also equally share the business's obligations, should there be any. When the attorney failed to incorporate Software, and assuming that Software is unsuccessful in obtaining de facto corporation status, Molly and Lenny continued to have a general partnership. It does not matter that they never formally agreed to form a partnership. Their sharing of the profits equally makes their relationship a general partnership until they agree otherwise. Thus, if Software Inc. does not have de facto status, Molly will be liable as a general partner. However, she will only be liable to the extent the business is without funds.

Therefore, Molly can be liable as a general partner.

## II. Liability to National Bank

### A. Software Inc.'s Liability for the Loan

This issue is whether Software Inc. is liable for the loan to National Bank.

Generally, corporations and partnerships are liable for the debts incurred during the normal course of business.

Here, National Bank issued a $100,000 business loan to Software Inc., secured by Software Inc.'s accounts receivable. If Software Inc. has de facto status, then the loan was authorized by the corporation. If Software Inc. is a partnership, the loan was similarly taken during the course of business, for the purpose of the partnership, and was authorized by the partners. Regardless of Software Inc.'s status, the loan was received by Software, which subsequently enjoyed the benefits of the loan, and will thereby be held to have at least ratified the loan by accepting the loan.

Therefore, Software Inc. is liable for the loan, regardless of its status.

### B. Lenny and Molly's Liability for the Loan

#### 1. De Facto Corporation

This issue is whether Lenny and Molly can escape personal liability through de facto corporation.

This rule is discussed above, in section I.C.1.

Because Lenny and Molly made a good faith attempt to incorporate, and acted in good faith as if they were incorporated, they potentially could receive de facto corporation status, and thereby its included limited liability.

Therefore, Lenny and Molly could escape liability through de facto status.

**2. Corporation by Estoppel**

This issue is whether Lenny and Molly can escape personal liability through corporation by estoppel.

Even if a corporation fails to properly file its articles of incorporation with the Secretary of State, and even if a corporation fails to receive de facto corporation, a creditor may nevertheless be estopped from denying the existence of a corporation. If a creditor treated a corporation as such, and looked to corporate assets in making a loan, a corporation can be protected though corporation by estoppel.

Here, Software Inc. projected income of about $300,000/year for the next five years from its service contracts. National Bank provided Software Inc. a $100,000 business loan secured by the accounts receivable for the service contracts. National Bank believed Software, Inc. was a valid corporation. They could have done their due diligence to verify their corporation status. Further, National Bank only looked to Software Inc.'s assets, not Molly or Lenny's, in determining whether to issue the loan. Finally, they issued a business loan, underpinning National Bank's focus upon Software as a corporation. Because they treated Software as corporation in issuing the loan, they will be estopped from denying Software's corporation status in attempting to collect on the loan.

Therefore, Molly and Lenny could escape personal liability through corporation by estoppel.

**3. Piercing the Corporation Veil**

This issue is whether even if Software Inc. has de facto or corporation by estoppel, National Bank can go after Molly and Lenny personally by piercing the corporate veil.

This issue is discussed above, in section I.C.2.

Because Lenny and Molly failed to properly capitalize Software Inc., it is possible that National Bank could similarly seek to pierce Software's corporate veil.

Therefore, Molly and Lenny could be personally liable for the loan thru piercing the corporate veil.

**4. Liable as General Partners**

This issue is whether if there is corporate status, Lenny and Molly are liable as general partners.

This issue is discussed above in section I.C.3. General partners are personally liable for the remaining debts of the business.

Because Lenny and Molly originally functioned as a general partnership, if Software Inc. does not have corporate status, Lenny and Molly will be held to be general partners. Just as general partners get to share profits equally, they also must share the obligations equally.

Therefore, Molly and Lenny will each be liable for one half of the remaining obligation on the loan to National Bank.

# ANSWER B TO QUESTION 6

**Liability towards Injured Pedestrian:**

**Software Inc. v. Pedestrian**

**De Jure Corporation:**

A de jure corporation is one that is properly formed. To form a de jure corporation the parties have to prepare the necessary documents required by the state for incorporation. Here, Molly and Lenny did not create a de jure corporation due to the fact that their attorney carelessly failed to file the documents. The fact that the corporation was not created does not mean that there are not other corporate like entities that could have arisen.

**De Facto Corporation:**

Molly and Lenny's strongest argument would be that they created a de facto corporation. A de facto corporation is where the parties take all the necessary steps to incorporate, but for some reason their attempt to incorporate was unsuccessful. If the parties have a good faith belief that a corporation was formed a court can find that a de facto corporation was created, which gives the parties all the same benefits and obligations that would arise under a normally created corporation. Based upon these facts a court would most likely find that a de facto corporation was created, Lenny and Molly took all the necessary steps to create a corporation and held themselves out to be a corporation and if it were not for the carelessness of their attorney in filing the paperwork they would be considered a corporation.

## Liability of Shareholders in a De Facto Corporation:

Now that it is found that a de facto corporation was created we look to see if it is liable towards the pedestrian for the injuries suffered. The bonus of a corporation is that it protects its shareholders from liability, and therefore if a de facto corporation was formed Software Inc. might be liable for the injury, and possibly Lenny as it was caused by his negligence but Molly would be shielded from liability beyond what she had invested in the company.

## Liability of a Corporation for Damages Caused by its Agents

A corporation can be liable for damages caused by its agents during the scope of their employment. In a corporation directors and officers are considered agents of the corporation and this is further demonstrated by the fact that they had the ability to bind Software Inc. to contracts and that they seemed to be the only two people working for the corporation. If the damages were created completely outside of the scope of their employment then a corporation will not be found to be liable for the damages but here based upon the facts Lenny was going to visit a prospective buyer and his driving to the meeting was within the scope of his employment.

What the corporation would have to argue is that while the accident occurred on his way to the meeting it did not benefit from Lenny's reckless driving and therefore the corporation would not be liable because the accident was caused by Lenny's negligence. This argument would most likely fail because a corporation can be held liable for negligent acts by their employees if they are not wandering too far from the scope of their employment and since Lenny was on the way to the meeting he was not wandering outside of the scope of employment and therefore the corporation can be held liable for the injuries caused to the pedestrian.

**Lenny v. Pedestrian**

The question would be whether Lenny could also be held liable due to his negligent acts. The Pedestrian would argue that Lenny negligently caused the injuries that he suffered and while as a SH of the corporation he might not be held liable he could still be held liable for negligently driving and causing the accident. The fact that Lenny was working in furtherance of the business interests of the corporation does not mean that he could not be held liable separately. Due to the fact that the accident was caused solely by his negligence Lenny could be found liable for the injuries to the plaintiff along with the corporation.

**Molly v. Pedestrian**

If a de facto corporation is formed then Molly cannot be held personally liable for the actions of the agents of the corporation. The only time a shareholder can be liable is if the plaintiff is able to pierce the corporate veil by showing that the corporation was merely an alter ego of the party or that it was underfunded. This is not the case here and therefore Molly would not be liable if a de facto corporation was formed.

**General Partnership:**

If the courts find that no de facto corporation was formed then Molly and Lenny would be in a general partnership with one another. A general partnership arises when two people agree to enter into a business venture for profit. That is demonstrated by the fact that previous to their attempted incorporation Molly and Lenny worked together selling software equipment and that they equally split their profits between each other. Under a general partnership the partners are not protected from liability like a shareholder of a corporation is. Therefore, if a general partnership is formed and a party brings a suit against one partner for damages arising out of their work for the partnership then all partners are personally liable for any award against the partnership. Therefore, unless Molly was able to argue successfully that Lenny's actions were

outside of the scope of the partnership then she would be held personally liable for any damages that are caused by the actions of Lenny. Because it does not seem likely Molly would be able to successfully argue that his actions were outside of the scope of employment, both Molly and Lenny would be personally liable for any injury suffered by the other party due to Lenny's accident.

**Liability towards National Bank for Loan:**

**Corporation by Estoppel:**

Even if a de facto or de jure corporation is not formed Molly and Lenny could argue that a corporation by estoppel was formed. Their argument would be that even if they were not a corporation the fact that National Bank dealt with them as if they were a corporation would estop them from denying that they were a corporation and holding the shareholders personally liable.

**Software Inc. would be Liable**

Software Inc. would be liable for the loan obtained from National Bank. The loan was taken out by them as a corporation and there does not seem to be any evidence to demonstrate that it was taken out for anything other than proper purposes. National Bank would try to argue most likely that Software Inc. is not liable for the loan because at this time Software Inc. only has negligible assets and therefore this would not provide much capital to repay the loan to National Bank.

Most likely Software Inc. would not be attempting to escape liability as they are already out of business and only have negligible assets so a recovery against them would not harm the corporation. This could lead National to make an argument to pierce the corporate veil because of undercapitalization but this argument would fail because the business was not undercapitalized; instead it was not able to fulfill the contract which was the basis on which National Bank loaned the money to them.

Because Software Inc. took out the loan and there is no evidence that it was used for any purposes other than to help the company they will be found liable to the bank for the loan and therefore National Bank will be able to bring an action against Software Inc., even though there is little for them to recover.

**Molly would not be Liable**

Unless a general partnership was formed as discussed above Molly will not be liable for the National Bank loan. The fact that National Bank acted as if it was dealing with a corporation would stop it from then asserting that it was in actuality a partnership and so therefore Molly would not be liable under a theory that it was merely a partnership.

As a shareholder in a corporation she is protected and there is no evidence to show that she did anything that would cause her to not be protected. National Bank might try to argue that it based its loan based upon the accounts receivable from the service contract developed by Molly but this argument would fail. She created the service contract within the scope of her employment and there is no evidence to show that she was at fault in any way for the failure of the business. Due to the fact that National Bank would not be able to show that Molly did anything that would make her liable for the losses suffered by Software Inc., a court would not find her liable to National Bank and she would therefore be safe.

**Lenny would not be Liable**

Due to the fact that Software inc. left negligible assets when it went out of business for National Bank to collect on they would most likely go after Lenny for the damages. Their argument would be the fact that the reason for the failure of the corporation was the fact that Lenny stopped working due to the car accident. They would argue that he was the person that created the revenue for the corporation through his sales calls and once he stopped working Molly did not have the experience

to continue running the business profitably and therefore by Lenny's actions the corporation went out of business. They would argue that his quitting was not in the scope of his employment and that it was in no way beneficial to the business and they would therefore argue that Lenny should be liable because their loss is due to Lenny's decision to not return to work.

Lenny would argue that even if his failure to go to work was the cause of the business to fail that does not make him liable for the debts entered into by the business. There is nothing here showing that Lenny or Molly did anything improper in obtaining the loan and that the loan was made with the corporation based upon the assets of the corporation and therefore Lenny should not be held liable.

Even though it seems like National Bank has an argument based upon the fact that the sole reason that the business failed was the fact that Lenny stopped going to work, this would not be sufficient to create liability on Lenny's behalf because the bank loan was entered into by Software Inc. and not with Lenny. Additionally, Lenny could argue that the loan was based solely upon the service contracts and not the sale of products, which was his main area of involvement. Alternatively, National Bank will argue that while it might have been prepared by Molly, Lenny was the one that sold the service contract and therefore it was his area of involvement. Even if the court found this they still would not find that Lenny had acted sufficiently in bad faith to find that he was liable to National for the loan.

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# ESSAY QUESTIONS AND SELECTED ANSWERS

## JULY 2014

## CALIFORNIA BAR EXAMINATION

This publication contains the six essay questions from the July 2014 California Bar Examination and two selected answers for each question.

The answers were assigned high grades and were written by applicants who passed the examination after one read. The answers were produced as submitted by the applicant, except that minor corrections in spelling and punctuation were made for ease in reading. They are reproduced here with the consent of the authors.

| Question Number | Subject |
|---|---|
| 1. | Contracts/Remedies |
| 2. | Evidence |
| 3. | Business Associations / Professional Responsibility |
| 4. | Criminal Law and Procedure |
| 5. | Trusts / Community Property |
| 6. | Torts |

# Question 3

Alice's and Bob's law firm, AB Law, is a limited liability partnership. The firm represents Sid, a computer manufacturer. Sid sued Renco, his chip supplier, for illegal price-fixing.

Renco's lawyer asked Alice for a brief extension of time to respond to Sid's interrogatories because he was going on a long-planned vacation. Sid told Alice not to grant the extension because Renco had gouged him on chip prices. She denied the request for an extension. Sid also told Alice that he'd had enough of Renco setting the case's pace, so he wasn't going to appear at his deposition scheduled by Renco for the next week, and that he'd pay his physician to write a note excusing him from appearing. Alice did nothing in response.

In the course of representing Sid, Alice learned that Sid planned a tender offer for the publicly-traded shares of chipmaker, Chipco. Alice bought 10,000 Chipco shares. By buying the 10,000 Chipco shares, she drove up the price that Sid had to pay by $1 million. When Alice sold the 10,000 Chipco shares, she realized a $200,000 profit.

1. What ethical violations, if any, has Alice committed regarding:

   a. The discovery extension? Discuss.

   b. The physician's note? Discuss.

   c. The Chipco tender offer? Discuss.

   Answer according to California and ABA authorities.

2. What claims, if any, does Sid have against Alice, AB Law, and Bob? Discuss.

# QUESTION 3: SELECTED ANSWER A

**<u>Governing Law:</u>** California is governed by the California Rules of Professional Responsibility as well as certain sections of the business code. The ABA has promulgated its Model Code of Professional Responsibility as well.

**<u>(1) What ethical violations, if any, has Alice committed regarding (1) the discovery extension, (2) the physicians' note, or (3) the Chipco tender offer?</u>**

**<u>Discovery Extension:</u>**

**Duty of Fairness**: An attorney has a duty of fairness to the opposing party to act in good faith. While an attorney has no duty to accept all requests made by opposing counsel if not required, and while an attorney has a competing duty to her client to act in the client's best interests and should advocate for her client's interests zealously, denial of a good faith request for a short extension may be considered a breach of A's duty of fairness to opposing counsel.

Here, Alice ("A") represents Sid ("S") in suing Renco ("R"). R's attorney has requested a brief extension to respond to interrogatories. The reason for R's request is to go on a long-planned vacation. Without a showing that R's counsel has continuously attempted to delay the litigation by asking for continuances and extensions, A's duty of fairness likely requires her to accept such brief extension. Her denial is based on her client's order that it not be granted for no other reason than "because R had gouged him on chip prices". Because if R's counsel requested an extension from the court based on good reason it might well be granted, it is improper for A to require such unnecessary resort to the court. A has likely violated her ethical duties of fairness.

**Duty of Loyalty:** An attorney has a duty of loyalty to always act in her clients' best interests and not to engage in conflicts of interest or compete with the client.

Here, A will likely argue that her duty of loyalty to S requires that A not fail to acquiesce to her client's requests. However, the duty of loyalty does not extend this far. An attorney must not advocate for her client to the point that it causes her to make other ethical violations.

**Scope of Decision-Making:** While the client has the right to state which claims he or she wishes to pursue and make major decisions regarding settlement or whether to plea, etc., it is within the attorney's scope of authority to determine the proper strategy for effectuating these goals.

A should not allow S to "order" her to deny the extension based on no substantive reason. This is within A's scope of authority to decide, and A should not acquiesce to a bad-faith denial of a good-faith request. If A and her client cannot agree on the scope of representation, withdrawal from the case may be appropriate to avoid A being pulled into improper conduct.

**Physician's Note:**

**Duty of Candor/Honesty:** An attorney must not make any false representations to the court or opposing counsel, and must not allow her client to make any false representations to the court.

Here, A has stated that he is going to bribe his doctor to get a note to excuse him from appearing at his deposition. This will constitute a fraud upon the court because it is not true that D is unavailable. Further, there is no valid reason for S to fail to appear at his deposition. An attorney can breach his or her ethical duties by failing to speak when she has a duty to counsel her client against illegal or fraudulent activity and advise him that he or she cannot be a part of such conduct. Here, when A failed to respond to S's statement, she impliedly acquiesced in his proposal. This is an ethical violation because it will cause A to participate in a fraud upon the court and will violate her duty of candor.

**Withdrawal:** An attorney must withdraw from a case when she learns of conduct that will constitute a crime or fraud that will necessarily involve the lawyer's services. If it will not involve the lawyer's services, the attorney may but does not need to withdraw.

Here, paying one's doctor to write a false note excusing him from appearing may constitute such improper behavior that reflects poorly upon the profession. Such conduct is clearly in bad faith and relates directly to the representation, directly involving A. Thus, A should have withdrawn from the representation had she not been able to dissuade S from failing to appear at his deposition for a fraudulent reason because she will necessarily be involved.

**Duty of Confidentiality:** An attorney has a duty of confidentiality not to disclose any information related to the representation of the client. However, there is an exception to this rule which allows disclosure if the attorney learns that the client plans to commit a crime or fraud. Further, California imposes a duty on an attorney who has learned that his client plans to commit a crime or fraud to attempt to dissuade the client from his proposed actions and further, if that fails, to tell the attorney that the attorney plans to disclose the information to the appropriate authorities.

Here, it is unclear the length S plans to go to in order to get him a "note". However, this likely does not constitute an actual crime or fraud, so A likely has no right to breach her duty of confidentiality to her client. Since she has not, she has not violated this rule.

**Duty to Diligently Pursue Completion of the Case:** An attorney has a duty to diligently pursue a case to completion without allowing it to languish in the court system.

Here, by impliedly acquiescing in S's statement that he plans to fail to appear at his deposition, this will require a further scheduling out of a deposition at a time convenient

for the parties and court reporter. This is a bad faith delay of the case that constitutes breach of A's ethical duties.

**Chipco Tender Offer:**

**Duty of Loyalty:** As stated above, an attorney has a duty of loyalty to her client to always act in the best interests of the client. This includes not acquiring an interest adverse to the interest of the client. California allows an attorney to obtain an interest adverse to that of her client in certain circumstances.

Here, when A learned of S's plan to make a tender offer for the publicly traded shares of Chipco, she immediately purchased Chipco shares and then sold them for a $200,000 profit. A's acquisition of these funds constitutes a breach of A's duty not to obtain an interest adverse to her client's, because the price S had to pay on the shares was raised by one million dollars. A has caused serious financial injury to S by acquiring an adverse interest and essentially taken a profit that should have gone to S. In doing so, A has breached her ethical duties.

**Conflict of Interest:** An attorney has a concurrent conflict of interest when there is a substantial likelihood that her ability to represent her client will be materially limited by her own personal interests, her duties to another client, a former client, or a third party. An attorney may take on the representation despite the concurrent conflict of interest if the attorney can believes that she can competently and adequately represent the interests of the parties, and if she obtains written consent from all involved parties. California has no "reasonable lawyer" standard and does not require written consent, only written notice, when the interest is personal to the lawyer.

Here, in gaining a personal interest in Chipco, A may have created a conflict that will materially limit her representation of S. However, A may argue that this is a deal on the side and is unrelated to the subject of the litigation in which she represents S; and further, A may argue that ownership of the shares has no bearing on her representation of S. If the court determines that she has acquired a conflict of interest, A has breached

her duty by failing to get written consent. In California, she has further breached her duty by failing to give written notice to S.

**Duty of Confidentiality:** See above. In using confidential information S provided to her in telling her about the tender offer for her own benefit, A may have breached her duty.

**(2) What claims, if any, does S have against A, AB Law, and B?**

**Limited Liability Partnership:** A limited liability partnership is a special type of partnership that affords limited liability to all its partners, created by filing a Statement of Qualification with the Secretary of State. In a limited liability partnership, the individual partners are not personally liable for any damages sustained by the partnership itself.

**A:** See above.

A will be personally liable for her own torts.

**B:** See above.

Because B is a partner in an LLP, he has limited liability. Thus, S will have no claim against Bob ("B") A's partner.

**AB Law:**

**Authority:** A partnership is liable for its partner's actions if the partners have authority to act for the partnership. Authority may be actual (express or implied), apparent, or ratified. Actual authority exists where a reasonable person in the agent's position would believe he had the right to act on behalf of the business. This may be express, through an agreement, or implied, through actions or conduct. Apparent authority exists where a reasonable person in the shoes of the third party believed that the person had authority to act. Ratification occurs where no authority exists but the business has

adopted the contract through action such as accepting its benefits. A partner in a partnership has both apparent and implied authority to act on behalf of the partnership.

Here, as a partner of AB law, A has actual authority to act on behalf of the partnership. Her acts taken in the scope of her law practice will thus subject the partnership to liability. Thus, A will both be personally liable for her own torts, and S will further be able to collect against AB Law for her actions.

**Unjust Enrichment:**

Here, S will sue A personally and AB Law for likely malpractice for losses caused by her breaches of her duties. Her misconduct has led to a loss by S of 1 million dollars, and has resulted in a gain to A of $200,000. In equity, a court may under unjust enrichment theory disgorge profits made by someone and impose a constructive trust. A constructive trust is not truly a trust but is an equitable remedy imposed by the court which forces the wrongdoer to hold unjustly realized profits in trust for the benefit of the rightful owner. Because she has been unjustly enriched by action taken in breach if her duties to S, the court will likely impose a constructive trust on the profit realized by A and will thus force A as trustee of these funds to distribute them to their proper owner, S.

**Intentional Interference with a Business Expectancy:** Intentional interference with business expectancy occurs where a person knows of a business expectancy of another party and knowingly interferes with that expectancy, resulting in damages. Here, S had planned a tender offer with C. Her actions in purchasing Chipco shares may constitute an interference with this expectancy with S, although A will argue that this expectancy is not yet an enforceable contract and that she has a valid defense of fair competition. This will be balanced by the court.

# QUESTION 3: SELECTED ANSWER B

## Discovery Extension

### Scope of Representation

A client usually determines the ends (goals) of a representation, whereas the lawyer generally determines the means (legal strategies). If a client is insisting upon actions that the lawyer does not wish to take, the lawyer may limit the scope of employment through informed written consent by the client. Here, it appears that Alice let Sid influence her legal decision-making by telling her to deny the request for an extension to respond to Sid's interrogatories. This type of decision should normally be decided by the lawyer because it falls into legal strategy. Although it is permissible for the lawyer to seek the client's input, the final decision should ultimately be left up to the lawyer. Alice let Sid control the litigation means.

### Fairness to Opposing Counsel/Adverse Parties

A lawyer should treat opposing counsel and adverse parties fairly during the representation. A lawyer should not engage in certain actions if it is known to be for the purpose of harassing or making a task unduly burdensome for opposing counsel/adverse party. Here, Sid told Alice to reject the request to extend the time for answering the interrogatories. Renco's lawyer asked for a reasonable "brief extension" to respond since he was going on a long-planned vacation. This seems to be a reasonable request and is not an attempt by Renco's attorney to delay for an improper purpose. Sid's reasons for wanting to deny the extension, however, would be considered improper. He denied the request because Renco had "gouged hi on chip prices," so he was acting out of spite. He told this directly to Alice, so she knew his improper motives. She should have counseled him to allow the extension since it was a reasonable request and made clear that Sid's motives were improper. Because she did not do this, Alice violated her duty of fairness to Renco and its lawyer by furthering her client's improper purpose.

That being said, a lawyer does owe a duty to her client to diligently dispose of the case (work productively and not delay unnecessarily). If for some reason the extension requested was unreasonable, or it had been one of many requests for extensions, then perhaps Alice would be justified in denying the request. She has a duty to her client to make sure that his case is handled efficiently and effectively. The facts do not suggest this was the case, but if it was, then again it is possible she may not be in violation of an ethical duty.

## **Physician's Note**

### Duty of Candor

A lawyer owes a duty of candor to opposing counsel, adverse parties, and the court. A lawyer must not submit evidence that she knows to be false or make a false statement of fact or law that she knows to be untrue. If she makes such a statement without knowing it is false and later learns of its true nature, the lawyer has a duty to correct the evidence or testimony.

Sid told Alice he was not going to appear at his deposition for Renco the next week because he'd had enough of Renco setting the case's pace. He also told Alice that he was going to pay his physician to write a note excusing him from appearing at the deposition. Alice did nothing in response. Alice knows that Sid is not sick and that he just does not want to attend the deposition. He is going to get a fake doctor's note written to excuse him, so this would be false "evidence" or a false statement of fact being presented to the opposing side. Alice has a duty not to allow such false information to be presented to the other side. That being said, there is a conflict with her duty of confidentiality to Sid not to disclose his statements to her since they were made during and related to the representation.

A lawyer owes a duty of confidentiality to her client for anything related to the representation, even if not made by the client. Under the ABA, a lawyer may reveal confidences if the client persists in engaging in criminal or fraudulent conduct that will

result in death or serious bodily harm, or if the lawyer's services are being used to perpetuate a crime or fraud by client that will result in serious financial harm. California does not have an exception for financial losses. Neither of these exceptions appears to be present. Sid's actions will not cause harm to anyone to the extent of death or serious bodily harm. It may pose a financial burden on Renco because they have to pay the lawyer for time that was spent preparing and now it will be postponed, but the amount spent is not likely to satisfy the requirement of financial harm under the ABA. Therefore, since no exception applies, Alice cannot reveal Sid's confidences.

So Alice cannot reveal the confidences but she must not present false evidence. What she should have done is counseled Sid by trying to get him to show up for the deposition and not pay a doctor to make a false note. If that did not work, then she should have withdrawn from the representation since he was persisting in engaging in fraudulent conduct. If the withdrawal would be harmful to Sid, a court might not let her withdraw and it may request why she is choosing to withdraw. If that is the case, then Alice may reveal Sid's confidences regarding the letter. Because Alice did not take these steps and said nothing when Sid mentioned a fake doctor's note, she breached her duty of candor to Renco and its lawyer.

Duty of Fairness

Again, as mentioned earlier, Sid has improper motives for wanting to submit the doctor's note and not attend the deposition. He wants to regain control of the pace of the litigation and is acting out of spite toward Renco for the price he was charged for the chips. Alice should know based on the comments Sid has made to her that he only wants to delay the case for improper purposes. Because she is aware of this, Alice is violating her duty of fairness to opposing counsel and adverse party.

**Chipco Tender Offer**

Duty of Loyalty

A lawyer owes a duty of loyalty to her client. If the interests of another client, the lawyer, or a third party materially limit the lawyer's ability to effectively represent the client, then she has a conflict of interest. The lawyer must act in the best interest of the client. Tied with the duty of confidentiality mentioned below, a lawyer also cannot use information learned during the course of the representation to the disadvantage of her client.

Alice used the information she learned from Sid during the representation that Sid was going to make a tender offer to her advantage by purchasing shares of the stock and driving up the price. Alice benefitted by realizing a $200,000 profit while Sid had to pay $1 million more than he would have before she purchased the shares. Alice was looking out for her interests first and negatively impacted her client's interests in the process. Because she subordinated her client's interests to her own, Alice violated the duty of loyalty she owed to Sid.

Duty of Confidentiality

A lawyer owes a duty of confidentiality to her client. She must not reveal any information related to the representation that she learns, and she must not use that information to the disadvantage of her client.

Here, Alice learned while representing Sid that Sid planned to tender offer for the publicly-traded shares of Chipco. She used this information to Sid's disadvantage by purchasing 10,000 Chipco shares, which drove up the price that Sid had to pay. Although this purchase is unrelated to the representation, it involved information learned during the representation. The duty of confidentiality is broad and covers any information related to the representation. Alice may try to argue that this information is unrelated to Sid's illegal price-fixing claim against Renco, but it would likely be found to be covered by the duty of confidentiality. Price-fixing involves the market of that particular industry, and if Sid intends to make a tender offer for a competitor chipmaking company, it would affect the same market involved in the litigation that she is representing Sid for against Renco. Therefore, a court would find that the information is attenuated but still within the realm of the confidences covered by the duty of

confidentiality. Since Alice used the information against Sid to his disadvantage, she violated her duty of confidentiality.

**<u>Sid v. Alice, AB Law, and Bob</u>**

AB Law is a limited liability partnership (LLP). A limited liability partnership operates almost exactly the same as a general partnership except the partners in an LLP are not personally liable for the debts of the partnership like they are in a general partnership. Therefore, the partnership is liable for the negligent acts (but not intentional torts) of its partners but the other partners are not personally liable for different partner's negligent acts or debts of the partnership. A partner always remains liable for her own actions.

<u>Alice</u>

Alice obviously violated several of her ethical duties. The breach of the duty of loyalty that she committed against Sid by purchasing Chipco stock caused actual pecuniary harm to her client. This was an intentional act on Alice's part. Under her breach of the duty of loyalty, since she financially benefitted from her actions, realizing a $200,000 profit from buying and selling her shares of stock, she would be liable to Sid for profits realized as a result of her breach of the duty of loyalty. Therefore, Alice is personally liable for $200,000. She may also be liable for the harm caused to Sid by the breach. Sid had to pay $1 million more than he otherwise would have if Alice had not purchased the shares. But for Alice's purchase of the stock, Sid would not have had to pay $1 million more for the tender offer. It was also foreseeable to Alice that if she purchased the shares, it would drive the price of the stock up for Sid's tender offer. Therefore, she is also liable as the actual and proximate cause of Sid's loss due to her breach. Alice is personally liable for $1,200,000 to Sid.

As for a specific claim, Sid may be able to claim misappropriate. Alice was in a relationship of trust and confidence with him as a fiduciary. Sid had nonpublic information that most people would find material, meaning it was affect whether someone would purchase a stock or not. Sid did not tell this information to Alice for an

improper purpose and surely did not anticipate she would use the information to purchase stock. Therefore, Sid would not be a tipper and Alice cannot be a tippee. But she can be a misappropriator since she was in this fiduciary relationship with the source of the non-public material information and she purchased stock in reliance on that information. Therefore, she is liable to Sid for the same amount of damages mentioned above because they were profits that would need to be disgorged and harm caused from her misappropriation.

Bob

Because these actions were taken by Alice, even if the partnership is liable, Bob cannot be personally liable for the harm caused by Alice. It is a limited liability partnership, so partners are not personally liable for the debts of the partnership or torts of other partners. Therefore, Sid does not have any claims against Bob.

AB Law

A partner is an agent of the partnership and thus can bind the partnership to certain obligations. The partnership is also liable for the negligence or non-intentional torts committed by partners while in the scope of employment for the partnership.

Here, Alice was working as Sid's lawyer when she learned the information that she misappropriated from him. Her actions, however, would likely be considered beyond the scope of her employment as a partner. She took the information and used it for personal reasons. If she had, for example, not filed an important document on time resulting in a dismissal with prejudice, then Sid could sue for malpractice and the LLP would be liable because the claim arose from her duties as a lawyer. This harm caused to Sid was not because of Alice's actions as an attorney for Sid. Therefore, a court would likely find that the LLP is not liable for Alice's actions and Sid has no claim against AB Law. If the court did find her actions were within the scope of her duties as a partner, then AB Law would also be liable for the losses Sid incurred.

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# ESSAY QUESTIONS AND SELECTED ANSWERS

## FEBRUARY 2015

## CALIFORNIA BAR EXAMINATION

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| Question Number | Subject |
| --- | --- |
| 1. | Contracts |
| 2. | Real Property |
| 3. | Civil Procedure |
| 4. | Remedies |
| 5. | Business Associations |
| 6. | Wills/Trusts |

# QUESTION 5

Andy, Ruth, and Molly decided to launch a business called The Batting Average (TBA), which would publish a monthly newsletter with stories about major league baseball players. Andy, a freelance journalist, was responsible for writing the stories. Andy conducted all of his business activities via a close corporation called Baseball Stories, Inc., of which he was the only employee. Ruth was responsible for maintaining TBA's computerized subscriber lists, mailing the newsletter every month, and billing TBA subscribers. Molly provided all equipment necessary for TBA. Andy, Ruth, and Molly expressly agreed to the following: Molly would have exclusive authority to buy all equipment necessary for TBA; and TBA's net profits, if any, would be equally divided among Andy, Ruth, and Molly.

Andy subsequently wrote a story in the newsletter stating that Sam, a major league baseball player, had been taking illegal performance-enhancing drugs. Andy knew that the story was not true, but wrote it because he disliked Sam. As a result of the story, Sam's major league contract was terminated. While writing the story, Andy's computer failed. He bought a new one for TBA for $300 from The Computer Store. The Computer Store sent a bill to Molly, but she refused to pay it.

Sam has sued Andy, Ruth, Molly, TBA, and Baseball Stories, Inc. for libel.

The Computer Store has sued Andy, Ruth, Molly, and TBA for breach of contract.

1. How is Sam's suit likely to fare? Discuss.

2. How is The Computer Store's suit likely to fare? Discuss.

# QUESTION 5: SELECTED ANSWER A

**1. Sam's Suit**

1-1. Does Sam have a valid claim for libel against Andy?

The issue is whether Sam has a valid claim for libel for the story Andy wrote. In order to claim a libel, a plaintiff must show that (i) there was a defamatory statement, (ii) of or concerning the plaintiff, (iii) which was published, and (iv) resulted in a harm to the plaintiff's reputation. When the plaintiff is a public official or a public figure, the plaintiff must also show (i) the defendant acted with malice, and (ii) the defendant's statement was false.

Defamatory Statement of or concerning the Plaintiff. For a claim for a libel, the defamatory statement cannot be a mere name calling but in general must allege a specific fact that is harmful to the reputation of the plaintiff. Also, it must identify the plaintiff. Here Andy wrote a story in the newsletter stating that Sam, a major league baseball player, had been taking illegal performance-enhancing drugs. The article specifically identified Sam and it specifically alleged that Sam took illegal performance-enhancing drugs. Therefore, there were allegations of specific acts of wrongdoing that were allegedly committed by Sam. Therefore, Andy's article constitutes a defamatory statement of or concerning the plaintiff.

Publication. Publication requires that the defendant share a defamatory statement at least with one person other than the plaintiff. Here Andy published his article in the newsletter with subscribers. Therefore, there was clearly a publication.

Damages. In a libel case, damages to the reputation can be presumed if the plaintiff meets all the requirements for defamation and also show malice and falsity. A libel is a publication of a defamatory statement in a written form. Here, as will be discussed below, Sam should be able to meet all the requirements so the damages can be

assumed. Also, the article constitutes a libel as it is a publication in a written form with subscribers. Even if the damages were not presumed, Sam's major league contract was terminated as a result of Andy's story. Thus, Sam would be able to show he suffered harm to his reputation as shown by his losing the contract. Therefore, Sam can show damages.

Malice. Given the constitutional protection of free speech, a public official or a public figure must meet a higher burden of proof in order to win in a defamation suit. A public official is a government official and a public figure is a figure well known in the society, such as celebrities or professional sportsmen. A public official or a public figure must show, in addition to the 4 requirements of defamation that the defendant acted with malice. In this context, in order to show malice, a plaintiff must show that (i) a defendant had actual knowledge that his statement was false, or (ii) a defendant acted with reckless disregard to the truth of his statement. Here Sam is not a public official but he is a public figure. He is a major league baseball player, not just a local player who plays for a hobby. Thus, Sam must be well known in the society and is a public figure. Thus, he must show that Andy acted with malice when he published his story. Andy published his story knowing that it is false because he disliked Sam. While the fact that he acted out of personal grudge or dislike of Sam does not show that Andy acted with malice, the fact that Andy published a defamatory article about Sam knowing that it was false shows that he acted with malice for purposes of defamation. Thus, if Sam can prove that Andy knew that the story was not true, Sam would be able to show Andy acted with malice.

Falsity. A public official or a public figure must also show that the defendant's story is not true. Here the facts indicate that Andy's story was not true so Sam should be able to meet this burden.

In conclusion, Sam is likely to succeed on his claim on defamation against Andy.

1-2. Is Baseball Stories, Inc. liable to Sam?

The next issue is whether Baseball Stories, Inc. ("BSI") can be held liable for Andy's libel. Andy, a freelance journalist, conducts all of his business activities via a close corporation BSI, of which he was the only employee. Under the theory of respondeat superior, an employer is liable for the employee's tort if the employee committed the tort within the scope of his employment. While an employer is not generally liable for an employee's intentional tort, the employer could still be liable if (i) the employee was motivated by a desire to further the employer's interest, (ii) the tort was authorized or ratified by the employer, or (iii) the tort was part of the nature of the employee's job.

Here Andy and BSI's businesses consist of writing articles for journals. Thus, Andy's publication of the article in the newsletter was within the scope of his employment. Here Andy is likely to be liable for intentional tort because he was not merely negligent in publishing the story but he intentionally published the story knowing that it was false. Sam can argue that Andy was motivated by his desire to increase subscription and popularity of the newsletter and BSI's business of publishing articles. Thus, Sam can argue that BSI should be held liable for the defamation committed by Andy.

1-3. Can Andy be held liable to Sam, notwithstanding Baseball Stories, Inc.?

A person is always liable for his or her own tort. Thus, Andy should be directly liable for the libel against Sam. Also, a court may pierce the veil and hold a shareholder liable for the tort committed by the corporation if, for example, (i) the shareholder did not treat the corporation as a separate entity and did not observe corporate formalities, or (ii) the corporation was inadequately capitalized. This is most likely in a closely held corporation and even more so when a plaintiff is a tort victim who did not rely on the limited liability of the corporation. Here BSI is a close corporation and Andy is the only employee. Thus, it indicates that Andy had a controlling influence over BSI. While a corporation can have a sole shareholder and only one employee, the corporate formalities must be observed in order to maintain the limited liability status of the

shareholder. Thus, if Andy commingled his personal funds with BSI's, used BSI's funds as if they were his own, used BSI's other assets as his own, or he inadequately capitalized BSI, Sam may be able to show that Andy and BSI are alter egos and Sam may be able to pierce the veil to reach Andy's personal assets for tort liabilities. Having said that, Andy should be directly liable to Sam in any case because it was tort committed by him personally.

<u>1-4. Did Andy, Ruth and Molly form a partnership when they launched TBA?</u>

Given that Andy and BSI can be held liable for Andy's libel, the next issue is whether Ruth, Molly and TBA can be held liable for Andy's libel. A partnership is formed when two or more people agree to carry on a business as co-owners for profit. No specific formalities are required to form a general partnership and whether the parties intended to form a partnership does not matter as long as there was an agreement to carry on a business enterprise for profit. Here Andy, Ruth and Molly decided to launch a business called The Batting Average (TBA). It is not clear from the name what type of entity they intended to form. However, it was formed to publish a monthly newsletter with stories about major league baseball players. Also, there is no indication it was intended to be a non-profit organization. In fact, Ruth was responsible for maintaining the subscriber lists and billing the subscribers. Also, they expressly agreed that TBA's net profits, if any, would be equally divided among Andy, Ruth and Molly. Thus, they agreed to form a business venture of publishing articles about major league baseball players for profit. Also, an agreement to share net profits shows that they formed a partnership. It does not matter that they never used the word "partnership" or they never intended to form a partnership.

The next question is what type of partnership Andy, Ruth and Molly formed as a result to determine their and TBA's liability. A default partnership is a general partnership where all partners are liable for their liabilities of the partnership. A creditor of the partnership must first look to the assets of the partnership and if they are insufficient, they can pursue the partners' personal assets. Therefore, in a general partnership, the

partners act as guarantors for the partnership liabilities. There are other forms of partnership or business enterprise that provide some form of limited liability for some or all owners, such as a limited partnership, limited liability company, a limited liability partnership or a corporation. However, they all require filing a form of certification with the Secretary of State and they each require that their names indicate a limited liability by including the words such as "limited partnership," "LP", "limited liability company", "LLC" or "Inc." or "Incorporated." There is no indication here that Andy, Ruth and Molly or TBA filed any certificate of limited partnership to form a limited partnership or a certificate of qualification to form a limited liability company, nor did they file articles of incorporation to form a corporation. Also, the name, "The Batting Average" does not have any of the words indicating that they formed a business entity with limited liability. Since no formalities were observed, they would also not be able to argue that they formed a de jure corporation. Therefore, Andy Ruth and Molly formed a generally partnership when they decided to launch their business TBA.

<u>1-5. Can TBA be held liable to Sam for Andy's tort?</u>

Given that TBA is a general partnership, the next issue is whether it or Ruth and Molly can be held liable for Andy's tort. A partnership is liable for tort committed by a partner in the scope of his partnership. Here Andy committed a tort while he was publishing the article for the newsletter published by TBA. Thus, TBA would be liable for the tort and Sam would be able to look to the assets of TBA. In a general partnership, all the partners are liable for the partnership liabilities if the partnership assets are insufficient to meet those liabilities. Thus, if TBA's assets are not sufficient to meet Sam's claim, Ruth and Molly could also be held liable and may be required to pay out of their own personal assets. However, Ruth and Molly may be entitled to indemnification from Andy since Andy was the tortfeasor.

In conclusion, Sam is likely to be successful on his libel claim against Andy. In such event, (i) TBA and BSI would likely be vicariously liable and (ii) if the assets of TBA are insufficient, Ruth and Molly would also likely be liable out of their personal assets.

**2. The Computer Store's Suit**

The issue is whether (i) Andy, Ruth and Molly formed a partnership, (ii) Andy had an express, implied or apparent authority when he bought a computer for TBA, (iii) TBA can be held liable for Andy's contract liabilities, and (iv) Ruth and Molly can be held liable.

2-1. Did Andy, Ruth and Molly form a partnership?

As discussed above, Andy, Ruth and Molly agreed to carry on a business venture of publishing monthly newsletters for profit and to share any net profits derived therefrom. They did not make any necessary filings with the secretary of state and TBA does not have a name indicating limited liability. Therefore, TBA is a general partnership.

2-2. Did Andy have an Express, Implied or Apparent Authority when he bought a computer for TBA?

The next issue is whether Andy had an express, implied or apparent authority when he bought a new computer for TBA for $300 from The Computer Store. All the partners of a partnership are considered agents of the partnership and they are generally authorized to act on behalf of the partnership relating to the partnership's business, although each partner's authority may be limited by agreement. Under the agency theory, a principal can be held liable under the contract entered into by the agent if the agent had an authority to enter into such contract. An authority can be actual or apparent. An actual authority arises when the principal either expressly grants the authority to the agent either by words or conduct or it is implied from (i) the past course of dealing between the principal and the agent, (ii) the principal's past acquiescence, or (iii) such authority is incidental to other express authority granted to the agent.

Here Andy is a partner of TBA and thus he generally had the ability to act on behalf of TBA. However, Andy, Ruth and Molly expressly agreed that Molly would have exclusive

authority to buy all equipment necessary for TBA. Therefore, Molly had the exclusive and express authority to buy all the equipment, including a computer used in the business. Since her authority was exclusive, Andy did not have an express authority to buy computers on behalf of TBA. There is no indication that TBA or Molly acquiesced in the past in Andy buying a computer. The Computer Store may argue that Andy was responsible for writing articles for TBA and thus using and buying a computer was incidental to his authority to write articles for TBA. However, given that buying equipment was Molly's exclusive authority, it is unlikely that Andy had any authority to buy equipment or computers on behalf of TBA.

The next question is whether Andy had an apparent authority to buy computers. An apparent authority arises when the principal holds the agent out to a third party as having certain authorities or powers. Given that TBA is an enterprise with only three owners and Andy was one of them and given that Andy was writing articles on behalf of TBA, The Computer Store is likely to argue that Andy had an apparent authority to buy a computer. On the other hand, TBA can argue that the fact that The Computer Store sent a bill to Molly indicates that they were aware that Molly was responsible for purchasing equipment. Also, the fact that Andy wrote articles for TBA can also only mean that he is an employee of TBA or a freelance writer. Thus, TBA may have a viable argument that Andy had neither actual nor apparent authority when he bought the computer and thus it should not be liable under the contract. However, even when the agent did not act with actual or apparent authority, the principal can be held liable if the principal later ratified the contract, which can be either express or implied if the principal kept the benefits of the bargain. Here, if TBA kept the computer and used it, there is likely to be ratification and thus TBA would be liable for $300 to The Computer Store.

2-3. Can Andy, Ruth and Molly be held liable for breach of contract?

Assuming that Andy acted within the scope of authority on behalf of TBA when he bought the computer or TBA later ratified the contract by keeping the benefits, the next issue is whether TBA's partners, Andy, Ruth and Molly can be held personally liable. As

discussed above, they formed a general partnership. In a general partnership, partners are liable for the partnership liabilities. Thus, if TBA's assets are not sufficient to meet the liabilities to The Computer Store, they can each be held liable and required to pay out of their personal assets.

# QUESTION 5: SELECTED ANSWER B

General partnership

A general partnership is an association between two or more people to carry on as co-owners a business for profit. There are no formalities required to form a partnership. There is no writing requirement or filing requirement with the Secretary of State. The subjective intent of the parties is immaterial. All that is required is that they intend to carry on as co-owners a business for profit. In other words, a partnership is formed, simply by meeting the definition of a partnership. Here, Andy, Ruth and Molly decided to launch The Batting Average (TBA), a business to publish monthly newsletters with stories about major league baseball players, and agreed to assign responsibilities among themselves for the management of the business. Furthermore, the sharing of gross profits gives rise to a presumption of partnership formation. Here, Andy, Ruth, and Molly expressly agreed to share TBA's net profits equally among themselves.

Andy, Ruth, and Molly formed a general partnership.

Sam v. Andy

General partners are always liable for their own torts. Thus, if Andy is found liable for libel, he will be personally liable for the tort regardless of the liability of TBA.

Libel

A prima face case for libel requires a defamatory statement, of or concerning the plaintiff, publication, and damages. In addition, when the defamatory statement concerns a public figure, such as a major league baseball player, the plaintiff must prove falsity and fault. For the fault requirement, a public figure must prove actual malice. Actual malice exists when the defendant knew that statement was false or recklessly disregarded the truth or falsity of the statement. Here, Andy wrote a newsletter stating that Sam, a major league baseball player, had taken illegal performance-enhancing drugs.

Defamatory statement of or concerning the plaintiff

A statement is defamatory if it adversely reflects on the plaintiff's reputation. Here, the statement that Sam was taking illegal performance-enhancing drugs clearly lowers his reputation in the community and in his profession. In fact, his major league contract was terminated due to Andy's newsletter. Furthermore, while the facts do not present the newsletter, it is safe to assume that Andy at least mentioned Sam by name. As a result of the newsletter, Sam was terminated.

Publication

For publication, the defamatory statement must be made to a third person who understands it. This requirement is clearly satisfied as Andy published the story in a newspaper.

Damages

Sam suffered general and special damages. For libel, damage to reputation may be presumed and as his contract was terminated, Sam has also suffered pecuniary loss.

Falsity and Fault

The facts state that Andy "knew that the story was not true". This would satisfy both additional requirements for constitutional damages as the statement is in fact false and Andy acted with actual malice when he published the newsletter knowing it was not true. The fact that he wrote the story because he disliked Sam would not establish actual malice, but his intentional disregard for the truthfulness of his statement satisfies.

Thus, Sam will be successful in a suit against Andy for libel.

Liability of Baseball Stories

In terms on Baseball Stories' and TBA's liability for Andy's tort, the issue is whether Andy was acting as an agent and whether he was acting within the scope of his employment and/partnership. An employer/partnership will be vicariously liable for torts committed by agents/employees/partners that are within the scope of scope of

employment/partnership. Sam would argue that because Andy conducts all of his business via Baseball Stories and is its only employee he was acting within the scope of his employment and Baseball Stories is vicariously liable.

Liability of TBA

A partnership is vicariously liable for torts committed by agents of the partnership that are within the scope of the partnership. General partners are agents of the partnership. Thus, Andy is an agent of TBA and TBA will be liable for Andy's tort if he was acting within the scope of TBA.

Sam could also argue that Andy was working on a computer purchased for TBA, and Andy was responsible for writing stories for TBA; thus he was acting as an agent of TBA and within the scope of his partnership.

Liability of Molly and Ruth

General partnerships are jointly and severally liable for all partnership obligations. Thus, a tort judgment creditor may sue any general partner for his entire loss. However, the creditor must first exhaust partnership resources before seeking payment for partners individually. Thus, Sam could hold Molly and Ruth personally liable for Andy's tort, but Sam must first exhaust TBA's resources. If he fails to do so, Molly and Ruth could look to the partnership for indemnification and/or contribution from the partners.

2. Computer Store's suit

A partnership will be liable for contracts entered into on its behalf by agents who have actual or apparent authority or contracts that have been ratified by the partnership. Partners are agents of the partnership. Thus, Andy, Ruth, and Molly are agents of TBA.

To determine whether the principal (TBA) will be bound if must first be determined whether the agent (Andy) had actual or apparent authority or the TBA ratified Andy's purchase.

Actual express authority

There is actual express authority when such authority is granted in the four corners of the partnership agreement or expressly granted by a requisite vote. Here, Andy, Ruth, and Molly agreed that Molly would have exclusive authority to buy all equipment necessary for TBA. There were no changes made to this agreement by the partners and Andy did not receive permission from Ruth and Molly to purchase a new computer for TBA. Thus, Andy did not have actual express authority.

Actual implied authority

There is actual implied authority, when the agent reasonably believes he has authority based on the manifestations of the principal. As stated above there have been no such manifestations by TBA. Furthermore, it is unreasonable for Andy to believe he has such authority because the partnership agreement between him and Ruth and Molly expressly grants such authority to Molly.

Apparent authority

Apparent authority is based on the reasonable expectations of a third party. Where a principal holds out an agent as possessing authority and a third party reasonably relies on such holding out, there is apparent authority. While TBA has not made direct representations to The Computer Store on behalf of Andy's authority, generally partners have authority to enter into contracts in the ordinary course of partnership business. Furthermore, apparent authority may be created by an agent's title. For example, if Andy told The Computer Store he was a partner of TBA, such an expression would reasonably induce The Computer Store to rely on Andy's authority as a partner. Thus, even though Andy did not have actual authority to purchase the computer for TBA he likely had apparent authority, which would bind TBA for the contract.

Ratification

Ratification occurs where an "agent" purports to act on behalf of the principal when in fact he does not have actual or apparent authority, and the principal subsequently

ratifies the action (with full knowledge of its terms). There are no facts to suggest that TBA ratified Andy's purchase and thus ratification is not available to bind TBA.

Liability

As mentioned above, general partners are personally liable for partnership obligations. Thus, if apparent authority is found, The Computer Store will have a claim against TBA, Andy, Ruth, and Molly.

Even though Molly will be personally liable to Computer Store, she may seek indemnification from TBA and may also seek contribution from Andy and Ruth as partners. In addition, Ruth and Molly and likely to have a claim against Andy for violation of the partnership agreement.

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# ESSAY QUESTIONS AND SELECTED ANSWERS

## FEBRUARY 2015

## CALIFORNIA BAR EXAMINATION

This publication contains the six essay questions from the February 2015 California Bar Examination and two selected answers for each question.

The answers were assigned high grades and were written by applicants who passed the examination after one read. The answers were produced as submitted by the applicant, except that minor corrections in spelling and punctuation were made for ease in reading. They are reproduced here with the consent of the authors.

| Question Number | Subject |
|---|---|
| 1. | Contracts |
| 2. | Real Property |
| 3. | Civil Procedure |
| 4. | Remedies |
| 5. | Business Associations |
| 6. | Wills/Trusts |

# QUESTION 5

Andy, Ruth, and Molly decided to launch a business called The Batting Average (TBA), which would publish a monthly newsletter with stories about major league baseball players. Andy, a freelance journalist, was responsible for writing the stories. Andy conducted all of his business activities via a close corporation called Baseball Stories, Inc., of which he was the only employee. Ruth was responsible for maintaining TBA's computerized subscriber lists, mailing the newsletter every month, and billing TBA subscribers. Molly provided all equipment necessary for TBA. Andy, Ruth, and Molly expressly agreed to the following: Molly would have exclusive authority to buy all equipment necessary for TBA; and TBA's net profits, if any, would be equally divided among Andy, Ruth, and Molly.

Andy subsequently wrote a story in the newsletter stating that Sam, a major league baseball player, had been taking illegal performance-enhancing drugs. Andy knew that the story was not true, but wrote it because he disliked Sam. As a result of the story, Sam's major league contract was terminated. While writing the story, Andy's computer failed. He bought a new one for TBA for $300 from The Computer Store. The Computer Store sent a bill to Molly, but she refused to pay it.

Sam has sued Andy, Ruth, Molly, TBA, and Baseball Stories, Inc. for libel.

The Computer Store has sued Andy, Ruth, Molly, and TBA for breach of contract.

1. How is Sam's suit likely to fare? Discuss.

2. How is The Computer Store's suit likely to fare? Discuss.

# QUESTION 5: SELECTED ANSWER A

**1. Sam's Suit**

1-1. Does Sam have a valid claim for libel against Andy?

The issue is whether Sam has a valid claim for libel for the story Andy wrote. In order to claim a libel, a plaintiff must show that (i) there was a defamatory statement, (ii) of or concerning the plaintiff, (iii) which was published, and (iv) resulted in a harm to the plaintiff's reputation. When the plaintiff is a public official or a public figure, the plaintiff must also show (i) the defendant acted with malice, and (ii) the defendant's statement was false.

Defamatory Statement of or concerning the Plaintiff. For a claim for a libel, the defamatory statement cannot be a mere name calling but in general must allege a specific fact that is harmful to the reputation of the plaintiff. Also, it must identify the plaintiff. Here Andy wrote a story in the newsletter stating that Sam, a major league baseball player, had been taking illegal performance-enhancing drugs. The article specifically identified Sam and it specifically alleged that Sam took illegal performance-enhancing drugs. Therefore, there were allegations of specific acts of wrongdoing that were allegedly committed by Sam. Therefore, Andy's article constitutes a defamatory statement of or concerning the plaintiff.

Publication. Publication requires that the defendant share a defamatory statement at least with one person other than the plaintiff. Here Andy published his article in the newsletter with subscribers. Therefore, there was clearly a publication.

Damages. In a libel case, damages to the reputation can be presumed if the plaintiff meets all the requirements for defamation and also show malice and falsity. A libel is a publication of a defamatory statement in a written form. Here, as will be discussed below, Sam should be able to meet all the requirements so the damages can be

assumed. Also, the article constitutes a libel as it is a publication in a written form with subscribers. Even if the damages were not presumed, Sam's major league contract was terminated as a result of Andy's story. Thus, Sam would be able to show he suffered harm to his reputation as shown by his losing the contract. Therefore, Sam can show damages.

Malice. Given the constitutional protection of free speech, a public official or a public figure must meet a higher burden of proof in order to win in a defamation suit. A public official is a government official and a public figure is a figure well known in the society, such as celebrities or professional sportsmen. A public official or a public figure must show, in addition to the 4 requirements of defamation that the defendant acted with malice. In this context, in order to show malice, a plaintiff must show that (i) a defendant had actual knowledge that his statement was false, or (ii) a defendant acted with reckless disregard to the truth of his statement. Here Sam is not a public official but he is a public figure. He is a major league baseball player, not just a local player who plays for a hobby. Thus, Sam must be well known in the society and is a public figure. Thus, he must show that Andy acted with malice when he published his story. Andy published his story knowing that it is false because he disliked Sam. While the fact that he acted out of personal grudge or dislike of Sam does not show that Andy acted with malice, the fact that Andy published a defamatory article about Sam knowing that it was false shows that he acted with malice for purposes of defamation. Thus, if Sam can prove that Andy knew that the story was not true, Sam would be able to show Andy acted with malice.

Falsity. A public official or a public figure must also show that the defendant's story is not true. Here the facts indicate that Andy's story was not true so Sam should be able to meet this burden.

In conclusion, Sam is likely to succeed on his claim on defamation against Andy.

1-2. Is Baseball Stories, Inc. liable to Sam?

The next issue is whether Baseball Stories, Inc. ("BSI") can be held liable for Andy's libel. Andy, a freelance journalist, conducts all of his business activities via a close corporation BSI, of which he was the only employee. Under the theory of respondeat superior, an employer is liable for the employee's tort if the employee committed the tort within the scope of his employment. While an employer is not generally liable for an employee's intentional tort, the employer could still be liable if (i) the employee was motivated by a desire to further the employer's interest, (ii) the tort was authorized or ratified by the employer, or (iii) the tort was part of the nature of the employee's job.

Here Andy and BSI's businesses consist of writing articles for journals. Thus, Andy's publication of the article in the newsletter was within the scope of his employment. Here Andy is likely to be liable for intentional tort because he was not merely negligent in publishing the story but he intentionally published the story knowing that it was false. Sam can argue that Andy was motivated by his desire to increase subscription and popularity of the newsletter and BSI's business of publishing articles. Thus, Sam can argue that BSI should be held liable for the defamation committed by Andy.

1-3. Can Andy be held liable to Sam, notwithstanding Baseball Stories, Inc.?

A person is always liable for his or her own tort. Thus, Andy should be directly liable for the libel against Sam. Also, a court may pierce the veil and hold a shareholder liable for the tort committed by the corporation if, for example, (i) the shareholder did not treat the corporation as a separate entity and did not observe corporate formalities, or (ii) the corporation was inadequately capitalized. This is most likely in a closely held corporation and even more so when a plaintiff is a tort victim who did not rely on the limited liability of the corporation. Here BSI is a close corporation and Andy is the only employee. Thus, it indicates that Andy had a controlling influence over BSI. While a corporation can have a sole shareholder and only one employee, the corporate formalities must be observed in order to maintain the limited liability status of the

shareholder. Thus, if Andy commingled his personal funds with BSI's, used BSI's funds as if they were his own, used BSI's other assets as his own, or he inadequately capitalized BSI, Sam may be able to show that Andy and BSI are alter egos and Sam may be able to pierce the veil to reach Andy's personal assets for tort liabilities. Having said that, Andy should be directly liable to Sam in any case because it was tort committed by him personally.

<u>1-4. Did Andy, Ruth and Molly form a partnership when they launched TBA?</u>

Given that Andy and BSI can be held liable for Andy's libel, the next issue is whether Ruth, Molly and TBA can be held liable for Andy's libel. A partnership is formed when two or more people agree to carry on a business as co-owners for profit. No specific formalities are required to form a general partnership and whether the parties intended to form a partnership does not matter as long as there was an agreement to carry on a business enterprise for profit. Here Andy, Ruth and Molly decided to launch a business called The Batting Average (TBA). It is not clear from the name what type of entity they intended to form. However, it was formed to publish a monthly newsletter with stories about major league baseball players. Also, there is no indication it was intended to be a non-profit organization. In fact, Ruth was responsible for maintaining the subscriber lists and billing the subscribers. Also, they expressly agreed that TBA's net profits, if any, would be equally divided among Andy, Ruth and Molly. Thus, they agreed to form a business venture of publishing articles about major league baseball players for profit. Also, an agreement to share net profits shows that they formed a partnership. It does not matter that they never used the word "partnership" or they never intended to form a partnership.

The next question is what type of partnership Andy, Ruth and Molly formed as a result to determine their and TBA's liability. A default partnership is a general partnership where all partners are liable for their liabilities of the partnership. A creditor of the partnership must first look to the assets of the partnership and if they are insufficient, they can pursue the partners' personal assets. Therefore, in a general partnership, the

partners act as guarantors for the partnership liabilities. There are other forms of partnership or business enterprise that provide some form of limited liability for some or all owners, such as a limited partnership, limited liability company, a limited liability partnership or a corporation. However, they all require filing a form of certification with the Secretary of State and they each require that their names indicate a limited liability by including the words such as "limited partnership," "LP", "limited liability company", "LLC" or "Inc." or "Incorporated." There is no indication here that Andy, Ruth and Molly or TBA filed any certificate of limited partnership to form a limited partnership or a certificate of qualification to form a limited liability company, nor did they file articles of incorporation to form a corporation. Also, the name, "The Batting Average" does not have any of the words indicating that they formed a business entity with limited liability. Since no formalities were observed, they would also not be able to argue that they formed a de jure corporation. Therefore, Andy Ruth and Molly formed a generally partnership when they decided to launch their business TBA.

1-5. Can TBA be held liable to Sam for Andy's tort?

Given that TBA is a general partnership, the next issue is whether it or Ruth and Molly can be held liable for Andy's tort. A partnership is liable for tort committed by a partner in the scope of his partnership. Here Andy committed a tort while he was publishing the article for the newsletter published by TBA. Thus, TBA would be liable for the tort and Sam would be able to look to the assets of TBA. In a general partnership, all the partners are liable for the partnership liabilities if the partnership assets are insufficient to meet those liabilities. Thus, if TBA's assets are not sufficient to meet Sam's claim, Ruth and Molly could also be held liable and may be required to pay out of their own personal assets. However, Ruth and Molly may be entitled to indemnification from Andy since Andy was the tortfeasor.

In conclusion, Sam is likely to be successful on his libel claim against Andy. In such event, (i) TBA and BSI would likely be vicariously liable and (ii) if the assets of TBA are insufficient, Ruth and Molly would also likely be liable out of their personal assets.

**2. The Computer Store's Suit**

The issue is whether (i) Andy, Ruth and Molly formed a partnership, (ii) Andy had an express, implied or apparent authority when he bought a computer for TBA, (iii) TBA can be held liable for Andy's contract liabilities, and (iv) Ruth and Molly can be held liable.

2-1. Did Andy, Ruth and Molly form a partnership?

As discussed above, Andy, Ruth and Molly agreed to carry on a business venture of publishing monthly newsletters for profit and to share any net profits derived therefrom. They did not make any necessary filings with the secretary of state and TBA does not have a name indicating limited liability. Therefore, TBA is a general partnership.

2-2. Did Andy have an Express, Implied or Apparent Authority when he bought a computer for TBA?

The next issue is whether Andy had an express, implied or apparent authority when he bought a new computer for TBA for $300 from The Computer Store. All the partners of a partnership are considered agents of the partnership and they are generally authorized to act on behalf of the partnership relating to the partnership's business, although each partner's authority may be limited by agreement. Under the agency theory, a principal can be held liable under the contract entered into by the agent if the agent had an authority to enter into such contract. An authority can be actual or apparent. An actual authority arises when the principal either expressly grants the authority to the agent either by words or conduct or it is implied from (i) the past course of dealing between the principal and the agent, (ii) the principal's past acquiescence, or (iii) such authority is incidental to other express authority granted to the agent.

Here Andy is a partner of TBA and thus he generally had the ability to act on behalf of TBA. However, Andy, Ruth and Molly expressly agreed that Molly would have exclusive

authority to buy all equipment necessary for TBA. Therefore, Molly had the exclusive and express authority to buy all the equipment, including a computer used in the business. Since her authority was exclusive, Andy did not have an express authority to buy computers on behalf of TBA. There is no indication that TBA or Molly acquiesced in the past in Andy buying a computer. The Computer Store may argue that Andy was responsible for writing articles for TBA and thus using and buying a computer was incidental to his authority to write articles for TBA. However, given that buying equipment was Molly's exclusive authority, it is unlikely that Andy had any authority to buy equipment or computers on behalf of TBA.

The next question is whether Andy had an apparent authority to buy computers. An apparent authority arises when the principal holds the agent out to a third party as having certain authorities or powers. Given that TBA is an enterprise with only three owners and Andy was one of them and given that Andy was writing articles on behalf of TBA, The Computer Store is likely to argue that Andy had an apparent authority to buy a computer. On the other hand, TBA can argue that the fact that The Computer Store sent a bill to Molly indicates that they were aware that Molly was responsible for purchasing equipment. Also, the fact that Andy wrote articles for TBA can also only mean that he is an employee of TBA or a freelance writer. Thus, TBA may have a viable argument that Andy had neither actual nor apparent authority when he bought the computer and thus it should not be liable under the contract. However, even when the agent did not act with actual or apparent authority, the principal can be held liable if the principal later ratified the contract, which can be either express or implied if the principal kept the benefits of the bargain. Here, if TBA kept the computer and used it, there is likely to be ratification and thus TBA would be liable for $300 to The Computer Store.

<u>2-3. Can Andy, Ruth and Molly be held liable for breach of contract?</u>

Assuming that Andy acted within the scope of authority on behalf of TBA when he bought the computer or TBA later ratified the contract by keeping the benefits, the next issue is whether TBA's partners, Andy, Ruth and Molly can be held personally liable. As

discussed above, they formed a general partnership. In a general partnership, partners are liable for the partnership liabilities. Thus, if TBA's assets are not sufficient to meet the liabilities to The Computer Store, they can each be held liable and required to pay out of their personal assets.

# QUESTION 5: SELECTED ANSWER B

General partnership

A general partnership is an association between two or more people to carry on as co-owners a business for profit. There are no formalities required to form a partnership. There is no writing requirement or filing requirement with the Secretary of State. The subjective intent of the parties is immaterial. All that is required is that they intend to carry on as co-owners a business for profit. In other words, a partnership is formed, simply by meeting the definition of a partnership. Here, Andy, Ruth and Molly decided to launch The Batting Average (TBA), a business to publish monthly newsletters with stories about major league baseball players, and agreed to assign responsibilities among themselves for the management of the business. Furthermore, the sharing of gross profits gives rise to a presumption of partnership formation. Here, Andy, Ruth, and Molly expressly agreed to share TBA's net profits equally among themselves.

Andy, Ruth, and Molly formed a general partnership.

Sam v. Andy

General partners are always liable for their own torts. Thus, if Andy is found liable for libel, he will be personally liable for the tort regardless of the liability of TBA.

Libel

A prima face case for libel requires a defamatory statement, of or concerning the plaintiff, publication, and damages. In addition, when the defamatory statement concerns a public figure, such as a major league baseball player, the plaintiff must prove falsity and fault. For the fault requirement, a public figure must prove actual malice. Actual malice exists when the defendant knew that statement was false or recklessly disregarded the truth or falsity of the statement. Here, Andy wrote a newsletter stating that Sam, a major league baseball player, had taken illegal performance-enhancing drugs.

Defamatory statement of or concerning the plaintiff

A statement is defamatory if it adversely reflects on the plaintiff's reputation. Here, the statement that Sam was taking illegal performance-enhancing drugs clearly lowers his reputation in the community and in his profession. In fact, his major league contract was terminated due to Andy's newsletter. Furthermore, while the facts do not present the newsletter, it is safe to assume that Andy at least mentioned Sam by name. As a result of the newsletter, Sam was terminated.

Publication

For publication, the defamatory statement must be made to a third person who understands it. This requirement is clearly satisfied as Andy published the story in a newspaper.

Damages

Sam suffered general and special damages. For libel, damage to reputation may be presumed and as his contract was terminated, Sam has also suffered pecuniary loss.

Falsity and Fault

The facts state that Andy "knew that the story was not true". This would satisfy both additional requirements for constitutional damages as the statement is in fact false and Andy acted with actual malice when he published the newsletter knowing it was not true. The fact that he wrote the story because he disliked Sam would not establish actual malice, but his intentional disregard for the truthfulness of his statement satisfies.

Thus, Sam will be successful in a suit against Andy for libel.

Liability of Baseball Stories

In terms on Baseball Stories' and TBA's liability for Andy's tort, the issue is whether Andy was acting as an agent and whether he was acting within the scope of his employment and/partnership. An employer/partnership will be vicariously liable for torts committed by agents/employees/partners that are within the scope of scope of

employment/partnership. Sam would argue that because Andy conducts all of his business via Baseball Stories and is its only employee he was acting within the scope of his employment and Baseball Stories is vicariously liable.

<u>Liability of TBA</u>

A partnership is vicariously liable for torts committed by agents of the partnership that are within the scope of the partnership. General partners are agents of the partnership. Thus, Andy is an agent of TBA and TBA will be liable for Andy's tort if he was acting within the scope of TBA.

Sam could also argue that Andy was working on a computer purchased for TBA, and Andy was responsible for writing stories for TBA; thus he was acting as an agent of TBA and within the scope of his partnership.

<u>Liability of Molly and Ruth</u>

General partnerships are jointly and severally liable for all partnership obligations. Thus, a tort judgment creditor may sue any general partner for his entire loss. However, the creditor must first exhaust partnership resources before seeking payment for partners individually. Thus, Sam could hold Molly and Ruth personally liable for Andy's tort, but Sam must first exhaust TBA's resources. If he fails to do so, Molly and Ruth could look to the partnership for indemnification and/or contribution from the partners.

<u>2. Computer Store's suit</u>

A partnership will be liable for contracts entered into on its behalf by agents who have actual or apparent authority or contracts that have been ratified by the partnership. Partners are agents of the partnership. Thus, Andy, Ruth, and Molly are agents of TBA.

To determine whether the principal (TBA) will be bound if must first be determined whether the agent (Andy) had actual or apparent authority or the TBA ratified Andy's purchase.

Actual express authority

There is actual express authority when such authority is granted in the four corners of the partnership agreement or expressly granted by a requisite vote. Here, Andy, Ruth, and Molly agreed that Molly would have exclusive authority to buy all equipment necessary for TBA. There were no changes made to this agreement by the partners and Andy did not receive permission from Ruth and Molly to purchase a new computer for TBA. Thus, Andy did not have actual express authority.

Actual implied authority

There is actual implied authority, when the agent reasonably believes he has authority based on the manifestations of the principal. As stated above there have been no such manifestations by TBA. Furthermore, it is unreasonable for Andy to believe he has such authority because the partnership agreement between him and Ruth and Molly expressly grants such authority to Molly.

Apparent authority

Apparent authority is based on the reasonable expectations of a third party. Where a principal holds out an agent as possessing authority and a third party reasonably relies on such holding out, there is apparent authority. While TBA has not made direct representations to The Computer Store on behalf of Andy's authority, generally partners have authority to enter into contracts in the ordinary course of partnership business. Furthermore, apparent authority may be created by an agent's title. For example, if Andy told The Computer Store he was a partner of TBA, such an expression would reasonably induce The Computer Store to rely on Andy's authority as a partner. Thus, even though Andy did not have actual authority to purchase the computer for TBA he likely had apparent authority, which would bind TBA for the contract.

Ratification

Ratification occurs where an "agent" purports to act on behalf of the principal when in fact he does not have actual or apparent authority, and the principal subsequently

ratifies the action (with full knowledge of its terms). There are no facts to suggest that TBA ratified Andy's purchase and thus ratification is not available to bind TBA.

Liability

As mentioned above, general partners are personally liable for partnership obligations. Thus, if apparent authority is found, The Computer Store will have a claim against TBA, Andy, Ruth, and Molly.

Even though Molly will be personally liable to Computer Store, she may seek indemnification from TBA and may also seek contribution from Andy and Ruth as partners. In addition, Ruth and Molly and likely to have a claim against Andy for violation of the partnership agreement.

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# ESSAY QUESTIONS AND SELECTED ANSWERS

## JULY 2015

## CALIFORNIA BAR EXAMINATION

This publication contains the six essay questions from the July 2015 California Bar Examination and two selected answers for each question.

The answers were assigned high grades and were written by applicants who passed the examination after one read. The answers were produced as submitted by the applicant, except that minor corrections in spelling and punctuation were made for ease in reading. They are reproduced here with the consent of the authors.

| Question Number | Subject |
|---|---|
| 1. | Civil Procedure |
| 2. | Real Property |
| 3. | Criminal Law and Procedure |
| 4. | Community Property |
| 5. | Business Associations/ Professional Responsibility |
| 6. | Constitutional Law/Real Property |

# QUESTION 5

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

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

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

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

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

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

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

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

# QUESTION 5: SELECTED ANSWER A

1)

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

**Duty of Loyalty.**

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

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

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

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

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

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

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

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

Under this standard, Harry, Jane, and Sam have breached the duty of care, and will not be afforded the protection of the business judgment rule. The facts indicate that Jane knew that LargeCo was largely owned by Harry's wife, yet Jane directed Harry, a director she knew to be interested, to negotiate the terms of a transaction with LargeCo. This was likely unreasonable; a reasonable director would have had a disinterested

party negotiate the terms of a possible acquisition. Furthermore, Jane and Sam failed to take reasonable steps in becoming informed about the deal. The facts indicate that Harry, again an interested party, telephoned Jane and Sam, and that Jane and Sam agreed that the offer was a good idea. This is not sufficient; Jane and Sam undertook no independent investigation to determine if the terms of the proposed acquisition were fair to the corporation. Sufficient steps would have included, for example, obtaining an independent audit of Online's value as a business. Here, there are no facts Jane and Sam took **any** steps in becoming informed about the deal. Therefore, they have both breached the duty of care in this respect.

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

**Issuance of the Stock For Less Than Par Value.**

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

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

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

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

**Derivative Action.**

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

2) Harry's Ethical Violations

**Duty of Loyalty:**

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

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

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

**Business Deal with the Client:**

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

Here, Harry has failed to meet these requirements. By entering Online into a deal with LargeCo, of which his wife is majority shareholder, Harry is essentially entering into a business deal with Online. The facts suggest the deal is not fair, because 2 days later Harry enters into a joint venture with LargeCo for 10x the price paid to Online. The terms of the deal were not fully disclosed in writing, because the deal was discussed

over telephone. Harry did not advise Online that it should have independent counsel. Finally, Harry did not receive written consent by Online for the deal.

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

**Duty of Competence**

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

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

# QUESTION 5: SELECTED ANSWER B

1. What are Dick's remedies?

Direct Remedies

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

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

Derivative Suit

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

a. Jane

i. Watered Stock

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

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

ii. Breach of Duty of Loyalty

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

iii. Breach of Duty of Care

All directors owe a corporation a duty of care. A director must conduct business as a reasonably prudent director in the same or similar circumstances. A director may rely upon experts when voting on decisions, and may also rely upon other members of the board, but only if they are reasonably qualified to give that advice. A director will not be held liable for good faith business judgment decisions. Here, in voting on the decision to sell Online, Jane "agreed with Harry" that the offer was a good idea, and Harry accepted the offer. This deal was for the sale of the entire company,

and Jane did absolutely no due diligence whatsoever to ensure that the deal was in fact a good one. Importantly, she relied only upon Harry, an attorney, and not upon Dick, who was an expert in technology matters, and who would have been a better resource on the value of the company. Jane could argue for the business judgment rule, but because she did so little in the way of due diligence, she will not be able to argue good faith successfully. This is especially true because she knew of Harry's marital relationship with the majority shareholder of LargeCo.

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

b. Sam

i. Watered Stock

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

ii. Breach of the duty of Care

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

c. Harry

i. Interested Director/Breach of Loyalty

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

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

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

ii. Duty of Care

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

d. Fundamental Corporate Change

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

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

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

2. Harry's Ethical Violations

<u>Potential Conflicts</u>

Under the California rules, an attorney may not represent a client where the representation would be directly adverse to another client in the same matter, or where there is a significant risk that the representation will be materially limited by the lawyer's representation of another client, or the lawyer's own personal interests. A lawyer may still take on a representation under the California rules if the lawyer believes that he can

still competently represent both clients, all affected clients give informed, written consent, and the representation is not prohibited by law or ethical rule. California extends the written notice requirement to potential conflicts, while the ABA does not. The ABA rules also include a "reasonable lawyer standard" where a lawyer must reasonably believe he can competently represent both parties.

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

Actual Conflicts

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

Duty of Loyalty

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

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

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# ESSAY QUESTIONS AND SELECTED ANSWERS

## FEBRUARY 2017

## CALIFORNIA BAR EXAMINATION

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| Question Number | Subject |
|---|---|
| 1. | Wills |
| 2. | Remedies / Torts |
| 3. | Evidence |
| 4. | Business Associations |
| 5. | Professional Responsibility |
| 6. | Criminal Law and Procedure |

# QUESTION 4

Years ago, Art incorporated Retail, Inc. He paid $100 for its stock and lent it $50,000. He elected himself and two family members to the Board of Directors, which in turn elected him as President and approved a ten-year lease for a store. He managed the store and was paid 10% of Retail's gross revenues as compensation.

Subsequently, Barbara bought 20% of Retail's stock from Art.

Retail's board approved a contract to buy 30% of the inventory of XYZ Co., a company owned by Art.

Subsequently, Art began taking home some of Retail's inventory without paying for it.

Retail had net profits in some years and net losses in others. It paid dividends in some years, but not in others. In some years, Retail's board met three times a year; in others, it never met.

Recently, Retail ceased business. Its assets were limited to $5,000 in cash. Among the claims against Retail was one by Supplier, who was owed $10,000 for computer equipment. Another claim was Art's, for the $50,000 that he had lent and had just become due. Supplier and Barbara, individually, filed lawsuits against Retail and Art.

1. On what legal theory, if any, can Supplier reasonably seek to recover against Art on its claim against Retail? Discuss.

2. Does Barbara have a cause of action against Art, either derivatively or personally? Discuss.

3. If Retail is forced into bankruptcy court, will Art be able to collect from Retail any portion of his $50,000 loan? Discuss.

# QUESTION 4: SELECTED ANSWER A

**1. Recovery Against Art on Supplier's Claim Against Retail**

**Corporation**

Retail, Inc. is a corporation, as indicated by the word "Inc." (for Incorporated) in its name and by the fact it was "incorporated". Perhaps the most important feature of a corporation is the limited liability of its shareholders. The shareholders of a corporation are generally not liable to the corporation's creditors, beyond the amount of their capital contributions (i.e. their stock ownership). There is an important public policy interest in preserving the limited liability of shareholders, so that corporations can feel free to take risks, which is good for the economy and society in general.

Limited liability can be ignored by the courts only in very particular circumstances. This is called "piercing the corporate veil", and requires that: (i) the corporation be a closely-held corporation, (ii) it be necessary to prevent fraud or abuse, and (iii) it would be unfair not to do so. Courts will rarely order a piercing of the corporate veil, but may do so in circumstances such as these ones, which require piercing to avoid unfairness to Retail. Where piercing is ordered, the shareholders involved in the wrongdoing can be held personally liable for the corporation's liabilities.

Here, Art incorporated Retail, Inc. and owned 100% of the stock. He later sold 20% of Retail's stock to Barbara. Accordingly, Retail is a closely held corporation (held by Art an Barbara only). Supplier has a claim against Retail, not guaranteed by Art personally, for $10,000 for computer equipment. Absent a finding by the court that the situation warrants piercing the corporate veil, i.e. that there is sufficient fraud or abuse, and sufficient unfairness, Supplier cannot seek recovery against Art.

**Piercing the Corporate Veil**

Piercing of the corporate veil can occur under either a finding of "alter ego", fraud or insufficient capitalization.

**Alter Ego.** Under the alter ego doctrine, the corporate veil can be pierced where the shareholders have sought to benefit from the benefits of incorporation but ignored all of its burdens. Factors which will be taken into consideration by the courts include: failure to observe corporate formalities, failure to keep the corporation's assets separate from that of its shareholders, failure to keep proper accounting, self-dealing, etc.

Here, there is some evidence that Art used the corporation as his alter ego. He elected himself and two family members to the Board of Directors and elected himself as President, all things which ensure that he keeps full control over the corporation, but which are not wrongful in any way. He then used that control to approve a compensation for himself of 10% of Retail's gross revenues, which is also not wrongful. Retail's board then approved a contract to buy 30% of the inventory of XYZ Co., a company owned by Art. Although XYZ Co. was owned by Art, the transaction is not necessary self-dealing, if it was fair to the corporation. The terms of the transaction are not known, but there is no indication of abuse or that the transaction was so much more detrimental than beneficial to Retail as to be "fraudulent" vis-a-vis Retail's creditors.

Art then began taking home some of Retail's inventory without paying for it. The facts do not state whether Art intended to return this inventory, or to keep it, or to use it for his own purposes, but it seems that he failed to keep the corporation's assets separate from his own. A court would frown upon this and see it as a relevant element in the action for piercing the corporate veil.

Retail had net profits in some years and net losses in others. It paid dividends in some years but not others. This in itself is perfectly normal.

In some years, Retail's board met three times a year; in others, it never met. This shows a disregard for corporate formalities, since a corporation's directors must meet on a regular basis. A board that does not meet at least twice a year is not complying with corporate formalities. A court would frown upon this and see it as a relevant element in the action for piercing the corporate veil.

**Fraud.** Under the fraud theory, the corporate veil can be pierced where the shareholders have been using the corporation merely as a shield against their existing liability and for the sole purpose of defrauding existing creditors.

Here, there is no indication that Art has used the corporation only to defraud existing creditors. The fact that the corporation is now insolvent and has unpaid debts is not in itself indicative of fraud.

**Insufficient Initial Capital.** Under the insufficient capitalization theory, the corporate veil can be pierced where the initial capital contributions of shareholders at the inception of the corporation were clearly insufficient to meet the corporation's foreseeable future liabilities, taking into account the corporation's foreseeable future revenues.

Here, Art incorporated Retail Inc. years ago. He paid $100 for his stock and lent it $50,000. Retail then entered into a ten-year lease for a store, approved compensation for himself, etc. The liabilities of a retail store are likely to quickly exceed $100. In particular, if Art had to lend the corporation $50,000 at its inception, it is an indication that Retail needed this amount of funding either to fund its initial operations or to induce potential co-contractants, such as the landlord, to enter into transactions. By choosing to do almost all of Retail's initial funding by loan rather than by capitalization, Art was likely trying to ensure his $50,000 would not be last in the waterfall in the event of a distribution in bankruptcy.

It is for situations like this one that the insufficient capitalization theory exists. It was foreseeable at incorporation that Retail would have liabilities greater than $100, yet its

initial capital was no more than $100. When Barbara became a shareholder, she bought 20% of the stock from Art, not in the context of a corporate issuance. The corporation's capital was not increased.

Art will argue that Retail is a retail store and that it has expected revenues, which should be sufficient to satisfy liabilities. He was not operating a highly risky business. The facts show that he has had net profits in some years and that at some point Retail probably had become capable of meeting its liabilities "on its own". However, the facts also show that the initial capitalization was extremely low and that large liabilities, such as the ten-year lease, were incurred immediately at Retail's inception.

It appears that Retail was inadequately capitalized at incorporation.

**Unfairness.** In all cases, the proponent of piercing the corporate veil must show it would be unfair if the veil was not pierced.

Here, Retail has ceased business and its assets ($5,000) are insufficient to satisfy all of its liabilities. If Supplier cannot seek recovery against Art personally, it will receive next to nothing on the dollar for its $10,000 debt. Among the reasons that Retail is insolvent, Art's wrongful conduct is likely responsible: Art took home some of Retail's inventory; Art had Retail enter into a transaction with XYZ Co., a company owned by Art - which transaction was potentially unfair to Retail (this will be up to Supplier to prove); one of the biggest claims on Retail's assets is a loan by Art himself (which he had to make to Retail to make up for the insufficient initial capital contribution), etc.

Supplier can make a strong argument that it would be unfair to allow Art to hide behind the corporate veil and not hold him directly liable for Retail's debt to Supplier.

**Conclusion**

Accordingly, Retail is a closely held corporation and there is evidence that Art, a

shareholder, has insufficiently capitalized it at incorporation (and perhaps even used Retail as its alter ego, although this will be much harder to prove), and that it would be unfair not to allow Supplier to seek recovery against Art directly. The court will likely pierce the corporate veil and allow recovery against Art.

**2. Barbara's Cause of Action Against Art**

**Art's Duties to Barbara and Direct Action**

Shareholders generally do not owe fiduciary duties to each other. Only in closely-held corporations, majority shareholders can be found to owe fiduciary duties of care and loyalty to the minority shareholders. In accordance with those duties, majority shareholders may not abuse their position of power to abuse the minority shareholders and deny them their rights as shareholders.

If they do, a minority shareholder can ask the court to order remedies in oppression, including a mandatory repurchase by the corporation of the minority shareholder's stock. Other remedies in oppression are available to the court, going all the way to mandatory dissolution of the corporation in particularly egregious situations of oppression. Where a minority shareholder is oppressed, the proper recourse is a direct recourse by the minority shareholder against the majority shareholder(s), seeking oppression remedies.

Here, while Art and two of his family members composed the Board of Directors, Retail's board approved a contract to buy 30% of the inventory of XYZ Co., a company owned by Art. If there is evidence that the corporation was not made on arm's length terms, Barbara could argue that the transaction was an abuse of power of a majority shareholder. Art began taking home some of Retail's inventory without paying for it, which Barbara can argue is an abuse of his power as a majority shareholder, director and President of Retail.

Because Retail is closely held, Barbara cannot simply sell her shares on a stock exchange and exit the corporation. Barbara could likely seek oppression remedies. If the corporation is ordered to buy out her shares for their fair value, this will likely be worthless to Barbara: her stock is worth nothing or next to nothing, since the corporation is insolvent, and even if it had a worth the corporation would not have sufficient assets to buy her back.

A dissolution of the corporation will not be helpful either, given that the corporation is insolvent and creditors will be paid first.

Accordingly, Barbara can likely take oppression remedies against Art, but unless she can convince the court to order damages in her favor (which would be extremely difficult), this recourse will not be useful.

**Art's Duties to Retail**

Shareholders generally do not owe fiduciary duties to the corporation, unless they participate in the management of the corporation to a great extent, either as directors or if a unanimous shareholders' agreement gives them the power to do so.

Here, Art is a director of Retail.

Directors owe fiduciary duties of care and of loyalty to the corporation.

**Duty of Care.** The duty of care requires a director to act as a reasonable, prudent person would do in the management of his own affairs. The directors are not "guarantors" of their bad decisions and will generally be protected by the business judgment rule (the "BJR"), and found not to have breached their duty of care even where they made a decision which later turns out to have been ill-advised. The BJR protects directors only where the decision has been (i) informed, (ii) made in good faith, (iii) made in the absence of a conflict of interest and (iv) had a reasonable basis.

Directors will also generally be found to have acted in compliance with their duty of care if they have relied on reports, opinions, information, etc. reported to them by directors, officers and employees of the corporation, by outside advisors or by a committee of the board of which they are not a member, in each case provided that the information reported was within the competence of the person(s) reporting it and that the reliance was reasonable, taking into account the directors' duty of care to the corporation.

Here, Art voted on his own compensation (10% of Retail's gross revenues) - this is not necessarily a breach of the duty of care or duty of loyalty, if the compensation is what a reasonable, prudent person would grant to a manager. 10% of gross revenues is not unreasonable for a store manager, although it could be unreasonable depending on the store's revenues. There is no clear breach of the duty of care here.

Here, Retail entered into a transaction with XYZ Co. There is no indication that Art breached his duty of care by entering into this transaction, because the terms of the transaction are not known. Art is not protected by the BJR here because he is in a conflict of interest, but again, there is no indication that the transaction was not one which a reasonable, prudent person would approve.

The distribution of dividends is at the directors' discretion - failure to pay a dividend in some years is not a breach of the duty of care or duty of loyalty and will not be reviewed by the court absent extreme circumstances.

Finally, Art began taking home some of Retail's inventory without paying for it. This is a breach of the duty of care and a breach of the duty of loyalty.

**Duty of Loyalty.** The duty of loyalty requires a director to act in good faith, in what he reasonably believes to be the best interests of the corporation. A director is in a conflict of interest if he (or a close relative or another of his corporations) has a personal interest in a transaction with the corporation.

In the event of such a conflict, the director will be found to have breached his duty of loyalty unless the transaction is shown either (i) to have been fair to the corporation, or (ii) to have been approved by a majority of disinterested directors or disinterested shares, after having been fully informed.

Here, the Retail/XYZ transaction involved a conflict of interest for Art. He should not have voted on it. Neither should the other board members have voted on it, since they are family members of Art, and therefore not "disinterested" directors. A vote of a majority of disinterested shares (i.e. Barbara's shares) should have been held to approve the transaction, and she should have been fully informed.

However, the facts do not describe the terms of the transaction. If Art can show the transaction was fair to the corporation, he will not be held to have breached his duty of loyalty.

Art breached his duty of loyalty by taking home some of Retail's inventory without paying for it, unless he reasonably believed this to be in the best interests of the corporation. There are no facts indicating that this might be the case, and the conduct appears improper. This is likely a breach of Art's duty of loyalty.

**Derivative Action**

Where a director breaches his duty of loyalty or his duty of care to the corporation, only the corporation has a recourse, not the shareholders individually. A shareholder may, however, take a derivative action provided that (i) the shareholder held stock at the time of the alleged breach and continues to do so throughout the derivative action, (ii) the shareholder can adequately represent the corporation's interests, (iii) the shareholder has made a written demand on the board to enforce the claim, but his demand was denied, and (iv) the shareholder joins the corporation as a defendant to the lawsuit.

In some cases, the court may accept a derivative action without a written demand

having been made on the board, if the shareholder can show such demand would have been futile (for instance, if he is asking the corporation to sue all of the directors, it is extremely unlikely that the directors will agree).

If the shareholder is successful in his derivative action, the corporation will receive the benefit of the judgment. The shareholder can be indemnified for his legal costs and fees. If the shareholder is unsuccessful, he will be personally liable for all legal costs and fees, including the other party's if their reimbursement is ordered.

The corporation itself can have the suit dismissed only if it can show to the court that the transaction was fair as determined by an independent committee of the board or outside independent advisors.

Here, Barbara was a shareholder at all relevant times. She can likely represent Retail's interests adequately - there is no indication she can't do so. As noted above, she would have to first make a written demand on the board to take action. If they refuse, she can then take a derivative action to enforce Retail's rights against Art.

**Conclusion**

Retail has a recourse against Art for any loss caused by a breach of his duty of care or duty of loyalty. The recourse can be taken by Barbara in a derivative action. However, except for a recourse for the value of items which Art took home without paying for it, it will be difficult to show that Art is otherwise liable to Retail.

**3. Collection by Art of The $50,000 Loan to Retail**

In bankruptcy, secured creditors have a priority. All unsecured creditors are treated the same, unless there has been subordination. Under the Deep Rock doctrine, when the corporate veil is pierced, the court can order that any loans made by the shareholders to the corporation be subordinated to the debts of the corporation to other ordinary

creditors.

Here, Art lent $50,000 to Retail. Given the piercing of the corporate veil described above, Art's claim can be subordinated to the claim of Supplier.  Accordingly, Supplier will be able to recover the $5,000 if Retail is forced into bankruptcy.

Art will be unable to collect from Retail any portion of his $50,000 loan.

# QUESTION 4: SELECTED ANSWER B

**1. Supplier's legal theories of recovery against Art on its claim against Retail.**

Supplier's ability to recover from Art depends on what type of business entity was created and if Art has breached any duty to Supplier.

Corporation

A corporation is a business entity separate from its shareholders. Therefore, shareholders of a corporation are not personally liable for the corporation's obligations unless the corporation was not properly formed, or the shareholders abused its corporate form. A corporation requires proper formalities for creation, which include filing with the secretary of state. A closely held corporation is one in which there are few shareholders, and liability of the shareholders is more readily found because of its more intimate nature.

Here, it appears that Art incorporated Retail, Inc. years ago; therefore without any further facts it appears that Retail Inc. was properly formed with regards to formalities. Retail Inc. can also be seen to be a closely held corporation by the court.

Shareholder Liability: Corporate Veil

Assuming the corporation was properly formed at its onset, Art can only be liable if the corporation abused its corporate form and thus will not be afforded the protections of the corporate veil.

A shareholder is generally not personally liable unless the corporate form is abused. A court will disregard the separateness of a corporation and its shareholders and pierce the veil if it appears that 1) the corporation was undercapitalized at its inception, 2) the corporate formalities were not adhered to, or 3) the corporation was created to perpetrate a fraud. It will also consider whether a parent corporation was operating by mixing its directors and officers with another corporation owned by it.

Alter Ego

Art is a shareholder, director, and as president, he is an officer of Retail Inc., and at the same time he is XYZ Co.'s owner. Retail Inc.'s board approved a contract to buy 30% of XYZ's inventory, which alone may appear to only have an impact on Art's duty of loyalty as a director of Retail Co. who approved the transaction. However, it does not appear that Retail Co. owns or otherwise deals with XYZ other than the contract. Nonetheless, because Art is an owner of both, a court will consider it.

Undercapitalized

The shareholders of a corporation must put at risk enough unencumbered capital to take care of the corporation's potential liabilities.

When Art incorporated Retail, he paid $100, for its stock, and thus he became a 10% shareholder. He also lent the corporation $50,000 at its onset, which appears to have satisfied Retail Inc.'s potential debts because after years it had only owed $10,000 under a contract to outside creditors and ceased business with $5K left. Therefore, since it was able to operate for years with the $50K capitalization, this appears to be sufficient.

Formalities

Supplier would argue that Retail's board did not hold meetings every year, which shows that it was not a proper corporation. However, Art will likely argue that since Retail's board had no significant matters to discuss, it only met when necessary, which is apparent by the fact that it met three times a year in some years. Because a corporation should hold regular meetings, this appears to be against the proper corporate formalities.

Therefore, a court can use this to decide whether to hold Art liable.

Perpetrate a fraud

There appears to be no bad faith in creating the corporation so this will not be considered.

Overall, a court is reluctant to pierce a veil absent clear evidence of lack of separateness; therefore Art may be personally liable to Supplier, but it is unlikely.

Personal Liability

If the veil is pierced, Supplier will be able to obtain $10,000 personally from Art.

**2. Barbara's cause of action against Art.**

**Barbara's Derivative Suit**

Barbara may bring an action on her own or as a shareholder of Retail Inc. against the corporation.

Derivative Actions

A shareholder may bring a derivative action on behalf of the other shareholders of the corporation for a breach by the directors. Any recovery will go to the corporation rather than to the shareholder personally. To bring such an action, the shareholder must 1) have made a demand on the board for the complained-of action, to which the board either refused, or 90 days have passed without an answer, or demand would be futile; 2) the shareholder must adequately represent the other shareholders; and 3) the shareholder must hold shares throughout the entire suit.

Futile

Here, there are no facts to suggest that Barbara made any demand on the board, however, because Retail's board consists of Art and two of his family members, Barbara will argue that demand would be futile, because his family members would be biased in favor of Art. Art will argue that had she made a demand it would have been answered, and the derivative suit would be improper. Nonetheless, the fact that only three members are on the board and all three are related, would likely render the demand futile.

Adequately represents

The shareholder must have enough shares to adequately represent the shareholders.

Here, the only shareholders appear to be Barbara and Art; therefore, since Art took action with regard to the complained-of event, Barbara is essentially asserting it on her own behalf; therefore this is met.

Shareholder throughout suit

Barbara owns 20% stock and has retained that stock until suit, therefore this is met.

Therefore, Barbara can bring a derivative action.

Breach of Duty of Loyalty

A director has the duty to put the corporation's best interest before his own. The duty of loyalty can be breached in three ways: 1) usurping a corporate opportunity, 2) engaging in an interested director transaction, and 3) engaging in a competing venture.

Interested Director Transaction

A director is not permitted to engage as an interested party in a transaction, which essentially means that he may not sit on both sides of the transaction, or that the director may not engage in a transaction with one of his family members, unless he gets the approval of the majority of the disinterested board or its shareholders, or the transaction is substantively fair.

Here, Barbara can bring an action for a breach of duty of loyalty by Art for approving a contract to buy 30% of the inventory of XYZ Co., a company owned by him. Since Art is a director of Retail Inc. and also an owner of XYZ Co., he sat on both ends of the transaction when he approved a contract to buy inventory from a company he owned.

Approval by Board

However, Art will argue that the board approved the contract, and in the alternative that the transaction was substantively fair. However, since the board consisted of three

people, who were each related to one another, and the board also consisted of Art, who was the primary interested party, then the approval was not obtained by a majority of the disinterested shareholders, because family members are always interested parties in their family's affairs. This can be further shown by the fact that the family has close ties, since Art elected the two family members to the board, which in turn elected him as president.

Substantively Fair

If the transaction is substantively fair, an interested party transaction will be permitted after full and fair disclosure.

Even though the board could not have properly approved, the transaction involved buying 30% of XYZ's inventory, which is close to half of its inventory. While there is no price indicated, it is likely that Art gave a discounted price for the contract because he was a party to both sides. Art will argue that it was beneficial to the corporation to buy from XYZ since he could provide them with better quality inventory at a better price, whereas an outsider would have no such incentive. Nonetheless, he would have had to disclose the information to the board, and the board would have to agree. Since the board approved, he may be able to defend against the derivative suit for breach of loyalty under this theory.

However, if the court finds that the bias of his family members on the board is superior to the transaction being substantively fair, Barbara will prevail in showing a breach of the duty of loyalty.

Competing Venture

Art has taken Retail’s property for himself, and since XYZ appears to have a similar business as Retail, perhaps the inventory was that which originally came from the contract between them. Therefore, if so, he would be replenishing his inventory at XYZ at the expense of Retail Co., and thus would be engaging in a competing venture.

Therefore, Barbara can also prevail by showing this.

Duty of Care

A director owed the corporation a duty of care to act in good faith as a reasonable prudent director would under the circumstances.

Good Faith

Art's taking of the inventory from Retail without paying for it can be used to show bad faith by a director. He may also be seen as an officer because he managed the lease for a store and was paid 10% of Retail's gross revenues as compensation. Therefore, as an officer, he must have also acted in good faith for the best interest of the corporation.

Ordinary Prudent Director

Barbara can argue that an ordinary prudent director would not steal inventory from the corporation without paying for it; therefore he acted against his duty of care.

Business Judgment Rule

The business judgment rule protects the good-faith decisions made by directors in compliance with the duty of care that in hindsight end up being erroneous.

Here, Art did not act in accordance with the duty of care because he acted in bad faith with regards to taking the inventory. Therefore the BJR will not protect him.

Dividends

Barbara can also bring an action derivatively for the fact that the corporation did not distribute dividends in some years. However, a corporation has discretion whether to distribute dividends, because dividends are not a right of the shareholders.

Since Retail had net profits in some years and net losses in others, it was prudent for them to withhold dividends for the years they had no profits, assuming that the times corresponded. Even if they did not correspond, distributing dividends is in the discretion of the board.

**Barbara's Personal Action**

A personal action may also be brought by Barbara against Art (if the veil is pierced - as a director) and if it is not pierced, then as a shareholder.

Duty To Shareholders

Generally, shareholders do not owe a duty to other shareholders, however, a majority shareholder owes the duty to a minority shareholder not to use its majority share to discriminate against the minority shareholder, and not to sell his shares to a prospective looter.

There are no facts to suggest how much the stock of Retail Inc. cost; however Art paid $100 for its stock and Barbara owned 20% of the stock from Art. Assuming Art holds the remaining stock himself, Art would be a majority shareholder, and would thus be required to act fairly with regards to the use of his shares.

Here, Art's transaction with XYZ does not appear to prejudice Barbara as a shareholder in any way; therefore Barbara will not be able to prevail in a personal suit against Art.

**3. Liability of Retail Inc. for Art's loan.**

Liability of Corporation at Dissolution

A corporation that ceases business is still held liable for debts to creditors. A shareholder who contributes capital will receive reimbursement.

Equitable Subordination

Under equitable subordination, all creditors, whether shareholder creditors or outsiders, may seek to collect their debt to the corporation equally. However, if a shareholder acted wrongfully, the Deep Rock doctrine prevents him from recovering equally.

If Retail Co. is forced into bankruptcy, Art will be able to recover his loan in proportion to

the debt owed to Supplier. Since there is only $5,000 cash left, he will be able to obtain a proportional amount, taking into consideration Supplier's $10K debt. If Art is found to have acted wrongfully, however, then he will not be able to recover since there is only $5,000 left and Supplier would have priority over Art's debt.

COMMITTEE OF BAR EXAMINERS
OFFICE OF ADMISSIONS

# CALIFORNIA BAR EXAMINATION
## ESSAY QUESTIONS AND SELECTED ANSWERS
## February 2020

This publication contains the five essay questions from the February 2020 California Bar Examination and two selected answers for each question.

The answers were assigned high grades and were written by applicants who passed the examination after one read. The answers were produced as submitted by the applicant, except that minor corrections in spelling and punctuation were made for ease in reading. They are reproduced here with the consent of the authors.

| Question Number | Subject |
|---|---|
| 1. | Torts |
| 2. | Professional Responsibility |
| 3. | Contracts |
| 4. | Evidence |
| 5. | Business Associations |

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# QUESTION 5

Andrew, Bob, and Christine are attorneys who formed a law firm. They filed no documents with the Secretary of State or any other state office. They equally share the firm's profits after paying all expenses and make all business and management decisions. Associate attorneys are paid a fixed salary, plus 25% of gross billings for any clients they bring to the firm. Senior attorneys are paid based upon the number of hours they bill plus an annual bonus if they bill more than 2,000 hours in a year. The senior attorney bonus pool is equal to 5% of firm profits, which is split equally by the number of qualifying senior attorneys each year. Andrew, Bob, and Christine agreed to bestow the title "nonequity partner" on senior attorneys even though senior attorneys have no management authority. The firm website and business cards for senior attorneys list their title as "partner."

Martha, a senior attorney, met Nancy at a social function. Nancy told Martha about her business's legal problems. Martha gave Nancy her business card. After looking at the card, Nancy asked Martha if as a "partner" she can agree to the firm handling her legal problems at a reduced hourly rate in return for a promise of future business. Martha was aware that the firm has a strict policy of not reducing hourly rates, but signed a written agreement for it to handle Nancy's legal matters at a reduced hourly rate.

1. What type of business entity is the firm using to conduct business? Discuss.

2. Are the associate attorneys employees, partners, members, or shareholders of the firm? Discuss.

3. Are the senior attorneys employees, partners, members, or shareholders of the firm? Discuss.

4. Is the firm bound by the agreement that Martha signed with Nancy? Discuss.

# QUESTION 5: SELECTED ANSWER A

(1) TYPE OF BUSINESS ENTITY

GENERAL PARTNERSHIP

A general partnership (GP) is formed when two or more persons associate to carry on a business for profit as co-owners. There are no formalities required to form a GP. The subjective intent of the parties to form a GP is also irrelevant. You don't even need a written or formal agreement. General partners are each personally and jointly and severally liable for the debts of a GP, whether arising in tort or contract. There is no limited liability for the partners of a GP.

A presumption arises that there is a GP and that the persons are partners when such persons share profits, unless those profits are shared due to being rent or repayment of a debt rather than true profit sharing. Other factors that may evidence a partnership (but these factors do NOT create a presumption) include the sharing of gross revenues, the sharing of losses, whether the persons call themselves "partners" and call their business a "partnership" and the extent of the business activities (greater extent of business activities suggests a partnership). Partners have no right to compensation (meaning wages/salary) absent an agreement to the contrary. Partners have equal rights to manage the business of the partnership and control its affairs.

Here, A B and C formed a law firm, so there is the intent to carry on a business for profit. They didn't file documents with the state, but that is not required for a GP. They share profits after paying expenses, which creates a presumption of a partnership and that they are partners. They also make all business and management decisions which evidences that they are running a business as co-owners. It is likely the firm is a GP.

CORPORATION

A corporation is formed when articles of association are filed with the Secretary of State. The articles need to have the name of the corporation, the names and addresses of the incorporators and registered agent, the authorized stock of the company and associated rights, and the purpose of the corporation which can be any lawful purpose. A de jure corporation comes into existence only when the secretary accepts the articles. There can also be a de facto corporation if the state has an incorporation statute, the persons make a good faith colorable attempt to comply with the formalities for forming a corporation (but fail to do so), and such persons assert the privileges of a corporation.

Here, there was no filing of articles with the state, so there is no corporation. Also, no de facto corporation because no good faith effort to file.

LIMITED PARNTERSHIP OR LIMITED LIABILITY PARNTERSHIP

In a limited partnership, there are general partners and limited partners. The limited partners

have limited liability, meaning they are only liable to make their capital contributions. A limited partnership is formed when a certificate of limited partnership is filed with the state, executed (signed) by the general partners and stating the name of the limited partnership, which must have L.P. or LP or "limited partnership" in the name. An LP comes into existence when that public document is filed or on the deferred date for existence to take place, if any.

A limited liability partnership requires filing of a certificate of qualification executed by at least 2 partners, and must have "LLP" or "limited liability partnership" in the name. An LLP comes into existence when that public document is filed or on the deferred date for existence to take place, if any. All partners in the LLP have limited liability.

Here, there was no filing with the state so the firm is not a LLP or LP.

LIMITED LIABILITY COMPANY

An LLC is a hybrid organization. Its owners (members) have limited liability like a corporation. However, LLCs get the pass-through tax treatment that partnerships get. On the other hand, corporations are subject to double-taxation (taxed once at the corporation level and then again when distributions are made to shareholders). To form a limited liability company, a certificate of formation must be filed with the state. Here, there was no filing with the state so the firm is not an LLC.

CONCLUSION: The firm is a GP.

(2) ASSOCIATE ATTORNEYS

See rules above as to when persons are considered partners. Here, the associate attorneys are paid a fixed salary, they do not share profits, so no presumption of being partners. They are not given the label or title of partners nor is there any indication they participate in management or control of the business, which would have been evidence of being partners. They get 25% of gross billings for bringing clients to the firm. The fact that this is only a share of gross billings, rather than net billings (which would be profits) is evidence they are not partners. Also the fact that they only get 25%, a relatively small percentage, of such gross billings also evidences they are not partners because this shows the firm is simply providing them with an incentive to bring in new billings. If they were co-owners (partners), they wouldn't need such incentive. Given all of this, the associate attorneys are not partners.

The owners of an LLC are called members and the owners of a corporation are called shareholders. Since the firm is neither an LLC or corporation (see above), the associate attorneys are not members or shareholders.

An employee is someone who is hired by an employer to provide services to the employer regarding the employer's business. An employee is an agent of the employer, who is the principal. Evidence of an employee-employer relationship can be found when the employee is paid a fixed salary or wages and where the employer has authority for managing the details and method of how the employee performs her job. Here, given the associates get a fixed

salary, they are likely employees.

CONCLUSION: The associates are employees of the firm.

(3) SENIOR ATTORNEYS

See rules above as to when persons are considered partners. Here, the senior attorneys are paid a salary based upon the number of hours they bill, they do not share profits, so no presumption of being partners. Their salary is "fixed" in the sense that it is based upon a unit charge per hour (e.g. $600/hour) and then that unit charge is multiplied against the number of hours the senior bills in every year. The annual bonus is part of the compensation package, but it is contingent–only applies if the senior bills more than 2000 hours a year, so such bonus does not take away from the fact that the senior is paid a "fixed" salary based on number of hours billed. While it is true that the bonus is equal to 5% of profits, split equally among the number of qualifying seniors, this is not evidence of the sharing of profits in the sense that it is not all seniors who get to participate in this share of profits–just the ones who are eligible for the bonus having billed the requisite number of hours. Put another way, it is not as though the position of being a senior automatically provides the right to share in the profits. While it is true that that the seniors have the title "nonequity partner" and that the website and business cards say "partner", the label or title of "partner" is not conclusive. The facts say that A, B and C "agreed to bestow" the title nonequity partner, which makes it seem as though this was just a concession on A, B and C's part to make the seniors feel their position in the firm was one of seniority or importance, rather than an intent for them to actually be partners in the firm. The fact that A, B and C had the power to decide what title seniors get also shows that A, B and C are in a superior position compared to the seniors rather than them all being equal partners. Furthermore, the seniors do not participate in management or control of the business, which would have been evidence of being partners.

The owners of an LLC are called members and the owners of a corporation are called shareholders. Since the firm is neither an LLC or corporation (see above), the senior attorneys are not members or shareholders.

See above for rules as to employees. Here, given the seniors do not get to participate in the management of the firm, and that all such business and management decisions are made exclusively by A, B and C, it is likely that seniors are simply employees of the firm.

CONCLUSION: The senior attorneys are employees of the firm.

(4) THE AGREEMENT WITH NANCY

A partnership is bound by the contracts entered into by its partners and employees (both of whom are considered agents) where such agents had actual authority, apparent authority or where the partnership ratifies the agreement.

Actual authority can be express or implied. Express actual authority is where the partnership expressly by words or writing provides authority. Implied actual authority exists where based

on the manifestations (words or conduct) of the partnership, the agent reasonably believes she possesses authority.

Apparent authority exists where based on the manifestations of the partnership, third parties reasonably believe the agent has authority to bind the partnership. The partnership statute says that apparent authority exists where the partner is acting within the scope of the partnership business or business of a kind conducted by the partnership, unless the partner lacked actual authority and the person knew or received notification of such.

Ratification is where the partnership agrees to the contract after it has been entered into, either formally and expressly through a formal decision or impliedly by accepting the benefits of the contract.

Here, Martha is an employee of the firm and thus is an agent of the firm. She does not possess actual authority (express nor implied) to bind the firm to a contract providing for reduced hourly rates because the firm has a strict policy of not allowing for reduced rates and Martha knows this is so (therefore, she could not have reasonably believed she had such authority).

It is questionable whether Martha possessed apparent authority. On the one hand, she did because the firm gave her a business card that refers to her as a "partner". A third party in the shoes of Nancy upon seeing such an official business card bestowed upon Martha by the firm, and that Martha was given the title "partner" on that card, would reasonably believe that Martha possesses the authority to bind the firm into contracts regarding legal business and to negotiate rates for legal services in exchange for future business. Those kinds of matters are apparently within the regular business of a law firm. Most people would believe that the title "partner" carries with it great seniority and authority. A reasonable third party in Nancy's shoes would have no idea or knowledge of the behind-the-scenes compensation package of persons like Martha which would otherwise reveal that such persons are not really partners. They also would have no idea of the firm's strict policy of not allowing reduced hourly rates because it is likely that policy is just internal and not disclosed to the public. Furthermore, the fact that the website also refers to Martha as a partner also would give third parties the reasonable belief that senior attorneys had authority to negotiate fees and fee agreements with prospective clients.

In addition, Nancy specifically asked Martha if she could agree to the reduced hourly fee arrangement and in response Martha went ahead and signed a written agreement. Presumably, therefore, Nancy responded to Martha in the affirmative and represented that she did in fact possess authority. She might even have signed her name as "partner" on the agreement or used official firm letterhead. However, it should be noted that under agency-principal law, apparent authority exists based on the actions of the principal, not the agent, so here the unilateral actions and representations of Martha alone would not be enough to imbue Martha with apparent authority as those are not actions or manifestations of the firm.

While it is true that Nancy and Martha met a social function, this is of no moment to the issue of whether the firm is bound by the agreement. Persons regularly form business relationships at social functions. It is not as though the agreement was signed at the social function. Probably

it was signed afterwards in the office of the law firm.

As to ratification, there is no indication that the law firm ratified the agreement.

CONCLUSION: The firm is bound by the agreement Martha signed with Nancy because Martha possessed the apparent authority to enter into such agreement on behalf of the firm.

# QUESTION 5: SELECTED ANSWER B

**1. Business Entity**

First, we assess what type of entity the firm is.

**Limited Partnership**

A limited partnership is formed when it is filed with the Secretary of State, signed by all general partners. A limited partnership has general partners, which manage the partnership and are personally liable for the partnerships acts, and limited partners who are not liable for the partnerships acts, do not have management duties, and are only liable for their contribution/investment. Here, the business filed no documents with the Secretary of State or any other state office, and none of the partners signed such agreement. Therefore, it is unlikely that the firm is a limited partnership.

Limited Liability Partnership

A limited liability partnership must also be filed with the Secretary of State. In a limited liability partnership, all partners have limited liability and are not liable for the acts of the partnership. Here, nothing was filed with the Secretary of State, and there are no facts that suggest that they, Andrew, Bob, and Christine are limited partners or that anyone in the firm is a limited partner.

**LLC (Limited Liability Company)**

A limited liability company is also filed with the Secretary of State, with an agreement, and agents for service selected. Here, no facts suggest an LLC was formed or anything was filed with the Secretary of State, therefore, it is unlikely that the firm is an LLC.

**Corporation**

A corporation is formed when its articles of incorporation are filed with the Secretary of State, stating the corporation's purpose. Here, there were no articles of incorporation filed with the Secretary of State with anything related to the purposes of a corporation, so the firm is not a corporation.

**General Partnership**

A general partnership is the default form of partnership, where partners share profits, co-own, and manage the business together. No writing is required and it does not need to be filed with the Secretary of State. Here, Andrew, Bob, and Christine equally share firm profits after paying all expenses and make all business and management decisions together. This is likely a general partnership as they are co-owners of a business they run and manage together, and they share profits.

**2. Classification of the Associate Attorneys**

Next, we assess the classification of the associate attorneys

**Employees**

An employee is a person who works for the company that does not share profits, and works under the management and direction of partners/directors. At this firm, associate attorneys are paid a fixed salary, plus 25% of gross billings for any client they bring to the firm. It could be argued that associate attorneys are employees as they receive a fixed salary and are paid for their performance, 25% of gross billings for anyone they bring to the firm. They do not share profits or partake in any management of the firm, so it is likely that the associate attorneys are employees.

**Partners**

As mentioned above, partners run and manage a business and share profits. The associate attorneys do not have management authority and they do not share profits, two of the most crucial factors that determine whether someone is a partner. Likely, they are not considered partners.

**Members**

Members are people who are part of an LLC. Here, an LLC is not established, so it is unlikely that they would be considered members.

**Shareholders**

Shareholders are people who own stock or equity in a corporation. Here, no facts suggest they own any stock or shares in the firm or if the firm is a corporation. Likely, they would not be considered shareholders either.

**3. Classification of the Senior Attorneys**

Another issue is what the senior attorneys are classified as.

**Employees**

As mentioned above, an employee is a person who works for the company that does not share profits, and works under the management and direction of partners/directors. Here, senior attorneys are paid based upon the number of hours they bill plus an annual bonus if they bill more than 2000 hours in a year. The senior attorney bonus pool is equal to 5% of the firm's profits, which is split equally by the number of qualifying senior attorneys each year. In addition, Andrew Bob, and Christine agreed to bestow the title nonequity partner on senior attorneys even though they have no management authority. Also, the firm website and

business cards for senior attorneys list their title as "partner." Here, the senior attorneys are paid upon the numbers of hours they bill, a bonus if they reach more than 2000 a year, and an attorney bonus pool is equal to 5% of the firm's profits. They are paid based on their performance, but they do get their bonus from 5% of the firm's profits. It could be argued that the senior attorneys share profits, which is something not in the realm of what employees get to do. However, they do not have management authority. If this was a limited partnership, it could be argued that the senior associates are limited partners because they have no management authority but get to share some profits. However, no limited partnership was established here, and even though the senior attorneys have titles as partner, and share a small sum of profits, they have no management authority and are paid based on performance, so it is likely that the senior attorneys are also employees of the firm.

**Partners**

Here, senior attorneys are paid based upon the number of hours they bill plus an annual bonus if they bill more than 2000 hours in a year. The senior attorney bonus pool is equal to 5% of the firm's profits, which is split equally by the number of qualifying senior attorneys each year. They also have the title of partner on the firm website and agree to bestow the title of nonequity partner. However, they have no management authority, and only share as mentioned above, they lack management authority and are paid on performance rather than share all of the profits, so it is likely that the senior associates are still employees. The title and small share of profits are not enough to rule them as partners as they cannot make decisions for the partnership. If this was a limited partnership, the traits of the senior associates mirror limited partners, but as mentioned above, an LLP was not established and therefore they are likely employees of the firm.

**Members**

As mentioned above, members are people who run an LLC, and an LLC was not established in the facts so the senior attorneys are not members.

**Shareholders**

As mentioned above, shareholders own stock or equity in a corporation, and make decisions and vote for corporate issues regarding the corporation. Nothing in the facts suggest the senior attorneys are shareholders.

**4. Whether the firm is bound by Martha's Agreement with Nancy**

Last, we assess whether the firm is bound by the agreement Martha signed with Nancy. In order for a partnership to be liable for the acts of the partner, authority must be established. A partner is essentially an agent of the partnership and can act on behalf of the partnership to enter into agreements and conduct business.

**Actual authority**

First, we assess whether there was actual authority. Actual authority can either be express or implied.

**Actual Express Authority**

Actual express authority is when the partnership/principal gives actual express authority through an agreement, conduct, or words expressly granting the partner/agent to conduct an act. Here, Martha, a senior attorney, met Nancy at a social function and Nancy told Martha about her business legal issues. Martha gave Nancy her business card, and after looking at the card (which showed Martha as a "partner") she can agree to the firm handling her legal problems at a reduced hourly rate in return for future business. Martha was aware that the firm has a strict policy of not reducing hourly rates, but signed the agreement for it to handle Nancy's legal matter at a reduced hourly rate. Here, Martha did not have express authority to enter into an agreement with reduced hourly rates, it was strictly against firm policy and therefore Martha lacked express actual authority to enter into the agreement.

**Actual Implied Authority**

Actual implied authority is formed when the partner/agent reasonably believes that he/she is allowed to act in a certain way based on conduct of the partnership/principal. Here, there is no evidence of conduct that would make Martha reasonably believe she had the authority to enter into such agreement. The firm has a strict policy of not reducing hourly rates, and Martha acted against that. There was no implied authority for Martha to enter into the agreement.

**Apparent Authority**

Last, we assess apparent authority. Apparent authority is given when a third party reasonably believes that the partner/agent has authority to act on behalf of the principal/partnership. Here, the firm’s website and business cards for senior attorneys stated that they are "partners." Nancy saw Martha’s business card that stated she was a partner, and asked if she can agree to the firm handling her issues for a lower rate, in capacity as a partner. Nancy reasonably believed that Martha had authority to act in such way and enter into the agreement, and no facts suggest she could not reasonably believe so. Even though it was against firm policy, it is likely that the firm will be bound to the agreement by apparent authority.

The State Bar of California

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# ESSAY QUESTIONS AND SELECTED ANSWERS

## OCTOBER 2020

## CALIFORNIA BAR EXAMINATION

This publication contains the five essay questions from the October 2020 California Bar Examination and two selected answers for each question.

The answers were assigned high grades and were written by applicants who passed the examination after one read. The answers were produced as submitted by the applicant, except that minor corrections in spelling and punctuation were made for ease in reading. They are reproduced here with the consent of the authors.

| Question Number | Subject |
|---|---|
| 1. | Professional Responsibility |
| 2. | Business Associations |
| 3. | Real Property |
| 4. | Criminal Law and Procedure |
| 5. | Remedies |

# QUESTION 2

Acme Inc. is a corporation that has been profitable for several years and now holds $20 million cash in its treasury.

Acme's board of directors consists of Brown (Acme's Chief Executive Officer), Chase (Acme's Chief Financial Officer), and ten other non-employee ("outside") directors.

Acme's board of directors recently met to consider the best course of action with regard to the cash in its treasury. At this meeting, Brown and Chase strongly recommended that Acme pay a dividend to its shareholders. The board then heard a report from an outside consulting firm regarding the favorable prospects for Acme's expansion into a new line of business. After a lengthy discussion, the ten outside directors voted in favor of a resolution not to declare a dividend and instead to hold the accumulated cash for the corporation's future use. Brown and Chase voted against this resolution. The entire board of directors also voted unanimously to make a $100,000 cash contribution to a private university. Brown is a graduate of this university and a member of its board of trustees. The other Acme board members knew these facts at the time the board unanimously authorized the contribution.

One of Acme's many shareholders, Davis, is upset about the board's decision not to declare a dividend. He sent a letter to Acme's board demanding inspection of Acme's records relating to this decision.

Another Acme shareholder, Evan, filed a lawsuit against Acme and its board seeking orders that Acme pay a dividend to its shareholders and be enjoined from contributing $100,000 to the university.

1. Did Acme's outside directors possess the authority to reject Brown’s and Chase's recommendation to pay a dividend from cash in the treasury? Discuss.

2. Does Davis have a right to inspect Acme's records relating to the board meeting described above? Discuss.

3. Is Evan likely to prevail in his suit for an order that the corporation pay a dividend? Discuss.

4. Is Evan likely to prevail in his suit to enjoin Acme from paying $100,000 to the private university? Discuss.

# QUESTION 2: SELECTED ANSWER A

A corporation is an entity distinct from its owners, the shareholders. A corporation can sue or be sued.

Here, Acme Inc. is a corporation and can sue and be sued.

Pay Dividends:

The first issue is whether Acme's outside directors possessed the authority to reject Brown's and Chase's recommendation to pay a dividend from cash in the treasury.

The board of directors in a corporation manages the internal affairs of the corporation. In order to make decisions, the board must either call a meeting with the required quorum and vote on the matter, decide using unanimous written consent, or they must ratify the matter after the fact with proper board approval. A board meeting either occurs annually, at which the time and place and date are set out in the articles or bylaws, or through a special meeting, which requires at least two days' notice stating the time, date, and place of the meeting. A director can be an officer or shareholder, but they are not required to be.

Here, Acme's board of directors recently met to consider what to do with their cash in the treasury. Brown and Chase recommended that Acme pay a dividend to its shareholders, but then ten outside directors voted in favor of a resolution not to declare a dividend instead. It is unclear whether this was an annual meeting or a special meeting, but assuming that the proper notice was given if it was a special meeting, the next issue is whether the decision was properly voted on.

In order for the board to make a valid decision, there must be a quorum. Unless the bylaws or articles of incorporation state otherwise, a quorum is a majority of the directors on the board. In addition, for a proper vote, there must be a majority of the quorum voting in favor of the decision.

Here, there are twelve directors, including Brown and Chase. It appears that all of the directors were present at the meeting, and thus had a proper quorum. Next, ten of the outside directors voted in favor of a resolution to not declare a dividend and instead hold the cash for the corporation's future use. This vote was ten out of twelve directors, and thus was a proper board approval.

Therefore, this decision by the outside directors was proper. The fact that they were outside directors does not affect their ability to vote.

In addition, the decision as to whether or not to declare a dividend is in the complete discretion of the board, subject to limitation rules pertaining to the corporation's solvency. A dividend is a distribution that is given to shareholders who have rights to dividends. The board may not permit a dividend distribution if either the corporation would not be able to pay their debts as they come due, or if the corporation's assets are lower than their liabilities, including the preference payment required to be given to preferred shares upon dissolution.

Here, the board decided to not give dividends out and thus the limitation rules do not apply. The decision to not give dividends was in the board's sole discretion, absent an abuse of discretion. This decision was proper and the directors possessed the authority to reject Brown and Chase's recommendation to pay a dividend from cash in the treasury. Although Acme had $20 million in its treasury, the board was not required to

give out a dividend.

Davis's inspection Rights:

The next issue is whether Davis has a right to inspect Acme's records.

A shareholder has an unqualified right to inspect the corporation's books and records in regards to the bylaws and articles, the communications that the board has made to the shareholders in the last three years, the annual report that the corporation files in the last three years, the minutes at shareholder meetings, and other ordinary records pertaining to their rights as a shareholder. In addition, a shareholder, with five days written notice, may request to inspect other books and records relating to the finances and other records of the corporation upon a showing of a proper purpose. This proper purpose must be related to their rights and duties as a shareholder. Typically, after showing a proper purpose, the board should approve the request. Either the shareholder may inspect the records or have an attorney inspect the records for them.

Here, Davis is requesting a right to inspect Acme's records relating to the board meeting described above. The board's minutes from the meeting likely relates to Davis' rights as a shareholder, because as described below, Evan may assert that the board violated its fiduciary duties to the corporation in the meeting. A shareholder has a right to bring a derivative suit on behalf of the corporation if they satisfy the required procedures and the court finds that the suit should go forward. Therefore, having these minutes from the board meeting where the board decided to not declare a dividend can be offered as proof that thee directors possibly violated their duties as directors. However, shareholders do not have a right to demand a dividend distribution. Therefore, if Davis is simply upset about the dividend distribution, then getting these records may not relate

to his rights as a shareholder. Davis may argue that the board abused its discretion. Nevertheless, if Davis does in fact show a proper purpose then he must make a written demand to the board with five days' notice.

Dividend:

The next issue is whether Evan is likely to prevail in his suit for an order that the corporation pay a dividend.

A shareholder may sue a corporation either in a direct action in order to obtain judgment personally or a derivative suit in which the shareholder sues to vindicate a claim on behalf of the corporation. In a derivative suit, the corporation collects the judgment.

Here, Evan would be suing in a direct action because he is suing on behalf of his right to receive a dividend.

However, as described above, the decision as to whether or not to declare a dividend is in the complete discretion of the board, subject to limitation rules pertaining to the corporation's solvency. The board may not permit a dividend distribution if either 1) the corporation would not be able to pay their debts as they come due, or if 2) the corporation's assets are lower than their liabilities, including the preference payment required to be given to preferred shares upon dissolution.

Here, Acme Inc.'s cash in the treasury amounts to $20 million. Therefore, Acme Inc. likely would be able to give out a cash dividend to its shareholders. However, as described, this decision is within the board's discretion and the board decided to not make distributions. Therefore, Evan would likely fail in his suit against the corporation for not giving out a distribution.

However, Evan may assert in a derivative action that the directors violated their duty of care in making the decision.

Derivative Action:

In order to file a derivative action, the shareholder must be a shareholder at the time of commencement of the suit, and a shareholder at the time of the alleged wrongful conduct or a shareholder by operation of law.

Here, Evan is currently a shareholder. Further, it appears that Evan was a shareholder when the decision was made to not distribute dividends. Therefore, standing is satisfied.

Further, a shareholder must make a written demand on the board to bring suit on behalf of the corporation. The shareholder must then wait 90 days before bringing the suit unless the shareholder can show that the corporation will suffer irreparable injury or the board has already objected to bringing suit. Further, some jurisdictions permit a shareholder to not bring demand if it would be futile. A demand may be futile where the majority of the directors are interested in the transaction.

Here, it is unclear whether Evan made a demand on the corporation. There is no indication that it would be futile to bring a written demand in relation to the dividend distributions because there do not seem to be interested directors in the decision to not declare dividends. Further, there is no indication that the board has objected to bring suit. Further, there likely would not be irreparable injury to the corporation in waiting 90 days to bring suit because the suit is solely based on the decision to not make a dividend distribution, which as described, is in the board's discretion.

Therefore, Evan must first make a written demand and must wait 90 days to bring suit.

Duty of Care:

Evan may assert that the board breached its duty of care in deciding to not distribute dividends. Each director has a duty of care to act in good faith, act as a reasonably prudent person would under the circumstances, and act in a manner that a reasonable director would believe is in the best interest of the corporation. Where there is no indication that there is a lack of good faith or self-dealing or conflicts of interest, the burden is on the shareholder to prove that this duty was breached. Further, directors are permitted to rely on outside reports in making their decisions where they are prepared by officers of the corporation, attorneys, accountants, or other professionals that the director believes is competent.

Here, Brown and Chase strongly recommended that Acme pay the dividend but the outside directors decided that it was not in the corporation's best interest. While the ten directors did not go with their recommendation, they did not have to. The ten directors made a reasonable inquiry into the decision after hearing a report from an outside consulting firm regarding the favorable prospects for Acme's expansion into a new line of business. Therefore, as long as the directors reasonably believed that the firm was competent, the ten outside directors could reasonably rely on this outside consulting firm in making the reasonable decision that the corporation should instead hold the accumulated cash for the corporation's future use, including expanding to a new line of business. Further, it states that there was a lengthy discussion before the directors decided to not vote in favor of the distribution which indicates reasonable diligence in their decision-making procedures. Further, there is no indication of a lack of good faith. Therefore, the court will defer to the board's decision in the matter based on the

business judgment rule - the board made a reasonably inquiry into the facts related to making the decision to not distribute the funds, there was no bad faith or conflict of interest, or self- dealing. Therefore, the burden was on Evan to prove the duty of care standard was breached. As described above, he likely cannot prove that it was breached, especially because the decision to declare a dividend is in the board's discretion.

Therefore, Evan's suit will likely not succeed against the board for the dividend decision.

Payment to the Private University:

The next issue is whether Evan is likely to prevail in his suit to enjoin Acme from paying $100,000 to the private university.

As described above, this would be a derivative action in which Evan would be bringing the suit on behalf of the corporation due to the directors' breach of their fiduciary duty. The board makes the managerial decisions as to the internal affairs of the corporation. Therefore, this decision was solely in the board's discretion and Evan does not have a personal direct suit against Acme Inc.

Duty of Loyalty:

Evan may assert that the board breached its duty of loyalty when it decided to give a cash contribution to a private University that Brown graduated from and is a member of the board of trustees.

Each director of the board owes a duty of loyalty to the corporation to act in the corporation's best interests. A breach of the duty of loyalty may occur where a director engages in self- dealing. Self- dealing occurs where the corporation enters into a

transaction where a person or entity on the other side of the transaction is a director, or a director's family member, someone the director has a personal or professional relationship with or an organization in which the director is a director, shareholder, or officer.

Here, the private university that Acme gave the money to was a university in which Brown graduated and is a member of the board of trustees. Therefore, there may be a duty of loyalty violation. Where there is a self-dealing transaction, the director that is interested, here Brown, may satisfy his duty of loyalty by disclosing all material facts fully and adequately to the board and the board votes in a proper board vote to engage in the transaction. The quorum required for the board vote excludes any interested directors and there must be a proper vote based on disinterested directors. In the alternative, the interested director may fully and adequately disclose the information to the shareholders who must conduct a proper vote with the disinterested shareholders voting in favor of the transaction with more votes in favor than against. In the alternative, the terms must be fair to the corporation.

Here, Brown graduated and is a member of the board of trustees and is also on the board of Acme Inc. Therefore, Brown would be considered an interested director. There is no indication that there was a shareholder approval of the decision to make the contribution. However, it states that the Acme board members knew of these facts at the time that the board unanimously authorized the contribution. Therefore, Brown may have fully and adequately disclosed his interests in the contribution before the board voted. However, Brown was not permitted to vote in the transaction because he was an interested director. However, without Brown counted in the quorum or in the vote, the

quorum would have been 11 out of 12 directors for a proper quorum - more than the majority. Further, the vote required would be a majority of the disinterested directors. Here, all 11 of the disinterested directors voted in favor of the contribution. Therefore, there is an adequate vote in favor of the transaction.

In the alternative, the terms of the transaction may be fair to the corporation, even if the decision was not validly disclosed and voted on. The court will consider alternatives, the corporation's assets, the corporation's need to engage in the transaction, and other factors. There are no facts here that indicate that this transaction to the university was not fair to the corporation. A corporation is permitted to make charitable contributions and all of the directors unanimously agreed that the decision was a good decision.

Therefore, if the fact that Brown actually voted in the transaction does not defeat the validity of the vote, the contribution was validly approved. Further, Brown did not violate his duty of loyalty to the corporation because Brown disclosed the facts of his interest and board voted with the proper amount of disinterested votes. Further, the terms appear fair to the corporation.

Therefore, Evan likely will not prevail in a suit against the Acme directors for paying $100,000 to the private university.

Duty of Care:

Evan may also assert a derivative action on behalf of the corporation alleging that the directors violated their fiduciary duty of care to the corporation in giving the distribution to the university. Using the standard described above, there is no indication that there was a lack of good faith on behalf of the board of directors. Further, the duty of loyalty does not appear to have been breached. Further, under the circumstances it may have

been reasonable to give $100,000 to the university under the circumstances. This amount of money is not much compared to the $20 million that Acme has in its treasury. All of the directors voted unanimously which indicates that a director would reasonably believe that this decision was in the best interest of the corporation.

Therefore, the duty of care was likely not breached.

Improper Distribution:

Evan may also assert that the $100,000 contribution was an improper distribution due to the solvency standards described above. However, as indicated, $100,000 out of $20 million in the treasury does not appear to be enough money that would make the corporation unable to pay its debts as they come due. Further, it likely will not make it so the corporation's liabilities outweigh its assets, including the preferences required upon dissolution.

Therefore, Evan likely will not succeed in asserting that the distribution to the corporation was an improper distribution.

# QUESTION 2: SELECTED ANSWER B

1. Did Acme's outside directors possess the authority to reject Brown's and Chase's recommendations to pay dividend?

The board

In a corporation, the board of directors run the big picture of the corporation. They appoint the officers and managers as well as vote on major corporate transactions. Board of directors can be comprised of two types of directors. Inside directors and outside directors. Outside directors are those who are otherwise disinterested in the day to day operations because their only relationship to the corporation is their board position. Inside directors however are directors that work in the corporation as managers. These are often the CEO and CFO as the case is here with Brown (B) and Chase (C).

Power of the board

The board of directors votes on major corporate transactions. These include mergers, acquisitions, partial or whole assets sales, dividend distributions, and new large investments. The board of directors, unless specified otherwise in the bylaws, must approve all the matters before it by a majority vote. Inside directors and outside directors votes are equal. In order to have a proper vote, there must be quorum. Quorum requires a majority of disinterested directors. Disinterested directors are those directors that do not have a personal stake in the matter at hand.

Quorum

Here, Acme has 12 directors. Two inside and two outside directors. The vote at issue is a vote regarding the distribution to pay a dividend. Since all 12 directors voted, we assume that quorum was met as all 12 were present.

Majority vote

In order to pass a vote, the board must pass it by a majority. 10 voted against the dividend and 2 voted for the dividend. A majority clearly voted against the dividend. Therefore, the dividend was properly rejected. The fact that the outside directors voted is of no consequence. An outside director possesses the same amount of voting power as any inside director.

Conclusion

The board properly voted on a corporate transaction that was within its power to either institute or reject. The board had quorum to vote on it because all 12 directors were present. Finally, the board rejected it by a majority vote. The fact that dividend was the recommendation of the CEO and CFO means nothing. The entire point of the board is that they are people unrelated with the day to day operations of the corporation that give an outside view. The CEO and CFO salaries may depend on stock price. Issuing a dividend may increase stock price. Therefore, the CEO and CFO have an incentive to increase the stock price via dividend. The board was under no requirement to accept their recommendation and properly rejected it with a majority vote.

2. Does Davis have a right to inspect Acme's records relating to the board meeting described above?

Shareholder inspection rights are a keystone right of shareholders. Shareholders, if certain conditions are met, have the right to inspect the books and records of the corporation including board meeting minutes. In order for a shareholder to have inspection rights, they must show that they are indeed a shareholder and that they have a proper purpose in asking for inspection.

Shareholder

Only a shareholder can inspect a corporation’s records. The amount of shares held is irrelevant. The only requirement is that the person is a current shareholder of the corporation. Here, Davis is a shareholder of the corporation. Therefore, this requirement is met.

Proper purpose

A shareholder must have a proper purpose. A proper purpose can be many things including investigating potential fraud, reviewing financial statements, making sure corporate formalities were followed properly. A proper purpose is anything that has to do with a shareholder’s interests in the health of the corporation as it relates to their ownership of the corporation. An improper purpose arises when a shareholder is attempting to inspect the records for personal benefit or with the goals to harm the corporation.

Here, Davis is upset about the board’s decision not to declare a dividend and wants to inspect the records. Davis will argue that he has a proper purpose because he wants to

know the reasons why a dividend was not declared. Perhaps once he looks at the meeting minutes and realizes that the money was saved for better business opportunities later on he will be satisfied. Also, Davis may argue that he wants to make sure the board was properly informed or had no conflicts. The corporation may argue that Davis is just trying to harass them. However, there is no indication of any ill will on the part of Davis. Davis has a right to understand how and why the board came to its decision. Overall, Davis likely has a proper purpose.

Conclusion

Davis has a right to inspect the corporation's records. Davis is a shareholder of the corporation and he has a proper purpose related to his interests as to why a dividend was not declared.

3. Is Evan likely to prevail in his suit for an order that the corporation pay a dividend?

Evan is suing the corporation in an attempt to order the corporation to pay a dividend. Evan may be able to do this through either a direct suit or a derivative suit.

Direct suit

In a direct suit, Evan is suing the board of directors himself as a shareholder. A direct suit involves a board infringing on the rights of individual shareholders. Evan will argue that the board is infringing on his right as a shareholder to pay him a dividend. On the other hand, the board will argue that they are under no obligation to pay out dividends. Evan will argue that the corporation has $20 million in cash reserves and the shareholders are entitled to see some of that profit. The board however will ultimately prevail. The board will be correct in that the board has ultimate power to make decisions

for the corporation. This includes whether to give dividends or not give dividends. The board has complete discretion and Evan's direct suit will fail.

Derivative suit

A derivative suit is a lawsuit where a shareholder demands that the corporation sue the board of directors directly for some violation. Usually a fiduciary duty violation. Here, Evan may argue that it was a violation of the duty of care not to issue a dividend and improper for the board of directors to use an outside consulting firm and therefore the money should be distributed to shareholders instead of saved for later.

In order to bring a derivative suit, a shareholder must make a demand on the board, be a shareholder at the time of the harm, hold shares throughout the suit, and adequately represent all the shareholders. There is no evidence if demand was made but to proceed it must be made or shown to be futile. Evan was a shareholder at the time of the harm and the assumption is that he will hold throughout the suit. Finally, there is nothing to indicate that Evan does not adequately represent the shareholders.

Duty of care

The duty of care requires a director to act as a reasonably prudent director under the circumstances. The duty of care requires that a director act with the requisite skill, knowledge, and care of an ordinary director and employ their personal skills in their care. As part of the duty of care, directors must make sure that they are properly informed in regard to the corporate decisions that they make. Evan will argue that the directors violated the duty of care when they followed the recommendation of an outside consulting firm in deciding to save money instead of giving a dividend. The board however will argue that they are entitled to rely on outside sources such as attorneys,

consultants, and accountants in coming to informed decisions. The whole purpose of those outside sources is to provide directors with better knowledge and understanding. Additionally, the directors will stress that they are under no obligation to give the dividend even if using an outside consultant was a violation. Overall, the directors are unlikely to be in violation of the duty of care in this situation.

<u>Business Judgment Rule</u>

The business judgement rule (BJR), is a presumption that directors acted in an informed matter in the best interests of the corporation. The BJR presumes that directors acted in good faith and protects them from liability for basic corporate decisions. For a shareholder to succeed in arguing the duty of care violation, they must rebut the BJR. The BJR can be rebutted through a showing of bad faith, self-dealing, gross negligence towards their duties, and more. Here, Evan will argue that the BJR should be rebutted because the directors failed to make their own decision and therefore acted in bad faith. The directors on the other hand will argue the opposite that bringing in the consultants was in good faith because it helped them make an informed decision. Overall, the BJR is unlikely to be rebutted here because there is no bad faith.

<u>Conclusion</u>

Evan is unlikely to succeed in any suit against the corporation. Evan will not succeed in a direct suit because the board is under no obligation to issue a dividend. He will also not succeed in a direct suit because the board acted in good faith and did not breach the duty of care.

4. Is Evan likely to prevail in his suit to enjoin Acme from paying $100K to the private university?

Derivative suit

In this case, Evan will only be suing via derivative suit because he is challenging a corporate transaction that doesn't independently involve shareholders. See rules above for derivative suit. Here once again, Evan held the shares during the harm, will likely hold throughout, and will adequately represent the shareholders. Once again, Evan will have to make a demand on the board or show that demand is futile. We have no evidence that he made demand but to proceed with the suit he will have to.

In the derivative suit, Evan will be alleging that the board violated their duty of care by giving $100,000 to a university and also the duty of loyalty by giving it to the university of the CEO.

Duty of care

See rule above. Evan will argue that the directors failed to act as reasonably prudent directors because they are spending money outside of the company. The $100,000 could have gone to shareholders but instead it went to a university. Assuming that the university is not within the business ACME runs, Evan will argue that this was equivalent to setting corporate funds on fire. The board will argue that it is well accepted that a corporation may make donations where it sees fit without violating the duty of care. The board will argue that there are a lot of intangible benefits of donating money, especially to a university. It helps with recruiting and getting good new employees. Additionally, public image of being a caring corporation is important. Finally, the board will argue that it has been ruled by courts that general corporate donations purely out of

good will are within the board's discretion. Finally, the board will argue that $100,000 out of $20 million is a very small amount that is not going to create a negative financial impact on the corporation. Overall, the board will succeed in arguing that the donation was valid.

Business judgment rule

See rule above. Evan will argue that the board should not be protected by the business judgment rule because of the conflict of interest since the CEO wanted to give money to his alma mater where he is a member of the board of trustees. The board however will argue that they did not act in bad faith because a majority of disinterested directors approved the transaction. There was no self-dealing here because 11/12 directors who did not go to the school voted in favor of it. Further, 10 of those 12 directors were outside directors. Overall, Evan may have some ground arguing that the business judgment rule should not invoke protection because of the interest of the CEO. However, the board also has a strong argument that they acted in good faith.

Conclusion

The board likely did not breach the duty of care. Even if Evan can rebut the BJR, Evan is unlikely to show that the actions actually amounted to a duty of care violation given the circumstances.

Duty of loyalty

Under the duty of loyalty, a director has to act in the best interests of the corporation. Evan will argue that the Brown violated the duty of loyalty by giving money to his own school. Evan will further argue that the board overall violated the duty because money

given outside the corporation and outside their corporate interests is a waste of money. Similar to the discussion above for duty of care, directors had valid, corporate and moral reasons for giving money outside the corporation. The board will argue that the directors were actually acting in the best interests of the corporation by giving money to the university. Overall, the board is unlikely to have failed to act in the best interests of the corporation. However, Brown may have violated the duty of loyalty because of his conflict of interest.

Conflict of interest

A director may not enter into the transaction that the director has a conflict of interest with. Here, Evan will argue that Brown has a conflict of interest in the transaction and therefore the transaction is improper. The conflict of interest arises because Brown is attempting to give money to an organization that he is not only affiliated with, but that he sits on the board of. Brown will likely concede that this in fact a conflict of interest because Brown sits on one board that is giving money to another board. However, Brown will argue that a safe harbor applies.

Safe harbor

A conflicted transaction may nonetheless be valid if the conflict is disclosed and either 1) a majority of disinterested shareholders approve 2) majority of disinterested directors approve or if the transaction is fair.

Here, the second two both apply. The fact pattern indicates that the entire board knew of the conflict of interest. The entire board then unanimously voted to approve it. That means that 11 directors voted in favor of it. All those 11 directors are disinterested so the transaction is valid under the safe harbor.

Additionally, Brown is likely to argue that the transaction is fair. A corporation has a lot to gain from donating to universities as discussed above and $100K for a corporation that has $20 million in cash reserves is an insignificant amount.

Conclusion

Evan will likely fail in his suit because the board did not violate any fiduciary duty to the shareholders by giving $100K to the corporation.

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The State Bar
*of California*

OFFICE OF ADMISSIONS

# ESSAY QUESTIONS AND SELECTED ANSWERS

## FEBRUARY 2022

### CALIFORNIA BAR EXAMINATION

This publication contains the five essay questions from the February 2022 California Bar Examination and two selected answers for each question.

The selected answers are not to be considered "model" or perfect answers. The answers were assigned high grades and were written by applicants who passed the examination after the First Read. They are reproduced as submitted by the applicant, except that minor corrections in spelling and punctuation were made for ease in reading. These answers were written by actual applicants under time constraints without access to outside resources. As such, they do not always correctly identify or respond to all issues raised by the question, and they may contain some extraneous or incorrect information. The answers are published here with the consent of the authors.

| Question Number | Subject |
|---|---|
| 1. | Criminal Law and Procedure |
| 2. | Community Property |
| 3. | Torts / Remedies |
| 4. | Evidence / Professional Responsibility |
| 5. | Business Associations / Remedies |

## QUESTION 5

Arnold and Betty agreed to launch a business selling a durable paint that Arnold had developed and patented. They agreed to share all profits and to act as equal owners. Betty agreed to contribute $100,000 to the business venture. Arnold agreed to contribute his patent for durable paint. Arnold told Betty that he thought the patent was worth $100,000. He did not tell Betty that he had previously tried to sell the patent to several reputable paint companies but was never offered more than $50,000. Arnold and Betty agreed that Betty would be responsible for market research and marketing and Arnold would be responsible for incorporating the business and taking care of any other steps needed to start the enterprise.

Arnold first located a building within which to operate the business, owned by Landlord Co., and entered into a one-year lease in the name of Durable Paint, Inc. Subsequently, after Arnold took the necessary steps, Durable Paint, Inc. was incorporated. At the corporation's first board of directors meeting, Arnold and Betty were named as sole directors and officers. During that meeting, Arnold and Betty voted for the corporation to assume all rights and liabilities for the lease and to accept assignment of Arnold's patent rights.

Over the next six months, Durable Paint, Inc. faced unforeseen and costly manufacturing and supply problems. At the end of the first six months, the corporation had exhausted all its capital and was two months behind on rent. To make matters worse, a competitor developed a far superior product, making Durable Paint, Inc.'s patent effectively worthless. Durable Paint, Inc. had no other assets.

Landlord Co. sued Arnold and Betty personally for damages for breach of the lease.

Betty sued Arnold.

1. On what theory or theories might Arnold be found personally liable for damages to Landlord Co.? Discuss.

2. On what theory or theories might Betty be found personally liable for damages to Landlord Co.? Discuss.

3. On what theory or theories might Arnold be found personally liable for damages to Betty? Discuss.

# QUESTION 5: SELECTED ANSWER A

**Arnold's Liability**

There are multiple theories under which Landlord Co. can try to hold Arnold personally liable.

Corporation Formation - when did Arnold and Betty form a corporation?

*De Jure Corporation*

A corporation is a business entity which is separate from its legal owners (shareholders). This means that the shareholders of the business are not personally liable for the obligations and liabilities of the business. They are only liable to the extent of their investment (and for their own torts). In order to form a corporation (known as a de jure corporation if properly formed), articles of incorporation must be filed with the secretary of state following certain required procedures and including certain information.

Here, Arnold did not take the necessary steps to form Durable Paint, Inc. until after entering into the lease with Landlord Co. Accordingly, a de jure corporation was not formed when Arnold entered into the lease.

*De Facto Corporation*

If a corporation is *not* properly performed, the corporation still may be treated as a corporation for purposes of personal liability of its shareholders if there is a corporation formation statute, there is a good faith attempt to comply with the statute, and the corporation acts as if it is a corporation. In this situation, the incorporator must not know that it failed to form a corporation.

Here, Arnold did not form the corporation or attempt to form the corporation until *after*

the corporation entered into the one-year lease with durable Paint, Inc. Accordingly, Betty and Arnold cannot take advantage of the de facto corporation doctrine.

*Promotor Liability*

Promoter liability concerns a situation in which an individual enters into contracts on behalf of a corporation before the corporation is formed. In this scenario, the promoter is liable on the contract unless there is a later novation (between the corporation, third party and promoter) or the contract states that the promoter is not liable, in which case it is treated as a revocable offer for the corporation. The corporation is only liable on the contract if the corporation adopts the contract.

Here, while the corporation arguably adopted the contract, the facts do not state that there was a novation of Arnold or that the lease stated that Arnold was not liable for the lease. Accordingly, Arnold will be found personally liable on the lease as a promoter. The corporation, Landlord co. and the promoter would have been required to adopt a novation in order to release Arnold from the contract or the lease would have had to state that Arnold was not liable. Thus, Arnold will be found liable on the lease under the promoter theory (unless he is successful on his claim for corporation by estoppel).

*Corporation by Estoppel*

Corporation by estoppel is another doctrine which allows an entity that is not a corporation to be treated as a corporation for purposes of personal liability. This has been abolished in most states, but if applicable, it is applied when the entity has been treated as a corporation by a third party. In this scenario, the third party is estopped from arguing that the corporation is not a corporation. This applies in contract actions, but not in tort actions (because tort plaintiffs do not voluntarily enter into torts). This can

also prevent the incorporator from stating that the corporation was not formed as well. Here, Arnold entered into a one-year lease with Landlord Co. in the name of "Durable Paint, Inc.". Accordingly, Arnold held out the tenant of the lease as being a properly informed corporation. Thus, Arnold can argue that Landlord Co. had the opportunity to investigate Durable Paint, Inc. and see that it was not incorporated. If Arnold is successful in having the court apply this doctrine, Landlord Co. will be estopped from arguing that Durable Paint Inc. is *not* a corporation because it treated Durable Paint, Inc. as a corporation, in which case both *Arnold* and *Betty* would not be personally liable (unless Landlord Co. is successful in piercing the corporation veil, discussed below). However, since Arnold never tried to incorporate the entity before signing the lease, the court may be reluctant to assert this doctrine.

**Betty's Liability**

Partnership

*Formation - did Arnold and Betty enter into a partnership before incorporating the business?*

A partnership is an association of two or more persons to carry on a business for profits. Intent to carry on a business for profit is required, but intent to form a partnership is not. Sharing profits establishes a presumption that a business is a partnership. Equal management rights further add to such presumption. No formalities are required and there need be no written partnership agreement. A partnership is a separate entity from its partners; however, the partners are jointly and severally liable for all obligations and liabilities of the partnership. However, a person that is seeking remedies from the partnership must first extinguish all partnership assets before attempting to recover from

the partners personally.

Here, before the business was incorporated as a corporation, Arnold and Betty agreed to launch a business selling durable paint that Arnold had developed and patented. They agreed to *share all profits* and act as *equal owners*. This created a presumption that they intended to carry on a business for profit. Accordingly, before Arnold and Betty entered into a corporation, they entered into a partnership. The fact that they "called" the partnership "Durable Paint, Inc." is irrelevant for purposes of establishing a partnership. Thus, Arnold and Betty were both personally liable for all obligations of the partnership

*Authority - is the partnership liable for the lease?*

A partner is an agent for the partnership and has the actual and apparent authority to enter into all ordinary business transactions on behalf of the partnership. Actual authority is authority the partner reasonably believes she has from the written partnership agreement or agreement of the partners. Apparent authority is authority a third party reasonably believes the third party has based on the manifestations of the principal. A partnership is liable for obligations and liabilities entered into by a partner acting with authority. Accordingly, the partners are personally liable for all such obligations and liabilities as well (see rules above).

Here, Betty and Arnold agreed that Betty would be responsible for market research and marketing and Arnold would be responsible for incorporating the business and "taking care of any other steps needed to start the enterprise." Accordingly, Betty had actual authority to conduct market research and market the business and Arnold had actual authority to incorporate the business and take care of its other startup needs. Betty will

argue that entering into a one-year lease is not a step need to start the enterprise and that, therefore, Arnold had no actual authority to enter into the lease and that the partnership was therefore not liable on the lease. Landlord co. will argue that entering into a one-year (short-term) lease is a normal step needed to start an enterprise for developing paint. Landlord co. is likely to succeed on this point. As to apparent authority, entering into a one-year office lease is the type of ordinary business transaction that a third could reasonably think that a partner was entering into on behalf of the partnership. Accordingly, under either an actual authority or apparent authority theory, Arnold likely had authority to bind the partnership to the lease.

Therefore, Betty would be personally liable for the obligations of the partnership - i.e., the entering into of the lease. However, Landlord co. would first have to exhaust partnership assets (and the assets are apparently already exhausted).

Betty will argue she is not liable on the lease because the partnership turned into a corporation. While the partnership was dissolved when it turned into a corporation, the lease was entered into while the business was still a partnership. She may be able to argue that the liability (failure to make payments) was not incurred until the partnership was a corporation. If this is the argument, Landlord. Co. can attempt to proceed on a piercing the corporate veil theory.

Corporation's Adoption of the Contract

As discussed above, a corporation can assume a contract entered into by a promoter by adopting the contract after formation. In order for a corporation to adopt a contract, the directors, who are in charge of the management of the corporation, must vote by a majority to adopt the contract.

Here, the facts state that Arnold and Betty assumed all rights and liabilities for the lease. Arnold and Betty were named as the sole directors, and they both voted to adopt the contract. Accordingly, the corporation validly adopted the contract.

Piercing the Corporate Veil

As discussed above, shareholders of a corporation are not ordinarily liable for the obligations of the corporation. However, they may be held liable when the court pierces the corporate veil to prevent fraud and abuse. This will occur (i) when the corporation does not observe corporate formalities (alter-ego theory), (ii) the corporation was undercapitalized, or (iii) to prevent a fraud.

Here, Landlord co. will argue the corporation was undercapitalized as Betty only contributed $100,000 and Arnold contributed his patent. Landlord co. will argue that clearly the corporation was undercapitalized because it could not make payments on a one-year lease or take care of its startup costs. However, $100,000 is not a minor amount, and the facts suggest that the manufacturing and supply problems were unforeseen. However, six months is a very fast amount of time to lose $100,000. Further, the rent may have been expensive if the lease was for manufacturing space. If the lease was for office space, the rent would be cheaper, and the capitalization amount may have been reasonable. Ultimately, this is a question for the court, but Betty is likely to succeed on this point. There are no facts to suggest corporate formalities were not formed as the corporation held a board of director's meeting where the directors were named, and no corporate funds are implied to have been used for private use. Further, there is no evidence of fraud.

Accordingly, Landlord Co. is probably unlikely to succeed on a claim for piercing the

corporate veil unless it can prove undercapitalization.

**Arnold v. Betty**

*Contribution - Partnership*

When a partner is held personally liable for an obligation of the partnership, such a partner may be entitled to sue the partner who is actually responsible for such liability for contribution if they violated an obligation to the partnership. Further, a partner is a fiduciary to the partnership and partners and owes a duty of care to act in the best interest of the partnership and with reasonable care.

Here, as discussed above, Betty may be found personally liable to Landlord Co. for damages for the unpaid rent. However, as discussed above, Arnold entered into the partnership lease with Landlord Co. However, he did so with authority of the partnership. Accordingly, Betty will probably not succeed against Arnold in an action for damages based on contribution under a partnership theory.

Betty can argue that Arnold breached his duty of care in failing to form the corporation before entering into the relationship with Landlord and in failing to properly "capitalize" the corporation with a patent. However, Arnold will argue that it was Betty's job to conduct market research, not Arnold, and she should have known about the competitor. She will likely not succeed on this argument, but she may succeed in arguing that Arnold failed to properly form the corporation since he violated his duty of care in doing so and thereby injured the partnership.

*Fraudulent Misrepresentation*

A person may be found liable for fraud when they make a material misstatement of past or present fact upon which a reasonable person would rely and upon which the person

does, in fact, rely to their detriment.

Here, Arnold agreed to contribute his patent for durable paint to the partnership. He told Betty that he thought the patent was worth $100,000. However, he did not tell Betty that he had previously tried to sell the patent to several reputable paint companies but was never offered more than $50,000. Accordingly, at worst, he had no reasonable basis to believe the paint was worth $50,000, and at best, he failed to disclose a material fact. It is likely that Betty agreed to enter into the partnership and corporation with Arnold due to an equal share of investment and that this induced her to enter into such business. She then lost her investment and was held personally liable for an obligation of the business. Accordingly, she may be able to succeed against Arnold on a theory of fraudulent misrepresentation for his nondisclosure regarding the true worth of the patent.

*Duty of Care* - Corporation

A director owes a corporation the duty of care. Betty can sue Arnold on a derivative claim for violation of the duty of care in mismanagement of the corporation in causing it to financially exhaust its resources, but the damages would go to the corporation, and not to Betty. Further, Arnold can rely on the business judgment rule, which defers to the judgment of the directors so long as they act reasonably and in good faith without a conflict of interest.

# QUESTION 5: SELECTED ANSWER B

ANSWER TO QUESTION 5

I. Arnold's Liability to Landlord Co.

A. Partnership Liability

The issue is whether Arnold can be held personally liable as a partner of Durable Paint, Inc.

i. Formation

The issue is whether Arnold and Betty formed a valid partnership.

A partnership is the carrying on of a business for profit by two or persons as co-owners. There are three types of partnerships: general partnerships, limited partnerships, and limited liability partnerships. There are no formalities necessary to create a general partnership. A general partnership will be presumed where two parties share the profits of a business venture. The parties' subjective intentions are irrelevant when considering whether a partnership was formed. Where a partnership is formed, the partnership agreement will generally control the rights and liabilities of the partners, but where the agreement is silent, the provisions of the Uniform Partnership Act will control.

Here, Arnold and betty agreed to launch a business selling a durable paint that Arnold had developed and patented. Thus, they entered into an agreement to carry on a business for profit. Moreover, Arnold and Betty agreed to share all profits and act as equal owners in the partnership. Even though Betty contributed $100,000 as a capital investment and Arnold only contributed a patent worth $50,000, the two will likely be considered to have entered into a general partnership where Betty would be responsible for market research and marketing and Arnold would be responsible for incorporating

the business and taking care of other steps to start the enterprise. They did not enter into a limited partnership or limited liability partnership, because each require filing for certification with the secretary of state.

Thus, Arnold and Betty were each general partners of a valid general partnership.

ii. The Partnership's Liability on the Lease Contract

The issue is whether the partnership is liable on the contract entered into with Landlord Co., and if so, whether Arnold can be found personally liable.

A general partner is considered an agent of the partnership when acting in the ordinary course of business. An agent has authority to bind the principal where they have been given express authorization to do so. They have implied authority to do what is necessary to carry out their responsibilities. If the agent has authority to enter into a contract, either express or implied, the principal will be bound by the agreement. The agent will not be personally liable unless they did not disclose the identity of the agent.

Here, Arnold was an agent of the partnership and thus could act as its agent. The partners expressly agreed that he would be responsible for incorporating the business, but also in taking care of any other steps needed to start the enterprise. Arnold entered into a lease with for a building in which the Arnold and Betty would operate the business. Entering into the lease would be considered a "step needed" to start he enterprise, and thus Arnold was acting according to his actual express authority when he agreed to the lease. Because Arnold is a general partner of the partnership and acted under his authority to bind the partnership, the contract is binding on the partnership. Moreover, Arnold disclosed that he was entering into the lease on behalf of the partnership, which he named Durable Paint, Inc. Thus, Arnold is not personally

liable for the contract.

iii. Arnold's Liability as a General Partner

The issue is whether Arnold, as a general partner, is liable for the contracts.

General partners not in a limited liability partnership are personally liable for the obligations of the partnership. The general partners are jointly and severally liable and can seek contribution from any partners who do not pay their share. Absent any agreement otherwise, the partners are liable in the same proportions as they share in profits.

After six months, Durable Paint, Inc. breached the lease agreement. Arnold, as a general partner, would be personally liable for the breach by the partnership. However, though he is jointly and severally responsible to Landlord Co., the obligations of the partnership must be split equally between himself and Betty - which is the proportion in which they split profits. It is of no consequence that they contributed different amounts of capital investment. Thus, he can seek contribution from Betty for half of the debt.

B. Corporate Liability

The issue is whether Durable Paint, Inc. can be liable for the agreement.

Promoters are those who take the preliminary steps to set up a corporation and incorporate it. Promoters are not agents of the to-be corporation, and thus have no power to bind it in a contract. However, once incorporated, the corporation can adopt the agreement either expressly or impliedly. Adoption can be by a valid resolution of the board of directors, which requires a quorum (meaning a majority of directors must be present) and a majority of the quorum must approve the resolution. If they do so, both the corporation and the promoter are personally liable on the contract. If the corporation

instead executes a valid novation, replacing the promoter with itself on the contract, the promoter is no longer liable.

Here, Arnold entered into a lease with Landlord Co. on behalf of Durable Paint, Inc. At the time, Durable Paint Inc. was not yet a corporation because it had not yet been incorporated. Because Arnold was taking preliminary steps to incorporate it and set up the enterprise, he would be considered a promoter at the time he entered the lease. Thus, as a promoter, he was personally liable on the contract. However, the board, consisting of Arnold and Betty, then voted to "assume all rights and liabilities for the lease." The vote was unanimous and with all the directors present, and thus they had a quorum, and the resolution was approved by a majority of the quorum. Thus, the corporation expressly adopted the contract. It did not, however, execute a novation, as it didn't enter into an agreement with Landlord Co. to relieve Arnold of his liability. Accordingly, both Arnold, as a promoter, and Durable Paint, Inc., by adoption, are liable on the contract.

Moreover, even if the adoption was invalid, the corporation would be estopped from denying liability. Under the doctrine of corporation by estoppel, an entity that enters a contract that was not yet properly incorporated will be stopped from asserting that as a defense to contractual liability where it would be unjust to the other party to do so. Here, Arnold entered into the contract and listed Durable Paint, Inc. as the lessee. The corporation will be estopped from asserting as a defense that the corporation was not yet an incorporation to avoid liability.

C. Piercing the Veil

The issue is whether Arnold can be held personally liable for the obligations of Durable

Paint, Inc., as a corporation.

Generally, shareholders and directors cannot be held personally liable for the obligations of the corporation. However, if necessary to avoid a substantial injustice, the court can pierce the corporate veil and attach personal liability to shareholder where (1) corporate formalities are not observed, (2) the corporation is undercapitalized, and (3) the corporation is nothing but an alter ego of the shareholders.

Here, Arnold is presumably a shareholder of the corporation as well as an officer and director. Though he would generally not be personally liable for the corporation's obligations, the court may be able to pierce the veil. The corporation exhausted all its capital in only six months and was thus likely undercapitalized. Moreover, the sole directors and officers of the corporation were Arnold and Betty, who are also presumably the shareholders. Thus, Durable Paint, Inc. is likely considered merely an alter ego of Arnold and Betty. Even though it's unclear to what extent Arnold and Betty did not observe corporate formalities, the court will likely find that it can pierce the veil and attach personal liability for the corporation's obligations to Arnold. This especially true considering that the corporation no longer had any capital, had no assets, and the patent rights that it was assigned for Arthur's patent effectively became worthless, and thus Landlord Co. likely could not recover anything from the corporation and would be without remedy for the breach.

Thus, Arnold will be personally liable for the obligations of the corporation.

<u>II. Betty's Liability to Landlord Co.</u>

The issue is whether Betty can be found personally liable to Landlord Co. for breach of

the lease.

A. Partnership Liability

The rules regarding partnerships are set forth above.

Just like Arnold, Betty was a general partner in the partnership that was formed prior to the incorporation. Thus, as a general partner, she is liable on the contract, as it was entered into while the enterprise was a partnership under the authority of the partnership.

Accordingly, like Arnold, Betty can be held personally liable for the debts of the partnership, which had no assets by which Landlord Co. could recover at the time of the breach.

B. Shareholder Liability

The rules regarding corporations and shareholder liability are set forth above.

For the reasons discussed above, like Arnold, Landlord Co. will likely be able to pierce the corporate veil to hold Betty, as a shareholder and director, personally liable for the obligation of Durable Paint, Inc.

III. Arnold's Liability to Betty

A. Duty of Care

The issue is whether Arnold is liable to Betty for breaching his fiduciary duties to the partnership and corporation.

Each general partner in a partnership owes a duty of care in how they conduct the business of the partnership, just as each director owes a duty of care to a corporation.

Partners and directors must act with the reasonable care that an ordinarily prudent

person would under the circumstances. As a director, this requires acting in good faith and with a reasonable belief that your actions are in the best interest of the corporation. Under the business judgment rule, a director is presumed to have acted in good faith, on an informed basis, and with an honest belief that the action is in the best interest of the corporation. If a partner or director breaches a duty, he can be liable for any damages that result from the breach.

At the inception of their enterprise, Arnold falsely told Betty that he thought his patent was worth $100,000 when it was in fact worth only $50,000. As a result, he was not required to contribute any capital investment in the enterprise, as Betty assumed that he had made a contribution equal to her $100,000 capital investment. Thus, Arnold breached his duty of care by not acting in good faith when staring the business with Betty. However, there is no indication that Arnold breached any duty in incurring the obligation to Landlord Co. that would have caused any damages to the enterprise. Nor is it clear what damages his breach caused the enterprise.

Accordingly, even though he breached a duty, he would not be personally liable to the partnership or the corporation because it is unclear what damages, if any, resulted.

B. Misrepresentation

The issue is whether Arnold can be liable to Betty for misrepresentation.

Misrepresentation occurs when one knowingly makes a material representation of fact with the intent to mislead, and the other person reasonably relies on it.

It appears Arnold knowingly made a false misrepresentation to Betty regarding the worth of the patent, and he did so with the intent to induce a similar value capital contribution. Betty then reasonably relied on that misrepresentation to invest $100,000

rather than a lesser amount, which is now lost.

Thus, Betty may be able to recover for an excess she invested compared to how much she would have if she knew the patent was worth only $50,000.

The State Bar of California

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# ESSAY QUESTIONS AND SELECTED ANSWERS

## JULY 2022

### CALIFORNIA BAR EXAMINATION

This publication contains the five essay questions from the July 2022 California Bar Examination and two selected answers for each question.

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| 1. | Contracts |
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## QUESTION 4

The Articles of Incorporation for Corp Inc. (Corp) provide that it is a closely-held corporation formed for the purpose of manufacturing televisions. Corp has been highly profitable in this business for twenty years. The Articles also provide that, for the purpose of electing directors, each shareholder shall have one vote per share that they own multiplied by the number of open director positions, i.e., cumulative voting.

Aliyah and Bowen each owned sufficient shares to elect, through cumulative voting, one of the three directors of Corp. Aliyah and Bowen entered into a signed written agreement stating that they will vote to elect themselves to the board of Corp and agree on the election of any successor board members and, if they cannot agree on a particular successor, will abstain from voting in that election. They also agreed that, once they became directors, they would select Palmer as the new president of Corp. The agreement stipulated that it is binding on all subsequent owners of the shares. Aliyah and Bowen stamped "Subject to Agreement" on the backs of all of their share certificates.

Aliyah and Bowen were subsequently elected to Corp's board of directors, along with Chantal. At the next board meeting, Aliyah and Bowen voted to select Palmer as the new president of Corp, Chantal abstained, and Palmer was named as president.

Palmer immediately instituted several costly changes intended to shift Corp solely into the manufacturing of bicycles. Palmer reasoned that, by the time the directors heard anything about the changes, Corp would be so profitable that no one would complain.

Bowen discovered almost immediately what Palmer had done. Bowen then informed Daya of all of these facts, sold his shares to her, and resigned from the board.

Esgar, a shareholder of Corp since its inception, wishes to seek legal relief regarding Palmer's actions and Corp's change to solely manufacturing bicycles.

1. Is the agreement between Aliyah and Bowen valid? Discuss.

2. Is Daya bound by Aliyah and Bowen's voting agreement with respect to the election of successor directors? Discuss.

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3. On what theory or theories, if any, might Esgar bring an action to enjoin Corp from moving solely into manufacturing bicycles, and what is the likely outcome? Discuss.

4. On what theory or theories, if any, might Esgar bring an action for damages against Palmer related to Corp moving solely into manufacturing bicycles, and what is the likely outcome? Discuss.

# QUESTION 4: SELECTED ANSWER A

**1. Is the agreement between A and B valid?**

Type of Entity

The first issue is what type of business entity is at issue. A de jure corporation is one that has been properly formed through the filing of articles with the secretary of state. Here, the facts indicate that Corp Inc. is a closely held corporation. Thus, it will be presumed that Corp Inc. (C) was properly formed and is a valid de jure corporation. Because it is a corporation, C has distinct legal personhood and the capacity to sue, or B sued. Additionally, its shareholders will enjoy limited liability.

A and B's Role in the Company

The next issue is the role that A and B play in the company. A corporation is generally managed by a board of directors, but financially owned by shareholders (who enjoy limited liability). Here, the facts indicate that A and B each own shares in Corp, thus they will be considered shareholders. It is unlikely that they will be controlling shareholders, given that each was only capable of electing one director to the board through cumulative voting (had they been controlling shareholders, they likely could have elected more individuals to the board than one each). Thus, A and B are shareholders of Corp Inc., and, as shareholders, they also have the power to vote in the corporation's annual election of the board of directors. Corp adheres to cumulative voting, so A and B, as shareholders, are permitted to pool their votes behind one candidate in the hopes of electing someone to the board (as they did here).

Moreover, A and B were subsequently elected as directors, and thus also serve as

directors of Corp in addition to being shareholders. This may potentially expose them to liability (see more discussion below). However, the agreement they entered into was done so prior to them becoming directors, thus this agreement will be viewed as an agreement between shareholders, not directors.

<u>Validity of Agreement to Vote Together as Shareholders</u>

The issue is whether A and B's agreement is valid. The agreement contains two key provisions: 1) A and B agreed to elect themselves to the board and to agree on the election of successor board members (and if they could not agree, they would abstain from voting); and 2) A and B agreed that once they became directors, they would select P as the new president of Corp. Moreover, the agreement indicated that it would be binding on subsequent owners of their shares (and they indicated as such on the actual share certificates). Here, each of the two provisions will be addressed separately.

The first provision provides for how A and B will vote as shareholders. A shareholder voting agreement, known as a "voting pool," is permissible, as long as it is in a signed written agreement clearly setting forth the terms. Here, A and B will argue that they entered into a valid shareholders agreement when they agreed to elect themselves to the board of directors. Shareholders are permitted to enter into contracts agreeing on how to vote at director elections and, here, A and B entered into a signed written agreement doing just that. Thus, the provision of the shareholder agreement which provides that A and B will vote to elect themselves to the board of directors will likely be upheld as valid.

However, it is less clear whether this voting agreement would be binding on successor shareholders (this will be discussed further below).

Validity of Agreement to Select P as President

The next issue is whether the second major provision of the shareholder agreement, providing that they will elect P as president, can be upheld. Although shareholders are permitted to enter voting agreements, they are *not* permitted to enter into agreements that will control how they will vote and act in their capacity as *directors*. This is because directors are required to exercise their independent business judgment and have a duty to look out for the best interests of the corporation, thus we don't want them to be constrained by prior voting agreements (if they have contracted to elect P, but P is a bad option, we want the directors to make the best decision for the company, not feel bound by a prior K). Here, A and B have entered into an agreement providing that they will select P as president of Corp once they become directors. This part of the agreement must be struck down as invalid because shareholders cannot limit their discretion as directors through agreements such as this. The court will likely find that this agreement was designed to control their actions as directors and it will be struck down as invalid.

Some courts have recognized a limited exception to this rule in the context of a close corporation, where all of the shareholders enter into the agreement (if all the shareholders are on board with an agreement as to how to elect the directors, that may be permissible). The concern behind this rule is that courts don't want controlling shareholders who can elect directors entering into agreements that will harm the minority shareholders; thus, if all the shareholders enter the agreement, this concern is eliminated. Here, A and B may argue this exception should apply. However, this argument will fail, because even though C is a closely held corporation, this agreement

was only entered into by A and B, not by all of the shareholders.

Thus, the provision of the agreement providing that they will elect P as president once they are made directors will be struck down as invalid.

Conclusion

The provision of the agreement governing how A and B will vote as shareholders at director elections will be upheld as valid. The provision governing how A and B will vote for P once they become directors will be struck down as invalid.

**2. Is D bound by A and B's voting agreement with respect to the election of successor directors?**

The facts indicate that B, unhappy with P's actions, sold his shares to D and resigned from the board. As discussed above, the voting agreement between A and B provided that it would be binding on subsequent owners of the shares. As already demonstrated, the voting agreement between A and B was likely valid given that shareholders are permitted to enter agreements governing how they will vote at director elections. Thus, the issue becomes whether this agreement binds D.

In order to form a voting agreement that is binding on subsequent shareholders, some jurisdictions may require that the parties enter into a "voting trust" that is filed with the secretary of state. Here, it does not appear that A and B have done so, so this agreement will likely not be found to apply to subsequent shareholders if the jurisdiction follows such a rule.

However, they will argue that the agreement should still be binding on D under general contract/equitable principles because D, the subsequent purchaser of B's shares, had

valid notice of the agreement given that B informed D of "all of the facts" and the shares had "subject to agreement" stamped on the back. A and B will argue that D had notice of their agreement and of their intent to make the agreement binding on subsequent purchasers, and as such, D should be estopped from arguing she is not bound by the agreement. A court may go either way, but the more likely result is that since D was on notice of the agreement and bought the shares "subject to" the agreement, D too will be bound by the agreement's terms.

**3. E's Action to Enjoin Corp from Manufacturing Bicycles**

E seeks to file an action against C in the hopes of enjoining C from changing from a corporation that manufactures televisions into a corporation that manufactures bicycles. In order to do so, E should bring a derivative lawsuit on behalf of the corporation to enjoin it from engaging in ultra vires actions.

E's Status in the Corporation

The facts indicate that E has been a shareholder of Corp since its inception. Thus, E is a shareholder of Corp and has standing to bring either a direct action to vindicate his own rights or potentially a derivative action on behalf of the corporation to protect the corporation's rights. A shareholder can only bring a direct action to challenge specific harms to them, such as being denied a distributed dividend or if a tort is committed against them by the corporation.

Derivative Shareholder Lawsuit

A shareholder of a corporation may bring a derivative lawsuit on behalf of the corporation against its own directors/officers, where the shareholder believes those

directors/officers are not protecting the rights and interests of the corporation. In order to do so, the shareholder must: 1) have been a shareholder at the time of the wrong and continue as a shareholder throughout the time of the suit; 2) adequately represent the interests of the shareholders; and 3) make a demand on the board, unless such demand would be futile.

Here, the facts indicate that E has been a shareholder since Corp's inception, and there are no facts suggesting he is no longer a shareholder; thus the first requirement is met. There are also no facts to indicate that E does not represent the interests of the other shareholders; this requirement is likely met. Finally, there are no facts to suggest that E has already made a demand on the board. If E does not do so, E may be prohibited from bringing suit. However, E can argue that demand here would be futile--the board contains three members, A, B, and Chantal, and two of those three members elected the president whose actions E is challenging. E can argue that A and B are interested directors because they made the decision to hire P, and thus 2 / 3 of the board members would be biased in favor of not bringing a lawsuit (because it could potentially open them up to liability, as the ones who voted to have P as president). Demand would likely be futile on these facts.

Thus, it appears that E can bring a derivative lawsuit, assuming that E either makes adequate demand or demonstrates demand is futile.

Ultra Vires Action

Through the derivative lawsuit, E will challenge P's decision to move Corp solely into the business of manufacturing bicycles as an ultra vires action that is not permitted by Corp's Articles of Incorporation. When a corporation registers with the secretary of state,

they will file Articles of Incorporation. The AOI will state a purpose for the corporation. In modern times, most AOI state a very broad purpose for the corporation such that almost any legitimate commercial activity is permissible. However, even today, there are still corporations with a limited, enumerated purpose in the AOI. If the corporation's controlling officers/board take an action contrary to the stated purpose, shareholders can bring a derivative action to prevent the action as an improper "ultra vires" action.

Here, C has an AOI with a stated purpose: manufacturing televisions. Moreover, C has been highly profitable in this business for years, and there are no facts to suggest that C has ever engaged in any activity other than manufacturing televisions. Thus, E will argue that C's purpose as a corporation is limited to manufacturing televisions. However, once P became president, P instituted numerous costly changes that shifted C into the business of manufacturing bicycles--E will argue this is an ultra vires prohibited act that is contrary to Corps stated purpose in the AOI. E can point out that televisions and bicycles are vastly different products that are manufactured differently, sold in different markets, and serve different purposes. E will argue that shifting C's purpose from making TVs to bikes constituted a fundamental corporate change that required amending of the AOI, and yet there was no valid amendment of the AOI. To amend the AOI, there must be a special meeting of shareholders called to vote on whether to amend the AOI. Here, there was no such special meeting; P simply made the unilateral decision to change the purpose of the corporation that has been operating for years. This was an ultra vires action without approval.

Accordingly, E can likely establish that manufacturing bicycles is an improper ultra vires action that Corp should not be permitted to undertake.

Direct Action

E can also potentially bring a direct action on the grounds that his shareholder rights were violated because he was not permitted to vote on a fundamental corporate change, i.e., the amendment of the Articles of Incorporation. E will argue that P's actions were an attempt to unilaterally amend the AOI without calling a special shareholder voting meeting and, as such, E's rights as a shareholder were violated by Corp and E may be permitted to sue directly on these grounds.

Right to an injunction

In order to obtain a permanent injunction the moving party must show success on the merits, inadequate remedy at law, irreparable harm, the balance of hardships/equities tips in their favor, and public interest does not disfavor the injunction. E can likely establish these elements given that Corp engaged in a wrongful ultra vires action that will likely cause imminent harm to the shareholders' interest in the form of lost profits.

Conclusion

E can likely bring a derivative lawsuit to enjoin Corp from changing to bicycle manufacturing because this is an ultra vires action and there was no special shareholder meeting called to amend the AOI.

**4. E's Action for Damages Against P**

E also seeks to bring an action against P directly for damages in connection with the ultra vires action. As a preliminary matter, E would once again need to bring a derivative action on behalf of the corporation itself, not a direct action (see above; analysis would be the same--E can probably bring a derivative lawsuit). E will bring a shareholder's

derivative action against P in his capacity as a corporate officer and allege that he breached the duty of care.

Liability as an Officer

Officers are generally viewed as agents of the corporation (an agent is one who agrees to work for the principal's benefit subject to the principal's control). P, as president of Corp, is thus considered an officer and an agent of Corp. As an agent, P owes the corporation a duty of care and a duty of loyalty.

Breach of Duty of Care

Here, E will argue that P's decision to move Corp solely into bicycle manufacturing constitutes a breach of the duty of care. Corporate officers/agents are required to act as reasonably prudent persons, and their goal must be to serve the best interests of the corporation. Here, E will argue that P breached his duty of care by unilaterally implementing costly changes that entirely changed the direction of Corp's business. E will argue that Corp has been operating for twenty years in the TV manufacturing industry, and they have been highly profitable. Thus, E will argue it was unreasonable for P to cast aside twenty years of effort and goodwill in the hopes of pursuing a new line of business. E will argue that P also acted unreasonably by making these changes without going through the proper channels and acting unilaterally behind the directors backs--E will argue that shareholders have a right to vote on such fundamental decisions or, at the very least, P should have ran such a serious decision by the board of directors (had he done so, it is clear that B likely would have disagreed and voted against such a change given that B resigned from the board immediately upon finding out P's actions).

E will likely successfully be able to show that P failed to act as a reasonably prudent person when P made the unilateral decision to entirely change Corp's business and engage in an ultra vires action without ever seeking the consent of the board or the shareholders.

Business Judgment Rule

P will argue his actions were protected by the business judgment rule.

The business judgment rule provides that corporate officers and directors are not liable for mistaken business judgments that were made in good faith. This creates a rebuttable presumption that the director/officer (here, P) was acting in good faith in the best interests of the corporation. This can only be overcome by a showing of bad faith, fraud, illegality, or the failure to be reasonably informed.

P will argue he was acting in good faith and is thus protected by the BJR, because his reasoning behind the decision was to increase Corp's profits. He was not acting out of self-interest, but rather he was trying to maximize Corp's profits by entering a new market (his hope is it would be so profitable that no one would complain). He will argue that the costly changes he implemented were in a good faith attempt to expand C's business and maximize shareholder profit and is thus protected by the BJR.

Here, however, E can likely overcome the business judgment rule for two reasons: 1) there are no facts to suggest that P did any research or investigation into whether this would be a good decision for the company, so it was highly likely that P was not reasonably informed (overcomes the BJR); and 2) P appears to be acting in bad faith/slightly fraudulently because he made all of the changes unilaterally without telling the directors, in the hopes that they would not find out until it was too late and C was

already making money from the bikes. The fact that P intentionally concealed his plans for the company's new direction suggests he was acting in bad faith (and potentially even fraudulently since he failed to disclose that he was making material, fundamental changes to the business).

Conclusion

E can derivatively sue P for breaching his duty of care owed to Corp as an officer by unreasonably and unilaterally engaging in ultra vires acts, and E can most likely overcome the business judgment rule presumption.

## QUESTION 4: SELECTED ANSWER B

1. Valid Shareholder Agreement

Shareholders have the power to vote directors into office. Additionally, shareholders are able to vote for fundamental changes such as mergers, dissolutions, amendments to articles, and sale of substantially all assets. Additionally, shareholders are able to enter into voting agreements with each other. Voting agreements are contracts between shareholders to vote in a specific way. Voting agreements must be signed and must pertain to matters in which shareholders have the power to vote on. Here, Aliyah ("A") and Bowen ("B") entered into a written agreement stating that they will vote to elect themselves to the board of Corp and agree on the election of any successor board members, and if they cannot agree on a particular successor board member, they will abstain from voting. This agreement is enforceable because it is written and both A and B have the power to elect directors because of their status as shareholders. The fact that the voting is cumulative does not impact A and B's ability to enter into a voting agreement.

However, their agreement to vote for Palmer once they became directors will not be enforceable. Board members do not have the ability to enter into voting agreements with each other. Board members are charged with exercising a duty of care to act as a reasonable director under the circumstances, which means being informed on matters and having a good faith and honest belief that their actions are in the best interest of the corporation. A voting agreement among directors runs counter to a director's duty to act with care and reasonableness. Therefore, this provision of the voting agreement is unenforceable.

2. Is Daya Bound?

Voting agreements can be binding on successors if the successor has notice of the agreement (i.e., there is some notice on the actual stock certificate). Here, A and B stamped the certificates with "subject to agreement" on all of their stock certificates so Daya ("D") would be on notice of the shareholder agreement between A and B. Thus, she is probably bound to the enforceable terms of the voting agreement (see above). Daya could argue that she is not bound because B violated federal securities laws by selling his shares to her. A corporate insider runs the risk of violating Rule 10b5 when they trade on the basis of material, non-public information without first disclosing the information to the person they are trading with. Here, B did disclose all of the material facts to D. Thus, he likely didn't violate federal securities laws and Daya will probably be bound.

3. Enjoining Corp

To be valid, corporations must have a suitable purpose (as well as filing Articles of Incorporation with the secretary of state). Generally, a corporation's purpose is stated as "any lawful purpose." That is sufficient to fulfill this requirement. However, when a corporation is formed for a specific purpose, such as for the purpose of manufacturing televisions, that purpose must be strictly adhered to. If not, the director or officer has committed an ultra vires act. Remedies available for ultra vires act include an injunction if brought by a shareholder, damages for breach of duty if brought by the corporation, or dissolution if brought forth by the state and there is evidence of unlawful actions or other wrongdoing. Here, Corp was incorporated for the specific purpose of manufacturing

televisions. Corp has adhered to this purpose for twenty years. Palmer's attempt to shift the corporation into the bicycle manufacturing industry diverges from the specific purpose of manufacturing televisions that is stated in the Articles of Incorporation. This is an ultra vires act. As such, Esgar is a shareholder and can sue to enjoin Palmer's actions. Additionally, Palmer can be civilly liable to the corporation for damages caused by a breach of duty if he has committed one. The facts do not suggest that there was unlawful activity, so the state is unlikely to seek dissolution.

Palmer will argue that he had authority to take the actions he did. An agent can bind a principal if there is an agency relationship in which both parties have consented that agent is to act for the benefit of principal and principal asserts control over agent. For an officer (i.e., agent) to be able to bind a corporation (i.e., principal), there must be either actual or apparent authority to act. Actual authority can be express or implied. Express authority derives from the express agency agreement between the two parties. Implied authority is present when the agent has a reasonable belief that they have the power to take the action in question based on the principal's conduct (i.e., past dealings, necessity, emergency, etc.). Here, the facts do not state whether Palmer had actual authority to shift corporate operations into another industry. Normally, the president of a corporation has implied authority, if not actual authority, to enter into business transactions with other entities. However, because Corp has a limited purpose to manufacture televisions, it is unlikely that Palmer had a reasonable belief that he could move Corp into the bicycle manufacturing business. In fact, he reasoned that no one would care once his actions proved to be profitable. As such, Palmer probably did not have a reasonable belief based on Corp's conduct that he had the implied authority to

take the course of action he did. Absent express authority, which is unlikely given the specific purpose of Corp, he probably will not have a justification for his actions.

Palmer could also argue that he has apparent authority to act. Apparent authority is present when a third party reasonably believes that an agent has the authority to take a certain action based on the principal's conduct. Here, apparent authority is unlikely because Corp has a specific purpose, so any third party that dealt with Palmer could not have a reasonable belief that Palmer had authority to enter into the bicycle manufacturing business. Thus, Palmer likely did not have apparent authority either.

Furthermore, he will be liable for the transactions because he acted without actual authority.

Palmer could argue that Corp has ratified his actions, and therefore, Esgar is not able to enjoin Palmer's actions. A board of directors can ratify a transaction if they expressly accept it by way of a board resolution, or if they accept the benefits of the transaction. Here, the facts do not state that the board has made any board resolution or otherwise accepted the benefits of Palmer's actions. Thus, the board of directors likely did not ratify Palmer's actions.

4. Damages Against Palmer

Derivative Suit

Shareholders can bring actions directly when their rights as shareholders have been infringed. Additionally, a shareholder may bring forth a derivative suit on behalf of the corporation when the corporation is harmed because of an action taken by a director or officer. To be able to bring forth a derivative suit, a shareholder must have standing,

must be able to adequately represent the corporation's interests, must be a shareholder through the duration of the litigation, and must file a demand on the corporation's board of directors to take action. A shareholder must wait ninety days after making demand on the board to take action before filing a suit. In some states, the demand requirement is not required if making such a demand would be futile or if irreparable harm will result. A shareholder has standing to sue if they owed stock in the corporation when the transaction or conduct occurred. Here, Esgar has standing to sue because he has been a shareholder since its inception. Furthermore, nothing in the facts suggests that he won't be able to adequately represent Corp's interests.

The facts do not state that Esgar has made a demand on the Board to take action against Palmer for his acts. However, Esgar can argue that waiting 90 days until the Board decides whether it will take action or not can lead to irreparable harm to him as a shareholder. If a court accepts this argument, Esgar will be able to successfully bring forth a derivate suit against Palmer so long as he remains a Corp shareholder throughout the litigation.

Note that, in the event that Corp wins the suit, Esgar will not be entitled to any damages. Damages will be awarded to Corp. However, Esgar will be able to have his legal fees paid for.