

6)

1. A derivative action is a suit filed by a stockholder of a corporation on behalf of the corporation. In a derivative suit, the stockholder essentially steps into the shoes of the corporation, and attempts to enforce what the corporation will not. Derivative lawsuits are often used to assert claims against a corporation's board of directors or officers where the corporation will not itself assert the claims. If a derivative suit is allowed to proceed, the stockholder can never recover his attorneys fees or costs from the company.

There are several grounds to dismiss this suit. The first ground upon which the suit could be dismissed is standing. Under the TBOC, in order to properly have standing to file a derivative suit, a party must be a stockholder (or have a proper claim to the rights of a stockholder) of the corporation at the time the events leading rise to the claim occurred. Rick's purchase of WK stock did not occur until after he had learned about the copyright infringement.

It is possible that a court might find that Rick does have standing, and choose not to dismiss his claim. This finding of standing would be based on the fact that Rick now owned stock in WK, and Pirate's infringement was ongoing. This is probably the better theory in the instant case copyright infringement isn't typically a one day event. It appears to be ongoing, and while the board has chosen not to sue, that fact does not preclude the reality that copyright infringement is ongoing.

Even if proper standing is found for Rick, he is definitely not going to be able to sue because he didn't make a proper demand. In Texas, if a stockholder wants to assert a derivative claim, it absolutely must file a demand on the corporation insisting that the corporation pursue action against the alleged injuring party. This demand letter must be sent 90 days before the stockholder asserts the claim, and demand must be refused. While in some states a court might have found that asking Rick to make demand in the instant case would be futile since the board has already declined the opportunity to enforce its rights, in Texas, a stockholder must make demand under any circumstances. Therefore, because Rick did not make a timely demand, his suit will be dismissed.

Furthermore, even if Rick's suit proceeds past the procedural issue of demand, it could possibly be dismissed based on the business judgment rule. The corporation is a necessary party to any derivative action, so Rick would have to join them to his suit. The company should file a summary judgment motion asserting that its board of directors made a good faith, informed decision with a rational basis under the business judgment rule,

and Rick has offered no evidence to rebut the presumption. The board certainly considered filing suit against Pirate, but ultimately determined that it would be poor use of their money, and advertising would create value. That seems to be a valid basis for decision under the business judgment rule.

2. In order to form a close corporation, Walt and Katie must take substantially the same steps that should be taken to file any kind of corporation. As the promoters, Walt and Katie must file a certificate of incorporation with the secretary of state along with the proper filing fee. First, the certification of incorporation should include the name of the corporation. The corporate name must include Inc., Co., Incorporated, Company, Corporation, or some other title that makes it clear to others that they are operating under the corporate form. That certificate should also include their names and addresses, the names and addresses of the board of directors (if they choose to have one), the names and addresses of the initial corporate officers (if they choose to have others), the corporate address, and the corporation's registered agent. Furthermore, the certificate absolutely must include a statement of purpose for the corporation -it is sufficient to state that the corporation exists for "any proper purpose." While they wouldn't have to worry about ultra vires action from a shareholder since they are choosing to be closely held, it is better to be safe than sorry when it is possible that the State could get involved if they authorize actions outside the proper purpose. The certificate of incorporation should include information about the stock structure of the corporation -at a bare minimum they should divulge the amount of shares authorized, par value if any, and the amount initially being issued. Finally, they must have an organizational meeting (which would normally require them to give notice, but it would be futile for them to give notice to themselves) so they can elect initial officers and directors if they plan on simply holding the company. Another note about a close corporation is that if Andrew and Katie decide to operate without a board of directors, they will owe each other the same duties of loyalty and care that a normal board of directors would owe a corporation.

The biggest benefit to forming a closely held corporation is the ability to elect through sub-chapter S of the Tax Code to be a tax-through entity. Sub-chapter S corporations pay no tax. Instead, they pass their earnings through to their stockholders, who pay tax on the earnings. While in typical corporations, a shareholder would really pay taxes twice (once when the corporation itself paid taxes, and once again when it paid its personal income taxes), the S corporation shareholders pay only their personal taxes. Obviously, closely held corporations have the same limited liability advantages of other corporations. There might be a bit more danger of veil piercing than with big corporations, given the small number of shareholders and extensive shareholder participation in management. One more advantage to closely held corporations is that while they still require corporate formalities from a legal standpoint, as a practical standpoint the formalities can have a much lesser effect on the day to day business plan. In a typical corporation, the board of directors can't act without unanimous consent in writing, or majority consent in a meeting. Scheduling meetings isn't always easy, given that most corporate

directors serve on multiple boards or hold other jobs in addition to their capacity as a board member. The officers likewise must get permission for many undertakings (for example, even the president of a corporation must get board approval to sell real estate). In a close corporation, if the shareholders decide to operate without a board (or even if they serve as a formal board themselves), they'll have a much easier time making quick decisions because they won't have to work their way up the typically exhaustive hierarchy of corporate governance.

END OF EXAM

6)

1. A derivative action is a suit by a shareholder on behalf of the corporation. In a derivative suit, any damages or other proceeds from the suit go to the corporation, not the shareholder himself, though a shareholder may be compensated by the corporation for his attorneys fees if the suit is successful. Rick's action appears to be a derivative suit, as he is suing on behalf of the corporation rather than for himself.

Under the Texas Business and Organizations Code, there are three requirements for a shareholder to bring a derivative suit. First, the shareholder must own shares or receive them by operation of law at the time the events giving rise to the claim occur. Rick does not appear to meet this requirement, and a court may dismiss the suit on this ground. Rick bought his shares of WK Solutions after Pirate began selling the identical software program. Also, Rick did not receive his shares by operation of law from someone who owned the shares when Pirate began selling the software. He did not receive them in a divorce action or through a will. Because Rick did not own his shares of WK at the required time, a court may dismiss his derivative suit, unless he can prove that the events giving rise to the action occurred after he bought the shares.

Another requirement of a derivative suit is that the shareholder bring a demand to the board to bring suit. The shareholder must wait 90 days for the board to refuse to sue before he can bring a derivative action. The shareholder must make this demand, even if it is unlikely that the board will agree with the demand. In this case, Rick did not make any demand on the board to bring suit. Therefore, the court can dismiss the derivative suit.

The third requirement is that the shareholder fairly and adequately represent the corporation's interests in the suit. Rick may think he is representing the corporation's interests by suing, but WK's directors could likely prove that the corporation's interests are not being served by the suit. WK's directors could show that they considered suing Pirate, but that it made more financial sense to spend money that would have gone to attorneys fees on advertising instead. Courts do not like to second-guess the business decisions of corporate directors, so they will likely agree with WK's directors that the derivative suit does not fairly and adequately represent the corporation's interests, and dismiss Rick's suit.

2. To form a Texas corporation (whether closely-held or publicly-held), Walt and Kate must file a Certificate of Formation with the Texas Secretary of State and pay the required fee. The Certificate of Formation must include: 1) the name of the person organizing the corporation, 2) the name of the corporation (must include "Inc.", "Corporation", or "Company"), 3) the number of initial directors, 4) the name and address of initial directors, 5) the name and address of the registered agent who is designated to receive service of process on behalf of the corporation, 6) the purpose of the corporation (though it may be very wide--for example "for any lawful purpose"), and 7) all relevant stock attributes (i.e., number of authorized shares, classes of stock, par value, pre-emptive rights, etc.). Once the Secretary of State files the Certificate of Formation, the corporation is created. The Secretary of State will then give the organizer an Acknowledgement of Incorporation.

After filing the Certificate of Formation with the Secretary of State's office, the organizer must hold an initial meeting and give at least 3 days' notice of the meeting. At the initial meeting, which need not be in Texas, the organizer and initial directors will adopt bylaws (if they choose to), elect additional directors (again, if they choose to), and conduct any other business of the corporation.

A close corporation will allow Walt and Kate to restrict the transferability of their shares, which would not be available in a publicly held corporation. Walt and Kate could choose to place a right of first refusal upon the sale of any of the shares of their closely-held corporation, or they could restrict transferability in some other way. In order for transfer restrictions to be enforced, Walt and Kate must put the transfer restrictions in the Certificate of Formation, the corporation's bylaws, or in a shareholder agreement filed with the corporation's secretary. Additionally, the transfer restriction must be conspicuously noted on the stock certificate itself. If Walt and Kate comply with these requirements, they may place transfer restrictions on the shares of their closely-held corporation, thereby limiting ownership to themselves.

END OF EXAM

6)

This question is governed by the Texas Business Organizations Code.

1. In Texas under the TBOC A derivative action is an action brought by a shareholder, on behalf of the company. Since it is brought on behalf of the company, any amount received from a derivative action goes to the company, but the shareholder that prevails will receive attorney's fees. Derivative actions occur when a Shareholder believes that the company should have brought the suit itself. Part of bringing a derivative action requires that the shareholder first make a demand upon the board of directors to bring the action. Then the shareholder must wait 90 days for their decision UNLESS it can prove that delay will cause irreversible harm.

Here, the derivative action should be dismissed. First, Rick does not have standing to bring a derivative suit. In Texas you must own stock at the time of the alleged wrong OR be a successor in interest to someone who did i.e. inheritance etc. Here Rick did not own the stock at the time when the alleged oversight occurred, he read about the problem, THEN went out and purchased stock. Second, in Texas a court will not question the **business judgment** of an independent board of directors or appointed counsel who decides that it is in the company's best interest to not pursue a direct lawsuit. Here the court will apply the business judgment rule-not duty of loyalty because there are no interested directors-Pirate is an outsider. When evaluating business judgment, the court focuses on process. Was there a meaningful collection of data, consideration. Here the facts favor WK. The board DID consider suing Pirate for infringement, but decided that it was a better use of money to advertise instead. This sort of analysis reflects the type of process we want to see under the business judgment rule. Third, Rick failed to make demand upon the BOD. In Texas demand is NEVER EXCUSED under the TBOC. Here Rick need to make a demand upon board 90 days before filing suit. He did not and his suit should be dismissed.

Therefore, the court should dismiss the action because 1) Rick had no standing to sue, 2) the company in its sound business judgment opted to not sue AND 3) Rick failed to make proper demand.

2)

To form a close corporation under the TBOC Walt and Kate must follow the general incorporation rules, but specify in the certificate that they will operate as a close corporation. They must file a certificate of incorporation with the state and pay the incorporation fees.. They must use an approved name that includes "Inc." or the like in the name. In the certificate they must include the names and addresses of promoters and initial directors, they must give the number of directors, the purpose of the company (though "any lawful purpose" is sufficient), they must specify the life of the corporation (otherwise it is perpetual), they must set out information about the stock (number of shares, par value etc.)

Limiting ownership:

A close corporation will allow them to limit the ownership to themselves, in ways a normal corporation does not. They can place many limits on the stock certificates that would ordinarily be restraints on alienability. They can give themselves a right of first refusal on any stock sale if the conspicuously note those limitation on the certificates themselves. Alternatively, they could give themselves preemptive rights, which would allow them to maintain their respective % ownership in the company if new shares are issued for cash.

Benefits:

A close corporation will allow much more flexibility in management to Walt and Kate they can even do away with the BOD in the certificate of incorporation. Because close corporations are not publicly traded and don't pose nearly as much risk to the public, the TBOC allows them to agree to nearly any sort of management structure they are not tied into the general TBOC rules. Because they will be at the reigns, Walt and Kate can also stop any new issuance of stock before it happens. Although they cannot set aside entirely fiduciary duties, the TBOC will allow the members of TBOC to define the fiduciary duties. When considering the flexibility of the management things that at ordinary corporation deals with including notice to SHH, voting requirements, quorum, how decision are made can all be modified to fit what Kate and Walt desire.

END OF EXAM