Question 5 **Selected Answer #1** **February 2011**

1. The issue is whether shareholder approval was necessary for the purchase of Mining's assets and the assumption of Mining's liabilities by Diamond Inc. Diamond is a registered corporation in the state of Tx. Shareholder approval is necessary for fundamental changes such as merger and sale of substantially all assets.

First, Mining Corp. is also a Texas Corporation. This corporation sold all of its assets to Diamond Corp. so at a minimum the approval of their shareholders was required. The sale of all or substantially all of a corporation's assets, not in the ordinary course of business must be first submitted to the shareholders and put to a vote. A vote of yes by 2/3 of the outstanding shares entitled to vote on the matter is required. This is not required for the acquiring corporation. The acquiring corporation just needs Board approval.

But, the transaction in question was also more than just a sale of assets, it was also an assumption of liabilities. This will probably be considered a merger. A merger includes a situation where two companies combine and at the end only one is left standing. That is what happened here. Diamond not only purchased all the assets, it assumed all of Mining's liabilities. This is a merger. A merger is a fundamental change, which requires shareholder approval on both sides. The only exception to shareholder approval is in the case of a short-form merger where on company (prior to the merger) already owns 90% of the other company. A short-form merger may be done without approval from either side's shareholders. This is not a short-form merger since Diamond owned no interest in Mining prior to the transaction and vice versa. Since this transaction is in effect a merger the board needed to present the plan of merger to the shareholders and get approval of 2/3 of the outstanding shares entitled to vote. This needed to be done on both sides (Diamond and Mining).

2. The issue is what actions the former board of directors can be held liable for. Directors of a corporation owe duties to the corporation and its shareholders they owe a duty of loyalty, duty of good faith, and reasonable care. All of the duties of an officer are subject to the business judgment rule. This rule presumes that the directors act in good faith and will not hold directors liable for decisions made in good faith based on their judgment of what is best for the corporation.

(a) $500,000 settlement

The former board after improperly assuming all of Mining's liabilities, and failing to investigate prior to doing so, voted unanimously to approve a $500,000 settlement of one of Mining's liabilities. This settlement caused the corporation to become insolvent. Generally, directors of a corporation are shielded from liability, but this is not true when they violate a duty. The directors here have violated the duty to use reasonable care by approving the assumption of liabilities without investigating and authorizing a settlement, which makes the corporation insolvent. The board is entitled to rely on opinions from certain parties, but the owner of the company whose assets you are acquiring is not one of them. They were not entitled to rely on George's assurance that all liabilities were listed in the corporate books.

(b) $100,000 loan to Patrick

Prior to the purchase of assets the board voted unanimously to loan Patrick, the CEO, $100,000 to buy a yacht. This is not a necessary business purchase or business expense, which would be covered by the business judgment rule. The board violated their duties of loyalty, self-dealing, good faith, and reasonable care, in making this personal loan to Patrick.

(C) Un-Cut Diamond

Lastly, after the acquisition of Mining the board voted to give Patrick a bonus of an uncut diamond, a corporate asset, valued at $250,000. This was done three months after the company became insolvent due to the settlement agreement. If this bonus was paid while the company was still insolvent, then it is a violation of director's duties as well. If the corporation had sufficient assets and surplus then it is possible the bonus could be covered by the business judgment rule. But, due to Patrick's poor performance and bad business deals, even with sufficient assets, the giving of a bonus may be a violation of good faith and reasonable care owed to the corporation.

END OF EXAM

1. In regards to the assumption of Mining's assets and liabilities, only the selling company's shareholder must approve such an action unless mining would continue to do business after the sale. A sell of substantially all the assets of a company and liabilities is considered a fundamental change to the seller company since a true sale of substantially all assets mean the selling company cannot engage in the same business after the sale.

In this case, Mining, the selling company would have had to seek shareholder approval before making the sell. Since Mining Corp. is a Texas Corporation, and this is a fundamental change, the shareholders would have had to have been given at least 21-60 days notice before the meeting and at least 2/3 of the shares entitled to vote would have to vote for the sale.

In regards to the selling company, to buy of substantially all assets and liabilities of another business is not a fundamental change and therefore, it would not required the approval of Diamond, Inc. shareholders to be able to buy the assets.

2. (a): In regards to the settlement, the court will have to determine if the $500,000 settlement was in the best interest to the corporation. Directors have a duty of care to the corporation and must act as a reasonably prudent person would act and must make good faith decisions based on the best interest of the corporation. The burden of proof will be on the shareholders, the duty of care is subject to the business judgment rule. Therefore, if the court determines that Board of directors did their homework and prudently investigated whether the settlement would be in the best interest of the corporation, the court will not overturn or question the Board's decision. Notice, that a court might find that a settlement was not in good faith since the Board should have investigated Mining's assets and liabilities before they decided to buy the assets and liabilities. But, the court might find that a settlement was done in good faith and in the best interest of Diamond, Inc. at the time.

(b) The loan of $100,000 to Patrick will likely be held against the board of directors. The board of directors can make loans to officers or other board members but it must be done in the best interest of the corporation. The facts do not suggest that the loan was given to Patrick in the best interest of the corporation. For example, if it would have been given so Patrick could take business classes to increase his knowledge of corporations, this might have been considered like a loan that is made to benefit the corporation. The facts only suggest that Patrick used this money to buy a yacht and nothing else supports the inquiry that the yacht was purchased in the best interest of the corporation.

(c) In regards to the large "un-cut" Diamond given to Patrick, I believe the shareholders will be able to hold the previous board members liable. Patrick, as chief executive officer, is entitled to compensation based on his status of CEO for Diamond Inc. However, this bonus was made to Patrick in a time that the corporation had already spent $500k on a settlement and the corporation's debts exceeded its assets. Even though a corporation can still make distribution and payments when debts exceed assets, the Diamond was considered a "bonus" to Patrick and the facts do not suggest that this "bonus" payment to Patrick was the best interest of the corporation.

Under all the previous examples, the general rule is board of directors are not going to be liable for acts they take on behalf of the corporation because they are acting for the corporation. However, they have to be able to withstand a challenge that what they did is in the best interest of the corporation. It does not seem like any decision made was based on the corporations best interest.

END OF EXAM

1. Shareholder approval by Mining was required for the purchase of Mining's assets and liabilty assumptins under the Diamond and Mining merger.

When a corporation's assets and assumption liabilities are to be assumed by another corporatin - this requires a special shareholders meeting for a major corporate change. Two-thirds of all outstanding shares must vote to approve of this merger. A majority of the quorum of shareholders will not be adequate. Notice must be given to the shareholders, date, time, where, and purpose.

Here, Mining shareholders are not mentioned at all. The facts indicate that George, close friend of Patrick, owned Mining, and he solely negotiated for the purchase of assets and assume the liabilities of Mining. Thus this purchase will likely be held invalid, unless George was the sole board and shareholder of Mining.

Diamond shareholders approval was not required for the purchase and Mining's assets and liabilities. The acquiring corporation's shareholders are typically not subject to any susceptibility, given their board of directors exercised their good faith duty of care and loyalty. Diamond assuming Mining's assets and liabilities does not presume a change in Diamond's corporate structure. Thus Diamond shareholder approval was not required.

2.

a. $500,000 settlement

Diamond's board of directors will be held liable for the $500,000 settlement.

Under the TBOC, the board is held to a good faith duty of care and duty when executing its duties based on its fiduciary relationship with the corporation. Even if board action renders an outcome unfavorable outcome for the corporation, the courts will often defer to the board under the business judgment rule - assume that the board does what is in the corporations best interest.

Here the board fell short of its duty of care to Diamond. Although Patrick, the chairman and executive officer of Diamond was known to be not particularly effective and did relatively little work for Diamond, the board deferred to Patrick when he suggested Diamond assume Mining's

assets and liabilities. Additionally Patrick knew George, of Mining, personally as a friend and the facts do not indicate Patrick knew George beyond this relationship, so there is a possibility Patrick acted based on his personally friendly relationship with George and not in his business capacity. The board relied on George's statements to Patrick that the liabilities were in the corporate books and opted to not investigate into Mining's assets and liabilities before closing. Thus the board did not act with due care - as an ordinary prudent board would have in this situation - wherein the corporation was acquiring the assets and liabities of another corporation they knew very little about, absent their inefficient and biased officer's's report. The board was negligent because it had very little prior knowledge of Mining, did not adequately inquire into such before closing, and did not conduct an investigation would have shown the preexisting liabilities to the miners. Therefore the $500,000 it paid out to miners' settlements can be held to be the liabilities of the board and the shareholders may institute derirative suits against the board on behalf of the corporation.

However Diamond's board may attempt to seek indemnity from Patrick for fraud.

b. $100,000 loan

Diamond's board of directors will be held liable for the $100,000 loan to Patrick, which he used to purchase a yacht.

Under the TBOC, the board may loan money to an officer given it is for a valid purpose related to the corporation. As fiduciaries of the corporation, the board must still exercise a good faith duty of care and loyalty in this case when granting loans to officers.

Here the board loaned Patrick $100,000 for his own personal purposes - to purchase a yacht. There are no facts indicating the a yacht for Patrick would benefit or further Diamond's corporate puproses. Thus the board breached their duty of care base on misfeasance. The board did not act as an ordinarily prudent board when it loaned $100,000 to an officer known to be not particularly effective or engaged in the corporation. Additionally, the board knew the $100,000 would be allocated towards a small yacht and there were no facts cited that it would for for the corporation, but it would be for Patrick personally.

Thus the board will be held liable for the $100,000 loan to Patrick.

c. Value of the un-cut diamond

Diamond's board of directors will be held liable for the value of the un-cut diamond given to Patrick as a bonus.

Under the TBOC, the board of directors is responsible for setting the salaries and the officers. It is presumed the board will exercise its good faith duty of care and loyalty and use reasonble discretion when determining the salaries of officers.

Here, although there are no facts suggesting Patrick performed exemplarily in his capacity as an executive officer, the board may have been pleased with his participation in the acquisition of Mining's assets and liabities (not likely though!). It is assumed the board was within their discretion to give Patrick his bonus of the $250,000 value diamond. Nonetheless in light of all the circumstances, it would seem that the board did breach its duty of care when it gave Patrick this diamond as the corporation was already deficient from its $500,000 pay out to the Mining's miners. Since Diamond was currently in debt when the $250,000 was given to Patrick as a bonus, it can be reasoned that the board did breach its duty to act as an ordinarily prudent board. Fairness and justice would require that the board instead apply the value of the diamond to paying off the corporation's debts.

Therefore the board can be held liable for the $250,000 value of the diamond.

END OF EXAM