

Question 2 – July 2012 - Selected Answer 1

1) George could have taken an ultra vires action to prevent HC from entering into an agreement with NHI. At issue is what remedies are available to a shareholder when the corporation seeks to do business beyond their purpose stated in their certificate of formation.

Under the TBOC, a corporation must do business according to its purpose state in its certificate of formation and anything outside of that is considered ultra vires. There HC's purpose stated it was formed "to construct and sell single family residences and no other purpose." Therefore, the board's agreement to enter into an agreement with NHI to finance a chain of nursing homes is outside that stated purpose and ultra vires.

In TX, ultra vires contracts are no longer void. However, shareholders may seek an injunction to prevent them from engaging in the activity. Therefore, George as a shareholder could have sought such relief. Furthermore, the directors who are responsible for the ultra vires activity may be held liable for any resulting loss. Here, NHI's venture failed and HC's entire \$1 Million investment was lost. Therefore, the responsible directors – which would be all of them because they voted unanimously – can be held liable for the loss to the corporation.

2) Tim may file a derivative suit in the name of the corporation. At issue is what conditions must be met and who may file a derivative action for a corporation.

Under the TBOC, in order to bring a derivative action a shareholder must have held shares at the time the alleged misconduct occurred OR have obtained the shares by operation of law. Here Time has obtained the shares by operation of law because they passed to him through George's will as his sole heir. Therefore, he meets this requirement.

Second, to file a derivative action the shareholder must adequately represent the interests of the corporation. This has been interpreted to mean they must hold shares throughout the litigation. Here, Tim wishes to vindicated his uncle's opposition to HC's actions, therefore there's no evidence he plans on selling his shares any time soon.

Third, a condition precedent to bring a derivative action is filing notice of the claim on the corporation 90 days prior to filing it. This notice must state the claim in particularity. Also, Tim must file this even if doing so will be futile as it is likely is here because the directors are likely unwilling to bring a suit against themselves for their actions and resulting in losses to HC.

After the suit is filed, the corporation through disinterested directors or a committee appointed may try to stop the action if they find it is not in the corporation's best interest. The court is not likely to approve the dismissal because here all of HC's directors breached their duties of care when they entered into an ultra vires contract that resulted in losses. Therefore there are no "disinterested directors" who may choose to dismiss the suit in the corporation's best interest and it's doubtful a majority of shareholders would do the same. Therefore, Tim may proceed with his derivative action against HC's directors on behalf of HC – any resulting recovery will go to HC, and not to Tim.

Question 2 – July 2012 - Selected Answer 2

1) George (“G”) could have filed suit for injunctive relief based on a violation of the duty of care owed by the directors to the corporation, as well as challenging the action as “ultra vires”. Under Texas law, a board has the authority as a fiduciary to act loyally and in good faith to effectuate the purpose and best interest of the corporation. Normally, as allowed by law, certificates name “any legal purpose” as the corporate purpose, but where a certificate limits the scope, directors are bound and any action is deemed “ultra vires”. Although directors are normally protected by the business judgment rule not to second guess the decisions made in good faith after reasonable investigation, they will likely lose this protection (burden on G to prove) when action explicitly ultra vires. If suit had been brought after the act, shareholders could have either ratified or held the directors liable for such acts; however, because such acts are not per se invalid, G would have had a good cause for equitable relief to prevent it in the first place because of high likelihood of success and irreparable injury. Thus, G could have attempted to enjoin based on a violation of certificate – ultra vires acts – by the corporate fiduciaries.

2) Tim can file a derivative suit on behalf of the corporation to recover the losses from the unauthorized venture. Because it is public, HC is not a close corp and any recovery will go to the corporation and not T, but he can get reasonable attorney fees and expenses if he wins.

The first requirement is standing, which usually requires being a shareholder at the time of the complained of act. There is an exception, however, when T acquires subsequently by operation of law – inheritance here. Thus, if T can prove he adequately represents HC’s interest (generally remains a shareholder through the suit) he can bring a derivative action.

The second requirement is that he serve a demand on the board stating with specificity the nature of the claim and allow the board 90 days to act – even if he knows they are biased against it. Moreover, T must join HC as a defendant in the suit.

Furthermore, the directors have the ability to create an independent disinterested investigation committee. If this committee conducts a good faith investigation and concludes that suit is not in the best interest of the corporation, the court must accept its finding (assuming again good faith) and dismiss the suit.

Finally, T may settle but the court must approve of such.

Therefore, T can bring a derivative suit if he has standing throughout, makes a valid demand on the board, joins HC, and an independent committee does not in good faith find it to be against HC’s best interest.

Question 2 – July 2012 - Selected Answer 3

1. George could have taken several actions before he died. First, George could have sought to have a shareholder vote to replace the directors with other directors who favored the challenged action. Shareholders with a total of 10% or more interest in the outstanding shares can call a special meeting. Shareholders must be given notice between 10 and 60 days before the meeting is held, and the notice must state a purpose (here, to remove directors). Removal of directors is a proper shareholder purpose, so a meeting could be held for this purpose. At the meeting, the shareholders could vote to remove and replace the directors, with or without cause, by a vote of a majority of shares entitled to vote. Thus, if George holds the requisite proportion of

stock, or could get shareholders with the requisite amount of stock to agree, he could call a meeting and attempt to have these directors replaced.

Second, George could seek to have this action enjoined as ultra vires. The statement of purpose in a certificate of formation must state a purpose. This statement is binding on the corporation (ie, that's all the corp can do), and any other action is ultra vires, or without authority. Although ultra vires contracts are not automatically void, shareholders can sue seeking to enjoin the ultra vires activity. Here, constructing nursing homes is ultra vires because the certificate provides that the purpose is to construct single family housing only, but nursing homes are not single family housing. Thus, George could have sued to enjoin this activity. Moreover, the directors who authorize the ultra vires activity (here, all of them because the vote was unanimous) can be held personally liable for ultra vires losses (the \$1M here).

Finally, George could have reported this action to the Secretary of State, who has authority to take action (up to a court order to terminate the existence of the corporation) against ultra vires activities.

2. Tim may bring a derivative action against the directors. A derivative action is a suit asserting a right belonging to the corporation. Here, the corporation, not the shareholders individually, are potentially harmed by this action, so a suit against the directors (for breach of duty of care to the corporation by conducting ultra vires activities) asserts a right belonging to the corporation and is properly brought as a derivative action. In this action, any damages would go to the corporation, but the shareholder who brings suit is entitled to costs and attorney's fees, so Tim would get these. The corporation must be joined as a defendant.

In order to commence such a proceeding, several requirements must be met. First, Tim must demonstrate stock ownership at the time of the challenged action. Here, the vote to engage in ultra vires activities occurred before Tim became a shareholder of record, as did the ultra vires contract itself. However, a shareholder may bring a derivative action if he acquired the shares by operation of law (including by heirship) from someone who had them at the appropriate time, which is satisfied here. Second, the shareholder must be able to adequately represent the interests of the corporation, which requires--at least--that the shareholder own stock through the full duration of the proceeding. Third, the shareholder must make a written demand on the corporation to bring suit, stating the claim with particularity, and the corporation to bring the suit itself (they would unlikely do it here because you're essentially asking the directors to sue themselves). Tim may not bring a derivative suit until 90 days after the demand.

A derivative suit may only be settled by court order. Moreover, the disinterested directors (or a committee of two or more thereof) may, upon good faith determination that the suit is not in the corporation's best interest, seek to have the suit dismissed, and the court must dismiss the suit if it determines that the determination was made in good faith. Finally, these requirements may not apply if HC is a close corporation with 35 or fewer shareholders. In such a case, Tim, as a shareholder, may bring suit personally, it will not be treated as a derivative action, the relief would go directly to Tim, and the requirements (discussed above) for derivative actions would not need to be satisfied. There are not enough facts to determine whether this exception is applicable.