

Question 7 – February 2015 – Selected Answer 1

1. Sara could have filed an injunction to enjoin E-cigs board from meeting and voting, and argue that it was ultra vires conduct. Under the Texas Business Organizations Code (TBOC), a Texas corporation can be formed for any lawful purpose. If the certificate of formation has a specific purpose then any action taken outside of that purpose is considered ultra vires, or outside the purpose of the corporation. A shareholder may bring a suit to enjoin the board of directors from voting or taking action on an ultra vires act. Here, E-cig's certificate of formation stated its purpose as "to manufacture and/or market tobacco-free, electronic cigarettes, and no other purpose". This means that anything outside of this purpose is ultra vires. E-cig's board wanted to meet and vote on investing \$500,000 on a tobacco farm, clearly outside E-cig's purpose making this action ultra vires. Sara, being a shareholder at this time, could have brought suit to enjoin the board from acting on this ultra vires purpose. Thus, Sara could have enjoined E-cig's board from acting ultra vires to E-cig's purpose.
2. A qualified shareholder may bring a derivative suit to recover damages on behalf of E-cig, and Lola is not qualified to take such action. Under the TBOC, a derivative suit is a suit brought by a shareholder on behalf of the corporation to recover damages for the board's actions. For a derivative suit to be commenced a shareholder must give the board a written demand of the purpose of the letter and that the corporation is owed damages, the shareholder must then wait 90 days to file suit, or show that irreparable harm will be suffered if the 90 days are taken. A shareholder must also fairly and adequately represent the corporation. In order to bring a derivative suit a shareholder must be a shareholder of the time of the transaction or received the stock from someone who was by operation of law (inheritance or divorce decree). Here, a qualified shareholder, one a shareholder at the time of the transaction, may bring a derivative suit on behalf of E-cig but must first give a written demand on the board, and fairly and adequately represent E-cig.

Further, TBOC allows for a successful shareholder to be awarded attorney's fees and costs, but an unsuccessful shareholder is not awarded anything.

If E-cig is a closed corporation, a corporation with 35 or fewer shareholders and not publicly traded, a court would likely find the derivative suit as a direct action and recovery would go to the plaintiff/shareholder.

Lola is not a qualified shareholder because she was not a shareholder at the time of the transaction, Sara was, and did not receive them by operation of law (inheritance or divorce) but purchased them from Sara.

Additionally, if a derivative suit is dismissed by a majority vote of disinterested board members, the court must first approve the dismissal and will do so if the disinterested majority acted in good faith and in the corporation's best interest.

Thus, a qualified voter may bring a derivative suit to recover damages on behalf of E-cig, and Lola is not a qualified voter.

Question 7 – February 2015 – Selected Answer 2

1. Sara could have sought an injunction against the company for engaging in ultra vires activities.

The issue here is whether Sara could have prevented E-Cig through its board of directors from entering into a transaction to invest in a tobacco farm. Upon formation, a corporation must state in its certificate of formation, the purpose of the corporation. Under the Texas Business Organizations Code, a corporation may engage in activities that are outside the scope of the purpose (i.e., an ultra vires activity), however, shareholders are permitted to seek injunction of the activity and/or can file suit against the board of directors who voted for the ultra vires activity if it causes a loss to the corporation.

Here, the purpose of the corporation was to manufacture electronic cigarettes and "no other purpose". Thus, an investment into a tobacco farm - whose product would ostensibly be for the making of conventional paper cigarettes, would be outside the scope of the purpose and be considered an ultra vires activity. Sara's immediate remedy would be to seek an injunction from the court preventing such activity.

Note, the directors could have sought amendment of the corporation's purpose to include conventional cigarettes or tobacco by amending the certificate of formation. This would require a majority vote in favor of the change by the Board, presentation of the proposal to shareholders in writing and a shareholder vote of 2/3 of the shares entitled to vote. If all of these steps were successful, the amended certificate could be delivered to the Texas Secretary of State and the activity would not be ultra vires.

2. A qualified shareholder could seek to file a derivative action against the corporation, or possibly a direct action against the board of directors for resulting losses from the ill-fated investment. Lola is likely not a proper plaintiff.

The issue here is two-fold, what actions are available to shareholders to possibly redress the tobacco investment by E-Cig, and may Lola bring such action.

One possible action would be to file a shareholder derivative lawsuit. This action is brought by a shareholder against the corporation for harm suffered by all shareholders (versus a direct suit where a shareholder alleges a particularized harm such as failure to honor preemptive rights vis-a-vis additional stock purchase). In order to bring a shareholder derivative action, the shareholder (1) must have held the shares at the time of the harm (or received them as a bequest or by divorce, but not by purchase or gift), (2) must adequately represent the interests of the other shareholders (this is usually satisfied by holding the stock for the duration of the litigation), and (3) must provide particularized notice of the claims to the corporation 90 days before filing suit.

Here, a qualified shareholder would be able to bring a shareholder derivative suit to challenge the improvident investment and resulting loss from the tobacco farm investment. The Board in turn would try to dismiss by a vote of a majority of disinterested shareholders stating the suit was not in the corporation's best interest. However, since the entire Board voted for the investment, that would likely be successful.

The next issue is whether Lola is the proper shareholder to bring the action. The answer is probably not. While the resulting loss occurred while Lola was a shareholder, the actual harm occurred when Sara was still the record owner of the stock - i.e., when the Board of Directors actually voted to invest in the tobacco farm. Lola did not receive the shares as a bequest and instead purchased them and she therefore is likely an improper party.

Sometimes a court will treat a shareholder derivative action as a direct action when the corporation is closely-held and has few than 35 shareholders. However, the facts here state that the corporation was traded on the NYSE and thus while the number of shareholders is not stated, it is not going to be considered a closely-held corporation.

The best option would be to have a shareholder who held the shares at the time of the Board vote file a shareholder derivative suit but Lola is not that shareholder.

Question 7 – February 2015 – Selected Answer 3

1. Sara could have filed suit against E-Cig for undertaking an ultravires activity and sought an injunction. At issue is what a shareholder is allowed to do when the corporate directors undertake an ultravires activity and the shareholder disagrees with the undertaking. Under the Texas Business Organizations Code (TBOC), when a corporation is formed, it must submit a certificate of formation to the Secretary of State's office with the following information: name of the corporation (including "inc."), names and addresses of the organizers, names and addresses an number of the initial directors, names and addresses of the registered agent, a statement of the corporation's purpose, the duration of the corporation, and the stock structure. The statement of the corporation is specific and lists a specific purpose. Any purpose or activity that the corporation undertakes outside of the purpose stated in the certificate of formation is called and ultravires activity. Ultravires activities are valid, but shareholders

are allowed to file suit against the directors to enjoin them from undertaking ultravires activity. Additionally, directors are liable if the ultravires activities result in losses. Here, E-Cig's certificate of formation states that the corporation's purpose is "to manufacture and/or market tobacco-free, electronic cigarettes and no other purpose." Therefore, when E-Cig's directors voted to invest in a tobacco farm, which is not included in the statement of purpose (it contradicts the statement of purpose), an ultravires activity was undertaken by the corporation. Even though an ultravires activity (investing in a tobacco farm) is valid under the TBOC, a shareholder who disagrees with the ultravires activity can still bring suit to enjoin it. Since Sara is a shareholder of E-Cig and disagrees with the ultravires activity of investing in a tobacco farm, she can bring suit to enjoin the activity. In conclusion, Sara could bring a suit to enjoin the corporation from investing in the tobacco farm. It is also possible that Sara could have filed a derivative suit on behalf of the corporation to stop the tobacco farm investment on the basis that it breaches the fiduciary duties that are owed to the corporation by the directors (see discussion below).

2. To recover damages from E-Cig's activities, a shareholder could file a derivative suit. At issue is what a shareholder can do when the corporate directors breach fiduciary duties owed to the corporation. Under the TBOC, a shareholder can bring a derivative suit against the directors of the corporation when the directors breach a fiduciary duty owed to the corporation. A derivative suit is one in which a shareholder brings suit against the directors of the corporation on behalf of the corporation. In order to bring a derivative suit, the shareholder must: 1) be a shareholder at the time the injury happened; 2) be a fair and accurate representative of the corporation during the time of the suit (this may mean owning shares during the pendency of the suit); and 3) give notice to the corporation that the shareholder plans to file suit and demand that the corporation file suit (the shareholder must give the corporation 90 days to consider this before the shareholder files suit). Shareholders can bring derivative suits when the corporate directors have breach their fiduciary duties to the corporation, such as breach of the duty of care and the duty of loyalty. The duty of care requires that directors act in good faith and exercise reasonable and prudent care, while the duty of loyalty requires directors to act in good faith and act in the best interest of the corporation. Here, a shareholder could bring suit against the corporate directors on the basis that they breached their duty of care and their duty of loyalty when they invested in the tobacco farm. Specifically, a shareholder who brings this suit will have to have been a shareholder at the time of the injury (when the directors actually invested), be a shareholder during the trial, and have given notice and demand to the corporation. Here Lola will probably not be allowed to bring a derivative suit because was not a shareholder at the time of the injury, rather, she purchased her shares from Sara the day after the investment was completed. Certain shareholders who did not own stock at the time of the injury can bring a derivative suit, namely if they inherit the shares or obtain the shares through divorce proceedings. Since Lola does not fall within either of these exceptions, she will not be able to bring a derivative suit against the directors. While certain shareholders would be able to bring this suit, Lola is not one who can.

Finally, at the trial, a majority of the disinterested directors could show that the suit is not in the best interest of the corporation, and the court would be required to dismiss the suit. Since we are not at trial, since Lola will not be able to successfully bring a suit, this is not at issue.