

### Question 7 – February 2018 – Selected Answer 1

(1) The shareholder agreement was properly adopted because it was made in a writing signed by both shareholders.

Under Texas law, shareholders of a corporation may enter into a "shareholder's agreement" thereby making the corporation a close corporation, managed by the shareholders themselves. For a shareholders agreement to be valid, it must be in writing, and signed by all shareholders.

Here, the agreement was drafted in writing and was signed by both Carol and Brad. Therefore, the agreement was adopted properly.

(2) The agreement did not contain unlawful terms:

A shareholders' agreement may limit the board's powers and may even eliminate the board all together. The agreement may also assign management to the shareholders or some or one of the shareholders according to the agreement. The agreement is generally valid for 10 years, but the shareholders may contract to the contrary.

Here, the agreement was drafted in writing and was signed by both Carol and Brad. The agreement properly eliminated the board, and appointed Carol as president and sole manager. The 25 year period was valid because both shareholders agreed to it. Therefore, the agreement's terms were lawful.

(3) Carol properly refused to allow Ted's accountant to inspect ABC's books and records:

Under Texas law, shareholders have the right to inspect the books and records of the corporation at a convenient time if they state a proper purpose. Moreover, this right vests in the shareholder if he has owned the stock for at least 6 months prior to the request, or if he owns more than 5% of the corporation. If the shareholder does not state a proper purpose to the inspection, the corporation may deny his request.

Here, Ted is a 50% shareholder, so he is entitled to the request. However, he did not state any purpose for his request. Therefore, Carol properly refused his request to inspect the books and records of ABC.

(4) Ted is entitled to rescission of the purchase of ABC's stock because he was not informed of the shareholders' agreement:

Under Texas law, shareholders can generally freely transfer their interest in the corporation. However, where there is a shareholders' agreement in place, the agreement may place reasonable restrictions on transfers. The transferee of a stock must be given notice of the agreement, or otherwise he may be entitled to rescission of the purchase.

Here, the facts are silent about whether the agreement places any restrictions on transfers, so it is assumed that they are allowed. However, Brad did not tell Ted about the shareholders' agreement

in place. Since Ted never agreed to the agreement, he is entitled to rescission or the purchase of ABC's shares.

### **Question 7 – February 2018 – Selected Answer 2**

(1) The shareholders of a close corporation may choose to govern the corporation using a shareholder's agreement, instead of the more formal procedures that are used in larger corporations. ABC is a close corporation since it has only two shareholders and its shares are not publicly traded. In order to enter into a shareholder's agreement, all shareholders must agree. Here, both Brad and Carol--who together owned all the shares of ABC--agreed to enter into the shareholder's agreement. Therefore, the shareholder's agreement was properly adopted.

(2) Shareholder's agreements are intended to give shareholders more flexibility in running the corporation. Shareholder's agreements are allowed to eliminate the board of directors and decide how the company is to be managed. Therefore, the shareholder's agreement does not contain any unlawful terms.

(3) Shareholders have the right to inspect a company's books and records as long as it is done for a proper purpose. Ted did not state any purpose when demanding to inspect the books and records. Since Ted did not provide the proper purpose for which he wanted to inspect the books and records, Carol's refusal to allow the inspection was proper.

(4) Ted is entitled to rescission of the purchase of ABC's shares. Stock certificates are supposed to indicate if the corporation is a close corporation that is governed by a shareholder's agreement. The purpose of this is to give notice to potential buyers of what type of company they are buying into. Here, it appears that the stock certificate which Ted received from Brad did not contain any indication that ABC was governed by a shareholder's agreement. Since Ted did not have notice that he was buying shares in a company that was governed in a different way than traditional corporations, he will be able to rescind his purchase.

### **Question 7 – February 2018 – Selected Answer 3**

(1) Adoption of Shareholders Agreement

The Shareholder's Agreement was properly adopted.

All Texas Corporations are governed by the Texas Business Organizations Code ("TBOC"). Under the Code, a close corporation is a corporation of 100 or fewer shareholders, all are U.S. Citizen natural persons, and the company is not publicly traded. The Certificate of Formation must designate that it is a Close Corporation. Under the TBOC, Close corporations have a default centralized management system like most corporations but a Close corporation can alter its management style to be more flexible (do away with the board and be managed by shareholders) upon adoption of a shareholders agreement if all shareholders agree in writing to

change the management setup or if it is in the certificate of formation and approved by shareholders. A copy of the shareholder's agreement should be given to all shareholders and stock certificates should designate stock as close corporation stock but failure to do either does not effect validity of the agreement. A statement of operation should be filed with the Texas secretary of state to give notice of the shareholders agreement to third parties and bind subsequent transferees to the terms of the agreement.

Here, Brad and Carol are the only shareholders of a duly formed and incorporated corporation. Therefore it has less than 100 shareholders, who are assumingly US Citizens and are natural persons, and the facts dont indicate this is a publically traded company. Assuming that it validly created a close corporation they can agree to change the management style of the corporation. Here, both of them agreed in a signed writing because they both signed the agreement. While a copy of the agreement does not seem to have been given (no one else to give copy to) and the stock cert does not designate as stock close corporation stock this is something that should be done but does not invalidate the agreement. A statement of operation was not filed with the Secretary of State but this also does not invalidate the agreement it just may not be enforceable against third parties.

Therefore, yes the agreement is valid and properly adopted.

## (2) Lawfulness of Shareholder Agreement Terms

Under the TBOC this is a valid shareholder agreement changing the terms of a close corporation.

Under the TBOC, Close corporations have a default centralized management system like most corporations but a Close corporation can alter its management style to be more flexible (do away with the board and be managed by shareholders) upon adoption of a shareholders agreement if all shareholders agree in writing to change the management setup or if it is in the certificate of formation and approved by shareholders. Under the TBOC officers and directors can dual serve.

Here, Brad and Carol, the sole shareholders agreed to do away with the Board and adopt a flexible management style with Carol as the sole manager and president (sole officer) which they can do under the proper procedure (discussed above) in a shareholder agreement. Therefore the terms are valid because it was properly done by shareholder agreement and there is nothing in the TBOC against dual service as manager and officer.

Therefore, there are no unlawful terms it is just changing the management style of the close corporation.

## (3) Inspection Refusal

Carol properly refused but Ted has a right to inspection if he goes through the proper procedure.

Under the TBOC, A shareholder has a right to inspect the books of a corporation for a proper purpose if they have held stock for six months or if they are 10% or more shareholder. They need to submit their request to the secretary of the corporation and state the purpose for the inspection.

Here, Ted has not been a shareholder for six months but is a 50% share owner and has a right to inspect the books because he owns more than 10%. However, he also needs to designate a purpose and go through the proper procedure. Carol is probably the proper person to submit the request to in such a small corporation but since he did not designate a purpose then Carol may refuse.

Therefore, Carol properly refused but Ted is entitled to inspection if he goes through the proper procedure.

#### (4) Rescission of Shares Purchase

Ted may be able to get a rescission of the share purchase for lack of notice given as to the close corporation status.

Under the TBOC, Close corporations have a default centralized management system like most corporations but a Close corporation can alter its management style to be more flexible (do away with the board and be managed by shareholders) upon adoption of a shareholders agreement if all shareholders agree in writing to change the management setup or if it is in the certificate of formation and approved by shareholders. The Certificate of Formation must designate that it is a Close Corporation. A copy of the shareholder's agreement should be given to all shareholders and stock certificates should designate stock as close corporation stock but failure to do either does not effect validity of the agreement. A statement of operation should be filed with the Texas secretary of state to give notice of the shareholders agreement to third parties and bind subsequent transferees to the terms of the agreement.

Here, when Brad sold Ted his stock he had no notice of the shareholder agreement. The certificates it did not designate the stock as close corporation stock and it is unclear whether the certificate of formation designated the corporation as a close corporation which would have given him inquiry notice. He did not receive the shareholders agreement so he didn't get actual notice. Most importantly he did get record notice because they did not file a statement of operation with the Texas Secretary of State which would have put him on notice. because of this he may be able to get a rescission of the contract to sell the stock certificates.

Therefore, he should be able to get a rescission based on misrepresentations and lack of notice.