Question 4 – July 2019 – Selected Answer 1

(A) BORRIS'S ACTION: Bring a Shareholder Derivative Suit Against Solar

If Borris had not sold his shares, he could have sought an injunction and brought a shareholder derivative suit against the Board of Directors (Board) on behalf of Solar. A derivative suit is brought by a shareholder to enforce the company's rights when the board of directors does not or violates their duties, including the duty of care and of loyalty.

i. Injunction

Borris could first seek an injunction to prevent the company from closing on the transaction. This injunction would give Borris time to file a shareholder derivative suit. For the injunction, Borris must show immediate and irreparable harm.

The court may grant the injunction ex parte if Borris files an affidavit that attempted service on Solar and the board, explain the potential injury and there is no time for a hearing on the injunction, as well as file a bond or security with the court for value of injunction. An ex parte order is temporary until a hearing with both parties can be scheduled.

ii. Shareholder Derivative Suit

Before filing suit, shareholder must file notice and request to the Board of the alleged violation or claim and request that the directors address it or file suit. This must be filed at least 90 days before the filing of the derivative suit. The suit can only be filed after the board refuses to bring the claim or the 90 days expires. The 90 day notice requirement can only be waived if the shareholder can show that the company will face immediate and irreparable harm. After the filing of the suit, the company must be joined as a defendant.

If the court had found that any director(s), such as the board's chair, had acted intentionally, then the director is prohibited from reimbursement from Company for his legal costs and judgment. If a director wins the suit, Company may reimburse the director. If the director loses and disinterested directors or legal counsel find that he acted in good faith, Company may choose to reimburse him.

Here, Borris will likely be successful in arguing that the 90 day notice requirement must be waived because Solar was going to wire the money to purchase the Californica Company in one week. If the court does not waive the period, Borris must

file notice with the board and allege the investment is improper, the directors violated their duties of care, and, at least, the chair of the board violated the duty of loyalty. If and when the board refuses to stop the transaction, Borris may file suit and join Solar as a defendant.

Borris could argue that the directors violated the duty of care in that they did not act in good faith, were not informed, and as a reasonably prudent person in the circumstances would do. However, the Business Judgment Rule (BJR) provides broad protection for the directors because directors are not guarantors of success. The BJR requires that the court looks at the director's conduct at the time of the conduct, not in hindsight. The directors will be protected under the BJR in their decision re the California Company if they are found to have acted in good faith, be well informed on the transaction, and believe the transaction was in the best interests of the company.

Borris could argue that the board chair, at least, violated the duty of loyalty because the transaction was self-dealing. The duty of loyalty requires that the directors act in good faith and in the best interests of the company. Self-dealing transactions or unsurping a corporate opportunity violate the duty of loyatly. Here, the fact that the board chair partially owned the batter manufacturer is a clear violation of the duty of loyatly because he used the company for his person gain. However, the director could prove he did not violate the duty by either having the shareholders (which is unlikely here) or board ratified the deal, or show that he disclosed all material facts and the decision was made by distinerested directors.

If Borris is successful, the judgment will go to Solar and Borris will be reimbursed for attorney's fees and court costs.

(B) CLARA'S ACTION

i. Clara Cannot Bring a Derivative Suit

Clara may not bring a derivative suit because she did not own the stock at the time of the investment transaction and she did not receive the stock through an operation of law (e.g., inheritance).

ii. Clara May Sue for Damages for Breach of Duty of Care

However, Clara may file suit against the directors for violation of the duty of loyalty, specifically the board chair, and the duty of care for damages.

For a claim against for violation of the duty of care, Clara can show the directors owed a duty, the duty of care, to Solar and the shareholders to act in good faith, be well informed, and act as a reasonable prudent person would in the circumstances. There are no facts to show that the directors did not become inform on the transaction or not act as a reasonable prudent person would in the circumstances. As discussed above, the BJR offers broad protection to directors. Absent more facts, Clara will likely loose on this claim.

ii. Clara May Sue for Damages for Breach of Duty of Loyalty

For a claim against for violation of the duty of loyalty for damages, Clara can show the directors owed a duty, the duty of loyalty, to Solar and the shareholders to act in good faith and in the best interests of the company. The duty of loyalty cannot be waived. As discussed above, requires that the directors act in good faith and in the best interests of the company.

Self-dealing transactions, such as the board chair profiting from the purchase of the California company, breached that duty. That breach caused and resulted in the value of Solar's shares to "drop dramatically". As discussed above, the board's chair only defenses are to show that the shareholders (which is unlikely here) or board ratified the deal or show that he disclosed all material facts and the decision was made by distinerested directors. Clara will likely succeed on this claim against the board chair.

iii. Clara Cannot Sue for Ultra Vires

Clara will not likely be able to sue for ultra vires activities.

Under TBOC, companies must include a statement of purpose in their certification of incorporation. If the directors take actions that are not line with that coporate purpose, the directors may be liable for their "ultra vires" acts if the acts cause the company to decline in fail or losses.

Here, the manufacturing of lithium ion batteries likely fall under Solar's stated purpose "of manufacturing or marketing solar cells and panels, and no other purpose" because such batteries are a key componenet of solar energy collection. Thus, the transaction is not ultra vires.

If lithium ion batteries are not used in the manufacturing or marketing of solar cells and panels, Clara may sue to hold the Directors liable for ultra vires activities. Since the directors voted unanimously, they could all be held liable if the court finds that the investment was ultra vires.

Right of appraisal does not apply because it is not noted on the stock certificate and Solar is not a close corporation and likely has more than 2,000 shareholders and different classes of voting stock.

Question 4 – July 2019 – Selected Answer 2

Borris could have filed a derivative action against Solar

Under Texas law, a corporation who engages in conduct outside the law or outside the purposes provided in its certificate of formation is said to have engaged in "ultra vires" acts. A derivative lawsuit is one in which, theoretically, a corporation is suing itself to stop the corporation from engaging in ultra vires actions. A derivative lawsuit can be brought through a shareholder who is said to have standing. A shareholder has standing when the shareholder was a record owner at the time of the ultra vires actions, or became one as an opperation of law (though not through sale).

Here, it appears Borris has standing as a shareholder to file a derivative action. Solar Inc (solar) states in its certificate of formation that its sole purpose is to "manufature or market solar cells and panels." By investing in lithium ion batteries, the board of directors voted to engage in conduct outside its scope--i.e. ultra vires acts. Boris became a shareholder several months before the board made its decision. As such, Borris has standing to file a derivative action.

90 days before filing a derivative action, a shareholder must made a demand on the board to vote on whether to bring the action. Demand is excused if either: 1) the corporation rejects the demand sooner than 90 days; or 2) the shareholder can show that the corporation will suffer imminent irreparable harm. If the corporation still decides to continue the act despite voting on the deman, the shareholder--in his complaint--must allege that the board of directors did not recieve the votes of a disinterested majority.

Here, Borris could have filed a derivative action. First, Borris would have had to made a demand 90 days before filiing which made it clear that Solar was engaged in ultra vires action. The board must then vote on the demand. If they rejected the demand within 90 days or if Borris could have shown that Solar would suffer imminent and irreparable harm, then 90 days would not be required. If the board voted to ignore the demand, Borris's peition would need to show lalege that the board of the directors did not recieve the votes of a disinterested majority.

Clara would be unable to file a derivative suit; however, she may have standing for a direct suit

As discussed above, a shareholder only has standing to bring a suit when they are either shareholders at the time the ultra vires action occurred, or after if they became shareholder's by operation of law (not including sale). Here, Clara was not a shareholder during the Lithium battery vote and she became a shareholder shortly after by sale. As such, Clara lacks derivative suit standing.

However, a shareholder may also bring suit on their own for breach of fiduciary duties of the directors. A shareholder has standing against the directors because the shareholder has value and directors are fiduciaries to their company. A corporation has limited liability, so in order to reach the directors through the corporation, she would need to bring an action by piercing the corporate viel. A shareholder can also sue the directors personally for breach of fiduciary duty.

Fiduciary duty requires a duty of loyalty and a duty of care. The duty of care is to act as an informed reasonably prudent business operator. Clara can claim that, by knowingly engaging in ultra vire conduct, the directors failed to exercise their duty of care.

Question 4 – July 2019 – Selected Answer 3

A. Boris could have made a demand upon Solar to stop its ultra vires action and, if it did not do so, bring a derivative suit against Solar on Solar's behalf.

The issue is what action Boris could have taken to prevent Solar from investing in the battery manufacturer.

Under The Texas Business and Commercial Code, a corporation is limited to act within the scope of its purpose stated in its certificate of formation. Often the purpose will be stated in broad terms to allow a larger scope of action, but this is not always the case. When the purpose is limited, actions outside the scope are considered ultra vires acts. As these acts go beyond the scope of the purpose, a shareholder may make a written demand upon the corporation's board of directors to cease the ultra vires act. If the board continues its actions, the shareholder may initiate a derivative suit after 90 days of notice unless the board denies the request and the 90 day delay would cause irreparable injury to the corporation. To bring a derivative suit, the shareholder must be one at the time the challenged action takes place or after if they become a shareholder by operation of law (such as inheriting through a will), the suit is initiated on the corporation's behalf, and the suit is in the best interest of the

corporation. The corporation at this point may ratify the suit, seek a stay to investigate the matter, or seek dismissal if it deems the suit is not the corporation's best interest.

Boris was a shareholder since the year the corporation was formed. Several months after his purchase of shares, Solar's Board of Directors decided to invest in litium ion battery manufacturer which was outside the scope of the manufacturing or marketing of solar cells and panels. This constitutes an ultra vires act. Boris could then have made a written demand on the corporation to cease its actions and then in 90 days bring suit as it would be in the corporations best interest. If Boris won the suit, he would receive attorneys fees but all recovery would have gone to the corporation itself.

Therefore, Boris could have filed a derivative suit against the ultra vires action if he made a written demand 90 days before initiating the suit as he was a shareholder at the time the challenged action began, the suit would be on Solar's behalf, and it would be in Solar's best interest.

B. Clara would be unable to bring a derivative suit for the ultra vires act but would be able to bring suit against the Board Chair who breached their duty of care due to self dealing.

The issue is what action Clara could take to recover damages suffered by Solar as a result of the battery manufacturer investment.

A shareholder may seek removal of the Board of Directors who breached their fiduciary duties to the shareholders. Breach may be found against the duty of loyalty and the duty of care. These are designed to prevent any director on the board from having competing or adverse interests to the corporation. If it is discovered that a director acted in self dealing or in a way that created an adverse interest, a shareholder may be liable for any economic consequences to the shareholders as well as be removed from the board for the violation. A special meeting of the shareholders may be called with at least 10 days notice by personal delivery of the notice (unless email notice is sufficient if consented to) to seek removal of the the director in violation. Shareholders are often not allowed to pierce the corporate veil to seek reimbursement for violations of the certificate of formation nor breaches of duty. Against the Board as a whole, shareholders may find violations if the ordinary prudent person would not have made such an investment.

Here, Clara would be unable to seek a derivative suit as she was not a shareholder at the time the investment was made nor did she become one by operation of law. Instead, she was a shareholder when it became known that Solar's board chair partially

owned the battery manufacturer. This constitutes self dealing and a violation of the duties of loyalty and care. If the corporation did not know of these material facts and was unable to ratify the facts, the breach would allow for the termination of the board chair. If the entire Board did know of the facts, that may allow for termination of all Board members and the shareholders could hold a special meeting to elect a new board as they were aware of the breaches in duty and did not act to prevent it. Although the shareholders will be unable to pierce the corporate veil, they may attempt some recovery if the director (or Board as a whole) made profit from the breach.