

Question 4: Corporations

Beth, Charles, and David are the directors of Web, Inc. (Web), a corporation that is in the business of creating websites.

Adco, Inc. (Adco), a corporation that markets computer advertising, had an urgent need for a complex website that would cost thousands of dollars to create. Adco approached Web about creating the website. Adco explained that it did not have the cash to pay for the work but claimed that it was a well-established corporation and asked Web to extend credit for the work.

Beth, Charles, and David unanimously agreed to take on the work, conditioned upon a prior review of Adco's financial statements and a determination of Adco's credit-worthiness. After learning this, Adco contacted David and told him that the sooner Web could start on the website, the sooner Adco would be able to pay Web.

David was anxious to obtain Adco's business. He falsely told Beth and Charles that he had obtained and reviewed Adco's financial statements and that, based on his review, "we should proceed with the work." Beth and Charles, without further inquiry, agreed, and Web created the costly website. Adco is unable to pay Web.

Beth, Charles, and David have now learned that Adco's shareholders have regularly taken its funds for their personal use.

In an unrelated transaction, Charles received a call from his friend Sam who wanted Web to create a new game website. Charles told Sam that the new game website was such a small job that he could do it at home for less money than Web.

Charles told Sam to send the payment for the game website to Charles at his home. Sam was pleased with the work and sent the check to Charles as requested. Shortly afterwards, Beth and David learned of this transaction.

1. What duties to Web, if any, have been breached by Beth, Charles, and David regarding the money lost on the Adco job? Discuss.
2. What rights, if any, does Web have against Adco's shareholders for Adco's failure to pay for the website? Discuss.
3. What rights, if any, does Web have against Charles regarding the contract with Sam? Discuss.

Response Provided By Professor Anita Stuppler:

1. **What duties to Web, if any, have been breached by Beth, Charles, and David regarding the money lost on the Adco job? Discuss.**

DUTY OF CARE (BETH AND CHARLES)

Directors have fiduciary duties to their corporation. They must discharge these duties in good faith and with the care that an ordinary and prudent director in a like position would exercise under the same or similar circumstances and in a manner that the directors reasonably believe to be in the best interest of the corporation. Directors may rely on information and reports, such as financial statements, prepared by corporate officers or employees whom the directors reasonably believe to be reliable and competent.

Good Faith

Beth and Charles, directors of Web, Inc. ("Web"), agreed to create a website for Adco, Inc. ("Adco") after Adco approached Web, a corporation in the business of creating websites. The website was costly (thousands of dollars), and Adco was short of cash and asked Web to extend credit for the work. Beth, Charles, and David (also a director of Web) unanimously agreed to do the work, conditioned upon a prior review of Adco's financial statements.

When David falsely represented to Beth and Charles that he had obtained and reviewed Adco's financial statements, and, based upon his review, Web should proceed with the work, Beth and Charles relied on David's false representation and did no further inquiry.

Although Beth and Charles could argue that they acted in good faith in relying on David's representations, their failure to do any inquiry of their own may have been a lack of good faith by them.

The "Ordinary and Prudent Person" Standard

When Beth and Charles relied on David's false representations and failed to do any further inquiry regarding Adco's financial statements, they did not act with the care of an ordinary and prudent director in that position.

Reasonable Belief as to the Best Interest of the Corporation

Although Beth and Charles believed that David's representations regarding Adco's financial statements were true, since Adco was short of cash, and the website work was so costly, it may not have been in the best interest of the corporation for Beth and Charles to rely on David's representations without further inquiry of their own.

Since Adco failed to pay for the costly website, and Web has lost money on this work, the losses could be attributed to the breach of care by Beth and Charles.

Business Judgment Rule

At common law, the duty of care was known as the Business Judgment Rule. Directors who failed to act in good faith and with the care of an ordinary and prudent director in a like position and in the best interest of the corporation could be liable for poor or erroneous corporate decisions.

The failure of Beth and Charles to do any personal inquiry regarding the financial statements of Adco indicated a lack of good faith and a failure to act as an ordinary and prudent director and in the best interest of the corporation. Indeed, even though David was a fellow director, a reasonable and prudent director would have taken steps to verify the accuracy of David's representations nonetheless.

Again, since Adco has failed to pay Web, and Web has sustained losses, these losses could be attributed to the reliance of Beth and Charles on David's false representations and a violation of the Business Judgment Rule, because Beth and Charles failed to act in good faith to verify the truth of David's representations.

DUTY OF CARE (DAVID)

The standard for the duty of care is defined *supra*.

David was anxious to obtain Adco's business. Although David, Beth, and Charles had unanimously agreed to extend credit to Adco conditioned upon a prior review of Adco's financial statements and a determination of Adco's creditworthiness, David never obtained and reviewed the financial statements. Instead, he **falsely** represented to Beth and Charles that he had obtained and reviewed the statements and that, based on his review, Web should accept and proceed with the work. David's failure to obtain and review Adco's financial statements, and his **false** representations to Beth and Charles, are violations of his duty of care to act in good faith as a director of Web.

David's failure to obtain and review the financial statements, and his **false** representations to Beth and Charles, also constituted a violation of his obligation to act with the care of an ordinary and prudent director in David's position.

Although David may have reasonably believed that it was in the best interest of Web to obtain Adco's business quickly, this does not justify his failure to review the financial statements, nor does it justify his false statements to Beth and Charles.

Also, David breached his duty of care to Web, because an ordinary and prudent director would probably not have extended credit to a financially unstable entity such as Adco, which was short of cash and ultimately failed to pay for the costly work.

Business Judgment Rule

The Business Judgment Rule is defined *supra*.

Although a director is entitled to rely on documents such as financial statements if the director reasonably believes these documents to be reliable and competent, David never obtained or reviewed Adco's financial statements. Thus, he violated the Business Judgment Rule.

Therefore, David violated both his duty of care to Web and the Business Judgment Rule.

2. What rights, if any, does Web have against Adco's shareholders for Adco's failure to pay for the website? Discuss.

PIERCING THE CORPORATE VEIL

Under ordinary circumstances, shareholders of a corporation may not be held personally liable for corporate debts. However, the corporate veil may be pierced, and the shareholders may be found personally liable for the corporation's debts, if the corporation does the following acts:

Acts as the Alter-Ego

When a corporation acts as the alter-ego of the shareholders, and the shareholders treat corporate assets as their own, and some basic injustice results, the corporate veil may be pierced.

Here, Web's directors, Beth, Charles, and David learned that the shareholders of Adco have regularly taken Adco's funds for personal use (treating corporate assets as their own). Adco has failed to pay Web for the costly website, because it is short of cash and cannot meet its obligations to Web for the credit Web has extended to it for the website. Thus, an injustice would result if the veil is not pierced and the shareholders of Adco held personally liable.

Inadequate Capitalization at the Time of Formation of the Corporation

Inadequate capitalization at the time of formation of a corporation is another ground for piercing the corporate veil. Here, Adco may have been inadequately capitalized at its formation because it appeared not to have had enough unencumbered capital to reasonably cover its prospective liabilities. Adco was short of cash and asked Web to extend credit for the work of creating a website that cost thousands of dollars to create.

Avoidance of Existing Obligations, Fraud, or Evasion of Statutory Provisions

Adco's shareholders regularly took Adco's funds for personal use and depleted Adco's corporate funds to the point where Adco did not have enough cash to pay for the website. Adco failed to pay for the work done for it on credit. If neither Adco nor its shareholders are held liable for payment for the website, Adco would be avoiding existing obligations, and a fraud would thus be perpetrated upon Web.

Liability upon Piercing

Some courts refuse to pierce the corporate veil in contract cases, since the contracting party had an opportunity to investigate the corporation's stability. Adco is unable to pay its creditor, Web, but Web had conditioned its extension of credit to Adco upon Web's review of Adco's financial statements. Web never reviewed Adco's financial statements before commencing work on the website, even though they had an opportunity to investigate Adco's stability.

Therefore, Web may have difficulty in piercing Adco's corporate veil to get paid for the work on the website.

3. What rights, if any, does Web have against Charles regarding the contract with Sam? Discuss.

DUTY OF LOYALTY

Conflicting Interest Transactions

When a director has a conflicting interest in a transaction, the director has a fiduciary duty of loyalty to the corporation to apprise the corporation of the conflict.

Charles is a director of Web and owes a duty of loyalty to Web as such. Charles agreed to create a game website for Sam, his friend. Charles was to do the work at home and to have Sam pay him, rather than the corporation, for the work. Charles had Sam send the check for the work to Charles' home address. This arrangement constituted a conflict of interest for Charles because it involved the creation of websites, the very business in which Web was engaged. Hence, when Charles made this personal arrangement with Sam, without first obtaining approval from Web, Charles breached his duty of loyalty to Web.

Charles did not present Sam's conflicting transaction to a majority of the board of directors of Web. In fact, he did not even tell the other directors, and Beth and David learned about the transaction with Sam after Charles had completed the work and been paid. Thus, there was no opportunity for other directors to approve of Charles doing this conflicting small job at home.

Although a court will evaluate the amount that was paid to Charles and the potential need of Web to enter into the transaction with Sam, Charles may still be required to set aside the transaction or be liable to Web for damages.

Since the transaction with Sam has been completed, it may not be enjoined, and therefore Charles will be liable to Web for damages.

CORPORATE OPPORTUNITY DOCTRINE OR USURPATION OF CORPORATE OPPORTUNITY

A director is prohibited from diverting a business opportunity from his corporation to himself without first giving the corporation an opportunity to act.

This doctrine is triggered when the director takes advantage of a business opportunity in which the corporation would have had an interest or expectancy. The opportunity needs to be within the corporation's line of business. The board of directors must be apprised of the opportunity and given a chance to accept or reject the opportunity.

When the corporation is not given the chance to act, the corporation can recover the profits that the director made from the transaction.

Here, Charles never gave Web a chance to accept or reject the transaction with Sam. Web had an interest or expectancy in creating a game website for Sam because it was in the business of creating websites (opportunity within the corporation's line of business).

Although it could be argued that since Sam's game website was a small job, the corporation may have rejected the opportunity to do the work, Charles still should disgorge the profits from the work he performed for Sam.

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