Business law class notes essay sample

ASSIGN BUSTER

A director plays a vital role in a corporate organization. They manage the business, design business policies and select the officers. Liability of the directors is a crucial aspect where a director is expected to be honest, vigilant and protect the shareholders trust in him. Shareholders own the corporation and elect the board of directors whose approval is required for major corporate actions. Liability comes into picture when directors or officers tend to cause financial harm to the corporation, commit a crime or try to breach their duty of care to the corporation. The directors often forget that they are elected or appointed to the position of the director by the shareholders based on their qualifications and with the responsibility and trust to protect the shareholders interest and maximize their gain. However, they start placing their own interest in front of the interest of the shareholders and the company. Hence the integrity and loyalty of the directors is questioned on continues basis in the business world. Directors are found to be liable when they intentionally or negligently cause harm to the third parties. A couple of times they fraudulently induce the association to breach the contract, terminate employees on false grounds or defame them. Section 21. 401 of Texas code, does provide the board of directors of Texas corporations with freedom to manage and steer the company as long as the director do not abuse that freedom and power.

Duty of Care:

In the Duty of Care, the directors owe a fiduciary duty to the company, shareholders, clients and third party. A director is held liable under the following circumstances: * If he does not work in faith and interest of the company, shareholders and client. * Breaching the duty to monitor and

supervise the company. * Laxity in monitoring company's activities, business or activities of the management. * Failure to stop wrongdoing activities of the management or directors of the company. * Failure to take action or prevent the misconduct results in hurting shareholders and clients, which should be avoided. * Even if the director's are not actively involved or know about a misconduct they are yet held liable to shareholders and clients , because they trust the directors and expect them to be monitoring the company's activities protecting the assets of the company. * If he/she makes a decision on a subject matter that he/she has a financial or other interest; therefore, the director should make an informed business judgment decision after considering and studying all aspects and for the betterment of the company and all involved. * If he/she is grossly negligent in company business activities, subject matter or decision making process. * The director is also liable for failing to exercise good business judgment and making good faith attempts to fulfill his/her fiduciary duties of acquiring sufficient knowledge and learning before making any decisions for the interest and betterment of the company, shareholders and clients.

There have been several instances where the directors have violated their rights which resulted in disasters and have affected the investors. Let us look into a couple of cases that manifest the directors having breached the duty of care and loyalty.

Case 1: Perlman v. Feldman

ACT OF BREACHING FIDUCIARY DUTY:

Incident:

This is a derivative action brought by minority stockholders of Newport Steel

Corporation to compel accounting for, and restitution of allegedly illegal gains which accrued to defendants as a result of the sale in August, 1950, of their controlling interest in the corporation. Feldman was the president, chairman of the board, and majority shareholder of Newport Steel. Newport had operated under the benefit of the “ Feldman Plan”—which required purchasers of steel to advance the price of the steel before delivery (essentially an interest free loan). He sold his shares to Wilport, a syndicate of steel buyers, and procured the resignation of his own Board of Directors. The court held that the ‘ Feldman Plan” was a corporate asset that belonged to all shareholders. In selling control, Feldman deprived the minority shareholders of the benefit of that asset and thus improperly appropriated it to himself. Burden of proving no breach of fiduciary duty is on the defendant.
Court’s decision:

The court held that Feldman must share control premium with minority shareholders.

Case2: Lewis v. S. L. & E., Inc.

LAXITY IN MONITORING COMPANY’S BUSINESS AND CORPORATE ACTIVITIES:

Incident: This case arises out of an intra family dispute over the management of two closely-held affiliated corporations. Plaintiff Donald E. Lewis, a shareholder of S. L. & E. (“ SLE”), Inc., filed a lawsuit against Alan E. Lewis, Leon L. Lewis, and Richard E. Lewis, directors of SLE and officers, directors and shareholders of Lewis General Tires, Inc. (“ LGT”). They are brothers of Donald. He charged that his brothers had wasted the assets of SLE by causing SLE to lease business premises to LGT at unreasonably low rental. SLE had owned a building, which it leased to LGT. All six of the

children entered into a “ shareholders’ agreement” with LGT, under which each child who was not a shareholder of LGT on June 1, 1972 would be required to sell his or her SLE shares to LGT at a price equal to the book value of the SLE stock.

When the date to sell the shares approached, Donald refused to do that because he believed that SLE’s book value was lower that it should have been. The district court held that Donald had failed to prove waste by the defendant directors. On appeal, Donald argued that the district court had made a wrong decision. He said that he was entitled to judgment since defendants failed to prove that the transactions in question were fail and reasonable. The appeal court turned to the question of burden of proof. Because the directors of SLE were also officers, directors and/or shareholders of LGT, the burden was on the defendant directors to demonstrate that the transactions between SLE and LGT were fair and reasonable. However, the defendants failed to carry their burden. Evidence showed that the rent was below the market value. The defendants breached duty of loyalty to SLE. Court’s decision:

On appeal, Donald argues that the district court improperly allocated to him the burden of proving his claims of waste, and that since defendants failed to prove that the transactions in question were fair and reasonable, he was entitled to judgment. The District court subsequently filed lengthy and detailed findings of fact and conclusions of law. Many of the courts findings went to the validity and probative value of the testimony given by plaintiff’s expert witness and the court ultimately declined to credit that testimony. On this basis, the court held that Donald had failed to establish the rental value

of the Property during the period at issue, and that defendants were therefore entitled to judgment on the derivative claims. Contract between Cookies and Herrig was fair and reasonable to the corporation. Case3: Cookies Food Products v. Lakes Warehouse

BREACHING DUTY OF LOYALTY BY FRAUDLENTY MANIPULATING AND CONVERTING CORPORATE FUNDS: Incident:

This is a shareholder’s derivative suit brought by the minority shareholders of a closely held Iowa corporation specializing in barbeque sauce, cookies food products. The target of the lawsuit is the majority shareholder , Duane “ speed” Herrig and two of his family –owned corporations , Lakes Warehouse distributing and Speed’s Automotive company . Plaintiff’s all edged that herrig, by acquiring control of cookies and executing self-dealing contracts breached his fiduciary duty to the company and fraudently misappropriated and converted corporate funds. In 1975, L. D. Cook organized Cookies Food Products, Inc. as a barbecue sauce manufacturing and distributorship. The company was not very successful until, Duane “ Speed” Herrig began distributing the barbecue sauce to retail outlets. Over the years, Herrig’s distributorship agreement spurred significant growth in barbecue sauce revenue. In 1981, Herrig acquired a majority stake in Cookies and in 1982; Herrig even developed his own taco sauce! Herrig received royalties for the taco sauce and his distribution agreement with Cookies increased subsequent to his acquisition of a majority interest. The plaintiff alleges that Herrig was involved in self-dealing. Court’s decision:

The court held that no contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or

entity in which one or more of its directors are directors or officers or are financially interested, shall be either void or voidable because of such relationship or interest . If any of the following occur: a. The fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves, or ratifies the contract or transaction without counting the votes of such interested director. b. The fact of such relationship or interest is disclosed or known to the shareholders entitled to vote [on the transaction] and they authorize such contract or transaction by vote or written consent. c. The contract or transaction is fair and reasonable to the corporation. The court found that there was no disclosure issue and that the contract between Cookies and Herrig was fair and reasonable to the corporation.

Case 4: Sinclair Oil Corporation v. Levien.

NEGLIGENCE OF CORPORATE ACTIVITES:

Incident:

This is an appeal by the defendant, Sinclair Oil Corporation, in a derivative action requiring Sinclair to account for damages sustained by its subsidiary, Sinclair Venezuelan Oil Company (hereinafter Sinven), organized by Sinclair for the purpose of operating in Venezuela, as a result of dividends paid by Sinven, the denial to Sinven of industrial development, and a breach of contract between Sinclair's wholly-owned subsidiary, Sinclair International Oil Company, and Sinven. Sinclair USA is a big oil company. It owned about 93% of Sinclair Venezuela. The latter was, itself, a public company with several hundred shareholders. The directors and officers of Sinclair Venezuela were all directors, officers, or employees of Sinclair USA. Sinclair USA needed

money. The directors of Sinclair Venezuela declared very good dividends over a number of years so that the parent corporation could replenish its bank account. It is not a suit to force declaration of dividends, but rather a suit by the minority shareholders that the payment of these dividends hurt Sinclair Venezuela because they had business opportunities that they could have taken advantage of if not for the dividend policy.

The threshold question was whether the case should be judged under conflict of interest analysis. If you do, Sinclair USA must prove overall reasonableness. On the other hand, is the case to be judged under the business judgment rule where the plaintiff, in order to stay in court, would have to show fraud, ultra viries, illegality, arbitrary action, or gross negligence to “ shred the shield”. The court pointed out that the dividends did not violate any bank loan agreement or the Delaware restrictions on dividends, so the payment of dividends was not a breach of fiduciary duty because all shareholders benefited equally. The court held that causing Sinclair Intl. to breach its contract with Sinven was overreaching and caused the burden to shift to Sinclair to prove “ intrinsic fairness”—a burden it failed to meet. The rule is that when a parent controls a subsidiary and receives a benefit at the expense of the subsidiary’s minority shareholders, the intrinsic fairness test applies and burden is on parent. Court’s decision:

The chancellor found as a fact that the directors were not independent of Sinclair. The chancellor held that because of Sinclair’s fiduciary duty and its control over Sinven, its relationship with Sinven must meet the test of intrinsic fairness. The standard of intrinsic fairness involves both a high degree of fairness and a shift in the burden of proof. Under this standard the

burden is on Sinclair to prove, subject to careful judicial scrutiny, that its transactions with Sinven were objectively fair.

Case 5: Talbot v. James.

VIOLATING FIDUCIARY RELATIONSHIP TO THE COPORATION:

Incident:

This equitable action was brought by C. N Talbot and Lula E. Talbot, appellants herein, against W. A James, individually and as President of Chicora Apartments, Inc and Chicora apartments Inc. C. N. Talbot and Lula E. Talbot sued W. A. James alleging that W. A. James, as an officer and director of the Corporation, violated his fiduciary relationship to the Corporation and the plaintiffs as shareholders by diverting specific funds to himself. Lula E. Talbot owned a tract of land. James offered to use that tract of land for the erection of an apartment complex. The parties formed a Corporation, known as Chicora Apartments, Inc., to construct and operate an apartment complex. On November 6, 1963, James Construction Company entered into a construction contract with Chicora Apartments, Inc. The contract sum was the actual cost of construction plus a fee of $20, 000. Lula Talbot demanded to examine the corporate records, but she was refused by James. The record showed that James, as president of Chicora Apartments, Inc., entered into a contract with himself as sole proprietor of James Construction Company without making full disclosure of his identity of interest to the other officers and shareholders of the corporations, therefore he breached fiduciary duty to other officers and shareholder. Court’s decision:

This is a clear case that James violated the duty of loyalty to the company and other directors and shareholders. After the a reviewing the accounting,

testimonies and evidence the court ordered a judgment in favor of Chicora Apartments in the amount of $25, 025. 31 from W. A. James.

Statutory Liabilities:

Some legislation provides quasi–criminal liability if the director authorizes, directs, participates or acquiesces in defense. 1. Awareness of liability: This arises when a director acts beyond the corporation’s authority. This awareness ensures that the director knows the scope of the corporation’s mandate, as defined by its corporate documents, and that the corporation is required to restrict its activities to that particular mandate. This is conducted annually by the directors , in consultation with board and executive directors. 2. Awareness of contractual liability: This is to ensure that the corporate documents provide for authority to sign contracts and to enlighten the director about the ways in which personal liability arises. This occurs annually and is conducted by director in consultation, board of colleagues and executive officer. 3. Awareness of liability in tort: This is to let the director know in what way personal liability arises from claims of injurious conduct. He should be aware that negligence in mismanagement results in claims. This is conducted annually by the director and executive officers. 4. Awareness arising from statue: Personal liabilities also arise under statutes which the director is supposed to know.

This occurs annually between the director, colleagues and executive director. 5. Statutory liability relating to incorporating legislation (including filings), wages, taxes – income, goods & services, sales, source deductions, employment, environmental protection. The concern here is about the director knowing and understanding the requirements stemming from each

of these issues, and the obligation on directors to ensure that these requirements are met. 6. Awareness of liability arising from common law duties: Does the director know that he or she is liable to the corporation for losses suffered as a result of failure to meet his or her ‘ fiduciary duties’? Does the director understand the scope of these fiduciary duties? 7. Assessment of statutory liability arising from the specific mandate or activities of the corporation: Has a review been prepared, either internally or though seeking external legal advice, identifying regulatory requirements that the corporation is required to meet? This occurs every two years, or more frequently if the regulatory environment is changing rapidly and the entire board is present.

Conclusion:

The directors are required to perform their duties in good faith and act as ordinary care persons in regards to the activities or functioning of the company. Director must also have at least basic understanding of the business of the company. Director must continually monitor the company’s activities, affairs, policies, financial position and financial statement on regular basis to assure that all business activities are fare and nothing is suspicious. “ The directors are under a continuing obligation to keep informed about the activities of the corporation.” (Eisenberg, 2005, pp. 389) Furthermore, a director must also consult with legal counsel from time to time to receive advise on suspicious activities or business dealings. Moreover, in State of Texas the directors have a job under duty of care to stay informed and do everything possible to act for the betterment of the company and not be part of the cause to harm the company. A director must

have the ability to use sound business judgment relating to the affairs of the company.

DISREGARD OFFFF CORPORATE ACTIVITY:

The disregard of corporate activity refers to situation when one abuses corporate privileges i. e. when the shareholders treat the assets of the corporation as their own and take out funds whenever they desire for their person use hence providing inadequate capitalization. Generally, the corporate form isolates Subsidiary Corporation from liability for corporate misdeeds. However, the courts will ignore the corporate entity and strip the organizers and managers of the corporation of the limited liability that they usually enjoy when, for example, the incorporation itself was accomplished to perpetrate a fraud. One of the biggest advantages to incorporating a business is that shareholders of the corporation enjoy broad protection from being held personally responsible for the debts and liabilities of the corporation. Creditors can reach the corporation’s assets, but once those assets are exhausted they cannot generally reach the personal assets of the shareholders or owners of the corporation. Formation of subsidiaries can similarly protect parent companies from the liabilities of their subsidiaries. However, in certain circumstances, courts will “ pierce the corporate veil,” meaning that the corporate entity will be disregarded such that personal liability for the corporation’s debts and obligations can attach to the corporation’s owners and shareholders. What is “ pierce the corporate veil”:

Many times, a creditor will ask a court to ignore the liability protection offered by the corporation or LLC status of a business. In doing so, the creditor is asking the court to pierce the corporate veil and make the

business owners personally liable for the debts, liabilities and obligations of the business itself (which they generally would not be liable for, due to the limited liability protection afforded to corporations and LLCs). This is generally a remedy which the court will consider where the owners of the company in question used their business to defraud the business creditors, or do some other wrongful and illegal act. This sometimes occurs, for example, where owners are using the business as a shell and a court determines that the business is really just an alter ego of the owners (this is known as alter ego liability, and while there are some technical differences, it boils down to basically the same thing as piercing the corporate veil). Courts are also willing to pierce the corporate veil where notdoing so would lead to some type of fraud or injustice. The main idea here is that owners who abuse the company entity in some way which harms others will find themselves personally liable. For example, if a corporation takes on immense debt that far exceeds its assets, so that it’s obvious from the start that the business could never hope to repay these debts, the court may pierce the corporate veil so that the creditors are not unjustly out-of- pocket for all of the money they loaned. The precise factors that a court looks at in determining whether to pierce the corporate veil very from state to state, as each state has developed its own test and standards.