**Alternate Case Problems**

*Chapter 20*

**Corporations**

**20-1. S Corporations.** James, Randolph, and Judith Agley, and Michael and Nancy Timmis were shareholders in F & M Distributors, Inc., Venture Packaging, Inc., and Diamond Automations, Inc. James Agley was also a shareholder in Middletown Aerospace. All of the firms were S corporations organized and located in Michigan and doing business in Ohio. None of the shareholders was a resident of Ohio, and none of them personally did business in Ohio. Between 1988 and 1992, the Agleys and the Timmises included their prorated share of the S corporations’ income on Ohio personal income tax returns. They believed, however, that out-of-state shareholders should not be taxed in Ohio on the income that they received from an S corporation doing business in Ohio. They contended that the income was earned by the S corporation, not by the shareholders. They also emphasized that none of them personally did business in the state. Finally, they asked the Ohio Tax Commissioner for refunds for those years. Should the state grant their request? Why or why not? [*Agley v. Tracy,* 87 Ohio St.3d 265, 719 N.E.2d 951 (1999)]

**20-2. Business Judgment Rule.** Charles Pace and Maria Fuentez were shareholders of Houston Industries, Inc. (HII), and employees of Houston Lighting & Power, a subsidiary of HII, when they lost their jobs because of a company‑wide reduction in its workforce. Pace, as a shareholder, three times wrote to HII, demanding that the board of directors terminate certain HII directors and officers and file a suit to recover damages for breach of fiduciary duty. Three times, the directors referred the charges to board committees and an outside law firm, which found that the facts did not support the charges. The board also received input from federal regulatory authorities about the facts behind some of the charges. The board notified Pace that it would refuse his demands. In response, Pace and Fuentez filed a shareholder’s derivative suit in a Texas state court against Don Jordan and the other HII directors, contending that the board’s investigation was inadequate. The defendants filed a motion for summary judgment, arguing that the suit was barred by the business judgment rule. Are the defendants right? How should the court rule? Why? [*Pace v. Jordan,* 999 S.w.2d 615 (Tex.App.—Houston [1 Dist.] 1999)]

**20-3. Duties of Majority Shareholders.** Atlas Food Systems & Services, Inc., based in South Carolina, was a food vending service that provided refreshments to factories and other businesses. Atlas was a closely held corporation. John Kiriakides was a minority shareholder of Atlas. Alex Kiriakides was the majority shareholder. Throughout most of Atlas’s history, Alex was the chairman of the board, which included John as a director. In 1995, while John was the president of the firm, the board and shareholders decided to convert Atlas to an S corporation. A few months later, however, Alex, without calling a vote, decided that the firm would not convert. In 1996, a dispute arose over Atlas’s contract to buy certain property. John and others decided not to buy it. Without consulting anyone, Alex elected to go through with the sale. Within a few days, Alex refused to allow John to stay on as president. Two months later, Atlas offered to buy John’s interest in the firm for almost $2 million. John refused, believing the offer was too low. John filed a suit in a South Carolina state court against Atlas and Alex, seeking, among other things, to force a buyout of John’s shares. On what basis might the court grant John’s request? Discuss. [*Kiriakides v. Atlas Food Systems & Services, Inc.,* 541 S.E.2d 257 (S.C. 2001)]

**20-4. Inspection Rights.** Craig Johnson founded Distributed Solutions, Inc. (DSI), in 1991 to make software and provide consulting services, including payroll services for small companies. Johnson was the sole officer and director and the majority shareholder. Jeffrey Hagen was a minority shareholder. In 1993, Johnson sold DSI’s payroll services to himself and a few others and set up Distributed Payroll Solutions, Inc. (DPSI). In 1996, DSI had revenues of $739,034 and assets of $541,168. DSI’s revenues in 1997 were $934,532. Within a year, however, all of DSI’s assets were sold, and Johnson told Hagen that he was dissolving the firm because, in part, it conducted no business and had no prospects for future business. Hagen asked for corporate records to determine the value of DSI’s stock, DSI’s financial condition, and “whether unauthorized and oppressive acts had occurred in connection with the operation of the corporation which impacted the value of” the stock. When there was no response, Hagen filed a suit in an Illinois state court against DSI and Johnson, seeking an order to compel the inspection. The defendants filed a motion to dismiss, arguing that Hagen had failed to plead a proper purpose. Should the court grant Hagen’s request? Discuss. [*Hagen v. Distributed Solutions, Inc.,* 328 Ill.App.3d 132, 764 N.E.2d 1141, 262 Ill.Dec. 24 (1 Dist. 2002)]

**20-5. Duty of Loyalty.** Digital Commerce, Ltd., designed software to enable its clients to sell their products or services over the Internet. Kevin Sullivan served as a Digital vice president until 2000, when he became president. Sullivan was dissatisfied that his compensation did not include stock in Digital, but he was unable to negotiate a deal that included equity (that is shares of ownership in the company). In May, Sullivan solicited ASR Corp.’s business for Digital while he investigated employment opportunities with ASR for himself. When ASR would not include an “equity component” in a job offer, Sullivan refused to negotiate further on Digital’s behalf. A few months later, Sullivan began to form his own firm to compete with Digital, conducting organizational and marketing activities on Digital’s time, including soliciting ASR’s business. Sullivan had all e-mail pertaining to the new firm deleted from Digital’s computers in August, and then resigned. ASR signed a contract with Sullivan’s new firm and paid it $400,000 for work through October 2001. Digital filed a suit in a federal district court against Sullivan, claiming that he usurped a corporate opportunity. Did Sullivan breach his fiduciary duty to Digital? Explain. [*In re Sullivan,* 305 Bankr. 809 (W.D.Mich. 2004)]

**20-6. Fiduciary Duty of Directors.** In 1978, David Brandt and Dean Somerville incorporated Posilock Puller, Inc. (PPI), to make and market bearing pullers. Each received half of the stock. Initially operating out of McHenry, North Dakota, PPI moved to Cooperstown, North Dakota, in 1984 into a building owned by Somerville. After the move, Brandt’s participation in PPI diminished, and Somerville’s increased. In 1998, Somerville formed PL MFG as his own business to make components for the bearing pullers and sell the parts to PPI. The start-up costs included a $450,000 loan from Sheyenne Valley Electric Cooperative. PPI executed the loan documents and indorsed the check. The proceeds were deposited into an account for PL MFG, which did not sign a promissory note payable to PPI until 2000. When Brandt learned of PL MFG and the loan, he filed a suit in a North Dakota state court against Somerville, alleging in part a breach of fiduciary duty. What fiduciary duty does a director owe to his or her corporation? What does this duty require? Should the court hold Somerville liable? Why or why not? [*Brandt v. Somerville*, 692 N.W.2d 144, 2005 ND 35 (N.D. 2005)]

**20–7.** **Duties of Directors and Officers.** First Niles Financial, Inc., is a company whose sole business is to own and operate a bank, Home Federal Savings and Loan Association of Niles, Ohio. First Niles’ directors include bank officers William Stephens, Daniel Csontos, and Lawrence Safarek; James Kramer, president of an air-conditioning company that services the bank; and Ralph Zuzolo, whose law firm serves the bank and whose title company participates in most of its real estate deals. First Niles’ board put the bank up for sale. There were three bids. Farmers National Bank Corp. stated that it would not retain the board. Cortland Bancorp indicated that it would terminate the directors but consider them for future service. First Financial Corp. said nothing about the directors. The board did not pursue Farmers’ offer, failed to respond timely to Cortland’s request, and rejected First Financial’s bid. Leonard Gantler and other First Niles shareholders filed a suit in a Delaware state court against Stephens and the others. What duties do directors and officers owe to a corporation and its shareholders? How might those duties have been breached here? Discuss. [*Gantler v. Stephens,* 965 A.2d 695 (Del.Sup. 2009)]

**20–8.**  **Piercing the Corporate Veil.**Smith Services, Inc., a trucking business owned by Tony Smith, charged its fuel purchases to an account at Laker Express. When Smith Services was not paid on several contracts, it ceased doing business and was dissolved. Smith continued to provide trucking services, however, as a sole proprietor. Laker Express sought to recover Smith Services’ unpaid fuel charges, which amounted to about $35,000, from Smith. He argued that he was not personally liable for a corporate debt. Should the court pierce the corporate veil? Explain. [*Bear, Inc. v. Smith,* 303 S.W.3d 137 (Ky.App. 2010)]

**20–9.** **Piercing the Corporate Veil.** In 1997, Leon Greenblatt, Andrew Jahelka, and Richard Nichols incorporated Loop Corp. with only $1,000 of capital. Three years later, Banco Panamericano, Inc., which was run entirely by Greenblatt and owned by a Greenblatt family trust, extended a large line of credit to Loop. Loop’s subsidiaries then participated in the credit, giving $3 million to Loop while acquiring a security interest in Loop itself. Loop then opened an account with Wachovia Securities, LLC, to buy stock shares using credit provided by Wachovia. When the stock values plummeted, Loop owed Wachovia $1.89 million. Loop also defaulted on its loan from Banco, but Banco agreed to lend Loop millions of dollars more. Rather than repay Wachovia with the influx of funds, Loop gave the funds to closely related entities and “compensated” Nichols and Jahelka without issuing any W-2 forms (forms reporting compensation to the Internal Revenue Service). The evidence also showed that Loop made loans to other related entities and shared office space, equipment, and telephone and fax numbers with related entities. Loop also moved employees among related entities, failed to file its tax returns on time (or sometimes at all), and failed to follow its own bylaws. In a lawsuit brought by Wachovia, can the court hold Greenblatt, Jahelka, and Nichols personally liable by piercing the corporate veil? Why or why not? [*Wachovia Securities, LLC v. Banco Panamericano, Inc.,* 674 F.3d 743 (9th Cir. 2012)]

**20–10. A Question of Ethics**

New Orleans Paddlewheels, Inc. (NOP) is a Louisiana corporation formed in 1982, when James Smith, Sr., and Warren Reuther were its only shareholders, with each holding 50 percent of the stock. NOP is part of a sprawling enterprise of tourism and hospitality companies in New Orleans. The positions on the board of each company were split equally between the Smith and Reuther families. At Smith’s request, his son James Smith, Jr. (JES), became involved in the businesses. In 1999, NOP’s board elected JES as president, in charge of day-to-day operations, and Reuther as chief executive officer (CEO), in charge of marketing and development. Over the next few years, animosity developed between Reuther and JES. In October 2001, JES terminated Reuther as CEO and denied him access to the offices and books of NOP and the other companies, literally changing the locks on the doors. At the next meetings of the boards of NOP and the overall enterprise, deadlock ensued, with the directors voting along family lines on every issue. Complaining that the meetings were a “waste of time,” JES began to run the entire enterprise by taking advantage of an unequal balance of power on the companies’ executive committees. In NOP’s subsequent bankruptcy proceeding, Reuther filed a motion for the appointment of a trustee to formulate a plan for the firm’s reorganization, alleging, among other things, misconduct by NOP’s management. [*In re New Orleans Paddlewheels, Inc.,* 350 Bankr. 667 (E.D.La. 2006)]

**1.** Was Reuther legally entitled to have access to the books and records of NOP and the other companies? JES maintained, among other things, that NOP’s books were “a mess.” Was JES’s denial of that access unethical? Explain.

**2.** How would you describe JES’s attempt to gain control of NOP and the other companies? Were his actions deceptive and self-serving in the pursuit of personal gain or legitimate and reasonable in the pursuit of a business goal? Discuss.