*Chapter 20*

**Corporations**

Answers to Learning Objectives/

Learning Objectives Check Questions

at the Beginning and the End of the Chapter

**Note that your students can find the answers to the even-numberednumbered *Learning Objectives Check* questions in Appendix E at the end of the text. We repeat these answers here as a convenience to you.**

**1A.** ***What is a close corporation?*** A close corporation is a corporation whose shares are held by rela­tively few persons (and those persons are often its directors or officers).

**2A.** ***What four steps are involved in bringing a corporation into existence?*** The four basic steps to bring a corporation into existence include (1) selecting the state of incorporation, (2) securing the corporate name, (3) preparing the articles of incorporation, and (4) filing those articles with the state.

**3A.** ***In what circumstances might a court disregard the corporate entity (“pierce the corporate veil”) and hold the shareholders personally liable?*** Generally, when the corporate privilege is abused for personal benefit or when the corporate business is treated in such a careless manner that the corporation and the shareholder in control are no longer separate entities, a court will re­quire an owner to assume personal liability. Commingled assets, fraud, non­compliance with corporate formalities, and thin capitalization are among the circumstances that may justify piercing the corporate veil.

**4A.** ***What are the duties of corporate directors and officers?*** Directors and officers are fiduciaries of the corporation. The fiduciary duties of the directors and officers include the duty of care and the duty of loyalty.

**5A.** ***What is a voting proxy?*** A proxy is written authorization given by a shareholder to a third party to vote the shareholder’s shares at a shareholders’ meeting.

Answers to Critical Thinking Questions

**in the Features**

# Adapting the Law to the Online Environment—Critical Thinking

***Some observers predict that numerous lawsuits will be filed against the FCC in the immediate future. Why would this be likely?*** Undoubtedly, broadband providers such as Verizon and Comcast will challenge the FCC’s authority to regulate them. After all, they were successful in doing so before. Others may bring lawsuits that concern the independence of the Federal Communications Commission. In principle, a regulatory agency is not supposed to be influenced by the executive branch—that is why it is called independent. The head of the FCC, Tom Wheeler, was going to create a “light touch” regulation for the Internet until the Obama administration told him to regulate the Internet under Title II of the 1934 Communications Act in November 2014. Additionally, if the FCC eventually uses its new regulatory powers over the Internet to control prices, you can be sure that lawsuits will abound.

# Beyond Our Borders—Critical Thinking

***Do corporations benefit from shareholders’ derivative suits? If so, how?*** A corpo­ration can benefit directly from a derivative suit becauseany damages recovered by the suit normally go into the corporation’s treasury, not to the shareholders. A corporation benefits indirectly by the extra protection offered by the existence of a derivative suit as a possible course of action.

Answers to Critical Thinking Questions

**in the Cases**

**Case 20.1—Critical Thinking—Legal Consideration**

***Why would the appellate court permit Polyflow to get away with not paying for delivered and presumably merchantable goods?*** Drake filed a suit in a Pennsylvania state court to collect the unpaid amount of its contract with Polyflow. The court entered a judgment in Drake’s favor. A state intermediate appellate court reversed this judgment, however, permitting Polyflow to get away with withholding payment for Drake’s delivered and presumably merchantable goods. This result can seem inequitable. But a careful consideration of the facts reveals that the outcome is fair.

Polyflow timely raised the defense of Drake's lack of capacity to sue due to the plaintiff’s failure to submit a certificate of authority to do business within the state. Litigation is a lengthy process. Under state law, Drake could have submitted the required certificate any time before the verdict. But Drake failed to cure its lack of a certificate during the entire period of the suit. Drake could have obtained a certificate and thereby refuted Polyflow’s defense at trial—a defense that was fatal to Drake's case—but Drake failed to do so. The court was bound to rule in Polyflow’s favor.

**Case 20.2—Critical Thinking—Ethical Consideration**

***The failure of Teal Properties and Jerry Teal to reimburse the tenant, Dog House, for the repair costs placed the tenant in a dire financial situation. Does this consequence make the landlord’s conduct unethical? Discuss.*** A breach of contract is a failure to keep a promise. This is clearly unethical. In this case, the contract included a promise by the landlord—Jerry and Teal Properties—to reimburse its tenant—Dog House—for the funds expended to repair the flood damage to the leased premises. Neither Jerry nor Teal Properties repaid Dog House.

And in the circumstances of this case, the landlord’s failure to keep this promise was accomplished through fraud, which constitutes further ethical and legal misconduct. Jerry’s deceit was intentional. He used the insurance proceeds to meet personal financial obligations rather than to reimburse Dog House, after assuring the tenant that it would be paid. And he knew that Dog House relied on the promise to make the repairs. Thus, he likely surmised that this failure to pay Dog House would place it in a precarious financial situation, possibly even “close to bankruptcy,” which is what happened.

**Case 20.3—What If the Facts Were Different?**

***Suppose that Loft’s board of directors had approved Pepsi-Cola’s use of its personnel and equipment. Would the court’s decision have been different? Discuss.*** Possibly. Guth contended that the Loft board had approved Pepsi’s use of Loft’s personnel and facilities, but there were no board minutes, no contract, and no other record or anything else in writing to prove the directors’ consent. The court found, among other things, that “Guth's use of Loft's money, credit, facilities and personnel in the furtherance of the Pepsi venture was without the knowledge or authorization of Loft's directors.” The court also pointed out that Guth had selected the members of the board and that their livelihoods were dependent on him, intimating that even if he had sought their consent, it could be construed as coerced.

Answers to Questions in the Reviewing Feature

at the End of the Chapter

**1A.** ***Theory***

The court would be likely to pierce the veil of the corporation and hold Sharp personally liable. Because he commingled personal funds with corporate funds and generally treated the business as his alter ego, as one would treat a proprietorship, the limited liability that accompanies corporate status could be lost.

**2A.** ***Articles***

Sharp is likely to be personally liable based on piercing the corporate veil due to ignoring the corporate form. Technical details in the articles of incorporation alone would not be likely to result in liability being imposed; the fact that the entire operation ignored the corporate status matters more in losing the liability shield.

**3A.** ***Credit***

Extending credit to customers is a normal business activity and is not improper. Such details need not be discussed in the articles of incorporation or the bylaws, which generally concern the purpose of the business itself and basic ownership structure issues.

**4A.** ***Classification***

The corporation was formed and operated in Georgia, so it is a domestic corporation. It is owned by one person, so it is private; its stock is not traded, so it is also a close corporation.

Answer to Debate This Question in the Reviewing Feature

at the End of the Chapter

***The sole shareholder of an S corporation should never be able to avoid liability for the torts of her or his employees.*** Perhaps it makes sense to allow individuals to use business organization forms that allow them to pass through profits to their personal tax returns, but it makes little sense to allow them to escape liability with such structures when their employees or agents commit torts.  Normally, employees do not have liability insurance or even assets that could pay for tort judgments against them.  Those who suffer from these torts would therefore end up with nothing, even if they win at trial.

It should make no difference whether an S corporation is owned by one person or by many persons.  A major benefit of all corporations, whatever form they take, has been to shield shareholders from liability.  Therefore, if a shareholder of an S corporation knows that he or she will not have limited liability, there is less reason to use the S corporation structure.  Its use will decrease as a result.

Answers to Issue Spotters

at the End of the Chapter

**1A.** ***Name Brand, Inc., is a small business. Twelve members of a single family own all of its stock. Ordinarily, corporate income is taxed at the corporate and shareholder levels. How can Name Brand avoid this double taxation of income?*** Small businesses that meet certain re­quire­ments can qualify as S corporations, created specifi­cally to permit small businesses to avoid double taxa­tion. The six requirements of an S corporation are (1) the firm must be a domestic corporation; (2) the firm must not be a member of an affiliated group of corporations; (3) the firm must have fewer than a certain number of share­holders; (4) the shareholders must be individuals, estates, or qualified trusts (or corporations in some cases); (5) there can be only one class of stock; and (6) no shareholder can be a nonresi­dent alien.

**2A.** ***Wonder Corporation has an opportunity to buy stock in XL, Inc. The directors decide that, instead of Wonder buying the stock, the directors will buy it. Yvon, a Wonder shareholder, learns of the purchase and wants to sue the directors on Wonder’s behalf. Can she do it? Explain.*** Yes. A shareholder can bring a derivative suit on behalf of a corpora­tion if some wrong is done to the corpo­ration. Normally, any damages recov­ered go into the corporate treasury.

Answers to Questions and Case Problems

**at the End of the Chapter**

**Business Scenarios and Case Problems**

**20–1A . *Preincorporation***

As a general rule, a promoter is personally liable for all pre‑incorporation con­tracts made by the promoter. The basic theory behind such liability is that the promoter cannot be an agent for a nonexistent principal (a corporation not yet formed). It is imma­terial whether the contracting party knows of the prospective exis­tence of the corporation, and the general rule of promoter liability continues even after the corporation is formed. Three basic exceptions to promoter liability are:

(1) The promoter’s contract with a third party can stipulate that the third party will look only to the new corporation, not to the promoter, for performance and li­a­bility.

(2) The third party can release the promoter from liability.

(3) After formation, the corporation can assume the contractual obliga­tions and li­ability by *novation*. (If it is by *adoption*, most courts hold that the promoter is still personally liable.)

Peterson is therefore personally liable on both contracts, because (1) neither Owens nor Babcock has released him from liability, (2) the corporation has not assumed contractual responsibility by novation, and (3) Peterson’s contract with Babcock did not limit Babcock to holding only the corporation liable. (Peterson’s liability was conditioned only on the corpo­ration’s formation, which did occur.)

Incorporation in and of itself does not make the newly formed corpora­tion liable for pre‑incorporation contracts. Until the newly formed corporation assumes Peterson’s contracts by novation (releasing Peterson from personal li­ability) or by adoption (under­taking to perform Peterson’s contracts, which makes both the corporation and Peterson li­able), Babcock cannot enforce Peterson’s contract against the corporation.

**20-2A. *Conflicts of interest***

Various state statutes contain different standards for contracts made between two corpo­ra­tions when a director of one corporation has a material interest in the other. In gen­eral, however, the courts will uphold these contracts providing that:

(1) The contract was fair and reasonable to the corporation at the time the con­tract was entered into.

(2) The director with conflicting interests gave a full disclosure of such interests to the other directors.

(3) The contract was approved by a majority of the disinterested direc­tors or share­holders.

In the case of Wick and Oxy Corp., the contract may be set aside for two rea­sons. First, the conflict‑of‑interest transaction was not fully disclosed to all members of the board; and sec­ond, the contract was not approved by a majority of disinterested directors. Thus, Wick has breached his fiduciary duties to Oxy, and Oxy can set aside the contract.

**20–3A. Spotlight on Smart Inventions—*Piercing the corporate veil***

As stated in the text, the doctrine of *respondeat superior* applies to agents of corporations. Under this doctrine, a corporation is liable for torts (or crimes) committed by its agents or officers within the course and scope of employment. Thus, if Nokes was an agent acting in the scope of his employment, then Smart Inventions can be liable for Nokes’ fraud.

Because Nokes and Persson founded the company and were the only two shareholders and officers, Smart Inventions was most likely a close corporation. When Nokes negotiated to purchase of all of Persson’s shares, Nokes would have been acting on behalf the corporation (since he was the only remaining officer and corporate representative). Nokes intentionally lied about the financial condition of the corporation and the withheld information about a new product that he suspected would be successful. In these circumstances, Smart Inventions should be liable for Note’s fraud.

Indeed, the court that heard the case ruled that Nokes was acting on behalf of Smart Inventions and awarded nearly $720,000 in damages, fees, and costs to Persson. On appeal, a state intermediate appellate court affirmed the award of damages against Smart Inventions. The court explained that “Nokes possessed the information about the Tap Light and could have disclosed it at any time before the execution of the Stock Redemption Agreement. Even if .  .  . Nokes acted only in his individual capacity during the .  .  . nego­tiations between him and Persson, he was clearly acting for Smart Inventions by the time the agreement was executed, as his signature on behalf of Smart Inventions demonstrates. Accordingly, his continued concealment of the Tap Light was an ‘act or omission’ of an offi­cer of Smart Inventions within the scope of his employment and, as a matter of law, the act or omission of Smart Inventions.”

**20–4A . *Close corporations***

Yes, Pourgol’s acts may likely have constituted misconduct. In this problem, Burnett charged Pourgol with the submission of incorrect plans to obtain the building permit, misrepresentation of the extent of the renovations, and a failure to fix the house. The submission of incorrect plans might arguably have been a mistake and the misrepresentation a misstatement in good faith. But these acts may instead have been intentional and fraudulent. Assuming the charges are true and all of the acts were wrongful, including the misrepresentation and failure to fix the house, they certainly form the basis for a finding of misconduct.

A close corporation is a private corporation with a small number of shareholders. Close corporations are often managed by their shareholders. To prevent such situations as the one that arose in this problem, shareholders must take an active role in the governance of a corporation. The corporate articles or bylaws might be amended to, for example, require more than a single shareholder or a simple majority to approve an action. A minority shareholder, or a dominated shareholder, or a formerly disinterested shareholder may also pursue a remedy through a direct or derivative (on behalf of the corporation) suit.

Here, the facts do not state which shareholder, if either, held a majority of the shares. But Burnett might have taken any of the steps mentioned above to prevent misconduct. In the problem, Burnett has taken the step of filing a suit against Pourgol.

In the actual case on which this problem is based, the court denied Pourgol’s motion to dismiss Burnett’s complaint.

**20–5A. *Rights of shareholders***

Yes. Woods has a right to inspect Biolustre’s books and records. Every shareholder is entitled to examine corporate records. A shareholder can inspect the books in person or through an agent such as an attorney, accountant, or other authorized assistant.

The right of inspection is limited to the inspection and copying of corporate books and records for a proper purpose. This is because the power of inspection is fraught with potential for abuse—for example, it can involve the disclosure of trade secrets and other confidential information. Thus, a corporation is allowed to protect itself. Here, Woods, through Hair Ventures, has the right to inspect Biolustre’s books and records. She has a proper purpose for the inspection—to obtain information about Biolustre’s financial situation. She, and other shareholders, had not received notice of shareholders’ meetings or corporate financial reports for years, or notice of Biolustre’s plan to issue additional stock. Hair Ventures had a substantial investment in the company. In the actual case on which this problem is based, the court ordered Biolustre to produce its books and records for Hair Ventures’ inspection.

**20–6A . Business Case Problem with Sample Answer—*Duty of loyalty***

Dweck breached the fiduciary duty of loyalty that a director and officer owes to his or her corporation—in this case, Kids. The essence of the duty of loyalty is the subordination of self-interest to the interest of the entity to which the duty is owed. The duty presumes constant loyalty to the corporation on the part of the directors and officers. The duty prohibits directors from using corporate funds or confidential corporate information for their personal advantage.

Here, Dweck breached her duty of loyalty to Kids by establishing a competing company that usurped Kids' business opportunities and converted Kids' resources—employees, office space, credit, and customer relationships—to conduct the competing firm’s operations. The “administrative fee” was most likely insufficient compensation. Dweck would be liable to Kids for the damages caused by this breach of duty.

In the actual case on which this problem is based, the court held that Dweck breached her duty of loyalty to Kids and awarded as damages the lost profits that Kids would have generated from the business diverted to Success.

**20–7A. *Piercing the corporate veil***

Yes, there are sufficient grounds in the facts of this problem to support piercing the corporate veil and holding Kappeler personally liable to Snapp. First, in a case in which a plaintiff seeks to pierce a corporate veil, there must be a fraud or other injustice to be remedied. In that situation, the factors that a court will consider in determining whether to pierce the corporate veil include (1) a party is tricked or misled into dealing with the corporation rather than the individual, (2) the corporation has insufficient capital to meet its prospective debts or other potential liabilities, (3) corporate formalities, such as holding required corporate meetings, are not followed, and (4) personal and corporate interests are commingled.

In this problem, the amount that Snapp ultimately paid the builder exceeded the original estimate by nearly $1 million—and the project was still unfinished. Kappeler could not provide an accounting for the Snapp project—he could not explain double and triple charges nor whether the amount that Snapp paid had actually been spent on the project. These facts support a conclusion of fraud. And they also indicate that Kappeler may have tricked or misled Snapp into dealing with the corporation rather than with Kappeler as an individual. Castlebrook had issued no shares of stock, which indicates insufficient capitalization. The minutes of the corporate meetings “all looked exactly the same,” indicating that in fact the required corporate meetings had not been held. And Kappeler had commingled personal and corporate funds.

In the actual case on which this problem is based, in Snapp’s suit against the builder, the court pierced the corporate veil and held Kappeler personally liable. A state intermediate appellate court affirmed.

**20–8A. *Torts***

Yes, R&K can be held liable for the torts of its employees. A corporation is liable for the torts committed by its agents or officers within the course and scope of their employment. The doctrine of respondeat superior applies to corporations in the same way as it does to other agency relationships.

In the facts of this problem, Jennifer Hoffman took her cell phone to a store owned by R&K for repairs. She believed that R&K’s employee Keith Press examined her phone in a back room, accessed private photos of her stored on the phone, and disseminated the photos to the public. After the incident, Hoffman learned from another R&K employee that personal information and pictures had been removed from the phones of other customers. Hoffman filed a suit against R&K and others, seeking to recover damages for several torts, including infliction of emotional distress and negligent hiring and supervision. In this situation, the doctrine of respondeat superior applies to R&K. The corporation can be held liable for the torts committed by its employees within the course and scope of their employment. This can include Press’s hiring and his unauthorized accessing of private data on customers’ phones.

In the actual case on which this problem is based, R&K filed a motion for summary judgment. The court denied the motion. A state intermediate appellate court affirmed the denial. In light of Hoffman’s testimony, R&K “failed to eliminate all triable issues of fact as to those causes of action \*  \*  \* premised upon the theory of *respondeat superior*” and those alleging negligent hiring and supervision.

**20–9A. A Question of Ethics—*Improper incorporation***

**1.** The sign indicated—at least to Weimar—that an impartial trial could not be had. A judge or a juror asked to make a finding or render a conclusion in this dispute might perceive the sign as an endorsement of Lyons or his corporation—or so Weimar likely contended. Because the sign was on the courthouse lawn, so Weimar’s argument might have run, it could be interpreted as implying that the court favored Lyons. The court denied the motion for a change of venue, apparently because it did not accept Weimar’s assertion of certain partiality in the existence of the sign.

**2.** The court applied the doctrine of corporation by estoppel and denied Weimar’s motion to dismiss the counterclaim. Weimar argued that the doctrine’s application in this case “makes no sense because a dissolved corporation does not exist and could not receive payment on any judgment awarded in its favor.” The court ultimately ruled in the defendants’ favor. Weimar appealed to the Montana Supreme Court, which upheld the lower court’s ruling. The state supreme court explained that under the doctrine of corporation by estoppel if “a business held itself out as a corporation, and .  .  . a third party dealing with it assumed it to be a corporation, both the corporation and the third party are estopped from raising the issue as to whether or not the corporation is validly incorporated. In short, the fact that an entity is not a corporation should not, in and of itself, be a defense to an otherwise valid obligation.” The court noted that these principles cover an entity “whose certificate has been revoked by the state.” The doctrine of corporation by estoppel “prevents a party from denying a party-corporation's status. The doctrine may apply to the corporation itself, or to the corporation's opponent.”

The court emphasized Lyons’s good faith, as indicated in part by his avowals that he had been unaware of the involuntary dissolution and had always acted as a corporation, and his filing of new articles of incorporation under the same corporate name “immediately upon learning of the involuntary dissolution. Moreover, Lyons Concrete, Inc., fulfilled its contract with Weimar in good faith. For Weimar's part, he contracted with the entity as a corporation, accepted the benefit of the entity's performance, and even partially paid the entity for that performance.”

Besides “good faith,” the ethical values that underlie this doctrine might include honesty, integrity, responsibility, and the “Golden Rule”—act with respect to others as you would have them treat you.

**3.** The court concluded, and on appeal the Montana Supreme Court upheld, that the parties’ written contract was a “fixed price” transaction, but that the oral agreements were on a time-and-materials basis. The court found that the written contract was for identified work at a price of $19,810, followed by “a series of binding oral agreements” for additional work. Lyons had completed the work he had agreed to, but some of the work had not been done in a workmanlike manner.

With respect to the deficiencies, Weimar had waived some of them by accepting them or by causing them when he insisted on hasty performance or had his own employees perform improper preparation (form) work. In a rush to complete the project, Weimar “repeatedly advised his subcontractors to disregard [Lyons'] potential defects.” The court entered a judgment in Lyons’s favor for $16,763, plus interest, costs, and attorney’s fees. For the deficiencies attributable to Lyons’s work, the court credited Weimar with $8,967.19 for their repair.

**Critical Thinking and Writing Assignments**

**20–10A. Business Law Critical Thinking Group Assignment**

**1.** These parties owed fiduciary duties to each other, which they breached by withholding cash from each other. Weintraub misappropriated corporate cash and Griffith kept all of the proceeds from the sale of the casino.

**2.** Griffith owed $58,447.20 to Weintraub for his 49 percent share of the proceeds from the casino’s sale and its profits. Weintraub owed Griffith $68,850 as his share of the cash that Weintraub took from the casino.

**3.** Of course, Weintraub violated his ethical duties to Griffith and to their corporation by misappropriating corporate cash. Griffith violated his ethical duties by intentionally withholding Weintraub’s portion of the corporate assets on the sale of the casino. In both cases, it would be inequitable for the parties to enjoy the full benefits of the sale and profits of the corporation without also being responsible for the money they each withheld from the other.