Lee Burgess: Welcome to the Bar Exam Toolbox podcast. Today, we are going to be discussing an issue in our "Listen and Learn" series related to corporations – this one, on the duty of loyalty. Your Bar Exam Toolbox hosts are Alison Monahan and Lee Burgess, that's me. We're here to demystify the bar exam experience, so you can study effectively, stay sane, and hopefully pass and move on with your life. We're the co-creators of the Law School Toolbox, the Bar Exam Toolbox, and the career-related website CareerDicta. Alison also runs The Girl's Guide to Law School. If you enjoy the show, please leave a review on your favorite listening app, and check out our sister podcast, the Law School Toolbox podcast. If you have any questions, don't hesitate to reach out to us. You can reach us via the contact form on BarExamToolbox.com, and we'd love to hear from you. And with that, let's get started.

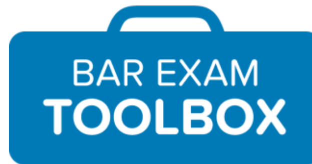
Lee Burgess: Hello, and welcome back to the "Listen and Learn" series from the Bar Exam Toolbox podcast! Today we are going to be talking about the duty of loyalty. The duty of loyalty comes up in a number of contexts, but today we're going to be talking specifically about the duty of loyalty owed by directors and officers of a corporation. The duty of loyalty is a commonly-tested issue in Corporations essays.

Lee Burgess: So, let's start with the general rule: A Director (or Officer) owes the corporation a fiduciary duty of loyalty, which means that the director, in his dealings with the corporation, must act in the best interests of the corporation and without personal conflict. The duty of loyalty forbids directors from: (a) entering into conflicting interest transactions; (b) usurping a corporate opportunity; (c) competing with the corporation; or (d) trading on inside information.

Lee Burgess: Of these four prohibited types of conduct, conflicting interest transactions and usurpation of corporate opportunities have the most complex rules. Let's start by defining a conflicting interest transaction.

Lee Burgess: A conflict of interest occurs when the director or officer, or a family member either: (a) is a party to the transaction; (b) has a beneficial interest in the transaction or is so closely linked to it that the director's judgment may reasonably be affected; or (c) is involved with either entity (director, employee, or owner) that is conducting business with the corporation, and that transaction would normally be brought before the board of directors because of its importance to the corporation.

Lee Burgess: Okay, let's come up with some quick examples to illustrate these different kinds of conflicted transactions. Say that David is on the board of directors of Realty Corp., a corporation that buys and develops land. Realty Corp. enters into



contracts with David and his two siblings to buy parcels of land that David and his siblings inherited from their parents. Each one of these transactions would be a conflicted transaction because David, a director, and/or one of his family members are a party to the transaction.

Lee Burgess: Now, let's assume instead that Realty Corp. enters into a contract to buy construction equipment from BuildCo, a corporation in which David is the majority shareholder. This would also be a conflicted transaction because David stands to profit from the transaction with BuildCo. To use the language of the rule, David has a beneficial interest in the transaction.

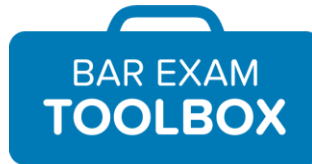
Lee Burgess: Finally, let's assume that Realty Corp. enters into a major contract with Trees-R-Us, a logging company. David does not own any shares of Trees-R-Us, but he is on the board of directors of the company. That's still a conflicted transaction because he is involved with another entity that is conducting business with Realty Corp. and the transaction is a major one that would normally be brought before Realty Corp.'s board.

Lee Burgess: So far, it looks like David is really in a jam with all of his conflicts. David doesn't want to breach his duty of loyalty, but he also doesn't want to deprive Realty Corp. of the ability to enter into these transactions. Is there anything David can do to avoid liability? Yes, there are three ways a conflicted transaction will not constitute a breach of the duty of loyalty by the conflicted director. Here's the rule:

Lee Burgess: A conflicting interest transaction with the corporation is a breach of the duty of loyalty unless the director shows that: (a) it was approved by a majority of disinterested directors after full disclosure of all relevant material facts; (b) it was approved by a majority of disinterested shareholders after full disclosure of all relevant material facts; or (c) the transaction as a whole was fair to the corporation at the time it was entered into (fair price, beneficial to corporation, and fair dealing).

Lee Burgess: Okay, that covers conflicting interest transactions. Let's move on to usurpation of a corporate opportunity, starting with defining a corporate opportunity:

Lee Burgess: A corporate opportunity is any opportunity that: (a) the corporation has an interest or expectancy in; or (b) is in the corporation's line of business. Modern authorities constitute a business opportunity broadly to include those outside the corporation's traditional line of business. A director or officer may only pursue a corporate opportunity if he: (1) first presents it to the corporation's board of directors; and (2) the board decides not to pursue the opportunity. It is



not a defense to show that the corporation would not have been able to take the opportunity.

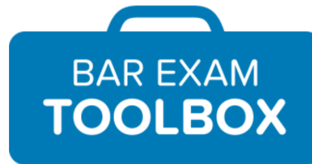
Lee Burgess: So, going back to our earlier example, say that Realty Corp. has plans to buy up any vacant parcels on Main Street that go on the market. A friend of David's lives on Main Street and tells David that she is considering selling her parcel. Without telling Realty Corp., David buys the parcel from his friend. David has usurped Realty Corp.'s opportunity because it had an expectancy in purchasing the parcel.

Lee Burgess: Here's another example. From his role as a director of Trees-R-Us, David learns that a real estate conglomerate is selling off its logging arm. Without telling Realty Corp., David decides to buy the logging company. While Realty Corp. is not a logging business and does not have an expectancy in buying a logging company, it regularly contracts with logging companies as part of its business. As a result, the opportunity would likely be considered within Realty Corp.'s line of business, and David is not allowed to usurp that opportunity.

Lee Burgess: So that's it for our rules. Hopefully, our examples so far have helped illustrate how the rules apply to some basic fact patterns. We're now ready to move on to our bigger hypos. But before we do, a quick note on strategy. The duty of loyalty is often tested with the duty of care, piercing the corporate veil, and direct vs. derivative suits. Additionally, if you're taking the bar exam in California, duty of loyalty is also often tested with professional responsibility issues. Keep that in mind as you practice your exam writing. Okay, let's get to it. This hypo was adapted from the July 2015 California bar exam:

Lee Burgess: "Online, Inc. was duly incorporated as an Internet service provider. Online's Board of Directors was composed of Jane, Sam, and Harry. Looking to expand its operations, Online sought to enter a strategic partnership with LargeCo, Inc. Jane had learned about LargeCo through Harry's wife, who she knew was the majority shareholder of LargeCo. Jane directed Harry to negotiate the terms of the transaction with LargeCo. In the course of Harry's negotiations with LargeCo, LargeCo offered to acquire the assets of Online in exchange for a cash buy-out of $1,000,000. Harry telephoned Jane and Sam; Jane and Sam agreed with Harry that the offer was a good idea; and Harry accepted LargeCo's offer.

Lee Burgess: Two days after completion of the transaction, LargeCo announced a joint venture with TechCo, which was solely owned by Harry. The joint venture was valued at $10,000,000. In its press release, TechCo described the joint venture as a 'remarkable synergy of LargeCo's new technology with TechCo's large consumer base.' Did Harry breach his duty of loyalty to Online? Discuss."



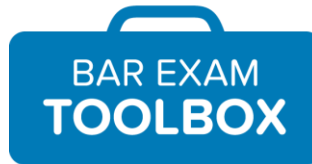
Lee Burgess: Alright, so first thing we want to figure out is which of the four types of prohibited conduct are implicated here. We're told that Harry is a director of Online, Inc., and Online sought to enter into a transaction with LargeCo, a corporation of which Harry's wife is the majority shareholder. This tells us that we're dealing with a conflicting interest transaction. But what kind? We know that neither Harry nor his wife were a party to the transaction, and that Harry was not involved with LargeCo. Harry did, however, have a beneficial interest in the transaction because his wife, as majority shareholder of LargeCo, stood to profit from the transaction. It also appears that Harry had an additional interest in the transaction because, two days later, his company TechCo entered into a joint venture with LargeCo as a direct result of the transaction.

Lee Burgess: So now we know that the transaction with LargeCo is a conflicted interest transaction. The next step is analyzing whether Harry took the necessary steps to avoid liability. Here, there is no indication that Harry provided notice for a special meeting of the board. There is also no indication that the disinterested board members, Jane and Sam, voted on the transaction. Harry might argue that he disclosed the transaction to Jane and Sam by phone, but there is no indication that he provided full disclosure of all relevant material facts, and Jane and Sam's subsequent agreement by phone does not constitute a formal vote.

Lee Burgess: So far it's looking pretty bad for Harry, but we're not quite done. Remember that Harry can avoid liability by showing that the transaction as a whole was fair to Online. Unfortunately for Harry, it doesn't look like that's the case here. LargeCo bought all of Online's assets for $1,000,000. Two days later, apparently relying on the technology LargeCo acquired from Online, LargeCo entered into a joint venture with TechCo valued at $10,000,000. Without more information, we can't know how much of the $10,000,000 valuation is attributed to Online's technology, but it seems likely that $1,000,000 was not a fair price. Accordingly, Harry breached his duty of loyalty to Online.

Lee Burgess: Now that we've done a full analysis of a conflicting interest transaction, let's do another hypo on a different issue. This one is adapted from the February 2009 California bar exam:

Lee Burgess: "Stage, Inc. is a properly formed close corporation. Stage's Articles of Incorporation include the following provision: 'Stage is formed for the sole purpose of operating comedy clubs.' Stage has a three-member board of directors, consisting of Al, Betty, and Charlie, none of whom is a shareholder.



Lee Burgess: Some time ago, Charlie persuaded Al and Betty that Stage should expand into a new business direction – real estate development. After heated discussions, the board approved and entered into a contract with Great Properties, a construction company, committing substantial Stage capital to the construction of a new shopping mall, which was set to break ground shortly.

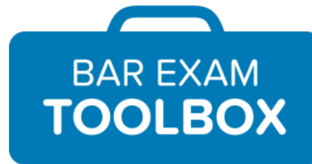
Lee Burgess: Although Charlie remained enthusiastic, Al and Betty changed their minds about the decision to expand beyond Stage's usual business. Stage was struggling financially to keep its comedy clubs open. Al and Betty decided to void Stage's contract with Great Properties in order to devote all of Stage's capital to its comedy clubs.

Lee Burgess: Last month, Great Properties approached Charlie about another real estate project under development. Great Properties was building a smaller mall on the other side of town and was seeking investors. Aware that Al and Betty were unhappy about the earlier contract with Great Properties, Charlie believed that Stage's board would not approve any further investments in real estate. As a result, Charlie decided to invest his own money in the endeavor without mentioning the project to anyone at Stage. Did Charlie breach his duty of loyalty to Stage? Discuss."

Lee Burgess: Alright, this question is about Charlie entering into a transaction without telling Stage. That tells us that we're dealing with a potential usurpation of corporate opportunity. We know that Stage's traditional line of business is operating comedy clubs. But we also know that the board of directors had agreed to shift direction and enter into a contract with Great Properties to develop a shopping mall. Charlie may argue that Al and Betty had voided that contract in order to devote all of Stage's capital to the comedy clubs, and therefore, the board would not have considered another deal with Great Properties.

Lee Burgess: On the other hand, we are told that Stage was having financial troubles, and Al and Betty would have rejected the initial deal solely because it was too costly. Al and Betty may well have approved the second deal, which involved building a smaller mall and presumably required a smaller investment of capital. And even if Charlie could show that Stage would not have been able to enter into the second deal, that is no defense.

Lee Burgess: You could go either way on this one, but given that Stage initially entered into a contract with Great Properties, it's likely that a court would consider a similar deal to fall within Stage's line of business. Because Charlie invested in the endeavor himself without ever presenting the opportunity to the board, Charlie



usurped Stage's corporate opportunity, therefore breaching his duty of loyalty to Stage.

Lee Burgess: Before we wrap up, let's do one more quick one. This one is adapted from the February 2002 California bar exam:

Lee Burgess: "Acme Corporation was a publicly traded corporation that operated shopping malls. In June 2001, Sally, president and sole owner of BigCo, approached Paul, Acme's president. She proposed a cash-out merger, in which BigCo would purchase for cash all shares of Acme, and Acme would merge into BigCo. Sally offered $100 for each outstanding share of Acme's stock, even though Acme's stock was then currently trading at $50 per share, and historically had never traded higher than $60 per share.

Lee Burgess: Paul, concerned about Acme's future, decided in good faith to pursue the merger. In July 2001, Paul telephoned his broker and purchased 5000 shares of Acme at $50 per share. Paul then presented the proposed merger to Acme's board of directors and urged them to approve it. The board voted to submit the proposed deal to a shareholder vote, and the shareholders overwhelmingly approved the deal because of the immediate profit they would realize on their shares.

Lee Burgess: In December 2001, shortly after completing the merger, BigCo closed most of the Acme malls and sold the properties at a substantial profit to a developer who intended to develop it for light industrial use. Did Paul breach his duty of loyalty to Acme? Discuss."

Lee Burgess: Okay, we know that Paul learned about a potential merger from Sally, BigCo's president, and then went out and bought shares of Acme stock based on that information. We're not going to get into securities law violations here; that's a topic for another day. But suffice it to say, Paul engaged in insider trading, which we know is a breach of the duty of loyalty.

Lee Burgess: Unlike the other hypos we reviewed today, there are no defenses or procedural steps that Paul can take to avoid liability. It doesn't matter that Paul pursued the merger in good faith, that the shareholders approved the merger, or that BigCo arguably paid a fair price for the shares. Insider trading is a breach of the duty of loyalty, plain and simple.

Lee Burgess: This last hypo was kind of an easy one, but that's okay. Remember, not every question or issue on your exam is going to be difficult for you. It's important

that you are able to recognize low hanging fruit and dispose of easy issues quickly and efficiently so you can spend more time on harder questions.

Lee Burgess: And that's all we have for you today. If you enjoyed this episode of the Bar Exam Toolbox podcast, please take a second to leave a review and rating on your favorite listening app. We'd really appreciate it. And be sure to subscribe so you don't miss anything. If you have any questions or comments, please don't hesitate to reach out to myself or Alison at lee@barexamtoolbox.com or alison@barexamtoolbox.com. Or you can always contact us via our website contact form at BarExamToolbox.com. Thanks for listening, and we'll talk soon!

RESOURCES:

"Listen and Learn" series
California Bar Examination – Essay Questions and Selected Answers, July 2015
California Bar Examination – Essay Questions and Selected Answers, February 2009
California Bar Examination – Essay Questions and Selected Answers, February 2002
Examples & Explanations: Corporations, by Alan R. Palmiter
Podcast Episode 23: Tackling an MEE Corporations Question
Podcast Episode 35: Tackling a California Bar Exam Essay: Corporations
Podcast Episode 120: Listen and Learn – Piercing the Corporate Veil