

### **ESSAY QUESTION NO. 3**

#### **Answer this question in booklet No. 3**

Sam is on the board of directors for Outdoor Kids Inc., an Alaska non-profit corporation. Outdoor Kids needs land to build a campground for the kids they serve. One day at a coffee shop, Sam meets with Vivian. Vivian is the new Vice President of Lands for a construction and engineering firm, RNR Corporation. Vivian is interested in helping Outdoor Kids and promises to speak to folks back at RNR about whether RNR has land that might work for this purpose.

RNR's articles of incorporation require that all RNR land transactions be approved by the RNR board of directors. Vivian speaks to Bob, who is both RNR's President and one of its directors, about Outdoor Kids' land need and he agrees that RNR's five acre parcel outside of town would be a great campground. Vivian and Bob decide to offer the five acre parcel to Outdoor Kids for \$500, which is substantially below market value. This offer is conveyed in a letter signed by Bob, as the RNR president and director, and he also communicates his personal delight at being able to help Outdoor Kids. Outdoor Kids' board of directors quickly approves the purchase and delivers to Bob a purchase and sale agreement signed by the President of Outdoor Kids, a draft deed, and a \$500 check payable to RNR Corporation. The purchase and sale agreement has a signature line for RNR Corporation, identifying Bob as President and director of RNR.

Bob signs the agreement and deed and hands them to his secretary with verbal instructions to include them in the board of directors' packet for consideration at the next board meeting. Vivian later sees the signed agreement and deed on the secretary's desk and in a burst of exuberance, grabs them and hand delivers them to Outdoor Kids' corporate office.

Bob and Vivian never communicate to Outdoor Kids that the land deal is contingent on approval by the RNR board of directors.

Outdoor Kids records the deed and calendars a big public event to celebrate. They also begin building cabins on the property. Invitations are issued to RNR's directors thanking RNR for selling its land at a charitable price. Bob is out of town and never hears about the big event. None of the directors respond to the invitation. Several months after the public event, at the next RNR Board of Director meeting, the board declines to approve the land transfer with a vote of 4 nays to 1 yea, and Bob sends a letter advising Outdoor Kids of the bad news. Sherry, an RNR shareholder, is very angry when she later learns that Outdoor Kids is not willing to deed the land back to RNR. Sherry wants to file an action that will force Outdoor Kids to rescind the land transfer. Sherry also wants to hold Bob and Vivian accountable for their actions.

1. Discuss the type of action that Sherry can pursue against Outdoor Kids and any preliminary steps she must take before pursuing that action.
2. Discuss whether RNR will be bound by Bob's and Vivian's conduct.
3. Discuss the type of action that Sherry could bring against Bob and Vivian and the remedy she should seek.

## GRADERS' GUIDE

### \*\* QUESTION NO. 3 \*\*

#### **SUBJECT: BUSINESS LAW**

**Question 1-** Discuss the type of action that Sherry can pursue against Outdoor Kids and any preliminary steps she must take before pursuing that action. **(40 points)**

Had this problem arisen in a context that did not involve a corporation, Sherry could have sued Outdoor Kids directly seeking rescission of the land sale on the grounds that Bob lacked legal authority to sell the land, or that Outdoor Kids had committed the tort of conversion. Because Sherry's sole relationship to the transaction is as a shareholder in the corporation whose lands were improperly sold, Sherry's legal action options are much more limited. Sherry has no individual cause of action against Outdoor Kids for injuries to her corporation nor does she have the right to seek rescission of the deed through a suit in her name. Instead, Sherry must structure her lawsuit as a derivative action under AS 10.06.435. A derivative action is one where the shareholder is suing in the name of and on behalf of the corporation and only for the direct benefit of the corporation. All remedies obtained would flow directly to the corporation. This rule prevents a multiplicity of lawsuits against a wrongdoer and requires instead that the wrong be addressed in a single suit for the benefit of all shareholders. Hikita v. Nichiro Gyogyo Kaisha, Ltd. 713 P.2d 1197, 1199 (Alaska 1986). In addition, the rule insures that damages recovered are available for payment to the corporation's creditors, Martin v. Maldonado 572 P.2d 763, 773 n.34 (Alaska 1977). It also protects the right of the board of directors to determine how the recovered damages should be utilized. Hikita at 1199.

A prerequisite for Sherry being able to sue as a shareholder on behalf of RNR Corporation in a derivative action under AS 10.06.435 is that she must first make a formal demand of RNR's directors to seek redress for the injury. The only exception to this rule is where a majority of the directors are implicated in the wrongdoing. In this case, only Bob was involved in the wrongdoing. The other four RNR directors did not participate in the wrongdoing; therefore, this exception should not be implicated. (AS10.06.435(c)). If Sherry fails to make formal demand of RNR's directors, her derivative action may be dismissed. (AS10.06.435(d))

**Question 2-** Discuss whether RNR will be bound by Bob's and Vivian's conduct. **(40 points)**

RNR may be bound by the actions of Bob and Vivian because of the operation of two different legal principles, 1) apparent agency and 2) ratification by silence.

1) Apparent Agency. Pursuant to AS 10.06.020 and AS 10.06.025, a derivative action cannot prevail in a claim that a corporate agent failed to obtain directors' approval for the alleged improper sale in a suit against a third party, if the third party can establish that the corporate agent completing the sale had apparent authority. Apparent authority "is created ... when a principal's conduct, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf by the person purporting to act for him." Askinuk Corporation v. Lower Yukon School District, 214 P.3d 259, 264 (Alaska 2009). In a corporate setting, the action of a board of directors as principals need not be extensive to create the appearance of authority for the corporation's officers to take a particular action. Limitations on an officer's authority to act on behalf of the corporation are the exception rather than the rule. However, consummating a real estate transaction is one of the more common limitations on corporate officer authority. Therefore, the RNR directors' action in designating Bob as president and Vivian as Vice President of Lands, titles that could lead a third party to reasonably assume that there was substantial authority to engage in a land transaction, may be found to be sufficient to create apparent authority. There are limited facts to suggest that the RNR board of directors engaged in any other conduct that would have led Outdoor Kids to assume that they had authorized Bob to enter into the land sale without board approval. Bob's letter which he signed as both president and director could have led a third party to reasonably assume that Bob's signature carried the weight of both company officer and director approval. If the RNR board can be shown to have known that Bob customarily signed his correspondence both as president and director, this conduct might be sufficient to establish apparent authority for the actions taken by Bob. Other than giving Vivian the title of Vice President of Lands thereby suggesting that she had authority to engage in land transactions, the RNR directors did nothing else to create the impression that she had authority to deliver the signed agreement and deed without RNR director approval of the transaction. Whether or not Vivian's conduct itself led the Outdoor Kids to assume that she had authority is irrelevant since it is the conduct of the principal that controls the analysis, not the conduct of the agent. Likewise, the directors' lack of response to the Outdoor Kids' invitation to the public event celebrating the charitable land sale is irrelevant to the apparent agency analysis since this conduct occurred after the land sale transaction and thus cannot form the basis for apparent authority. A closer legal question is whether a court would find that it was reasonable of the Outdoor Kids to not have scratched beneath the surface of the

corporate structure of RNR to determine whether board approval was required for a land transaction that involved only \$500. “In the official commentary to AS 10.06.020-.025 .... legislative counsel recognized that a third party’s belief in the real authority of a corporate agent must ‘go beyond the white heart and empty head standard of subjective good faith.’ Nonetheless, we have held that a third party need not investigate the extent of an agent’s authority or ‘deal only at its peril’”. Askinuk at 265. Apparent agency requires that the third party be reasonable in its belief that the agent has authority to act on behalf of the principal. Even though real estate transactions more commonly require board of director approval, under the facts, a court could conclude that Bob and Vivian were apparent agents of the RNR directors.

2) Ratification by Silence. RNR must overcome the defense that RNR Directors ratified Bob’s sale of the land. Alaska has recognized the doctrine of “ratification by silence”. Sea Lion Corporation v. Air Logistics of Alaska Inc. 787 P.2d 109, 117 (Alaska 1990). In Sea Lion, an agent acted on behalf of the corporation without having actual authority to do so. The corporation subsequently learned of the misrepresentation of authority, but kept silent about it to the detriment of the third party. The Court subsequently found the corporation to be bound by the agent’s unauthorized actions. Under the facts of this case, the RNR directors reasonably should have become aware that someone had sold RNR lands without Director approval. Yet they stayed silent for several months, until their board meeting at which they disapproved of the sale. Meanwhile, Outdoor Kids recorded the title, and began expending funds to improve the property. A court would likely find that the RNR directors ratified Bob’s actions through their silence and not allow them to set aside the transaction.

**Question 3-** Discuss the type of action that Sherry could bring against Bob and Vivian and the remedy she should seek. **(20 points)**

Again, Sherry cannot individually sue Bob and Vivian for the harm to the value of her RNR interests, but she can sue Bob and Vivian on behalf of RNR as a derivative action. As a precondition to bringing her derivative action, Sherry would need to make demand on the board of directors to pursue the claim on behalf of the corporation. AS 10.06.435(c). Only if the directors failed to do so could her action proceed. A shareholder action against Bob and Vivian alleging that they sold RNR’s land without legal authority to do so, may proceed and be successful even though an action against the third party involved in the complained of conduct would not succeed. There are no corporate statutory protections or defenses given to officers or directors to shield them from derivative actions by shareholders for their ultra vires acts. Under AS 10.06.015, a shareholder can proceed

with a derivative action against an incumbent or former officer or director for loss or damage caused by the individual's unauthorized actions. Since Sherry cannot seek rescission of the land sale on behalf of RNR, she would seek monetary damages measured by the difference between the sales price of \$500 and the market value of the land.