

ESSAY QUESTION NO. 4

Answer this question in booklet No. 4

Buzzard Corporation is an Alaska corporation. It currently has 25 shareholders, each of whom owns 400 shares. Thus, there are 10,000 outstanding shares of stock. Buzzard is run by 5 directors who are all elected every three years at an annual shareholder meeting. The next election of directors will take place in a year. The bylaws provide that the required quorum of shareholders for any meeting is a simple majority. Buzzard's articles and bylaws make no mention of cumulative voting.

A special meeting of the shareholders was lawfully called at which two resolutions were put to a vote of the shareholders. At the meeting, 8,000 shares were present to vote with 10 shareholders voting in person and 10 shareholders voting by proxy. The following are the two resolutions:

Resolution One - The bylaws shall be amended so that the shareholders may no longer engage in cumulative voting in director elections.

Resolution Two - The Corporation shall indemnify President Paul for all legal costs he incurs to defend against a derivative action in which he is alleged to have wrongfully caused the corporation to invest in a failing business enterprise. Note to shareholders: As of the time of the Special Meeting, there has not yet been any determination as to President Paul's liability. Approval of this item requires a majority of the outstanding shares.

Please respond to the following:

- 1) With respect to Resolution One about cumulative voting, 5,200 votes were cast in favor and 2,800 votes were cast against Resolution One.
 - a. Describe the process of cumulative voting of corporate shares in general.
 - b. Discuss whether the vote was sufficient to pass the resolution.
- 2) With respect to Resolution Two about indemnity, 4,900 votes were cast in favor and 3,100 votes were cast against Resolution Two.
 - a. Discuss whether Resolution Two is lawful under Alaska law where it provides for the unqualified indemnity of Paul, and allows indemnity before resolution of the derivative action.
 - b. Discuss whether the vote was sufficient to pass the resolution.

GRADERS' GUIDE
***** QUESTION NO. 4 *****
BUSINESS LAW

Question 1- With respect to Resolution One about cumulative voting, 5,200 votes were cast in favor and 2,800 votes were cast against Resolution One.

- a. Describe the process of cumulative voting of corporate shares in general.
- b. Discuss whether the vote was sufficient to pass the resolution.

(a) Describe the process of cumulative voting of corporate shares. **(35 Points)**

Under AS 10.06.420(a), in an election for directors, each person entitled to vote may take his or her total number of shares, multiply them by the number of directors to be elected and allocate that number of votes across the slate of candidates by placing all of the votes in favor of a single candidate or among any number of candidates. In this way, shareholders with the smallest number of shares can load up their votes behind one candidate and have a greater influence on the election outcome than they otherwise could without cumulative voting. This process is intended to make it more likely that a group of minority shareholders might be able to elect at least one or more directors to represent their views. Cumulative voting is presumed to exist unless the articles of incorporation expressly provide otherwise.

(b)- Discuss whether the vote was sufficient to pass the resolution?
(15 Points)

The facts state that the articles and bylaws did not reference cumulative voting. Therefore, the shareholders have a right to exercise cumulative voting in director elections since the default statutory right to do so has not been limited in the organizing documents. AS 10.06.420(d).

At first glance, one might assume that because there were 5,200 votes in favor of the resolution, the resolution passed. It garnered not only a majority of the votes cast, but also a majority of the outstanding shares. However, the public policy behind cumulative voting is an important one, and any action to limit it requires a heavier than normal burden. Alaska law is no exception. AS 10.06.420(d) provides that the cumulative voting right cannot be limited if the votes cast against the resolution would be sufficient to elect one director if they had been cast at an election of the entire board. Under the facts of the question, there are 10,000 outstanding shares and 5 directors. Thus a director could mathematically be assured of being elected by the holders of 2,000 shares. Because the votes cast against the resolution were 2,800 shares, the holders of those 2,800 shares would have been able to elect at least one director if they had instead been cumulatively voting in a director election.

Thus, the 2,000 share threshold was met and the resolution did not pass. Therefore, at the next annual shareholder meeting, the shareholders will still have the right to cumulate their votes as they vote in the next directors' election.

Question 2- With respect to Resolution Two about indemnity, 4,900 votes were cast in favor and 3,100 votes were cast against Resolution Two.

- (a) Discuss whether Resolution Two is lawful under Alaska law where it provides for the unqualified indemnity of Paul, and allows indemnity before resolution of the derivative action.
- (b) Discuss whether the vote was sufficient to pass the resolution.

(a) Discuss whether Resolution Two is lawful under Alaska law. (40 Points)

Under the common law, there was no right of indemnification held by a director or officer who was unsuccessful in the defense of an action. If the director or officer was successful in the defense, then there was a split of authority on whether there could be indemnity. In addition, common law did not allow reimbursement of expenses prior to a determination of liability of the officer or director. Laws of Corporations at page 1117, H. Henn, J. Alexander (West Group 1983).

Under common law, once it had been established that the defense of the action was successful, some courts allowed officers indemnity on the grounds that they were acting as agents of the corporation. Some courts allowed directors to stretch to the law of trusts to gain a legal basis for indemnity on equitable principles. *Id.* at 1117 fn2.

This unsettled nature of the common law made joining corporate boards a riskier and more costly proposition for even the most ethical of directors. State legislatures wanting to make their states more attractive to business began adopting statutes that authorized corporations to indemnify officers and directors under certain circumstances and even allowed legal costs to be reimbursed in advance of legal determinations, but subject to refund.

Insurance markets swelled with corporate director and officer liability protection policies, and state legislatures acknowledged these policies as lawful corporate expenditures even though the coverage might provide funding in situations where officers or directors behaved unlawfully or breached their duties to the corporation, and the corporation would otherwise be prohibited from indemnifying the officer or directors under those circumstances. *Id.* at 1144.

Alaska adopted its current corporate indemnification laws in 1988 and they are fashioned after an earlier version of the Model Business Corporation Act.

The Alaska legislature expressly authorized a corporation to pay for legal expenses in advance of the final disposition of the lawsuit but only if 1) the officer or director provided the corporation with a written affirmation of good faith belief that his or her conduct met the standards required to receive indemnification under the statute; and 2) he or she furnished a personal written undertaking to pay back the sums received if the statutory standard of conduct was ultimately found not to have been met. AS 10.06.490(e).

AS 10.06.490 (a) and (b) outline two situations in which a corporation is allowed to provide indemnity. Subsection (a) covers lawsuits not by or in the name of the corporation. Subsection (b) covers lawsuits by or in the name of the corporation. In both instances, the officer or director can only be indemnified by the corporation if he or she acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the corporation.

In addition, Alaska law is clear that when the officer or director is successful in his or her defense of an action, the officer or director “shall be indemnified against expenses and attorney fees actually and reasonably incurred in connection with the defense.” AS 10.06.490(c) (Emphasis added).

Applying this law to Resolution Two and President Paul’s situation, the first question is whether he can be reimbursed his expenses prior to a final determination in the case. The answer is a qualified “yes”. The facts suggest that President Paul is alleged to have wrongfully harmed the corporation by causing it to make a bad investment. In order for Resolution Two to be lawful, it would need to ensure that the corporation required from President Paul his written affirmation of good faith, and his written undertaking to pay back the money if the final determination is that the conduct did not meet the statutory standards.

The next question is whether President Paul can be indemnified once the case is finally determined. The language of Resolution Two does not have a qualification on the corporation’s duty to indemnify President Paul to those situations that are permissible under Alaska law. Therefore, as written, the indemnity is overbroad. Whether or not Resolution Two is unlawful as applied cannot be determined until the outcome of the case is known. The procedural setting in which Resolution Two would likely be tested would be after the final determination, when either President Paul seeks to obtain indemnity for the remainder of his costs, or the corporation seeks to recover reimbursement of moneys it previously paid to President Paul.

If President Paul is found to have no liability, he is legally entitled to the full indemnity of Resolution Two under AS 10.06.490(c).

If President Paul is found to have some liability, but his level of liability does not rise to the level of bad faith, and his actions were not known or reasonably knowable to be against the interests of the corporation, then the corporation may indemnify him under Resolution Two. AS10.06.490(b).

If President Paul was found to have acted in bad faith and against the interests of the corporation, the corporation cannot indemnify him under Resolution Two, and must seek reimbursement of the expenses paid to date.

There is language in the statute which leaves the door open to allowing indemnity in cases brought by or for the corporation, but it puts President Paul's fate in the court's hands. It states:

"Indemnification may not be made in respect of any claim... to which the person has been adjudged to be liable for negligence or misconduct in the performance of the person's duty to the corporation except to the extent that the court ...in the action...determines ...that despite the adjudication of liability, in view of all the circumstances of the case, the person is fairly and reasonably entitled to indemnity for expenses that the court considered proper." AS 10.06.490(b).

Thus, the legality of Resolution Two will depend upon the corporation's proper implementation prior to a final ruling by the court in the underlying action, and then later upon the court's ultimate conclusions as to the motives and knowledge behind President Paul's conduct.

(b) Discuss whether the vote sufficient to pass the resolution. **(10 Points)**

Resolution Two was put forward under the authority of AS 10.06.490(d)(3), which permits a corporation to indemnify a corporate officer under certain circumstances upon approval of the outstanding shares. The resolution in this instance garnered an approval vote of 4,900 shares which is short of the majority of the 10,000 outstanding shares. Therefore, the resolution did not pass, and it will not result in indemnification of President Paul.