

GRADERS' GUIDE

*** QUESTION NO. 8 ***

SUBJECT: BUSINESS LAW

Question (1): Pete wants to recover from Rotor Heads the lost profits that Fire Stoppers would have earned under the defaulted contracts. How should he structure his lawsuit against Rotor Heads to achieve this goal? (33 points)

[Derivative Action on behalf of Fire Stoppers Inc.]

The damages sought, namely the lost profits, belong to the corporation, Fire Stoppers. Generally, a shareholder has no individual cause of action for injuries to his corporation. (Exceptions noted below but not relevant to this answer.) 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 P2d 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 P2d 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. Hakita at 1199.

Thus, Pete would have the right to sue as a shareholder on behalf of Fire Stoppers in a derivative action under AS 10.06.435 and he would seek the lost profits from the Alaska city contracts on behalf of the corporation. In order to maintain a derivative action:

- (1) Pete must state in a verified complaint that he has standing to sue as a shareholder at the time of the alleged injury to the corporation;
- (2) Pete must state in the complaint that he made demand of the corporation's directors to seek redress for the injury or was not required to do so because a majority of the directors were involved in the wrongdoing, or were under the control of a persons who are implicated in the harm to the corporation. (AS10.06.435(c)(d)).

In his complaint, Pete would allege that Rotor Heads harmed Fire Stoppers, a third party beneficiary of the shareholder agreement, by failing to provide the helicopters as promised and thereby breaching the shareholder agreement. This breach caused Fire Stoppers to lose the profits it would have earned from the Alaska city contracts. Pete could also allege in the derivative action, as an alternative theory of recovery, that Rotor Heads breached its fiduciary duty, as a majority shareholder, and possibly a director of Fire Stoppers, by pursuing

its own financial interests in its own contracts at the expense of Fire Stoppers and its other shareholders.

Question (2): Discuss whether Pete can sue Rotor Heads in his own name and for his own personal benefit, for the diminished value of his shares in Fire Stoppers. (33 points)

[Exceptions to Derivative Lawsuit]

There are two exceptions to the general rule that a shareholder has no individual cause of action for injuries to his corporation:

- (1) where the shareholder suffers an injury separate and distinct from that suffered by other shareholders; and
- (2) where there is a special duty, such as a contractual duty, between the alleged wrongdoer and the shareholder.

Hikita at 1199. Norman v. Nichiro Gyogyo Kaisha, Ltd., 645 P.2d 191 (Alaska 1982). Arctic Contractors, Inc. v. State, 573 P.2d 1385, 1386 (Alaska 1978).

Prior to Hikita, the Alaska Supreme court had interpreted the second of the two exceptions narrowly by holding that a shareholder agreement did not give rise to any special duty, but rather was intended primarily to benefit the corporation. Thus, in Norman, the Alaska Supreme court did not allow the shareholder to sue for the lost value of his stock even though he had entered into an agreement with the other shareholders requiring each to contribute either money or services to the new business, and the failure by one of the shareholders to do so had caused his share value to plummet. The first exception was considered inapplicable since the diminished stock value was an injury shared by all shareholders.

In the Hikita case, the Alaska Supreme Court reversed its earlier position and held that a shareholder can sue for breach of a shareholder agreement, even if he has not suffered an injury separate and distinct from that suffered by other shareholders. The court noted that this ruling now put Alaska in step with the majority of jurisdictions.

Generally, a stockholder cannot sue in his own name, and on his own behalf, to recover for any loss resulting from depreciation of the value of his stock, as the result of an injury to the corporation itself. ... This rule does not apply where the wrongful acts are not only wrongs against the corporation but are also violations by the wrongdoer of a

duty arising from contract or otherwise, and owing directly by him to the stockholders.

W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 5913, at 434 (1984).

Pete's direct lawsuit against Rotor Heads would be allowed under the second exception. The shareholder agreement between Pete and Rotor Heads gave rise to a special duty by Rotor Heads to Pete to contribute the helicopters as promised. Rotor Heads clearly breached that duty, and Pete is entitled to sue in his own name to recover the diminished value of his shares in Fire Stoppers. Under Hikita, he can recover these damages even though it is not an injury separate and distinct from that suffered by other shareholders.

Question (3): What must Pete do to dissolve Fire Stoppers, and how could Rotor Heads stop him? (34 points)

[Action for Involuntary Dissolution and Avoidance of Dissolution.]

(a) Pete may initiate an action in Alaska Superior Court to involuntarily dissolve Fire Stoppers Inc. under AS10.06.628. He has standing to bring this suit since he holds at least 33 1/3% of the shares in the corporation (AS10.06.628(a)(2)). His grounds for dissolution would be one of the following:

“[T]he corporation has an even number of directors who are equally divided and cannot agree as to the management of its affairs so that its business can no longer be conducted to advantage...” AS 10.06.628(b)(2)

“[T]here is internal dissension and two or more factions of shareholders in the corporation are so deadlocked that its business can no longer be conducted with advantage to its shareholders.” AS 10.06.628 (b)(3) or

“[I]n the case of a corporation with 35 or fewer shareholders of records, liquidation is reasonably necessary for the protection of the rights or interest of the complaining shareholder or shareholders”. AS 10.06.628(b)(5).

(b) Rotor Heads can block the dissolution by causing the shares owned by Pete to be purchased by Fire Stoppers or Rotor Heads, at their fair value. AS 10.06.630. Pete may argue that the shares should be valued as though the Alaska city contracts had been performed, so that Rotor Heads is not unjustly enriched by its wrongful conduct. In the event Rotor Heads and Pete cannot agree on the fair value of the shares, the corporation will be dissolved unless Rotor Heads petitions the court to determine value. AS 10.06.630(b). If so petitioned, the court would appoint three appraisers, and render a final and binding decision on the value. The purchasing party (Rotor Heads or Fire

Stoppers) would have to pay that amount, less an allowance for part of the costs of the appraisal. If they fail to do so, the court will proceed to order dissolution and charge the purchasing party with the full costs of the appraisal. AS 10.06.630(c) and (d).