ESSAY QUESTION NO. 7

Answer this question in booklet No. 7

Frontier Ale Inc. brews and markets beer in Alaska, and its three directors are Stan, Joe and Bill. To date, Frontier Ale (Frontier) has used only hops grown in the lower 48 in its brewery process.

Director Stan is also a member manager of ABC LLC (ABC) which sells hops grown in the Matanuska Valley. ABC has had difficulty finding markets for its hops. Stan knows that they need a big sale soon or else they will have to shut down operations.

Stan suggests to President Paul of Frontier that Frontier should purchase hops from ABC to enhance their image as an Alaskan ale. Stan provides Paul with a proposed contract, but does not divulge to Paul his role as ABC's member manager or disclose ABC's financial instability. ABC's financial status is not available to the general public.

President Paul tasks Frontier's chief brewer to test the quality of ABC's hops and Frontier's chief financial officer (CFO) to analyze the pricing. After reviewing their reports, Paul decides to recommend the board approve the contract at Frontier's next board of directors' meeting.

At the next Frontier board meeting, Stan, Joe and Bill listen to presentations by President Paul and the CFO in which they recommend that Frontier enter into the contract to purchase hops from ABC. All directors agree it sounds like a smart plan. The directors vote unanimously in favor of a motion to authorize the president to enter into the contract with ABC. Stan never mentions his role with ABC to the other directors.

Several months later, before an upcoming board meeting, Frontier purchases a plane ticket for Director Joe to fly from his home in Fairbanks to Anchorage for the board meeting, but at the last minute Joe is unable to attend due to a family emergency. Joe changes the ticket and instead flies to see his mother in Iowa, who is in a hospital needing emergency surgery.

After Joe returns home, President Paul contacts Joe and asks Joe to refund Frontier the cost of the ticket. Joe indicates that he is low on cash, and requests that President Paul offset the ticket cost against Joe's future board fees. President Paul agrees to the suggested arrangement.

1. Discuss whether Stan's actions in regard to the hops sales contract did or did not breach the duties he owed to Frontier.

2. Assume that Stan took all action necessary to ensure that he breached no duty to Frontier. Discuss the result of the voting on the hops contract motion if the vote for the resolution instead is 2 yeas and 1 nay, with Stan voting yea.

3. Discuss whether there any problems with the financial arrangement that President Paul and Director Joe have worked out for Joe's repayment of the ticket cost, and discuss whether it would be better handled by Frontier simply guaranteeing a loan for Joe from a financial institution.

GRADERS' GUIDE
*** * * QUESTION NO. 7 * * ***
BUSINESS LAW

1. Discuss whether Stan's actions in regard to the hops sales contract did or did not breach the duties he owed to Frontier Ale.
(60 points)

A. Duty of Care analysis

Stan owes a duty of care to Frontier Ale. A director's duty of care owed to the corporation is codified in AS 10.06.450(b). That section provides:

"(b) A director shall perform the duties of a director…in good faith, in a manner the director reasonably believes to be in the best interests of the corporation, and with the care, including reasonable inquiry that an ordinarily prudent person in a like position would use under similar circumstances. Except as provided in (c) of this section, a director is entitled to rely on information, opinions, reports or statements… prepared or presented by (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented…."

Subsection (c) provides:

"(c) A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by (b) of this section unwarranted."

Because Stan's interest in ABC LLC was not disclosed, none of the officers of the company or the other two directors would be in a position to judge whether Stan's comments about the hops deal were motivated by his concern for his own financial interests as owner of a financially failing business enterprise or because of a genuine desire to improve the business operations of Frontier Ale. Factually, it is unclear what Stan's motivations were. But a strong argument could be made that his actions were more in line with protecting ABC LLC rather than Frontier Ale. At a minimum, Stan's failure to disclose to President Paul and the CFO that ABC LLC was financially unstable impeded Frontier Ale's management from being able to more fully investigate the financial stability of ABC LLC to ensure that the hops contract would not harm Frontier Ale.

Further, Stan cannot take shelter under the safe harbor language of AS 10.06.450(c), by claiming he simply relied upon the advice of President Paul and the CFO. Given the fact that ABC LLC's financial status was not discernable to the public, Stan knew that neither the President nor the CFO possessed a material fact that might have altered their judgment on whether

Frontier Ale should switch its hops supplier. Thus, Stan's reliance on the company managers' reports was not warranted under the circumstances. Had Frontier Ale's officers possessed this information, their recommendation to the Frontier Ale Board might have been different. Therefore, Stan cannot say that he acted in good faith in relying upon the reports by Frontier Ale's management. Stan's vote in favor of the contract was likely more motivated by his desire to protect ABC LLC than a belief that the contract was in the best interests of Frontier Ale, and therefore he breached his duty of care to Frontier Ale.

B. Duty of Loyalty analysis

Stan also owes a duty of loyalty to Frontier Ale. This duty requires Stan to disclose any potential conflicts of interest he may have in his dealings with and on behalf of Frontier Ale. This duty has also been codified under Alaska law at AS 10.06.478, which provides that a proposed contract between a corporation and another business, where a director of the corporation also holds a position with the other business, is not void or voidable merely because the director acts on both sides of the deal. To address any conflict of interest, the statute requires a director who has "a material financial interest" in the other business to disclose fully the material facts of the transaction and the director's financial interest to the corporation's board. Then, the action approving the contract can proceed if the other directors pass it in good faith by the other directors "by a sufficient vote without counting the vote of the interested director." AS 10.06.478(a)(2).

The question is whether Stan had a material financial interest in ABC LLC which was required to be disclosed. AS 10.06.478(b) states that "a common directorship does not alone constitute a material financial interest within the meaning of" the statute. However, the facts do not present a common directorship. As a member manager in a limited liability company, Stan's position with ABC LLC is more akin to that of a president or CEO, and not just at a level of a director in a corporation. Thus, Stan appears to have a material financial interest in ABC LLC that he was required to disclose.

Stan's failure to disclose the information he possessed about the financial instability of ABC LLC was likely a breach of his duty of care to Frontier Ale, and his failure to disclose his material financial interest in ABC LLC was a breach of his duty of loyalty to the corporation.

2. Assume that Stan took all action necessary to ensure that he breached no duty to Frontier Ale. Discuss the result of the voting on the hops contract motion if the vote for the resolution instead is 2 yeas and 1 nay, with Stan voting yea.
(10 Points)

Assuming Stan made the proper disclosure of his material financial interest to the Frontier Ale board under AS 10.06.478, the contract must pass by a sufficient vote without counting the vote of the interested director. Under the facts of the question, that would not be the case. Without counting Stan's vote, the vote was 1 for and 1 against approving the contract. Therefore, the motion would have failed and the contract would not have been approved.

3. Discuss whether there any problems with the financial arrangement that President Paul and Director Joe have worked out for Joe's repayment of the ticket cost, and discuss whether it would be better handled by Frontier Ale simply guaranteeing a loan for Joe from a financial institution.
(30 Points)

Director Joe asked President Paul to cause the corporation to loan Joe the value of the plane ticket until the cost can be recovered against Joe's board fees. There are no facts to suggest the value of the ticket or the length of time it will take for the cost to be recovered from his board fees. Under AS 10.06.485(a), the corporation may not make a loan to a director without the approval of two-thirds of the voting shares. Therefore, President Paul's decision to loan Director Joe money on behalf of the corporation violates Alaska statutes. The consequence of the act is that the corporation has committed an ultra vires act, which would give rise to a cause of action by any Frontier Ale, Inc. shareholder to file in the name of the corporation a derivative action to recover for any damages owed to the corporation as a result of the statutory violation. Other consequences would depend upon the language contained in the corporate articles and by-laws with respect to shareholder rights and remedies. Because the monetary magnitude of the violation is likely low, it is doubtful that these remedies would be resorted to. However, an internal ethical violation charge against the director and a board reprimand of the President would be likely.

The question also asks if it would be better if Frontier Ale simply guaranteed a loan for Joe from a financial institution. This would not resolve the problem with the direct illegal loan. Alaska Statutes eliminate this workaround by stating explicitly that "[i]f a corporation acts as a guarantor on a loan to a director…, the guarantee is treated as a loan under this section." AS 10.06.485(d).