

AGN:
Caroline Bradley

SPRING SEMESTER 2014

BUSINESS ASSOCIATIONS

**THREE HOURS.
THIS IS A CLOSED-BOOK EXAM.**

Try to show thought and critical analysis of the materials and issues dealt with in the course.

DO read the questions carefully and think about your answers before beginning to write.

DO refer to statutory provisions, cases and other materials where appropriate. If you make general statements, try to back them up with specific references.

DO NOT use abbreviations unless you explain what you are using them to stand for.

DO NOT make assumptions in answering the hypothetical.

DO explain what further information you might need in order to answer the question properly.

DO write legibly and clearly.

You will get credit for following these instructions, and may be penalized for failing to do so.

Arcadia is a state in the US which has a corporation statute in the form of the Delaware General Corporation Law (DGCL), a partnership statute in the form of the Revised Uniform Partnership Act (RUPA)/ the Florida partnership statute, and a limited liability company (LLC) statute in the form of the Florida LLC statute.

Atlas, Blade, Colossus and Daredevil are brothers, and they are also officers and directors of Zcorp, Inc., a corporation incorporated in Arcadia. Zcorp is in the business of manufacturing cars. Zcorp's shares are traded on the Arcadian stock exchange. Zcorp has four outside directors: Elektra, Firestar, Glory and Huntress. Elektra and Firestar are engineers with expertise relevant to Zcorp's business. Glory is an accountant and the CEO of a prominent Arcadian advertising firm who has known the brothers since they were all in elementary school. Huntress is married to Atlas.

Some years ago Zcorp agreed to enter into a joint venture with Elektra and Firestar to produce a new type of ignition switch for use in Zcorp cars. The joint venture was established by setting up a limited liability company (LLC). Zcorp acquired 50% of the membership (and voting) interests in the LLC (these interests are described in the LLC's operating agreement as "LLC stock"), and Elektra and Firestar each acquired 25% interests. Although members of the LLC have rights to participate in the management of the LLC's business, in practice Elektra and Firestar make all of the decisions. They do not bother too much about the details, including accounting details, preferring to spend their time on the aspects of their work that interest them. And they are often too busy to go to the bank, relying on the LLC's supply of petty cash if they need cash for any reason.

The LLC operating agreement provides:

... Members may compete with the business of the Company, are not required to refrain from dealing with the Company in the conduct or winding up of the Company's business as or on behalf of a party having an interest adverse to the Company, and are not obligated to account to the Company and hold as trustee any property, profit, or benefit derived by them in the conduct or winding up of the Company's business or derived from their use of property of the Company, including (without limitation) an appropriation of an opportunity of the Company.

Zcorp began to use the LLC's ignition switches in its cars. After a while Zcorp began to receive reports of problems with the cars that have these switches, including reports of accidents that could be related to the problems with the switches. The Zcorp Board of Directors met to discuss this issue and decided unanimously not to carry out a detailed investigation. The Board also decided unanimously that announcing a recall of the affected cars would be devastating to the company's business. The minutes of the meeting where the Board decided not to initiate a recall merely recited that the Board had considered some suggestions of problems but had decided after investigation that the suggestions were not substantiated by evidence. After the meeting Zcorp continued to receive reports of problems but did nothing to address them except to send letters to salespeople suggesting there might be some issues with the ignitions.

After the Board of Zcorp learned about the problems with the ignition switches, Elektra and Firestar persuaded a wealthy friend of theirs, Indigo, to invest in the LLC. Indigo did not ask too many questions about the investment because she trusted Elektra and Firestar. They did not tell her about the problem. Indigo's investment gave her a 10% membership interest in the LLC. After it became clear that the ignition switch problem was serious, but before any general disclosure to the market, Elektra told Indigo about the problem. Indigo informed her husband (who owned stock in Zcorp) about the problem and her husband sold his Zcorp stock.

A journalist wrote an article about the Zcorp ignition switch problem and the price of Zcorp's stock fell dramatically. The state attorney general in Arcadia (who has been aggressive in taking action against sellers of dangerous products and has been looking for a case of criminal products liability based on a theory of reckless disregard for human safety) initiated an investigation into Zcorp's actions. Zcorp announced a recall of cars with the problematic switches. A number of class actions have been filed against Zcorp on behalf of consumers claiming many millions of dollars of damages. Atlas thinks that the LLC should have product liability insurance but it turns out that Elektra and Firestar failed to pay the premiums when they were due so the policy has lapsed.

Continued....

Answer the following 5 questions, explaining (where applicable) what further facts you would need to know and giving reasons for your answers:

1. (20 points) Do you think that the Board of Directors of Zcorp dealt properly with the ignition switch issues as a matter of corporate law, and as a matter of their ethical responsibilities? In your answer explain the reasons for your conclusions and say what, if anything, they should have done differently, and why.
2. (25 points) Shareholders in Zcorp (long-term shareholders and investors who bought shares shortly before the announcement of the recall) want to sue the directors and officers of Zcorp. On the basis of the facts set out above, explain what claims they will want to bring and what difficulties they will encounter in doing so.
3. (25 points) Analyze Indigo's legal rights and liabilities based on the facts in this question.
4. (15 points) If the LLC does not have sufficient assets to pay claims of one of its creditors is there anyone else the creditor can sue for payment based on the facts of this question?
5. (15 points) Should the owners of business firms be allowed to limit their liability to other owners of the firm without any limitation? Why or why not?

APPENDIX

FLORIDA REVISED LIMITED LIABILITY COMPANY ACT

Florida Statutes § 605.0105:

Operating agreement; scope, function, and limitations.—...

(3) An operating agreement may not do any of the following:....

(e) Eliminate the duty of loyalty or the duty of care under s. 605.04091, except as otherwise provided in subsection (4).

(f) Eliminate the obligation of good faith and fair dealing under s. 605.04091, but the operating agreement may prescribe the standards by which the performance of the obligation is to be measured if the standards are not manifestly unreasonable.

(g) Relieve or exonerate a person from liability for conduct involving bad faith, willful or intentional misconduct, or a knowing violation of law...

(4) Subject to paragraph (3)(g), without limiting other terms that may be included in an operating agreement, the following rules apply:

(a) The operating agreement may:

1. Specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts...

(c) If not manifestly unreasonable, the operating agreement may:

1. Alter or eliminate the aspects of the duty of loyalty under s. 605.04091(2);

2. Identify specific types or categories of activities that do not violate the duty of loyalty; and

3. Alter the duty of care, but may not authorize willful or intentional misconduct or a knowing violation of law.

(5) The court shall decide as a matter of law whether a term of an operating agreement is manifestly unreasonable under paragraph (3)(f) or paragraph (4)(c). The court:

(a) Shall make its determination as of the time the challenged term became part of the operating agreement and shall consider only circumstances existing at that time; and

(b) May invalidate the term only if, in light of the purposes, activities, and affairs of the limited liability company, it is readily apparent that:

1. The objective of the term is unreasonable; or

2. The term is an unreasonable means to achieve the provision's objective.

(6) An operating agreement may provide for specific penalties or specified consequences ... if a member or transferee fails to comply with the terms and conditions of the operating agreement or if other events specified in the operating agreement occur.

Florida Statutes § 605.04091 Standards of conduct for members and managers.—

(1) Each manager of a manager-managed limited liability company and member of a member-managed limited liability company owes fiduciary duties of loyalty and care to the limited liability company and members of the limited liability company.

(2) The duty of loyalty is limited to:

(a) Accounting to the limited liability company and holding as trustee for it any property, profit, or benefit derived by the manager or member, as applicable:

1. In the conduct or winding up of the company's activities and affairs;
 2. From the use by the member or manager of the company's property; or
 3. From the appropriation of a company opportunity;
- (b) Refraining from dealing with the company in the conduct or winding up of the company's activities and affairs as, or on behalf of, a person having an interest adverse to the company, except to the extent that a transaction satisfies the requirements of this section; and
- (c) Refraining from competing with the company in the conduct of the company's activities and affairs before the dissolution of the company.
- (3) The duty of care in the conduct or winding up of the company's activities and affairs is limited to refraining from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or a knowing violation of law.
- (4) A manager of a manager-managed limited liability company and a member of a member-managed limited liability company shall discharge their duties and obligations under this chapter or under the operating agreement and exercise any rights consistently with the obligation of good faith and fair dealing.
- (5) A manager of a manager-managed limited liability company or a member of a member-managed limited liability company does not violate a duty or obligation under this chapter or under the operating agreement solely because the manager's or member's conduct furthers the manager's or member's own interest.
- (6) In discharging his, her, or its duties, a manager of a manager-managed limited liability company or a member of a member-managed limited liability company is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by any of the following:
- (a) One or more members or employees of the limited liability company whom the manager or member reasonably believes to be reliable and competent in the matters presented.
 - (b) Legal counsel, public accountants, or other persons as to matters the manager or member reasonably believes are within the persons' professional or expert competence.
 - (c) A committee of managers or members of which the affected manager or member is not a participant, if the manager or member reasonably believes the committee merits confidence.
- (7) A manager or member, as applicable, is not acting in good faith if the manager or

member has knowledge concerning the matter in question which makes reliance otherwise authorized under subsection (6) unwarranted.

(8) In discharging his, her, or its duties, a manager of a manager-managed limited liability company or member of a member-managed limited liability company may consider factors that the manager or member deems relevant, including the long-term prospects and interests of the limited liability company and its members, and the social, economic, legal, or other effects of any action on the employees, suppliers, and customers of the limited liability company, the communities and society in which the limited liability company operates, and the economy of this state and the nation.

(9) This section applies to a person winding up the limited liability company activities and affairs as the legal representative of the last surviving member as if such person were subject to this section.