

# **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 question 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 and Urbania are states in the US. Arcadia has a partnership statute based on RUPA, but which includes no provisions for limited liability partnerships, and a corporations statute which borrows in all significant respects from the Delaware General Corporations Law. In Arcadia disputes involving issues of business law are resolved either through arbitration or in litigation in the Arcadian Chancery Court (which is modeled on the Delaware Chancery Court). The Urbanian corporations statute is based on the RMBCA.

Three years ago, the Arcadian legislature enacted the Arcadian Limited Liability Business Enterprise Act (ALLBEA) (selected provisions of this statute are set out in the APPENDIX to this exam (see pp. 5-6)). An Arcadian limited liability business enterprise (LLBE) is required to have an LLBE agreement. Unless the LLBE agreement provides that the LLBE is to be managed by its owners, LLBEs formed under the ALLBEA must have at least two “managing agents” who are responsible under the statute for managing the business of the LLBE. The managing agents are required to hold management meetings at least 12 times per year. Owner-managed LLBEs are free to choose their own arrangements for meetings, but the statute requires any alternative arrangements for meetings to be set out in the LLBE agreement.

Bill and Ted, who live in Urbania, decided to establish an Arcadian LLBE, Billed Imports LLBE (BI) to carry on the business of importing toys from Ruritania (which is a developing country with low wage rates). Bill developed contacts with toy manufacturers in Ruritania through his job as Vice President for toy manufacturing for a large corporation incorporated in and based in Urbania, and he has put these contacts to use on BI’s behalf. Ted has a background in retail distribution.

Bill and Ted rented office premises and hired staff for BI in Arcadia before they actually filed to establish BI. Bill and Ted took for themselves the title of “supervising managers”, a term which does not appear in the ALLBEA. BI has never had a written LLBE agreement.

Initially Bill and Ted shared ownership of BI equally, and agreed that they would take major decisions jointly. Soon, however, they realized that they would need more capital to develop the business. They borrowed money from Bigbank and approached friends and relations and encouraged them to buy “participation shares” in BI. Some of

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the friends and relations agreed to buy the participation shares which gave them the right to a share in the profits of BI and limited rights to participate in decision-making with respect to BI's business. The contract with the purchasers of the participation shares specifies that all disputes between the purchasers and seller (BI) are to be resolved by means of arbitration by an arbitrator appointed by BI. Ted promised his sister, Karen, that she would be the arbitrator BI would designate if any such disputes arose.

After Bill and Ted had established BI they approached Joe and invited him to become BI's managing agent. On the basis of Joe's representations to them (not all of which were true), Bill and Ted were convinced that Joe's expertise was essential to the success of BI's business. Joe drove a hard bargain and insisted that his contract of employment included a provision that stated that Joe "is not subject to any fiduciary responsibilities whatsoever in respect of his functions as managing agent" of BI. Joe's contract also provides that if he feels that his ability to run BI's business effectively is prejudiced by any actions of Bill and/or Ted, he is entitled to a generous severance package.

Initially, BI's business was very successful. Bill and Ted have very generous remuneration packages in their role as supervising managers, although they have never really paid much attention to BI's business and have let Joe do pretty much what he wants with the business.

Joe has made regular trips to Ruritania to visit the factories there since he was hired by BI. However, Joe has stayed in increasingly expensive hotels for these trips, and, over time, his visits to Ruritania have been extended to allow for time for tourism. He always claims back from BI more in "expenses" than he spends. When Joe is in Arcadia he spends more time trying to find new employment than he does on BI's business.

In the last few months it has become clear that many toys manufactured in Ruritania are unsafe. When BI was unable to establish that the toys it was importing from Ruritania were safe, stores cancelled orders they had placed with BI. Joe, who has now lined up a very attractive new position with a computer games company, says he wants to invoke the provision of his contract relating to the severance package.

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Bill and Ted have begun to look into BI's accounts and have realized that Joe had taken money from BI to which he was not entitled. BI does not have enough money to pay all of its creditors, including the owner of the leased office premises and the employees. The holders of the participation shares want their money back.

**Answer the following questions, explaining what further facts you would need to know and giving reasons for your answers:**

1. (30 points) On what theory or theories might Bill and Ted be liable to the different creditors of BI? Do you think they should be liable to the creditors in these circumstances? Would it make a difference to your answer if BI were an Arcadian partnership (and Bill and Ted were partners) or an Arcadian corporation?
2. (15 points) What issues are raised by the sale of "participation shares" by BI? Would it make a difference to your answer if BI were an Arcadian partnership or corporation?
3. (30 points) Explain whether Joe has any legal liability arising out of these facts, and, if so, to whom. Would it make a difference if BI were an Arcadian partnership (and Bill, Ted and Joe were partners)?
4. (25 points) Do you think that Bill and Ted should have any liability to BI as "supervising managers" in respect of their behavior as described? Would it make a difference to your answer if BI were an Arcadian corporation and they were directors of the corporation?

## **APPENDIX: SELECTED PROVISIONS OF ALLBEA:**

### **SECTION 110. LLBE AGREEMENT**

(a) Except as otherwise provided in subsections (b) and (c), the LLBE agreement governs:

- (1) relations among the owners and between the owners and the LLBE;
- (2) the rights and duties of the managing agents;
- (3) the activities of the LLBE and the conduct of those activities; and
- (4) the means and conditions for amending the LLBE agreement.

(b) To the extent the LLBE agreement does not otherwise provide for a matter described in subsection (a), this act governs the matter.

(c) An LLBE agreement may not:...

- (4) subject to subsections (d) through (g), eliminate the duty of loyalty, the duty of care, or any other fiduciary duty;
- (5) subject to subsections (d) through (g), eliminate the contractual obligation of good faith and fair dealing...
- (9) unreasonably restrict the right of a member to maintain a direct or derivative action...
- (11) except as otherwise provided restrict the rights under this act of a person other than an owner or managing agent.

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

(1) restrict or eliminate the duty:

- (A) to account to the LLBE and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the LLBE's business, from a use by the member of the LLBE's property, or from the appropriation of a LLBE opportunity;
- (B) to refrain from dealing with the LLBE in the conduct or winding up of the LLBE's business as or on behalf of a party having an interest adverse to the LLBE; and
- (C) to refrain from competing with the LLBE in the conduct of the LLBE's business before the dissolution of the LLBE;

(2) identify specific types or categories of activities that do not violate the duty of loyalty;

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- (3) alter the duty of care, except to authorize intentional misconduct or knowing violation of law;
- (4) alter any other fiduciary duty, including eliminating particular aspects of that duty; and
- (5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing.

(e) The LLBE agreement may 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...

(g) The LLBE agreement may alter or eliminate the indemnification for an owner or managing agent and may eliminate or limit a member or manager's liability to the LLBE and owners for money damages, except for:

- (1) breach of the duty of loyalty;
- (2) a financial benefit received by the member or manager to which the member or manager is not entitled;
- (3) a breach of the duty not to make improper distributions;
- (4) intentional infliction of harm on the company or a member; or
- (5) an intentional violation of criminal law.

(h) The court shall decide any claim under subsection (d) that a term of an LLBE agreement is manifestly unreasonable. The court:

- (1) shall make its determination as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time; and
- (2) may invalidate the term only if, in light of the purposes and activities of the LLBE, it is readily apparent that:
  - (A) the objective of the term is unreasonable; or
  - (B) the term is an unreasonable means to achieve the provision's objective.