Caroline Bradley FALL SEMESTER 2009

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.

McBradleys Inc. (“M Inc”) and McBradleys Franchising Inc. (“MF Inc”) are corporations incorporated in a state in the United States which has a corporations statute in the form of the Delaware General Corporation Law (DGCL) and a partnership statute in the form of the Revised Uniform Partnership Act (1997) (RUPA).

M Inc owns and runs a chain of fish restaurants which are designed with a distinctive traditional British appearance, and which sell traditional British dishes such as fish and chips, eels and mash and oyster pie. A contract between M Inc and MF Inc provides that the McBradleys Restaurant System is owned jointly by both corporations. Under this contract, M Inc receives 20% of the franchise fees generated by MF Inc. Changes to the system and to the contract must be agreed by both corporations. The contract includes a provision which states:

> The parties to this agreement shall not owe any fiduciary duties to each other and nothing in this agreement is intended to make either party an agent, joint venturer, partner or employee of the other for any purpose...

MF Inc has granted a number of franchises to other firms to operate fish restaurants under the McBradleys name. Franchisees operate the franchises under a large number of detailed rules set out in the McBradleys Franchise Conditions.

The McBradleys corporations were formed by a brother and sister: Alf and Betty. Alf and Betty each own 30% of the shares in both corporations. Alf is responsible for supervising the running of the restaurants and Betty is in charge of supervising the franchise operations. Alf is the CEO of M Inc and Betty is its President. Betty is the CEO of MF Inc and Alf is its President. Alf’s and Betty’s CEO contracts provide that the CEO must dedicate his or her entire time to the business of the corporation. The CEO’s remuneration is to be adjusted upwards to reflect any increase in the profitability of the corporation. Both Alf and Betty are directors of both corporations.

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Both McBradleys corporations have two other senior executives who are members of the Board of Directors and 10% shareholders: Charles, who is Alf and Betty's cousin, and the Chief Financial Officer (CFO) and Daisy, who went to elementary school with Alf and Betty and is now the Corporate Counsel. The corporations also have four non-management directors who own some shares in both corporations. Charles, Daisy and the non-management directors are generally happy to leave decisions about the day-to-day management of the businesses to Alf and Betty. Each corporation has a small number of minority shareholders (but the minority shareholders of each corporation are different).

Under Betty's management, MF Inc has been very careful to limit the number of McBradleys restaurants in any area and to ensure that franchisees comply with the high standards required in the Franchise Conditions. The franchised restaurants have been extremely profitable. However, although Betty is very focused on managing the franchise operations carefully, Alf has recently decided that he is more interested in working on improving his golf game than in managing the McBradleys restaurant chain. Some months ago, Alf persuaded the Board to appoint his twenty year old son, Eddie, as a Vice President of M Inc with a generous remuneration package (Eddie is not a director or shareholder of M Inc and has no connection with MF Inc). Eddie is very smart, but has no management experience. Although Eddie has been trying to do his job well, standards in the McBradleys-owned restaurants have fallen. One cause of the falling standards was Eddie's decision to fire one of McBradleys' long-term fish suppliers and to hire Fred, a friend of his, to supply McBradleys with fish for much lower prices. Fred's fish is of poor quality and some of the customers of the restaurants have been taken ill after eating it. A number of the restaurants have been fined for failure to meet health standards.

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Betty has decided that she cannot allow this situation to continue because she is concerned about the possible impact of a decline in the reputation of the McBradleys restaurants on the value of the franchise. She wants to renegotiate the contract between M Inc and MF Inc to reduce M Inc's share of the franchise fees generated by MF Inc. She also wants to have greater control over the restaurant business.

Alf has approached George, who is a friend of his, and has asked George if he would like to buy Alf's shares in the two corporations. George does not yet own any shares in either corporation, but he knows that Alf has made a lot of money from his involvement with the McBradleys restaurant business. Alf has not told him about the recent problems in the business.

Answer the following 4 questions, explaining what further facts you would need to know and giving reasons for your answers:

1. (25 points) Analyze the legal issues raised by the contract between M Inc and MF Inc. In your answer please consider the nature of the relationship, the implications and effect of the clause of the contract set out above, and what issues might arise in the context of any renegotiation of the contract.

2. (25 points) A minority shareholder in M Inc who learns that M Inc's financial position is very precarious and that M Inc is unlikely to be paying any dividends any time soon would like to sue the directors and officers of M Inc for breaches of their duties to the corporation. What duties should such a shareholder argue the directors and officers have breached? What problems will the shareholder encounter in trying to sue the directors and officers. You may assume that M Inc has adopted a provision under DGCL §102(b)(7) relieving the directors of the corporation from liability in damages for negligence.

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3. (25 points) If George buys Alf's shares in both corporations and later discovers that the shares were worth much less than he paid for them, what legal claim or claims can he bring against Alf?

4. (25 points) Discuss **one** of the following statements (note that you do not need to link your discussion to the facts of the hypothetical):

i. Restoring public trust in business also requires businesses to operate more in the public interest (mutuality) and build symbiotic relationships with stakeholders (balance of power). It requires greater transparency and accountability by business with key enhanced roles here for the Board of Directors...

Arthur W. Page Society & Business Roundtable, The Dynamics of Public Trust in Business— Emerging Opportunities for Leaders, 2009.

ii. It is well known that businesses aggressively seeking profit will tend to push right up against, and too often blow right through, the rules of the game as established by positive law. The more pressure business leaders are under to deliver high returns, the greater the danger that they will violate the law and shift costs to society generally, in the form of externalities. In that circumstance, if the rules of the game themselves are too loosely drawn to protect society adequately, businesses are free to engage in behavior that is socially costly without violating any legal obligations…

Leo Strine, post to NYT Dealbook, October 2009.

iii. The wholly Byzantine approach, whereby parties must define the duties and rights they intend to keep while simultaneously disclaiming other duties that the parties wish to exclude, adds unnecessary chaos into the parties' contract negotiations, thereby increasing their contracting costs. Instead, assuming a clean slate where the organic agreement crafts the rights and duties owed among and between members and managers gives the parties clear expectations about which duties will apply and clear expectations about the other parties' conduct.

Myron Steele, excerpt from article included in the course blog, October 2009.