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BUSINESS ASSOCIATIONS EXAM MEMO

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.

The question asks about the directors' compliance with the requirements of corporate law and ethics with respect to "the ignition switch issues." I think these issues relate primarily to the defects in the ignition switches and how the Board dealt with the issue of the defects rather than to the structuring of the LLC and whether the setting up of the LLC involved a conflicting interest transaction. I also think that issues relating to derivative litigation belong in an answer to question 2.

The first step in thinking about the Board's actions with respect to the defects is to consider whether the Board's decisions not to carry out a detailed investigation and that a recall would be devastating to the business benefit from the protection of the Business Judgment Rule. Courts are reluctant to second guess decisions of Boards of Directors (e.g. Schlensky v Wrigley, Kamin v American Express). The hypo raises issues with respect to how informed this Board was. The facts state that the Board decided not to carry out a detailed investigation, although the minutes "merely recited that the Board had considered some suggestions of problems but had decided after investigation that the suggestions were not substantiated by evidence." There is an inconsistency here between what the minutes suggest (that there was some investigation) and the description in the question of what the Board did (decided not to have a detailed investigation). This would be an issue in any litigation (raises the tools at hand issue, s 220 DGCL right to inspect books and records). The Board does have a duty to be informed (e.g. Smith v Van Gorkom). However, the facts of the hypo are different from Smith v Van Gorkom, where the Board had a duty to shareholders with respect to the price they would be offered for their shares. Here the Board is trying to deal with a suspected defect in its products (and a defect resulting from Zcorp's own activities through the LLC rather than one resulting from the actions of an unconnected business). If the reports suggesting a possible defect were in fact inaccurate then the Board would be acting appropriately in failing to recall cars. And the question of what to do to establish whether or not there is a problem is within the realm of business judgment up to a point. If the way that the Board acted in fact involves the reckless disregard for human safety the Arcadia State Attorney General suspects, then the Board's decision to act as it does (as it involves criminal liability) cannot benefit from Business Judgment rule protection. But the facts do not tell us whether what they did does constitute criminal products liability.

In the context of DGCL §102(b)7) (which limits directors' liability in damages for negligence) we read Walt Disney and Stone v Ritter. Although the facts of these cases are different from the facts of the hypo (e.g. does it make sense to see the hypo as involving a failure of compliance?) , the hypo does raise issues with respect to the Board's acting (or not acting) in good faith in the best interests of the corporation.

If the Board did not act illegally then it is unclear whether there is any liability on

the facts we have in the hypo. But the Board does seem to have acted unethically. We read some material at different points during the semester which raised issues of ethics and corporate social responsibility, although the discussions often seemed to really involve legal compliance (e.g. the Perry Ellis Code of Ethics) or the business case for behaving ethically (the impact on the bottom line, e.g. Deloitte Review, Government and the Publicly Accountable Enterprise).

Many answers to this question looked at the facts as involving conflicts of interest. It is true that Elektra and Firestar seem to have a greater amount of moral (if not legal) responsibility for any defects in the ignition switches as engineers who have been in de facto control of the LLC's business. However Zcorp was a significant investor in the LLC also. To the extent that the Zcorp directors are implicated in the development of defective ignition switches in the LLC this does raise issues about whether they acted independently in the context of deciding not to set up an investigation. But here this perhaps does not add very much to the analysis: there isn't any suggestion that the decision not to investigate and not to issue a recall was motivated by any desire to favor the LLC. The crucial question seems to be whether the Board was informed or whether the directors abdicated their duties.

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.

This question focuses not just on the issue of the directors' and officers' duties but on the feasibility of legal claims by long-term shareholders and investors. And whereas question 1 focuses on the "ignition switch issues" this question has a broader scope allowing for consideration of legal issues relating to the setting up and operation of the LLC's business (n.b. this would be subject to statutes of limitations issues we did not cover during the semester and which the given facts do not allow us to address).

Long-term shareholders would want to bring a derivative suit based on the directors' and officers' management of Zcorp's business arguing that they breached their duties of care and loyalty to the corporation (e.g. Tooley). In bringing their claims the shareholders will have to consider the possible protection of DGCL §102(b)(7) (e.g. Walt Disney, Stone v Ritter) and whether demand would be excused or required, focusing on the applicability of the Business Judgment Rule and whether the Board members are independent (Grimes v Donald). Even isf demand is excused it is possible for the corporation to regain control over the litigation by appointing a special litigation committee (e.g. Zapata, Oracle).

Investors who bought shares after the ignition switch issues became apparent to the Board but before they were publicly announced (i.e. people who changed their position and could claim they had paid more for their shares than was appropriate given Zcorp's financial position) would want to consider bringing claims under §10(b) and

Rule 10b-5 because omissions to disclose information can give rise to liability as do false statements. The investors would need to focus on whether the information which was not disclosed was material (e.g. Basic v Levinson, Texas Gulf Sulphur). The fact that after a journalist wrote about the ignition switch problem "the price of Zcorp's stock fell dramatically" is indicative of materiality. But there is also an issue about the time at which Zcorp's duty to disclose arose. Basic v Levinson allows investors to claim reliance based on the fraud on the market theory- here we do not know whether the market for Zcorp's shares is efficient (cf West) (or what the Supreme Court will do with fraud on the market in Erica P John v Halliburton).

Veil piercing does not belong in the answer to this question. Veil piercing is a remedy available to creditors rather than to shareholders. And Zcorp is a publicly traded corporation. We did during the semester consider the idea that a parent corporation might be liable for the debts of its controlled subsidiary under a veil piercing theory (Re Slicone Gel Breast Implants Litigation), but that is not what is going on when Zcorp shareholders seek a remedy from Zcorp.

3. (25 points) Analyze Indigo's legal rights and liabilities based on the facts in this question.

Indigo invests in the LLC after the Board of Zcorp discovers the ignition switch problem. She is persuaded to invest by Elektra and Firestar and does not ask questions. She acquires a 10% interest in the LLC. The LLC seems to be going to incur significant liability because of the ignition switch defects, and thus Indigo's investment is worth much less than she thought it would be. What Elektra and Firestar have done looks like fraud - except that they seem to have omitted to disclose relevant information rather than making false statements of material facts. So Indigo would like to find a way to bring a securities law claim which would apply even in the context of omissions. Her situation is similar to that in Robinson v Glynn and she may want to bring a claim for damages under §10(b) and Rule 10b-5. This would only be possible if the interests in the LLC are securities. This was not the case in Robinson v Glynn (a discussion of this case is appropriate). In the hypo the LLC interests are denominated "stock." Also, although Indigo has rights to participate in governance of the LLC she is not an officer.

Some people wanted to find liability on the part of Elektra and Firestar based on the idea that members of an LLC owe each other fiduciary duties. But with respect to actions before Indigo becomes a member there can be no basis for recognizing any duties owed to her by Elektra and Firestar on this basis. As far as we know before Indigo invests in the LLC they are operating at arm's length.

A number of answers to this question suggested Indigo would have liability as a result of the LLC's liability with respect to the ignition switches. Some answers suggested she would only have liability with respect to events after she joined the LLC. But as a member of an LLC she benefits from limited liability - she stands to lose what she invests in the LLC (which is why a securities law claim is attractive to her) but

unless there is any basis for veil piercing, clawback of moneys paid to her when the LLC was insolvent etc she is not liable to contribute to the LLC's debts. This is pretty basic.

After Indigo learns about the ignition switch problems from Elektra she informs her husband who sells his Zcorp stock (from the description of the facts it seems that he sells the stock before the information becomes public). Indigo obtains the information because of her role as a member of the LLC. We should consider whether she may be a tippee under Dirks or a misappropriator under O'Hagan.

Under Dirks, Indigo is only a tippee if Elektra passes on the information in breach of her fiduciary duties to Zcorp, in circumstances where she is or hopes to obtain a financial benefit. It is not clear that this is the case.

Under O'Hagan, Indigo is only liable if her passing of the information to her husband breaches a duty she owes to either Elektra or the LLC (as the source of the information). Thus if she does not owe a duty of confidentiality with respect to the information to the LLC she is not liable, and nor is she liable if even though she has a duty to the LLC she passes on the information to her husband in the context of a family relationship with duties of trust and confidence.

With respect to the first issue: whether she has a duty of confidentiality to the LLC, under Florida Statutes § 605.04091 a member of an LLC has a duty of loyalty which requires "accounting to the limited liability company and holding as trustee for it any property, profit, or benefit derived... [f]rom the use ... of the company's property." Members are also required to refrain from dealing with the LLC as or on behalf of a person with an interest adverse to the LLC. If Indigo had no thought of personal financial gain in transmitting the information she would seem to have no liability under the statute. Even if she was motivated by the idea of avoiding a loss for her husband here the question states that the 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." It is arguable that this provision, if it is valid, excludes duties of confidentiality. Florida Statutes § 605.0105 provides that an LLC operating agreement may not eliminate the duty of loyalty although it may alter or eliminate aspects of the duty of loyalty if this is not manifestly unreasonable. Because the operating agreement here lists aspects of the duty of loyalty to limit them it is not clear how it should be seen under the Florida rules. But the assessment of manifestly unreasonable under the Florida rules has to be made as of the time the provision was included in the operating agreement (here seemingly the establishment of the LLC and not when Indigo joined the LLC).

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?

This question is the veil piercing question. In particular it deals with the issue of veil piercing with respect to an LLC. The rules on LLC veil piercing vary, although even where courts apply veil piercing to LLCs (e.g. Kaycee Land and Livestock v Flahive) they may note that LLCs are subject to fewer formal requirements than corporations are. Elektra and Firestar are the people who seem to have managed the LLC's business in a way that in the cases can give rise to veil piercing liability because they "make all of the decisions" and "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." But even if Elektra and Firestar might be liable based on these facts they may not be useful deep pockets for the LLC's creditors. Zcorp and Indigo do not seem to be at risk of liability based on their behavior, although in Sealand v Pepper Source the court was prepared to affect the financial position of Andre who was not responsible for the issues of non-compliance with formalities. The Silicone Gel Breast Implants case suggested that a parent may be liable for debts of a wholly-owend subsidiary based on a high level of control of the subsidiary's operations, although in the hypo Zcorp does not in fact seem to be exercising much control over the LLC's operations (and Zcorp is only a 50% owner of the LLC).

This analysis illustrates a difficulty with the facts of the question: in the cases we read which suggested veil piercing as a remedy the idea of non-compliance with formalities as the basis for unity of interest and ownership was about sole owners treating a limited liability entity as not separate from themselves. Although Elektra and Firestar behave rather like Marchese in the Sealand case they do not do so as the sole owners of the LLC.

Some people tried to make a reverse veil piercing argument with respect to Zcorp. This seems to misunderstand reverse veil piercing, which is used to reach into limited liability entities on the basis that their owners do not treat them as separate. I.E. if the debtor is the owner of a limited liability entity does not treat the entity as separate the owner's creditors may be able to look to assets technically owned by the entity to satisfy the owner's debt.

[§ 303 (b) of the Uniform LLC Act provides that failure to observe usual company formalities is not a ground for imposing personal liability on members or managers, and this provision is in Florida statutes §605.0304(2) (although this provision was not on the list of statutes for which you were responsible on the exam) - this doesn't say anything about failure with respect to accounting formalities.]

If Zcorp (or any other member of the LLC) has received distributions from the LLC in respect of profits which did not in fact exist this could be a basis for clawback of monies.

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?

This is a normative question and invites you to express your opinions, with reasons. The question asks about the liabilities of owners to other owners of a business. During the semester we came across this issue in the context of partnerships and LLCs where we saw that statutes (RUPA and the Florida LLC statutes) regulate the extent to which partners and members of LLCs are allowed to contract out of fiduciary duties (and these two statutes have a slightly different approach to the issue). We also read two cases which suggest a relatively liberal approach to the issue: McConnell v Hunt and Taste of Italy. So the question really asks what the value is of fiduciary duties in the context of partnerships and LLCs.

The question is **NOT** asking about the benefits and costs of limited liability of owners to creditors - it is not a question about limited liability.