Caroline Bradley SPRING SEMESTER 2015

BUSINESS ASSOCIATIONS EXAM MEMO

1. (25 points) Griffin, Hob and Imugi feel that they have not been treated very well by their family: they have not been involved in the family business and they think that they should have been receiving higher dividend payments (the others seem to have a much more luxurious lifestyle than they do). Are there any legal claims they can bring based on these facts?

Although many people seemed to find this question difficult it wasn't really a hard question - it just involved thinking through the materials we studied and applying them to the facts. The relationships are a bit complicated but could be sorted out by drawing a diagram.

The facts given in the question don't really allow us to figure out whether G,H and I actually have any sort of viable claim with respect to the dividends. The question doesn't give any information about any specific financial rights the class B stockholders have. We can say that they can bring a claim to enforce any specific financial rights they have as holders of the class B stock (this would be a contract claim and could be brought as a direct rather than a derivative claim).

If there are no relevant rights specifically attaching to the class B stock we start from the principle that decisions as to dividends are Board decisions protected by the Business Judgment Rule (e.g. Kamin v American Express). If the corporations are organized to pay high salaries to the family members who work for them then there might be questions as to whether the salaries were too high. This would be a question of business judgment subject to issues of conflict of interest and waste. We do not know anything about how these decisions were taken.

In addition to thinking about the directors' duties, we could consider the duties imposed on controlling stockholders: Sinclair Oil v Levien tells us that decisions which involve self-dealing by controlling stockholders are subject to review of their fairness, which might be implicated by the dividend/salary issues. If a controlling stockholder were to pay itself dividends that were not paid to the minority stockholders that would be self-dealing under Sinclair Oil.

If the corporations are close corporations for the purposes of the Arcadia corporations statute there may be some basis for a minority oppression remedy. We read a number of cases on minority oppression, including Donahue v Rodd Electrotype. The facts here don't suggest the sort of lock-in freeze-out situation which would be the best basis for a remedy. G,H and I did not decide to get involved in the corporations as far as we know and they haven't been excluded from management after being involved. But if the majority decided not to pay them any dividends there could be a problem.

Dividends in Inc. might be reduced because of the contracts between Hotels and Supplies and the LLC which disadvantage Hotels. These contracts are self-dealing contracts under Sinclair Oil and directors conflicting interest transactions. We don't know if the safe harbor procedures were adopted to approve the contracts (disclosure and independent director/shareholder approval) but we have some information with respect to fairness - the Supplies contract is more problematic than the LLC contract (relevant cases include Lewis v SL&E, Benihana).

Some claims about the dividends might be stated as direct claims, also oppression claims would not be derivative claims. But claims for breaches of directors duties would be derivative claims. I don't think a long discussion of the conditions for derivative litigation is necessary here.

Some people wrote about B's move to have Hotels guarantee G&H's obligations to Xtra here. If this had resulted in any loss to Hotels it could help to reduce Hotels' profits which would be relevant to the G,H & I claims about dividends. We are not told there has been any claim on the guarantee so the liability here seems to be contingent, and the issue therefore really belongs in question 2. Perhaps this benefit to G&H (if the guarantee is valid) would reduce the amount of any detriment they might have incurred through the Inc dividends policy. I does not share in this benefit.

Some mistakes: this is not a veil piercing situation, it is legitimate to have non-voting stock, an entity that has "Inc." in its name is a corporation (it is wrong to discuss whether it might be a partnership), there don't seem to be any securities law issues based on these facts, and the directors' duty implicated by the contracts seems to be the duty of loyalty (based on the conflict of interest) rather than the duty of care (Caremark and Francis v United Jersey Bank weren't really relevant here except with respect to the non-management directors (i.e. the directors who are not officers)), there isn't an insider dealing issue based on these facts.

2. (25 points) What legal issues should Ajatar, Bennu and Firedrake be worrying about?

A and B are implicated in the issues raised in question 1 relating to dividends and the contracts between Hotels and Supplies and LLC. F is involved in the Hotels-LLC contract as managing member of LLC. But there are some additional issues that affect them:

For A, in addition to issues relating to A's exercise of control (in some ways more an issue for the others who just go along with what he says and who may therefore be failing to exercise their duties as directors/officers at all (cf. Francs v United Jersey Bank) but A as the controlling stockholder is subject to the fiduciary duties which apply to controlling stockholders) there is the issue of the approach by VLC. When A replies to VLC " "Why would you want to buy all of the shares when you can get control by buying mine?" this suggests the relevance of Perlmann v Feldman. Directors and officers are supposed to act in good faith in the best interests of the corporation and a controlling stockholder owes fiduciary duties to the minority. The question does not involve the sort of facts relating to assets in short supply that featured in Perlmann v Feldman (which raised issues about the interests of the corporation) but here there seems to be an approach to Inc rather than just to A to buy his shares and he seems to be diverting an opportunity which might go to the shareholders to himself. This isn't a "corporate" opportunity but could be seen as an opportunity which should be offered to the shareholders. The cases we read where controlling stockholders took a benefit that was not offered to the minority (e.g. Donahue) could be relevant. On the other hand, if the corporation is run for the benefit of all shareholders after the change of control (cf. the dissent in Perlmann v Feldman) the minority haven't really lost anything they had a right to expect. Answers which just assumed this was problematic without going through analysis of why this might or might not be problematic got lower marks than those which tried to engage in some analysis.

For B there is the issue of the guarantee by Hotels of G&H performance to Xtra. This issue involves questions of authority and questions about B's duties. If B has actual or apparent authority to give the guarantee it is binding on Hotels and Hotels could decide whether to sue B with respect to any loss it incurs on the guarantee. But the fact of the forged resolution suggests this is not within B's actual or apparent authority. However the forged resolution may bind Hotels based on the fact that it is authenticated by C, the Secretary (Re Drive In Development, First Securities v Dahl). With respect to B's authority and breach of duties, the facts only say that B decides to do this to help G&H. So the guarantee doesn't seem to be designed to benefit B in any way. The cases we read about problematic guarantees (e.g. Molasky v Karps, GOF v Robin) were cases where the person arranging the guarantee had an interest in the guarantee. Nevertheless there is no obvious benefit to Hotels in giving the guarantee, so it would seem to breach B's duty to act in good faith in the best interests of the corporation (Stone v Ritter suggests that this is a breach of the duty of loyalty, although in a different context). The facts do not suggest that Xtra has invoked the guarantee, so there does not appear to be any loss to Hotels. The purported resolution is a forgery, although because C as Secretary signs the copy of the resolution Xtra will likely be able to enforce the guarantee. If the guarantee is invoked and enforced there is a loss to Hotels which should be recoverable against B (and C) because of their breaches of duty.

With respect to F, who is responsible for the management of the LLC, there are issues relating to the opportunity to acquire the farm. The question doesn't say whether F buys the farm for the llc or for himself. If he buys the farm to experiment with the llc's resources there is an issue as to whether his management powers extend to this sort of action. We are given no facts to allow us to decide whether such a purchase would be within the scope of his authority or not. If he buys the farm for himself there is a question about whether this is an opportunity that is an opportunity of the llc or one which he would be free to take for himself. Looking at this issue requires analogizing from the opportunities cases we saw in other contexts (e.g., Meinhard v Salmon, Broz, North East Harbor Golf Club) as we did not read any llc opportunities cases (although cf. Hunt v McConnell).

Some mistakes: there aren't any issues about what sort of entities are involved here and there is no reason to consider whether any of the entities is a partnership: Inc. denotes a corporation and llc denotes an llc; there is no indication in the facts given that there might have been any lack of compliance with formalities with respect to formation of any of the entities; there isn't really any need to discuss veil piercing here (there aren't the sort of facts that give rise to veil piercing nor is there any hint of creditor claims against any of the entities for which the entities have insufficient resources); shareholders don't generally need the approval of other shareholders to sell their shares; there isn't any basis in the facts given for any securities claims: fraud or insider trading.

3. (25 points) What issues are raised by the arrangements for Griffin and Hob's restaurant? In your answer you should analyse the relationships between Griffin and Hob and Griffin and Hob and (a) Xtra, (b) Jac and (c) Kool Kitchens.

This is a partnership question and invites thinking about which of the arrangements described might constitute partnerships. RUPA § 202 provides: "the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership."

G & H seem to be within this definition. Holmes v Lerner was the case we read about partnership formation and could be cited here although the facts of that case are more complicated than the facts shown about the G & H relationship.

The loan by Xtra could be conceived of as a partnership between G, H and Xtra because of the agreement to share profits. Although the guarantee by Hotels reduces the risk of Xtra's investment which reduces the likelihood that Xtra would be seen as a co-owner. There is a sense of control by Xtra ("Xtra sends a supervisor to the restaurant once each month to see what is going on, and to ask Griffin, Hob and their staff for information. Griffin and Hob also provide weekly financial reports to Xtra.") that suggests that Xtra may be a principal in a principal-agent relationship (e.g. Gay Jenson Farms v Cargill). But, as some answers pointed out, the situation here is much less extreme than the Cargill situation. In that case the court focused on the ways in which Cargill's and Warren's businesses were intertwined: Cargill's interest in Warren was much greater than Xtra's interest in G&H seems to be. So it is possible that this is merely a contractual relationship where Xtra's remuneration for the loan will depend on the restaurant's profits. Thus either there is (1) a partnership between G,H and Xtra or (2) a partnership between G and H which is an agent of Xtra or (3) a partnership between G and H with contractual obligations to Xtra. In situations (1) and (2) Xtra would be liable for debts of the partnership.

There is a partnership between G and H or between G and H and Xtra. Except to the extent that the partnership agreement displaces the default rules in the partnership statute they will apply. So, with respect to the hiring of J we are told that this was done by H. Ordinary matters may be decided on by a majority and extraordinary matters require unanimity (RUPA §401). In a partnership involving G and H only this suggests both must agree (although there is a possibility of ratification). In a partnership involving G, H and Xtra it would matter whether the hiring was an ordinary or extraordinary matter (but ratification would be possible here too). J cares about authority too: a partner has apparent authority to bind the partnership to matters in the ordinary course of the partnership business which could (but might not — this is a question of fact) include hiring a chef.

H subsequently offers J a share of profits raising the question whether J thereby becomes a partner. Introduction of new partners must be agreed to by all the partners (RUPA §401). If all the partners go along with treating J as a partner she may be a partner and have the apparent authority to bind her partners to acts in the ordinary course of the partnership business which might or might not include the purchase of the kitchen equipment from Kool Kitchens (another question of fact).

If J is a partner there is a question whether the other partners can require her to leave. If she is a partner she is entitled to her share of the value of the partnership business.

4. (25 points) Essay question: here there was an opportunity to show me how you had thought about the material we read during the semester. I didn't have a view about how the answers should look but I was looking for thought and use of the material we read. Some people seemed to have run out of time (even with the 4 hours allowed, which surprised me) and some of the responses to this question were short, even cursory. Answers that made an argument using the cases etc were better than those that made general, unsupported, arguments.

Either:

(a) Discuss the following statement:

> **The clearer and more uniform a rule is, the more easily it is regarded as a formality that can justifiably be manipulated so long as compliance with its explicit formulation is maintained**

Jan Deutsch, quoted on the class blog,

On the blog I wrote: "We have read a number of decisions this semester where the legal rules were expressed in a way that was not very clear. Does the statement explain why that is? At the same time we have seen a lot of references to the idea that the courts shouldn't interfere in business decision-making too much. Do the cases we have read strike the right balance between the two sets of concerns (avoiding only formal compliance and not interfering too much with business decision-making)?"

The question invites contrasting examples of clear rules being manipulated successfully with less clear rules being applied to avoid the possibility of manipulation. We read many cases this semester where the result depended on factual assessments, for example the cases that focused on issues of fairness. Even where there are safe harbors (e.g. directors conflicting interest transactions) these factual issues remain present. Frequently the courts describe the rules of business organization law as being about substance rather than about form (e.g. questions about whether a partnership or agency relationship exists). We read some cases where the courts were faced with behavior that seemed to be consistent with a formal interpretation of the relevant rules (e.g. VGS v Castiel).

On the other hand, responsible business activity should involve efforts to comply with legal rules, and legal rules which were arbitrary would not encourage compliance. Businesses that endeavor to act consistently with the requirements of law should not be surprised by unexpected applications of the law. Safe harbors reflect this concern in a range of rules which emphasize procedure: fully informed decision-making by independent or neutral persons is largely insulated from review by the courts.

Or
(b) Discuss the Business Judgment Rule. Is it a rule? Do you think it encourages good business judgment?

This is a more open ended question. It is also a bit obvious and perhaps doesn't encourage as much creative thought. Many answers cited Joy v North as to the rationale for the BJR. The BJR is a presumption that Boards act properly and that judges should not review their business decisions. Shareholders choose directors to make business decisions which involve risk. If the shareholders are unhappy with what the Board does they can sell their shares or appoint new directors (answers could have considered whether this sort of protection is sufficient for shareholders). Diversification of investment is another consideration which supports the BJR (although it also limits shareholder monitoring of the Board/officers). More court supervision of Board decision-making would discourage risk-taking. Also court review takes place after the fact so it is difficult to evaluate the decison-making as of the time it was done. This idea of Board decision-making as involving risk-taking deserves some critique as in practice the BJR also seems to end up sometimes protecting bad business decisions which had nothing to do with risk-takling (e.g. Kamin). The circumstances which give rise to rebuttal of the presumption (conflict of interest, being uninformed (gross negligence), illegality, no rational business purpose) are worth a mention as are the circumstances in which the BJR comes into play (litigation over claims of breach of directors' duties, consideration of the demand requirement in Delaware). Note that although Van Gorkom tells us that gross negligence displaces the BJR since the introduction of statutes like DGCL §102(b)(7) we have to think about the issue of good faith/loyalty in thinking about whether challenges to Board action can be pursued (e.g., Malpiede v Towson).

In light of the post-Van Gorkom developments the question whether the BJR encourages good business judgment becomes more complicated to think about. The original rule was very deferential to Board decision-making, Van Gorkom suggested that the duty to be informed was more demanding than it had been and that the failure to be informed could lead to liability in damages. Much of what the case and subsequent cases produced was an emphasis on procedures: perhaps all the law can really require with respect to decision-making, but the procedural developments involve expense (e.g. hiring compensation consultants and other advisers) and may not all lead to better decisions. After 102(b)(7) the risk of liability in damages is reduced although declaratory remedies are still available (and this could have reputational effects for Directors).

Asking this question whether the BJR encourages good business judgment raises the question whether we can tell what this is. So the question could be a broader invitation to think about what is and isn't good business judgment. Ths issues relating to socially responsible business and legal compliance could be discussed along with shareholder value maximization - issues we talked about during the semester.