

AGN: \_\_\_\_\_

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SPRING SEMESTER 2016

# **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.**

Global Medical Solutions Inc. (GMS) is a corporation incorporated in Arcadia, a state in the US. GMS is in the business of researching, developing and selling drugs and medical devices. Aretha founded GMS twenty years ago, together with Bella and Carla just after they all graduated from Arcadia State University (ASU). The three founders are very close, and have stuck together through their various marriages and divorces, through thick and thin. They vacation together frequently at a home in the mountains of Arcadia that they own together. After a lot of hard work GMS discovered a few very successful products and the company has been doing well. It has attracted a number of outside investors who have bought both preferred and common stock in GMS.

Each of Aretha, Bella and Carla owns common stock which carries 25% of the votes which may be exercised at meetings of the stockholders of GMS. Stock owned by participants in the GMS Employee stock option plan, established and approved by stockholder vote five years ago, carries 15% of the votes which may be exercised at stockholder meetings. The remaining common stock, carrying 10% of the voting rights, is owned by friends and family of the founders (Aretha, Bella and Carla) and a number of outside investors. The preferred stock has limited voting rights: holders of the preferred stock have the right to vote on any matter which may affect the rights attaching to the preferred stock, and they also have the right to elect two directors to the Board of Directors of GMS. GMS has operated for many years with a seven member Board of Directors (the certificate of incorporation and the terms of issue of the preferred stock specify that GMS is to have seven directors). The seven directors are Aretha, Bella and Carla, the two directors appointed by the preferred stockholders (currently Dev and Ed) and two directors chosen by the common stockholders. Currently these directors are Harvey, who is Bella's cousin and was previously the Arcadian Secretary of State, and Ingmar, the Dean of the ASU Business School (which receives regular donations from GMS).

Bella is the Chief Research Officer of GMS and heads up the research department. Juno, who is employed in the research department of GMS, has invented a new type of stent (a medical device) which she thought would function better than existing models of stent on the market. She did the work on the stent (which is quite different from the work she has been asked to do for GMS) on GMS premises after finishing her assigned work. Juno went to a conference at the ASU Business School to present some of her recent work for GMS. While she was there she met Kai, who was at the conference to look for investment opportunities. Over the next few months Juno and Kai met together regularly to discuss how they might work together to raise funding to test and develop Juno's stent.

One day Bella saw Juno and Kai talking together and began to wonder what was going on as she knew that Kai worked for a hedge fund that invested in the health care sector. After asking around she learned that Juno and Kai had been discussing working together and she approached Juno and said she understood that Juno might be planning to go into business with Kai. Juno said to Bella that she shouldn't kick up a fuss because Juno knew that Bella had helped to manipulate the data from trials on one of GMS's drugs that had recently been approved by the Food and Drug Administration (FDA) and that the FDA would have been unlikely to approve the drug had the true facts been apparent. She points out that, as Bella knows, the FDA has been active in pursuing this type of misconduct and that criminal enforcement action is a possibility. Bella decides to keep quiet about Juno's plans.

The Board thought for a while about bringing in a new Chief Financial Officer (CFO). Aretha suggested that Luke (who is her nephew and Ingmar's son-in-law) would be ideal for the position. The Board approved a draft compensation agreement for Luke, and a new by-law which would increase the number of directors to eight and also allow the Board to fill a vacancy on the Board until the next meeting of the stockholders. They then voted to appoint Luke as a director. Aretha presented the draft agreement to Luke, but he raised questions about some of the terms, so, without discussing Luke's proposed changes to the Agreement, Aretha went ahead and signed an amended version of the agreement which was much more generous to Luke than the draft approved by the Board, especially with respect to payments on termination. After only a few months it became clear that Luke was not a good fit at GMS. The preferred stockholders are unhappy and want to challenge Luke's appointment as CFO and as a director or remove him from his position as CFO and as a director.

A recent news story in the Arcadian Examiner focused on Juno's and Kai's new venture and presents Juno's stent as a major breakthrough. GMS stockholders want to know why they aren't going to share in the profits associated with the stent. Meanwhile, there are rumors that the FDA has begun to investigate GMS' drug trials and the stockholders are unhappy about this too.

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

1. (25 points) GMS stockholders are concerned about the news story about Juno's stent and the rumors of the FDA investigations. What legal claims may the GMS stockholders have against any of the actors in this story with respect to these issues? Are they likely to succeed in bringing these claims?

2. (25 points) Discuss the issues raised by Luke's situation.

3. (25 points) Juno and Kai establish a member-managed LLC to carry on business together. Both become members of the LLC, and the operating agreement for the LLC contains the following clause:

any Member may compete with the business of the Company, is 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 is not obligated to account to the Company and hold as trustee any property, profit, or benefit derived by the Member in the conduct or winding up of the Company's business or derived from the use by the Member of property of the Company, including (without limitation) an appropriation of an opportunity of the Company.

The Arcadian LLC Act contains the following provision:

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

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

(f) Eliminate the obligation of good faith and fair dealing, 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...
2. Identify specific types or categories of activities that do not violate the duty of loyalty;
3. Alter the duty of care, but may not authorize willful or intentional misconduct or a knowing violation of law; and
4. Alter or eliminate any other fiduciary duty.

If Juno decides after a while that a business venture with Mina would be more likely to succeed than the one she has entered into with Kai, do you think that the provision of the operating agreement set out above would help her leave the LLC and set up in business with Mina, avoiding liability to Kai in the process?

4. (25 points) Discuss the proposition that business organization law necessarily involves a balance between form and substance.