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Business Associations Exam Memo: Spring 2016

General Comments: Read the question. If the question describes an entity as a corporation do not analyze the facts as if it might be a partnership. This suggests either a lack of care (in not reading the question) or a lack of knowledge (not understanding that incorporation means the business is not a partnership) or both.

Despite the exam instructions there were a number of assumptions in the answers and also some uses of unexplained abbreviations. Sometimes the language used in the answers was a bit casual for a formal context like an exam. And there were some tendencies to be over-emphatic as though emphasis is a substitute for analysis (which it is not). Using words like "blatantly" and "egregious" is probably not a good idea unless they are part of the legal test you are applying. If you do think that the facts suggest egregious or blatant breaches of duty explain the reasons for the conclusion rather than just setting out the conclusion.

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?

The question raises issues associated with GMS' loss of a profitable opportunity ("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") and possible liabilities resulting from the FDA investigation ("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 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 question raises issues of the duties of an employee, an officer and the Board of Directors as a whole.

Juno: Juno seems to be merely an employee, rather than an officer. I don't think it makes sense to assume she is a stockholder because we don't know if she participates in the employee share ownership scheme (and even if she did that wouldn't be the basis for any fiduciary duties here). We don't know the terms of her contract (which might restrict her ability to compete with GMS). However, as an employee she is an agent with fiduciary duties to act in the interests of her employer. Huong Que v Luu and Tarnowski were the cases we read that illustrate an agent's fiduciary duties. These are not opportunities cases but we know from Meinhard v Salmon that non-corporate fiduciaries are subject to constraints on taking opportunities and opportunities are really just an example of a secret profits situation. We don't know exactly what rules apply to

Juno in this situation in Arcadia, but we can identify some of the facts that may make a difference. Although the development of the stent is quite different from the work Juno was employed to do she did the work on GMS premises (which involves use of GMS property: the premises and perhaps other resources there) and she met Kai at a conference she attended for the purposes of her work for GMS. We also know that Bella approached Juno about her negotiations with Kai, which suggests that Bella saw what Juno was doing as an issue for GMS. Bella was diverted from pursuing the issue by Juno's invocation of Bella's own wrongdoing (n.b. query whether Juno should have reported the FDA data manipulation issue to others at GMS and/or to the FDA). So there is a basis for seeing the taking of the stent as the taking of an opportunity which belongs to GMS. Can the Board of GMS be trusted to decide what to do about this (i.e. a derivative litigation issue)? So far, GMS hasn't pursued the issue because of Bella's own failure to act in good faith in the best interests of GMS: she seems to have manipulated data and to have allowed this to prevent her going after Juno's breach. But if the Board were presented with the issue of whether to sue Juno for her breach of duty, it is not clear that they would have a problem making this decision in a way that would satisfy the Business Judgment rule. There are some doubts based on the implications for Bella: A and C have been very close to Bella for a very long time and may want to protect her (*cf* Delaware County Employees Retirement Fund v. Sanchez, cited on the class blog) and Harvey is Bella's cousin. But there is no basis to think Dev and Ed would support Bella at all costs and Ingmar's gratitude for GMS' donations to the ASU Business School might incline him to go along with A and C or not. If Luke were on the Board at the relevant time this might make a difference. We don't have enough facts to assess the independence issue. But it isn't clear that a majority of the Board lacks independence with respect to this issue.

Bella: Bella seems to be in breach of her duties to GMS with respect to the drug trial data and allowing Juno to take an opportunity belonging to GMS. The issues with respect to Bella involve her duties as an officer rather than as a director or shareholder: in dealing with Juno and with respect to the drug trials she seems to have been acting within her capacity as Chief Research Officer at GMS. Her acts involve breaches of the duty of care at least (though probably of the duty of loyalty variety as in Stone v Ritter) and may have caused loss to GMS. The facts also implicate issues of a lack of good faith. However, it is not necessary for there to be a lack of good faith here because as an officer, with respect to her acts as an officer, Bella does not benefit from protection under statutes such as DGCL §102(b)(7). Even if officers benefit from business judgment rule protection this situation is not such as to involve the business judgment rule: the data manipulation involves an illegality, and allowing Juno to take the opportunity is affected by Bella's conflict of interest.

The Board: In addition to the issues of the individual liability of Juno and Bella, with respect to the rest of the Board there is an issue whether they have been paying enough attention, and whether their lack of monitoring caused loss to GMS for which they should be liable. We don't know based on the facts of the question whether there is any basis for a successful Caremark claim. It would be a good idea to cite the

Caremark language about a sustained and systematic failure of monitoring as the basis for liability and the Stone v Ritter characterization of such a failure as a breach of the duty of loyalty. But the question does not give enough facts to allow for any conclusions about the risks of liability here.

There are some derivative litigation issues here as the claims against Juno and Bella and the Board are derivative rather than direct claims under Tooley. In order to pursue a derivative suit with respect to Juno and Bella's breaches and the Board's inaction the plaintiffs would have to plead demand excusal. Some answers addressed the DGCL §220 books and records issue: this would likely be necessary to allow the shareholders to gather enough information for a claim. I discussed the independence issue with respect to the claim against Juno above: similar analyses with respect to demand excusal would apply to all three claims. Even is demand were excused the Board could establish a special litigation committee to regain control of the litigation (e.g. Zapata).

Mistakes: Some answers discussed issues that are not relevant to this question. Issues of authority aren't really relevant because there aren't the sort of questions about validity of contracts or tort liability that would implicate them. Similarly there are no veil piercing issues here as there are no issues of liability to creditors here (and no - shareholders aren't creditors until they become judgment creditors and even there since the claims here are derivative claims so GMS would be the judgment creditor if the claims were to succeed) and the business isn't run in the ways that give rise to this sort of liability (think Sealand). The idea that Juno and Kai may have formed a partnership doesn't really do much work here. If Juno has breached her duties then GMS would have rights to the stent: GMS could have ownership rights or at least a right to the profits made by the stent. I don't see how GMS could get more through using the idea of Kai as Juno's partner than it would get through this sort of disgorgement theory. Any discussion of Aretha and Luke belongs in the answer to question 2.

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

The question states that "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)." And the question also refers to 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." Thus Luke's appointment as a director and officer raises the sort of issues raised in the Disney litigation and also issues relating to amendment of a certificate of incorporation provision by means of by-laws and the rights of the preferred stockholders. Litigation to enforce the rights of the preferred stockholders would be a direct action rather than a derivative action. Litigation about questions of the directors'

and Aretha's duties with respect to Luke's appointment and compensation would be derivative.

With respect to Luke's appointment as an officer the facts of the question are similar to those in the Yahoo litigation (noted on the class blog). That decision related to a s220 application but it also illustrates facts which if established by evidence would be very different from the Disney situation. The Disney case illustrates a generous executive compensation arrangement followed by no-fault termination that did not involve breaches of directors' duties. Here the question states that after the Board approved a draft contract Aretha amended it in a way that was more generous to Luke (her nephew) without checking with the Board. There is an issue as to whether this was within the scope of her authority (we have no facts that shed any light on this issue). Even if it is within the scope of her authority there is a question whether her behavior breached her duties of care and loyalty to GMS. She has a family relationship with Luke which raises questions about her independence (i.e. whether she is subject to a conflict of interest).

With respect to Luke's appointment as a director, the facts of the question raise issues with respect to the purported increase in the number of directors specified in the certificate of incorporation and terms of issue of the preferred stock by means of a by-law adopted by the Board of Directors. The Casebook states that bylaws "may contain any provision relating to the business and affairs of the corporation, so long as the provision does not conflict with the law or the charter." (p. 310, and see, e.g., Datapoint v Plaza Securities). DGCL §102(b) states: "In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:(1) Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, or the governing body, members, or any class or group of members of a nonstock corporation; if such provisions are not contrary to the laws of this State." A provision that may be included in the certificate of incorporation should not be able to be amended by a by-law. In contrast to the situation in Jones v Wallace, here the specification of the number of directors was expressly made a term of the issuance of the preferred stock.and any increase in the number of directors could be seen as a change in the rights of the preferred stock on which the preferred stockholders have a right to vote (they would be able to appoint 1/4 of the directors rather than 2/7). The failure to provide for a vote on this change is a breach of the preferred stockholder's rights.

In addition to the preferred stockholders being able to challenge Luke's appointment, the common stockholders may be able to remove him without cause. Vice Chancellor Laster held in In re VAALCO Energy, Inc. Stockholder Litigation, Consol. C.A. No. 11775-VCL that the only Delaware corporations that are allowed to have only for cause removal of directors are those with classified boards or cumulative voting for directors. Thus a corporation that declassified its board could no longer enforce a for-cause

director removal provision. If Arcadia follows this rule, given that nothing in the question suggests that GMS has a classified Board, the shareholders should be able to remove Luke as a director without cause.

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?

Juno was an employee of GMS and left her employment taking with her the stent she invented while employed by GMS. Part of question 1 involved analyzing whether the stent should be regarded as property in which GMS had an interest on the basis that

Juno developed it while working as an employee (agent) of GMS. The question does not tell us what the answer is. If GMS owns rights to the stent than any LLC involving Juno and Kai would be developing other ideas of Juno's (at least after any dispute between GMS and Juno is resolved in GMS' favor). If Juno did have the rights to the stent then this is part of the venture between Juno and Kai. But presumably Juno may have other ideas she could develop while involved in the LLC. The facts of the question do not spell out any of the details of the LLC operating agreement except the limitation of liability provision. The question does specify that Juno wishes to leave and set up a business with Mina instead. Therefore the question is asking how a person can go about leaving an LLC. How easy this is for Juno will depend on whether she wishes to take her existing inventions with her.

The cases we read about LLC dissociation and dissolution were Lieberman v Wyoming.com LLC and Dunbar v Tignor. We know from these cases that the rights of LLC members are dependent on the provisions of the operating agreement. Dissociation by a member may not be a good idea as the dissociated member may end up in a position where any capital contributions are stuck in the LLC with no right for the dissociated member to be bought out and no possibility for any remedies under the LLC act as duties are owed to members and not ex-members (cf Lieberman). LLC members aren't forced to remain members but they don't necessarily benefit from partnership type protections on the termination of the relationship. It may be possible to apply for judicial dissolution or expulsion (eg Dunbar, and the discussion of this issue with respect to Hunt v McConnell, casebook pp 204-5). But there do not seem to be any grounds for Juno to ask for expulsion of Kai or dissolution: her desire to leave does not seem to be based on any bad behavior by Kai.

On the other hand, if Juno has not made any capital contribution to the LLC and she has the rights to the stent (and her own ability to invent new devices) becoming a dissociated member without any rights under the LLC statute might not be so bad. The risk would be that Kai could argue she breached the operating agreement or her fiduciary duties in leaving. The operating agreement seems to be quite clear that it limits Members' fiduciary duties of loyalty with respect to the conduct and winding up of the business, including appropriation of an opportunity. In Hunt v McConnell the court held that a similar provision was valid. But the circumstances here are different from those in that case, where Hunt had behaved badly, justifying judicial dissolution of the LLC. And here the Arcadian statute does not permit the elimination of the duty of loyalty although it does permit elimination or alteration of aspects of the duty of loyalty, if not manifestly unreasonable. Here the agreement seems to address different aspects of the duty of loyalty in a way that arguably results in a complete elimination of the duty of loyalty or at least an alteration in a way that should be seen as manifestly unreasonable. It is possible that the statute could be interpreted to allow this type of clause or not. Is what the statute requires a specific listing of aspects of the duty that allows the participants to realize what is involved or does the statute require some part of the fiduciary duty of loyalty to be applicable in LLC relationships? Does it make a difference that Juno and Kai embarked on their business relationship in circumstances where she was preparing

to exploit an invention in which GMS might have an interest?

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

Issues of form and substance were recurrent in the materials we studied during the course, right from the beginning when we read that agency and partnership are determined by the substance of a relationship rather than by what the parties call it (the form). Examples include Cargill and Holmes v Lerner. The second case is particularly useful as an example because of the attempted use of form which the court denies, focusing on the creation of the partnership relationship. In these cases the remedies available to third party creditors are enhanced by the idea that a person's control over the affairs of another should give rise to liability to their creditors.

Sometimes we saw that where participants in business enterprises try to take advantage of form in order to achieve a result which differs from what they should reasonably expect (opportunistic behavior) the courts may refuse to give effect to their actions. An example here would be VGS v Castiel.

In the veil piercing context formalities are important. In order to benefit from the limited liability associated with doing business through the corporate (or LLC) form, the owners must ensure that they treat the business as separate from themselves, including respecting corporate (or LLC) and accounting formalities.

In the corporate context it can often seem that the formalities matter more than the substance. Courts will decline to review the substance of business decisions under the Business Judgment Rule, and where decisions are made appropriately from a procedural perspective the courts will decline to review substance. However failures of procedure may lead to fairness review of business decisions.