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Business Associations Exam Memo: Spring 2018

Board

J sells
Zcorp stock

B C D E F G
CEO CFO SEC CISO pref ╱ LLC
25% 5% 5%

B H I

Zcorp ↔ Wave LLC
Acquisition

G, E, D settlement/NDA agreements on behalf of Zcorp

General Comments

Comments on Specific Questions

1. (25 points) What legal issues does the proposed acquisition by Zcorp of Wave LLC present for Zcorp and its officers, directors and shareholders? In your answer you should consider any issues that arise as of the time of Board approval of the merger, and also after the merger has been carried out, specifying what, if any, procedural steps would make a difference to your analysis.

Board decisions are generally protected by the Business Judgment Rule (BJR) unless there is a basis for displacing the BJR. Traditionally gross negligence was a basis for displacing the BJR. Here the Board seems to have approved the idea of acquiring Wave very quickly, without thinking of other options, and based on B's arguments. Under Smith v Van Gorkom we might worry about the Board members' liability for breach of the duty of care, but we know that we also need to worry about exculpation under DGCL §102(b)(7) and the need to establish something more than a breach of the duty of care in the context of claims for damages against directors (e.g. Walt Disney) (lack of good faith, knowing violation of law, breach of the duty of loyalty etc.). A mere breach of the duty of care would be enough for a claim for injunctive relief to prevent the acquisition being completed, which is an aspect of the question's focus on issues before and after the transaction. Given that the Board members' failure to think about other possibilities raises a question about whether they were acting in good faith in the nest interests of Zcorp (cf. Stone v Ritter even though it is a board oversight case rather than a board decision case) there might be the basis for a successful damages claim here too. Some answers argued that the Board's reliance on B's expertise might be justified. B is in a different position with respect to this decision than Van Gorkom was in that case, but there is also the conflict of interest issue here.

The facts here suggest a transaction in which the CEO and 25% shareholder has a personal interest (Wave is in financial difficulties and the price is described as generous; the hypo does not state what financial interest B and H have in W although it does state that it is an entity they set up together and there is nothing to suggest theyhave no current financial interest in W). We discussed and I noted on the class blog some litigation relating to similar acquisitions involving Oracle and Tesla. In the Tesla litigation the Vice Chancellor thought it was reasonably conceivable that Elon Musk's 22.1% shareholding together with other factors might constitute control. Here there are close connections between B and C and D who have 5% shareholdings so it seems that B might be able to influence votes attached to at least 35% of the common stock. The hypo states that "to a large extent [C and D] have always seen their role as facilitating Bo's work" (in a manner that has similarities to the situation at Oracle. The facts suggest a possibility that B would be found to be a controlling stockholder (and see, e.g., CB pp 612-4 on the definition of control). This issue of control, together with the way in which Z is run, is relevant to whether the Board members are disinterested and able to make a business judgment that would benefit from BJR protection, and it would also be relevant to the question whether board members could be trusted with a decision as to whether to sue B with respect to duty of loyalty issues. And Sinclair Oil shows that where a controlling stockholder engages in self dealing to the exclusion of minority stockholders courts will review decision-making for fairness (Sinclair Oil involved a parent corporation with a much larger ownership stake than B has here although B does seem to be running Z to benefit B as much as Z).

One answer suggested that the situation involving G, E and D could also be seen as relevant to the director independence issues here.

We studied some other cases relating to controlling stockholder transactions. For example, under Kahn v MFW a controlling stockholder transaction that is subject to approval by fully empowered independent directors and majority of the minority stockholder approval is evaluated under the BJR. But note that these cases were cases involving proposals to buy out minority shareholders in the controlled corporation, which is a different situation from the one in the hypo. In cases like Kahn v MFW the issues are about the price offered to buy out existing shareholders. In the circumstances of the hypo the issues are about whether shareholders will suffer because of what seem to be Z's problematic decision to acquire W, and at a price which may be too high. Here the procedure which could result in BJR protection would involve full disclosure by B to the Board of Z and a good faith decision by independent board members to approve the transaction. Without this sort of procedure the transaction would be subject to fairness review (e.g. Lewis v SL&E, Benihana).

Some discussion of derivative litigation would be relevant here. Under Tooley the litigation would seem to be derivative (harm to Zcorp from breaches of directors duties, remedy to Zcorp). As the underlying transaction is decided on by the Board, the question whether demand is required or not would depend on whether the BJR applies. If this is a controlling stockholder transaction, given the defects in procedure it would seem that demand would be excused. Even if the BJR applies there are some issues with respect to the independence of a majority of the Board which have implications for demand excusal.

There are some possible securities issues with respect to positive statements by Z about the acquisition and later stock price decline. The price decline seems to reflect a number of different factors.

There are no veil piercing issues in these facts. Z is publicly traded, not the sort of one person/ small number of shareholders situation in which veil piercing occurs. Also there are no creditors in the hypo facts who want to impose liability on shareholders because they are shareholders who have been using the corporate form improperly. Z is not a close corporation. Close corporations are not listed on stock exchanges. A few answers suggested that Board decisions on extraordinary matters must be unanimous: this is the RUPA partnership default rule, not a corporate rule. Unanimity applies to Board decisions by written consent.

2. (25 points) What legal issues do these facts raise with respect to Isaac and Jeb?

There are some uncertainties about the background facts here: we don't know whether I leaves W after its acquisition by Z (which raises a possibility of duties also being owed by I to Z), and, if so, what the form of the acquisition is - all this is left uncertain by the facts of the hypo but could make a difference to how we might think about the legal implications. But there's nothing to suggest that when I negotiates with J W no longer exists so it would be appropriate to consider I's duties to W under the operating agreement as affected by the statute, as this is what the question tells us about. The hypo states that I plans to invest money received from the acquisition of W by Z in a new venture. If it turns out that the acquisition is invalidated because of the conflicting interest issues I may not in fact receive this money.

The core of the question here relates to the issue of what duties a member of an LLC has not to share information about the LLC's business with other people. There are two problems here: first, I's sharing of information with J about W's technology is part of persuading J that I would be a good person to work with, and there are some implications that I plans to use what he learned at W in future in business with J and, second, the information also raises questions about Z's financial position relevant to J as an investor in Z stock.

W has a provision in its operating agreement limiting (excluding?) fiduciary duties but the operating agreement does require Members to maintain the confidentiality of information relating to the business. There is some ambiguity as to whether the duty of confidentiality here is merely a contractual duty or a fiduciary duty. Apart from the duty of confidentiality the operating agreement provides for no duties, although the implied duty of good faith and fair dealing would apply. There is an issue about whether this provision in the operating agreement is valid under the Arcadian statute which prohibits the elimination of fiduciary duties. Is the duty of confidentiality enough not to constitute an elimination of duties? The provision does not seem to fit with the idea of identifying "specific types or categories of activities that do not violate the duty of loyalty." The provision s more general than that to the point that it might be treated as eliminating the duty of loyalty. Even if it is not seen this way there is an issue as to whether the exclusion of other aspects of the fiduciary duties is manifestly unreasonable. In some ways these questions may not matter as it seems that what I is doing implicates the very issue — confidentiality — that is not excluded by the operating agreement. Sharing information with J about W and its products (wavelets) is prohibited under the operating agreement. Thus W could seek a remedy from I with respect to loss caused to W from the use of W's confidential information or profits made by the I and J venture using W's confidential information. Here the distinction between a standard contractual remedy (damages) and a fiduciary duty remedy (disgorgement) could make a difference.

In addition, the information I shares with J about the wavelets vulnerability leads J to sell stock in Z (the fact that he did sell the stock is suggestive (but not determinative) that the information may have been material). Here I seems to be a misappropriator under O'Hagan: he has information from his position in W which relates to Z, and which he discloses to J in circumstances that breach I's duty to W. There is a question as to intent here: the hypo states that I "lets slip" the information, but also that I "knows that Jeb owns common stock in Zcorp and that the information may be interesting to him because of this." It's not clear whether this would be enough for I to be seen as disclosing the information with scienter. But it makes sense to consider whether J is prohibited from selling the stock as a tippee of a misappropriator. Dirks addresses the liability of tippers and tippees under classical insider trading theory. But there is an argument here that this looks like a tipping situation under Dirks. If I communicates the information to derive a financial benefit (profits expected from going into business with J), I is a tipper, and if J knows that I should not have disclosed the information J is a tippee prohibited from trading.

3. (25 points) What legal issues does George's situation raise with respect to George, Eve, Devon and the Board of Directors as a whole?

A number of people did not notice that George is described in paragraph 1 of the facts as a member of the Board of Z, as well as being described on page 3 as not being an officer. This is the same George. So analyzing Z's liability for acts of non-employees or considering whether G might be an employee was not relevant. G is a director and is subject to the duties that apply to directors. If G were not a director and not an employee there could be a question of whether Z could get out of the settlement agreements on this basis, but the question suggests the issues here arise out of shareholders being upset rather than because Z is trying to avoid liability under the settlement agreements.

Creepy George raises issues similar to those we thought about during the semester involving Steve Wynn and Wynn Resorts. There is a past settlement agreement relating to sexual harassment which could have put the Board on notice that G might engage in behavior in future that could result in liability for Z, and this could be relevant to Caremark liability for the Board members. B told G not to do it again, but this might not be enough. The hypo suggests G has not stopped the behavior but has just kept it quiet until recently. When this becomes more difficult G arranges with E (CISO) and D (the Secretary) to have Z enter into settlement and non-disclosure agreements. Ultimately shareholders discover what has been happening. The question also states that some of G's activities could involve criminal liability. G, as a director who may have engaged in criminal activity in the context of his relationship with Z has not been acting in good faith in the best interests of Z, which is a breach of the duty of loyalty. And there are a number of other issues here: the issue of whether the settlement and NDA agreements are within the authority of E and D or are not valid and binding on Z; the issue of E and D's liability for breach of fiduciary duties in keeping things quiet and perhaps acting outside the scope of their authority; and the issue of B and C's liability for breach of fiduciary duties in failing to supervise G. Because of the shareholders' unhappiness, again there are derivative litigation issues, and there are also potential securities law issues with respect to the failure to disclose the problems earlier.

G, in his interactions with Z employees which may have involved criminal acts has not complied with his duty to act in good faith in the best interests of Z so has breached his duty of loyalty (c.f. Stone v Ritter). This type of behavior is not subject to exculpation under statutes like DGCL § 102(b)(7) (exculpation is not possible "for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law"). We also know that illegality is an exception to the BJR (e.g. if the Board decided to perform an illegal act the BJR would not apply).

With respect to the other directors there is an issue of how in general they should react to this type of situation, and how they should react to the specifics of this situation. There are issues of reputation for Z and there are also legal issues for the directors as they have some responsibility for oversight, so as to avoid Z violating the law (Caremark, Stone v Ritter). Directors are not required to ferret out misconduct but if they are on notice that there are issues they cannot just ignore them (e.g. Francis v United Jersey Bank, Caremark). Nevertheless, Caremark tells us that only a sustained and systematic failure to have an appropriate information and reporting system will result in liability. On the facts of the hypo B knew that there was an issue about G's behavior because she knew about the past settlement. The hypo suggests that employees know about his behavior (e.g. some find it creepy) so there is a factual question about whether Board members in general really knew or ought to have known what was going on. But at the point when G approaches E and D there are 3 of the Board members apart from G who have some knowledge of the problematic, even illegal, behavior. When E and D decide to cover up the problems rather than addressing them by raising the issues with the Board, or trying to have G removed as a director or at least preventing his interactions with employees they seem to have breached their duties to Z — the duty of care, and even the duty of loyalty in the sense of failing to act in good faith in the best interests of the corporation (even if G's contacts etc are useful to Z his possibly criminal behavior is a serious problem the Board should not ignore).

As to the authority of E and D, the facts do not say what responsibilities have been expressly given to E and D as officers of Z. So we cannot say what their actual authority s. And settling claims against Z could be a function delegated to an officer rather than a matter that would require Board approval. It wouldn't be usual for a CISO to be responsible for dealing with such issues, more likely a General Counsel, but we aren't told whether Z has such an officer. This goes to the issue of apparent authority: an officer of a corporation has as a matter of apparent authority the authority such an officer would usually have. So we know that a corporate secretary has apparent authority with respect to authenticating board resolutions (In re Drive in Development, First Securities v Dahl). The situation here is rather different from the cases such as GOF v Robin involving guarantees of third party liabilities as G is a director of Z, and Z might therefore have an interest in settlement in these circumstances. Nevertheless, if the agreements were outside the actual authority of E and/or D they would be libale for acting beyond the scope of their authority.

It is not clear to what extent the issues of G's behavior affected Z's share price as the facts suggests a number of differnt factors that combined to produce the price drop. Whereas Steve Wynn's behavior seems to have been material with respect to Wynn Resorts shares, G is in a rather different position. If G's behavior was the sort of fact that a reasonable investor would want to know (TSC v Northway) then Z should have disclosed it. And a failure to disclose could give rise to liability under §10(b) and Rule 10b-5 where a person who invested before the information became public (Blue Chip Stamps) and could establish reliance (Halliburton), scienter (Ernst & Ernst v Hochfelder) and loss causation (Dura v Broudo) in addition to materiality.

Shareholders who held shares at the time of G's actions and continue to hold shares through the litigation would have standing to bring a derivative suit with respect to these events. He focus here with respect to demand would be in the independence question as there seems to be no business decision that would give rise to a question of business judgment. There is not a majority of the Board which seems to be independent here. Of the 6 Board members, G, D and E were involved in the cover-up and B had notice of the issue. The fact that C always supports B means that F is the only director who is clearly independent here. Demand should be excused, but Z could establish an independent special litigation committee to assess Z's interests with respect to the litigation (Auerbach, Zapata).

4. (25 points) choice of a or b.

Answers to both questions ranged in length and in the level of detail and thought that went into the answers. Sometimes I think this was a function of time. Both questions were presented as possible themes on the blog and many of the answers showed thought about the issues. Some answers made good use of examples from cases and materials identified on the blog. What follows are some of my thoughts about material that could be relevant to these questions. But the questions invite your views rather than mine, and it was interesting to read a range of opinions on the questions.

Some of the answers to the control question diverged a bit from what the question asks — the question asks about the advantages and disadvantages of indeterminacy with respect to the concept of control, and not a listing of every circumstance which we might think of as being relevant to some conception of control in business organization law.

a. Using examples from the course materials, discuss whether Boards of Directors do and should think of corporate social responsibility as an invitation to pursue socially beneficial activities, or only those which are beneficial to the corporation?

On the blog I wrote:

> This semester we discussed a number of issues relating to corporate social responsibility, broadly defined, including issues of corporate compliance, the #metoo movement, corporate responses to the Parkland tragedy, Etsy ("our mission is to keep commerce human"). The cases we read don't really encourage corporations to take on issues of social responsibility but they do allow space for corporations to take account of social issues in decision-making (e.g., the Business Judgment Rule).

The idea of the BJR, that courts don't interfere generally in business decision-making unless there is fraud, illegality, conflict of interest, gross negligence (subject to exculpation), means that Board's of directors have considerable freedom to make decisions in their corporation's best interests without having to worry too much about liability. We don't require Boards to make the best decisions: generally it is up to shareholders to decide whether they wish to continue to be shareholders in a particular corporation or not, or whether they want to vote to support directors at regular director elections. This approach allows Boards to justify decisions based on ideas of the public interest, as in Schlensky v Wrigley. But it does not compel them to consider the public interest unless failing to do so would make them vulnerable to being removed through a proxy contest or acquisition.

The idea that illegality is an exception to the BJR illustrates that the idea of social benefit (or prevention of social harm) embedded in legislation which makes certain acts unlawful is a part of corporate law. Corporate law recognizes that corporations should act within the law rather than being able to maximize profits at all costs. This is rather more limited than rules which might expect corporations to pursue social benefit, but it is real. And cases like Caremark and Stone v Ritter illustrate the idea that corporate compliance is to some extent encouraged by rules which recognize director liability for some failures of compliance. But there's a question whether compliance as such is the same thing as CSR: on the one hand compliance involves expense and non-compliance might increase profits if enforcement is weak, but on the other hand doing what is required by law is not the same as doing things for the public benefit which are not required by law.

Traditional ideas of fiduciary duty, illustrated in Meinhard v Salmon, suggest some idea that business law might encourage high standards of behavior. The case involves an idea of duties to a co-venturer rather than a general duty to behave well, but there is an implication of broader social benefit from enforcing a meaningful duty of loyalty. This idea, I think, permeates the whole discussion of the extent to which duties of fiduciaries are contractual, or not.

With respect to guns, after the Parkland shooting, we saw corporations reacting to concerns about guns. For example, Citigroup announced a firearms policy (noted on the blog) that would apply to its clients, and on April 19 I wrote on the blog that

> Andrew Cuomo and the New York Department of financial Services warned financial institutions based in New York that they should "review any relationships they may have with the National Rifle Association and other similar organizations. Upon this review, the companies are encouraged to consider whether such ties harm their corporate reputations and jeopardize public safety."

A number of answers focused on issues, like this, that we considered during the semester and many of the answers were very thoughtful and interesting to read.

b. Control is an important concept in business organization law, leading to risks of liability, but control is not defined in a clear or determinate way. Using examples from the course materials discuss the advantages and disadvantages of an indeterminate or uncertain conception of control in business organization law.

On the blog I wrote:

> We saw the idea of control in a number of different contexts, from control as a component of the agency relationship, to control as the basis for the imposition of fiduciary duties on controlling stockholders, to control as circumstances negating the idea of the sort of independent decision-making that justifies business judgment review (in one sense this is a specific example of the determinate/indeterminate rules issue).

Law uses control as a way of imposing liability: a principal in a principal/agent relationship is a person who can control the agent. We saw a court applying this concept in the Cargill case, where Cargill's control led to liability to farmers who dealt with Warren on the basis that Warren was Cargill's agent. The test for control here is not a clear, bright-line test, but focuses on many factors.

Similarly, in the veil-piercing context control is one component of veil piercing liability, combined with mis-use of the control. The concept here is also rather blurry: in Sea-land v Pepper Source the court talks about unity of interest and ownership, where the idea is really that if the owner of a corporation does not respect the separateness of the corporation the corporation's creditors should not have their rights limited to only looking to the corporation for satisfaction of their claims. And in some of the veil piercing cases the courts seem to be talking about veil piercing and agency as if they were the same thing. Note in Cargill the idea that Warren was really Cargill's business rather than being independent. But it is also worth noticing that in the vbeil piercing context the problem is not the level of control as such, it is that ownership control of a corporation is being used wrongly in ways that harm the interests of creditors. And the wrongful nature of the control is found partly in a failure to follow formalities required by law. In a sense formalities, or form, provides part of the test for determining whether the exercise of control is problematic or not.

In the agency and veil piercing contexts control is a way of navigating between form and substance to provide remedies to third parties. But control is also relevant to dieas of fiduciary duty. Fiduciary duties are imposed in circumstances where one person reposes trust and confidence in another. In Meinhard v Salmon the managing co-venturer's control intensified the fiduciary obligation.

We saw control in the corporate context in some different ways: the duties imposed on majority or controlling shareholders in close corporations and in public corporations. Here the idea is that being in a position to decide what the corporation does is the basis sometimes for an enhanced fiduciary duty. Shareholders are as a general rule are not subject to fiduciary duties, but controlling shareholders are. And the question of what constitutes a controlling interest does not have a clear answer: the test is one that focuses on the details of how control may be exercised rather than on a specific level of shareholding. Again, substance rather than form.

Control also features in circumstances where the courts need to consider whether directors are independent: with respect to approval of conflicting interest transactions, or in the context of a possible shareholder demand.

The uncertainty surrounding the idea of control is designed to do fairness, but the same uncertainty raises questions about whether people should be able to know what rules apply to them in advance rather than only ex post. In the merger context, for example, the Delaware courts have created safe harbors for transactions where a shareholder proposes to acquire shares in the corporation which vary depending on whether the shareholder is a controlling shareholder or not (e.g. Kahn v MFW for the controlling shareholder standard - independent board decision and majority of the minority shareholder approval; where the shareholder is not a controlling shareholder only an informed majority of the minority vote is required). On the other hand, if the uncertainty motivates possibly controlling persons to take care with respect to the procedures they employ that may not be a bad thing.

Sometimes courts recognize that controllers need protection from people who seek to remove their control: VGS v Castiel. Here the control rights were not specified with enough detail, but the court protected control despite this. This idea fits with the question to some extent, but perhaps not as well as some of the other examples, because it is not really about the idea of control as something indeterminate and which is difficult to pin down.