Memo on Fall Semester 2020 Business Associations Exam Section A Question
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Across the 2 sections 8 people answered all three of the section B questions although the instructions clearly asked for an answer to one of the questions. Some of the other answers to this section were also very short. In contrast some people wrote really thorough and interesting responses to these questions. There were some other examples in the answers to the questions generally of people stating things as facts which the question did not state, which seemed to indicate a lack of care/focus. This sort of thing does happen in normal times, but clearly the circumstances in which we were learning this semester were stressful, and it is not a surprise that some of that stress would manifest in exam answers.

I am not providing a memo on the section B questions. These questions addressed two issues (profit maximization and fuzzy rules) we talked about quite a bit and another question on what rule you would do away with. The points I assigned for the answers to these questions varied according to the complexity and detail of the answers. Some answers were longer and much more thorough than others. Some of the answers involved some very interesting arguments about the issues raised by the questions. Answers that suggested the writer had spent time thinking about the course materials, and/or made effective uise of the course materials to support the argument received more points than other, more perfunctory, answers.

PART A

The control issues are central to this hypothetical. Whether or not XY with a 25% shareholding and the appointment of one out of 6 directors, is a controlling shareholder, makes a difference to how we should think about a number of issues in this hypothetical. Where there is a dominant/controlling stockholder we know this can have implications for how courts review board or board committee decisions, and for whether demand may be excused in a derivative lawsuit. We know that control is interpreted flexibly in Delaware. Arcadia follows the Delaware corporations statute, and technically we don't know whether the Arcadia courts are similarly flexible but it makes sense to apply what we know about the Delaware case law.

I think it is not at all clear whether XY would be regarded as a controlling shareholder here. It is true that we know from Tesla that a 22% shareholding might be regarded as a controlling shareholding but there that was because of the special significance of Elon Musk, an officer and not merely a single director, to Tesla. The identification of Musk with Tesla, and the significance of Musk to Tesla, is unusual and does not appear to be replicated here. On the other hand, because Amy listens to Sonia and the others at Z let Amy have her way, there does seem to be a pretty good argument that XY is in effective control, at least after Z has the financial issues caused by the oil spill and needs an infusion of capital (circumstances which XY helped to create). So, I think that the analysis of the control issues might be different for question 1 and question 2. By the time of the events at issue in question 2 Z has arguably developed a level of dependence on XY which is different from the earlier situation.

1. (35 points) The tankers: explain what issues of corporate law are raised by Zedcorp's move into the transportation of liquid natural gas, including the purchase of the tankers and the leak. In your answer please explain what claims unhappy shareholders might bring and what difficulties they would likely encounter.

This was a predictable type of question covering issues we spent a lot of time on during the semester, although there are some factual details that make the analysis complicated. I also think that these facts invite thinking about what we have learned in general about directors' and shareholders' duties. It's basically a combination of issues raised in Shlensky v Wrigley, Dodge v Ford and Kamin v Amex, with some Sinclair v Levien/DGCL §144, and Caremark. Many people cited Smith v Van Gorkom for the uninformed business decision issues, but that case is factually more relevant to the situation to which question 2 relates.

Zedcorp gets involved in a risky new venture and the directors agree to it without doing much investigation, instead relying on one director (Neil) who is appointed by a shareholder who facilitates the acquisition of some tankers. The problematic tankers leak, causing a spill which may lead to criminal liability for the corporation, with possible fines, and perhaps civil liability. The financial impact will be harmful to the corporation. So, it would benefit shareholders to sue the directors/officers (because they will have D&O liability insurance) and XY. Because Z has already begun to be involved in LNG transportation it is not clear that injuncting this new line of business would make sense.

The move into the LNG transportation business looks like a business decision involving risk, which is the sort of decision boards of directors are expected and entitled to make. And if you consider the cases we read we have not read cases where a board's decision about engaging, or not, in a new business activity was treated as a potential breach of duty (consider Shlensky v Wrigley) unless there were duty of loyalty issues (e.g. Bayer v Beran). In making such decisions boards of directors are supposed to be informed, but courts are not enthusiastic about second guessing this sort of decision. The directors, in relying on Neil, and seemingly not doing additional investigation may be uninformed as were the directors in Smith v Van Gorkom. But this is a very different situation. In that case the decision the board was taking, and which was a breach of their duties, related to the price at which shareholders would be bought out of the corporation. So the types of judgment the boards are making are different. In merger cases directors have a duty to ensure that shareholders receive the best price obtainable for their shares, a duty which is owed directly to the shareholders, and there is no similar specific duty relating to decisions about changing the corporation's business activities.

Moreover, here there would be a causation issue that did not exist there. In that case the Board's decision to approve the price had a direct impact on the amount the shareholders would receive. Here it is not clear that the board's decision to move into LNG transportation was the proximate cause of any loss to Z. The proximate cause would be the defective tanker and the oversight issues, and it may be that Neil suggests the move into LNG transportation to help XY with its tankers issues but the question does not tell us that. It seems that even if shareholders could pursue claims of breach

of the duty of care here it would not necessarily produce any concrete benefit in terms of a financial remedy for the corporation (because of the proximate cause problem).

The Board's reliance on Neil is not clearly justified (it may be, we just don't have enough information to say, and he isn't an officer or clearly the sort of person boards are entitled to rely on). And there is an issue whether the Board was informed. Traditionally gross negligence, including being uninformed, displaced the BJR which generally presumes board decisions are appropriate. However we now know that there has to be something more than gross negligence for directors to be liable because corporations can exculpate directors with respect to liability in damages for breaches of the duty of care under DGCL §102(b)(7). It is true that exculpation only applies in Delaware where the corporation adopts an exculpatory provision, and it makes sense to note this fact. But it is extremely likely that a corporation would have adopted such a provision and that it would therefore be necessary for the shareholders to identify a lack of good faith, and not just gross negligence. A dereliction of duty/abdication of responsibilities would involve a lack of good faith, but it is not clear that the board was guilty of dereliction/abdication here. Nevertheless, I think the case to consider with respect to this hypo is Walt Disney, rather than Smith v Van Gorkom. And it is possible that the decision on the new line of business is an issue of deficient corporate governance rather than breach of the duty of care.

The decision here, to move into a new line of business which is risky, without making appropriate decisions about risk management, implicates Caremark oversight liability. There are a couple of issues with respect to the Board's actions: the decision to move into a new line of business (a business judgment) and, seemingly, a failure to make sure that the necessary safety measures were adopted to carry on the new line of business safely (a failure of oversight). It is the failure to ensure safety that resulted in the liability that causes loss to Z. One question we might ask is whether one safety failure is enough to meet the sustained and systematic failure standard? I think the question is whether the board ever even addressed the safety issues. If not, or if they decided on a plan and then didn't ensure its implementation, there would be the basis for liability.

A sustained and systematic failure to consider compliance issues, or issues of risk management (Marchand v Barnhill) can involve the sort of failure to act in good faith in the best interests of the corporation that Stone v Ritter suggests involves breaches of the duty of loyalty as well as a lack of good faith such that exculpation would not be available. The facts suggest that it may be possible to see the directors' behavior here as involving breaches of the duty of loyalty and as lacking good faith. We are not given facts to suggest the board addressed the LNG transportation safety issues at all.

There is a Chief Compliance Officer, Clarence, but we are not told that the board directed him to consider the safety issues. There could be liability issues for Clarence as an officer here if he were supposed to address these issues, and officers do not benefit from exculpation under §102(b)(7).

As to the acquisition of the tankers, we don't know to what extent the board was involved in the decision, merely that XY helped with the acquisition. It seems that we might analyze this as either an interested director transaction or possibly a controlling

shareholder transaction (if XY is a controlling shareholder). We know that conflicts of interest are an issue for directors (DGCL §144, Bayer v Beran, Benihana) and also for controlling stockholders (Sinclair Oil v Levien). It does not seem from the facts given that Neil disclosed XY's interest in selling the tankers at a good price, and the price seems to be advantageous to XY, suggesting it is not fair to Z. It seems that Z might be able to avoid the contract for the purchase of the tankers on the basis of the conflict. However, there is also the issue of the harm caused by the oil spill and Zedcorp's liability. Avoiding the transaction based on the conflict of interest does not help Z recover damages relating to the problems with the tanker. Perhaps from this perspective it might make sense to focus on XY's self-dealing: if XY was able through exerting control on the Z board, to ensure the tanker purchase occurred at a price which would help XY avoid a loss, this is a financial benefit it would be possible to argue XY should have to disgorge. But there are a lot of difficulties along the way. The question does not suggest that this is one of the things Sonia encouraged Amy to go along with.

From a financial perspective that leaves the oversight liability issue as the most likely source of damages that may benefit Z and, therefore, its unhappy shareholders. These are hard claims to pursue, but this might be an appropriate case.

The claims here would all be derivative claims (Tooley: who suffers the harm, who gets the benefit of any remedy). Demand is required unless excused on the basis of futility, because the underlying transaction is not protected by the BJR or because a majority of the board is not independent with respect to the litigation decision. As the oversight liability claim is the most likely to be useful to the shareholders in terms of a financial remedy to Z it makes sense to focus on this. It would seem that all of the directors are equally involved in any potential oversight liability and therefore they are not independent wth respect to a decision about litigation about this matter. Demand should be excused as to this claim. It would be possible for Z to establish a special litigation committee to take back control of the litigation.

Quite a few answers suggested that there might be a veil piercing issue here. **This is <u>completely</u> wrong: there is no veil piercing issue here.** Veil piercing claims are brought by creditors to impose liability on shareholders (almost inevitably in the case of corporations owned by 1 shareholder, either individual or a legal person). The question specifically asks what claims unhappy shareholders can bring, and not what claims creditors may bring. If veil piercing were possible on these facts (and there are no facts here to support a veil piercing claim anyway) it would involve imposing liability on shareholders. And Z clearly has more than 1 shareholder anyway.

Liability of a controlling shareholder is based on the controlling shareholder being subject to fiduciary duties which is a completely different legal theory from veil piercing.

2. (40 points) XY acquisition of additional shares in Zedcorp: explain what issues of corporate law are raised by this transaction. In your answer please explain what claims unhappy shareholders might bring and what difficulties they would likely encounter.

This was clearly a much less predictable (or predicted) question and many people struggled as to how to analyze it. I see it as a combination of Smith v Van Gorkom issues, Corwin/Kahn v MFW and securities fraud liability under s 10(b) and Rule 10b-5. However it is **not** a situation involving insider trading liability.

Why is this not insider trading? In order for a person to be guilty of insider trading they must trade/tip information they receive by virtue of an access relationship to information either as an insider (permanent or temporary) of the issuer or by virtue of a fiduciary type relationship with the source of the information. Sonia did not receive the valuation information through her relationship with Z even if she can be argued to be an insider of Z. She seems to have received the information in the course of her work for XY and she is using the information to benefit XY in acquiring the Z shares at a good price for XY. There is no breach of duty to XY so no insider trading. If by chance she acquired the information in the context of a relationship with the property developer in which she has obligations of confidentiality she might be prevented from trading under O'Hagan. But that does not appear to be the case as there is no hint of confidentiality in the description of how she came by the information.

There are some factual questions here relating to whether anyone at XY has breached duties in the context of this transaction. Let us be clear. If a non-shareholder of Z discovered information about the value of assets owned by Z and made an offer to acquire Z shares it would not be necessary to disclose this information. A controlling shareholder of Z, however, having fiduciary duties to Z and to other shareholders, would have a fiduciary duty to disclose the information. It is the fiduciary duty that creates an obligation of disclosure. If XY was offering consideration for the Z shares in membership interests in XY it would have obligations of disclosure of information relevant to the value of the XY membership interests. Here XY is offering a cash consideration for the Z shares.

The responsibility for valuing the Z shares is a matter for the Z board of directors. They are the ones who are charged with ensuring the Z shareholders are offered the highest price reasonably obtainable for their shares. And we know from Smith v Van Gorkom that it would be possible to identify the highest price for the shares through a market test where different potential acquirors might make competing offers (even though there was not an effective market test in that case). A fairness opinion is another way of establishing value. The burden of ensuring the proper price is on the board of the target company. We know this from Smith v Van Gorkom.

In many of the cases we have read we have transactions in which officers are involved, pushing transactions onto the board. In the question here there are two possible bases for a disclosure requirement: (1) if Neil has the relevant valuation information (not clear from the question), as a Z director he would have an obligation to disclose it at the board meeting which evaluated XY's offer and (2) a controlling stockholder is prohibited from self-dealing, and acquiring the shares at an undervalue would be self-dealing (note that it is not completely clear that XY is a controlling

shareholder).

Z’s financial issues (which XY seems to have had a role in bringing about) lead to a need for new capital which XY offers to provide. XY seeks to acquire a 52% shareholding which would allow it to appoint over half of the members of the board, resulting in XY clearly becoming a controlling stockholder if it was not a controlling stockholder already, or consolidating its control. XY is offering to buy shares from existing shareholders at a price that does not reflect value XY knows to be there (the land) but which the other Z shareholders are unaware of, and which is not disclosed to the shareholders. (Cf. Zahn v Transamerica)

There are 2 main issues here: the corporate issues surrounding the approval of this transaction by the Board and the shareholders (Corwin and Kahn), including issues relating to a lack of disclosure (Mindbody) and the securities law issues relating to the acquisition of the shares without disclosure of material facts. Z is a corporation and XY buys shares from the shareholders of Z so there is no issue as to whether the shares are securities (they are) and no need to analyze this (it is obvious). Analyzing whether there is an investment contract here is a mistake because shares in a corporation are stock. It is not appropriate to apply Robinson v Glynn because the stock analysis there was about ownership interests in an LLC, and the passive investment idea applies to that sort of ownership interest. But shares in a corporation are securities (I did mention United Housing v Forman in class but said it was a very unusual case and the facts here are nothing like the facts in that case).

It is not the case that any time a person buys securities they have a duty of disclosure under the securities laws. An issuer of securities has disclosure obligations, so here there could be issues for Z transmitting the offer to Z shareholders (we did not study the proxy disclosure rules although we talked about them in passing in the context of the Qualcomm complaint). XY is buying the shares without making disclosure of material information (the value of the land) and, if XY is a controlling shareholder, there is fraud in connection with the purchase of a security and XY acted with scienter (intentionally failing to disclose the information). The question states that “the land on which Zedcorp's premises are based is worth much more than anyone at Zedcorp realizes because the land has features that are particularly well suited to the needs of a property developer [Sonia] knows.” If the land is valuable enough to increase Sonia’s interest in owning shares in Zedcorp it seems that its value would be relevant to the decision of a reasonable shareholder in deciding whether to sell her shares for the offered price (e.g. contrast Santa Fe v Green).

These issues can give rise to direct rather than derivative claims. Shareholders who sell their shares have securities law claims under s 10(b) and rule 10b-5 and also claims against the Z directors like those involved in Smith v Van Gorkom. Shareholders who do not sell their shares are now shareholders in a corporation with a controlling shareholder who acquired control unfairly, which looks like a dilution claim and should be able to be pleaded as a direct claim.

PART B (25 points)

Answer 1 of the following questions, using examples from the course materials to illustrate your arguments:

1. If you could change one rule you learned about in this class, what would it be, and why?

2. Does corporate law require directors to maximize profits for the benefit of shareholders? Should it?

BJR - Kamin, Shlensky v Wrigley - vs dodge v ford smith v ap barlow

Profit max vs social benefit?
Profit max - long/short termism

3. Many concepts of business organization law are not defined in a clear or determinate way: they may be described as fuzzy rules. Discuss the advantages and disadvantages of indeterminate or uncertain concepts in business organization law.

Appendix: diagram of the hypo

[Arcadia DGCL]

XY LLC
sonia [member-manager]
[interest in Z land]
investment
fund
25%[control?]
1 director [ABC children of founders]

Neil	Amy	Brett	Clarence	Elena	John
	CEO	CFO	CCO		
	[Amy-Sonia]	[golf]	[golf]		

LNG - Neil idea
cheap tankers- XY
sale to Z helps XY
oil spill - criminal
charges

ZEDCORP
[transportation- marketplace]

AZ need for funds
XY Increase ownership in Z to over 50%
proposal for N to present to Board [52%]
more than ½ dirs
no disclosure re land
price reflets need for capital, not value of land
Board and shareholders approve