Memo on Fall 2021 Business Associations Exam

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As a general observation it is very striking that many of the answers to the questions on this exam used the word "likely" to refer to matters that are completely clear. For example, Caremark claims are derivative, there is nothing "likely" about it. Use of the word likely in this sort of context suggests you are unsure, and therefore that you don't in fact know. It may be that the use of the work "likely" is a habit, but the word should only be used where there is some uncertainty.

Part A

1. (25 points) Homebots: explain what issues of corporate law are raised by the exploding homebots. In your answer please explain what claims unhappy shareholders might bring and what difficulties they would likely encounter.

This is a Caremark question: are directors liable with respect to the failure to ensure safety of the homebots which have exploded causing fires and injuries? We know that under Caremark there will be liability where there is a sustained and systematic failure to ensure that a reasonable reporting system exists.

Liability can arise where there is a complete failure to address issues, where the Board adopts a compliance system and does not monitor it, or where the Board ignores red flags. Stone v Ritter characterizes Caremark liability as a breach of the duty of loyalty (a breach of the fundamental duty to act in good faith in the best interests of the corporation) and therefore we do not need to worry about exculpation under DGCL §102(b)(7).

The circumstances here are reminiscent of those alleged in Marchand v Barnhill and Boeing: in particular Zedcorp did not have a product safety committee of the Board. Marchand v Barnhill makes clear that oversight is a Board responsibility: the Board must take responsibility for oversight.

Here there is some uncertainty as to whether the Board did address safety issues at all. The Board did have an innovation committee but there is no suggestion that committee was charged with addressing safety issues (cf. Boeing). In a number of cases the Delaware courts have focused on mission critical risks (e.g. Marchand v Barnhill (food safety), Boeing (aircraft safety), Clovis Oncology (safety of cancer drugs). The Delaware courts have not explained this concept of mission critical risks. But it seems to apply where particular risks are core to the corporation's business. In that sense, robot safety, for a business which does nothing but make robots- would seem to fit this mission critical idea. Robots are not a peripheral part of Zedcorp's business. I don't think whether or not people died, as in Marchand v Barnhill and Boeing, should make much of a difference here, but it is not completely clear what is driving these cases. If the issue courts are worried about in these oversight cases is that the Board's failures will cause reputational harm to the corporation and this financial loss to shareholders, then perhaps the severity of the harm caused is relevant.

In the hypo it is clear that there was no system for ensuring that problems were

reported up to Drake and the Board, and the lack of such a reporting system, and the lack of any suggestion in the facts that the Board took any steps to address safety issues suggests a possibility of liability for the directors.

It is clear that the more detail plaintiff shareholders can include in their complaint to substantiate the lack of oversight the better: there need to be particularized factual allegations to support the claims of failure of oversight. The facts given in the hypo would not be sufficient, but more information might be obtained in a §220 books and records request.

The claim here would be a derivative claim under Tooley: the harm is to the corporation because the duties allegedly breached here are owed to the corporation and the remedy would also go to the corporation. Based on what we know about the facts, a plaintiff shareholder could argue that the directors face a substantial risk of liability and that this is therefore a demand excused case under United Food and Commercial Workers Union v Zuckerberg (if at least half of the demand board members are in 1 of 3 categories: (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand; and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that is the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand).

If a plaintiff shareholder is able to specify particularized facts supporting the Caremark allegations which would apply to all directors this should justify demand excusal. I don't think it makes sense to discuss the independence issue apart from the substantial risk of liability here, because the question gives no facts suggesting that any of the directors is more or less liable than any of the others. The independednce evaluation would be more relevant if there was one wrongdoer (or more than one) and other Board members had personal ties that would affect their ability to think independently about the possibility of litigation.

Even if demand were excused there would still be a possibility that Zedcorp could set up a special litigation committee to regain control of, and perhaps stop, the litigation.

The one director and officer many identified as having special responsibilities here was Drake, who has the responsibility for innovation. If Drake were supposed in this role to address all aspects of product development, including safety, then there is a basis for Drake to be liable in his role as an officer (although the facts given do not make this clear). In this role Drake would not benefit from exculpation. There is an issue of proximate cause here. And, in particular, there is a question of how Drake's role fits with the Board's responsibility to exercise oversight. If the situation were that the Board delegated innovation including safety, to Drake, then we might be in a situation where Drake, and not the other Board members, faced liability. In this case issues involving relationships between Drake and the other directors would be relevant to the demand excusal issue. But the question does not say this is the case. And, I think that the implication of Zedcorp having an innovation officer and an innovation committee (but not a safety committee) is that the Board hasn't focused on safety at all.

Many answers wanted to address the duty of care with respect to decision-making and the BJR. But here there isn't any suggestion the Board decided not to address safety issues, and oversight cases don't implicate the BJR. Also, exculpation would not apply in a Caremark situation (failure to act in the face of a known duty to act is a duty of loyalty breach under Stone v Ritter). There is no need for any lengthy discussion of either of these issues here.

There is an additional issue here as to whether the action of the APSC creates a situation where Yfund has the right to appoint an additional director. The payment to the hospital burns unit is not strictly a finding of liability involving a "fine", and we are not told the stock price has declined by 10%. If Yfund were to sue to try to enforce its view of its rights the claim would be a direct claim, and not a derivative claim. But, given that we know that courts are reluctant to give contracting parties in business organizations greater rights than those spelled out in their contracts Yfund would be unlikely to succeed.

2. (20 points) Elton's investment in Starcorp options: explain what liability Elton may have incurred as a result of his purchase of the Starcorp options

Elton, who is an officer of Yfund (we do not technically know what Yfund's business form is, although we know that opportunities issues arise in the context of fiduciary relationships generally) and a director of some of Yfund's investee companies, including Zedcorp, learns about Starcorp's plans because of his work for Yfund which introduces him to engineers.

The work for Yfund led Elton to become more interested in learning about robotics, but it is not clear to what extent his attendance at the conference where he learns about Starcorp relates to his work for Yfund/Zecorp/Xcorp. If it were necessary or appropriate to enable him to exercise his functions as a director it would be related to his work for Yfund (and Zedcorp and Xcorp). If not, and as he has no specific responsibility to look for new investment opportunities for Yfund, it would not seem to be within his work responsibilities.

Query whether it makes a difference that "all Yfund employees understand that Yfund is always interested in new and promising investment opportunities." This may create an expectation that employees will bring opportunities to Yfund. And whereas directors are not expected to dedicate all of their working time to a corporation of which they are a director, an officer/employee is expected to dedicate their working hours to their employer's business. It is more likely that the opportunity would be seen as coming to Elton through and related to his work for Yfund than for Zedcorp/Xcorp. It is less likely that the investment in Starcorp would be regarded as an opportunity of Xcorp than of Zedcorp because of the difference in lines of business. And whereas Yfund seems to be in the business of investing, it is not clear that investing in other robotics companies is part of Zedciorp's line of business.

The questions here are (1) whether Elton is able to take this opportunity for himself without offering it to Yfund or Zedcorp, (Broz v CIS, Ebay) and (2) whether Elton is insider trading when he buys the Starcorp options (O'Hagan, Dirks). We do not know what type of entity Yfund is (whether it is a corporation or not) but we have seen a number of opportunities cases (Reading v Regem, Meinhard v Salmon, Broz).

Both questions involve similar analysis. If the attendance at the meeting where Elton learned about Starcorp was part of his job with Yfund, then he learned about the opportunity in a context where he should be looking out for Yfund's interests rather than his own. With respect to Zedcorp, the capacity in which he comes upon the opportunity makes a difference.

Information that comes to Elton through his work for Yfund is subject to a confidentiality agreement. If attendance at the meeting was related to his work, or if his ability to understand the significance of the information came about through his work for Yfund, or directorship of Zedcorp, then, when he uses the information to trade he is a misappropriator under O'Hagan (if Elton learns the information in the course of his work for Yfund the information belongs to Yfund and is caught by the confidentiality agreement). The information seems to be material as when it is made public the price of Starcorp shares increases significantly (price impact as evidence of materiality).

Alternatively, Elton might be a tippee. We do not know how he comes across the information. Presumably it is not part of a public presentation (because of the price impact of the subsequent announcement) and may be communicated in a private conversation at the meeting. If the communicator was doing so in breach of their fiduciary obligations to Starcorp and hoping for a personal benefit and Elton understood this then Elton would be a tippee (Dirks). If the communicator was passing on the information to Elton knowing of Elton's work for Yfund and/or role at Zedcorp and was hoping to promote Starcorp's interests then when Elton uses the information for himself he looks like a misappropriator of an opportunity that really belongs to Yfund, and perhaps Zedcorp, and also for the purposes of insider trading liability.

Note that there are no facts in the question relating to precisely how Elton got the information, so the tipper/tippee discussion isn't precisely demanded by the given facts (although it is definitely appropriate), but the issue relating to Elton's possible duties to Yfund and consequent misappropriation possibility is raised clearly by the given facts. Many people focused on Starcorp as the source of the information for the purposes of misappropriation theory, but it is clear that the source of the information means any owner of (material non-public) information to whom a trader/tipper owes duties of confidentiality. Many people assumed that the only way people might learn things at conferences is from the formal presentations rather than through private conversations with other attendees. Some recognized that Elton might acquire the information in a range of different ways, including overhearing it. The point I would like to emphasize here is that it is good practice to avoid making assumptions.

3. (35 points) The Zedcorp-Xcorp merger: 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.

Yfund is trying to arrange a merger between Zedcorp and Xcorp on the basis that the combination will be advantageous to both corporations ("Yfund concluded that a merger between Zedcorp and Xcorp would make strategic sense, and believed that by providing additional funding and improving governance in the merged corporations the combined businesses could be much more successful than each corporation was

likely to be separately.") However, Yfund also decided to ensure it would become a controlling stockholder in the new entity that would own both corporations. We do not know the terms of the transaction (e.g. if existing shareholders are to be offered cash or a combination of cash and shares in the new entity or shares in the new entity) but there does seem to be a question as to whether the terms offered to the shareholders are fair (cf. Smith v Van Gorkom). In this situation directors of both corporations have a duty to protect the interests of the shareholders, and the adoption of appropriate procedures for approval of the transaction is encouraged by case law. **The fundamental issue in this question appears to be whether the shareholders of Zedcorp and Xcorp are treated fairly (whether directors have breached their duties to shareholders), rather than whether the directors have breached duties to the corporations.**

The facts, do, however, suggest that a merger between Zedcorp and Xcorp is a conflicting interest transaction for some of the officers and directors of both corporations (i.e. there may be breaches of duty to the corporations as well as to the shareholders). They may have a material financial interest because they are directors and/or officers of both corporations (3 of the 7 board members of both corporations are in this situation), and in the case of the CEOs because they have new remuneration packages (an additional director of each corporation)(DGCL s 144). Thus more than half of the directors of both corporations seem to have a conflict of interest with respect to the transaction, displacing the BJR, unless there is fully informed approval by disinterested directors or shareholders. The question does not specify how the Board votes occurred, but there was no disclosure of the remuneration packages to the Boards. However, as a merger transaction this transaction also needs to be approved by the shareholders (cf. Smith v Van Gorkom). Board approval alone is not sufficient. The question states shareholders voted to approve the merger, but it is not clear that the shareholders were fully informed about all material details when they voted.

As to the fundamental issue of fairness to the shareholders, there is a question as to Yfund's role in promoting the transaction which falls within the ambit of Corwin and Kahn v MFW (establishing conditions under which going private transactions are subject to BJR review rather than an entire fairness analysis). If Yfund is a controlling shareholder (*cf.* Tesla, though recognizing it is an unusual case) the Kahn conditions would apply (and there is no suggestion of conformity to these conditions e.g. no fully empowered committee of disinterested directors); if not, then Corwin. But in either case there is a problem because of the lack of disclosure of the CEO remuneration packages, which renders the Board and stockholder votes ineffective (Mindbody).

Claims by shareholders to challenge the terms of the merger would be direct claims (contrast Brookfield Asset Management) because Revlon duties would seem to apply because of Yfund's acquisition of control through the merger. Shareholders would presumably either want to challenge the merger directly and prevent it from occurring, or to obtain a remedy for any unfairness to them.

PART A

Zedcorp and Xcorp are corporations incorporated in Arcadia, a state in the US. Arcadia's corporations statute is modeled on the Delaware General Corporation Law.

Zedcorp's business involves the development and sale of robots to perform various tasks. Some of Zedcorp's robots are designed for industrial use and others are for use in the home. One recent example is the homebot, a floor-cleaning robot which can be programmed to vacuum clean or wash floors. Zedcorp's engineers are also working on a line of solar-powered gardening robots. Zedcorp's common stock is traded on the Arcadian Stock Exchange.

Aretha is Zedcorp's CEO, Bruce is the CFO and Drake is the Chief Innovation Officer. All three have worked closely together for 10 years. They are all founders of Zedcorp and members of the Zedcorp Board of Directors, together with Elton, Freddie, Josephine, and Lana.

Yfund is an investor in Zedcorp, and owns 23% of the common stock in Zedcorp and all of Zedcorp's Class A preferred stock. The preferred stock gives Yfund the right to appoint one director to the Board, and Yfund appointed Elton to the Board. The preferred stock also entitles Yfund to appoint one (and no more than one) additional Director to the Zedcorp Board if any of certain events occurs. These events include the failure to pay a dividend in any calendar year, a 10% decline in the Zedcorp stock price, and a finding of liability by any state or regulatory authority involving a fine of $100,000 or more.

Xcorp is in the renewable energy business, focusing on developing improved battery technology for the storage of energy from renewable sources. Rihanna is the CEO of Xcorp, Lana is the CFO, and Nicki is the Chief Innovation Officer. The other members of the Xcorp Board of Directors are Drake, Elton, Selena and Taylor. Yfund owns 10% of the shares in Xcorp and has appointed Elton as a Director of XCorp.

Elton is a Vice President of Yfund, and his job at Yfund requires him to manage relationships with a number of Yfund's investee companies. His responsibilities do not expressly include looking out for new investment opportunities for Yfund, although all Yfund employees understand that Yfund is always interested in new and promising investment opportunities. All employees of Yfund are required to sign confidentiality agreements which require them to keep confidential any information they learn in their work for Yfund.

Homebots turn out to have a problem: a number have exploded while in use, and have caused fires and, in some cases, serious injuries to people living in the premises

in which the homebots were operating. Whereas Zedcorp had an innovation committee of the Board, it never had a product safety committee. Early reports of the problems reached engineers working at Zedcorp and they tried to fix the problems but did not disclose them to Drake. Eventually the Arcadian Product Safety Commission (APSC) investigated these issues and Zedcorp agreed to pay $250,000 to the burns unit of a hospital in Arcadia City and to implement a series of new safety and governance policies at Zedcorp, including a Board committee to focus on product safety, under a deferred prosecution agreement. Yfund argued that this agreement gave it the right to appoint an additional Director to the Zedcorp Board. Zedcorp's officers did not agree.

Elton got to know a number of young engineers as a result of his involvement in the Boards of Zedcorp and Xcorp. He began to attend scientific conferences on issues relating to robotics and artificial intelligence. At one of these meetings he learned that Starcorp, a company whose shares are traded on the Arcadian Stock Exchange, was moving into robotics and had some very interesting plans, although these were not at that time public. Elton bought a number of options to buy Starcorp shares. Soon after he did so, Starcorp made a public announcement about its new initiatives and the price of its shares increased significantly.

Yfund concluded that a merger between Zedcorp and Xcorp would make strategic sense, and believed that by providing additional funding and improving governance in the merged corporations the combined businesses could be much more successful than each corporation was likely to be separately. Yfund also believed that it could structure the transaction to allow it to become the controlling stockholder in the combined entity (to be called Newcorp). Yfund believed that Elton, Lana and Drake could be relied on to support the merger. But in order to improve the likelihood of the merger succeeding Yfund negotiated with the two CEOs, Aretha and Rihanna, offering them attractive remuneration packages for future work for Newcorp. Neither disclosed these remuneration packages to their Boards when the merger proposal was discussed. Both Boards and the shareholders of both corporations approved the merger.

Answer the following questions, explaining what further facts you would need to

know and giving reasons for your answers:

1. (25 points) Homebots: explain what issues of corporate law are raised by the exploding homebots. In your answer please explain what claims unhappy shareholders might bring and what difficulties they would likely encounter.

2. (20 points) Elton's investment in Starcorp options: explain what liability Elton may have incurred as a result of his purchase of the Starcorp options

3. (35 points) The Zedcorp-Xcorp merger: 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.

PART B (20 points)

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

1. Is the business organization law you have studied this semester sufficiently attentive to the need to facilitate compliance?

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

3. Form or substance?