Memo on Business Associations Exam Fall 2022
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Part A
Use of language:

Legal rules involve terms of art. It does not make sense to paraphrase legal tests. You should use the words the courts use to establish the rules. And you should use terms of art carefully. Many people referred to A as a majority shareholder: he is not a majority shareholder (a person entitled to exercise over half the voting rights) but he may be a controlling shareholder (a person who is able to exercise control and get his own way). Misuse of terminology in this way is sloppy.

Knowledge of the rules

If, during the semester, we study a case that changes the rules (e.g. Zuckerberg) it does not make sense to analyze the issues as if that case did not exist. Or to cite the earlier case law and then just add in a reference to the new case. Sometimes it makes sense to study the evolution of case law to understand how we got to where we are. But when you are answering a hypothetical you should be applying the rules as they are now (based on the assigned materials) rather than how they used to be. I imagine that this issue was caused by a reliance on outdated outlines (commercial or otherwise). That is risky. And sloppy.

Answering the exam questions:

Quite a few people chose to answer questions A1 and A2 together, rather than separately, as the exam asks. As a matter of strategy I am not sure why this would make any sense. If the person who wrote the exam thinks that the questions are separate it seems to me that it would make sense to answer them separately. Prioritizing your convenience over convenience to the examiner seems to me to be short sighted and unlikely to help you. Lawyers may often be faced with procedural requirements they consider to be unnecessary, but deciding to ignore them is unlikely to be a successful strategy.

In addition, the first question asks how the directors and officers have breached their duties and what risks of liability they face, and the second question asks what difficulties the shareholders would face in suing them. The overlap is between the risks of liability in q.1 and the shareholder difficulties in q.2. To the extent that shareholders have difficulties this will reduce the risks of liability. I had provided access to at least one prior exam where this sort of separation occurred and explained that the shareholder difficulties question was primarily about derivative litigation. Barriers to derivative suits do affect risks of director liability but would not require detailed treatment in q. 1. The BJR is a harder issue - it obviously reduces the risks of liability in some cases, and it is also a hurdle for shareholders in a derivative suit. I think some reference to the BJR belongs in both answers. Also exculpation, which does not eliminate the breach of duty but limits remedies available with respect to the breach (so it is relevant to the directors'/officers' risks of liability and to the shareholders' difficulties). Recognizing this is part of the point. And whereas generally I ask you to avoid overlap in your answers, if the questions require the discussion of the same issue

from different perspectives you should go with that. Declining to address the ways in which the BJR and exculpation have an impact on directors and shareholders separately in combining your answers to the 2 questions is a failure to comply with the exam instructions. I recognize that there is no specific exam instruction about providing 3 answers to the 3 part A questions, although you are instructed to answer all 3 questions (and not 2). I did not penalize people who chose to combine answers to the 2 questions as such, but it wasn't a good idea, and if you did this you probably would have done better if you had addressed the questions separately (ie the failure to spell out which parts of the analysis were relevant to each question was an omission that affected the grade).

Renumbering/not numbering the questions:

Some people chose to number the questions differently from the numbering on the exam. This is a similar issue to choosing to answer two questions together. You should answer the questions as they are presented on the exam. You should also identify which of the part B questions you are answering.

Conclusory reasoning:

I do not think that the approach to answering a hypo where you tell me your conclusion and then explain the conclusion is a helpful one to adopt in answering an exam like this. The sort of general description of a conclusion that you will include at the beginning of your answer will almost inevitably suggest that you do not know the material. The reason for this is that the issues are going to be presented in such a way that there are no easy conclusions. The answer is almost always going to be "maybe", or "it depends". Presenting simple conclusions undermines the effectiveness of your answer rather than strengthening it. Lots of real world legal questions don't have clear answers.

As to "analysis", describing the Guth v Loft test and then saying therefore A took a corporate opportunity is a conclusion with no link to the specificities of the test, rather than analysis. Go through the aspects of the test and show me how they fit with the facts.

Errors in the description of the rules:

Although (in a takehome exam) you won't get credit for describing the rules without analysis you will be harmed by the errors you make in describing the rules. For example, if you tell me officers cannot be exculpated where you should know from the class that since August 2022 officers can be exculpated in Delaware (although not with respect to derivative claims) that is a mistake.

Don't make your reader guess what you are trying to say:

I should be able to understand the arguments in your answer without having to guess what you are saying. Try to write clearly, explaining which issue you are addressing at each point in the answer. Try to separate out the issues rather than muddling everything up together.

Common sense:

Try to use common sense. If a hypo includes references to a context you don't know about (e.g. moneylaundering), don't try to go beyond what the question tells you (i.e. don't assume without facts given in the question that the moneylaundering happening through X's systems means that it is a criminal enterprise and Xs customers are losing money through fraud). Reading some answers it seemed to me that some people were looking for there to be problems that weren't necessarily raised by the facts as descibed in the question. While lawyers do need to be aware of the possibility of legal risks you need to be careful about how you interpret the facts you are given (this is part of the don't make assumptions exam instruction).

Hedging your bets:

Often the issues don't have clear answers. But sometimes things are quite clear. So, if you use words like likely or probably in circumstances where the answer is completely clear, that is going to be a problem. For example in the hypo the claims shareholders can make are derivative claims, they are not probably derivative claims.

1. [45 points] How have the officers and directors of Xcorp breached their duties to Xcorp, and what risks of liability do they face?

There is no veil piercing issue in this question. Apart from anything else the question asks about duties of directors and officers and veil piercing is a doctrine that allows creditors to pursue claims against a shareholder (almost invariably the single shareholder of the corporation).

In a question like this, one issue is always going to be whether to address the risks faced by the directors and officers from the individual or collective perspective. Where the directors/officers are similarly situated I think it doesn't necessarily make sense to discuss them individually. You can discuss the general risks and then explain how any of the individuals might be differently situated.

One issue here relates to the Board decision not to expand into the business of investment advice, although it is presented as an activity that would fit well with X's business and where there is not much competition. This is a classic business judgment rule (BJR) situation and Shlensky v Wrigley would be the most relevant case. That case leaves open the idea that the decision could be challenged if motivated by an improper reason. In the case the court accepted that Board decisions needs not be based solely on ideas of profit maximization (although the case is complicated by the fact the plaintiff did not sufficiently plead that installing the lights would increase profits). Many people wanted to argue that to the extent the decision was based on A's reluctance because he is bored with fintech this was a problem: some people thought this involved a breach of A's duties, others that there might be Board liability.

In terms of the Board decision I think we should note that we did not read one case that suggested directors might be liable for deciding not to engage in a potentially profitable activity. This is the sort of decision Boards make all the time and the BJR would generally apply. If the Board decided to divert resources away from this activity to

some expensive venture A preferred that did not involve a corporate benefit, that might be different (it is not clear the dating app is such a venture). The facts are open to the interpretation that A is important for the success of X's business as he is the one with the ideas and the Board might entirely reasonably take its lead from him. His interest in working on particular products might be important to the success of the business. On the other hand his boredom could be an issue for the business if he is inclined to dedicate his time and attention elsewhere (e.g. dereliction of duty). We don't know.

If A is breaching his duties to X here we would also want to ask whether his breach of duty is the proximate cause of any loss to X (cf. Francis v United Jersey Bank).

Another issue relates to **the failure to adopt an AML compliance system**. Many people wanted to analyze this as both a business decision (the decision not to focus on the compliance issue) and as a Caremark issue. I think the facts here suggests that the Caremark analysis is the way to go. There is a difference between a decision to adopt a compliance system that doesn't work (BJR) and a decision to ignore compliance issues (Caremark). This is the 2nd type of situation.

According to the facts given the Board did nothing to address issues of AML compliance even after G raised the issue at a Boad meeting. We know from Stone v Ritter and Marchand v Barnhill that a sustained and systematic failure to address issues of compliance can lead to liability. Liability can arise where nothing is done; where a compliance system is introduced but not monitored, and where the Board ignores red flags (or actual failures of compliance). Many people wanted to argue, citing Graham v Allis-Chalmers, that there would only be laibility in a red flags case, but this is not accurate. A failure to act in the face of a known duty to act is a basis for liability as we saw in many of the cases we studied. Whether or not the Board met these criteria for liability before G's intervention in the Board meeting it does seem to have done after that point. And then F's later revelations reinforce this point.

There are some questions whether when the Board decided there were more urgent matters it was deferring rather than ignoring the issue (might go to sustained and systematic failure). G might be able to avoid liability here as he did try to address the issue, although we haven't seen so far in the Caremark cases this sort of distinction between different actors, and there might be questions whether he did enough to encourage the focus on compliance (cf Francis v United Jersey Bank). If we focus on the duty of loyalty (as Stone v Ritter says we should) and the duty to act in good faith in the best interests of the corporation, did G meet this standard or not?

G informing Yfund of the lack of an AML compliance system and that X thinks financial advice would be a profitable area raises the question what information a director appointed by an investor should share with the investor. Presumably G is on the X Board to look out for Y's interests and it is also not unreasonable to imagine G would share some information with Y. We don't know to what extent Y's agreement with X for the acquisition of the preferred stock addresses any of these issues, but G would seem to be in a situation involving conflicts of duties and therefore has some problems. Y does have a legitimate interest in knowing about X's compliance failures, although this might be confidential information G should not be disclosing. Boith pieces of information raise this question: are they the sort of

confidential information that G should not be disclosing, or not?

With respect to the idea of investing in an investment advice business some people wanted to analyze this as a possibl corporate opportunity or as raising issues of insider trading. There are some specific difficulties with these theories: this is an idea about a potential profitable business strategy rather than a specific opportunity, or information that makes sens to see as material non-public information about a specific issuer.

Also on disclosure issues, F has a conflict of duties when she informs the X Board of information she learned through her role at the Arcadia Times. But as thidss does not involve breaches of her duties to CX it is unnecessary to discuss it in answering this question.

A and H agreeing to work together on the dating app: there seemed to be some ambiguity here. I intended this to involve an analysis of whether A was taking a corporate opportunity here: Guth v Loft, with the questions being about whether X had an interest/expectancy and whether the opportunity was in X's line of business where a dating app seems quite different to the sort of fintech X has been doing. And because the assessment of whether the opportunity is a corporate opportunity is at the time the fiduciary thinks about taking it I am not sure X's later decision to acquire the app Is very relevant. We don't know how X has defined its business plan (for example, if the business plan were we do whatever A wants to do, then this would be a corporate opportunity of X). I think it is likely this is not a corporate opportunity, although A is an officer and the standard is typically more demanding for officers.

Some people read the question and thought the money A decided to invest was X's money (perhaps because of the use of X employees to work on the app (which I saw as a diversion of X resources to the app, similar to what news stories said occurred after Musk's acquisition of Twitter). I don't think this is the best reading of the given facts because I am not clear how it would then make sense for x to buy the app. But issues about whether A has authority to make this decision would arise. In any case there is clearly a problem with the diversion of resources that should be used to benefit X to the app.

The **agreement that X will acquire the dating app at the price A and H suggest** is a conflicting interest transaction. Or, if X already owns part of it it is a complete fraud on X asking X to pay for whatever it has already acquired (?). This is another area where there may be a temptation to make assumptions. Just because the proposal is put forward by A and H and they suggest the price does not mean that it is a bad idea for X to acquire the app or that the price is unfavorable to X. We would need more information.

A transaction in which a director has a material financial interest (we don't know how much A invested here) is a conflicting interest transaction that is subject to fairness review unless approved by fully informed disinterested directors or shareholders (Bayer v Beran, Benihana, Fliegler v Lawrence). Here we are only told about approval by the Board. There is no indication of approval by shareholders. And there is no information about what A told the Board (cf fraud on the board issues as in Mindbody).

There are also questions about whether a majority of the Board members is

disinterested with respect to a transaction in whch A may have a material financial interest. G looks to be pretty clearly disinterested, as does F. As to the others, B and C are longtime friends of A, D is the Chair of the University department where A was a student, and E is a friend of B's mother. There are reasons to doubt the disinterestedness of 4 of the 6 directors other than A. We also know the Board tends to go along with A's wishes. But we don't know. It may be that this transaction is subject to review for fairness (cf the Tesla Solarcity litigation).

Many people wanted to discuss this transaction from the perspective of thinking of A as a possibly controlling stockholder, looking at Kahn and Corwin. It is possible that A is a controlling stockholder here (cf Tesla) but Kahn and Corwin do not seem to be relevant as there is no mention in the facts of any stockholder approval. Those cases tell us that in some circumstances transactions that might be subject to fairness review can, if appropriate procedures are adopted, benefit from the BJR standard of review. There are no facts to support this sort of analysis here as there is no stockholder vote. On the facts we are given it is possible there was fair dealing and fair price, and it is possible A's financial interest was not material. But the absence of a shareholder vote means that discussion of Kahn and Corwin is not really relevant.

If the transaction is not fair to X it can be avoided, and therefore any money X spent on the transaction should be returned. If this were to happen then there would be no loss to X and no basis to claim damages against the Board members. If the transaction were found to be fair to X then there would be no harm to X and no basis for any liability on the part of the Board members.

2. [20 points] What difficulties would shareholders of Xcorp face in trying to sue the directors and officers of Xcorp?

In the review sessions we looked at an earlier exam which had a smilar question and I explained that what I was looking for in this sort of question was an analysis of the derivative litigation issues (direct/derivative, demand, SLCs). I thought this question was a very straightforward question. There are some complexities relating to the independence issue, but generally this should not have been a hard question.

On the derivative litigation issues I think all the claims X shareholders could bring here are derivative claims (cite Tooley test, Brookfield Asset Management). Some people wanted to argue there are securities disclosure claims. But the question says nothing about any public statements X made about its compliance being excellent, so there is really no basis in the question for such a claim. It is true that I said in class that often in oversight cases there is the possibility of derivative claims and direct claims about disclosure (although that is going to depend on whether any statements made by the issuer are specific enough to give rise to liability), but it does not make sense to discuss claims where there are no facts given to suggest them.

Claims for breaches of duty owed to the corporation, where the remedy would go to the corporation, are derivative. Sometimes breaches of duty by controlling shareholders might give rise to direct claims but here that could be an issue only with respect to a possible overpayment for the app, and the harm there is clearly to X (Brookfield Asset Management) and not to the shareholders.

On the demand issue (cite Zuckerberg), with respect to the oversight claim all members of the Board, except perhaps G, face a substantial likelihood of liability based on the facts given, and demand should be excused with respect to this claim. It is true, as many said, that Caremark liability is difficult to establish, but we saw a number of cases where claims survived motion to dismiss during the semester, and the facts given in the question are similar to facts in some of those cases. Evaluation of whether there is a substantial likelihood of liability is done on the basis of the particularized facts the plaintiffs allege in the complaint, not based on a general idea that some claims are harder to prove than others.

On the other claims (A's breaches of the duty of loyalty: the opportunity, the use of X employees to work on the app, the possible fraud on the Board; the Board's quick approval of the acquisition of the app possibly for an unfair price) we would need to look at the material personal benefit (A) and independence (the rest of the Board) issues. We don't know whether the Board members would be regarded as independent here but it is possible that half the Board is affected by material personal interest (A) or a lack of independence from A (B,C, and possibly D, E). The question is whether the relationships are such as to create bias, and that is a factual assessment. But it looks as though shareholders may be able to plead facts suggesting the sort of close relationships that would justify demand excusal. It makes sense to note that there may be practical difficulties in acquiring enough information to create effective pleadings with respect to this issue and others.

Many answers provided a rather confusing treatment of the demand excusal issue, involving discussion of the pre-Zuckerberg case law, which is now largely irrelevant. For example the idea that demand is excused where the underlying transaction was not the product of sound business judgment is now not part of the demand excusal test under Zuckerberg. Saying it is is an error. This may have been an error caused by reliance on an outline produced before the Zuckerberg decision. And our casebook included earlier cases, but you were also supposed to read Zuckerberg and I did discuss the case and explain that the case now establishes the test you are supposed to apply.

Some answers treated the application of the Zuckerberg test to the entire package of possible claims. In fact there needs to be a separate evaluation with respect to demand excusal for each possible claim.

3. [15 points] Does Hasan have any liability here? Explain your conclusion.

The question says that H acquires information from A about AML compliance issues affecting a number of companies, including an issuer he owns shares in and that he sells the shares as a result. The information seems to have originated with G, and it seems that A learned the information at an X Board meeting.

Was the information material non-public information? It is not clear, although it does seem to have affected H's view as to whether it made sense to continue owning the shares.

There are a number of possible scenarios here. If G's disclosure of this information violated a fiduciary duty to the issuer (e.g. if G is a director of the issuer) and G's disclosure was for his own personal benefit and not in the context of, for

example, a relationship of confidentiality such as that between members of a Board of Directors, then G would be a tipper, and the recipient of the information would be constarined from using the information if that person knew the information was communicated in breach of duty (Dirks). It is not clear G is a tipper based on this analysis, but if A were a tippee and then passed on the information to H in such a way that H understood it had been communicated in breach of G's duty, then H would not legally be able to sell the shares.

If A is not a tippee from G, A may also be prevented from trading or communicating the information because the information seems to have been acquired in the context of a relationship in which A owed fiduciary duties (to X). A may then be a misappropriator rather than a tippee. And for a misappropriator to pass on mnpi in breach of a duty of confidentiaity for personal benefit invoilves liability. The recipient of information from a misapropriator, knowing of the breach of duty is a tippee from a misappropriator and precluded from trading.

If A's communication of the information to H did not involve a breach of duty to H, then H may still be precluded from trading as a misappropriator. It seems that the business relationship between A and H may be a partnership, based on the facts given, and partners are subject to fiduciary duties to each other and to the partnership which include duties of confidentiality. If H acquires the information in the context of a relationship with duties of confidentiality and then uses the information to trade, then H is a misappropriator (US v O'Hagan).

Learning about the AML compliance issues of specific named companies -
A tells H what he has learned from G - he learned the info in the context of his position at Xcorp- as an insider of Xcorp
duty not to tip/trade
H learns the info in the context of the joint work on the app - a partnership? Discuss whethervthis is a partnership
Duties of confidentiality?
When H trades he is likely a misappropriator ?

PART A

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

Xcorp was founded as a Fintech (financial technology) company by Adam, Billie, and Chas, who all shared a dorm room at the University of Arcadia, and have been close friends ever since. While they were still students they began working together on a plan to build a business. Adam studied computer science and wanted to create apps that would allow consumers to manage their money more effectively and at a lower cost than would be possible working with mainstream financial institutions. Billie was a business major and focused on finance and accounting, and Chas studied marketing. At Xcorp they are all directors, officers and shareholders. As the ideas person, Adam, the CEO, owns 30% of the common stock, and Billie, the Chief Financial Officer (CFO),

and Chas, the Chief Marketing Officer, each own 10% of the common stock. For a long time Xcorp also has had three outside directors, Don, Ella, and Frankie. Don is the Chair of the University of Arcadia Computer Science Department and has known Adam since he was a student, Ella is the President of the Bank of Arcadia and has been a long time friend of Billie's mother, and Frankie is the technology correspondent for the Arcadia Times newspaper.

Xcorp began by working on a payments app, which has been very successful, and more recently moved into the lending business, in particular by facilitating loan transactions between borrowers and individuals interested in making money by lending money for a financial return. Adam led a team that developed a process to assess the risks of making loans to particular borrowers. That line of business has been doing well. The Board of Xcorp has been discussing whether Xcorp should expand into the provision of investment advice. There is evidence that this is an area where there is not much competition and which would fit well with Xcorp's other business. But Adam is rather bored with Fintech by this point and the Board decides not to pursue this idea.

Xcorp has raised some venture capital funding from Yfund which now owns a significant amount of preferred stock which carries the right to appoint one director to the Xcorp Board of Directors. Yfund appointed Gerard, who also acts as a director of a number of other companies in which Yfund has invested, to the Board.

At the first Board meeting Gerard attended, he raised the issue of compliance with Anti-Moneylaundering (AML) regulation under Arcadia state law and federal law. Because of Xcorp's activities in processing payments, Arcadia is a money services business and subject to these rules. None of the three founders of Xcorp has any knowledge of, or interest in, compliance. Gerard says that Xcorp should hire a Chief Compliance Officer to develop and run a compliance program. The Board decides that there are more urgent matters to address and that they will consider this idea at a future meeting. Gerard informs Yfund of these developments and also that Xcorp believes that the provision of financial advice would be a profitable area. Yfund's management decides to look for opportunities to invest in businesses focusing on financial advice.

A year ago, Adam met Hasan at a technology conference and learned that Hasan was developing a dating app with a sophisticated algorithm to match people. Adam is interested in Hasan's work because of his own work for Xcorp on lending risk assessment, and he quickly decided to join with Hasan in developing the dating app, agreeing to provide a significant amount of funding, and also to provide expertise. They did not formalize the relationship in any way. Some months ago, Adam asked two of Xcorp's employees to help out with work on the dating app. Recently, because Adam and Hasan were about to meet with prospective investors, Adam increased the number of Xcorp employees who were working on the dating app. At an Xcorp Board meeting, Adam introduces Hasan to the Board, and they give a presentation about the dating app. Adam says to the Xcorp Board that he thinks that the dating app would be a useful addition to Xcorp's range of products and would be able to be the basis for expansion

beyond Fintech. Gerard is skeptical but the others are used to thinking of Adam as the person at Xcorp with the best ideas and they agree that Xcorp should buy the dating app business for the price Adam and Hasan suggest.

In the course of their collaboration, Adam and Hasan have spent quite a lot of time discussing the various technology-related businesses that have recently been established in Arcadia. They discuss the inconvenience of having to worry about regulation, and Adam tells Hasan about Gerard's concern about Xcorp's lack of AML compliance procedures, and also that Gerard has said that many newer technology businesses in Arcadia have similar compliance issues, naming some of these companies. Hasan happens to own shares in one of these other companies and decides to sell the shares.

Through her work at the Arcadia Times, Frankie learns that a whistleblower has disclosed Xcorp's lack of AML compliance measures, and also that staff at Xcorp are aware that Xcorp's payments app and loans platform are in fact being used to launder money, and that the Arcadia Division of Finance has begun an investigation into Xcorp. She informs the Xcorp Board of this news before it is published. After the Arcadia Times publishes this information Xcorp's shareholders are concerned.

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

1. [45 points] How have the officers and directors of Xcorp breached their duties to Xcorp, and what risks of liability do they face?

2. [20 points] What difficulties would shareholders of Xcorp face in trying to sue the directors and officers of Xcorp?

3. [15 points] Does Hasan have any liability here? Explain your conclusion.